23 November 2018

The National Treasury

240 Madiba Street

PRETORIA

0001

The South African Revenue Service

Lehae La SARS, 299 Bronkhorst Street

PRETORIA

0181

BY EMAIL: 2019AnnexCProp@treasury.gov.za

Adele Collins (acollins@sars.gov.za)

RE: ANNEXURE C PROPOSALS FOR 2019 BUDGET: CORPORATE INCOME TAX

We have attached the Annexure C Proposals from the SAIT Business Taxes Work Group. We appreciate the opportunity to participate in the process and would welcome further dialogue.

Please do not hesitate to contact us should you need further information.

Yours sincerely

Lesley Bosman

Chair of the Business Taxes Work Group

Enclosures: Annexure C Proposals

SAIT representatives to be invited to National Treasury workshops

South African Institute of Tax Professionals

ANNEXURE C SUBMISSIONS FOR 2019 BUDGET: CORPORATE INCOME TAX

ANNEXURE C SUBMISSIONS FOR 2019 BUDGET: CORPORATE INCOME TAX

1. IMPACT OF CLAWBACK PROVSION ON SECTION 8C VESTING

1.1 Detailed factual description

In terms of a typical clawback provision, employees will be asked to accept Clawback terms as a condition of accepting forward looking share scheme awards. The clawback will be triggered by specific events such as financial misstatement and events that could damage the reputation of the company. Typically, up to say, 3 years after the vesting date of shares (or should an investigation not be concluded, an extended period), the company can claw back the equivalent cash value of the shares at the point of their vesting.

A clawback is intended to be a post-vesting event, which entitles the employer company to demand an amount in cash from the employee who participated in a share scheme award. The company may not demand the return of the shares that vested.

The maximum cash amount equals the value of the shares upon vesting. The Company does not claim a higher amount if the value of the shares has increased.

Whilst the wording will differ from contract to contract, a typical claw back provision may read as follows:

"In the event that the Company is required to prepare an accounting restatement due to the material noncompliance of the Company with any financial reporting requirement, the Company will seek to recover from any current or former executive officer of the Company who received incentive-based compensation during the 3-year period preceding the date on which the Company is required to prepare the accounting restatement, the amount, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement. Pursuant to this agreement, Employee agrees to promptly return to the Company any and all amounts received to the extent the Company is entitled to recover such amounts under this clawback provision."

As one can see, this type of clawback can hardly be viewed as a tax planning device. Accounting restatements will most likely come from material malfeasance or an unintended calculation error.

Commercial necessity of clawback provisions

Excessive executive remuneration and perverse incentives continue to fuel debate amongst company stakeholders. First the global financial crisis of 2008-9 and more recently the well-publicized corporate scandals raised widespread concern that inappropriate remuneration practices create unacceptable risk-taking and incentivise executives to focus on short-term gains. There is an enlarged focus on the role that executive remuneration plays in increasing the company's risk exposure.

In an attempt to curb problematic remuneration arrangements clawback provisions are becoming more prevalent in executive share schemes, especially schemes offered by listed companies.

Put simply, a clawback provision creates an obligation on employees to repay remuneration to the company that should not have been paid to them, as it was awarded erroneously.[1]

Clawback policies are recommended in most EU jurisdictions, as well as in the UK, and are mandated by legislation in the USA and the Netherlands. The Australian Federal Government has also proposed to amend legislation to provide for an executive remuneration clawback. The South African regulatory framework in relation to director and executive remuneration does not provide for mandatory remuneration clawbacks, but certain guidelines are set out in the King IV Report on Corporate Governance™.

Clawbacks serve as a risk management tool:

- Clawbacks are designed to deter executives from pursuing inappropriate strategies that would enable them to benefit from short-term increases in the company's value, but which could potentially undermine the sustainability of the company in the long-term.

[1] Clawback provisions differ from Malus provisions. The latter is a "pre-vesting" risk adjustment tool over executive pay, although the trigger events for malus are often the same as or very similar to those prescribed for clawback.

— Clawbacks may also discourage the manipulation of data by executives in order to increase their bonuses. There are a number of examples of executives who have overstated their companies' financial results by large amounts in order to boost their bonuses and gains from the sale of their shares.

1.2 Legal nature of the problem

Section 8C has the effect of deferring the taxation of a gain or the deduction of a loss to the point of vesting of an equity instrument. The vesting of an equity instrument is central to the application of the section because it determines the timing of the taxation or deduction.

The timing of the vesting of an equity instrument depends on whether the equity instrument is a "restricted" or an "unrestricted equity instrument".

In terms of section 8C(3), a restricted equity instrument is deemed to vest at the earliest of several events, one of which is when all the restrictions (which result in that equity instrument being a restricted equity instrument) cease to have effect.

The other subparagraphs of the definition of "restricted equity instrument" do not apply. In our view, the only paragraph which requires further analysis is paragraph (b)(ii) of the definition of "restricted equity instrument". Paragraph (b)(ii) states that a restricted equity instrument in relation to a taxpayer means an instrument

"(b) which is subject to any restriction that could result in the taxpayer—

(i) forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or

(ii) being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument;"[2]

---

[2] It is important to read paragraph (b)(ii) with paragraph (b)(i). When a Participant is forced to forfeit ownership or the right to acquire ownership of an equity instrument otherwise than at market value he is "penalised financially", it is in

If clawback provisions have the effect of imposing a further restriction in terms of paragraph (b)(ii) of the definition of "restricted equity instrument", this would have an impractical, unbusinesslike or oppressive consequence, as is apparent from the following:

- All of the conditions for vesting of the award have been met (both the employment condition and performance conditions). In other words, the Participant has fulfilled the contractual obligations under the scheme rules and acquire the shares. While it is arguable that it is an implied term of the Participant's employment contract that he must not commit fraud or misconduct, this has nothing to do with the provisions of the scheme rules (which is the relevant contract). The contract has been performed. If it had not, the Participant would not have acquired the shares. There is also no desire to cancel the contract.

- From a policy perspective, the existence of "wrongdoing" (intention or misconduct) is typically disregarded when considering whether to apply the clawback provisions. This is in line with clawbacks required in terms of regulations in the US, the EU, the UK, and Australia. In terms of all of the regulatory instruments in these jurisdictions, the clawbacks could be invoked regardless of whether or not there was wrongdoing on the part of the company or the individuals concerned. The Participants are agreeing to pay the clawback amount even where they are not directly to blame (e.g. the head of human resources would be bound by the clawback provisions if the CFO misstates the accounts of the group of companies, despite having no oversight over the preparation of the accounts).

- If the clawback were to impose an additional restriction, shares would vest immediately before the Participant disposed of the shares or immediately before the Participant died (assuming all restrictions are lifted at death) or at the end of the clawback period (when all of the restrictions cease to have effect). Setting aside death, this would mean that a Participant could "cherry pick" a desirable vesting date by disposing of the shares on a day when the share price is most favourable. It would be administratively burdensome for the employer company to keep track of vesting dates in such a scenario.

Clawback provisions are not driven by tax structuring considerations. There is no desire to artificially

---

this context that one must consider whether the Participant is being penalised "in any other manner" in terms of the clawback provision (for purposes of paragraph (b)(ii)).

influence the F(tax) vesting date, but rather by considerations of executive accountability.

Clawback provisions were introduced into foreign legislation and governance codes over the past few years and have only started to make their way into the South African market since about 2016. The legislature cannot have had clawback provisions in mind specifically when drafting paragraph (b)(ii) of the definition of “restricted equity instrument” in 2008.

1.3 Proposed solution

Section 8C should be amended to clarify that a provision in a share incentive scheme entitling an employer company to claw back a cash amount equal to the value of shares on the vesting date due to the occurrence of certain trigger events is not a restriction as contemplated in subparagraph (b)(ii) of the definition of “restricted equity instrument” in section 8C(7).

Alternatively, section 8C should not apply twice in respect of the same shares, especially if the shares are no longer held by the employee. This option would eliminate the need to define the various clawback provisions that should be excluded from the section 8C trigger.

2. REFUNDS OF AMOUNTS PREVIOUSLY ACCRUED TO EMPLOYEES

2.1 Legal nature of the problem

Section 11(nA) of the Income Tax Act currently permits a taxpayer to claim a deduction for the refund of any amount that previously accrued to the taxpayer in the course of his/her employment, to his/her employer.

Where the refund is paid by the taxpayer in the same tax year in which the amount was accrued to/received by the taxpayer, the taxpayer should ultimately be refunded the PAYE paid by the employer to SARS upon assessment for that particular year.

However, an issue arises where the amount was accrued to/received by the taxpayer in one tax year and the refund is only paid by the taxpayer to the employer in a subsequent tax year, particularly where the amount required to be refunded to the employer is significant.

The taxpayer may essentially only claim a refund from SARS against any PAYE/provisional tax incurred in that particular subsequent tax year which may be a far smaller amount. Where large amounts are involved, the taxpayer could then remain in a tax loss position for years and simply receive refunds from SARS over time. To the extent that the taxpayer stops earning taxable income, he/she will stop receiving refunds and the taxpayer's employer is then potentially out of pocket on the basis that it may be practically impossible for the employer to recover outstanding amounts from the taxpayer even if the taxpayer is sequestrated by his/her previous employer. Very simply, and in these circumstances, SARS has been unduly enriched at the employer's perspective.

2.2 Detailed factual description

a) Facts:

An example of how section 11(nA) applies:

— Company pays a bonus of R1,000 to an employee, Mr A as a 1-year retention bonus. PAYE of R450 is paid to SARS and Mr A receives R550. Mr A resigns in violation of the retention requirements four months later due to personal circumstances at home. Mr A is accordingly obliged to repay the bonus of R1,000. Even thoguh Mr A only received cash of R550, Mr A is now required to repay R1,000 to his employer.

b) Outcome:

— Section 11(nA) provides for a deduction upon Mr A refunding R1,000.

— If Mr A can refund the amount in the same year that the R1,000 accrues (either Mr A must have surplus cash available or borrow to fund the R450), Mr A will ultimately be refunded by SARS upon assessment.

- However, if Mr A only refunds the amount in a subsequent tax year, a major problem arises as Mr A can obviously only recover from SARS in that year whatever PAYE was withheld during that particular year of assessment (which is likely to be far less). Mr A then will enjoy a lengthy "tax holiday" with SARS refunding him until the loss is eliminated.

- Practically, if even Mr A borrowed to fund the PAYE portion of the amount repaid, he will probably have to manage his repayments to align with SARS refunds. (SARS in turn will likely audit Mr A on an annual basis as the refunds will be significant in relative terms and Mr A will experience delays in receiving SARS refunds.)

2.3 Nature of business impact and proposed solution

We submit that this is an untenable scenario which is easily remedied and is unlikely to burden the fisc.

We propose that a provision be introduced to allow the taxpayer's employer to lodge an application with SARS that would enable the employer of the taxpayer to claim a refund from SARS of PAYE that was paid by the employer in a year prior to the year in which the taxpayer begins to refund the money to his/her employer.

We recommend that this provision have retrospective effect from 1 March 2016 and only apply in circumstances in which the refund is paid in a year subsequent to the year in which the amount was accrued/received by the taxpayer. Such a solution would avoid having to re-open prior year assessments, which is administratively difficult to deal with from a SARS' perspective.

Although this will only have application to limited circumstances, we submit that SARS would welcome such an amendment as it will assist SARS to provide both individual taxpayers and corporate employers with relief in cases of hardship arising from the current rules, where SARS has previously indicated they would like to assist, but simply lack the legal remedy to do so.

Applying the facts set out above. Upon application and to avoid manipulation, only a pro rata portion of the tax that was withheld as PAYE should be repaid by SARS to the employer.

For example, if Mr A repays R550 to the employer (i.e. 100% of the after-tax amount paid to him), SARS should be required to repay 100% of the tax withheld. i.e. R450. However, if Mr A only repays R275 (50% of the after-tax amount he received) to the employer, then SARS should only be obliged to repay R225 to the employer.

3. VESTING OF SHARES BY A SHARE INCENTIVE TRUST INTO THE HANDS OF ITS BENEFICIARIES WHERE THE RECEIPT OF THE SHARES IS ALREADY SUBJECT TO TAX IN THE HANDS OF THE BENEFICIARIES IN TERMS OF SECTION 8C

3.1 Legal nature of the problem

Paragraph 64E of the Eighth Schedule was introduced into the Income Tax Act with effect from 1 March 2017 in order to eliminate any form of economic double taxation in a scenario where a share incentive trust realises its assets (typically shares in a company) and distributes the proceeds to the beneficiaries of the trust who hold their interests in the trust as "restricted equity instruments" as contemplated in section 8C. Paragraph 64E then disregards the portion of the capital gain arising in the hands of the respective beneficiary from CGT to the extent that this amount is already included in the beneficiary's hands in terms of section 8C.

3.2 Detailed factual description

a) Facts:

Often, instead of the trust selling the shares and then distributing the proceeds arising from the sale of shares to the beneficiaries, the trust may, upon the occurrence of a particular event, actually vest the shares into the hands of the beneficiaries.

b) Outcome:

Paragraph 64E does not contemplate this fact pattern although the economic effect of vesting the shares into the hands of the beneficiaries is arguably the same and the beneficiaries should be subject to tax in terms of section 8C on the value of the shares so received.

Paragraph 80(1) does not assist in deriving a logical outcome as it excludes a vesting of a capital gain into the hands of the beneficiary where the beneficiary acquires the asset as an equity instrument as contemplated in section 8C(1). On this basis, the trust is then liable for CGT on any gain arising on the vesting of the shares to the beneficiary. Irrespective of this interpretation, a capital gain either arises in the hands of the trust, or in the hands of the beneficiary as a consequence of the deeming rules in paragraph 80(1) thereby resulting in economic double taxation.

3.3 The nature of the business impact and proposed solution

Paragraph 64E should be extended to cover circumstances where beneficiaries of a trust are taxed in terms of section 8C on the value of shares vested into their hands by the trustees of a trust and any capital gain arising on this disposal should be disregarded to the extent that it is already included in the taxable income of the beneficiaries.

4. BASE COST OF DEBT ASSETS ACQUIRED AS A RESULT OF DIVIDENDS ACCRUED

4.1 Detailed factual description

It often happens that a company will declare a dividend to a shareholder which is (by agreement) to be credited to a shareholder's loan account in favour of the shareholder against the relevant company. If the shareholder were to dispose of the relevant shareholder's loan the question arises as to the base cost of the shareholder's loan claim.

Non-cash dividends of this kind arise for a myriad of reasons. In essence, the goal is to fix the allocation of company profits for a financial period so that the shareholders have a real property right in the underlying profit allocation. The need for this fixed promise of profits often arises in the context of BEE. Small companies owed by several shareholders may also utilise this technique to fix relative profits shares.

4.2 Legal nature of the problem

There are differing opinions in the market as to whether the loan created in such a scenario would have a base cost for capital gains tax purposes. If, according to some advisors, the loan has a zero base cost then if the loan is disposed of a capital gain would arise on the disposal of the loan which would not be equitable given the fact that the dividend accrued would have already formed part of the shareholder's gross income in terms of paragraph (k) of the gross income definition as contain in section 1 of the Income Tax Act.

4.3 Proposed solution

In order to address the stated problem and to provide certainty and equity, it is proposed that a similar provision to paragraph 20(1)(h)(ii)(bb), (cc), (dd) of the Eighth Schedule to the Income Tax Act be inserted into paragraph 20 of the Eighth Schedule. The latter provisions acknowledge the scenario where an asset is received or created in circumstances where the value is included in gross income in terms of paragraph (i), (h) or (c) of the gross income definition.

The Comprehensive Guide to Capital Gains Tax (Issue 7) ("the Guide) at page 198 refers to these items as pre-existing personal rights which are given up in exchange for debt assets. So for example services rendered the amounts of which are included in the gross income of the taxpayer but which have not been paid (the debt asset). In regards the latter, paragraph 20(1)(h)(ii)(dd) would result in such debt asset deriving a base cost equal to the value included in the gross income of the taxpayer. Based on the current provisions contained in paragraph 20, there is no reason in principle not to extend the base cost provisions to loans that arise (are created) as a result of the accrual of a dividend. The latter position has been accepted by the South African Revenue Service if one has regard to paragraph 8.5B of the Guide at page 198 as well as Binding Private Ruling 289 dated 19 January 2018.

The amendment would thus constitute the formalisation of an existing South African Revenue Service practice and provide certainty.

5. SECTION 8E AND SECTION 8EA – REFERENCE TO QUALIFYING PURPOSE

5.1 Detailed factual description

In terms of section 8E of the Income Tax Act, any preference share that is secured by a financial instrument (as defined in section 8E(1) of the Income Tax Act) is regarded as a hybrid equity instrument unless the preference share was issued for a qualifying purpose. Qualifying purpose for purposes of section 8E is defined with reference to the definition of qualifying purpose as defined in section 8EA of the Income Tax Act.

5.2 Legal nature of the problem

Section 8EA of the Income Tax Act and more specifically the definition of qualifying purpose as contained in section 8EA(1) of the Income Tax Act was amended by section 15(1)(d) of Act No. 15 of 2016 with effect from 1 January 2017 to cater for so called start-up companies. The effect of the latter amendment is that the determination of whether a company is an operating company or not is to be made at the time that a dividend or foreign dividend in respect of the relevant preference share is received or accrued by the relevant holder of that preference share.

In the case where a preference share is issued by a company that does not constitute an operating company ("the issuer") and such preference share is secured by a financial instrument, an anomalous scenario could arise if during a year of assessment a dividend is declared and accrued on the preference share prior to the issuer becoming an operating company (dividend 1) where in the same year of assessment a dividend is declared subsequent to dividend 1 (dividend 2) and the issuer is at the time of declaration and accrual of dividend 2 an operating company.

Based on the current wording of section 8E(2) of the Income Tax Act, both dividend 1 and 2 would be treated as income in the hands of the relevant shareholder on the basis that the preference share in question constituted a hybrid equity instrument at any time during the relevant year of assessment. The latter is anomalous in the sense that section 8EA of the Income Tax Act was specifically amended to exclude dividend 2 from the re-characterisation rules of section 8EA of the Income Tax Act but unfortunately, notwithstanding the latter, dividend 2 will still be taxed as income by virtue of the provisions of section 8E being applicable.

In the case of section 8EA(2) of the Income Tax Act, similar wording would have the effect that dividend 2 would also be subject to tax notwithstanding the fact that the company is at the time of the receipt or accrual of a dividend an operating company.

The issue arises because of dividend 1 being received or accrued prior to the issuer becoming an operating company read in conjunction with the provisions of sections 8E(2) and 8EA(2) of the Income Tax Act.

5.3 Proposed solution

In order to address the stated problem and to provide certainty and equity, it is proposed that the provisions of section 8E(2) be amended to provide for a carve out to the application of section 8E(2) of the Income Tax Act. For example, a proviso to the effect of: "Provided that the provisions of this sub-section shall not apply in respect of any dividend received or accrued on any preference share, as contemplated in paragraph (c) of the definition of hybrid equity instrument, and issued by a company that is an operating company at the time of the receipt or accrual of any dividend or foreign dividend in respect of that preference share".

A similar proviso would need to be made to the provisions of section 8EA(2) of the Income Tax Act. The wording would be slightly different though: "Provided that the provisions of this sub-section shall not apply in respect of any dividend received or accrued on any preference share of the definition of hybrid equity instrument and issued by a company that is an operating company at the time of the receipt or accrual of any dividend or foreign dividend in respect of that preference share".

6. QUALIFYING INTEREST WHERE SHARES ARE DISPOSED UNDER A DEFERRAL TRANSACTION

6.1 Legal Nature of the problem

The dividend stripping provisions set out in section 22B and paragraph 43A of the Eighth Schedule to the Income Tax Act require inter alia that the shareholder who bear any the tax imposed by the provisions, hold a qualifying interest in the company whose shares are being sold. The qualifying interest can be held at any time during the 18 month period prior to the disposal.

The Taxation Laws Amendment Bill released on 24 October 2018 ("the 2018 TLAB") introduces additional provisions into the dividend stripping legislation to cater for roll-over relief transactions. In broad terms, dividends declared on shares which are transferred under a 'deferral transaction' can be subject to tax under the dividend stripping provisions if the company who acquired the shares under the deferral transaction sells those shares outside of roll-over relief within 18 months of the dividend having been declared.

Based on a plain reading of the provisions as amended by the TLAB (once promulgated), it would appear that the dividend stripping provisions would only be applicable if the company who acquired the shares under the deferral transaction held a qualifying interest in the company concerned. We submit that this could lead to anomalous results.

6.2 Detailed factual description

a) Facts:

Company A holds a 10% interest in OpCo, an unlisted company. Company B holds 15% of the shares in OpCo. The remaining shares in OpCo are held various other parties (i.e. there is no majority shareholder). Company A and Company B are not connected. OpCo declares a dividend on R100 million to shareholders. The dividend would be regarded as an extra-ordinary dividend for purposes of the dividend stripping provisions.

b) Outcome:

If Company A were to sell its shares in OpCo outside of the roll-over relief provisions, the dividend stripping provisions would not apply to the R10 million dividend it received as the qualifying interest criteria has not been met. Similarly if Company B were to sell its OpCo shares outside of the roll-over relief, the provisions would not apply.

If however, Company A were to sell its OpCo shares to Company B and within 18 months of the extra-ordinary dividend being received, the dividend stripping provisions would be triggered as Company B would hold 25% of the shares in OpCo. As a result of the deferral transaction, dividends which would not otherwise be taxed would fall within the ambit of the dividend stripping provisions.

a) Facts:

OpCo has 3 shareholders – Company A holds 60% of the shares whilst Company B and Company C hold 20% each. An extraordinary dividend is declared by OpCo to its shareholders. If the shareholders were to sell the OpCo shares outside of roll-over relief, the dividend stripping provisions would not apply to Company B and C as the qualifying interest criteria would not be met.

The shareholders sell their OpCo shares to a competitor company (New Co) and are issued New Co shares. Company B and Company C are issued with 10% of the shares in NewCo. NewCo lists.

b) Outcome:

As a result of New Co being listed Company B and Company C would hold a qualifying interest in New Co. If they sell the New Co shares within 18 months of the OpCo dividend having been declared, the dividend stripping provisions would be triggered.

6.3 Proposed solution

Taxation of dividends on shares disposed of under a deferral transaction should only be taken into consideration for purposes of the dividend stripping provisions, if those dividends would have been taxed under the provisions had the original disposal not been a deferral transaction. Put differently, only those dividends which would otherwise have fallen within the dividend stripping provisions should be roll-over under the deferral transaction.

7. INTEREST EARNED BY BODY CORPORATES

7.1 Legal nature of the problem

Section 10(1)(e)(ii) of the Income Tax Act exempts from Income Tax any receipts and accruals other than levies derived by a body corporate, share block company or association to the extent that the aggregate of those receipts and accruals does not exceed R50 000.

The Sectional Title Schemes Management Act was amended with effect from 7 October 2016 and requires body corporates to establish and maintain a reserve fund to cover the cost of unforeseen maintenance and repairs to the common property.

As a result of this requirement, the funds held by body corporates and the interest earned thereon has increased substantially. Interest income earned by many body corporates now far exceed the R50 000 threshold provided for in section 10(1)(e)(ii) of the Income Tax Act placing the body corporates in a tax paying position.

7.2 Proposed solution

The tax exempt amount of R50 000 set out in section 10(1)(e)(ii) of the Income Tax Act was introduced in 2008 and has not been adjusted. The monetary threshold should be increased to ensure that the body corporates are not subject to tax as result of the Sectional Title Schemes Management Act.

Alternatively, financial instrument income earned on the reserve fund should be exempt it is entirety given that sectional title funds may vary greatly.

8. SECTION 24I GAINS AND LOSSES IN COMPANIES THAT ARE NOT TRADING

8.1 Legal nature of the problem

Section 24I of the Income Tax Act governs the taxation of gains or losses on certain foreign exchange transactions. The charging section in section 24I of the Income Act prescribes that in determining the taxable income of a company for the tax year the foreign exchange gains / losses shall be included in or deducted from the income of the company, irrespective of whether that company is trading or not.

As a result, a company has no discretion whether or not to include / deduct foreign exchange differences in / from its income. Thus, where a company (even a non-trading company) has a foreign exchange loss in a particular tax year it is required / obliged in terms of section 24I to claim the foreign exchange loss.

In the case of a non-trading company, this will in most instances result in an assessed loss. Unfortunately, in order to carry forward any assessed loss from a preceding year of assessment it is clear from the wording of section 20(1)(a) that a company must be carrying on a trade in the current year of assessment.

Although one would have expected that a company in these circumstances will be entitled to carry forward the assessed loss to the subsequent tax year –

a) section 20(1) would preclude the company from carrying forward the assessed loss on the basis that the company is not trading; and
b) there is nothing in the wording of section 24I which would suggest that foreign exchange losses in relation to exchange items can be carried forward to subsequent years of assessment and set-off against foreign exchange gains in relation to those same exchange items.

The consequence of the above will be that the company will be subject to income tax on the foreign exchange losses that it has not actually utilised, which increases its effective tax rate significantly without any reasonable justification for it.

8.2 Detailed factual description

a) Facts:

A non-trading South African tax resident company ("SACo") obtains a USD denominated loan (USD 100 000) for purposes of acquiring shares in a foreign company when the exchange rate was R10:1USD.

At the end of the first year of assessment the spot exchange rate is R15:1USD.

In the following (2nd) year of assessment, the spot exchange rate is R12:1US.

b) Outcome:

Section 24I of the Income Tax Act will apply to SACo, irrespective of whether or not it is trading.

In relation to the first year of assessment, SA Co will, in terms of section 24I, be deemed to have incurred a foreign exchange <u>loss</u> on the loan of R500 000 (USD 100 000 x (15-10)). Assuming SACo has no other taxable income it will result in an assessed loss.

In relation to the second year of assessment –

- section 20 of the Income Tax Act will prohibit SACo from carrying forward the assessed loss from the first year of assessment;

- for purposes of calculating the foreign exchange gain / loss on the loan, SACo is required to utilize the translation date rate (R15 : 1USD) and the spot rate (R12 : 1USD); and

- as a result, SACo would realise a foreign exchange gain of R300 000 (USD 100 00 x (15 - 12) which must be included in its taxable income and SACo would be liable for income tax.

Having regard to this basic example it is noted that, to the extent that SACo is not carrying on a trade, it will trigger an income tax liability in circumstances where –

a) it has not actually utilized the foreign exchange loss (i.e. it had no taxable income to deduct against the deemed deduction in section 24I); and

b) SACo has (at the end of the 2nd tax year) actually realised a loss on the loan given that the exchange rate on the transaction date was R 10:1 USD and the spot rate was R12:1USD.

It does not appear correct that SACo should not be entitled to carry forward the foreign exchange loss from the prior year of assessment, otherwise it will have the anomalous result referred to above. SACo should only pay income tax on any actual gains made on the relevant exchange item (i.e. if the exchange rate on the relevant date is better than R10:1USD.

8.3 The nature of the business impact and proposed solution

To the extent that non-trading companies are not entitled to carry forward foreign exchange losses, they will be subject to income tax on foreign exchange losses that they have not actually utilized resulting in an effective tax rate well in excess of 28%.

Our proposed solution is for either i), section 24I to only apply to trading companies / entities or ii) the Income Tax Act to allow excess foreign exchange loss carryovers solely to be set-off against foreign exchange gains (by amending section 24I or 20 of the Income Tax Act).

9. REAL ESTATE INVESTMENT TRUSTS: INTERPLAY OF SECTION 25BB(5) OF THE INCOME TAX ACT WITH SECTION 45(4)(B)(I) OF THE INCOME TAX ACT (THE DE-GROUPING ISSUE)

9.1 Legal nature of the problem

This problem arises where a company that is not a REIT or a controlled company as defined in section 25BB(1) of the Income Tax Act (the transferor) disposes of immovable property assets (for example) or other assets as contemplated in section 25BB(5) of the Income Tax Act to a company that is a REIT or a controlled company as defined in section 25BB(1) of the Income Tax Act (the transferee) in terms of an intra-group transaction as envisaged in section 45 of the Income Tax Act. The issue arises if and when the transferee and the transferor de-group. The effect is that a capital gain is triggered on assets which are intended by section 25BB(5) of the Income Tax Act to give rise to disregarded capital gains. Capital gain is triggered by section 45(4)(b)(i) of the Income Tax Act. The reason for this is that the provisions of section 25BB(5) are subject to the provisions of Part III of Chapter II of the Income Tax Act (i.e sections 41 through 47).

9.2 Proposed solution

Suggested amendment as follows:

45(4)(b)(i) an amount equal to the lesser of

(aa) the greatest capital gain ……….; or

(bb) the capital gain ….. ,

is deemed to be a capital gain ……. increased by 50 per cent of that amount. <u>Provided that this subparagraph does not apply to a transferee company that is a REIT or a controlled company as defined in section 25BB(1) on the last day of a year of assessment in respect of assets still held comprising-</u>

immovable property of the transferee company that is a REIT or a controlled company as defined in section 25BB(1) at the time of the transferee company ceasing to form part of any group of companies in relation to the transferor company contemplated in subsection 4(a)(i) or a controlling group company in relation to the transferor company;

a share or linked unit in a company that is a REIT at the time of the transferee company ceasing to form part of any group of companies in relation to the transferor company contemplated in subsection 4(a)(i) or a controlling group company in relation to the transferor company; or

a share or a linked unit in a company that is a property company as defined in section 25BB(1) at the time of the transferee company ceasing to form part of any group of companies in relation to the transferor company contemplated in subsection 4(a)(i) or a controlling group company in relation to the transferor company.

10. REAL ESTATE INVESTMENT TRUSTS: THE 18 MONTH HOLDING RULE IN SECTION 42(7)(A); 44(5)(A)(I), 45(5)(A)(I) AND 47(4)(A)(I)

10.1 Legal nature of the problem

Similarly to Issue 1, the application of these provisions result in capital gains being triggered on assets that are not supposed to be subject to tax as a result of section 25BB(5). Similar amendments to issue 1 to be made to sections 42(7)(a), 44(5)(a)(i), 45(5)(a)(i) and 47(4)(a)(i) excluding of course the reference to a de-grouping. So for example in the case of section 42(7)(a)_

10.2 Proposed solution

(7)(a) that asset constitutes a capital asset, ….. balance of assessed loss of that company. Provided that this subparagraph does not apply to a transferee company that is a REIT or a controlled company as defined in section 25BB(1) on the last day of a year of assessment in respect of assets comprising: immovable property of the transferee company that is a REIT or a controlled company as defined in section 25BB(1) at the time of the disposal;

a share or linked unit in a company that is a REIT at the time of the disposal; or

a share or a linked unit in a company that is a property company as defined in section 25BB(1) at the time of the disposal.

[similar amendments to the 44, 45, 47 equivalents]

11 REAL ESTATE INVESTMENT TRUSTS: APPLICATION OF SECTION 23N TO REITS OR CONTROLLED COMPANIES

11.1 Legal nature of the problem

Because of the fact that these companies distribute almost all if not all of their profits on an annual basis, they have very little if any tax base. Therefore, section 23N can become problematic for them and the 75% of receipts or accruals derived from the letting of immovable property is sometimes the only base on which interest can be claimed.

11.2 Proposed solution

Consideration should be given to extending this 75% uplift to the amount of rental income as defined in section 25BB(1) of the Income Tax Act.

12 SECTION 45 AND INVENTORY SOLD BETWEEN GROUP COMPANIES

12.1 Legal nature of the problem

The provisions of section 45 of the Income Tax Act apply unless the parties elect out of the provisions. Trading stock is effectively deemed to have been transferred between group companies at the lower of cost or net realisable value as the transferee steps into the shoes of the transferor.

12.2 Detailed factual description

This poses a problem where groups of companies regularly transfer inventory from say a manufacturing company within the group to a distribution or retail entity. Unless the parties elect out of the provisions of section 45 as and when inventory is moved between the companies, the manufacturing concern will automatically be deemed to dispose of the inventory at cost. This type of transfer regularly arises when a manufacturer / producer is part of a supply chain. As an economic matter, these types of supply chains add more domestic economic value than manufacture / production of an isolated product.

We suggest that the section 45 treatment of trading stock should rather require an active election-in by the parties than an election-out so that both parties can be taxed in the normal course, in line with their accounting treatment, unless they actively elect-in.

12.3 The nature of the business impacted

Businesses who sell inventory to group companies.

12.4 Proposed solution

We recommend that trading stock which is regularly and continuously disposed of by that company is excluded from the automatic application of the provisions of section 45 unless that trading stock is disposed of as part of a sale of business.

SAIT REPRESENTATIVES TO BE INVITED TO NATIONAL TREASURY WORKSHOPS

BUSINESS TAX TECHNICAL WORK GROUP			
1	Lesley Bosman (Chair)	KPMG	lesley.bosman@kpmg.co.za
2	Dawid van der Berg (Vice Chair)	PWC	dawid.van.der.berg@pwc.com

SAIT			
1	Keith Engel	SAIT	kengel@thesait.org.za
2	Erika de Villiers	SAIT	edevilliers@thesait.org.za
3	Malebo Moloto	SAIT	taxpolicyassist@thesait.org.za
4	Adél Marx	SAIT	taxpolicyadmin@thesait.org.za