23 November 2018

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RE: ANNEXURE C PROPOSAL FOR 2019 BUDGET: INTERNATIONAL TAX

We have attached the comments from the SAIT International Tax Work Group on the Annexure C tax proposals for the 2019 Budget pertaining to key international tax issues. 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.

Sincerely,

Anne Casey
Chair of the International Tax Technical Work Group

Enclosures: Annexure C Proposals

SAIT representatives to be invited to National Treasury workshops

ANNEXURE C PROPOSALS FOR 2019 BUDGET: INTERNATIONAL TAX

1. CONTROLLED FOREIGN COMPANIES HIGH TAX EXEMPTION AND WORKING CAPITAL EXEMPTION

1.1 Legal nature of the problem

The so-called high-tax exemption (section 9D(2A) further proviso) for controlled foreign companies (CFCs) applies where the aggregate amount of taxes payable by the CFC is at least 75 per cent of the normal tax that would have been paid by the CFC had it been a SA tax resident. In a global environment of decreasing corporate tax rates, the 75 per cent threshold should be decreased.

Further, the working capital exemption (section 9D(9A)(a)(iii)(cc)) of 5 per cent applicable to foreign business establishments should have a minimum monetary threshold introduced to avoid the imputation of relatively small amounts of passive income.

1.2 Factual description of the relevant transaction

In a global environment of decreasing corporate tax rates, the 75 per cent threshold of the high tax exemption no longer covers CFCs that are resident in countries that are not considered low tax jurisdictions, such as the UK, Canada, Netherlands and USA. Whilst in some cases the foreign business establishment exemption may apply to companies in those jurisdictions, it is not always the case. In addition, even where the foreign business establishment exemption does apply certain amounts of passive income may become imputable and will not be exempt due to the low threshold of the working capital exemption which is only 5 per cent.

1.3 Nature of the businesses impacted by the problem

Taxpayers with CFCs.

1.4 Proposed solution

The high tax exemption threshold should be decreased to around 60 per cent from the current 75 per cent.

As is the case in certain other jurisdictions in the case of listed groups the working capital exemption should have a minimum monetary threshold of around R1 million so that relatively small passive income amounts are not imputable where a company has a foreign business establishment but has passive income (e.g. bank interest) that exceeds the current 5 per cent threshold.

2. CAPITAL GAINS TAX PARTICIPATION EXEMPTION – REORGANISATION OF CFCs

2.1 Legal nature of the problem

The capital gains tax participation exemption (paragraph 64B of the Eighth Schedule) does not apply to disposals to CFCs. Relief for such transactions is provided in the corporate rules. However, the problem is that the corporate rules are too rigid and often cannot operate in harmony with the foreign laws applicable to the CFC.

2.2 Factual description of the relevant transaction

Paragraph 64B contains the so-called capital gains tax participation exemption. Prior to the 2015 amendment it was possible to apply the provisions of paragraph 64B to the restructuring of CFCs. In 2015, the provision was amended to exclude its application in the context of CFC restructurings and at the same time certain of the corporate rules were extended to apply to CFC restructurings.

Paragraph 64B provided greater flexibility than the corporate rules. It is understood that one of the concerns around the previous application of paragraph 64B was that where shares in a CFC were disposed of it gave the acquirer a step up in the base cost on those shares as a result of the application of paragraph 38 (1)(b). To address this concern, it could be provided that the acquirer would be deemed to acquire the shares in the CFC for the same expenditure as was incurred by the disposing entity.

A practical example of this is where a SA listed holding company holds 2 SA subsidiaries, namely:

- SA Sub 1 which is an intermediary holding company for the group's entities in the "A" industry;
- SA Sub 2 which is an intermediary holding company for the group's entities in the "B" industry.

SA Sub 2 holds a Dutch company which in turn holds various subsidiaries that operate in the "B" industry but also companies in Australia and the UK that operate in the "A" industry. The Australia and UK companies need to be moved across to SA Sub 1 to consolidate all entities that operate in the "A" industry under the intermediary holding company for the "A" industry. This is in preparation for an unbundling and separate listing of SA Sub 1.

If the Dutch company simply sold the shares in the Australian and UK companies then there would be no tax consequences in the Netherlands, Australia and the UK. However, there would be gains that would be imputable to the SA listed holding company unless it carried out the sale in terms of section 45. However, it cannot apply section 45 because upon the unbundling and separate listing of SA Sub 1 the parties would de-group and trigger a section 45 de-grouping charge. Therefore, a more cumbersome approach must be followed involving Dutch company unbundling the shares in Australia and UK to SA listed holding company (section 46) followed by SA listed holding company contributing the shares in Australia and UK to SA Sub 1 (section 42). Where the group structure has more intermediary companies, then it adds to the number of steps that must be carried out as a substitute to a simple sale.

If paragraph 64B would be amended as proposed, then Dutch company could sell Australia and UK directly to SA Sub 1 which would be deemed to acquire the shares at Dutch company's base cost.

2.3 Nature of the businesses impacted by the problem

Taxpayers with CFCs.

2.4 Proposed solution

It should be possible to apply the provisions of paragraph 64B to the restructuring of CFCs. It could be provided that the acquirer would be deemed to acquire the shares in the CFC for the same expenditure as was incurred by the disposing entity.

3. WITHHOLDING TAX TREATMENT OF TRANSFER PRICING SECONDARY ADJUSTMENT

3.1 Legal nature of the problem

The exclusion in the definition of a dividend in section 1 of the Income Tax Act of a distribution of an asset *in specie* arising from a section 31(3) transfer pricing adjustment gives rise to double taxation on the portion that is considered to be excessive under the transfer pricing rules.

This applies particularly in the context of interest and royalty remittances where the quantum of the debt and royalty paid is considered to be excessive.

Furthermore, the secondary adjustment should only be aimed at catching “reserves” that permanently leave a South African group.

3.2 Factual description of the relevant transaction

Section 50B of the Income Tax Act (“the Act”) provides withholding tax must be levied on interest at the rate of 15% on the amount of any interest paid by any person to or for the benefit of a foreign person to the extent the amount is regarded as having been received by or accrued from a source in the Republic. Interest is defined as per paragraphs (a) and (b) of the definition of interest in section 24J(1) of the Act.

Similarly, section 49C provides a foreign person to which a royalty is paid will be subject to withholding tax at the rate of 15% to the extent the royalty is regarded as having been received by or accrued from a source within the Republic.

The above concepts of interest and royalties fall within the ambit of Article 11 and 12 of the OECD Model Tax Convention on Income and on Capital.

To the extent a section 31(3) secondary adjustment is made, the amount which is considered not to be in accordance with arm's length principles will be deemed to be a distribution of an asset *in specie* and subject to dividends withholding tax of 20%. By removing the deemed distribution from the definition of dividend, relief provided for in Article 10 of any double taxation agreement ("DTA") will not be available.

Furthermore, as the legal form of the remittance is interest and royalty in nature, section 50B and section 49C will continue to apply to such amount paid or due and payable. This results in the same amount being subject to dividends tax of 20% as well as interest or royalties withholding tax of 15%.

The re-characterisation of such amount as a dividend for purposes of dividends withholding tax fails to take into account that the amount has already been subject to tax. The effective double taxation of this income is contrary to the principles of the OECD to avoid double taxation.

A secondary adjustment should be in line with economic reality and the reality of the shareholding structure. For example, a South African company sells goods to a foreign parent at below market related prices, with the result that less profit is recognised in South Africa. The effect is a permanent reduction in the South Africa group company's reserves available for distribution. The secondary adjustment should not apply in circumstances where the "reserves" are or will be unaffected. This would be the situation where, for example a South African company does not charge management fees to a foreign subsidiary.

Furthermore, the deemed dividend treatment should only be deemed to be a distribution to the actual shareholder and treaty rates should be available. As it stands, it is nothing more than a penalty. This is evident where a South African entity fails to charge a management fee to its foreign subsidiary. Based on the proposed legislation, a transfer pricing primary and secondary adjustment would be applied to the South African company. The foreign subsidiary then declares a dividend to its South African holding company comprising profits which would otherwise have been paid as a management fee to the South African company.

The South African company on-declares such amount to its shareholders and pays dividends withholding tax. Essentially the same amount has been double taxed.

3.3 Nature of the businesses impacted by the problem

Any interest-bearing loan funding advanced by connected foreign parties to South African tax residents and royalty payments made to foreign connected parties which are deemed to be excessive under section 31 of the Act.

Transactions between South African companies with foreign subsidiaries.

3.4 Proposed solution

We request that the practical considerations of adopting a policy change in respect of disallowing DTA relief for a secondary adjustment under section 31(3) is considered in the context of the Mutual Agreement Procedures and the positions adopted by South Africa under the Multi-lateral Instrument which has been signed but not yet ratified. Contracting Parties to DTAs will object against this treatment, resulting in lengthy mutual agreement procedures being initiated.

Consideration should also be given to allowing the withholding tax on interest or royalties as a credit against the withholding tax on dividends on the basis that the excessive amount has been recharacterised as dividends. Alternatively, any amount subject to a secondary adjustment should be exempted from the application of any interest or royalty withholding tax in section 50B and section 49C respectively.

As an overall consideration, the secondary adjustment should only be aimed at transactions which effectively decrease South African reserves.

4. SECTION 24I(4A) OF THE INCOME TAX ACT – REALISATION (TECHNICAL CORRECTION)

4.1 Legal nature of the problem

The provisions of section 24I(4) deal with the tax consequences attendant on exchange items representing debts owing to a taxpayer that have become irrecoverable by reason of becoming bad or by reason of having been disposed of at a loss (determined with reference to the foreign currency amount and due to a decline in the market value of the debt).

4.2 Factual description of the relevant transaction

The provisions of section 24I(4) were amended by the Taxation Laws Amendment Act 2018. In terms of this amendment, the provisions of section 24I(4) of the Income Tax Act apply, inter alia, (a) to the extent that on realisation the debt was irrecoverable by reason of becoming bad. The use of the word realisation is problematic in the sense that the word "realised" and hence the derivative realisation is a defined term in section 24I arising from payment, settlement or disposal of an exchange item. The current wording would thus not allow for a unilateral act such as a write off (without waiver) of an irrecoverable/bad amount.

4.3 Nature of the businesses impacted

Any business that writes off an irrecoverable/bad foreign denominated debt without formally waiving it could be impacted.

4.4 Proposed solution

In order to address the stated problem and to provide certainty and equity, it is proposed that the word realisation be removed from sub-section (4)(a) of section 24I.

5. SA TAX RESIDENT COMPANIES WITH FOREIGN FUNCTIONAL CURRENCY

5.1 Legal nature of the problem

SA tax resident companies with a foreign (i.e. non-ZAR) functional currency are required to translate amounts received / accrued and expenditure / losses incurred at the spot rate in terms of section 25D.

5.2 Factual description of the relevant transaction

It is particularly onerous to translate inventory related items at daily spot rates as it essentially requires an entity to run a double set of accounts, namely one set of accounts in its functional currency and another in ZAR. It should be permitted for such entities to use the average rate of exchange, which is defined in section 1 of the Act as, "in relation to a year of assessment the average determined by using the closing spot rates at the end of daily or monthly intervals during that year of assessment which must be consistently applied within that year of assessment." In this regard, SARS publishes average rates of exchange for major currencies which are typically used by taxpayers who are permitted to apply the average rate of exchange. This could be limited to activities of the entity that would constitute a permanent establishment in SA to ensure that the translation rule would only apply to active businesses.

5.3 Nature of the businesses impacted by the problem

SA tax resident entities with a foreign functional currency, particularly those who buy and sell inventory on a regular basis.

5.4 Proposed solution

Such entities should be permitted to translate at the average rate of exchange in the same manner that the taxpayers referred to in sections 25D(4) to 25D(7), namely headquarter companies, domestic treasury management companies and international shipping companies are permitted to.

6. DEFINITION OF FOREIGN PARTNERSHIP TO BE EXPANDED

6.1 Legal nature of the problem

The current definition of foreign partnership does not clearly cater for fiscally transparent foreign vehicles investing in South Africa.

6.2 Factual description of the relevant transaction

Certain foreign vehicles such as the Irish Common Contractual Fund ("CCF"), the Luxembourg Fond Commun de Placement and the UK Authorised Contractual Scheme ("ACS") have in recent years been established. A number of these vehicles have made or are intending to invest in South Africa.

The CCF, ACS and Fond Commun de Placement are treated for tax purposes by their respective jurisdictions to be fiscally transparent. The tax regimes applicable to these vehicles specifically provide that they are not classified as taxpayers and are not taxable persons for purposes of the tax legislation in those jurisdictions. Consequently, applicable DTA's will not apply to these vehicles and any cross-border transactions concluded by them.

In addition to this, certain DTA's for example the DTA concluded between Ireland and South Africa expressly provides that a CCF will not be considered to be a person for purposes of the DTA. This ensures the treatment of the vehicle will be transparent for tax purposes, allowing the investors, as the recipient and beneficial owner of any income, to be taxed as opposed to the vehicle itself.

Furthermore, it is worth noting that the terms of the Article 1(2) of the latest Model Tax Convention1 have been updated to provide clarity regarding which level a double taxation treaty is applied, i.e. at the level of the members/investors where vehicles may be considered by at least one involved party as fiscally transparent, such as the ACS and CCF.

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[1] OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing. *http://dx.doi.org/10.1787/mtc_cond-2017-en*

In the absence of a DTA expressly dealing with the fiscal transparency of such a vehicle, the current definition of foreign partnership may not be wide enough to clearly determine the correct entity which should be subject to tax on any income which is sourced or deemed to be sourced in South Africa. This creates confusion in the application of the provisions of the Act, particularly in relation to withholding taxes.

Questions such as whether these vehicles may be classified as a *partnership, body of persons or entity* as required by the definition of foreign partnership have been raised by investors and SARS alike. Furthermore, many of these entities are treated on a similar basis as our collective investment schemes and consequently capital gains will only be taxed on disposal of units held by investors in these vehicles. This does not necessarily fall within the requirement that the amount be included in the investors hand immediately on receipt or accrual thereof.

The result of this is confusion among investors as to the tax treatment on the remittance of income as well as the possibility that withholding tax may be levied at the level of the vehicle without the investors being in a position to claim a rebate for any withholding tax paid, alternatively a higher withholding tax is levied than that applicable to the investor's jurisdiction.

6.3 Nature of the businesses impacted by the problem

The above problem applies to all investment made in South African equities and financial instruments by entities which are treated as being fiscally transparent by their respective tax regimes.

6.4 Proposed solution

We recommend that the current definition of "foreign partnership" is expanded to include any vehicle which is treated for tax purposes as being fiscally transparent in the jurisdiction in which it is established.

7. FOREIGN TAX CREDITS FORFEITED ON BLOCKED FUNDS

7.1 Legal nature of the problem

Where funds are blocked in a foreign jurisdiction section 9A allows for deferral of income tax until the cash flows. Where withholding tax is levied by the foreign jurisdiction on the accrual basis and funds are blocked, the section 6quat foreign tax credit is lost if the blocked funds are released after 6 years from the accrual event. This is because the foreign tax credit can only be carried forward for 6 years.

7.2 Factual description of the relevant transaction

A South African company charges interest, royalties, management fees, services fees and/or other fees to a foreign company that are subject to tax in the foreign jurisdiction on a source basis, often by way of withholding taxes. The South African company becomes entitled to a foreign tax credit when the income is subject to tax in South Africa. On blocked funds the income only becomes subject to tax in South Africa when the funds are no longer blocked. By then the foreign tax credits may be older than 6 years and end up being forfeited.

7.3 Nature of the businesses impacted by the problem

South African resident businesses with operations in countries that do not freely allow the remittance of funds to South Africa.

7.4 Potential solution

We recommend that blocked funds related foreign tax credits should not be subject to the 6-year restriction in section 6quat.

8. CONSEQUENTIAL AMENDMENT TO DEFINITION OF PERMANENT ESTABLISHMENT

8.1 Legal nature of the problem

The South African domestic definition of "permanent establishment" (in section 1 of the Income Tax Act) is defined with reference to the definition of permanent establishment in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (MTC). Our domestic definition is, therefore, consequentially amended every time that the MTC definition is amended.

The Organisation for Economic Co-operation and Development (OECD) updated the MTC in November 2017 to include its Base Erosion and Profit Shifting (BEPS) permanent establishment (PE) recommendations. Article 5(5) was amended to widen the 'conclusion of contracts' agency PE rules. Essentially a person can now create a PE, even if the person does not have the authority to conclude contracts, but if the person habitually plays the principal role leading to the conclusion of contracts.

South Africa made an election not to update Article 5(5) of its Double Tax Agreements (DTA's) in its MLI submission to the OECD. Therefore, for DTA purposes, the narrower definition will continue to apply. However, because the South African domestic definition of PE (in section 1 of the Income Tax Act) refers to the MTC definition, the domestic definition was widened when the MTC was updated.

8.2 Factual description of the relevant transaction

A few examples of the potential impact of this incongruency includes:

- The taxing threshold for a foreigner selling goods in South Africa is a PE. Why should our domestic law have a stricter test than what we apply under DTAs, and which would in any event be overridden by them?
- And it works the other way. A royalty or interest will not have a South African source if it's attributable to a foreign PE. Now it's easier to attribute to a foreign PE than before.

8.3 Nature of the businesses impacted by the problem

Any business where a person can now create a PE, even if the person does not have the authority to conclude contracts, but if the person habitually plays the principal role leading to the conclusion of contracts.

8.4 Potential solution

We query whether it was intended that the domestic definition should be widened after a policy decision was taken not to update the DTA definition, or alternatively whether a legislative amendment can be made to the domestic definition of PE to address this unintended consequence.

9. INTERACTION BETWEEN DISPUTE RESOLUTION PROCEDURES AND MUTUAL AGREEMENT PROCEDURE (MAP)

9.1 Legal nature of the problem

The interaction between the dispute resolution procedures in Chapter 9 of the Tax Administration Act (TAA) and the mutual agreement procedure (MAP) be clarified.

Page 14 of the SARS *Guide to Mutual Agreement Procedures* provides as follows:

> "*There is a distinction between administrative decisions (decision by SARS on an objection against an assessment) and judicial decisions (decision by the tax court or higher courts). A MAP cannot override a judicial decision in the domestic context. A MAP after a judicial decision had been handed down would thus have to be conducted within the constraints of the decision. <u>It is therefore recommended that the domestic legal remedies after an appeal has been lodged or the rule 31 and 32 statements that have been filed be suspended until the MAP is concluded</u>. If agreement cannot be reached on such a suspension, the competent authorities may defer the MAP until the domestic remedies have been exhausted*." (Our emphasis.)

9.2 Factual description of the relevant transaction

A taxpayer may wish to file a MAP application / request and also appeal against an assessment.

9.3 Nature of the businesses impacted by the problem

Any business that would like to appeal against a tax assessment and also would like to make use of the Mutual Agreement Procedure in a Double Tax Agreement.

9.4 Proposed solution

It is recommended that Chapter 9 of the TAA be amended to provide for how and when the dispute resolution procedures is suspended once the MAP application / request is accepted by SARS. It is also recommended that should taxpayers prefer to see to the finalisation of the Chapter 9 procedures, that taxpayers can file a MAP application / request which is then suspended pending finalisation of the Chapter 9 procedures. This is to prevent taxpayers being out of the 3-year prescription period from notification to file a MAP application / request.

10. ORDER OF PRIORITY IN RESPECT OF SECTIONS 23M, 23N AND 31

10.1 Legal nature of the problem

There is no clarity as to the sequence in which section 31 applies in relation to section 23N and section 23M of the Act.

It is presumed that the legislation intended section 31 to apply last.

In terms of section 31(2), if the requirements of *"affected transaction"* are met (ie a non-arm's length transaction which results in a *"tax benefit"*), then the *"taxable income or tax payable by any person…must be calculated as if that transaction, operation, scheme or understanding had been entered into…"* on arm's length terms.

The term *"tax benefit"* is defined to *"include any avoidance, postponement or reduction of any liability for tax".*

Sections 23M and 23N both have the effect of limiting (and, in the case of section 23M, potentially deferring) interest deductions.

It appears that, to the extent that a deduction of interest is limited or deferred, no *"tax benefit"* arises. Therefore, presumably section 31 does not apply to such interest.

This would imply that sections 23M and 23N must be applied first before section 31 is applied. It would follow that a taxpayer subject to an interest limitation in terms of one of these two sections is not subject to a secondary adjustment on that amount of interest.

10.2 Factual description of the relevant transaction

The legislation is clear in providing that section 23N must be applied prior to section 23M (see section 23M(5) of the Act) in calculating the taxable income of a taxpayer.

There is no indication in the legislation as to when section 31 must be applied in testing of cross-border affected transactions.

10.3 Nature of the businesses impacted by the problem

This is relevant to all affected transactions as defined in section 31, financial assistance provided by a lender in a controlling relationship and any resident which has implemented a reorganisation and acquisition transaction as defined in section 23N.

10.4 Proposed solution

Clarification is requested regarding whether this interpretation is correct. If so, then possible consideration should be given to amending the legislation to ensure that sections 23N and 23M take precedence over section 31.

11. SECTION 23M(6)(A) EXEMPTION

11.1 Legal nature of the problem

Section 23M(6)(a) provides for an exemption from the application of section 23M where a foreign related creditor has acquired funding from a foreign lending institution which is not in a controlling relationship with the resident debtor and the interest rate does not exceed the official rate of interest (as defined) plus 100 basis points.

Section 23M(6)(A) looks at the original source of the funding and acknowledges that, where funds are borrowed externally in order to on-lend the funding to a South African related debtor, section 23M should not apply. However, the interest limitation is set so low that the exemption will very seldom be available, especially after our recent credit downgrades by ratings agencies.

11.2 Factual description of the relevant transaction

The intention of the legislature was to allow for an exemption from the limitation of interest rules in a situation where clearly the rate of interest is at arm's length and sourced in accordance with arm's length criteria.

It is extremely unlikely that this exemption would apply given the limitation of the interest rate to the official rate of interest (as defined) plus 100 basis points and taking into account the applicable transfer pricing rules of the creditors country of residence. The official rate of interest is defined in relation to debt denominated in a foreign currency to be a rate equivalent to the South African repo rate plus 100 basis points. This will typically be the interbank rate of that jurisdiction.

For example, the USD LIBOR rate as at 1 November 2018 was 2.17538%. If one applies the additional 200 basis points (referred to in the definition of the official rate of interest and in section 23M(6)(a) read together), the funding must have been sourced and onward lent at a rate not exceeding 4.17538%.

From a transfer pricing perspective, a margin would need to be provided for on the interest rate to ensure the related party lender is compliant with its jurisdictional transfer pricing rules. It is therefore unlikely that relief will apply to situations where a related foreign company can source debt funding using its balance sheet and onward lend that to a South African debtor.

11.3 Nature of the businesses impacted

Any taxpayer sourcing debt from a foreign person which is in a controlling relationship with the debtor and has soured funding at an arm's length rate from a foreign financial institution and onward lent that debt to the South African debtor taxpayer.

11.4 Proposed solution

We would recommend that another measure should be used to ensure that the interest is at arm's length for purposes of the section 23M(6)(a) exemption.

SAIT REPRESENTATIVES TO BE INVITED TO NATIONAL TREASURY WORKSHOPS

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