South African Institute of Tax Professionals

16 August 2018

The National Treasury

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The South African Revenue Service

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RE: DRAFT TAXATION LAWS AMENDMENT BILL (TLAB), 2018: COMMENTS PERTAINING TO KEY BUSINESS TAX ISSUES

We have attached the comments from the SAIT Business Tax Work Group on the 2018 draft Taxation Laws Amendment Bill pertaining to key business 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.

Yours sincerely

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BUSINESS TAX SUBMISSION

A. REFINEMENT OF RULES DEALING WITH CONVERSION OF DEBT INTO EQUITY AND THE ARTIFICIAL REPAYMENT OF DEBT (Proposed amendment of section 19 / paragraph 12A)

1. Background

The words 'concession or compromise' in the current debt forgiveness rules are widely defined to include any amendment to the terms or conditions of a debt. National Treasury has become aware of the unintended tax consequences which arise when legitimate transactions, such as a subordination or substitution take place. Accordingly, it has proposed certain amendments to address these. Whilst the amendments are welcome, other aspects of the current debt forgiveness rules remain problematic. In addition, the proposed amendments have created some areas of uncertainty.

2. Problem #1 – Dormant companies

The current exclusion in relation to dormant companies has been retained. However, this exclusion only applies to loans owing between section 41 groups of companies. The forgiveness of a debt owing to a person outside of the group or a non-resident group company would still trigger the debt forgiveness provisions. Given the dormant nature of the debtor, any assessed loss which the debtor may have had to shelter any tax impact would already have been lost. In addition, it is unlikely that the debtor would be able to settle any resultant tax debt.

<u>Suggested solution</u>

We suggest that the dormant company exclusion be extended to all companies, regardless of the company's relationship with the creditor.

3. Problem # 2 – Connected person test for loan capitalisations

Paragraph (b) of the definition of 'concession or compromise' applies to arrangements in terms of which an interest-bearing debt owed by a company is settled, directly or indirectly by the conversion to or exchange for shares or by applying the proceeds from shares issued by the company. Paragraph (b) further requires that the company issuing the shares "is, immediately after that arrangement a connected person in relation to the person that acquired shares <u>by reason or in consequence of that</u>

arrangement" (our emphasis). We submit that the wording of the underlined portion is potentially unclear. On a strict reading of the draft, paragraph (b) would only find application where an interest-bearing loan owing to a person who is not already a connected person is capitalised and as a result of the loan capitalisation that person becomes a connected person in relation to the company who issued the shares. The capitalisation of an interest-bearing loan owing to a creditor which is already a connected person at the time of the capitalisation would be excluded from the definition of 'concession or compromise'.

4. Problem # 3 – Disconnect between the explanatory memorandum and the draft bill

The explanatory memorandum makes reference to the concept of an 'equity loan'. This term is however not used in the draft legislation. Rather the legislation refers to 'interest-bearing' debt. Given that 'interest' is excluded from the definition of 'debt' for purposes of the debt forgiveness provisions, the inclusion of the term 'interest-bearing' is confusing. Moreover, having excluded interest from the ambit of the provisions, the distinction between interest-bearing and interest-free loans seems irrelevant.

Suggested solution

We suggest that the category of loan capital falling in the definition of 'concession or compromise' in instances where the loan is capitalised, be more clearly defined.

5. Problem # 4 – Debt benefit on conversion: claim held in respect of debt excluding interest

The calculation of the debt benefit on the conversion of debt to equity takes into account the amount by which the face value of the claim held in respect of that debt (per definition excluding interest) exceeds the market value of the shares acquired as a result of the arrangement. It is possible that the shares acquired compensates the lender for the capital of the debt as well as interest thereon. In such instance the face value of the claim held in respect of that debt could be interpreted to be net of interest. This could mean that the calculated debt benefit is understated.

6. **Problem # 5 – Connected person test in relation to paragraph (a) definition of 'concession or compromise'**

Paragraph (a) of the definition of 'concession or compromise' includes an arrangement in terms of which a debt is extinguished by the redemption of the claim in respect of that debt "by the person owing that debt or by any person who is a connected person in relation to that person …" (our emphasis added). The inclusion of the underlined portion would indicate that the delegation of the loan liability to a connected person who subsequently settles the liability would be regarded as a concession or compromise. It is not immediately clear in whose hands the concession or compromise would be triggered but as the redemption of the loan by the connected person at less than face value would in any event be a concession or compromise under paragraph (a)(i) of the definition, we assume that the taxpayer affected by the arrangement would be original debtor. In the above instance, the debt would not be redeemed in the hands of the original debtor and the loan claim would not be acquired by any person. It therefore appears that despite the existence of a concession or compromise, no debt benefit would be present.

Suggested solution

At a minimum, we suggest that arrangements in terms of which loan claims are ceded and loan liabilities are delegated and which would trigger a concession or compromise be more clearly defined. We are not quite certain how the connected person concern fits in practical terms to the problem at hand. How does a connected person redeem a debt without the underlying debtor also redeeming the debt. The connected person debtor would somehow have to assume the debt obligation first with the connected person becoming the debtor upon redemption.

B. CLARIFICATION OF THE INTERACTION BETWEEN THE ANTI-AVOIDANCE RULES DEALING WITH DIVIDEND STRIPPING AND CORPORATE REORGANISATION RULES (Proposed amendment to section 41 and section 22B / paragraph 43A)

1. Background

The 2017 amendments to the dividend stripping rules included a rule to override corporate re-organisation provisions. The amendments affected legitimate re-organisation transactions where no avoidance is present. In order to ensure that legitimate transactions are not affected, the override of the corporate re-organisation rules will be reversed. The disposal of shares pursuant to a 'deferral transaction' will not trigger the dividend stripping rules. The dividend stripping rules must however be considered where shares acquired under a 'deferral transaction' are disposed of within 18 months of that transaction.

2. General comments

It is clear that the proposals in respect of deferral transactions consider dividends declared 18 months prior to the deferral transaction and the disposal of shares within a period of 18 months after the deferral transaction, where that disposal is not in terms of a deferral transaction. It is however less clear how the dividends that are taxed in terms of the revised dividend stripping provisions should be determined.

3. Effective date of amendments to section 41

With effect from 18 December 2017 the dividend stripping rule overrides the corporate re-organisation rules as a result of the inclusion of section 22B and paragraph 43A in the carve-out in section 41. It is proposed that the reference to these sections be deleted with effect from 1 January 2019. The proposed amendments to the dividend stripping rules apply to disposals on or after 1 January 2019. The 1 January 2019 effective date of the section 41 amendment would result in legitimate re-organisation transactions entered into between 18 December 2017 and 1 January 2019 being subjected to the dividend stripping rules.

4. Suggested solution

To allow for legitimate re-organisation transactions to be concluded prior to 1 January 2019, we suggest that the effective date for the amendment to section 41 should be changed to 18 December 2017, thereby effectively reversing the 2017 amendment as intended.

5. Effective 36-month period

In the absence of a re-organisation transaction, the dividend stripping provisions would focus on dividends received within 18 months of the disposal. The proposed amendments consider dividends declared 18 months prior to a deferral transaction and the disposal of the shares within a period of 18 months after the deferral transaction and introduces an effective 36-month period.

6. **Suggested solution**

We recommend that the trigger for the anti-avoidance rules should be the disposal of the shares that were subject to the 'deferral transaction' within 18 months of receipt of an extra-ordinary dividend or dividend deemed to have been received in respect of the share under the proposed section 22B(3) / paragraph 43A(3).

<u>Example – Facts:</u> Company A declares an extraordinary dividend to Company B on 1 September 2017. The shares in Company A are transferred to Company C under a deferral transaction on 30 August 2018. Company C sells the shares in Company A outside of a deferral transaction prior to 1 March 2020.

<u>Outcome:</u> Company C would be required to include the extraordinary dividend in proceeds. Based on the proposed wording of section 22B(3) / paragraph 43A(3), the disposal of the Company A shares at any stage prior to 1 March 2020 would trigger the anti-avoidance provisions. We suggest that only disposals prior to 1 March 2019 i.e. within 18 months of the dividend should be tainted.

7. **Taxing section in section 22B(3) / paragraph 43A(3)** Paragraph (a) and (b) in section 22B(3) / paragraph 43A(3) set out circumstances in which a company who is party to a deferral transaction will be deemed to have received a dividend which was in fact received by another party to the deferral transaction / where received in respect of the shares acquired under the deferral transaction. Paragraph (b) makes reference to 'old shares' and 'new shares' whilst paragraph (a) does not. Section 22B(3) / paragraph 43A(3) requires that the higher of:

"(A) the amount, if any, that would have constituted an extraordinary dividend in respect of the old shares; and

(B) the amount constituting an extraordinary dividend in respect of the new shares, as determined with reference to the aggregate of the amount that accrued to or was received by that company as an exempt dividend in respect of the new shares and the amount that is treated as having accrued to or been received by that company as an exempt dividend in respect of the new shares' must for purposes of subsection (2) [subparagraph (2)] be treated as an extraordinary dividend that accrued to or was received by that company in respect of the new shares"

(a) Problem # 1

As the provisions of paragraph (a) do not refer to 'old shares' and 'new shares' it is not clear whether the provision of section 22B(3) / paragraph 43A(3) quoted above is intended to apply to dividends contemplated in paragraph (a) or whether the taxation of dividends under paragraph (a) are to be determined directly with reference to subsection (2) / subparagraph (2).

(b) Suggested solution # 1

The application of the taxing section to paragraph (a) dividends must be specifically provided for either through an amendment to the quoted section above or through the inclusion of a separate deeming provision in relation to subsection (2) / subparagraph (2).

(a) Problem # 2

In determining whether an amount "constituting an extraordinary dividend' in part B it is not immediately clear whether regard should be had to the market value of the old shares or the market value of the new shares. It is also not clear whether regard should be had to whether a qualifying interest was present at the time that the dividend was declared on the old shares and or held in respect of the new shares.

(b) Suggested solution # 2

The provisions of section 22B(3) / paragraph 43A(3) should expressly address how to determine whether any exempt dividend received should be treated as an extraordinary dividend both in terms of the timing of the determination (and hence the market value that is taken into consideration) as well as the qualifying interest requirement.

(c) **Problem # 3**

The wording at the end of subparagraph 3 "must for the purposes of subparagraph (2) be treated as an extraordinary dividend" creates ambiguity, in that the subparagraph (3) result may be added to a subparagraph (2) result in determining the extraordinary dividend.

(d) **Suggested solution # 3**

It should be made clear that the extraordinary dividend determined in subparagraph (3) is the extraordinary dividend.

8. Overall policy note

Although Treasury and SARS may have already past the point of no return in terms of the core substantive changes made in this area in 2017, we do again question the underlying method of remedying the real avoidance at hand. Dividends preceding sales are only a theoretical concern when the preceding dividend is effectively funded by the purchaser. The current version of the anti-avoidance rule has wrongfully delinked the extra-ordinary dividend event from the existence of the purchaser. Now all extraordinary dividends are problematic with some complex relief for reorganisation rules that now have to be further traced to prevent another round of perceived avoidance.

At bottom, the core problem is the distinction between dividends and capital distributions. The treatment of all distributions as dividends unless the parties elect otherwise is conceptually in error. A dividend essentially exists in accounting terms only to the extent dividends stem from current and historic accounting earnings. Share buyback distributions largely trigger negative reserves because these distributions exceed all current and historic earnings. It may be easier to trigger capital gains tax in these cases by treating distributions of this nature as capital regardless of any timing rules. The current 18-month formula is becoming complex to administer and enforce. Many extraordinary dividends (straight distributions above the 15 per cent threshold) are simply not abusive when these distributions actually come from earnings. The current anti-avoidance rules also wrongly trigger capital gains tax for all buybacks and redemptions where no third-party acquirers are ever involved.

C. INTRODUCTION OF SPECIFIC ANTI-DIVIDEND STRIPPING RULES REGARDING PREFERENCE SHARES (Proposed amendment to section 22B / paragraph 43A)

1. Background (current law)

Under current law pre-sale dividends received or accrued in respect of preference shares are only tainted by the anti-dividend stripping rules if the dividends exceed the amount of the dividends that would have been determined based on an interest rate of 15%. The provisions relating to preference shares will be amended to provide greater clarity as to which shares constitute preference shares as well as clarity regarding the determination of the amount of the extraordinary dividend. The proposed amendments are effective from 19 July 2017, being the date of introduction of the current anti-dividend stripping provisions.

2. Arrear dividends in respect of pre-July 2017 dividends

The anti-dividend stripping rules in relation to preference shares continue to apply to preference shares disposed of on or after 19 July 2017. Whilst preference share terms generally provide for the calculation of dividends at regular intervals over the term of the preference shares, these dividends are often not declared on these dates. Rather, arrear dividends are declared and paid on redemption date and must therefore be taken into consideration for purposes of the anti-dividend stripping rules. Where the preference share coupon is 15% or lower, this poses no problem. However, dividends in excess of this rate which accumulated under the terms of the preference share prior to 19 July 2017 would be subject to the anti-dividend stripping rules.

<u>Example – Facts:</u> On 18 July 2008 Resident Company A subscribed for R100 million preference shares issued by Company B. The preference shares carry a coupon of 18%, dividends are payable semi-annually, the preference shares are redeemable 10 years after the date of issue. Company B is unable to declare and pay the dividends on the stipulated dividend dates and settles the arrear dividends on redemption of the preference shares.

<u>Outcome</u>: Ignoring additional amounts that may have accrued as a result of the accumulation of the dividends, Company B will declare and pay a dividend of R180 million (R100 million x 18% x 10 years) on redemption of the preference shares on 18 July 2018. R30 million (R100 million x 3% x 10 years) of

this dividend would constitute an extraordinary dividend subject to the anti-dividend stripping rules. However, R162 million (R100 million x 18% x 9 years) of the preference share dividend relates to dividend periods prior to the introduction of the anti-dividend stripping rules. The extraordinary dividend in respect of the period after 19 July 2017 is only an amount of R3 million (R100 million x 3% x 1 year).

3. Suggested solution

<u>Suggestion #1 – Only dividends calculated with reference to dividend periods commencing on or after 19 July 2017 should be tainted</u>

The anti-dividend stripping rules refer to dividends that are received or accrued. In the context of preference shares we suggest that this requirement be relaxed and amended to refer to dividends which are determined in respect of dividend periods commencing on or after 19 July 2017. In other words, only the portion of the dividend that is calculated in respect of days from 19 July 2017 should be taken into account.

<u>Suggestion #2 – Allow taxpayers a window to unwind existing preference share structures</u>

As an alternative suggestion, the legislation could be amended in relation to preference shares issued prior to 19 July 2017 to allow for a window period within which the preference shares could be redeemed without triggering the anti-dividend stripping rules.

D. DETERMINATION OF AN OPERATING COMPANY FOR DEBT-FINANCED ACQUISITIONS OF A CONTROLLING COMPANY (Section 24O)

1. Background

The current provisions of section 24O allow for a special interest deduction where a shareholder company uses debt to directly or indirectly acquire a controlling interest in an operating company. The definition of operating company requires that at least 80% of the company's receipts or accruals constitute income as defined. Amendments to the provision are proposed to clarify the time at which the 80% test must be measured, being the end of the year of assessment of the shareholder.

2. **Once off extraordinary amounts**

In the explanatory memorandum it is stated that the amendment should address taxpayer concerns that the receipt of a large exempt dividend during the year of assessment could result in the operating company falling foul of the 80% income requirement. The proposed amendment would however not assist companies who receive a once off dividend which is in excess of 20% of the income for the year of assessment.

3. **Suggested solution**

The provisions of section 24O should allow for once off extraordinary gross income items that would otherwise result in the provisions of section 24O ceasing to apply.

E. **CLOSING OF A LOOPHOLE IN DEBT RELIEF RULES**

1. **Background**

Where debt which is subject to the debt forgiveness provisions was used to acquire capital assets, the forgiveness of the debt only triggers a tax event if the capital asset is still on hand at the time of the debt forgiveness or if the debtor has a capital loss. The debt forgiveness provisions will be amended to cater for capital assets which have been disposed of in a year prior to the year of assessment in which the debt benefit arises.

2. **Debt used to acquire capital assets**

In the explanatory memorandum reference is made to both capital assets and allowance assets. The draft legislation, however, only addresses the position where an allowance asset was disposed of in a prior year. It would therefore appear that where a capital asset which is not an allowance asset was disposed of in a prior year, the tax consequences for the debtor remain unchanged.

3. **Suggested solution**

The explanatory memorandum should be amended to align with the proposals contained in the legislation.

F. CREATING MORE CERTAINTY ON THE TAX TREATMENT OF DOUBTFUL DEBTS (Section 11(j))

1. Background

Currently the doubtful debt allowance is subject to the discretion of the Commissioner which means that a taxpayer can put forward the use of any suitable methodology for consideration by SARS. Although most taxpayers follow the SARS guideline to calculate their doubtful debt allowance as 25% of their book provision for doubtful debts, many other taxpayers apply a more specific methodology such as specific identification based on a list of debtors or the BASA ruling in the case of certain lenders. It is proposed that the SARS discretion contained in section 11(j) should be removed. Where a taxpayer prepares its Annual Financial Statements in accordance with IFRS, it is proposed that the doubtful debt allowance which can be claimed be determined with reference to the IFRS 9 impairment. Taxpayers who do not apply IFRS 9 will be required to determine the doubtful debt allowance based on debts which are 90 days or more in arrears and which would be allowed as a bad debt deduction if the debt had become bad.

2. IFRS standards applicable to SME's

The IFRS standards in relation to SME's differ from other companies. SME's will, therefore, not qualify for the IFRS 9 treatment.

3. Suggested solution

We query whether the proposed amendment to section 11(j) should not specifically cater for doubtful debts allowances of SME's with reference to IFRS for SME's.

4 Competitive disadvantage for non-bank lenders

There is a significant concern that non-bank lenders will be at a competitive disadvantage compared to the banks which they compete with as banks can claim more favourable allowances in terms of section 11(jA). Legitimate non-bank lenders who provide credit and are subject to the National Credit Act and other regulations will be affected. These include various stores who provide store credit as well as other non-deposit taking lenders. We understand that many of these lenders have been applying the so-called BASA ruling on a similar basis as the banks.

5 Suggested solution

Further consideration should be given to the position of non-bank lenders and whether they should not rather be treated on a similar basis as those of banks. There should be adequate consultation with the non-bank lenders so that a detailed understanding of their business, how they are regulated and how they manage their debtors is obtained. Different other industries should also be consulted during the process to establish whether the proposed methodology is appropriate in their instances, to avoid unintended consequences.

6 Impact of change in methodology

The proposed amendment will, in many instances, significantly impact the doubtful debt allowance that can be claimed by taxpayers. Some taxpayers will benefit from a greater deduction going forward whilst otherwise will be able to claim far less. These differences may have a significant impact on the tax calculations for the first year of assessment commencing on or after 1 January 2019.

7 Suggested solution

In addition, in order to minimise the impact that the change in methodology has on tax payable, we recommend that the impact of the change is phased in over a period of two or three years.