South African Institute of Tax Professionals

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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 INTERNATIONAL TAX ISSUES

We have attached the comments from the SAIT International Tax Work Group on the draft Taxation Laws Amendment Bill 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.

Yours sincerely

Anne Casey

Chair of the International Tax Work Group

INTERNATIONAL TAX ISSUES

A. ADDRESSING AN OVERLAP IN THE TREATMENT OF DIVIDEND AS DEFINED IN SECTION 1 AND AMOUNT DEEMED AS A DIVIDEND IN SPECIE IN SECTION 31 OF THE ACT

1. Treasury proposal

It has been proposed by National Treasury that legislative clarity should be provided in respect of an amount deemed to be a dividend *in specie* as a result of a secondary adjustment in terms of section 31 of the Income Tax Act ("the Act") and the application of treaty relief in terms of double taxation agreements (DTA's).

National Treasury and SARS view any secondary adjustment as a punitive measure and as such believe that the adjustment should not be entitled to relief under DTA's. The overlap between dividend as defined in section 1 and the amount deemed as a dividend in specie in section 31 has been utilised by taxpayers to obtain DTA relief in respect of an amount deemed a dividend *in specie* as a result of a transfer pricing secondary adjustment in terms of section 31 of the Act.

To curb this practice, National Treasury has proposed to provide clarity by excluding from the definition of "dividend" in section 1 of the Act, any amount deemed to be a dividend *in specie* as a result of a section 31 secondary adjustment. It is proposed that a deemed dividend as a result of a secondary adjustment instead be specifically included for purposes of the dividends tax.

2. Comment

We acknowledge that the intention is to provide for punitive measures in circumstances where a secondary adjustment is raised. However, we are concerned that the above amendments do not adequately take into account or address the significant impact of various tax instances over and above the secondary adjustment.

These include:

- The disallowance of any expense which is considered to be excessive in terms of section 31;
- Withholding tax of 20% leviable on the deemed dividend *in specie* as a consequence of the secondary adjustment in terms of section 31;
- Withholding tax of 15% leviable on any interest actually remitted as section 50A of the Act does not exclude excessive interest paid or payable which gives rise to a section 31 secondary adjustment;
- Penalties in accordance with section 223 of the Tax Administration Act ("TAA");
- Penalties on the underpayment of provisional tax in terms of paragraph 20(1) of the Fourth Schedule;
- Interest on the underpayment of provisional tax in terms of section 19(3) of the Act

The example below demonstrates the various punitive measures that would apply where a secondary adjustment is made in the case of a company which is thinly capitalised. It demonstrates that the additional amounts of tax, including withholding tax, interest and penalties are significant.

<u>Practical Example of a Secondary Adjustment for Thin Capitalisation</u>

Company A (Co. A) a Netherlands incorporated and tax resident entity, is the parent company of Company B (Co. B) a South African incorporated and tax resident. For the purpose of this example and simplicity, Co B is 100% owned by Co A.

Co B obtained a loan for an amount of R 1 000 000 from the foreign parent (i.e. Co A) which could be considered to be excessive in terms of the arm's length principles applied as per the draft interpretation note issued by SARS.

In this regard, a primary adjustment would be required in terms of section 31(2) resulting in the portion of interest that may have been deductible to be added back for income tax purposes. An example of the tax payable is set out below:

Loan	R1 000 000
Interest at prime interest rate	R100 000
Taxable income	R2 000 000
Normal Tax (prior to the adjustments)	R560 000
Taxable income	R2 000 000
Add back interest (primary adjustment)	R100 000
Taxable income	R2 100 000
Normal Tax	R588 000
WHT on interest @ 15% on R100 000	R15 000
WHT on dividend *in specie* @ 20% on R100 000	R20 000
*Paragraph 20 of 4th Sch penalty on underpayment of provisional tax @ 20%	R5 600
*Section 89*quat* interest on underpayment of provisional tax @ 10%	R2 800
* Section 223 of the Tax Administration Act understatement penalty (substantial understatement penalty)	R2 800
Total taxes, interest and penalties	R634 200

**For the purposes of this document we have assumed that the adjustment meets the requirements of paragraph 20 of the Fourth Schedule to levy underpayment penalties and we have also assumed that interest charged (in terms of section 89quat) on the outstanding amount will be levied for a year at the current interest rate of 10% as published by the Commissioner. In addition, we have assumed that a substantial understatement penalty (standard case) in terms of section 223 of the Tax Administration Act will apply.*

Furthermore, it is submitted that SARS as an observer of the OECD Model Tax Convention (OECD MTC) should not deviate from the principles clearly provided for in the OECD MTC and supported by international academic writers by disallowing DTA relief in relation to secondary transfer pricing adjustments as this will create uncertainty, not only for taxpayers but for potential foreign investors.

As it currently stands, our domestic tax law provides that where an amount of debt is considered excessive for South African transfer pricing purposes, the excessive portion of the debt will be regarded as a deemed dividend *in specie* and subject to dividends withholding tax.

In order for one to qualify for a reduced rate, each relevant DTA would need to be considered in order to determine whether such a deemed dividend would fall within the definition of a "dividend" as contained in the relevant DTA. To the extent that the definition is not met, the reduced rate will not apply. This is of particular importance where you have a deemed dividend arising by virtue of a thin capitalisation adjustment.

We note that the following extracts from various DTAs …*"income treated as a distribution by the taxation laws of the Contracting State of which the company making the distribution is a resident" and "as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is resident"* gives rise to the anomaly that the amendment wishes to address.

In relation to the above, we believe both extracts allow for a reduced withholding tax rate in respect of secondary adjustments in situations where there is a **direct** shareholding. Consequently, deemed dividend *in specie* adjustments should qualify for reduced withholding rates under the relevant DTA's.

The above extracts and international commentary are indicative of the OECD's intention to allow for some relief in cases where there have been transfer pricing adjustments. We note that in the majority of cases, typically a minimum of 5% withholding tax still applies to any dividend distributions. Consequently, in cases where dividends are remitted to jurisdictions which have concluded DTA's with South Africa, a 5% rate will apply. Where a deemed dividend *in specie* remittance is made to tax havens, a 20% withholding tax rate will apply which should be in line with the various BEPS initiatives.

3. Safe harbour test for thin capitalisation purposes

Finally, we wish to point out that the ability for most taxpayers to implement comprehensive transfer pricing benchmarking studies and policies to ensure arms' length funding transactions and arrangements are in place are limited to a few multi-national companies.

The current regulations dealing with arm's length funding transactions are vague and cumbersome. It is only possible to ensure an arm's length funding arrangement where appropriate benchmarking studies have been performed. To the extent such punitive measures are introduced by National

Treasury, regard should be had to reverting to a safe harbour test as previously adopted. This allows for an equitable approach to the matter for all taxpayers.

4. Recommendations

We disagree with the philosophy behind the amendment. The purpose of section 31 is to realign the stated transaction with a transaction that would have hypothetically arisen had the pricing been truly at arm's length. The secondary adjustment simply flows as a further shift to put the parties back in the original arm's length position. No reason exists to treat the secondary adjustment any worse than the first.

If the concept of a penalty does indeed prevail, we suggest that an actual special penalty be imposed rather than a penalty dividend, which seems to have a cumulative impact when all other provisions are taken into account. The penalty dividend also appears to have a greater double tax consequences when other countries are taken into account.

B. REVERSING EXCHANGE DIFFERENCES FOR EXCHANGE ITEMS DISPOSED OF AT A LOSS

1. Treasury proposal

In terms of a 2017 amendment, foreign exchange gains and losses in respect of the portion of an exchange item that has become bad is reversed. It is now proposed that foreign exchange gains and losses on exchange items disposed of at a loss by reason of a decline in the market value of that exchange item should also be reversed.

2. Comment

The proposed amendment to section 24I(4) of the Act to cater for situations where exchange differences are realised on the disposal of certain exchange items is welcomed. We do, however, believe that wording of the proposed amendment is problematic in the following sense:

- the use of the phrase "upon final realisation" before the words "the debt has become irrecoverable whether by reason of becoming bad or as a result …" creates the impression that section 24I(4) of the Act would subsequent to the proposed amendment only apply to irrecoverable debts triggered on a realisation event. The term 'realised' is defined in section 24I(1) and includes the payment, settlement and disposal of an exchange item. The latter does not cover a unilateral decision such as a write-down of debt, an impairment etc.

The matter can be addressed as follows:

"(4) Subject to section 11, in determining the taxable income of any person contemplated in subsection (2) in respect of a debt owing to that person as referred to in paragraph (b) of the definition of exchange item, to the extent that the debt has become irrecoverable, whether—

(a) by reason of the debt becoming bad; or
(b) as a result of the decline in the market value of that exchange item as determined on the date of realisation of that exchange item,

in which case,

(a) the amount of any foreign exchange gain, …."

C. RULES ADDRESSING THE USE OF TRUSTS TO DEFER TAX OR RECHARACTERISE THE NATURE OF INCOME

1. Treasury proposal

In order to close the loophole in the current legislation regarding the use of foreign trusts to defer tax or recharacterise the nature of income in respect of foreign companies held by the trusts, the following amendments are proposed (provided than more than 50 per cent participation or voting rights in the foreign company are directly or indirectly held by the resident) namely that:

- the participation exemption be disregarded in respect of foreign dividends for purposes of income inclusion in the hands of the resident donor or beneficiary as the case may be
- the participation exemption in respect of capital gains derived from the sale of shares be disregarded for purposes of attribution of the capital gain to the resident donor or beneficiary as the case may be

2. Comment

We have the following technical comments:

1. In the proposed section 7(8)(aA)(i)(aa) the test is whether the participation rights are held by that person or by any one or more connected persons. If the offshore trust held 30% and a beneficiary held 25%, the requirement of more than 50% would not be met. Consequently, where it states "by that person or by any one or more persons …", it should rather read "by that person alone or together with any one or more persons …".

2. At the end of item (aa) the word "and" should be added.

3. With regard to the effective dates, it is noted that retrospectivity is avoided by the new provisions applying only to amounts received or gains made on or after 1 March 2019. The exception, however, is in relation to section 25B, where clause 46(2) of the TLAB states that the amendment comes into operation on 1 March 2019 and applies in respect of any year of assessment commencing on or after that date. What it should refer to is any dividend received or accrued in any year of assessment commencing on or after that date.