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The National Treasury

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The South African Revenue Service

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RE: ANNEXURE C FOR 2017 BUDGET: COMMENTS PERTAINING TO BUSINESS TAX ISSUES

We have attached the comments from the SAIT Business Tax Work Group on the Annexure C tax proposals for the 2017 Budget 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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on behalf of

Business Tax Work Group

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BUSINESS TAX

1. REQUEST THAT PROPOSED AMENDMENTS TO SECTIONS 8E AND S8EA NOT BE RETROSPECTIVE (technical correction from 2016)

Problem Statement

It is proposed in the 2016 Taxation Laws Amendment Bill **(TLAB)** that amendments be made in the definitions of “hybrid equity instrument” in section 8E as well as “preference share” in section 8EA of the Income Tax Act (the Act) to include any right or interest where the value of that right or interest is directly or indirectly determined with reference to an underlying share with certain debt-like characteristics.

The amendments to sections will apply with effect from any year of assessment *ending* on or after 1 January 2017. This may mean that taxpayers with year-ends other than December will be affected retrospectively when the legislation is promulgated.

Proposed Solution

We recommend that the amendment should rather apply with effect from any year of assessment *commencing* on or after 1 January 2017 so that it will not have a retrospective effect.

2. ALIGNMENT OF SECTION 19 OF THE ACT AND PARAGRAPH 12A OF THE EIGHTH SCHEDULE

Problem Statement

We request that section 19 of the Act be amended to provide similar relief as that of paragraph 12A of the Eighth Schedule, specifically in light of the business rescue principles of the Companies Act. Subject to certain provisos, paragraph 12A provides relief in respect of the reduction of debt in respect of loans between companies forming part of the same group of companies. No adverse tax consequences will arise on the waiver of debt between companies that form part of the same group of companies or companies that are placed in liquidation / deregistration to the extent that the borrowed funds were used to directly or indirectly fund capital expenditure in terms of paragraph 12A(6)(d) and (e). However, no similar relief is available in section 19.

It often happens that long existing loans are reflected in dormant group companies with no underlying information as to how the loans arose and how the loan funding was utilised. If the loan funding was used to fund capital assets the group relief of paragraph 12A above could potentially apply, but if this information is not available the debtor company would be subject to tax on the debt reduction as explained above.

The exclusion of these provisions from section 19(8) results in adverse tax consequences for group companies and companies placed in liquidation or deregistration to the extent that the borrowed funds were used to fund revenue or operating expenditure. Therefore, debt reductions for companies that used their borrowed funds for capital expenditure in a group company or liquidation or deregistration context are in a better position than those in the same position but where funds were used for revenue purposes.

The exclusion of provisions equivalent to paragraph 12A(6)(d) and (e) provisions from section 19(8) has a direct financial impact and adverse tax consequences for group companies and companies that are in liquidation and/or deregistration where the borrowed funds were used for revenue or operating expenditure.

Proposed solution

It is recommended that the same exclusion rules provided for in paragraph 12A(6)(d) and (e) be inserted and included in the section 19(8) provisions (i.e. companies forming part of the same group and debt reduced in the course of or in anticipation of liquidation, winding-up, deregistration or final termination or existence of that company) so that the tax treatment is identical under both sections.

3. REGIME FOR START-UP VENTURE CAPITAL COMPANIES (VCC)

Problem Statement

The current design of the venture capital company regime contained in section 12J, does not enable venture capital companies to attract investors as intended. Of the 42 venture capital companies which had been approved by SARS by October 2016, we understand only a few are operating as intended.

Many of the venture capital companies are not able to raise the funds required by their funding models and have only attracted limited funds, if any.

A significant reason why the venture capital companies are struggling to attract investors is because it is often tax inefficient for an individual to invest in qualifying company shares through a venture capital company. This is the case because the venture capital company will suffer capital gains tax on the disposal of its shares in the qualifying company and the individual will suffer dividends withholding tax on the dividends distributed by the venture capital company. The effective tax rate on the growth in the value of the investment will be 34%. If the individual invests directly in shares it would only suffer capital gains tax and the effective tax rate on the growth in the value of the investment will be a maximum of 16.4% (based on the individual marginal tax rate of 41%).

The upfront deduction of the amount invested in the venture capital company may seem like an attractive tax incentive for investors in venture capital companies. However, venture capital investors expect a return of more than 30% per annum given the risk attached to these investments. At growth rates higher that 19%, an investor would be better off investing directly into the underlying investments as the adverse impact of the higher effective tax rate on the growth in the value in the investment will negate the benefit of the upfront tax deduction.

Proposed Solution

We recommend that the venture capital regime should be reviewed and redesigned so that it will achieve its objectives. The multiple levels of taxation should be addressed, possibly by exempting the venture capital companies from capital gains tax on the disposal of their investments in qualifying shares or by introducing fiscally transparent vehicles. The elimination of multiple levels of tax is probably more important than the upfront deduction.

4. VENTURE CAPITAL COMPANIES (VCC'S) – S12J (INCORRECT REFERENCE)

Problem Statement

It is required that a "venture capital share" ("**VCS**") and a "qualifying share" must:

- Constitute an "equity share" as defined in section 1(1)
- Not be a share "… *which would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in* ***paragraph (a)*** *of the definition of 'hybrid equity instrument' in that section*"

If one thus reads this definition with the requirements for a qualifying share (or VCS), there is a clear anomaly as a qualifying share must be an "equity share" but paragraph (a) deals specifically with shares 'other than equity shares'. This appears to be an incorrect reference which should rather refer to **paragraph (b)** of the definition of hybrid equity instrument.

Proposed solution

We propose a technical correction.

5. CAPITAL ALLOWANCES ON ROADS AND FENCES RELATED TO COMMERCIAL BUILDINGS AND BULIDINGS USED IN THE PROCESS OF MANUFACTURE

Problem Statement

The Act provides capital allowances for certain capital expenditure for manufacturing and commercial buildings (section 13 and section 13*quin*) as well as plant and equipment (sections 11(e), 12B, 12C amongst others). Based on the current interpretation applied by SARS It appears that there are a number of property improvement items, including roads, paving and fences, that do not qualify for a deduction. This may be because the wording in sections 13 and 13*quin i*s restrictive as it refers to buildings only. This is then interpreted by SARS as requiring the structure to have a roof or walls.

Items like roads, paving and fences are generally improvements to property that are required by taxpayers to optimise the use of other assets that may specifically qualify for deductions e.g. buildings as well as plant and equipment. By not allowing a deduction for these type of improvements, taxpayers are penalised for costs incurred that do not have an unlimited life, but is essential to the business.

Proposed solution

We request that the legislation be extended to apply to extend the capital allowances for items like roads, paving and fences or that an additional allowance such as the section 12U allowance proposed in the TLAB for roads and fences in the production of renewable energy be introduced.

6. NON-AVAILABILITY OF SECTION 11(0) ON SCRAPPING OF TELECOMMUNICATION LINES (S12D ASSETS)

Problem statement

Lines and cables used for the transmission of telecommunications qualify for capital allowances over 15 years in terms of section 12D. However, due to the significant extent of damage and theft to these lines, they often have to be replaced much sooner. These lines are sometimes also scrapped and replaced due to changes in technology. However, these assets have not been included in the assets that qualify for scrapping allowances in terms of section 11(o). We suggest that all depreciable assets should be treated similarly and qualify for scrapping allowances.

Proposed solution

We propose that the assets covered by the scrapping allowance provisions should be extended to aligned them with the capital allowance provisions. We also question the 15-year useful life under section 12D as for transmission lines it is often 10 years or less because of technological obsolescence.

7. SUBMISSION ON SECTION 24BA OF THE ACT

Problem Statement

According to the Explanatory Memorandum, when section 24BA was introduced, the essential purpose of the section was to add to the arsenal a further weapon against value-shifting. It is also clear from the Explanatory Memorandum that the motivation was to attack the so-called share mismatches where there were tax considerations at play.

For a start, the section, as its hypothesis, uses most unfortunate wording in that the benchmark is where the consideration is different from the consideration that would have applied had the asset been acquired in exchange for shares in terms of a transaction between independent persons dealing at arm's length. This implies that the persons were not dealing at arm's length. However, even where the parties were dealing at arm's length, they have to be tested as to whether they were dealing at arm's length. This is an impossible task, because they were dealing at arm's length in the first place. This problem is compounded by the requirement that the consideration must be considered "before taking into account any other transaction, operation, scheme … that directly or indirectly affects that consideration". This is entirely uncommercial. In many business transactions, the consideration will, indeed, be directly affected by other issues at hand, and simply because, in a purely commercial context, some other transaction has influenced the consideration, suddenly section 24BA rears its head, even though all of the terms are at arm's length.

It is understandable that section 24BA was introduced in order to plug shortcomings in the value-shifting rules. But it has been cast in such wide terms, that it is hitting at normal, arm's length and purely business-like transactions, and has unintended tax consequences.

And it must be remembered that this is not something that happens in isolation. Every time that a company "pays" for an asset by issuing its shares, the prospect of adverse tax consequences under section 24BA arises. And this occurs every time an asset-for-share transaction under section 42, or an amalgamation transaction under section 44, of the Act, is undertaken, where there is not a single party or only a group company involved (so that the carve-out in section 24BA does not apply).

Proposed Solution

The section needs to be redrafted in a manner which targets more precisely the mischief at which it is aimed. Currently it has the potential of taxing innocent transactions (in fact this is more than mere potential, as it has already arisen in at least one adverse ruling issued by SARS).

8. LIMIT ON DEBT OWED TO EXEMPT PERSONS (SECTION 23M) – LEVEL OF CONTROL

Problem Statement

Section 23M limits deductions when interest payments are made to exempt creditors. The purpose of this anti-avoidance rule is to prevent excessive deductions in terms of shareholders who are economically indifferent as to whether instruments held are shares or debt because the nature of the instruments can be changed at will due to the shareholder’s level of control. In the base case of concern, a sole shareholder of a company can choose debt or shareholder loans without consequence (and can effectively change the nature of the instruments without economic consequence).

At issue is the level of the ownership test for section 23M. A 50 per cent level is completely insufficient to exercise the kind of control necessary for an exempt party to be indifferent as to whether the interests are shares or debt. A 50 per cent shareholder simply cannot choose and reconfigure these interests in isolation from other shareholders (i.e. lacks the unilateral control to be indifferent as to whether the instrument is a share or debt).

Real Estate Investment Trusts (REIT's) often obtain debt funding from local pension funds that could also hold 50% or more of the equity shares in the REIT. Given that immovable property is financed by the REIT, s23M would often apply to limit the interest deductibility in the REIT. The REIT will likely then have to pay tax which would reduce its cash flow and its ability to make sufficient "qualifying distributions" to reduce its tax liability to zero as intended in terms of its flow-through nature. This would result in economic double tax as the taxable dividend of the REIT will partially be paid out of after-tax profits.

Proposed solution

Minimum request: The 50 per cent threshold should at least be changed to a "more than" 50% level as a demonstration of control. This change would match the international standard of other EBITDA cross-border limitation rules. Even our CFC regime requires more than 50% shareholding for control. *Note:* We again repeat that this test remains a significant challenge for mining companies because companies with mining rights are required to have a minimum 26 per cent minority due to the BEE empowerment codes imposed by the Department of Minerals and Energy. In order to make these rights more affordable, debt is often held by the majority mining company (with preference shares not being an option given their risk to the required BEE percentages). Relief again should be considered in this regard.

9. REIT BORROWINGS

Problem Statement

Investors often acquire REIT units with partially borrowed funds. Banks may lend up to 50% of the value of REIT interests. Investors borrow half and use 50% of their own cash for REIT units. The question is whether the interest can be deducted. Although REITs generate taxable income, section 11(a) arguably does not apply because the units are not a trade. In the days of PUTs (pre-REITs) with dual debenture units, the taxpayers could deduct the interest because of a ruling allowing interest deductions on back-to-back loans (even if the holder lacked a trade).

Proposed Solution

A REIT unit needs to be deemed a trade.

10. REIT – INTERPLAY BETWEEN SECTION 42 AND SECTION 25BB

Allowance assets

Section 42 of the Act provides for the tax neutral transfer of assets in exchange for the issue of equity shares. Section 42(3)(a) provides for the deferral of any recoupments in respect of allowance assets as defined in section 41 provided the seller held the asset as an allowance asset and the purchaser acquires the asset as an allowance asset.

An allowance asset is defined in section 41(1) of the Act to mean:

(a) *A capital asset in respect of which a deduction or allowance is allowable in terms of the Act for purposes other than the determination of any capital gain or capital loss; or*

(b) *Any debt contemplated in section (11(i) or (j).*

It is questionable whether an allowance asset acquired by a REIT remains an allowance asset as the REIT regime does not allow any capital allowances.

The denial of capital allowances under s25BB should not preclude the roll-over relief from applying to enable the tax neutral transfer of properties to REITS.

11. INTERPLAY BETWEEN SECTION 42 AND VESTING TRUST (TECHNICAL CORRECTION)

Section 42(8A)(b)(i) provides that section 42 will not apply to the disposal of any asset by a person to a company if the disposal would not be taken into account for purposes of determining any taxable income or assessed loss of that person. There are three kinds of trusts namely a discretionary, bewind or vesting trusts that could be involved in asset for share transactions. Anomalously, it appears that a vesting trust may not benefit from the section 42 roll-over relief whereas a discretionary or bewind trust would be in a position to benefit.

Trust deeds of vested trusts often provide for a vested right in and to net capital gains or other income. Given this, there is a risk that section 42 may not apply as the disposal would not be taken into account in the taxable income of the trust as in terms of section 25B(1) and (2) of the Act, such income would be deemed to be included in the income of the beneficiary once vested.

Proposed solution

This could not have been the intention of the legislature and we request that the application of roll-over relief in relation to vested trusts is clarified and confirmed.

12. DEFINITION OF IMMOVABLE PROPERTY FOR REIT LEGISLATION

Problem Statement

The definition of “immovable property” for the REIT legislation should include infrastructure assets such as, but not limited to, wind turbines, cellphone towers and solar panels. There has been a shift in the industry for users of infrastructure assets such that the users of infrastructure assets move from owing the assets to leasing the assets. Essentially, companies that own the infrastructure assets operate on the same business model as other REITs that own and lease shopping malls, office buildings etc. in that they own the assets and earn rental income on the assets. The only difference is the type of assets that the companies own, hence, we propose that the infrastructure assets be specifically included in the definition of "immovable property".

Proposed Solution

The term "immovable property" should be clearly defined for the REIT legislation in section 25BB. In this regard, we propose that the definition of immovable property must include a non-exhaustive list of items which will be included in "immovable property". We do not think that our proposal will be detrimental to SARS, in fact we believe that this will open up the REIT industry.

13. DIVIDEND WITHHOLDING TAX – SECTION 64M REFUNDS TO REGULATED INTERMEDIARIES

Problem Statement

Where a company is required to refund Dividend Withholding Tax **(DWT)**, section 64L of the Act provides for a one year period within which the company is required to source the refund from DWT from further dividends declared where after the company can look to SARS for the refund. However, under section 64M of the Act, regulated intermediaries have no recourse to SARS and must fund the refund out of DWT payable on future dividends.

The absence of any recourse to SARS can be problematic where the expected DWT on future dividends is insufficient to cover the refund, especially in an economic decline. We understand that it is SARS practice to allow the regulated intermediary to claim a refund from SARS in these circumstances.

Proposed Solution

Section 64M should be amended to allow for a refund to be claimed directly from SARS in circumstances where the refund exceeds the next DWT payment due by that regulated intermediary to SARS. This would align with informal SARS practice.

14. DIVIDEND WITHHOLDING TAX – TIMING OF REFUNDS

Problem Statement

Section 64L and 64M of the Act allows a beneficial owner who qualifies for exemption or treaty relief under section 64F and who has not timeously supplied the requisite dividend declaration or undertaking prior to the payment of the dividend, with a three-year period within which to submit the documentation and receive a refund of the DWT withheld.

This three-year period places a significant administrative burden on the companies / regulated intermediaries who are required to process these refunds, particularly where the volume of dividends and beneficial owners is high. Refunds, regardless of when during the three-year period they are claimed, require the company / regulated intermediary to record the refund in the underlying data which was submitted as part of the DWT reporting and having to amend the DWT return submitted in respect of the particular dividend. Where the company / regulated intermediary is dealing with multiple beneficial owners, the DWT return may need to be revisited on multiple occasions over the three-year period.

Proposed Solution

It is proposed that National Treasury engage with business and in particular the regulated intermediaries in order to identify a viable solution to the practical challenges encountered.

15. SHORT-TERM DISPOSALS AND ACQUISITIONS OF IDENTICAL FINANCIAL INSTRUMENTS

Problem Statement

The anti-avoidance rule contained in paragraph 42 of the 8th Schedule defers capital losses realised on the short-term disposal and acquisition of identical financial instruments by adding these losses to the base cost of the financial instrument acquired by the same person or connected person to that person within 45 days. It has a very wide ambit as it often applies to connected companies in the financial services industry that operate independently and may even be separately listed. It may be triggered inadvertently and have an unfair result for outside shareholders as the seller will not get the capital loss whereas the purchaser will benefit from the increased base cost. Furthermore, in the listed environment sharing information that is not in the public domain may be in contravention of regulatory rules.

Proposed Solution

We propose that the 45day anti-avoidance CGT rule should be narrowed to group companies as opposed to connected persons or, alternatively exclude listed who are not part of the same group.

16. PROPOSAL THAT 20% PENALTY FOR UNDERPAYMENT OF PROVISIONAL TAX SHOULD NOT APPLY TO FINAL ESTIMATE

Problem Statement

Previously, the 20% penalty for underpayment of provisional tax as a result of underestimation of provisional tax did not apply in relation to any final or last estimate, if the Commissioner had in terms of paragraph 19(3) of the Fourth Schedule increased such final or last estimate. The penalty now also applies where the Commissioner has increased such final or last estimate in terms of paragraph 19(3). The application of such penalty creates unnecessary risks for industry. Companies may inadvertently underestimate their provisional tax based on provisional results, in which instance they will suffer a harsh penalty.

Proposed Solution

We propose that taxpayers should be given an opportunity to rectify such underestimate through the paragraph 19(3) process. The Commissioner will not be prejudiced in the process, as the paragraph 19(3) process is normally completed shortly after the year-end results are available.

17. QUALIFYING INTEREST THRESHOLD IN SECTION 42

Problem Statement

It is not uncommon in the context of unlisted companies to have shareholders who hold less than 10% of the equity shares in the company. Where the company is the subject of an acquisition transaction or restructure, these shares could be the subject of a share-for-share transaction. Where the shareholder remains invested in the new entity and no value shifting has occurred there should be no principle reason why shareholder A who holds, say, 9% of the equity shares should be treated differently to shareholder B who holds 11%. The qualifying interest threshold of 10% for unlisted companies will however result in significant differences in the tax treatment of the two shareholders as shareholder A will be subject to tax on the share-for-share transaction on the date of the disposal and cannot defer the tax. Where shareholder A has insufficient funds to settle the tax liability, they may be required to dispose of part of the shareholding and their economic interest in the new company would be proportionally lower as a result.

It is not clear why unlisted companies are treated differently from unlisted companies.

Proposed Solution

We submit that the qualifying interest requirement in section 42 is unnecessary given the anti-avoidance provisions contained in section 24BA. We recommend that in the context of share-for-share transactions, the provision should merely require that the taxpayer hold an equity share in the company acquiring the asset.