24 November 2017

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The South African Revenue Service
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BY EMAIL: Nombasa Langeni (Nombasa.Langeni@treasury.gov.za)
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RE: ANNEXURE C FOR 2018 BUDGET: INTERNATIONAL TAX

We have attached the comments from the SAIT International Tax Technical Work Group on the draft Taxation Laws Amendment Bill pertaining to key International 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

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ANNEXURE C FOR 2018 BUDGET: INTERNATIONAL TAX

Page No

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ANNEXURE C FOR 2018 BUDGET: INTERNATIONAL TAX

1. DEFINITION OF RESIDENT

Legal nature of the problem

The revised interpretation of the place of effective management as set out in Issue 2 of Interpretation Note 6 "Resident - Place of Effective Management (Companies)" ("the Interpretation Note"), results in a number of subsidiaries typically located in Africa having to be registered as tax residents in South Africa.

Factual description of the relevant transaction

The Interpretation Note provides that the place where the "key management and commercial decisions" of a company are made will be a key factor in determining where that company is effectively managed.

Based on our experience, the day-to-day operational management of subsidiaries of large multi-national groups based in Africa will be carried out in the subsidiaries jurisdiction of establishment. However, due to reporting functions and risk procedures typically being based in South Africa, the key management and strategic and commercial decisions relating to these subsidiary entities generally take place in South Africa.

Many African-based subsidiaries are currently at risk of being effectively managed in South Africa, giving rise to such entities having to be registered as taxpayers in South Africa together with the filing of tax return and other compliance obligations.

We note that the tax rates in Africa are generally higher than in South Africa, and consequently, there will be no additional tax being collected in South Africa. The African entities will therefore continually be in a rebate position.

In light of this, we suggest that the compliance burden of these companies be relieved to ensure that, where there is no possibility of additional tax revenue being generated in South Africa, there is no unnecessary additional administrative and compliance burdens created. This could be achieved, for example, by re-introducing the high-tax "exclusion" from the "resident" definition in Section 1 of the Act to counteract the implications of the new place of effective management interpretation note. Alternatively, a specific measure could be introduced where the subsidiary is located on the African continent.

Nature of the businesses impacted by the problem

Multinational groups with subsidiaries in Africa.

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

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. It 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 normally 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.

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 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 2017 was 1.24333%. 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 3.24333%.

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.

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.

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.

3. SECTION 9D OF THE ACT – FUNCTIONAL CURRENCY

Legal nature of the problem

Where a South African holding company provides a South African Rand denominated loan to a controlled foreign company ("CFC") which has a functional currency other than Rand, section 9D of the Act provides no relief from imputation in respect of any foreign exchange differences arising on the conversion of the Rand loan to the functional currency of the CFC. This means that non-economic foreign exchange gains and/or losses will be taxed.

Factual description of the relevant transaction

South African companies regularly provide funds to their CFCs by means of Rand denominated loans. When these Rand denominated loans are translated to the functional currency of the CFC for financial reporting purposes, a foreign exchange difference will arise for both accounting and tax purposes.

Section 9D of the Act does not provide relief for such exchange differences in circumstances where there are cross-border transactions between South African holding companies. Section 9D(9)(fA) of the Act only provides for relief in respect of exchange difference arising from exchange items between fellow CFCs which are within the same group of companies.

On the basis that there is no economic currency exchange difference arising from a South African perspective as the loan remains a Rand loan in the hands of the holding company, we request that Section 9D of the Act be amended to exclude from imputation any exchange differences arising from Rand denominated loans with a South African holding company which is in the same group of companies as the CFC.

Nature of the businesses impacted by the problem

Corporate taxpayers with CFCs.

4. SECTION 9D AND PARAGRAPH 56 OF THE EIGHTH SCHEDULE TO THE ACT – DISCHARGE OF A DEBT BETWEEN A SOUTH AFRICAN RESIDENT PARENT COMPANY AND ITS CONTROLLED FOREIGN COMPANY

Legal nature of the problem

Any recoupment in terms of Section 19 of the Act which arises due to a loan waiver between a resident and its CFC will be attributable to the creditor resident shareholder in terms of section 9D of the Act and taxed in the creditors hands, not the debtor as required in terms of paragraph 56 of the Eighth Schedule to the Act.

This creates uncertainty regarding the applicability of Paragraph 56(2)(c) of the Eighth Schedule to the Act.

Factual description of the relevant transaction

Where loans have been advanced to a CFC by a resident entity, the waiver of such loan may result in a recoupment in terms of Section 19 of the Act.

Paragraph 56(2) of the Eighth Schedule to the Act provides that the creditor may in certain circumstances treat the loan waiver as a capital loss provided the debtor has taken such amount into account in calculating its taxable income.

A recoupment in terms of Section 19 of the Act will be attributable to the creditor resident shareholder according to Section 9D of the Act and taxed in the creditor's hands, not the debtor as required (see Paragraph 56(2)(c) of the Eighth Schedule of the Act).

We request that this anomaly is rectified as it may not have been the intention of the legislature to disallow the creditor to claim the capital loss and simultaneously be taxed on the recoupment under Section 9D of the Act.

We request clarity to be provided in relation to the interplay between Paragraphs 12A and 56 of the Eighth Schedule, and Section 19, in the circumstances outlined above.

Nature of the businesses impacted by the problem

Corporate taxpayers with CFCs.

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5. SECTION 9D AND SECTION 24I – IRRECOVERABLE CROSS-BORDER DEBT

Legal nature of the problem

The introduction of section 24I(4) of the Act provides for relief in respect of foreign exchange gains or losses on debt due to a resident where such foreign denominated debt has gone bad or is irrecoverable. It effectively acknowledges that the foreign exchange gain/loss will never be realized. The section does not deal with the situation where the foreign exchange gain or loss arises in the CFCs hands and is attributed to the resident shareholder creditor.

Factual description of the relevant transaction

Section 24I(4) of the Act cannot apply to the calculation of the CFC's net income as the gains or losses arise in respect of loan payable, not a loan asset as envisaged.

The net result is that the foreign exchange gain will be attributed to the resident creditor and no relief can be claimed by either party. Relief therefore is not available to a resident which has advanced debt to a CFC.

We suggest that a provision be made in Section 24I(4) of the Act to provide for such situations in relation to CFCs.

Nature of the businesses impacted by the problem

Corporate taxpayers with CFCs.

6. SECTION 9D(2A) – INDIVIDUAL'S EFFECTIVE RATE OF TAX ON FOREIGN DIVIDENDS > 20%

Legal nature of the problem

The general principle is that a CFC's net income is determined and an amount equal thereto is deemed to be earned by the shareholders pro rata. Where the shareholders are all companies, the CGT inclusion rates and effective tax rates that apply to the CFC and the shareholders would automatically be aligned. However, where the shareholder is an individual, special trust or insurance company in relation to the individual policyholder fund, an adjustment is necessary to ensure that the shareholder its taxed at the appropriate effective amount. Although there is provision for such an adjustment in relation to the CGT inclusion rates (in proviso (f) to section 9D(2A)) there is not an explicit adjustment in relation to the dividends tax rate.

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Factual description of the relevant transaction

Where the CFC receives a foreign dividend, there is not a proviso requiring the exemption to be calculated using the ratio of 25 to 45 (10 to 30 for the insurer), thereby ensuring that the shareholder, when the CFC rules are applied, will pay tax on that foreign dividend at the appropriate effective rate of 20%.

Instead, in determining the net income of the CFC, the exemption applicable to companies is by default used, being the ratio of 8 to 28. So when a foreign dividend is received by the CFC of, say, R100 the exempt portion, using the ratio of 8 to 28, is R28.57, and the taxable portion is thus R71.43. This amount is then taxable at the rate of 45% in the shareholder's hands, so that the effective rate of tax on the foreign dividend is 32.14%, instead of the 20% it should be.

We suggest that a proviso is made to Section 9D(2A) of the Act to deal with foreign dividends received by a CFC that is attributable to an individual, special trust or insurance company in relation to the individual policyholder fund.

Nature of the businesses impacted by the problem

Where the shareholder of the CFC that receives a foreign dividend is an individual, special trust or insurance company in relation to the individual policyholder fund.

7. SECTION 9D(2) – CFC CAPITAL GAINS NOT SHIELDED BY CAPITAL LOSSES OF SHAREHOLDER

Legal nature of the problem

In terms of section 9D(2) , a proportional amount of the net income of a CFC is included in the income of the resident shareholder/s. The net income of a CFC is equal to the taxable income of that CFC determined as if it is a resident taxpayer. This implies that, where the CFC makes a capital gain, the capital gain will, in terms of section 26A, be pulled into the CFC's ring-fenced taxable income which will then be pulled straight into the income of the resident shareholder/s. Consequently, any capital losses that the resident shareholder might have will not be available to shield the capital gain that the shareholder will, effectively, be subject to tax on. The problem is that the capital loss gets pulled directly into the shareholder's income in stead of forming part of the shareholder's CGT calculation.

We suggest that a CFC's capital gains should be imputed in terms of paragraph 3 of the Eighth Schedule.

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Factual description of the relevant transaction

For example, where a South African holding company holds shares in an African holding company which is a CFC, which in turn holds shares in African subsidiaries and the African holding company sells its shares in one of the African subsidiaries and makes a capital gain.

We suggest that a CFC's capital gains should be imputed in terms of paragraph 3 of the Eighth Schedule.

Nature of the businesses impacted by the problem

Corporate taxpayers with capital losses with CFCs that realise capital gains.

8. SECTION 9D – CFC TREATMENT OF CONSOLIDATED FINANCIAL RESULTS BASED ON IFRS 10 PROXY (TECHNICAL CORRECTION TO 2017 TAXATION LAWS AMENDMENT BILL)

Legal nature of the problem

We acknowledge that Treasury has confirmed that the small typing omission in the substituted definition of "controlled foreign company" will be addressed by the splitting of the definition of parts (a) and (b). Our further comments take this into account.

The new paragraph (b) of the definition of CFC will include: "any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident"

This wording is not totally clear and is open to different interpretations. Although it is not the intention, the wording could be read that an associate that is equity accounted for (i.e. not under IFRS 10 but under IAS 28) could be a CFC. This interpretation could potentially be taken because the associate's results are **reflected** in the consolidated financial statements under IAS 28 even though they are **not consolidated** under IFRS 10. This is not the intention as the IFRS 10 consolidation test is one of control which is a proxy for the requisite level of participation rights required by the CFC rules, i.e. greater than 50%.

Factual description of the relevant transaction

The IFRS 10 criteria for one entity to **consolidate** the results of another into its group financial statements is that the first mentioned entity must control the second one. In simple circumstances, holding a majority of the voting rights of another entity will result in control.

Where a SA Holdco holds a 100% interest in a foreign subsidiary which holds a 30% interest in a foreign company, the foreign subsidiary will be controlled and hence consolidated under IFRS 10. On the other hand, the 30% interest in other foreign company is likely to be classified as an associate for IFRS purposes. It will generally not be consolidated - its results will be **equity accounted in terms of IAS 28** as a single line in the financial statements that shows the investor's share in its profit or losses. Even though this line will ultimately reflect in the group financial statements of SA Holdco, the results of the other foreign company will not be consolidated and therefore the other foreign company should not be a CFC.

The new proviso to s 9D(2) could be interpreted that the imputation should still be based on s 9D-based net income of entities that are **consolidated** (the participation rights will merely be based on the percentage of financial results consolidated). The fact that the profit or loss of the associate appears in the consolidated financial statements of foreign subsidiary should not be sufficient to result in imputation under s 9D. This is in line with the discussions at the Treasury workshop on 19 September 2017.

This interpretation is, however, not totally clear because the reference to IFRS 10 can inadvertently pick up associates because their IAS28 equity accounted results is a financial result which is included in the consolidated financial statements. We suggest that IAS28 equity accounted entities should be specifically excluded from the legislation.

Nature of the businesses impacted by the problem

Corporate taxpayers that prepare consolidated financial statements in which they consolidate subsidiaries in terms of IFRS 10 and also equity account associates in terms of IAS 28.

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