South African Institute of Tax Professionals

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Dear Ms. Mputa and Ms. Collins

RE: ANNEXURE C PROPOSALS 2015

Thank you for the opportunity to contribute proposals for the inclusion in Annexure C of the Budget Review 2015.

Set out below, is the consolidated commentary on **International Tax matters only**, developed from both an internal review of the provisions as well as from consultations with members, stakeholders and industry. The commentary reflects the collective view of members, stakeholders and industry role players consulted.

1. INTERNATIONAL TAX MATTERS

1.1. Corporate migration – Paragraph 11(2)(b) of the Eighth Schedule

<u>Problem statement</u>

The exclusion to paragraph 11(2)(b) of the Eighth Schedule to the Income Tax Act (No. 58 of 1962) ("ITA") was inserted by section 126(1)(c) of the Taxation Laws Amendment Act, 2013 with effect from 1 April 2014. The exclusion, according to the Explanatory Memorandum at paragraph 5.10, seeks to prevent roll over relief from applying to outbound restructuring which shifts value to a lower level of South African taxing jurisdiction (i.e. moves outside SA tax net or from direct to indirect position within SA tax net).

The transaction which created the most concern was a cross issue of shares between a foreign company and a SA resident company which resulted in the foreign company obtaining control of the SA company without any tax resulting from the transaction. The proposal was then to insert the exclusion to result in a disposal if the issue of shares is in exchange for foreign shares, both directly and indirectly.

The exclusion states:

"…other than a share, option or certificate issued to any person by a company that is a resident in exchange, directly or indirectly, for shares in a foreign company."

In effect, any transaction whereby the issue of shares by a SA resident company is connected to the subsequent acquisition, by issue or transfer, of foreign shares will result in the SA issuing company disposing of the shares issued for capital gain tax purposes. The wording in the exclusion in paragraph 11(2)(b) is therefore substantially wider than a direct or indirect cross issue of shares where the majority control is transferred offshore for a minority interest in the SA issuing resident or where capital gains tax is postponed or avoided.

This overly broad exclusion is problematic as it now triggers tax merely for acquiring foreign shares by issuing local shares, irrespective of whether the motive is to avoid any taxation or not.

For example:

> SA HoldCo wants to restructure by putting its 100 per cent owned foreign sub A under its 100 per cent held SA sub B. Sub B issues shares to HoldCo in exchange for the shares in sub A. The issue of the shares by sub B is now a taxable event without migrating the control offshore or for avoiding future taxes.
>
> The same applies to any foreign company wanting to transfer its current foreign subsidiaries into a SA based Headquarter company. This now triggers tax for the Headquarter company notwithstanding that ultimate control has remained foreign.

This provision, in its current form, will apply to any foreign share acquisition by a SA resident company that is financed off a share issue, even if the SA Company is merely obtaining a minority interest in the foreign company or whether only minority share rights are issued to the foreign seller.

Proposed solution / recommendation

The exclusion to paragraph 11(2)(b) should be withdrawn until such time as National Treasury has been able to clarify the exact scope of this provision and the mischief it is trying to prevent.

Alternatively, the exclusion should be expressly limited to what the stated mischief was, namely migrating control over a SA company to a foreign company which together with the migration results in SA's taxing rights being lost in respect of the issuer or tax flows being lost when the before and after transaction positions in respect of the SA issuer are compared. This includes limiting the provision to cover only directly acquired foreign shares through a cross issue and not through a cash purchase.

1.2. Section 31 – Capital contribution between subsidiaries

Problem statement

Section 31(3) of the ITA is to be amended by section 50(1) of the Taxation Laws Amendment Bill, 2014 whereby the adjusted difference is deemed to be a dividend *in specie* paid by the resident company. Paragraph (a) of the definition of "affected transaction" sets out various connected person relationships to which the provisions of section 31 will apply. This includes paragraph (a)(iii) as applicable between a resident connected to any other resident that has a permanent establishment outside South Africa to which the transaction relates and paragraph (a)(i) between a resident and a non-resident.

Where value is transferred between connected persons not acting on an arm's length basis, the conceptual framework that value is transferred by a shareholder to a subsidiary company is problematic as conceptually, dividends only flow from a subsidiary to a shareholder (or connected person in relation to the shareholder).

For example:

> If SA HoldCo A undercharges its non-resident CFC, then the transfer of value from the shareholder to the Hold Co will be treated as a dividend *in specie* for the HoldCo. The same would apply if HoldCo does the same with the foreign permanent establishment of its SA subsidiary.

Proposed solution / recommendation

The transfer of value in terms of an affected transaction not at arms-length between a shareholder and its subsidiary should constitute a capital contribution or be excluded from the ambit of "affected transaction" as it results in a legal anomaly of "downward" dividends.

1.3. Section 31 – timing of affected transaction

Problem statement

Section 31(3) of the ITA is to be amended by section 50(1) of the Taxation Laws Amendment Bill, 2014 whereby the adjusted difference is deemed to be a dividend *in specie* paid by the resident company on the last day of the six months following the year of assessment in respect of which the adjustment is made.

It is, however, unclear whether the determination of "affected transaction" has to be made on that date, the date of transaction or the date of the last day of the year of assessment as no timing provision exists as to when the affected transaction test must be applied. Section 31(3)(b) states that the difference is the amount that would, but for (2) (i.e. the transfer pricing adjustment) have been applied in the calculation of the taxable income. It is submitted that this, though a hypothetical question, constitutes a test that can only be applied at the end of the year of assessment. It is therefore submitted that only differences existing at the end of the year of assessment should be reflected and that pricing adjustments made in terms of the agreement to reflect arms-length should be included in the determination of the difference. The hypothetical test should therefore not be applied at the time of the transaction as this is not the amount *that would, but for subsection (2), have applied in the calculation of taxable income.*

Proposed solution / recommendation

It is proposed that section 31(3)(b) be clarified that the timing of the determination for the purposes of "affected transaction" and of the difference, that is to be the dividend paid six months after year end, must be determined at the year end of the taxpayer.

1.4. Section 23M/s31 interrelationship

Problem statement

National Treasury's draft response document to the public comments on the interrelationship between section 23M of the ITA and section 31 of the ITA (pg. 15, issued on 15 October 2014) states the following:

> *Response: Noted. The purpose of section 31 is to ensure that if cross-border transactions, such as debt financing, are entered into by connected persons, they must be treated (for tax purposes) as if the amount lent and the interest rate charged between the parties are equivalent to that between two independent parties, i.e. the arm's length principle. In essence, section 31 seeks to correct mispricing due to the terms and conditions of the transaction. The excessive interest limitation has a broader objective. By limiting the amount of interest deductible, it discourages companies from excessive leveraging, which is often done because the tax system inherently encourages debt over equity financing…….."*

Therefore, section 31 does not just deal with the rate at which money is lent but also the quantum of such amount i.e. it also discourages excessive leveraging. Thus, even where the interest rate on the debt is at arms-length, if the quantum of the loan is not then the overextended loan should be treated as an amount equal to an arms-length debt, which will also directly reduce the arms-length interest chargeable as this interest rate now only applies to the lesser financial assistance given. This raises the question of whether section 31 is to be first applied to the loan amount and the actual arms-length interest is then thereafter subject to section 23M or is the loan and interest adjusted in terms of section 31 and then the adjusted interest is made subject to section 23M?

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Furthermore, it is unclear from a policy perspective, why the interest allowable in terms of section 23M should not represent the minimum interest deductible by the taxpayer irrespective of the relevant leverage applicable.

Proposed solution / recommendation

It is submitted that, contrary to the statements in the response document, the interrelationship between section 31 and section 23M remains unclear, especially where excessive leverage and not pricing is the matter to be corrected. It is submitted that this interrelationship should be clarified.

Furthermore, section 23M should represent a safe harbour as to the minimum quantum of interest deductible, thus notwithstanding the adjustments to be made in terms of section 31.

This proposed safe harbour and/or timing rule for section 31 could, as an alternative to a legislative amendment, be contained in an interpretation note to provide some guidance and comfort to taxpayers.

Should you have any enquiries or wish to discuss the submissions made please do not hesitate to contact me.

Yours sincerely

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