South African
Institute of
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RE: DRAFT TAXATION LAWS AMENDMENT BILL (TLAB), 2015: COMMENTS PERTAINING TO KEY BUSINESS TAX ISSUES

Attached are the comments associated with the draft Taxation Laws Amendment Bill pertaining to key business tax issues from the SAIT Business Tax Committee. We appreciate the opportunity to participate in the process and have been informed of the National Treasury workshop occurring on 2 September 2015.

We would welcome further dialogue so do not hesitate to contact us should you need further information.

Yours sincerely,

Dawid van den Berg

Chair of the Business Tax Committee

../2

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A. REVISED FORMULATION OF THE THREE-YEAR CAPITAL DEEMING RULE (SECTION 9C)

1. Summary of the draft proposal

The amendment explicitly seeks to ensure that return of capital distributions in respect of shares are deemed to be of a capital nature once shares are held for three years or more. The amendment also seems to be seeking to eliminate potential interest deductions in respect of shares held after three-years.

2. Committee concerns

The Committee questions the need for the amendment given that the tax issues raised appear to be more theoretical than real. In the main, section 9C mostly provides taxpayers with absolute certainty that shares held for three years or more are of a capital nature – a position that most will take in any event based on a facts-and-circumstances analysis.

As a practical matter, section 9C appears to have meaningful impact only in two settings. In the main, some share dealers may hold shares for three years or more that could arguably be viewed as ordinary in nature under the case law. These holders could conceivably receive the occasional incidental return of capital distribution and may incur some interest on debt acquired for shares. The second setting would entail private equity / joint venture arrangements that have external commitments to investors to sell subsidiary shares after a set period (usually 5-to-10 years). This latter group presumably has the power to choose whether a distribution is capital or a dividend. Any interest arising from the subsidiary shares presumably arise at the asset level via a section 45 push-down structure or at the share-level via section 24O transaction (the latter of which would occur only in a minority of cases). Therefore, the amendments should be as simple and clean as possible given the limited practical relevance of the change.

3. Committee suggestions

- Weak integration of the revised charging provision of subsection (2) and the "qualifying share" definition

The concern raised is only of a technical nature because the charging provision under subsection (2) and "qualifying share" definition is no longer linked. More specifically, the term "qualifying share" has been removed from the charging provision of subsection (2) but remains core to other parts of section 9C (subsections (2), (3) and (3)).

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Rather than adjusting the core rules of subsection (2) and the "qualifying share" definition, we would suggest a separate special provision as follows:

"(2C) Any return of capital received or accrued, or any expenditure incurred, in respect of an equity share held for a period of at least three years must be deemed to be of a capital nature."

➢ Clarification of effective date

In terms of the effective date, this amendment should then apply in respect of "a return capital received or accrued, or any expenditure incurred, on or after 1 January 2016. The proposed effective date is too open-ended.

➢ New definition of "disposal"

The new definition of disposal also creates confusion because the definition must include its ordinary meaning under the main act (as well as the 8th Schedule). The goal is to treat a disposal under the main act as a capital gain disposal under the 8th Schedule. Therefore, the 8th Schedule definition should not be the starting point; the main act should be the starting point instead.

We would accordingly suggest that the proposed definition be adjusted as follows: "disposal includes a disposal as defined under the Eighth Schedule." Given that the term disposal carries its otherwise ordinary meaning under the main act, one would then not need to refer to deemed disposals of section 9H and 9HA.

B. DEBT-FINANCED ACQUISITIONS OF CONTROLLING SHARE INTERESTS (SECTION 24O)

1. Summary of draft bill proposal

Section 24O allows an acquiring company to deduct the interest on borrowed funds used to acquire a controlling share participation in an operating target company even though shares are not "income" producing assets. Section 24O sought to replicate many aspect of pre-existing section 45 push-down structures.

Of apparent concern to National Treasury and SARS is the potential use of section 24O to obtain interest deductions in respect of debt used to acquire non-operating companies and non-controlling share interests. The proposed bill accordingly seeks a partial look-through approach to ensure that the interest deduction exists only in respect of operating companies (as opposed to other share participations).

../4

2. Committee concerns

The committee has no objection to the underlying policy associated with the amendment, but the proposal appears to be fairly cumbersome. The amendment is effectively seeking a partial look-through (i.e. a shareholding-by-shareholding) approach as opposed to a review of underlying assets. To be fair, this partial look-through does have the benefit of some measure of simplicity, but we question whether the revised section 24O can still be utilised in possible ways that appear abusive.

3. Committee suggestions

- Definition of operating company

The definition of "operating company" should match the definition of "operating company" of section 8EA. More specifically, the definition should have a specific inclusion of exploration companies (which are active but lack income).

- Simplifying measures

The allocation of interest deductions on a subsidiary-by-subsidiary basis can be cumbersome. We would suggest a 25 per cent cut-off either way. Under this approach, if qualifying shares exceed 75 per cent of more of the total, all of the interest deduction should be allowed; on the other hand, if less than 25 per cent of total fail to qualify, no interest deduction should be allowed.

You may also want to provide some relief for acquisitions of smaller business acquisitions given the costs of the valuations required under the new section 24O. Under this approach, company acquirers with a book value not exceeding R50 million would fall outside the provision (see the venture capital definition of section 12J(6A)(b)).

- Post-acquisition changes

It is not clear whether the section 24O interest deduction should automatically change if there is a removal or cessation of target operating companies and are concerned that the additional burden of managing shifting interests makes application of section 24) too risky for future use. Unrelated structural changes bearing on the interest deduction will most undoubtedly become a compliance trap for the unwary.

../5

We doubt whether section 45 debt push-down acquisitions are genuinely the subject of similar limitations under section 11(a) because section 11(a) is mainly an upfront determination only subject to change if there is an overall change in intention – section 11(a) does not have an asset-by-asset approach. However, if National Treasury / SARS are going to proceed along these lines of adjusting for post-acquisition changes in structure, equal positive consideration must be given to the increase in operating companies (not just decreases). We also reiterate the need for the 25 per cent cut-off proposal suggested above to reduce the need for trivial post-acquisition adjustments.

- Does the proposed anti-avoidance measure really achieve its objective?

We believe that section 24O needs to be re-evaluated on two levels. First, the operating company model appears to be overly inclusive and under-inclusive. We separately understand that some schemes exist to place a small level of operating income-producing assets into a target company solely to benefit from section 24O. The proposed amendment fails to limit these schemes. The real question that has to be asked under section 24O is whether the interest incurred to acquire the shares would have qualified for a section 11(a) deduction had the acquiring company directly acquired all of the underlying assets instead. The mechanical approach utilised will always lead to distortions.

We also wonder whether more than 50 per cent voting or value control should always be crucial as the trigger. Sometimes de facto control should be considered, especially in the case of acquisitions of larger share interests in listed companies (and possibly other large public companies). For instance, an acquisition of 20 per cent or more of the shares in a listed target company generally represents a controlling interest, especially when the acquirer becomes the largest shareholder of the listed company.

- Effective date

The effective date of the amendment unclear. We would suggest that the amendment apply to share "acquisitions" occurring on or after 1 January 2016. Acquisitions occurring before 1 January 2016 were contractually priced pursuant to the rules in existence at that time (see also the effective date of section 57 of the 2012 Taxation Laws Amendment Act associated with the introduction of section 24O).

C. DEFINITION OF "HOLD" (SECTION 41(1))

The proposed definition of "hold" should be deleted as meaningless now that all the definitions of shareholder have been removed. The real issue is the underlying meaning of the term "hold". We suggest that the term means "beneficial ownership" as opposed to "record/title" ownership.

This term should accordingly be clarified by way of law (relying on the pre-existing definition of "shareholder" under former section 1 that focused on beneficial ownership) or by way of SARS interpretation note. Reliance on a SARS interpretation note is probably preferred.

../6

D. POST-REORGANISATION DISPOSAL (SECTION 42(5))

1. Summary of draft bill proposal

The proposed amendment seeks to clarify the 18-month anti-avoidance rule of section 42(5). Disposals falling within section 42(5) will no longer be deemed to be "trading stock" but instead will result in an "ordinary revenue" income inclusion.

2. Committee concerns

The amendment fails to address the real issue. The real problem with the language pertains to the confused wording associated with "to the extent" and the "less than or equal market value" formulation. At a conceptual level, the anti-avoidance rule has two aspects – a trigger and a question of amount. The current language seeks to mix the two concepts, thereby causing confusion. The focus on gross receipts and accruals as opposed to "gain" gives rise to even more difficulty.

3. Committee suggestions

By way of background, the purpose of section 42(5) is to prevent the artificial indirect conversion of gain stemming indirectly from trading stock and allowance assets into capital gain. This problem can potentially arise when a taxpayer forms a company with assets mainly consisting of a trading stock and allowance assets, followed by the sale of the shares of the newly formed company shortly after formation. The sale of shares presumably could qualify as "capital"; whereas, the sale of the underlying assets would not. The goal of the provision is to convert capital gain to ordinary revenue but only to the extent of the gain existing at the time of formation.

> Example. Taxpayer transfers trading stock costing R2 million with a value of R5 million to a newly formed company in exchange for the shares. Taxpayer then sells the shares 10 months later in a disposal that is arguably ordinary for R6 million in consideration. The goal is to tax the gain of R3 million as ordinary and ignore the rest.
>
> Problem: The confusion arises around the "to the extent" language and the "less than or equal to market value formulation". Firstly, the "to the extent language" is being used as a trigger (with some arguing that the language means "if"; secondly, the language is focusing on all consideration equal to or less than the initial section 42 transaction date value. Indeed, one could argue that the provision could even force the trigger of an ordinary loss (because a loss sale will always have a value equal to or less than the section 42 market value).

../7

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We would suggest that the language of section 42(5) be changed so that the trigger and outcome are no longer focused on gross proceeds. Instead, the section should add a new trigger so that the provision applies only where the post-section 42(5) disposal occurs at a capital gain. If so, the gain should be treated as ordinary revenue but only to the extent of the gain that would have arisen had the disposal occurred in respect of the same initial formation. Our suggested language is as follows:

> [and where]
>
> "(c) the disposal of any such equity share would otherwise result in gain from the disposal of a capital nature,
>
> that person must treat that gain as an amount includible as gross income but only to that the gain does not exceed the gain that would have otherwise arisen had the equity share had been disposed of at the beginning of that period of 18 months in a disposal that would have been treated as a disposal of a capital nature."

Under this approach utilising the example above, the R3 million of initial gain would be treated as ordinary. The rest of the transaction would be treated as an Eighth Schedule disposal (R5 million consideration less the R2 million ordinary revenue less the R2 million base cost). Again, the trigger must be a gain disposal with only the portion of that gain treated as ordinary revenue (and the remainder staying under the 8th Schedule calculation).

E. CANCELLATION OF CONTRACTS

1. Summary of draft proposal

We understand that the transfer of assets, followed by the cancellation of the contract (including the return of the initial assets to the initial owner) can give rise to an artificial loss. While initial contract and cancellations occurring in the same taxable year are not a significant issue, the main concern stems from cancellations that occur in a taxable year following the initial year of the contract. These different year cancellations seemingly give rise to an artificial loss.

2. Committee concerns / suggestions

The Committee agrees that an initial sale followed by a contract cancellation should be tax neutral regardless of whether the cancellation occurs during the tax year of sale or a later tax year. Although the explanatory memorandum explains the theoretical problem and the theoretical solution, the lack of a numerical example makes it hard to test the amendment (and the validity of the problem) given the variety of provisions involved. We would accordingly suggest a numerical example in the Explanatory Memorandum to track the exact nature of the amendments. The heart of the problem appears to stem from paragraph 4(b) of the Eighth Schedule.

../8

It should be noted that we are working to develop one or two examples on this side to test the amendment. We may transmit a follow-up addendum on this point depending on our calculations. In the meantime, any comment on our side appears premature.

F. COLLATERALISED SECURITIES ARRANGEMENTS (VARIOUS PROVISION IN THE INCOME TAX ACT AND THE SECURITIES TRANSFER TAX ACT)

1. Summary of draft proposal

The proposed amendment seeks to ensure that taxation does not inhibit the use of securities as collateral under cession. Unlike some collateral arrangements, this collateralisation of securities entails the transfer of title as well as some freedom by the holder of the collateral so that the holder has some freedom to dispose of the collateralised security to third parties. These differences could easily trigger a taxable event upon collateralisation even though the borrower (i.e. the party providing the securities collateral) intends to retain full economic ownership of the collateral throughout the duration of the borrowing arrangement.

We further understand that the proposed amendment is part of a larger policy issue pertaining to regulatory banking capital. With Basel 3 and 4 pending, the capital requirements for banks have increased significantly. Use of collateral by the banks is important for regulatory purposes so funds are more readily available to lend in line with new regulatory limitations.

2. Committee concerns

We understand from various sources that the 12-month limit on the use of specified securities effectively eviscerates the value of the proposed amendment. Given that many banks lend and enter into other financing transactions for periods beyond 12 months (such as over-the-counter derivatives, repurchase agreements and collateralised loans), the banks accordingly need to retain control over collateralised securities throughout the duration of the risk period. We further understand that significant lending arrangements of this nature exist for durations between 5 and 10 years.

../9

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A bank would never want to relinquish control over the collateralised securities at any mid-point during the lending period nor would the bank want to be forced to change the nature of the collateral. Any changes of this nature would undermine banking capital requirements expected under the new banking regulatory paradigm. For instance, when banks lend funds to acquire immovable property, the title deed is often kept throughout the lending period as security – the bank should not be forced to chop and change its collateral. A forced change would effectively give rise to unnecessary transaction costs and higher risks (which will inevitably result in higher interest and / or financing charges).

We fear that the 12-month rule stems from confusion about the distinction between securities lending and collateral. The two transactions are not the same. A lending transaction is one for consumption whereas the posting of collateral is a credit mitigation transaction to insure against non-performance by the borrower under the lending agreement. Most securities lending has a short-term duration, and the lender simply wants equivalent shares in return at the close of the 12-month period. The borrower is free to use the borrowed securities in any way desired. By itself, the liability pertains only to the borrowing entity; there is no attachment to underlying assets but for the 12-month return. In a securities collateral arrangement, the focus is on the holding of underlying attached assets (in this case, the underlying securities) to protect against risk. Securities lending is about obtaining better profit margins on securities, otherwise held in static form for long-term growth, to improve market liquidity.

3. Committee suggestion

We suggest that the 12-month rule pertaining to the return of collateral placed under a collateral arrangement be dropped. However, the collateral receiver should no longer be free to simply dispose of the underlying collateralised securities. This wholesale freedom should not exist because free use of the collateralised securities makes the transaction indistinguishable from a disguised disposal. We instead suggest that the holder of the securities as collateral should only be allowed in order to further transfer the securities as collateral for other financial obligations under collateral arrangements because this practice is fairly standard globally for securities financing transactions. Limiting subsequent transfers by the holder of the collateral solely to transfers involving collateralised securities arrangements would also ensure that formal contracts of a similar nature exist for all arrangements so SARS and other regulatory authorities can trace the transferred securities and ensure this form of capital operates as proper collateralisation justifying the improved regulatory flexibility and promoting liquidity.

../10

4. Why the share lending limitation?

As stated above, we believe that a free use of banking capital should be supported, especially given the increased difficulty South Africa is likely to face when raising capital in the near future. However, we are not sure why the proposed amendment limits the collateral solely to shares.

As a general matter, banks prefer cash, debt securities and shares as collateral in the order described. Shares is only a third choice given the higher level of risk involved. The obvious missing link is debt instruments, especially debt issued by Government and its parastatals, such as Transnet. Banks always prefer debt instruments to equity so we would strongly suggest that debt instruments be included within the relief proposed for Income Tax and Capital Gains.

Dawid van der Berg

Chairman: Corporate Tax Technical Committee