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The National Treasury

240 Vermeulen Street

PRETORIA

0001

The South African Revenue Service

Lehae La SARS, 299 Bronkhorst Street

PRETORIA

0181

BY EMAIL: Mmule Majola (mmule.majola@treasury.gov.za)

Adele Collins (acollins@sars.gov.za)

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

We have attached the comments from the SAIT International Tax Work Group on the Annexure C tax proposals for the 2017 Budget pertaining to 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

Elandre Brandt

Chair of the International Tax Work Group

T (012) 941 0400
F (086) 626 0650
E info@thesait.org.za
W www.thesait.org.za

Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg
Roads, Pretoria, South Africa, 0081
Reg no 2007/014730/08

PO Box 712
Menlyn Retail Park
0063

INTERNATIONAL TAX

1. PROPOSE THAT SECTION 9C BE EXTENDED TO FOREIGN SHARES AND FUNDS

The rule in section 9C of the Act deeming the proceeds on disposal of shares after three years to be capital in nature only applies in respect of equity shares in South African resident and dual listed companies as well as portfolios in local collective investment schemes in securities or hedge fund collective investment schemes. South African tax residents are taxed on their world-wide income, which includes proceeds from foreign shares and foreign fund investments, but they do not enjoy section 9C protection thereon.

South African taxpayers holding foreign funds do not have the section 9C safe harbour that South African taxpayers invested in local shares have, even though they are taxed on their world-wide income. Given that South African tax residents are taxed on their world-wide income, section 9C protection should cover both their local and foreign shares and fund investments.
We propose that the definition of "equity share" in section 9C should be extended to include shares in non-resident companies and portfolios in foreign funds that are similar to collective investment schemes.

2. PROPOSE SECTION 9D IMPUTATION RELIEF FOR FOREIGN EXCHANGE DIFFERENCES BETWEEN HOLDING COMPANY AND CFC

When a South African holding company provides a South African Rand denominated loan to a controlled foreign company ("CFC") with a functional currency other than Rand, no section 9D imputation relief is available in respect of any foreign exchange differences arising from the conversion of the Rand loan to the functional currency of the CFC.

It often happens that a holding company would provide finance to its CFCs by means of Rand denominated loans. When these Rand denominated loans are translated to the functional currency of the CFC, a foreign exchange difference arises. As the Act currently stands, section 9D does not provide relief for such exchange differences as section 9D(9)(fA) only provides for relief in respect of exchange differences arising from exchange items between CFCs (the so-called "inter-CFC relief"). On the basis that there is no economic currency exchange difference from a South African perspective as the loan remains a Rand loan in the hands of the holding company, we request that section 9D be amended to exclude from imputation any exchange differences arising from Rand denominated loans with a connected party.

3. PROPOSE THE EXCLUSION OF HEADQUARTER COMPANIES FROM SUB-SECTIONS 9H(3)(E) AND (F)

Sub-sections 9H(3)(e) and (f) were introduced into the Income Tax Act with effect from 5 June 2015. The 2015 Explanatory Memorandum explained that these provisions were introduced to counter tax free corporate migrations (refer to pages 47 to 50 of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015).

The effect of these provisions is to claw back tax on amounts that were previously exempt as a result of the application of paragraph 64B of the Eighth Schedule and/or section 10B(2)(a), which apply where shares in a foreign company are disposed of in qualifying circumstances and where foreign dividends are received/accrued from a foreign company in qualifying circumstances, respectively.

Sub-sections 9H(3)(e) and (f) apply when a company ceases to be a resident. A headquarter company, in terms of section 9I(1)(a) is required to be a resident. Should a headquarter company cease to be a resident (and thus cease to be a headquarter company), it may be subject to sub-sections 9H(3)(e) and (f).

The headquarter company regime was introduced into the Income Tax Act as part of the Gateway to Africa initiative and to attract offshore groups to hold their African (and other offshore) investments via South Africa. It is submitted that having headquarter companies subject to sub-sections 9H(3)(e) and (f) is contrary to the Gateway to Africa initiative and contrary to a purpose of a headquarter company which is to exempt capital gains in respect of foreign companies and exempt foreign dividend flow-throughs. Accordingly, we propose that headquarter companies should be excluded from the application of sub-sections 9H(3)(e) and (f).

4. PROPOSE EXTENSION OF SECTION 24I(4) FOR IRRECOVERABLE CROSS-BORDER DEBT IN CFC

In today's economic climate, a number of groups are restructuring their offshore operations by winding up CFC's or waiving cross-border debt which has become irrecoverable. Where loans have been advanced to a CFC by a South African resident, any foreign exchange gain or loss may be taxed on an annual basis or may be deferred in certain circumstances in terms of section 24I(10A) of the Act. The foreign exchange gain or loss may arise in the hands of the resident or CFC depending on the currency denomination of the loan. The proposed amendment to section 24I(4) in the Taxation Laws Amendment Bill, 2016, 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.

It does not deal with the situation where the foreign exchange gain or loss arises in the CFC's hands and is attributed to the resident shareholder creditor. Section 24I(4) cannot apply to calculate the CFC's net income as the gains or losses arise in respect of a 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.

For example, a Resident company (SA Co) advanced a ZAR loan to a CFC, the functional currency of which is denominated in USD. The loan was advanced in 2010 and is currently irrecoverable. The foreign exchange gain on the loan was deferred in terms of section 24I(10). SA Co wishes to waive the loan as the CFC has no prospect of repaying the amount. Any waiver will trigger the full forex gain which is significant. The gain will be attributed to SA Co under section 9D of the Act. Provision should be made in section 24I(4) to provide for such situations in relation to CFC's.

5. LOANS FUNDING CFC'S - SECTION 9D AND PARAGRAPH 56(2)

Many companies are restructuring their loan funding arrangements with distressed CFC's. 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.

Where a cross-border loan is waived by a resident and the debtor is a CFC, such amount will be dealt with under section 19 or paragraph 12A. Paragraph 56(2) 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. Any section 19 recoupment will be attributable to the creditor resident shareholder in terms of section 9D and taxed in the creditors hands, not the debtor as required (see paragraph 56(2)(c)). We request that this anomaly be rectified as it could not have been the intention of the legislature that the creditor cannot claim the capital loss and be simultaneously taxed under section 9D taxed on the recoupment.

We further request that clarity be provided in relation to the interplay of paragraph 12A and paragraph 56(2) where the base cost or capital loss of a CFC's asset is reduced.

6. **PROPOSE TO EXTEND OR CLARIFY THE APPLICATION OF SECTION 42 TO THE CONVERSION OF PERMANENT ESTABLISHMENTS TO COMPANIES**

Prior to 2001, section 28bis provided for *"Assessments on transfer of business undertaking by foreign company to South African subsidiary*." Essentially, this provision allowed for the conversion of a South African permanent establishment of a foreign company to a South African subsidiary, subject to the Commissioner's approval and any conditions imposed.

When section 42 "Company Formations" was introduced into the Income Tax Act in 2001, it provided for the tax neutral conversion of permanent establishments to companies in section 42(12), which stated:

(12) Where in terms of a company formation transaction—
(a) any company (hereinafter referred to as 'the subsidiary') which is a resident acquires all the assets and assumes all the liabilities relating to the business undertaking of any company which is not a resident (hereinafter referred to as 'the foreign company'), carried on through a branch in the Republic;

(b) the business undertaking of that branch has been transferred to that subsidiary as a going concern; and
(c) at the time of the transfer of that business undertaking, all the issued share capital of the subsidiary was held for its own benefit by the foreign company,
that foreign company and that subsidiary must be deemed to be one and the same company in respect of any transaction of the branch, for purposes of determining any taxable income derived or any assessed loss incurred by the subsidiary after the transfer of that business undertaking.

Section 42 was replaced *in toto* in 2002 and the new section did not contain the equivalent of section 42(12) and no reasons for this exclusion were provided in the 2002 Explanatory Memorandum.

Currently, it is unclear if section 42, as it stands, would provide effective relief if a foreign company disposed of its South African permanent establishment assets to a South African company in exchange for shares and the requirements of section 42 were met. The reason is that the shares issued by the South African company may be regarded as being immediately attributable to the permanent establishment, which would thereafter cease to exist (on the basis that its business had been disposed of). When an asset ceases to be attributable to a permanent establishment, it is deemed to be disposed of for market value consideration in terms of paragraph 12(1) read with paragraph 12(2)(b)(ii). Therefore, although the shares would initially be acquired by the foreign company, via its permanent establishment, at the rolled-over base cost of the assets that were contributed to the South African company, the inherent capital gain would thereafter be triggered when the permanent establishment ceases to exist.

We propose that the tax law should provide for a conversion of South African permanent establishments to South African companies on a tax neutral basis in terms of section 42 because:

(1) There are often very good commercial reasons to convert a permanent establishment to a company, for example it is not possible to empower a branch from a BEE point of view with equity;

(2) A branch is often used where a foreign company envisages a once-off project or a short-term project in South Africa. If the work is then extended, it is regarded as more suitable to use a company as it is a separate juristic person, can have its own directors, it is easier to open bank accounts and to do business in general;

(3) South African taxing rights would be retained over the assets acquired by the South African company, which would be acquired at rolled-over tax cost / base cost;

(4) There is more certainty in relation to a company than a branch, when considering branch attribution principles;

(5) A company would be subject to dividends tax, whilst a branch is exempt from dividends tax (which would benefit the fiscus).

It is well understood that section 42 has the effect of creating 2 taxing points, firstly in the shares of the company (deemed to be acquired at roll-over base cost of the assets) and secondly in the assets of the company (deemed to be acquired at roll-over base cost). Where a conversion takes place, only the second taxing point would be created. The first would not, unless the South African company was property rich. If the fiscus would have concern that the foreign parent could convert the permanent establishment to a South African company and then sell the shares in the company tax free, it could be considered to stipulate requirements, e.g. that the foreign parent would need to continue to hold all of the shares in the South African company for a minimum period, e.g. 18 months, failing which for instance the South African company would become liable for the tax that was deferred by the application of section 42.

7. NON-RESIDENT INVESTORS IN TRUSTS

Many non-residents are currently investors in trust structures in the private equity industry. The non-residents typically acquire a vested right to all income and gains of the trust but not to the underlying asset for administrative reasons. The rights are vested on inception of the trust. The non-residents provide committed capital which will be drawn down by the trustees for purposes of making investments on behalf of the non-residents. The cost of running the trust as well as all management fees are borne by the non-residents. Based on the current wording of paragraph 80(2) SARS is of the view that as the non-resident does not have a vested right to the underlying asset, the gain will be taxed in the trust.

Paragraph 80 of the Eighth Schedule deals with the attribution of gains arising on the disposal of assets held by a trust. In this regard, paragraphs 80(1) and (2) are relevant and provide as follows:
(1) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (other than any person contemplated in paragraph 62 (a) to (e) or a person who acquires that asset as an equity instrument as contemplated in section 8C (1)) who is a resident, that gain -

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.

(2) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62 (a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or the portion of the capital gain so vested—

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests.

Paragraph 11(1)(d) of the Eighth Schedule deals with what may be considered to be disposal events for purposes of the CGT legislation and includes:

the vesting of an interest in an asset of a trust in a beneficiary;"

Paragraph 13(1)(iiA) of the Eighth Schedule deals with the time of disposal of an asset and provides:

"(iiA) the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests;"

We note that the South African CGT Guide Issue 5 (the CGT Guide) issued by SARS deals in depth with the CGT implications of trusts. We are of the view that the CGT Guide confuses a bewind trust and a vesting trust in relation to the interest a beneficiary has in the assets of a trust. We also note there is significant confusion as to the impact of paragraphs 80(1) and (2) and the application of the conduit principle which is a long-established principle in case law and preserved in terms of section 25B of the Act. The CGT Guide adopts the view that paragraph 80(1) and (2) essentially overrides the conduit principle. If so, this would give rise to inconsistent application of CGT where there are non-resident private equity investors.

We note that credence should be given to situations where a non-resident has funded the acquisition of an asset but due to the fund using a vested trust to acquire that asset as opposed to a partnership structure. The non-resident in this scenario is currently being taxed whereas a non-resident who makes a direct investment will not be subject to CGT. It is also not possible to unwind these structures into a partnership vehicle.

We suggest that the tax neutral liquidation of a trust in favour of a partnership structure should be considered. Alternatively, thought must be given to cater for situations where the funding of the trust assets comes from the beneficiaries, allowing the conduit nature of such trusts to be retained.

8. SECTION 72A: FILING IT10'S WITH ITR14'S

Section 72A of the Act requires taxpayers to submit their IT10's with their income tax returns. However, in practice, many multi-national companies cannot file their IT10 returns when filing their income tax returns. On e-filing a taxpayer is restricted to uploading a maximum of 10 files and each file can't be more than 2MB in size. Therefore, the IT10's cannot be submitted with the IT14 on e-filing but it is available when requested by SARS.

In addition, the SARS guide to completing the ITR14 states that if you have more than 10 CFC's, you don't need to submit the IT10's but must retain them for 5 years. The risk of not submitting will be in relation to prescription because SARS can argue that they did not have sufficient information to apply their minds.

We propose that section 72A be amended and aligned to the SARS Guide to completing the ITR14.

9. PROPOSE THAT DE-GROUPING CHARGE SHOULD NOT APPLY WHERE CFC IS DISPOSED OF AND PARAGRAPH 64B APPLIES

When a CFC is disposed of in circumstances contemplated in paragraph 64B of the Eighth Schedule to the Act, any capital gain or loss is disregarded and the section 9H(3) exit charge does not apply to the transaction. However, if the CFC was the transferee in an intra-group transaction within 6 years from the date of ceasing to be a CFC, section 45(4)(*bA*) overrides paragraph 64B, with the result that a transaction that is treated in all other respects as an exempt transaction results in a de-grouping charge in respect of assets held and not disposed of.

It is an anomaly that a transaction which is treated as tax neutral for all other purposes should trigger a de-grouping charge. We propose that, where paragraph 64B applies, section 45(4)(bA) should not apply.

10. PROPOSE THAT THE ENDING AND COMMENCEMENT OF FOREIGN YEARS OF ASSESSMENT IN VARIOUS PROVISIONS BE ALIGNED

Where a CFC is disposed of in circumstances where paragraph 64B of the Eighth Schedule does not apply and the CFC was the transferee in an intra-group transaction within 6 years from the date of ceasing to be a CFC, the resident must determine the foreign tax year in which the de-grouping charge must be declared.

T (012) 941 0400
F (086) 626 0650
E info@thesait.org.za
W www.thesait.org.za

Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg
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0063

The provisions of section 9H(3) identify when the foreign tax year ends and the subsequent foreign tax year commences. Section 9D(2)(*b*)(ii) also identifies when the foreign tax year ends, but its provisions are different to section 9H(3). Section 9H(3)(*b*) appears to conflict with section 9D(2)(*b*)(ii), which, in turn, affects the application of section 45(4)(*bA*).

The provisions of section 9D(2)(*b*)(ii), section 45(4)(*bA*) and section 9H(3) need to be aligned.

11. SECTION 10B(4) DISQUALIFICATION FROM PARTICIPATION EXEMPTION

Section 10B(4) disqualifies a foreign dividend from the participation exemption if the dividend directly or indirectly arose from, or was determined with reference to, an amount paid/payable which is deductible in the hands of the payor but not subject to normal tax in the hands of the payee or taken into account in the net income of a CFC. The full foreign dividend is arguably disqualified from the participation exemption even if only a small portion of the dividend directly or indirectly arose in this manner. The section does not require a causal relationship between the deductible payment and the receipt of the foreign dividend. The section also does not require a relationship between the person claiming the deduction and the person receiving the dividend. Legitimate commercial transactions could suffer unintended consequences.

We propose that the wording of the section should be narrowed to specifically target the avoidance.

12. PROPOSED WIDENING OF SECTION 42 RELIEF FOR EQUITY SHARES TRANSFERRED

There is a lack of tax relief when less than 50% held assets that are equity shares are transferred to a CFC or another foreign company in which a qualifying interest is held. The issue is that the transferor cannot access the participation exemption or section 42 for less than 50% held assets. The transferor can only get relief if it transfers a more than 50% held asset; or if it transfers the asset to a CFC in which it owns more than 70%.

We propose that the same relief should be available for equity shares held in a foreign company as for domestic assets. Relief should be provided for less than 50% held assets transferred. The threshold of 70% is too high – it should be 50% or more as the CFC tax kicks in at that level.

13. COLLATERAL ARRANGEMENTS WITH FOREIGN COUNTERPARTY

In the previous circle, Treasury provided relief for out and out collateral arrangements. This is welcome. It must however be noted that in terms of section 64EB of the ITA, if the collateral is taken from a foreign counterparty, this is classified as a repurchase arrangement. This has the result that the dividend corporate action on the share will continue to attract dividends tax even though the local entity is truly the beneficial owner of the share.

It is proposed that adjustments be made to section 64EB to specifically exclude out and out taking of collateral from a foreign counterparty.

14. CROSS CURRENCY SWAPS TO HEDGE LOANS TO ACQUIRE CAPITAL ASSETS

A cross currency swap entered into to hedge a loan taken to acquire capital assets creates timing mismatches for exchange differences. The exchange differences on the loan are deferred until the assets are brought to use. This may take years in certain instances. On the other hand, the exchange differences on the swap are mark to marketed.

Section 24I(7) needs to be adjusted or even deleted. Accounting principles contains no such deferral for loans taken up to acquire capital assets.

T (012) 941 0400
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E info@thesait.org.za
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15. STT IMPLICATIONS OF RISKLESS PRINCIPAL

SARS has previously issued ruling to some taxpayers on the STT implications of riskless principal. The ruling is however not codified in legislation. Effectively, the ruling provides that in certain instances, the secondary transfer of shares by an offshore riskless principal does not attract STT in the circumstances where the riskless principal acquired the shares effectively in an agency capacity – with an underlying buy order.

It is proposed that the principles of this ruling must be codified in legislation as it remains unclear to most broker dealers, to whom an equivalent ruling has not been issued.