Standing Committee on Finance
T Sepanya and A Wicomb

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Dear Nombasa and Adel

RE: SUBMISSION TO NATIONAL TREASURY ON THE 2017 DRAFT TAXATION LAWS AMENDMENT BILL AND THE 2017 DRAFT TAX ADMINISTRATION LAWS AMENDMENT BILL


We have considered the Draft TLAB, received a number of submissions and wish to make the following comments in respect of various clauses of the Draft TLAB in terms of which amendments are proposed to sections of the Income Tax Act, 58 of 1962 (“Act”). Where applicable, we have made references to the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2017 (“Explanatory Memorandum”), published on 19 July 2017.

1. Proposed amendments to section 7C of the Act

1.1. The proposed section 7C(1)(ii) inserts reference to a company which is “a connected person in relation to the trust referred to in sub paragraph (I)”.

1.2. The mischief which is said to be addressed by this proposal is the circumvention of section 7C by way of loans to companies which are held by trusts. This is explicitly stated in the Explanatory Memorandum.

1.3. The proposed change however goes beyond what is necessary to address this circumvention. It will include also companies which are not owned by trusts but which are merely connected to them. It would include for example:

1.3.1. A company which is a beneficiary of the trust;

1.3.2. A company which is owned by another beneficiary of the trust; and

1.3.3. A company which is in partnership with the trust.

1.4. There are many other examples of companies which are connected to a trust but which are not themselves within the “tax shelter” afforded by the trust structure.
1.5. We therefore respectfully submit that the words utilised should be limited to address the advancing of interest free or low interest loans to companies which are owned by trusts.

1.6. The wording used is also capable of being interpreted as including loans advanced by one company to another where some or all of the shares of those two companies are owned by a trust. Inter-company loans within a trust setting do not give rise to any avoidance and may give rise to a multiplicity of donations tax consequences where in truth no additional avoidance is involved.

*The proposed section (1A)*

1.7. The rationale behind the proposed amendment is clear. However, there may well be an interpretation difficulty with respect to timing.

1.8. In the case of a beneficiary which was initially connected to the trust and subsequently acquired a loan claim against the trust (which would often be the case where, for example, a parent bequeathes to a child a loan against the trust on the parent’s death).

1.9. In those circumstances the wording could be interpreted to mean that the child is deemed to have acquired the claim on the date on which the child became connected, which was much earlier than the date on which the child actually acquired the claim. This difficulty would be remedied if the amendment makes clear that its only once both of the conditions are fulfilled (connection and acquisition) that from that time forward the child would be deemed to have held the claim. The alternative explanation gives rise to a form of retrospectivity.

*The proposed clause (f) exemption for share schemes in terms of the proposed section 7C(5)(h)*

1.10. The introduction of the proposed exemption is welcomed as it will avoid the inadvertent application of the anti-avoidance rules to bona fide share incentive schemes.

1.11. However we submit that the following factors might inadvertently limit the scope of this relief:

1.11.1. In terms of section 7C(5)(h)(1)(aa) the loan involved could also have been advanced by a natural person;

1.11.2. The loan could also have been advanced to a company for purposes of the share scheme;

1.11.3. It is possible that the instruments in question are in fact equity shares and not only instruments which relate to or derive their value from underlying shares;
1.11.4. It is not entirely clear that the provision includes participation which is extended to become a beneficiary of such a trust when regard is had to the words “offered by the trust”;

1.11.5. The exclusion from the relief of circumstances where a participant under the scheme is also an owner or connected person in relation to the owner of the company appears to be unduly conservative and addresses an anticipated avoidance which in practice is likely to ever be encountered. More particularly, the exclusion anticipates that the owner of a company would transfer equity to family members by way of including them in a share incentive scheme. In reality, this is unlikely to arise. By including equity in a share incentive scheme the owner would subject the benefited family member to income tax at the full rate of 45% in relation to the benefit derived, by virtue of section 8C. No rational taxpayer would transfer shares to their family members in a way which fully subjects the gain to a rate of 45% tax, when they could merely transfer some of their equity to the family member and attract capital gains tax and possibly, in addition, donations tax at a substantially lower rate. We respectfully submit that this limitation of the welcome inclusion on share incentive schemes will defeat the object in the case of very many small, medium, family owner entrepreneurial companies which are legitimately entitled to include family members who work for their business in their share incentive scheme. Such family members will attract the full rate of tax in terms of section 8C and there is no tax benefit or avoidance achieved by doing so.

1.12. We therefore respectfully submit that this carve out to the exemption ought to be eliminated or alternatively that a de minimis should be introduced to avoid the perceived (but not clearly demonstrated) avoidance. As currently drafted the entire scheme would be disqualified from the relief if a family member acquired a tiny portion of the equity offered in terms of the share incentive scheme. This could be mitigated by introducing a de minimis rule of, for example, 5% or 10% participation by family.
2. **The proposed expansion of “controlled foreign company” in section 9D of the Act**

2.1. The Draft TLAB proposes to amend the definition of “controlled foreign company” (“CFC”) in section 9D of the Act to include-

“(b) (i) any foreign company, where one or more persons that are residents hold an interest in a trust that is not a resident… and that trust… directly or indirectly holds more than 50 per cent of the total participation rights in that foreign company or may directly or indirectly exercise more than 50 per cent of the voting rights in that foreign company; or

(ii) 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 resident”.

2.2. The Draft TLAB further proposes to insert the following proviso to section 9D(2):

“Provided further that for purposes of applying this subsection the percentage of the participation rights of a resident in relation to a controlled foreign company is equal to the percentage of the financial results of that foreign company that are reflected in the consolidated financial statements, as contemplated in IFRS 10, for the year of assessment of the holding company, as defined in the Companies Act, that is a resident”.

2.3. We hereby submit the following in relation to the above proposed amendments:

2.3.1. It is submitted that the proposed paragraph (b) to the CFC definition should be amended to provide that both subparagraphs (i) and (ii) should be applicable in order for an entity to constitute a CFC in terms of paragraph (b) to the CFC definition. In the absence of such an amendment it may be possible for a foreign entity to constitute a CFC in terms of the proposed paragraph (b)(ii) in circumstances where South African shareholders hold less than 50 per cent of the equity shares and/or voting rights in such foreign entity.

2.3.2. In addition, in terms of a current reading of the proposed amendment to the definition of a CFC, a foreign company will be a CFC in relation to any person (including natural persons and companies) where such person holds an interest in a trust or foreign foundation and the trust or foreign foundation directly or indirectly holds more than 50% of the participation rights or voting rights in a foreign company.

2.3.3. However, there is no definition of what “an interest” in a trust or foundation constitutes and more importantly how the portion of the amount equal to the “net income” of the relevant CFC which should then be included in the income
of such person, must be determined. In this regard, we submit that it would be impossible to determine such an interest, for, for example a discretionary beneficiary of an offshore trust.

2.3.4. It would therefore not be possible to determine the participation rights of such a beneficiary, and thus the allocation of the “net income” amount of the relevant CFC to the resident beneficiary.

2.3.5. In addition, where the person is a natural person (or any other resident that is not a company), any amounts received or accrued from that trust or foundation would also be taxed in terms of section 25BC. Therefore, such amounts would potentially be subject to double tax.

2.3.6. However, in any event, it appears from the Explanatory Memorandum that the intention is that the amendment to the definition of a CFC should apply only to resident companies which hold an interest in a trust or foreign foundation as described above and where the financial results of the relevant foreign company are reflected in the consolidated financial statements as contemplated in IFRS 10.

2.3.7. This makes sense, since then the proviso referred to above would determine the basis for the inclusion of the amount equal to net income of the relevant CFC in the company's income (subject to our comments in paragraph 2.3.11 below).

2.3.8. As stated above, this would also address the issue identified above that a foreign entity to constitute a CFC in terms of the proposed paragraph (b)(ii) in circumstances where South African shareholders hold less than 50 per cent of the equity shares and/or voting rights in such foreign entity.

2.3.9. Based on the above submissions, we propose that the wording of the amendment to the definition of a CFC be amended such that the requirements in (b)(i) and (b)(ii) be read together (ie the “or” should be replaced with “and”) and the consequential changes should be made.

2.3.10. In addition, the proposed paragraph (b)(ii) to the CFC definition should be amended to clarify that it only applies to subsidiaries (i.e. entities controlled by the holding company) as contemplated in IFRS10. In terms of the current proposed wording, there may be a risk of non-controlled foreign associates of the holding company constituting CFCs. In addition, the current wording of the proposed paragraph (b)(ii) may give rise to an entity constituting a CFC depending on whether South African shareholders are at a majority at
shareholder meetings of the foreign entity – which may in turn give rise to a fluctuation in the CFC status of the foreign entity on an annual basis.

2.3.11. The wording of the proposed proviso to section 9D(2) as quoted in paragraph 2.2 above may give rise to 100 per cent of the financial results of a foreign company constituting the participation rights which a holding company holds in such foreign company in circumstances where the holding company holds less than 100% of the equity shares and voting rights in the foreign company. In particular, in terms of IFRS10, 100% of the foreign company’s financial results would be reflected in the consolidated financial statements of the holding company, and the consolidated financial statements would then draw a distinction between controlling and non-controlling shareholding. Accordingly, the proposed proviso to section 9D(2) should be amended to clarify that the financial results of the foreign company would only give rise to participation rights for the holding company to the extent of the holding company’s proportional shareholding in the foreign company.

3. The newly proposed section 25BC

3.1. The newly proposed section 25BC states as follows:

“Distributions by non-resident trust or foreign foundation deemed to be income of resident

25BC. If—

(a) any person that is a resident, other than a person that is a company, is a beneficiary in relation to a trust that is not a resident or a foreign foundation; and

(b) that trust or foundation holds a participation right as defined in section 9D(1) in a foreign company and that company would have constituted a controlled foreign company as defined in that section had that trust or foundation been a resident,

any amount received by or accrued to or in favour of that person during any year of assessment from that trust or foundation by reason of that person being a beneficiary of that trust or foundation must be included in the income of that person.”

(underlining added).

3.2. It is submitted that the newly proposed section 25BC needs to be amended to clarify the timing of its application to ensure that the resulting tax could not be triggered twice. The heading to the proposed provisions appears to indicate its application in respect of distributions whereas the body of the provision appears to indicate that it may apply in respect of amounts received by or accrued to or in favour of a person. It accordingly appears
as though section 25BC could be triggered upon the vesting by the trust of assets – notwithstanding that the heading of the provision merely makes reference to distributions.

3.3. The effect of this in addition appears to be punitive in the sense of converting underlying capital, capital gains and exempt income to ordinary taxable income when the amounts are distributed to the South African beneficiaries.

3.4. Whilst we understand the desire to bring into the South African tax net the amounts received by or accrued via a company which would be a CFC in the circumstances described in the explanatory memorandum, we submit that the effect could be achieved by aligning the provisions with the current trust rules relating to distributions out of foreign amounts which clearly maintain the source, quality and nature of the underlying amounts when taxing them in the hands of the South African beneficiary. We respectfully submit that the new laws should be aligned with the existing provisions which have an equitable effect.

3.5. In addition, in terms of the current wording, there is no causality or link between the amount received/accrued and the fictional CFC which is held by the offshore trust/foundation and the treatment of the distributions by the trust or foundation. For example, an offshore trust may hold various investments and/or shares in companies or other entities which would not constitute CFCs if the fiction is applied that the trust is a resident, yet the full amount which is received by or accrues to the South African resident beneficiary from such trust/foundation will be taxed in terms of the proposed provision.

3.6. It is therefore submitted that the provision should also be amended to introduce a causal link between the distribution/amount which is included in the income of the resident beneficiary and the source of such distribution/amount.

4. Proposed amendment of section 10(1)(k)

4.1. Section 10(1)(k)(i) of the Act exempts a dividend from income tax. The exemption is subject to various provisos including, *inter alia*, sub-paragraph (ff) which excludes from the exemption a dividend received by or accrued to a company in respect of a share borrowed by that company. As a result of this proviso a dividend received by or accrued to a company on a share obtained in terms of a securities lending arrangement is subject to income tax.

4.2. With effect from 1 January 2016 the definition of a “collateral arrangement” was introduced into the Income Tax Act in terms of the Taxation Laws Amendment Act No 25 of 2015. Based on the Explanatory Memorandum to this Act, it was intended that a similar tax dispensation as applies to securities lending arrangements be introduced for the outright transfer of collateral.
4.3. However, the provisos to section 10(1)(k)(i) were not expanded to include a proviso that excludes a dividend received by or accrued to a company in respect of a share obtained in terms of a “collateral arrangement” from the exemption.

4.4. We recommend that section 14(1)(d) of the Draft TLAB be expanded to include a proviso that excludes a dividend received by or accrued to a company in respect of a share obtained in terms of a “collateral arrangement” from the exemption in section 10(1)(k)(i) of the Income Tax Act.

5. **The newly proposed section 11(jA)**

We have been provided with the following submission by a client, which represents their view as to the commercial and tax considerations set out in this section. The facts and circumstances quoted may not necessarily be of general application.

5.1. Section 11(j) of the Act currently provides for the determination of a taxpayer’s doubtful debt allowance.

5.2. The 2017 Draft TLAB proposes the insertion of a new paragraph (jA).

5.3. The new paragraph (jA) is intended to apply notwithstanding the current section 11(j) of the Act and allows a ‘covered person’ as defined in paragraphs (c)(i) to (iii) in section 24JB(1) of the Act i.e. a bank, to claim 25% of its loss allowance relating to impairment, as per IFRS 9, as a doubtful debt allowance for income tax purposes.

5.4. It is further proposed that a covered person is allowed to claim an 85% allowance of an amount that is in ‘default’ by applying the criteria in paragraphs (a)(iii) to (vi) and (b) of the definition of ‘default’ as defined in Regulation 67 of section 90 of the Banks Act (“Banks Act”).

**Problem statement**

*A: Reference to terms in the Banks Act inappropriate*

5.5. The proposed section 11(jA) attempts to align the income tax position with that of accounting and specifically IFRS 9. The reference to terms as defined in the Banks Act may create difficulty and inconsistency of interpretation.

*B: Increased allowance of 85% does not apply to all covered persons*

5.6. The specific paragraphs of the definition of ‘default’ in the Banks Act as referenced in section 11(jA), only relates to credit exposure other than retail exposure.
5.7. In terms of the Banks Act, retail exposure includes exposure to individuals (revolving credit, credit card, overdraft facility, term loans, instalment finance, students loans etc.), mortgages and SME lending.

5.8. An unsecured lender which business is entirely based on retail exposure, will therefore not meet the criteria to claim 85% of the allowance proposed. This means that unsecured lenders would never be permitted an allowance greater than 25%.

   C: Does not take into account the difference between covered persons operating in the unsecured lending market from ‘traditional banks’

5.9. As will be explained below, a different result is achieved for unsecured lenders as opposed to the traditional banks under IFRS 9 read with section 11(jA).

5.10. Specifically, unsecured lenders may grant credit on risk-based pricing and price for the probability that a client will default on payments. This is expressed as a probability that a client would be 90 days or more in arrears (written-off). An unsecured lenders’ credit exposure in respect of bad and doubtful debts often consists only of unsecured loans and credit facilities with repayment terms between 1 and 84 months.

5.11. In terms of the current accounting treatment, impairment provision for loans and advances is in line with the principles set out in International Accounting Standards (“IAS”) 39. Loans and advances are considered to be impaired if there is objective evidence of default as a result of events that occurred after initial asset recognition (known as loss events) and these loss events have an adverse impact on the loan or advance's estimated future cash flows that can be reliably measured. It should be noted that losses expected as a result of future events, no matter how likely, are not recognised as part of the impairment provision in terms of IAS 39.

5.12. In the unsecured lending market, default arises where one instalment or more has been missed. Further, loans are written off when in arrears for more than 90 days (three payments in arrears) or handed over to collection agents, whichever comes first. It is understood that historical date supports that in these conditions the actual amount of bad debts (measured after the fact) approximates the amount of the allowance claimed.

5.13. Traditional banks mostly extend loans secured by assets or guarantees. This means that even if a customer misses one or up to three payments, this did not evoke a credit management crisis, because the customer had an interest in the loan given that he could lose the secured asset. Historical probabilities supported that the customer would eventually repay his loan, albeit a month or so later than originally planned. Traditional banks only hand over debt at a later stage, first acknowledging default after 90 days (or three payments in arrears) and factually handing over 12 months in arrears or longer.
5.14. The absence of any secondary interest by the customer for the unsecured loans, affects their willingness to pay. Thus, the unsecured lending market is fundamentally different to the secured lending market.

5.15. The IFRS9 ECL model outlines a ‘3 stage’ model (‘general model’) for impairment based on changes in credit quality since initial inception.

5.16. Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month ECL is recognised.

5.17. Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition due to objective evidence. For these assets, lifetime ECL recognised. Lifetime ECL are the expected credit losses that result from all possible default events over the expected life of the financial instrument. Expected credit losses are the weighted average credit losses with the probability of default as the weight.

5.18. Stage 3 includes financial assets that are in default. For these assets, lifetime ECL are recognised.

5.19. Based on the above described impairment policy, the provision for bad and doubtful debts when IFRS9 becomes effective, will be included under stage 1 for unidentified impairments and stage 2 for identified impairments.

5.20. The explanatory memorandum to the Draft TLAB explains the proposed amendments in terms of the categories under the current BASA Directive as:

5.20.1. 25% of IBNR impairment provision;

5.20.2. 25% of portfolio specific impairment (“PSI”); and

5.20.3. 85% of specific impairment (“SI”) that is equal to the amount that is in default as determined by applying the criteria in paragraphs (a)(iii) to (iv) and (b) of the definition of default as defined in Regulation 67 of SARB contained in Government Gazette No. 35950 of 12 December 2012.

5.21. As discussed above, traditional banks would treat their current SI provision as stage 3 whereas an unsecured lender would treat their SI provision as stage 2 under IFRS9.

5.22. The decrease in the impairment allowance, as proposed by National Treasury, will have an adverse impact on the capital requirements for these banks.

5.23. Given that the impairment provision is merely the proactive recognition of expected losses on a discounted basis, it is accepted that the eventual loss will be deductible under section
11(a) or section 11(i) of the Act. Based on this principle, a deferred tax asset is required to be raised in respect of the portion of the accounting impairment provision which is excluded from the tax impairment allowance under section 11(j) of the Act.

5.24. For capital adequacy purposes, the current bank regulations require the deferred tax assets to be risk weighted at 250% resulting in a deduction against capital. As the deferred tax asset consumes capital, it reduces the available capital to support other activities of the banks business and will reduce capital available to support economic activity in South Africa and increasing the costs of lending products.

5.25. It is submitted that these factors would negatively impact shareholder value, taxable earnings and reduces the capital buffer available for stress events and earnings volatility. To remEDIATE the negative impact, banks may be forced to consider increasing the price of their products and services, or reducing their credit losses by reducing their credit appetite.

*D: Clarification required in respect of impairment provision raised in respect of stage1,2 and 3 of the ECL model under IFRS9*

5.26. Where the doubtful debt allowance is referenced to IFRS 9 instead of the current proposed definition of 'default' in the Banks Act, clarification is required on the allowance percentage in terms of the categories under the current BASA Directive and the impairment balances under the different stages of the ECL model in terms of IFRS 9.

**Proposed solution**

*A: Reference to terms in the Banks Act inappropriate*

5.27. The reference to definitions in the Banks Act creates practical and interpretation difficulty in applying the provision and propose that the reference rather be made to IFRS9. This will allow ease of reference to audited financial statements that can be used as the base for taxation

*B and C: Distinguish between covered persons with different profiles*

5.28. It is important to note that the underlying nature of the specific impairment provisions is not likely to change materially because of the adoption of IFRS 9. Stage 3 for traditional banks and stage 2 for unsecured lenders will still be akin to the actual bad debts written off (provision raised based on probability of default considered irrecoverable on bona fide grounds).

5.29. Under IFRS 9 this impairment represents ECL stage 3 for traditional banks and stage 2 for unsecured lenders.
5.30. For an unsecured lender, the specific provision or stage 2 is akin to an “actual bad debt”. That is the reason why a 100% allowance was granted under the current BASA Directive. A small quantum of this amount is later recovered.

5.31. Accordingly, it is recommended that National Treasury reconsider its position on the appropriate level of allowance granted i.e. 100% on all stage 3 IFRS 9 impairments and 100% on all stage 2 IFRS 9 impairments for unsecured lenders.

D: Clarification required in respect of impairment provision raised in respect of stage 1, 2 and 3 of IFRS9

5.32. It needs to be clarified that any impairment provision raised through the income statement in relation to stage 1, 2 and 3 of the IFRS 9 ECL model would not be deductible, save for the doubtful debt allowance. However, once an impairment is written off as a bad debt, such bad debt will qualify as a tax deduction in terms of section 11(a) or section 11(i) of the Act.

5.33. Where the proposed amendments make reference to the various stages of impairment under the ECL model of IFRS 9, National Treasury should clarify the appropriate level of allowance granted i.e. 100% allowance on current SI provision under the BASA Directive equates to 100% allowance for stage 3 IFRS 9 impairment balances for traditional banks and for unsecured lenders, 100% allowance for stage 2 and 3 IFRS 9 impairment.

6. The proposed section 19B

6.1. The draft section 19B provides for a potential recoupment where an intergroup loan was historically capitalised and the debtor and the creditor subsequently cease to form part of the same group within the stated time period.

6.2. Section 45 (also a group relief provision), provides that where either the transferor or the transferee company is liquidated within the recoupment period and such liquidating company is held 70% by an SA resident shareholder, the liquidating company and the holding company will for section 45 purposes be deemed to be one and the same company, thus not triggering the section 45 degrouping charges.

6.3. It is recommended that the above liquidation relief be extended to section 19B as well. In certain cases debt cannot be waived, as the debtor has not been dormant for the required time. A capitalisation would thus be the only other alternative. Should such capitalisation occur, and the liquidation roll over relief not be available, then the previous creditor cannot be liquidated / deregistered for a number of years after that else the clawback will arise.

6.4. In addition, it should be clarified whether, where section 41-47 group relief applies to a transaction, but a degrouping for purposes of section 19B occurs because of such transaction, this would also result in a rollover for section 19B purposes. For example, where
shares, obtained in terms of a section 19(8)(e) transaction, are unbundled in terms of section 46(1)(a)(i)(aa), whether a section 19B clawback will be triggered.

7. **The proposed replacement of section 22B and paragraph 43A of the Eighth Schedule**

7.1. **Proposed amendments:**

7.1.1. Clause 33 of the Draft TLAB proposes the substitution of section 22B of the Act which deals with dividends treated as income on the disposal of certain shares held as trading stock. In particular, clause 33 includes the following proposal:

"[22B](2) Where a company disposes of shares in another company and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or accrued to that company in respect of the shares disposed of must –

(a) to the extent that the exempt dividend is received by or accrues to that company –
   (i) within a period of 18 months prior to; or
   (ii) in respect, by reason of or in consequence of that disposal; and

(b) if that company immediately before that disposal held the shares disposed of as trading stock,

be included in the income of that company in the year of assessment in which those shares are disposed of or, where that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues.

(2) Subsection (1) is deemed to have come into operation on 19 July 2017 and applies in respect of any disposal on or after that date."

7.1.2. Clause 45 of the Draft TLAB proposes the substitution of paragraph 43A of the Eighth Schedule which deals with dividends treated as proceeds on the disposal of certain shares held as capital assets. In particular, clause 45 includes the following proposal:

"[43A](2) Where a company disposes of shares in another company and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or accrued to that company in respect of the shares disposed of must –

(a) to the extent that the exempt dividend is received by or accrues to that company –
   (i) which a period of 18 months prior to; or
   (ii) in respect, by reason of or in consequence of that disposal; and
(b) if that company immediately before that disposal held the shares disposed of as a capital asset (as defined in section 41),
be taken into account, in the year of assessment in which those shares are disposed of or, where that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues, as part of proceeds from the disposal of those shares.

(2) Subsection (1) is deemed to have come into operation on 19 July 2017 and applies in respect of any disposal on or after that date.”

7.1.3. For purposes of our submission we have assumed that the proposed amendments set out in paragraphs 7.1.1 and 7.1.2 above are deemed to have come into operation on 19 July 2017 and applies in respect of any disposal on or after that date, notwithstanding the fact that both clause 33 and clause 45 of the Draft TLAB refer only to section 22B(1) and paragraph 43A(1), respectively, which includes the definitions of “exempt dividend” and “qualifying interest”, and not to section 22B(2) and paragraph 43A(2), respectively, which sets out the relevant taxing provisions (as detailed above).

Submissions

7.2. Below we set out our submissions in respect of two fact patterns which in our view will be adversely impacted by the proposed amendments.

Ongoing transactions

7.3. In terms of the current wording of the proposed amendments, where a company, as a part of an ongoing transaction, has declared an “exempt dividend” (as defined), prior to the publication of the Draft TLAB on 19 July 2017, but as a result of the ongoing or incomplete nature of the transaction, that company has yet to dispose of the shares in the other company in which it holds a “qualifying interest”, the exempt dividend must be included in the income of the company (if held as trading stock) or be taken into account as proceeds for capital gains tax (“CGT”) purposes (if held as a capital asset) upon the future “disposal” of the shares.

7.4. As a result of the above, the proposed amendments will apply retrospectively to dividends that were declared by a company prior to publication of the Draft TLAB on 19 July 2017, i.e. the date on which the proposed amendments are deemed to have come into operation.

7.5. Whilst we acknowledge that the proposed amendments are in line with previous statements by National Treasury regarding share buy-backs and the need to address the possible circumvention of anti-avoidance rules dealing therewith, as enunciated, for example, in the 2017 Budget Review published on 22 February 2017, we submit that the retrospective
application of the proposed amendments will have an adverse impact on a number of ongoing restructuring / consolidation transactions which commenced in good faith prior to the publication of the Draft TLAB on 19 July 2017.

7.6. In particular, should the current wording remain unchanged, we submit that a number of ongoing transactions are likely to be cancelled or put on hold given the uncertain income or CGT treatment of exempt dividends upon the “disposal” of shares, which disposal will only occur in the future once the transaction has been completed (e.g. once all the conditions precedent of the agreement have been met. In particular, these taxpayers now face uncertainty which will endure until the final legislation (after completion of the consultation process and consideration of comments) is known towards the end of this year.

7.7. The cancellation or putting on hold of transactions which were formulated and commenced on the basis of the legislative regime as it existed at the time (i.e. prior to the publication of the Draft TLAB on 19 July 2017) will, we submit, have material negative economic consequences, particularly in relation to local and international investor confidence which, in turn, will hamper South Africa’s ability to attract capital via foreign direct investment. Given the prevailing uncertain policy and low growth environment in South Africa, legislative changes that result in commercial uncertainty should in our view be avoided or ameliorated where possible.

7.8. Companies entering into restructuring or consolidation transactions regularly employ share buy-backs in the ordinary course of business as a means to achieve legitimate commercial or business objectives. In particular, during economic downturns (as is presently the case) financially distressed companies are looking to dispose of some of its operations to regularise its business, whilst other companies are looking to acquire businesses to grow and expand its operations in order to capitalise on the next upswing in economic activity.

7.9. This is explicitly recognised on page 27 of the Explanatory Memorandum, where the following is stated,

   “Share buy-backs are allowed in terms of the Companies Act and the sole or main purpose of doing [a] share buy-back arrangement may not always involve tax planning but are based on commercial rationale, e.g. mergers and acquisitions.”

7.10. Further, it is a trite principle of our law that the retrospective application of a statute (provided the statute is expressly intended by Parliament to apply retrospectivity), should apply only to the extent necessary to give effect to that statute.

7.11. In this regard, it is our view that the mischief targeted by the proposed amendments, i.e. dividend stripping through share buy-backs as per the Explanatory Memorandum, can still be addressed effectively without it being necessary for such amendments to retrospectively
apply to dividends declared by taxpayer companies prior to the publication of the Draft TLAB.

7.12. Based on the above submissions, we propose that the wording of the proposed effective date provisions in respect of the amendments to section 22B of the Act and paragraph 43A of the Eighth Schedule be changed as follows (as underlined):

“(2) Subsection (1) is deemed to have come into operation on 19 July 2017 and applies in respect of any dividend declared on or after that date.”

Dividends declared in the ordinary course of business and liquidation distributions

7.13. Companies regularly declare dividends in the ordinary course of business to its shareholders without such dividend declaration being causally or directly and/or indirectly linked to a share buy-back arrangement or a disposal of the shares to another party in terms of a sale.

7.14. The current wording of the proposed amendments to section 22B and paragraph 43A contemplate that, where a company has received or accrued an “exempt dividend” as defined within a period of 18 months prior to “or” in respect, by reason or in consequence of a disposal of shares in another company in which it holds a “qualifying interest”, that company must take the exempt dividend into account for income tax or CGT purposes (as the case may be).

7.15. The current wording of the proposed amendments (in particular, the use of the word “or” in both clause 33 and clause 45 of the Draft TLAB) means that no causal link is required between the “exempt dividend” that was received by or accrued to a company and the subsequent disposal of the shares in another company in which that company held a “qualifying interest”.

7.16. In other words, the proposed amendments will apply to exempt dividends received by or accrued to a company, without the receipt of the exempt dividend being in respect of, by reason of or in consequence of the disposal of shares in another company in which that company held a “qualifying interest”, i.e. the receipt of the exempt dividend is not part of or causally connected to a subsequent disposal of the shares.

7.17. For example:

7.17.1. A company (Company A) receives or accrues an “exempt dividend” as defined in the ordinary course of business on 1 October 2017 from a company (Company B) in which it holds 50% of the shares on capital account (i.e. Company A holds a “qualifying interest” in Company B);
7.17.2. At the time of the receipt by Company A of the exempt dividend, there is no contemplated disposal by Company A of its shares in Company B; and

7.17.3. On 1 February 2019 (i.e. 16 months after the receipt of the exempt dividend), Company A wishes to dispose of its shares in Company B based exclusively on commercial considerations, e.g. it has received an attractive offer from an independent third party bidder for its shares in Company B.

7.18. Based on the current wording of the proposed amendments to paragraph 43A, Company A must, for CGT purposes, take into account the exempt dividend received on 1 October 2017 as part of the proceeds from the disposal of its shares in Company B on 1 February 2019, notwithstanding the fact that the disposal of its shares in Company B has no direct, indirect or causal connection with the exempt dividend it had earlier received from Company B.

7.19. In our view, it is likely that, should the CGT implications for Company A be sufficiently material, Company A may decide to delay the disposal or not dispose of its shares in Company B to the third party bidder (who may not be willing to countenance such a delay). This would have a negative and unintended impact on the ability of shareholder companies to efficiently and profitably exit from an investment or dispose of a business, which, in turn, may have an adverse impact on the normal functioning of the corporate takeover market as well as long term shareholder value-creation.

Liquidation, winding up or deregistration of a company

7.20. Similar adverse and possibly unintended consequences arise where a company is liquidated, wound up or deregistered since the liquidation, winding or deregistration of a company gives rise to a “disposal” by the shareholder of the shares in that company.

7.21. Prior to the winding up of the company, dividends may have been declared in the ordinary course of business (for example 12 months prior to the winding up). In addition, if the company still has any assets on hand, such assets may well be distributed to the shareholder(s) in anticipation of winding up, which in specie distribution may constitute a “dividend”. If the ordinary course dividends and liquidations dividend are received within 18 months prior to the liquidation of the company, the provisions of paragraph 43A may apply and the shareholder would have to include such dividends in the proceeds arising from the liquidation of the company.

7.22. We submit that it is evident from the above scenarios that the current proposed wording of clause 33 and clause 45 of the Draft TLAB goes far beyond the mischief targeted by the proposed amendments, i.e. addressing the circumvention of anti-avoidance rules dealing with buy-backs and dividend stripping.
7.23. As the Explanatory Memorandum states on page 29,

“The mischief [targeted] is the conversion of taxable share sale consideration into exempt dividends.” (our emphasis)

7.24. Accordingly, we submit that the current wording should be changed so as to narrow the application of the proposed amendments based on the mischief targeted by such amendments thereby avoiding the potential adverse business and/or economic impact set out in paragraph 7.19 above. In relation to the winding up, liquidation or deregistration of a company, an exempt dividend distributed in anticipation of the liquidation, winding up or deregistration of a company will very likely be “in respect of, by reason of or in consequence of” the disposal of the shares upon such liquidation, winding up or deregistration, and we submit that an exclusion should be explicitly included to cater for this aspect.

7.25. Based on the above submissions, we propose that the wording of the proposed amendments to section 22B of the Act and paragraph 43A of the Eighth Schedule should be changed as follows (as underlined):

“(2)…
(a) to the extent that the exempt dividend is received by or accrues to that company -
(i) within a period of 18 months prior to, and
(ii) in respect, by reason or in consequence of that disposal; and…”

7.26. We further propose that a disposal of shares as a result of the winding up, liquidation or deregistration of a company be excluded from these provisions.

Dividends in specie

7.27. As noted above, the mischief which is said to be addressed by the proposed substitutions is the conversion of taxable share sale consideration into exempt dividends. This is explicitly stated by the Explanatory Memorandum.

7.28. In specie dividends should be excluded from the application of section 22B of the Act and paragraph 43A of the Eighth Schedule, on the basis that any transfer of assets out of a company would (and rightly should) exclude their value from any subsequent sale or repurchase of the shares in that company. Commercially, an in specie distribution is completely distinguishable from the mischief identified in the Draft TLAB.

8. The proposed amendments to section 36

8.1. We note that the reason for the proposed changes to section 36 of the Income Tax Act (i.e. by the insertion of subsection 36(7EA)) is that the debt waiver provisions in section 19 of the
Act and par 12A of the Eighth Schedule to the Act do not apply to mining companies. This was acknowledged hence the reason for the amendments to section 36 of the Act as indicated in the draft Explanatory Memorandum on the Taxation Laws Amendment Bill 2017 under 2.1.

8.2. We agree that this is the case as section 8(4)(a) has an explicit exclusion for amounts “allowed to be deducted or set off under section 15(a)”. Therefore any recoupment in terms of the debt waiver provisions will not include any unredeemed capex deductible under section 15(a) read with section 36 of the Act.

8.3. It appears that despite the need to create parity between mining companies and non-mining companies, non-mining companies may, following the changes proposed in clause 30 of the Draft Taxation Laws Amendment Bill, be in a better position due to the exclusions to the debt waiver provisions in section 19(8) of the Act and paragraph 12A(6) of the Eighth Schedule to the Act (including the new proposed exclusions in clause 30 of the draft Taxation Laws Amendment Bill 2017). It seems that there was an oversight to not make the proposed section 36(7EA) subject to the same exclusions as set out in section 19(8) of the Act and paragraph 12A(6) of the Eighth Schedule to the Act (including the new proposed exclusions in clause 30 of the draft Taxation Laws Amendment Bill 2017).

8.4. We submit that the change in section 36(7EA) is made subject to the exclusions set out in section 19(8) of the Act; paragraph 12A(6) of the Eighth Schedule to the Act and the new proposed exclusions in clause 30 of the draft Taxation Laws Amendment Bill 2017 as follows:

“Where a debt that is owed by a person is reduced by any amount and that debt was used to fund any amount of capital expenditure incurred, the reduction amount in respect of that debt must be applied to reduce any amount of capital expenditure incurred in the year of assessment that the reduction amount arises unless the exclusions in section 19(8) or paragraph 12A(6) of the Eighth Schedule apply: Provided that any amount of the reduction amount that exceeds the capital expenditure incurred in the year of assessment that the reduction amount arises, must be treated as an amount received by or accrued by the mining company during that year of assessment in respect of a disposal of assets the cost of which has been included in capital expenditure incurred.”

9. The proposed amendments to section 37A

9.1. Amendments to penalties in section 37A(6), (7), (8)

9.1.1. We submit that it is important that the penalties be imposed at the discretion of the Commissioner and that the penalties should be subject to objection and appeal and subject to the provisions of section 223(3) of the Tax Administration
Act, 2011 ("Tax Administration Act"). We propose the insertion of the following words, "which penalty is subject to objection and appeal and subject to the provisions of the Tax Administration Act and specifically section 223(3) of the Tax Administration Act" at the end of the proposed changed subsection (6), (7) and (8).

9.2. Retain the Commissioner’s discretion regarding the additional penalty in section 37A(8)

9.2.1. We submit that the words “Where the Commissioner is satisfied that” should be re-inserted into the proposed section 37A(8), and the provision should read that the Commissioner “may” apply this penalty rather than requiring that the Commission “must”. The proposed change also effectively doubles the penalties that are currently applicable. Currently, two times the market value would be included in income of the mining company. Which would have been effectively taxed at 28%. Now it is 40% of two times the amount. We submit that this is excessive.

9.3. Remove the new requirement in section 37A(9)(a) of the Income Tax Act for additional reporting

9.3.1. The proposed section 37A(9)(a) of the Income Tax Act requires that taxpayers submit a report to the Director-General of the National Treasury in respect of that year of assessment providing the Director-General of the National Treasury with information comprising—

9.3.1.1. the total amount of contributions to the company or the trust;
9.3.1.2. the total amount of withdrawals from the company or the trust; and
9.3.1.3. the purposes for which any amount of those withdrawals were applied.

9.3.2. Under the 2016 Financial Provisioning Regulations:

9.3.2.1. In terms of Regulation 9 of the 2015 Financial Provisioning Regulations, every holder of a right in terms of the MPRDA must annually assess the adequacy of the sum of the financial provision as determined in terms of regulation 6 of 2015 Financial Provisioning Regulations and approved by the Minister of Mineral Resources.

9.3.2.2. This annual assessment must be undertaken by reviewing:

9.3.2.2.1. the annual rehabilitation plan;
9.3.2.2. the final rehabilitation, decommissioning and mine closure plan; and

9.3.2.3. the environmental risk assessment report.

9.3.2.3. This review must be undertaken by a specialist review team which must include a mining engineer, a surveyor and an environmental assessment practitioner.

9.3.2.4. The results of the review and the assessment of the adequacy of the sum of the financial provision including any adjustment, must be audited by an independent auditor and must be submitted for approval to the Minister responsible for mineral resources in the form of an auditor's report within 15 months of the effective date of the prospecting right, exploration right, mining permit, mining right or production right.

9.3.2.5. If the Minister of Mineral Resources is not satisfied with the assessment of the adequacy and the adjustment of the sum of the financial provision, the Minister of Mineral Resources may:

9.3.2.5.1. request the holder, at its own cost, to revise the assessment and the adjustment of the sum of the financial provision to the satisfaction of the Minister responsible for mineral resources;

9.3.2.5.2. request the holder, at its own cost, to have the review and the adjustment of the sum of the financial provision peer reviewed by another independent qualified auditor team which must include a mining engineer and an environmental assessment practitioner; or

9.3.2.5.3. appoint another independent qualified auditor team which must include a mining engineer and an environmental assessment practitioner, at the holders cost, to confirm the assessment and the adjustment of the sum of the financial provision in consultation with the holder.

9.3.2.6. The holder must increase the financial provision within 30 days of being informed of the shortfall, should the Minister of Mineral Resources require a further adjustment based on the review,
assessment and independent auditor’s report, to meet the required sum of the financial provision and provide proof of payment to the Minister of Mineral Resources.

9.3.2.7. The holder must provide a certificate signed by the holder’s independent auditor reconciling the sum of the financial provision and any update thereof and estimates of exposure and liabilities with regard to environmental rehabilitation disclosed in the financial statement of the holder to the Minister of Mineral Resources.

9.3.3. In light of these requirements, we submit that there is already sufficient reporting done to the DMR to show that there is compliance with regard to compliance with the Financial Provisioning Regulations.

9.3.4. Flowing from this, the only concern that SARS should have is to see the line-item inflows and outflows from the trust to assess compliance with section 37A.

9.3.5. We submit that SARS can already do this, by looking at the tax returns of the trust. It is therefore unnecessary to require an extra detailed level of reporting for mining companies as the tax returns are sufficient for this purpose.

9.3.6. We submit that the reporting requirement in the proposed section 37A(9)(a) should be deleted.