Standing Committee on Finance
Parliament of the Republic of South Africa
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Chair, Members,

Budget 2012 Tax Proposals – Preliminary Comment

1. We present herewith PricewaterhouseCoopers' initial commentary on the Tax Proposals included in the 2012 Budget Review.

2. As always, we remind members that tax legislation is notorious for having the proverbial "devil in the detail". As such, we may remain silent in respect of certain proposals that subsequently turn out to be objectionable or laudable, or we may commend ones that end up less favourable than initially anticipated, or we may oppose some that perhaps turn out to be less harsh than expected. We therefore eagerly await the actual text of draft amendment bills before submitting more comprehensive comment.

A. Overall

3. We consider the 2011 tax proposals to be a bit of a mixed bag. There are proposals that we are strongly supportive of (e.g. the alignment of the tax regime for contributions to retirement funds, interest deductions for share acquisitions and tax relief for special economic zones), but there are also proposals that we are strongly against (for example caps on deductible retirement fund contributions, the increase in the dividends tax rate and the shortened period for the utilisation of STC credits against dividends tax).

4. We set out below our more detailed comments.

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B. Proposals that are welcomed

Individuals

Retirement reforms

5. The simplification and increase of the percentage deduction limits for retirement fund contributions is welcomed. We commend especially the decision to now allow the deduction of contributions to provident funds and the treatment of contributions to pension funds, provident funds and retirement annuity funds on the same basis under a single formula.

6. We also welcome the increased minimum monetary threshold of R20 000 for deductible contributions, although we question the practicality thereof as it would only apply to persons earning less than R88 888 per year. The reality is that anyone earning less than that is highly unlikely to be contributing R20 000 to retirement savings and the minimum threshold may therefore be meaningless in practice.

7. However, it should be noted that we have some concerns with aspects of the retirement reform proposals discussed below.

Tax-preferred savings and investment accounts

8. In general, we are supportive of the introduction of tax-preferred savings and investment accounts. South Africa has an exceptionally low rate of household savings and any incentives that encourage households to save are to be welcomed.

9. However, we have some concerns with aspects of this proposal which are addressed below.

Increase in CGT exemption thresholds

10. We welcome the proposed increase in the CGT exemption thresholds. However, the Income Tax Act contains numerous other monetary thresholds that should be reviewed and adjusted on a regular (if not annual) basis so as to preserve their value in real terms. A review of all monetary thresholds should be undertaken.

Business

Relief for small business

11. We welcome the proposed relief of the administrative burden for micro businesses regarding the submission of tax returns and payment of taxes.

12. We also welcome the changes made to the progressive income tax rates for small business corporations. However, we note that the proposed increased rate of dividends tax will more than eliminate the tax savings enjoyed by these companies. It is therefore misleading for National Treasury to suggest that this will encourage the growth of small incorporated businesses. In fact, the increased dividends tax may do just the opposite.

Deductions for interest on acquiring shares

13. We welcome the proposal to allow a deduction for interest on debt used to acquire controlling interests in companies. However, we note with some concern the proposal that the deduction will be subject to the same controls applied to section 45 transactions, i.e. an application for a directive to be issued by SARS, and the uncertainty and administrative burden that this will create. We look forward to more detailed information on how the deduction will work.

Property loan stock companies

14. The proposal to reform the taxation of property loan stock companies is long overdue and we welcome this.

Special economic zones

15. We welcome the proposal to explore possible tax relief for special economic zones and look forward to more detail in this regard.

Reduction of tax rate for foreign companies

16. We welcome the proposed reduction in the tax rate for foreign companies from 33% to 28% in order to bring it in line with domestic companies. This will also bring South Africa's taxation of foreign companies in line with international practice and eliminate the possibility of disputes in terms of South Africa's double tax treaties.

Mark-to-market taxation of financial instruments

17. We tentatively welcome the proposal to reform the taxation of financial instruments and look forward to receiving further detail.

Equity loans to foreign subsidiaries

18. The proposal to treat certain loans to foreign subsidiaries as equity is long overdue and welcomed.

C. Areas of Concern

Individuals

Personal income taxes

19. While it is acknowledged that South Africa continues to have significant social and economic challenges and there is a need for redistribution to address the imbalances in our society between the haves and the have-nots, there is growing concern over the tax burden being placed on middle and higher-income taxpayers. While lower income-earners have enjoyed significant real tax relief over the last 10 years or so, this is not the

case when it comes to middle and higher-income earners who continue to bear an ever-increasing portion of the tax burden.

20. For 2012/13 it is projected in the Budget Review that a mere 277 550 individual income tax payers (4.5%) will pay 38% of all personal income tax. This burden has grown significantly over the years as a result of the continued real relief given to lower-income taxpayers and the reforms made to the taxation of benefits enjoyed by middle and higher-income earners, such as travel allowances, company cars and, most recently, the medical scheme contributions. While it is acknowledged that many of these reforms have resulted in greater equity between the determination of the taxable income of lower-income earners on the one hand and middle and higher-income earners on the other, they have, together with far more limited adjustment to the tax tables for middle and higher-income earners, resulted in a significant shift of the personal income tax burden to these taxpayers. Some of the proposals in the 2012 Budget, such as the conversion of additional medical deductions into tax credits and caps on deductions for retirement fund contributions, will significantly add to this shift of the burden.

21. The growing tax burden for middle-income earners in particular is fast reaching breaking point, particularly when other taxes (e.g. toll fees, electricity levies, municipal rates, fuel levies) and growing administered prices are taken account. South Africa's personal income tax regime has become uncompetitive when compared with comparable developing countries, both in Africa and elsewhere.

Disincentives to savings

22. A number of proposals contained in the Budget Review are of concern as they disincentives to savings. South Africa has an exceptionally low household savings rate in comparison to other developing countries. A low savings rate has the implication that more reliance has to be placed on foreign borrowings at higher interest rates, translates into higher costs of production and reduced competitiveness. Ultimately, lower savings rates translate to lower growth rates.

23. Minister Gordhan himself recognised this in July 2011 when he stated in a speech that-

> "*For too long South Africa's savings rates have been significantly lower than its economic and structural characteristics permit. We are missing out on the savings dividend that should result from having a large workforce relative to the retired population, not least because the high rates of youth unemployment means that the dependency ratio is not as low as it should be.*
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> *Most worrying is the overall lack of savings by South African households. Between 2001 and 2010 the household savings rate declined by an average of 0,1% of GDP every year. There are various reasons why: people's 'short-term' outlook, the lack of transparent and cost-effective savings products, and poor financial awareness among potential savers. So is the consumerist attitude in South Africa, which often*

has the ultimate impact of more and more people being highly indebted. A new mind set is needed about our actions and the long-term consequences of those actions.

An entrenched savings culture among South Africans would achieve important goals at both an individual level and for the country as a whole. A high savings rate would allow us to meet our investment needs domestically, supporting the government's commitment to a developmental state without borrowing from other countries and their investors. This would make us less reliant on volatile short-term capital inflows for funding, which can easily reverse and pose risks of instability for an emerging economy like ours."

24. The proposals in question that are objectionable are those to-

- scrap the existing interest exemption for individuals;
- cap the contributions to the proposed tax-preferred savings and investment accounts at R30 000 per year and R500 000 in aggregate;
- cap the deduction for contributions to retirement funds;
- increase the rate of dividends tax to 15%; and
- increase the effective CGT rates.

25. We address each of these in more detail below.

26. We submit that the existing interest exemptions for individuals should not be replaced by the proposed tax-preferred savings and investment accounts. Rather, the proposed tax-preferred savings and investment accounts should be introduced in addition to the interest exemptions. It is apparent from the 2011 Budget Review that the intention is that the proposed tax-preferred savings and investment accounts will be for savings for housing and higher education. While it is admirable that government wishes to promote savings for these purposes, it is not government's role to dictate to its citizens how or for what it should save. Savings for other purposes, such as medical, retirement, etc. are no less important. Limiting the relief to specific investment vehicles will result in unnecessary market distortions. It will also have a significant impact on retirees who clearly would not have a need to save for the stated purposes.

27. Capping the deductible contributions to retirement funds is ill-considered and will have a potentially negative effect on retirement savings. While this measure is clearly aimed at higher-income earners, it is short-sighted. Higher-income earners are precisely those taxpayers that can afford to save and they should be encouraged to do so. The caps effectively send the message to high-income earners not to save more than the capped amounts for retirement and will reduce the amount that such persons contribute to retirement funds. The suggestion that relief from tax will be given for these non-deductible contributions on retirement is meaningless as compensation for this treatment as the time-value of money will erode the value of that relief to almost a

nullity (the value of R1 in 20 years time is virtually nothing). The result is that many taxpayers are likely to curtail their contributions to retirement funds and may ultimately end up spending the amount. At best they may have to reduce contributions to retirement funds to account for the additional tax that they will have to pay or save in alternative vehicles with after-tax amounts. Either way, a reduction in the level of savings is inevitable.

28. It should also be noted that in many instances, a taxpayer effectively contributes to retirement funds for both the taxpayer and a spouse. In such cases taxpayers are effectively penalised when compared to the situation where each spouse contributes to retirement funds. This situation is inequitable.

29. A further point is that the basis of taxation adopted for retirement savings is the “exempt, exempt, tax” basis, i.e. income used to contribute to retirement funds is exempted, growth in the retirement funds is exempted and withdrawals from retirement funds are taxed. The proposed caps effectively introduce a dual basis for taxation of retirement savings, the above for contributions below the caps and a tax, exempt, exempt basis for contributions above R200000. This dual model adds unnecessary complexity to the system.

30. The proposed alternatives in order of preference are:

- There should be no monetary caps on deductions for contributions;
- The caps should be significantly increased;
- Taxpayers should be able to transfer any unused cap to a spouse;
- Any non-deductible contributions should be increased for inflation for carry-forward to subsequent years in order to preserve the value thereof in real terms.

31. Capping the contributions to the tax-preferred savings and investment accounts is not supported for similar reasons to that for the capping of deductions for contributions to retirement funds. Most importantly, this is a disincentive to the very persons who can most afford to save.

32. When it was first announced that STC would be replaced with a dividends tax, it was indicated that this would be done in 2 phases. The first phase was a reduction in the rate of STC from 12% to 10%. It was announced at the same time that dividends tax would be introduced at a rate of 10%. The announcement in the Budget that dividends tax would now be introduced at a rate of 15% came as a shock and amounts to an about turn on the part of government.

33. The increase in the dividends tax rate from 10% to 15% is a further disincentive to saving. Many individuals choose to invest in shares or unit trusts as a vehicle for savings.

Increasing the tax rate on dividends will reduce the after-tax return on these investments. Taxing dividends amounts to a tax on savings and increasing the tax rate will result in less savings. It is, however, recognised that in appropriate circumstances a higher dividends tax rate may be reasonable in order to reduce the opportunities for arbitrage between the maximum tax rate for individuals of 40% and that for companies of 28%. It may therefore be appropriate to levy a higher dividends tax rate for dividends paid by companies closely held by individual or trusts. However, the higher dividend tax rate should not be levied for dividends paid by widely held companies.

34. The proposed increase in the effective CGT tax rates for capital gains will, in a similar manner to the increase in the dividends tax rate, potentially result in reduced savings. It should further be noted that the lower tax rates for capital gains were a trade off for the fact that there would be no indexation of the tax base for capital assets. Capital assets, unlike trading assets, are held over a long period and much of the increase in their value over that period is due to inflationary effects. The rationale is that taxpayers should not be taxed on inflationary increases in the value of assets, but only on real increases in value. A capital asset with a cost of R100 will have a nominal value of R163 after 10 years at an annual inflation rate of 5%. If that asset was disposed of for R200, the taxpayer would make a real profit of R37. However, our CGT system would still subject that person to tax on the nominal profit of R100. The increase in the inclusion rate now potentially undermines this rationale.

Conversion of medical deductions to tax credits

35. It is acknowledged that tax credits rather than deductions will result in more equitable tax relief as between lower and higher-income earners. This is particularly so insofar as the capped deductions for medical scheme contributions are concerned.

36. However, we have some concerns with regards to other aspects. For those taxpayers under the age of 65, it is proposed that excess medical expenditure also be converted into tax credits with effect from 1 March 2014. This sounds fair in theory; however, it must be borne in mind that the excess expenditure is determined as that exceeding 7.5% of taxable income. Higher-income earners are therefore placed at a significant disadvantage to lower-income earners as their threshold for excess medical expenditure will increase as their taxable incomes increase with the effect that in the same circumstances less of their medical expenditure will be excess expenditure qualifying for tax relief. The result is that the system of determining qualifying excess expenditure is already progressive, although this is offset to some extent by the deduction regime which is regressive. The proposal to convert excess medical expenditure to tax credits will eliminate the regressive tax deduction, but will retain the progressive determination of excess medical expenditure. Higher-income earners are therefore subjected to a double whammy in contrast to the basic credit for medical scheme contributions, which is neutral. It is submitted that a more neutral mode of determining excess medical expenditure should be considered.

Business

Rate of withholding tax on interest and royalties

37. We are uncertain of the logic behind the proposal to increase the rates of tax on these payment made to non-residents of South Africa. Many of the double tax treaties entered into by South Africa provide that the paying country will have no right to tax these amounts. As South Africa has largely given away its taxing rights on these payments to the recipient country, this proposal is likely to result in little benefit to the fiscus.

Shortened period for STC credits

38. The proposal to reduce the period for the use of STC credits against dividends tax from 5 years to 3 years is not supported. This relief was a hard-fought victory for taxpayers and the only benefit is that it provides a transitional period in which economic double taxation resulting from the shift of the taxation of dividends from the company to the shareholder can be eliminated.

39. The rationale for shortening the period advanced in the Budget Review (being the delayed implementation and the increased rate) holds no water. Neither of these factors has anything to do with taxpayers and were entirely in the control of government.

Uniformity of taxing passive income and gains

40. There is uncertainty about how to interpret the suggestion that income and gains from capital should be uniformly taxed. For example, on the one hand dividends are currently fully exempt whilst, on the other hand, rental from fixed property is fully taxed. If National Treasury has some kind of convergence in mind, taxpayers will remain apprehensive of what final outcome is envisaged.

Indirect tax

Carbon Tax

41. While the proposal has been watered down to some extent from what was proposed in the first consultation paper, we remain extremely concerned that National Treasury is rapidly pushing ahead with the introduction of a carbon tax. It is of particular concern that announcements are made in the Budget of the design features, rates and proposed implementation date despite the fact that a second consultation paper is yet to be issued. This seriously brings into question government's commitment to the consultation process and the efficacy thereof.

42. Our biggest concerns with the proposal are:

    - If South Africa introduces a carbon tax it would be the first developing country to introduce such a tax of any significance. This will place the country at a significant competitive disadvantage relative to its peers with whom it competes. It would also result in South Africa placing a price on carbon before many developed countries, most notably the United States.

- Most countries that have introduced a carbon tax or are planning to introduce a carbon tax are far less carbon intensive than South Africa, primarily as a result of South Africa's heavy reliance on coal for energy relative to other countries. Notwithstanding that South Africa's economy is relatively carbon intensive, it is not exceptional in terms of energy intensity. The reason for the difference between South Africa's energy intensity and its carbon intensity is that coal emits far more carbon than other fossil fuels. The result is that a carbon tax will have a far greater economic impact in South Africa than in other countries.
- South Africa's undertakings to reduce emissions are subject to financial and technological support from developed countries for the implementation of adaptation mitigation action in developing countries. The introduction of a carbon tax in the absence of binding commitments by developed countries to provide such support is questionable.
- Carbon tax is but one possible policy intervention available to reduce carbon emissions and is not a panacea to the problem.
- The electricity sector is responsible for approximately 48% of South Africa's carbon emissions as a result of its dependence on coal. However, the electricity sector is highly regulated and the energy mix and price of electricity is regulated by government. The energy mix is regulated by the integrated resource plan. There is therefore a disconnect between a carbon tax and emission reductions in this sector. Levying a carbon tax on the likes of Eskom will have no impact on South Africa's energy mix and the additional cost will simply be passed on to consumers in the form of higher tariffs. It is estimated that the carbon tax proposed will add about 5c/Kwh to the price of electricity in the first year.
- The increased cost of electricity will undermine the competitiveness of South Africa's economy relative to other countries, particularly those that do not put a price on carbon emissions. In particular, the increased cost of electricity will have a severe impact on the competitiveness of the mining and manufacturing industries.
- South Africa has one of the lowest ratios of carbon consumed to carbon produced of any country. The implementation of a carbon tax will therefore amount to a tax on South Africa's exports with consequential implications for their international competitiveness and the foreign currency earnings that any country relies on to balance its current account and pay for imports.
- It is noted that the revenues from the carbon tax will not be earmarked. Nor does it appear that the tax will be revenue neutral in the sense that other taxes will be reduced. While it is acknowledged that "consideration will be given to spending to

address environmental concerns", it should be noted that government has an exceptionally poor track record of recycling environmental taxes for environmental purposes.

Electricity levy increase

43. While we acknowledge that including funding for energy-efficiency initiatives in the electricity levy rather than in the tariffs levied by Eskom will enhance transparency, we have some concerns in this regard. When the electricity levy was first introduced it was announced that this was a first step towards the introduction of a carbon tax and that the tax would be complemented by incentives that encourage firms to behave in a more environmentally responsible manner and that tax incentives to encourage the uptake and development of renewable energy could be enhanced.

44. It would now seem that the electricity levy is intended to remain a permanent feature of our tax system once a carbon tax is introduced. This is of concern as it would effectively mean that the carbon price imposed on electricity will be far greater than that contained in the carbon tax.

45. A further concern is that the electricity levy is expected to generate revenues of approximately R6.5 billion in 2011/12 and has generated revenues of approximately R14.7 billion since its introduction. However, no incentives promised in the 2008 Budget have yet to materialise with the effect that not a single cent of this tax has been recycled for environmental purposes. Government's track record in this regard is exceptionally poor yet we are expected to now accept that the additional R2 billion to be raised by the increase in the levy will be recycled for energy-efficiency initiatives.

RAF levy

46. We are concerned that we continue to see significant annual increases in the Road Accident Fund Levy. This levy has more than doubled since 2008 and it is concerning that taxpayers continue to be forced to pay for the mismanagement and fraud in the RAF.

D. National Treasury Drafting Resources

47. As a final matter, we take this opportunity to commend the legislation-drafters at National Treasury. Highly complex concepts are constantly being addressed under stressful time pressure. However, it is also obvious that the team is under-resourced with the result that sometimes inadvertent errors creep in. Nowhere is this more apparent than in the 2011 tax amendments where significant errors and anomalies have arisen. These errors and anomalies are having a significant impact on business transactions as a result of the uncertainties that they create.

48. In our view, the problems have a risen primarily as a result of the sheer volume and complexity of the amendments that National Treasury undertook in 2011 and the limited resources at its disposal. The problem is made more acute by the limited time available for tax practitioners and taxpayers to consider and comment on the proposed legislation and the small pool of such persons that actively participate in the development of our tax legislation. It would also be useful if further comments were sought where the draft legislation has been significantly amended after the first draft legislation has been issued. Many of the problems arising in the 2011 amendments have arisen in respect of legislation on which there was no opportunity to comment.

49. In light of this, while we acknowledge the need for many of the proposals contained in this year's Budget, the likely complexity of a number of these proposals is of concern. In particular, the following proposals are likely to be significantly complex to draft into the legislation:

- the proposals for limiting excessive debts in businesses;
- debt used to fund share acquisitions;
- property loan stock companies;
- the proposal for offshore section 45 transactions;
- debt cancellations and restructurings;
- mark-to-market taxation of financial instruments; and
- captive finance vehicles.

50. We are in desperate need for a period of consolidation in order to allow for taxpayers, tax practitioners and SARS to get to grips with the complex 2011 amendments and to correct the technical errors and anomalies that have arisen from those and previous amendments. Consideration should seriously be given to postponing some of the more complex and less pressing proposals by a year and having a longer period for consultation in this regard.

51. Important policy projects are also being delayed because the team is overburdened by the day-to-day workload.

52. A case in point is the Income Tax Act (ITA) re-write project. The current ITA was last consolidated and re-written 50 years ago, i.e. in 1962. There is little difference of opinion that the current ITA is desperately (and urgently) in need of a rewrite. National Treasury's current re-write project appears to have commenced some 5 years ago, but progress has been slow. As mentioned, the main reason for this delay appears to be the resource constraints at National Treasury.

53. Apart from the re-write project, there are several other initiatives that taxpayers are seeking, but which are being hampered by the resource problem.

We thank you for the opportunity to offer our opinion on the Budget, and we trust that you find this to be of assistance in your deliberations. Please do not hesitate to call on us for further analysis.

Yours sincerely,

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