TAXATION LAWS AMENDMENT BILL 39 of 2013

Select Committee on Finance : National Council of Provinces

Presenters: Tax Policy -National Treasury 06 November 2013

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National Treasury
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National Treasury Officials: Tax and Financial Sector Policy

- Lutando Mvovo: Acting Chief Director (Legal Tax Design)
- Beatrie Gouws: Director (Personal Income Tax and Savings)
- Kgaugelo Bokaba: Director (Business Taxes)
- Christopher Axelson: Director (Economic Tax Policy)

Retirement savings - contribution incentives

(Sections 11(k) & 11(l), para 2(l) of the 7th Schedule)

- The current system is too complex resulting in increased costs and admin burden. The regime also allows some individuals & employers to excessively benefit from the incentive.

- Reasons for change are:
  - The need to harmonise the tax treatment of contributions to & benefits from retirement funds;
  - The requirement to reduce the complexity of the current system; and
  - The need to ensure greater equity.

- Amendments will greatly simplify the taxation of retirement fund contributions
  – There will only be one tax deductible percentage limit of 27.5%
  – Employer contributions will be deemed a fringe benefit in hands of employee
  – No need for different definitions of income (pensionable vs non-pensionable), rather the greater of taxable income or remuneration

Contributions incentives for retirement savings

(Sections 11(k) & 11(l), para 2(l) of the 7th Schedule)

Source	Contribution type – base	% cap	Monetary cap	Retirement fund
Employer taxpayer	Employer contribution = fringe benefit = deemed employee contribution	Unlimited fringe benefit	Unlimited fringe benefit	All retirement funds
All individual taxpayers	The greater of remuneration or taxable income (excl. retirement annuity or lump sum income). Rollover of non-deductible contributions & any amount that remains are not taxable upon exit. Contributions include amounts paid towards risk benefits & administration costs.	27.5%	Maximum of R350 000	All retirement funds

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Valuation of fringe benefit for DB purposes

(Definitions of "DC component of a fund", "DB component of a fund", "retirement-funding income" in para 1 of the 7th Schedule & para 12D of the 7th Schedule)

- Going forward, any contributions made by a employer to an approved SA retirement fund will be taxable as a fringe benefit. With a defined contribution fund (DC), the value of the employer contribution reflects the value of the fringe benefit for the employee.

- With a defined benefit fund (DB), the value is harder to calculate due to an inherent element of cross-subsidisation across members where the value of actual contributions does not match up with the member's benefits.

- Amendments determine the value of the fringe benefit from a DB fund through the application of a compulsory formula. The formula approximates the increase in value of the annuity and lump sum benefit of the member as a result of one additional year of service, based on the value that the member will be entitled to as a retirement benefit.

Provident fund post-retirement annuity alignment

(The definitions of "pension fund", "provident fund", "retirement annuity fund", "pension preservation fund", & "provident preservation fund" in section 1, and para 6(1)(a) of the 2nd Schedule)

- Members of provident members cannot deduct their own contributions and are not compelled to annuitise at retirement, which means members often take entire retirement amount as cash lump sum and many spend it too quickly.
- Reasons for changes are:
  - Provident funds need to be aligned to other retirement funds so that provident fund members enjoy the same benefits and protection; and
  - Members are reluctant to annuitise since they lose old age grant if annuity larger than the grant (problem of means-test).
- Members will be required to annuitise upon retirement (vested rights protected)
  - If anyone is above the age of 55 at 1 March 2015 will not be required to annuitise. Also, any accumulated balance of funds and growth on those funds from 1 March 2015 will not need to be annuitised
- De-minimus amount raised to R150 000 (from R75 000)

Additional amendments to personal income taxes

- Increase in the amount that can be deductible for an employer when they provide a bursary or scholarship for tertiary education to employee or relative of employee.
  - Employee must earn less than R250 000 (was R100 000) and deduction cannot exceed R30 000 (was R10 000)
- Tax treatment of income protection policies has been amended to be in line with other personal insurance.
  - Contributions to income protection policies will not be deductible, but pay-outs will be tax free
  - Effective date of 1 March 2015 to allow time to change policies
- Employer provided housing that is acquired by employee will no longer be a taxable fringe benefit if employee earns less than R250 000 and house is worth less than R450 000.
- Excess donations above 10% of taxable income can now be rolled over

Business Taxes

Anti-Avoidance Proposals

- Measure to prevent base erosion and profits shifting
  - Hybrid Debt Instruments
  - Acquisition debt interest limitation
  - Connected persons debt limitations
- Removal of exemption for dividends applied against deductible financial instruments

Incentives

- Special Economic Zones (SEZs)
- Research & Development tax incentive

Anti-avoidance Provisions

Debt Versus Shares: Key Commercial Features

Debt

- Fixed Claim on Cash Flows.
- High priority on cash flows/collateral often required.
- No management control.
- Fixed Maturity.

Shares

- Variable claim on cash flows.
- Low priority on cash flows/no Collateral required.
- Management control.
- Infinite/extended life.

Debt Versus Shares: Current General Tax Rules

Debt

- Interest income received by creditor subject to tax at ordinary rates.
- Interest expense deductible if incurred in the production of income.
- Repayment of capital amount of debt instrument not taxable nor deductible.

Equity/Shares

- Dividends subject to withholding tax at 15 per cent (under Dividends Tax)
  - Cash dividends: liability in hands of shareholder (subject to certain exemptions, for example, dividends paid to resident companies)
  - In specie dividends: liability in the hands of the payor company (subject to certain exemptions, for example, dividends paid to resident companies)
- Dividend not deductible by payor
- Contributed Tax Capital not deductible
- Return of capital reduces base cost of shares
- Gain on disposal of shares generally subject to CGT

Hybrid Debt Instruments

Section 8F & 8FA

Background

- Belief that the tax law follows the form of the instrument in determining debt vs. equity nature of instrument

- Encourages some taxpayers to choose a label with consequential benefits (i.e. tax deductions in respect of interest payments on debt)

- Current anti-avoidance rule merely target instruments with short-term (i.e. 3 year) conversion features and is therefore too narrow

Proposal

- Two-fold regime: Rules focusing on the nature of the instrument itself (the corpus) and yield on instrument (interest)

- Both rules recharacterises the yield as dividends in specie (without recharacterising instrument (i.e. corpus)

- Recharacterisation on rules focusing on instrument (corpus) apply if:
  - The debt is owed to a connected person and has features indicating that redemption is unlikely within a reasonable period (i.e. 30 years from date of issue);
  - The debt has features requiring a conversion into shares
  - The redemption of the debt is conditional upon the solvency of the issuer

- Recharacterisation on rules focusing on yield (interest) apply if:
  - not determined with reference to a specified rate of interest or the time value of money
  - the yield is conditional on profitability of company

- Impact of proposal: no inclusion in income of payee and no deduction for payor

Exclusions from application of proposal

- Small business corporations (section 12E)
- Tier I and II capital:
  - issued by banks (or controlling companies in relation to a bank) or
  - issued to connected persons in relation to a bank to the extent that the debt does not exceed 5 per cent of overall Tier I & II capital , respectively, issued by that bank
- Any class of instruments issued by Short and Long-Term insurers
  - the redemption of which must be subject to approval by the Registrar (determined in terms of the FSB Act)
- Linked units held by pension fund, provident fund, long-term and short term insurers, and REIT if the fund, insurer or REIT holds:
  - At least 20 per cent of the linked units in the issuing company and
  - The shares and the instrument were acquired before 2013
  - 80 per cent/more of the value of assets is attributable (directly/indirectly) to immovable property

Acquisition debt and connected person debt interest limitations

Sections 12M and 12N

Background

- **Acquisition Debt**
  - Business can be acquired by either purchase of shares or assets
  - Interest on debt to acquire assets deductible if:
    - Linked to tax-free reorganisation transactions (sections 45 and 47) or
    - Used to acquire controlling share interest (section 24O)
  - Deductions subject to discretionary limitation (section 23K)
- **Connected person debt**
  - Interest expense is generally deductible if incurred in the production of income.

Reason for change

- **Acquisition debt**
  - Excessive debt for funding acquisitions poses a significant risk (taxable profits shifted through interest deductions)
  - Discretionary limitation was intended to be temporary and as information gathering mechanism
- **Connected person debt**
  - Debt can be used as base erosion tool:
    - Mismatch created if interest paid to exempt or foreign persons (i.e. deduction/exemption)
    - Mismatch enables taxpayers to over-leverage because of tax benefit of interest deduction

Proposal

- Aggregate deductions for interest on acquisition debt and connected person debt (in a **controlling relationship**) will be limited to:
  - Interest income, plus
  - 40 per cent of adjusted taxable income

- In determining adjusted taxable income:
  - interest received/accrued, currency gains/losses and CFC net income are excluded; and
  - Interest incurred, capital allowances and additional <u>75 per cent of rental income</u> is included

- Interest expense in excess of the limitation will be carried forward

Removal of exemption for dividends applied against deductible financial instrument
Section 10(1)(k)(i)(hh)

Background

- Dividends paid by resident companies generally **exempt from income tax** but **subject to Dividends Tax at 15 per cent** (subject to certain exemptions)
- Anti-avoidance provisions: intended at denying exemption where there is:
  - artificial shift of exempt dividend income or
  - a mismatch
- For example, no exempt from income tax for dividends from share lending arrangements (i.e. manufactured dividends)

Reasons for change

- Current rules do not cover shares held as an offset against the issue of derivatives (e.g. contracts for differences, total return swaps etc.)
- Company receives exempt dividends which are applied to offset deductible payments i.r.o. a share derivative (Net result is mismatch: receipt or accrual of exempt dividend with dividend applied to cover a deductible payment i.ro. share derivative)

Proposal

- No exemption if dividend is used as an offset against a deductible payments (i.e. where company receiving or accruing dividend incurs obligation to pay dividends where the obligations is determined with reference to dividends received or accrued)

General

Cross-Issue of Shares
Sections 24B and 40CA

Background

- Company that issues shares in exchange for the issue of another company's shares is deemed not to have incurred expenditure i.r.o. the share acquisitions (i.e. both companies have zero base cost)
- However, if company issues shares as consideration for assets the company is treated as having incurred expenditure equal to MV of share

Reasons for change

- Nil base cost rule overly broad and has adverse impact on BEE transactions
- Case Law [C:SARS v Labat Africa (669/10) [2011] ZASCA 157]
  - Removes necessity of having non-expenditure rule within the legislation (rule now exists via judicial precedence)

Proposal

- Zero base cost rule will be eliminated i.r.o. commercially driven transactions involving the issue of shares for assets
- Companies issuing shares for assets will obtain MV base cost in the assets (if outside tax free reorganisation rules)
- Labat decision applies in all other contexts

Tax incentives for Special Economic Zones

Section12Q

Background

- DTI has identified a lack of targeted tax incentives as one of the hindering factors to the success of Industrial Development Zones

Proposal

- Incentive to support of the DTI's broader initiative to improve governance, streamline procedures and provide more focused support for industry
- Companies operating within Special Economic Zones (SEZs) (approved by the Minister of Finance after consultation with the Minister of Trade and Industry) will be eligible for a favourable tax dispensation:
  - All businesses operating within approved SEZs will be eligible for accelerated depreciation allowances on capital structures and an employment incentive.
  - Certain companies (carrying on qualifying activities within an approved SEZ) will be subject to a reduced corporate tax rate of 15 per cent
  - All SEZs will qualify for VAT and customs relief similar to that for the current IDZs.

Refinement of the R&D regime

Section 12D

Background

- The R&D tax regime provides substantial tax incentives aimed at ensuring that local R&D is globally competitive
- Under this regime, expenses incurred for purposes of conducting R&D are 100 per cent deductible
- Moreover, these expenses may generate a further 50 per cent if the R&D is approved by the Minister of Science and Technology

Reason for change

- The adjudication committee has uncovered that the incentives can possibly be claimed in respect of activities that were never intended to fall within the ambit of the regime
- The language in the provisions also gives rise to uncertainties interpretation

Proposal

- Provisions will be streamlined in order to accelerate the adjudication process, particularly for projects in the pharmaceutical (generic medicines and clinical trials) and information and communication technology (ICT) related sectors.

TAXATION LAWS AMENDMENT BILL

International Tax

Presenter: Lutando Mvovo | Acting Chief Director, National Treasury **| 6 November** 2013

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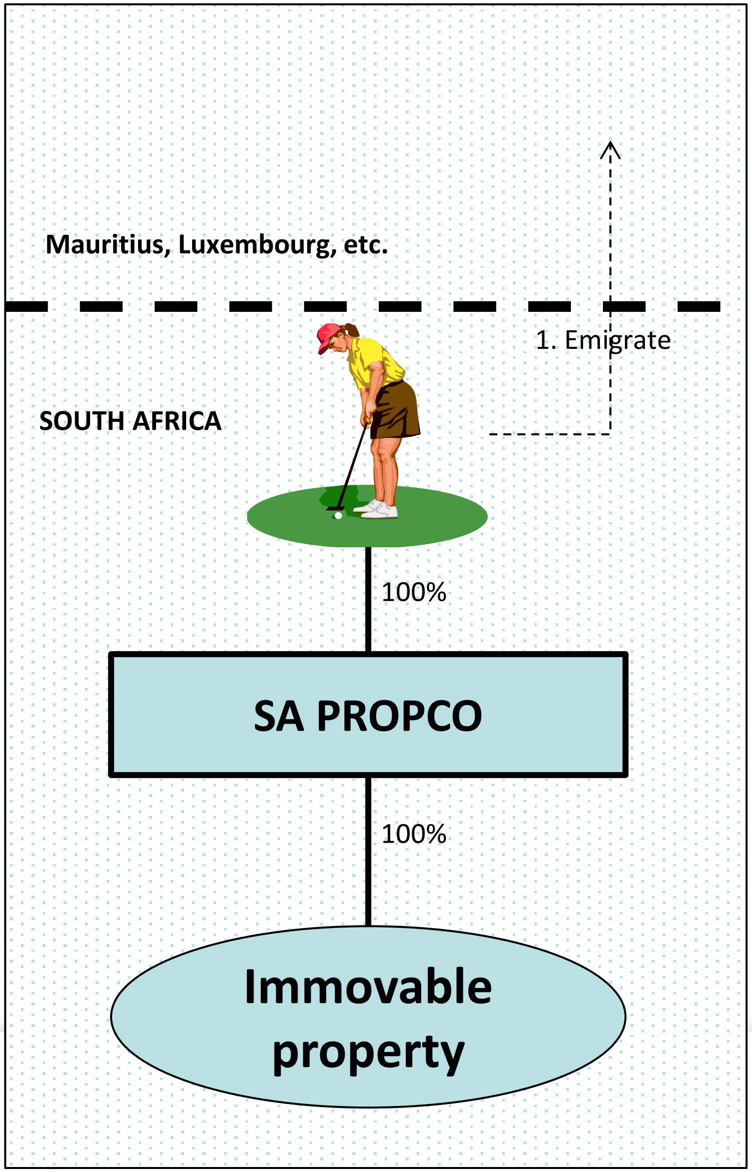
INTERNATIONAL SHIPPING TRANSPORT ENTITIES – INCENTIVE

[Clauses 24(1)(a), (b) and (c); 28(1)(t); 37(1)(a)(g) and(c); 46; and 47]

- **Current position:**
  - International shipping transport conducted by SA companies are subject to tax at 28 percent.
  - Net income of foreign shipping controlled foreign companies are exempt if the shipping is conducted outside SA
- **Reason for change:**
  - International trend is reduced taxation either through a tonnage tax or a total exemption for shipping activities
  - In view of these trends, the SA 28 percent tax is highly uncompetitive
  - SA effort to revive shipping industry
- **Proposed change:**
  - New regime to exempt international shipping transport companies [Exemption include: Income Tax, Dividends Tax, CGT, and Withholding Tax on Interest]

EXIT CHARGE ON INTERESTS IN IMMOVABLE PROPERTY

Clause 26



Current position:

- Emigrating resident exempt from tax
- Assumption that immovable property and indirect interest therein remain within SA taxing jurisdiction after becoming non-resident

Reasons for change:

- Through narrow interpretation of DTAs and domestic law, emigrants could possibly permanently avoiding tax on indirect interest in property
- Equity between normal shares and property shares

Proposal

- Immediate exit charge on property shares
- Bumped up tax cost

CURRENCY RULES FOR TREASURY MANAGEMENT COMPANIES [Clauses 7(1)(o); 75(1)(b); 81 and 147(1)(h), (i), (j) and (k)]

- **Current position:**
  - 2013/4 Budget: Minister announced establishment of exchange control free domestic treasury management companies as part of Gateway to Africa
  - Listed companies eligible for dispensation
- **Reason for change:**
  - Align the tax rules to exchange control
  - Without the corresponding tax changes, domestic treasury company would be taxable on currency gains and losses – will make SA unattractive as treasury location
- **Proposed amendments:**
  - Qualifying domestic treasury companies exempt from tax on currency gains and losses
  - Exemption similar to headquarter company exemption

RING-FENCING OF NET FOREIGN TRADE LOSSES

[Clause 59(1)(a)]

- **Current position:**
  - Income tax architecture ring-fences domestic tax base against foreign losses
  - i.e. foreign income taxable on a current basis, whilst foreign losses are ring-fenced for set-off only against foreign income
- **Reasons for change:**
  - Technical wording of ring-fencing provision appears to leave space for setting-off foreign losses against SA passive income
  - Fore example: Foreign rental losses may be used against SA interest income.
- **Proposed amendments:**
  - Ring fencing provision to expressly protect domestic base against any foreign losses [both active and passive]

UNIFORM CROSS-BORDER WITHHOLDING REGIME TO PREVENT BASE EROSION [Clause 93; 103; 104; and 105]

- **Current position:**
  - No withholding tax on technical fees
  - SA sourced services only taxable if the foreign entity has a local active business [permanent establishment] or is from a non-treaty country
- **Reasons for change:**
  - Technical fees generate local deductions the same as interest and royalties
  - Concerns that some foreign entities do not file returns, despite having permanent establishments in SA [thus escaping SA tax]
- **Proposed amendments:**
  - Introduce a new withholding tax on fees for SA sourced services as a means to identify and collect tax from foreign entities with local permanent establishments
  - New tax mainly apply to non treaty partners, with treaty partners merely identified if have permanent establishments or not

DRAFT TAXATION LAWS AMENDMENT BILL

Indirect Tax

Presenter: Lutando Mvovo | Acting Chief Director, National Treasury **| 6 November** 2013

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Simplification of VAT Registration [1]

(Section 23(1)(b); ss(3); s24(5A); s44(3)(e))

Background

- Compulsory registration may be triggered: (i) if a person makes > R1 m supplies in the preceding 12 months, or (ii) if a person reasonably expects to make supplies of R1 m in the next period of 12 months.
- In the main, voluntary registration is triggered if a person makes > R50K in a 12 month period (mostly applicable to small businesses) and if a person carries on an activity which is reasonably expected to generate taxable supplies of > R50K in any 12 month period.

Reasons for change

- Compulsory and voluntary registration is beset with problems: (i) SARS has to predict future viability of a business in order to register a person as a vendor; (ii) backdating of VAT registration by SARS often leads to interest and penalties; (iii) law is unclear and inconsistency in application of law; (iv) monetary thresholds for voluntary registration hampers small businesses development

Simplification of VAT registration [2]

Proposal

- Compulsory registration is streamlined
  - Predictive element associated with the R1 m threshold is eliminated – a person that will make supplies > R1 m in terms of a contractual obligation in writing will be allowed to register;

- Voluntary registration is streamlined – 2 types of registration: traditional and fast track VAT registration
  - <u>Traditional registration</u> – no monetary thresholds applicable; municipalities, foreign donor funded projects will be allowed to register. For persons other than above seeking registration under the traditional approach, a R5 m expenditure requirement is necessary. Persons under this approach have unlimited access to refunds

Simplification of VAT registration [3]

- Fast-track VAT registration
  - No monetary threshold applicable;
  - Persons seeking registration will be allowed to register (easier to register for VAT);
  - Persons under this approach will only be allowed refunds if taxable supplies of R100K is made in a 12 month period
  - SARS can deregister a vendor if the vendor does not make R100K in a 24 month period

E-commerce VAT registration [1]

(Sections 1; 15(2)(a)(vii) & 23(1A))

Background

- Currently foreign suppliers of e-commerce services to SA customers are not compelled to register for VAT: these foreign suppliers transact wholly over the internet and have no physical presence in SA;
- SA VAT Act lacks a place of supply rule to allocate taxing rights to SA;
- The above leads to an interpretative exercise to determine whether or not these foreign suppliers should be registered for VAT with no clear answers;
- Recipients of e-commerce services are required to self-assess the VAT on supplies received – this VAT charge is known as the reverse charge

E-commerce VAT registration [2]

Reasons for change

- Compliance with the self-assessment nature of the reverse-charge is low;
- Local suppliers of e-commerce are at an unfair advantage as local suppliers of e-commerce services charge 14% VAT on supplies made to SA customers;
- Foreign suppliers do not charge VAT on supplies to SA customers and thus enjoy a 14% advantage which allows them to slash their prices

E-commerce VAT registration [3]

Proposal

- Place of supply rule for foreign e-commerce foreign suppliers added – foreign suppliers compelled to register for VAT if:
  - E-commerce services are supplied to
    - (i) a SA resident customer, or
    - (ii) if payment for the e-commerce services originates from a bank registered in SA (in terms of the Banks Act)
- Foreign suppliers are compelled to register irrespective of the aggregate value of supplies made in a 12 month period;
- Foreign suppliers allowed to register on the payments basis to streamline administration