national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

SARS

File No: Budget 2007 **Ref:** K. Engel **Tel:** 012 315 5508 **Fax:** 012 315 5516

Portfolio Committee on Finance

Taxation Laws Amendments Bills

Response Document

12 June 2007

1. Background

1.1 Process

The Taxation Laws Amendment Bills, 2007, represent the first instalment of this year's tax proposals, as announced in the 2007 Budget Review. These Bills cover rates, thresholds, technical corrections (mostly from 2006) and certain urgent matters (e.g. taxation of retirement lump sums, extension of small business tax amnesty and prevention of amalgamation avoidance).

The Portfolio Committee on Finance held informal hearings on the Taxation Laws Amendment Bills, 2007 in early March. National Treasury and SARS presented the initial briefing on 9 March and public hearings were conducted on 13 March.

Initial versions of the Bills were provided to the Portfolio Committee on 26 February in order to satisfy the 10-day rule. Website release of the Bills occurred a few days thereafter. Comment for most issues was due by 23 March. Because of the delayed release of certain key retirement tax amendments, comment period for these retirement issues was extended to 25 April.

2.2 Public comments

Three stakeholders made submissions to the Portfolio Committee. The most comprehensive formal comments were submitted by the South African Institute of Chartered Accountants, which covered all aspects of the Bills. The Life Offices' Association and the Institute for Retirement Funds submitted combined formal comments on issues relating to the effective date of the repeal of the Tax on Retirement Funds.

The response document normally does not take into account informal comments submitted solely to the National Treasury and SARS (as opposed to submissions made to the Portfolio Committee). However, informal comments have been added to the response document because comments were solicited after the hearings, especially in respect of retirement tax issues. These informal submissions originated from:

Aroma Management Services
Bendels Consulting
Bruce Cameron
Deloitte and Touche
Edward Nathan Sonnenbergs
Ernst & Young
H. Miller Ackermann & Bronstein
Institute of Retirement Funds (IRF)
Legal Resource Centre
Life Offices' Association of South Africa (LOA)
KPMG
Mallinicks
PricewaterhouseCoopers
South African Institute of Chartered Accountants (SAICA)
Werksmans
University of Cape Town Pension Fund

3. POLICY ISSUES AND CHANGES

Provided below are responses to the policy issues raised by the (formal and informal) comments. This response document is divided into two segments. The first segment deals with general tax issues. The second segment deals with retirement-related tax issues. Comments that fall wholly outside the scope of the Bill are omitted.

3.1 General Comments

A. Income Tax

1. *Annuity payments to dependants of former employees and partners (section 11(m))*

Background: Were it not for section 11*(m)*, employers could deduct payments to former employees and their dependents under section 11*(a)* only to the extent these payments are incurred in the production of income. These payments typically involve situations where the employer is seeking to make these payments as part of the employer's common practice to stimulate employee goodwill, productivity and retention. For instance, employer payments to former employees (and dependents of former/deceased employees) have this effect if the employer has a policy or practice of making these payments in order to secure a productive and contented workforce. To promote these employer payments, section 11*(m)* adds certainty for employers by treating all annuity payments to former employees/partners and their dependants as fully deductible regardless of the production of income connection. However, deductible payments to dependents of former employees/partners are currently subject to a R2 500 ceiling. In view of the small ceiling which effectively renders this incentive meaningless, the proposed amendments delete the section 11*(m)* deduction for dependents.

SAICA: SAICA requests that the deduction for dependents of former employees/partners and dependants be retained. Instead, SAICA argues that the R2 500 ceiling should be lifted as a measure to encourage employers to assist these dependants.

Response: This comment is accepted. Annuity payments should create income for either the employee/partner or their dependants (i.e. if the employee/partner is deceased). Therefore, the paying employer should be eligible for a deduction without the R2 500 ceiling as a matter of symmetry (i.e. deductions should be fully allowed because the receipt of annuities creates a full income inclusion).

2. Research & development (section 11D)

Background: The 150% R&D incentive is currently available only for "novel, practical and non-obvious" scientific or technological information.

SAICA: SAICA requests that the trigger for the R&D incentive should be changed so that the 150% R&D incentive can be allowed for all "advancements" on R&D.

Response: This comment is not accepted. While the incentive for R&D is well-supported internationally, this form of incentive is easily susceptible to avoidance. Businesses may be tempted to reclassify normal operations as R&D simply by "advancing" or improving business processes that any business would do in its ordinary course of operations. Hence, the goal is to incentivise "novel, practical and non-obvious" scientific and technological findings – a standard that is well-founded under South African patent law.

* * * *

Background: The 150% R&D incentive is currently available only for R&D conducted within South Africa.

SAICA: SAICA requests that the incentive be made available for foreign located R&D.

Response: The suggestion is not accepted. The purpose of the incentive is to promote local R&D in order to upgrade local skills and infrastructure. Foreign R&D does not provide these local benefits.

* * * *

Background: Taxpayers may initially use a building for R&D purposes and then switch the use of that building to other purposes, such as manufacturing. A recoupment is triggered when R&D use is terminated, reduced by 10% for each year that the building was used for R&D.

SAICA: SAICA requests that the interaction of the R&D incentive for buildings be clarified when R&D use is terminated, followed by use for other purposes.

Response: The comment is accepted. The recoupment that is triggered when R&D use is terminated has been withdrawn as impractical.

* * * *

Background: The proposed amendments clarify that the R&D incentive is available for know-how in recognition that most R&D also relates to know-how associated with patents, etc.

SAICA: SAICA supports the extension of the R&D incentive to know-how.

Response: The comment is noted. However, the know-how must be essential to the use of patents, designs or copyrights. This limitation (found elsewhere for the amortisation of intangibles) is important because day-to-day activities can be readily misclassified as R&D in respect of know-how.

* * * *

Background: The R&D provisions require taxpayers to submit certain information to the Department of Science and Technology.

SAICA: To date, the information forms required from the Department have not been issued.

Response: The comment is noted. However, we have been informed that the Department is drafting documentation, and it is hoped that this documentation will be released in the near future. However, if the Department fails to issue any forms, the taxpayer need not supply information to the Department to obtain the R&D incentive. Taxpayers are at risk only if information is required, and they fail to comply.

* * * *

Background: Current law allows taxpayers to immediately deduct the cost of renewing a trademark during the year of renewal.

Ernst & Young: Ernst & Young questions whether the failure to include an immediate deduction for the initial registration of a trademark is an oversight.

Response: The comment is accepted. The law has been amended accordingly so that the initial cost of registering a trademark becomes immediately deductible in the year of initial registration.

3. *Deductible contributions to public benefit organisations (sections 18A)*

Background: Under current law, taxpayers can deduct contributions to certain public benefit organisations. However, these deductions are subject to a ceiling of 5% of taxable (i.e. net) income. The proposed amendments seek to increase this ceiling to 10%.

SAICA (also the Legal Resource Centre): SAICA requests that the 10% ceiling for deductible charitable contributions be amended to also permit a deduction of 10% of the loss for a year. While the increase in the ceiling to 10% is a welcome development, no relief exists for taxpayers making donations during a period of net loss.

Response: The comment is noted but not accepted. To base the 10% ceiling on the quantum of a loss will result in practical and conceptual difficulties. However, the comment at hand does raise an arguable shortcoming of the current system - taxpayers are ineligible for charitable deductions even if the taxpayer is operating under a temporary loss. This issue will have to be revisited at a later stage, once it has been thoroughly considered.

4. *Mark-to-market foreign currency taxation (section 24I)*

Background: Companies holding foreign currency are subject to tax on an annual mark-to-market basis (i.e. triggering gain or loss on that currency on a per annum basis regardless of whether sold or held). However, two sets of relief measures exist for loans between certain related parties because loans of this kind are often not readily convertible to cash. The first set of rules under section 24I(7A) exist for loans obtained or granted in years of assessment ending before 8 November 2005. These rules allow the currency gain/loss to be spread over ten years. The second set of rules under section 24I(10) allow all gains and losses to be postponed until the loan is realised (e.g. disposed of).

SAICA (and KPMG): SAICA seeks clarification as to the interaction of the two sets of rules. Do the pre-8 November 2005 loans remain fully subject to the old 10-year deferral rule of section 24I(7A)? Alternatively, do these pre-8 November 2005 loans become subject to section 24I(10) once section 24I(10) became effective?

Response: The comment and need for clarification is accepted. All loans operating under the 10-year deferral rule of section 24I(7A) were intended to continue operating under that section since those loans were already subject to that regime. Section 24I(10) was only intended for subsequent loans.

* * * *

Background: Section 24I provides an exemption from mark-to-market taxation in the case of foreign currency forward and option contracts acting as hedges for purchasing shares. The exemption applies to hedges for direct foreign share purchases as well as purchases made by a group member when the hedge originates from another member. One condition for this group exemption is that the group members be part of a financial accounting group using International Financial Reporting Standards and that those Standards not give rise to accounting income or loss.

Ernst & Young: Two issues are raised with the exemption. Firstly, it is questioned why the group exemption is dependent on accounting. Secondly, if accounting is key, request is made that groups utilising South African GAAP be given the same benefit.

Response: In terms of the first comment, reliance on accounting is at the heart of section 24I mark-to-market taxation. In a company context, accounting profits are a key measure of income (i.e. the ability to pay). Mismatches (especially in terms of currency and other financial instruments) are often at the heart of tax planning. Therefore, reliance on accounting will remain. As to the second comment, National Treasury and SARS agree that reliance on South African GAAP accounting should receive the same tax benefits, especially since South African GAAP essentially follows International Financial Reporting Standards for these types of instruments.

5. *Impact of the Secondary Tax on Companies ("STC") in respect of amalgamations (Section 44)*

Background: Under current law, amalgamations are generally eligible for rollover relief under section 44. Under section 44, the gains and losses of the amalgamated company are not subject to tax when the assets and liabilities of the amalgamated company become part of the resultant company; those gains and losses are instead rolled over to the resultant company. However, all profits of the amalgamated company are completely eliminated free of STC. This complete elimination has given rise to avoidance transactions. The proposed amendments currently seek to curtail this avoidance by triggering immediate STC on profits within the amalgamation.

SAICA (also Werksmans, Deloitte and Touche, Mallinicks, PricewaterhouseCoopers and Edward Nathan Sonnenbergs): SAICA requests that the amalgamation regime remain intact without the STC trigger. They instead argue that the new General Anti-Avoidance Rule be applied to eliminate problematic cases. Other commentators accept the need for change but request that STC merely be deferred.

Response: The suggestion that the avoidance be eliminated solely via the GAAR is not accepted. STC exemption within an amalgamation is a fundamental conceptual defect. While the GAAR or other remedies may well be applicable, depending on the facts of each particular case, their application would involve protracted litigation in view of the sums involved. However, the requests that STC be deferred are accepted. The proposed approach provides STC rollover treatment (i.e. where the resultant company fully inherits the amalgamated company's potential STC liability).

* * * *

Background: Under current law, taxpayers seeking amalgamation rollover treatment must completely liquidate the amalgamated company within 6 months (or obtain consent from SARS for a longer period). The required liquidation of the amalgamation company ensures that the amalgamation regime does not become susceptible to transactions that effectively amount to a partial sale.

Deloitte & Touche (and Edward Nathan Sonnenbergs): The 6-month period for amalgamations is often unrealistic because the resultant company generally does not assume all the liabilities of the amalgamated company. These non-assumed liabilities must then be paid-up by the amalgamated company, often requiring a lengthy process.

Response: The comment is accepted. The amalgamated company will be given a period of 18 months to terminate after the amalgamation (with SARS discretion for further extensions).

6. *Unbundlings involving shareholders not subject to normal tax (section 46)*

Background: The unbundling of a subsidiary by a parent company is typically subject to STC like any other distribution. However, section 46 provides relief from STC (as well as other taxes) if that subsidiary was under the practical control of the parent company before the unbundling. This relief recognises that some companies operate more efficiently when separated. One condition for section 46 relief focuses on the shareholders. More specifically, no shareholder of the parent company can acquire more than 5% of the unbundled subsidiary if that shareholder is not subject to normal (income) tax or the Tax on Retirement Funds.

At issue are retirement funds. With the announcement of the abolition of the Tax on Retirement Funds as of 1 March 2007, retirement funds will now be free of normal (income) tax and the Tax on Retirement Funds. This 5% level becomes unrealistic for private and government pension funds because listed shareholdings by these pension funds can easily amount to 15 or 20%.

Response: The comment is accepted. The purpose of the “not subject to tax rule” was primarily to prevent controlling shareholders from utilising section 46 relief as a mechanism to avoid tax on the subsidiary shares. Therefore, the proposed amendments will allow for section 46 relief as long as the shareholder “not subject to tax” has a shareholding of less than 20% (taking into account the holdings of connected persons).

7. *PAYE withholding for sole proprietors (Fourth Schedule)*

Background: Payment to certain personal service companies, personal service trusts and sole proprietors may be subject to PAYE if effectively viewed as a deemed employee. In 2006, these deemed employee PAYE rules for personal service companies and trusts were relaxed, but no changes were made for the benefit of sole proprietors. The proposed amendments provide comparable relief for this latter category.

SAICA: SAICA welcomes the amendment. However, SAICA suggests that the amendment for sole proprietors be backdated to the effective date for previous amendments made to personal service companies and trusts.

Response: The proposed amendments for sole proprietors will not be given a retroactive effective date for system reasons (i.e. the effective date will be 1 March 2007). PAYE is almost universally accounted for periods from 1 March through the end of February. Mid-year adjustments may be taken into account by reducing withholding later in the year. Adjustments for prior years are not feasible since the years have closed, individual withholdings and employer obligations have been reconciled, and the relevant certificates have been issued. These adjustments would also require complex system changes for both SARS and employers. These adjustments are ultimately not justifiable, especially given that the difference amounts to three weeks (i.e. the 7 February 2007 promulgation effective date for personal service company/trust relief vs. the proposed 1 March 2007 date for sole proprietors).

B. Value-added Tax

1. Turnover method impact of recent changes to SARS ruling practices

Background: Under current law, taxpayers providing mixed supplies could rely on the general turnover method as default means for allocating input VAT credits. This reliance stemmed from the "404 Guide for Vendors," which acts as general ruling.

SAICA: SAICA argues that the general ruling for the turnover method is no longer valid, meaning that all VAT vendors will need a separate ruling for managing inputs because no general fall-back position exists.

Response: The comment reflects a failure to understand the true situation. While a number of transitional changes are occurring in the rulings area, none of these changes will impact the ability to rely on the general turnover method as a default position. The turnover method as a default was included in the VAT 404 Guide for Vendors in 2007 as a binding general ruling.

2. Denial of VAT refunds if other taxes are due

Edward Nathan Sonnenbergs (also Ernst & Young): The proposed amendments will provide SARS with the discretion to prevent refunds if a taxpayer has failed to submit returns in terms of other taxes (potentially reflecting tax liabilities). Commentators object to this proposal as undermining the integrity of the VAT, which should be a stand-alone system that generates speedy refunds needed for operational cash-flows (especially for small business).

Response: The comment is accepted and the amendment has been withdrawn. Consideration will be given to this issue at a later stage after more thorough consideration, including feasibility in respect of administrative systems.

C. Stamp Duty on Leases

Background: The proposed amendments eliminate Stamp Duty on leases with terms of less than 5 years (i.e. short–term leases).

Aroma Management (also PricewaterhouseCoopers): The less than 5-year rule is impractical. Use of the less than 5-year rule will ultimately lead to the clumsy practice of having short-term leases expire within 4 years and 11 months.

Response: The comment is accepted. The less than 5 year rule stems from a technical wording problem. The proposed amendment has been adjusted so the exemption will cover all leases with a term of 5 years and less.

* * * *

Phone queries: Questions have been raised around the effective date of the proposed Stamp Duty amendment.

Response: The initially proposed 1 March 2007 effective date for the Stamp Duty changes is impractical given the expected date of finalisation of the amendments. The proposed amendments have instead be given an effective date of 1 June 2007, which is more administratively realistic.

D. Customs

H. Miller Ackermann & Bronstein: Requests that a single set of tariff changes, which are currently the subject of a legal dispute, be excluded from the ratification of the tariff changes in 2006.

Response: The comment is accepted.

3.3 Retirement taxation

1. Effective date for the repeal of the Tax on Retirement Funds

Background: In accordance with the announcement that the Tax on Retirement Funds is to be abolished from 1 March 2007, the tax is no longer levied from this date. Payments are still due in May in respect of the pre-1 March 2007 period. Liabilities for this period can also be freely detected and enforced.

IRF and LOA: Concerns were raised in the hearings that audit activity in this area has increased during the last few years. Some of these issues appear to stem from technical flaws left uncorrected simply because the phase-out of the Tax on Retirement Funds was anticipated. Tax collection from pensions for past violations is unfair to current pension members because the current members will effectively be paying taxes for amounts owed by previous members. Therefore, an absolute audit cut-off is being recommended for prior years.

Response: The concerns raised are fully appreciated. However, information on the full variety of issues at stake is still being collected, including the absolute and relative amounts involved. While some issues do indeed stem from technical issues and other sympathetic cases, other issues represent more straight-forward computational errors. Given the above, SARS is committed to obtaining further information for resolution in the Revenue Laws Amendment Bill due later in the year. In the meantime, an amendment has been proposed to add the dispute settlement procedures of the Income Tax Act to the Tax on Retirement Funds Act. These procedures will provide SARS with greater flexibility to settle disputes in terms of the repealed tax, especially for the more sympathetic cases described by the IRF and LOA.

2. *Lump sum payments on retirement/death (Second Schedule)*

Background: Pension and retirement annuity funds may pay out a 1/3rd maximum in respect of retirement lump sums; whereas provident funds allow full 100% lump sum payments upon retirement. All of these lump sums are eligible for relief via complex tax-free lump sum and averaging formulas. The proposed amendments simplify these formulas by utilising the following schedule:

0	to	R300 000	No tax
R300 000	to	R600 000	18%
R600 000 +			36%

IRF (also SAICA and Bruce Cameron): The commentators argue (with supporting examples) that the proposed rate schedule is too restrictive, leaving certain low-income workers in a worse position, especially in the case of full provident fund withdrawals. The main focus is on the 36%, rate which is viewed as applying at too low a threshold (i.e. over R1 million being more appropriate).

Response: National Treasury and SARS have performed their own calculations, which indicate that most taxpayers will be in a better position with the new regime. However, in order to assist in the problematic cases identified, a revised schedule has been proposed:

0	to	R300 000	No tax
R300 000	to	R600 000	18%
R600 000	to	R900 000	27%
R900 000 +			36%

* * * *

Edward Nathan Sonnenbergs: The law is unclear as to the application of the 18% rate. Should the 18% rate equally apply to multiple lump sum payments from one or more funds (i.e. should a variety of lump sum payments be aggregated) or does the 18% rate apply separately?

Response: The comment is noted for clarification. The lump sum formulas should be applied to all lump sum amounts on an aggregated basis. The formulas should apply equally regardless of how the lump sum payouts are structured. Differences should not result from planning.

3. Pre-retirement withdrawals (Second Schedule)

IRF (also Edward Nathan Sonnenbergs): Although the proposed amendments address retirement/death lump sum payouts, they do not address pre-retirement withdrawals (e.g. due to retrenchment). This failure to make amendments in respect of pre-retirement withdrawals creates two very different sets of results (pre- versus post-retirement). It also leaves open certain issues, such as the failure to increase the current R1 800 exemption for pre-retirement withdrawals. Lastly, wording within the Second Schedule further complicates the dividing line because the terminology distinguishing between pre-retirement and retirement/death withdrawals is often imprecise.

Response: Pre-retirement withdrawals are outside the scope of the amendments because these withdrawals raise a whole different set of issues. While these sums may be needed to survive during an extended loss of employment, pre-retirement withdrawals often result in excessive leakage from retirement savings (often for wasteful consumption). These issues are accordingly postponed until the pertinent regulatory aspects of retirement reform are adequately addressed.

4. Taxation of extraordinary benefits (i.e. surplus apportionment, Statement of Intent, and bulking interest) (Second Schedule)

Background: A number of one-off payouts have resulted from recent regulatory reforms. Firstly, the Pensions Act was amended to require employers to make payouts of employer-provided surpluses to members and former members. Secondly, the Minister of Finance entered into an agreement with the life insurance industry for the payout of funds to reimburse members and former members for excessive industry penalties. Lastly, payouts are being required as partial reimbursement for the improper practice of bulking interest.

IRF: The original wording of the amendments provided tax-free treatment for the payout to former members of bulking interest. However, this exemption was subsequently dropped.

Response: The comment is accepted. The exemption for bulking interest has been restored.

* * * *

Background: Surplus apportionment payments to former members are tax-free. Surplus apportionment payments to existing funds of members are merely added to those funds. No exemption applies to subsequent withdrawals.

University of Cape Town Pension Fund: The UCT Pension Fund argues that the tax-free/taxable distinction between former and current members should be removed. Surplus apportionment payouts should be tax-free regardless.

Response: Payouts to former members give rise to an immediate tax event but for the exemption. These payouts are typically small so forced payment into a fund makes little investment sense because administrative fund costs will outweigh any growth. Payouts to existing funds, on the other hand, do not trigger a taxable event (until later withdrawal), and the payout is already being added to a viable fund. No reason exists to give exemption for a subsequent withdrawal. Ongoing tracing of these surplus amounts is also impractical.

* * * *

LOA (also UCT Pension Fund): The effective date for tax-free surpluses should be moved to 1 January 2006 from the currently proposed 1 March 2007 effective date.

Response: The comment is accepted. The date has been moved as recommended in order to fully cover the intended beneficiaries.