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TAX

# Tax amendments – 2016

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## INTRODUCTION

The Taxation Laws Amendment Bill, 2015, the Tax Administration Laws Amendment Bill, 2015 and the Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2015 (the last-mentioned containing the rules for the Special Voluntary Disclosure Programme) were passed by Parliament this week. Generally Bills of this nature, once tabled, are not amended, but some small, but meaningful, amendments have been made in the Committee stage, as reported in the press.

Once again, and for the third year running, the number and scope of changes to the various fiscal Acts (mainly the Income Tax Act, 1962 (the Act) and the Value-Added Tax Act, 1991) are relatively limited. As before, our view is that this is not unwelcome. Most of the amendments are of a highly technical or esoteric nature and are more of interest to tax professionals than to business people in general.

Having said that, there are a number of controversial amendments, especially in regard to estate planning aspects and the administrative aspects of the law, which are dealt with below.

One of these estate planning aspects (discussed in more detail below) arose from recommendations of The Davis Tax Committee reports, but substantive recommendations are yet to find their way into the legislation, whether this relates to base erosion and profit shifting – so called BEPS – or in relation to estate duty and the taxation of local trusts. But that is something for the future.

Except where otherwise stated, amendments will take effect upon promulgation of the relevant Act.

## INDIVIDUALS

**Loans to trusts**

No doubt, the most controversial aspect in this year's legislation is the introduction of the new section 7C of the Act, which triggers a deemed donation where a natural person (or a company at his or her instance) has made an interest-free or low-interest loan to a trust of which that person or company is a "connected person" as defined (typically a beneficiary or relative of a beneficiary).

Currently there are rules under section 7 of the Act and under the Eighth Schedule to the Act where, in the case of such (typically) interest-free loans, because the non-charging of interest is deemed to be a donation (albeit not subject to donations tax), the amount of income and capital gains derived by the trust attributable to that deemed donation is taxable in the hands of the lender, as the notional donor. The amount of the donation is computed as being equal to the amount of interest which ought to have been paid on that loan, being the amount of interest that the trust would have paid as a borrower from a third party lender.

Section 7C now deems the amount to be an actual donation subject to donations tax. Unlike section 7, the new section 7C actually provides a method of calculating the donation, and that will be the "official rate of interest" used for fringe benefits tax purposes, multiplied by the amount of the loan, less the interest actually charged. The official rate of interest as defined in the Seventh Schedule to the Act is (a) in the case of a loan in rand, the repo rate plus 100 basis points, and (b) in the case of a foreign currency loan, the equivalent of the repo rate in that currency, plus 100 basis points; it being noted that section 7C applies to loans both to local and offshore trusts. At present, the repo rate in South Africa is 7%, which means that the donation is calculated at 8%. And with donations tax at 20%, it means that the effective tax rate will be 1.6% per annum of the amount of the loan. (In the case of the

UK or USA, for example, where the base rate is 0.25%, the deemed donation on a GBP or USD loan would be calculated at 1.25%, in which case the effective tax cost would be 0.25% of the loan.)

SARS has indicated that they will ***not*** accept an argument that, merely because section 7C deems the donation to be equal to the official rate of interest plus 100 basis points, this will be an acceptable interest rate for the purposes of section 7 of the Act, in order to determine the attribution of the trust's profits to the lender/donor. The criterion will still be what interest rate the trust would have paid had the trust borrowed the money from a third party.

Other relevant points are as follows:

- The loan need not necessarily be direct – it could be indirect, so that, for example, a back-to-back loan through a bank at a rate below the official rate of interest could well be included.
- If the loan creditor forgives the loan he or she cannot claim a deduction or capital loss.
- If the loan was provided by a company at the instance of more than one person, each person must be treated as having donated pro rata to his or her shareholding in that company.

Certain loans to trusts are excluded from the ambit of section 7C. These are:

- if the trust is a public benefit organisation or small business funding entity;
- in brief, where the loan is advanced to a vesting trust pro-rata to the vested interest (this is to govern the situation where a vesting trust is used as an investment or business vehicle);
- certain special trusts;
- the trust utilised the loan to fund a primary residence for the lender or his or her spouse;
- the loan is subject to the transfer pricing rules under section 31 of the Act;
- the loan was provided to the trust in terms of a sharia compliant financing arrangement; or
- the loan is deemed to be a dividend subject to dividends tax.

The new section comes into operation on 1 March 2017 and will also apply in respect of loans already in existence on that date.

**SVDP**

We have already distributed a number of publications on the SVDP, so that we do not propose to go into full detail yet again.

However, the final Bill did contain two additional amendments (following additional lobbying) which are noteworthy. These are as follows:

- On a technical level, the draft legislation could only apply where the individual applicant either owned the various assets himself or herself, or, where a trust owned the assets, the applicant deemed the trust assets to be his or hers. It could not apply if the applicant's or the trust's sole asset comprised shares in an offshore company, with the latter holding the underlying assets (and where such company would be a controlled foreign company). A provision has now been inserted into the legislation with a view to filling this gap.
- It will be remembered that, regardless of the actual income and capital gains derived, all receipts and accruals derived prior to 28 February 2015 are now exempted and, instead, the highest market value in rand on the last day of February of 2011, 2012, 2013, 2014 or 2015, multiplied by 40%, is included in taxable income in the 2015 tax year, to be taxed at 40% (giving an effective tax rate of 16% thereon). But there was no mechanism to determine what the base cost of the assets would be going forward for CGT purposes. A new section now states that the market value in the foreign currency of the asset that is to be included in income (the 100%, not the 40%) will become the base cost. But if the asset is subsequently sold at a lower figure, a loss cannot be claimed, and the base cost is deemed to be equal to the proceeds, so that no gain or loss will be derived.

It had previously been announced that the SVDP would be extended until 30 June 2017. It was stated in the press that, at the Committee stage, not least because of the delays in passing the legislation, it was decided to extend the period further until 31 August 2017.

## EMPLOYEE SHARE SCHEMES

Generally speaking, share schemes are governed by section 8C of the Act. The overriding structure of the section is that (a) shares acquired where the market value is greater than cost results in taxable income on the surplus, when the shares are acquired by

virtue of employment, and (b) where those shares are restricted, the difference between the market value and the cost is determined only when the restrictions are lifted.

Treasury has been seeking to tighten up on the rules continually, and their philosophy appears to be that, for so long as the shares are restricted, just about any benefit gained from the shares should be treated as ordinary income, being in the nature of remuneration. Thus the amendments this year are two-fold:

- First, an amendment to section 8C states that the employee must include in income any amount received by or accrued to him or her in respect of a restricted equity instrument except if it relates to a return of capital, a dividend or an amount to be taken into account determining the gain or loss in terms of the section (and the reason for the exclusions is that there are special rules governing these events anyway).
- The second amendment relates to the exemption from dividends under section 10(1)(k)(i) of the Act, and removes the exemption (and thus makes the dividend fully taxable) if the dividend relates to a share contemplated in section 8C and it was derived directly or indirectly from, or constitutes an amount realised from the acquisition or redemption of the share, or received in anticipation or the course of liquidation or deregistration of the company, or constitutes an equity instrument that is not restricted but which will, on vesting, be subject to section 8C.

There are corresponding amendments for shares in foreign companies receiving foreign dividends and return of capital.

## FINANCING TRANSACTIONS

**Hybrid debt instruments**

Section 8F of the Act deals with debt instruments which have so-called equity-like features, where the interest paid is disallowed as a deduction and is treated as a dividend in specie subject to dividends tax.

Two amendments have been made to this section:

- One of the triggers for that section is if the obligation to pay an amount is conditional upon the market value of the company's assets not being less than its liabilities. This gave companies problems where they needed to subordinate debt to meet solvency and going concern criteria for audit purposes. This requirement has now been softened so that the trigger will apply (a) where the obligation to pay an amount so owed on a date or dates falling within the year of assessment has been deferred by reason of the obligation being conditional upon the market value of the assets of the company not being less than the amounts of the liabilities of the company, and (b) a registered auditor has certified that the payment by the company is to be deferred by virtue of that reason. This new definition also defeats a scheme that was becoming quite popular in terms of which, instead of issuing redeemable preference shares, hybrid debt instruments would be issued, on the basis that the instrument itself would not be subordinated, but only the interest portion would be subordinated, thereby giving the interest dividend treatment (so lowering the cost of finance). Because the deferral is now limited to amounts owing in the current year of assessment, and not in future years of assessment, that scheme can no longer be used. This amendment comes into operation on 1 January 2016 and applies to tax years commencing on or after that date.
- Even if all the requirements for a debt instrument being hybrid are present, it will not be a hybrid if it constitutes "a third-party backed instrument". In effect, this means that the loan creditor can require a third person to acquire the instrument, or make a payment in respect thereof under guarantee or indemnity, or procure, facilitate or assist with the acquisition or with the making of the payment. This amendment is deemed to come into operation on 1 January 2017 and applies in respect of years of assessment commencing on or after that date. This, too, will defeat the scheme above, because such loans are invariably guaranteed.

**Hybrid interest**

This section – section 8FA of the Act – deems certain interest to be hybrid interest, without the instrument itself considered to be hybrid. Similarly the interest is not allowed as a deduction and is deemed to be a dividend in specie, subject to dividends tax.

There is now a similar exemption for a third-party backed instrument as described above. This comes into operation on 1 January 2017 and applies to tax years commencing on or after that date.

**Hybrid equity instruments**

These are governed by section 8E of the Act and result in dividends on certain shares (usually, but not exclusively, redeemable preference shares) retaining their non-deductibility in the issuer's hands, but becoming fully taxable in the holder's hands.

In order to avoid this treatment, certain schemes have been designed by putting up structures whereby the same treatment is obtained without technically triggering the section, for example, having a trust hold the preference shares, but having the interest in the trust contain the necessary provisions that would otherwise be contained in the terms of the shares themselves.

To counter this practice, the section now defines an "equity instrument" as being a right or interest the value of which is determined directly or indirectly with reference to a share or an amount derived from a share. The amendment then includes in the definition of hybrid equity instrument an equity instrument where the shares referred to, in short, are those which are referred to elsewhere in the definition of "hybrid equity instrument". The same treatment is then given to the equity instrument.

This amendment comes into operation on 1 January 2017 and applies to tax years ending on or after that date.

When section 8E was significantly modified in 2013, a number of such financing transactions, which were outside the ambit of the section prior thereto, became subject to the new provisions. Despite pleas to the Treasury to exclude these instruments from the ambit of the amendments, or to allow further time to restructure the arrangements, the amendments went ahead.

This created significant costs for the issuers, because the tax cost borne by the shareholders was usually passed on to the issuers by way of a gross-up clause.

Somewhat belatedly, an amendment has now been introduced to the effect that, if the share had been issued in terms of an agreement, all of which terms were finally agreed to before 1 April 2012, and it constitutes a hybrid equity instrument solely by reason of a right of redemption or a security arrangement acquired in accordance with the terms of that agreement, and the right or arrangement is cancelled on or after 26 October 2016 and on or before 31 December 2017, the dividends will not be subject to hybrid treatment after the date of cancellation of the right or arrangement, and the cancellation will not be treated as a disposal if no consideration is payable in respect of the cancellation.

**Third-party backed shares**

This is the counterpart to hybrid equity instruments, and is dealt with in section 8EA of the Act. Similar amendments have been made in respect of equity instruments and preference shares issued in terms of an agreement, all the terms of which were finally agreed to before 1 April 2012 where the enforcement right is cancelled on or after 26 October 2016 and on or before 31 December 2017, ie the section will not apply.

**Exchange gains and losses**

The tax treatment of exchange gains and losses is deal with under section 24I of the Act.

In general, when dealing with third party debts owing to a taxpayer in a foreign currency, the exchange gain or loss is brought to account annually for income tax purposes, even if unrealised, irrespective of the nature of the debt (ie whether it arose from a capital transaction or a revenue transaction).

An amendment is now to be introduced that, to the extent the debt becomes bad, and to the extent a foreign exchange gain has been brought to account in the current or a previous year, the bad debt may be claimed as a deduction in respect of that gain.

Somewhat puzzlingly, if there has been a foreign exchange loss, which would already have been claimed under section 24I in the current or a previous year, that must now be clawed back and included in income. Presumably the idea is that the total loss must then be a capital loss (assuming that this is not a debt owing for goods or services sold).

**Interest**

The definition of "interest" under section 24J of the Act refers inter alia to "interest or ***related*** finance charges". The Supreme Court of Appeal interpreted the word "related" very widely and included such items as guarantee fees, facility fees, and so on, and even went so far as to include the fees paid to attorneys for drafting the financing documents.

The word "related" is now to be substituted by the word "similar", so that it will read "interest or similar finance charges". The draft Explanatory Memorandum states that this is to clarify "the policy position that this applies to finance charges of the same kind or nature." No doubt this is to narrow the ambit as interpreted by the court. Nevertheless, we would believe that any fee that is related to the loan, and is determined by reference to the loan (for example a percentage of the loan), would still be a similar finance charge.

## INTERNATIONAL

**Controlled foreign company (CFC) rules**

The CFC rules, contained in section 9D of the Act, effectively seek to impute the profits of CFCs to the South African-resident shareholders.

One of the exemptions to the CFC rules is the so-called high tax exemption. In brief, this exemption provides that if the foreign company is paying tax abroad in an amount at least equal to 75% of the amount it would have paid in South Africa had it been a resident of South Africa, the CFC rules do not apply. In computing the foreign taxes payable, if the foreign CFC was able to offset losses from other group companies because they have group taxation in the foreign jurisdiction, then the CFC's tax would be calculated notionally as if the loss was not to be offset.

The amendment, which comes into operation on 1 March 2017 and applies in respect of a foreign tax year commencing on or after that date, removes the ability to ignore offset losses. This will mean that if the CFC does not pay tax as a result of the loss offset, and its effective tax rate is lower than 75% of the South African rate, the CFC rules will apply and the shareholder here will have to pay tax under the CFC rules. Of course, if the foreign subsidiary has a qualifying foreign business establishment, then the CFC rules will still not apply.

**Withholding tax on service fees**

This tax, at the rate of 15%, was due to commence applying on 1 January 2017.

All of the enabling legislation has been repealed with effect from the same date.

It should be noted, however, that where a non-resident is to provide consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or training services to a South African resident (or to a non-resident having a permanent establishment in South Africa), where the non-resident service-provider was, is or is anticipated to be physically present in South Africa for the purposes of rendering the service, and the expenditure incurred or to be incurred is anticipated to exceed R10 million, this is a reportable arrangement in terms of the Tax Administration Act, 2011, and the client in South Africa is obliged to report that to SARS in the prescribed format.

## EMPLOYMENT ISSUES

**Learnership allowance**

The deduction in respect of the learnership allowance under section 12H of the Act, which was to expire on 1 October 2016, is now to be extended to 1 April 2022.

**Employment tax incentive**

This incentive, which was to expire on 1 January 2017, has been extended to 28 February 2019.

It was also announced in the press that the proposed cap of R20 million per employer is to be removed.

**PAYE on directors' remuneration**

Prior to 2002, remuneration paid to directors of private companies was not subject to PAYE. The reasoning was that directors of private companies, who were typically also the shareholders, did not really know what their remuneration would be until they determined the profits earned by their companies, and they simply made ad hoc drawings, and only once the profits were determined could their remuneration be calculated. Thus they were provisional taxpayers.

By 2001, of course, accounting and record keeping had become a lot more sophisticated, and thus paragraph 11C of the Fourth Schedule to the Act was introduced. This contained special rules to determine the PAYE to be paid by directors of private companies, where their remuneration was not subject to the ordinary PAYE rules.

Paragraph 11C is to be repealed with effect from 1 March 2017. The rationale is that section 7B of the Act, which was introduced with effect from 1 March 2013, is adequate to deal with the position. Basically that section provides that wherever there is "variable remuneration", which means overtime pay, bonus, commission, an allowance and leave pay, the amount will be both deductible and taxable only on a cash paid basis.

Frankly, we cannot see how section 7B applies, as straightforward remuneration, albeit ad hoc, is not governed by the definition of "variable remuneration" as set out above. This seems to be a step back to the pre-2002 position (theoretically, at any rate).

## TAX ADMINISTRATION

**Understatement penalty**

In terms of sections 222 and 223 of the Tax Administration Act, 2011, understatement penalties can be imposed by SARS for an "understatement", which is defined as a default in rendering a return, an omission from a return, an incorrect statement in a return, or, if no return is required, failure to pay the correct amount of tax. For the most part, there were five possible levels of penalty, ranging from a minimum of 10%, for "substantial understatement", to a maximum of 150%, for "intentional tax evasion". The minimum 10% would always be imposed unless the taxpayer was in possession of an opinion from an independent registered tax practitioner that a court would more likely than not uphold the taxpayer's position. The only other time that a penalty could not be imposed is if it arose from a bona fide inadvertent error.

It was generally accepted (albeit not by SARS, in public anyway) that where the general anti-avoidance provision (the GAAR) contained in sections 80A to 80L of the Act (or the relevant GAAR in any other fiscal Act) was invoked by SARS, it was not legally possible to impose an understatement penalty. The reasoning is that, without SARS invoking the GAAR, the entire method of implementing the arrangements, and returning them in the tax return, would have been in accordance with the relevant legislation, and must be taxed by SARS in accordance with that manner. Thus there could not have been any default or omission or incorrect statement or incorrect amount of tax paid. It is only by invoking the GAAR that SARS can collect the tax it believes is rightfully due.

To remedy the situation, the legislation has now been amended specifically to include an "impermissible avoidance arrangement" as defined in the GAAR as being an understatement, and then to impose a 75% penalty if the GAAR is invoked.

In our view, this is an extremely harsh penalty to impose when, but for the invoking of the GAAR, the arrangements comply with all of the provisions of the relevant taxing Act. Moreover, unlike the other behaviours set out in the table of penalties, it is not entirely clear how one can escape paying the penalty with an opinion, other than an opinion which states that a court will more likely than not uphold the taxpayer's tax position. Additionally, the amendment will apply from date of promulgation, which means that even transactions entered into historically can now be subject to the penalty of 75%, and not only transactions entered into in the future.




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