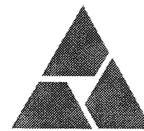

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8 October 2007

**OUR REF** Draft legislation 2007

Ms. Adele Collins
The South African Revenue Services

**E-mail:** acollins@sars.gov.za

Dear Adele

**COMMENTS ON THE DRAFT REVENUE LAWS AMENDMENT BILL, 2007**

We refer to your request for comments on the Draft Revenue Laws Amendment Bill, 2007 ("the Bill"). We set out our comments below:

1. **DEFINITION OF "DIVIDEND" – CLAUSE 5**

**General comment**

Paragraph A – Basic principles

1.1 We refer to the comment made in paragraph A – Basic principles on page 9 of the Explanatory Memorandum on the Bill ("Memorandum"), i.e. "the law technically excludes distributions of share premium from the dividend definition but is silent as to share capital". We do not agree with this statement for the following reasons:

1.2 From an accounting perspective, share capital represents either the quantum of the issued shares at their par value or the quantum of the issued shares at the full price issued where the shares do not have a par value. Where the company issues shares with a par value at a premium, the premium is reflected as "share premium" in the accounting records of the issuing company.

1.3 The current paragraph (c) of the definition of "dividend" contained in section 1 of the Income Tax Act, No 58 of 1962 ("the Act"), effectively excludes the cash equivalent of the amount by which the nominal value of the shares of that shareholder is reduced (subparagraph (i) of paragraph (c) of the definition) or

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the nominal value of the share so acquired from such shareholder (paragraph (ii) of paragraph (c) of the definition).

1.4 Section 1 of the Act contains a definition of "nominal value". It is defined as, in relation to shares issued by a "company", "(i) if the shares have a par value, such par value, or (ii) if the shares do not have a par value, an amount equal to the amount at which the par value of those shares would be determined if the company were to convert the shares into shares having a par value".

1.5 It is respectfully submitted that the current provisions of paragraph (c) of the definition of "dividend", read together with the definition of "nominal value" in relation to shares issued by a company, makes provision for "share capital" and the law therefore in its current form technically excludes distributions of share capital.

1.5.1 Paragraph B – Redemption (and reconstructions)

1.6 We refer to the comments made in paragraph B – Redemptions (and reconstructions), also referred to on page 9 of the Memorandum, i.e. "*The dividend definition provides special rules for redemptions, reductions or any other acquisition by a company of its own shares...Share nominal value acts as an offset against the definition as opposed to share premium (and share capital). However, no difference should exist because the removal of funds from a company in these circumstances is no different than any other distribution*".

1.7 It is noted that the current Companies Act, No 61 of 1973 ("the Companies Act") only makes provision for the reduction of the capital of a company in terms of section 85 of that Act. A company can seek to reduce its capital when it has lost part of its capital with the object to make the accounts and balance sheet accord with the actual position and also to free the company to pay dividends in respect of its future profits instead of having first to recoup its lost capital out of such profits or when the company finds itself in a position where the issued capital is in excess of its requirements and, due to the cost of holding the capital, it may wish to reduce its capital and therefore increase its return on capital for its shareholders. The redemption, reduction or other acquisition by a company of is own shares ***must*** result in a reduction of the nominal capital (per Anglo-French Exploration Co [1902]).

1.8 In addition, section 90 of the Companies Act makes provision for payments to shareholders. Other distributions, such as repayments from the share premium account, are made to shareholders in terms of that section. This section does not provide for reductions, redemptions or any other return of share capital. We are of the opinion that the comment made is therefore incorrect in terms of the application of the Companies Act.

**Removal of exclusion of profits of a capital nature earned before 1 October 2001 – Clause 5(1)(c)**

1.9 It is stated in the Memorandum that the exclusion of the pre-effective date profits (i.e. 1993 in the case of distributable profits or 2001 in the case of capital profits) will no longer be compatible with the new regime and must be entirely removed. It is however noted that one of the reasons for the introduction of the pre-effective date exclusions was to avoid subjecting to tax in the hands of a company amounts earned or accrued before the introduction of secondary tax on companies ("STC") and capital gains tax ("CGT"), i.e. to avoid the, albeit indirect, retrospective application of newly introduced taxes on amounts earned or accrued before the introduction of those taxes. ***The amendment to the dividend definition to remove the exclusion of profits of a capital nature earned before 1 October 2001 effectively introduces a tax on profits earned or accrued prior to the introduction of STC and CGT and is clearly of retrospective application and we are strongly opposed to its adoption.***

1.10 It is further noted that although the proposed amendment will only affect distributions made on or after 1 January 2009, not all companies currently planning on being wound-up, liquidated or deregistered or having its corporate existence finally terminated, may be in a position to have distributed its capital profits earned before 1 October 2001 prior to the effective date of the proposed amendment. This may be due to a variety of reasons such as limited cash resources, impracticality of distributing dividends in specie, etc.

1.11 That said, while the proposed delay in the introduction of the retrospective amendment may provide relief to those companies contemplating being wound up, etc, it does not address the position of companies who may seek to do so in the future and who will now be subject to tax on profits earned or relating to periods prior to the application of STC.

1.12 With respect to the deletion of the exclusion of pre-effective date distributable profits and pre-1 October 2001 capital profits, inequity will result for those who are unable to make distributions before 1 January 2009 as those who make distributions before 1 January 2009 would have benefited from the exemptions. We are strongly opposed to the introduction of retrospective legislation by stealth.

**Proposed amendments to paragraph (c) of the definition of "dividend" – Clauses 5(1)(f), 5(1)(g) and 5(1)(i)**

1.13 The proposed deletion and insertion of the words in paragraph (c) preceding subparagraph (i) cause the revised wording of the paragraph to be unintelligible. The words "***so much of the sum of***" should not be deleted or alternatively the phrase "***to the extent that it comprises***" should be inserted before the new phrase "***any profits distributed***".

1.14 In order to explain the potential problems that may arise as a result of the amendments to the definition of "dividend" proposed in clauses 5(1)(f) and 5(1)(g), we need to analyse various aspects of the definition contained in the preamble before the paragraphs which further expand or limit the definition of "dividend". In this regard we note the following.

1.15 The proposed amendment to the definition of "dividend" in section 1 of the Act includes *"any amount distributed by a company (...) to its shareholders ..."*.

1.16 The definition of "company" contained in section 1 of the Act means-

(a) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic ...; or
(b) any association, corporation or company incorporated under the law of any country other than the Republic ...;
(c) any co-operative; or
(d) any association (...) formed in the Republic to serve a specific purpose, beneficial to the public or a section of the public;
(e) any
   (i) portfolio comprised in any collective investment scheme in securities...; or
   (ii) arrangement or scheme carried on outside the Republic in pursuance of which members of the public are invited or permitted to invest in a portfolio of a collective investment scheme, ...

1.17 The definition of "shareholder" contained in section 1 of the Act means -

(a) in relation to a company referred to in paragraph (a), (b), (c) or (d) of the definition of "company" in this section, means the registered shareholder in respect of any share, ...;
(b) in relation to any company referred to in paragraph (e) of the said definition, the registered holder of any participatory interest included in the relevant portfolio ...;
(c) in relation to any close corporation, means a member of such corporation; or
(d) in relation to any co-operative means a member of such co- operative.

1.18 A "shareholder" therefore includes a registered holder of a collective investment scheme, a member of a close corporation and a member of a co-operative.

1.19 The term "share" referred to in paragraph (a) of the definition of "shareholder" is not defined in the Act. The general meaning of the word would therefore apply. A "share" is said to mean *"a part or portion of a larger amount which is divided among or controlled by a number of people"*. It is therefore arguable that -

1.19.1 any investment of capital (hereinafter referred to as "investment funds") of registered holders or members in any association or corporation, whether registered in the Republic or in any other country, (paragraphs (a) and (b) of the definition of "company");

1.19.2 the investment funds of any members of a co-operative (paragraph (c) of the definition of "company"); and

1.19.3 the investment funds of any participants in any association formed in the Republic to serve a specific purpose (paragraph (d) of the definition of "company") (hereinafter referred to as a "specific purpose association"),

would qualify as a "share" and accordingly the amount distributed would be a distribution to a "shareholder".

1.20 What is not clear is whether or not, once the proposed amendments are effected, the "share" of the "shareholders" of such associations, corporations, co-operatives and special purpose associations would, in the absence of any definition of "share capital", indeed constitute "share capital".

1.21 Further, as noted above, the definition of "shareholder" also includes the registered holders of any participatory interests in collective investment schemes (paragraph (b) of the definition), members of close corporations

(paragraph (c) of the definition) and, although arguably also included in paragraph (a) of the definition, members of a co-operative. Paragraphs (b), (c) or (d) of the definition however do not make any reference to a "share". It would therefore in our view, not be possible to argue that these registered holders or members have any participatory interest in the "share capital" of these entities.

1.22 It is however arguable that any distribution of the investments made by these members would not constitute a "dividend" as a result of the exclusion currently contained in subparagraph (i) or (ii) of paragraph (c) of the definition of "dividend" i.e. *"in the event of any reduction or redemption (...) of the capital of a company (...), ..., so much of the sum of any cash and the value of any asset given to the shareholder as exceeds the cash equivalent of (i) the amount by which the nominal value of the shares of that shareholder is reduced, or (ii) the nominal value of the shares so acquired from such shareholder, as the case may be"* as well as *"... any cash and the value of any asset given to a shareholder to the extent to which the cash and the value of the asset represents a reduction of the share premium account of a company"*.

1.23 This exclusion must be read with the definition of "nominal value" of a share (section 1 of the Act) that provides that, in relation to shares issued by a "company", *"(i) if the shares have a par value, such par value, or (ii) if the shares do not have a par value, an amount equal to the amount at which the par value of those shares would be determined if the company were to convert the shares into shares having a par value"*.

1.24 Based on this analysis, the investment funds would therefore be shares that do not have a par value for purposes of the definition of "dividend" and any reduction in the investment funds would not be a "dividend" for purposes of the Act.

1.25 We therefore submit that the deletion of the words " so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the cash equivalent" contained in paragraph (c) of the definition of "dividend" and the deletion of subparagraphs (i) and (ii) of that paragraph will cause holders of portfolios, members of close corporations and possibly members of co-operatives to be in receipt of a "dividend" even in circumstances where the capital invested by them as investment funds are distributed to them as their

investment funds would comprise neither "share premium" nor "share capital". This cannot have been the intention.

**Proposed insertion of paragraph (iiiA) to the proviso to the definition of "dividend" – Clause 5(1)(m)**

The implications of the proposed insertion are unjust in the following circumstances:

1.26 A company has issued new shares to shareholders at various stages and the share premium relating to each of the share issues was different. By way of example, consider the following facts.

1.26.1 When the company was formed it issued 100 shares to shareholder A at a premium of R1.00 per share (R100 share premium);

1.26.2 Some time later the company requires further capital and it issues 100 shares to shareholder B at a premium of R2.00 per share (R200 share premium); and

1.26.3 Some time after that another 100 shares are issued to a shareholder C at a premium of R3.00 per share (R300 share premium).

1.27 The company's available capital is now in excess of its needs and it decides to reduce its share premium by paying the full amount of the share premium (R100 + R200 + R300 = R600) to its shareholders in proportion to their contribution to the share premium account.

1.28 Based on the proposed provision, each share will be allocated a share premium of R2.00 (being R600 / 300 issued shares). Shareholder A will therefore have to be paid R2.00 per share where he/she only paid a share premium of R1.00 per share, shareholder B will be in a neutral position and shareholder C will be only receive R2.00 per share where he or she paid a share premium of R3.00 per share, i.e. R1.00 per share less that what he/she actually paid and that R1.00 per share, i.e. R100 in total will be a dividend declared by the company on which STC will be payable.

1.29 The proposed amendment clearly has implications beyond the intended mischief it is aimed at, i.e. disguised shareholder sales noted on page 10 of the Memorandum.

1.30 It is suggested that disguised shareholder sales not be assumed. Instead, where relevant, the legislation must give shareholders an opportunity to prove that they contributed a disproportionate amount of share capital. Paragraph (iiiA) should apply only in the event that this cannot be proved.

## 2. DEDUCTION IN RESPECT OF FOREIGN TAXES ON INCOME – CLAUSE 7

2.1 We respectfully submit that the proposed amendment to section 6*quat* of the Act to accommodate, to a limited extent, the deduction of foreign taxes paid on South African source income is unnecessary. The reasons for this submission are summarised as follows:

2.1.1 Section 11(a) of the Act provides that a taxpayer may deduct from any income derived by him "expenditure...actually incurred in the production of the income...".

2.1.2 Section 23(g) of the Act prohibits a deduction of any amounts not laid out or expended "for the purposes of trade".

2.1.3 Further, section 23(d) of the Act provides that "(N)o deductions shall in any case be made in respect of the following matters, namely –

> "*any tax, duty, levy, interest or penalty imposed under this Act, any additional tax imposed under section 60 of the Value-Added Tax Act, 1991 (...), and any interest or penalty payable in consequence of the late payment of any tax, duty or levy or contribution payable under any Act administered by the Commissioner, the Regional Services Councils Act, 1990 (...), the KwaZulu and Natal Joint Services Act, 1990 (...), the Skills Development Levies Act, 1999 (...) and the Unemployment Insurance Contributions Act, 2002 (...)*".

2.2 It is noted that this section does not prohibit the deduction of any tax, duty or levy imposed under any other Act whether or not administered by the Commissioner, ***nor does it prohibit the deduction of any tax, duty or levy imposed by any other jurisdiction.***

2.3 We are therefore of the opinion that any foreign taxes paid on South African source income is deductible in terms of provisions of sections 11(a), 23(d) and 23(g) of the Act.

2.4 It is further submitted that the proposed mechanism contained in section 6*quat*(5) of the Act regarding assessments issued in respect of prior years could be problematic as the information required to determine the taxable income related to the specific income may not be available.

2.5 Whilst we appreciate the fact that, as a general principle, countries are only prepared to surrender primary jurisdiction to tax if the source arises outside its border, the mere fact that the South African taxpayer will be denied a full deduction in certain circumstances, could jeopardise any further investment in and development of countries where such investment is needed and encouraged by the South African Government.

## 3. AMENDMENT TO SECTION 8C – CLAUSE 10(1)(f)

3.1 The proposed substitution in subsection (7) for paragraph (b) of the definition of "equity instrument" by the proposed paragraph, seems to also include cash bonuses payable to employees in terms of the so-called "phantom share schemes". This is because the new definition includes a "financial instrument" and the term "financial instrument" as defined in section 1 includes "*any other contractual right or obligation the value of which is determined directly or indirectly with reference to- (i) a debt security or equity.*" In terms of the rules of the majority of the phantom share schemes, the participating employees are only entitled to a cash bonus and the value of the bonus is determined with reference to the value of the employer company or other company shares at a particular time in the future. The cash bonus is subject to income tax. Consequently, there is no need to include phantom share schemes in section 8C. Surely this could not have been the intention as it merely complicates matters unnecessarily and at the same time the tax consequences will be the same whether the phantom share scheme is subject to section 8C or normal income tax principles.

3.2 It is not clear if this is an intended consequence as the Memorandum states (on page 53) that the purpose of sub-clause (f) is to counter the practice whereby

taxpayers have provided that on termination of the option period, the underlying equity instruments are disposed of and the proceeds paid to employees.

4. **CAPITAL V ORDINARY SHARES – CLAUSE 12**

4.1 The proposed recoupment of interest incurred in respect of the acquisition of shares (the new proposed subsection (5) of section 9C), could cause an anomaly in the Act in situations where the shares in question are shares held in a foreign jurisdiction and the dividends earned on the shares did not qualify for an exemption in terms of section 10(1)(k)(ii) of the Act.

4.2 The proposed amendment to section 9C of the Act contains a provision to deal with the interaction between the deemed disposal rules for trading stock (the new proposed subsection (7) of section 9C). However there seems to be no provision that deals with the situation where a taxpayer acquired a share and held it as trading stock and at a later date (before or after the expiry of 3 years) decides to hold the share on capital account. In the absence of any provision dealing with such a situation, one would assume that the normal rules will apply, i.e. the taxpayer will be deemed to have disposed of the share held as trading stock at its market value and to have reacquired the stock, now held as a capital asset, at the same market value.

4.3 There seems to be a conflict between the proposed subsection and paragraph 12(3) of the Eighth Schedule to the Act. This apparent conflict needs to be addressed.

5. **DEPRECIATION – COMMERCIAL BUILDINGS – CLAUSE 26**

5.1 The term "commercial" is not defined. Assuming the normal meaning of the term applies, the proposed new section 13*quin* will only apply to buildings used by taxpayers engaging in commerce, i.e. taxpayers engaged in trade and services. The proposed section 13*quin*(5) is considered a "catch all" provision as regards commercial buildings. We assume that warehouses and administration buildings of taxpayers whose trade comprise manufacturing will now be able to claim depreciation for the warehouses and administration buildings.

5.2 Taxpayers who are involved in manufacturing who do not use the building owned by them ***wholly or mainly*** for the purpose of carrying on therein for the

purpose of their trade any process of manufacture, (and who therefore not qualify for an allowance in terms of section 13 of the Act) should therefore also now be able to claim a section 13*quin* allowance.

## 6. INTELLECTUAL PROPERTY PAYMENTS – CLAUSE 34

### Foreign exchange control regulations

6.1 The current foreign exchange control regulations prohibit, without exception, a South African resident from disposing of any intellectual property ("IP") owned by it to a non-resident connected party. This is in terms of general policy dealing with the export of capital.

6.2 It is further a well-known fact that a company's wealth is reflected in its copyrights, patents, trademarks and other IP rights (hereinafter collectively referred to as "IP").

6.3 With this in mind, and taking into consideration the constantly changing global market environment, it may be considered short-sighted for South African multinationals or South African residents operating in the global markets ***not*** to own non-South African resident entities which own their non-South African registered intellectual property. For instance, should the South African resident hold all the IP in its name and it wishes to dispose of its foreign operations to a non-resident, it would necessarily have to dispose of the foreign entity as well as the IP associated with that entity. The latter part of the transaction will require foreign exchange control approval and could potentially cause significant difficulties for South African residents wishing to dispose of their foreign operations.

### General comment

6.4 We refer to the following comment made in the second sentence of paragraph B – Subsections (2) and (3) (Denial of deductions), i.e. "*... or where a foreign person treats that income as falling outside the South African tax net*". It is noted that a third party, whether connected to the taxpayer or not, will only be able to charge a royalty in respect of IP developed by that taxpayer in circumstances where the taxpayer disposed of the IP to that person. Put differently, it is therefore highly unlikely that the taxpayer would agree to pay a royalty to a third party where that taxpayer (as developer thereof) owns the IP.

In addition, ***the taxpayer would have had to recoup any deduction previously claimed based on the provisions of section 11D(9) of the Act***, i.e. SARS would have recovered the tax "subsidy" given.

6.5 Bearing in mind that the South African Reserve Bank ("SARB") **only** gives foreign exchange control approval for the disposal of IP to foreign third parties who are **not connected** to the South African resident, any transaction where a South African resident disposes of IP developed by that resident, can only be assumed to have taken place at an arm's length price, i.e. It is highly unlikely that the resident would not have disposed of the IP for a value less than a market related price.

**Denial of deductions**

6.6 The following comment was made in the preamble to the discussion of the research and development deductions (section 11D of the Act) in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006:

"*Innovation, research and technological development are key factors for improved productivity (leading to new or improved products, processes or services). This enhanced productivity in turn leads to increased economic growth and international competitiveness. However, R&D is costly, involving high levels of technical risk. Given the high entry costs (and the indirect positive externalities for countries as whole), Governments sometimes provide extra support for local R&D via direct subsidies as well as through tax incentives (the latter of which operate as indirect subsidies). While South Africa offers a variety of direct subsidies for R&D, the South African tax regime for R&D does not provide substantial incentives. South Africa accordingly needs an improved set of R&D tax incentives to ensure that local R&D is not at a global competitive disadvantage*".

6.7 It is our view that, as it is, the limitation of the section 11D deduction to activities undertaken ***in the Republic*** undermines the objective of the incentive that is aimed at increased economic growth and international competitiveness. The proposed introduction of the denial of deductions in circumstances where the licensor has a tax-exemption or where a foreign person treats the income as falling outside of the South African tax net **further undermines** the objective of increased economic growth and international competitiveness.

6.8 We are not aware of any other country which penalises its residents in this manner, i.e. being able to recoup the subsidy given as well as denying any deductions or only partly allowing any deductions for royalties payable for the use of the IP disposed of. This will only place the South African multinational or South African resident involved in the global market at a disadvantage to its competitors as it will have to increase its selling prices in order to negate the financial loss suffered as a result of the denial of a deduction in these circumstances. A potential consequence of the denial of the deduction of royalties paid as well as the disallowance of expenditure incurred outside the Republic in section 11D of the Act, could be that South African Multinationals could undertake their research and development activities in foreign countries where they enjoy similar deductions to those provided for in section 11D of the Act and, due to the fact that the related IP would not comprise "affected intellectual property" as defined, be entitled to a full deduction of the royalties paid.

6.9 It is further noted that, in circumstances where the foreign person who treats the income as falling outside the South African tax net is also a controlled foreign company ("CFC") of the South African resident, and the "net income" of the CFC is required to be included in the taxable income of the South African resident, the denial of the deduction in the hands of the South African resident will effectively result in form of "double taxation" of the same amount. The reason for this is that section 9D(9)(fA) of the Act only makes provision for the exclusion of any royalties paid or payable to that CFC by **any other CFC**, i.e. no provision is made for the exclusion of royalties paid or payable to that CFC by a South African resident. This would not normally result in a double taxation in circumstances where the South African resident is entitled to claim a deduction of the same amount.

6.10 Also, based on the current construction of section 9D of the Act, it cannot be said that the foreign person is subject to tax, and hence included the royalties in its income and hence the deduction will be allowed in the hands of the South African resident.

6.11 Further, if for any reason ownership of South African owned IP was transferred to a ***connected non-resident*** and the transfer did not occur at market value, then SARS can in any case apply the provisions of section 31 of the Act, i.e. the

so-called "transfer pricing provision", and in that way recoup the "subsidy" granted by way of section 11D(9) of the Act.

## 7. COMPANY REORGANISATIONS

**Narrowed Group definition (section 41) – Clause 48(1)(c)**

7.1 Paragraph A – Narrowed Group definition (section 41) on page 22 of the Memorandum states that "(A) group of companies eligible for intra-group rollover relief must all operate on the same tax plane (...). Therefore fully or partially exempt companies will now fall outside intra-group relief (...). As a result of these changes, the intra-group relief provisions will be mainly limited to fully taxable companies and close corporations".

7.2 The proposed "group of companies" definition excludes

7.2.1 A co-operative (paragraph (c) of the definition of "company");

7.2.2 Any association formed in the Republic to serve a specific purpose (paragraph (d) of the definition of "company") (referred to above as a "specific purpose association");

7.2.3 Collective Investment Scheme managed or carried on in the Republic (paragraph (e) (I) of the definition of "company")

7.2.4 Section 21 companies;

7.2.5 A company which is not a resident of the Republic;

7.2.6 A company which is exempt from tax in terms of section 10 of the Act;

7.2.7 A company that is a Public Benefit Organisation ("PBO") or recreational club approved by the Commissioner in terms of section 30 and 30A of the Act.

7.3 The proposed exclusions of companies which are not South African residents could frustrate a significant number of the Broad-Based Black Economic Empowerment ("B-BBEE") initiatives of those non-resident companies as the South African branch operations of those companies are often reorganised using the company reorganisation rules to pass ownership to B-BBEE candidates. If this exclusion of foreign companies is to remain, we suggest that

where foreign companies incorporate their branches for B-BBEE purposes, they be entitled to benefit from the intra-group rollover relief provisions.

7.4 The reason for the exclusion of co-operatives from the definition of "group of companies" in this context is unclear.

## 8. SECONDARY TAX ON COMPANIES – CLAUSE 55

### Insertion of definition of "group of companies" – Clause 55(1)(d)

8.1 The proposed amendment contained in clause 55(1)(d), i.e. the insertion of a definition of "group of companies", which will mean ""group of companies" as defined in section 41", will limit the dividends declared which will be exempt from STC in terms of section 64B(5)(f) of the Act. The proposed "group of companies" definition excludes

8.1.1 A co-operative (paragraph (c) of the definition of "company");

8.1.2 Any association formed in the Republic to serve a specific purpose (paragraph (d) of the definition of "company") (referred to above as a "specific purpose association");

8.1.3 Collective Investment Scheme managed or carried on in the Republic (paragraph (e)(i) of the definition of "company")

8.1.4 Section 21 companies;

8.1.5 A company which is not a resident of the Republic;

8.1.6 A company which is exempt from tax in terms of section 10 of the Act;

8.1.7 A company which is a Public Benefit Organisation ("PBO") or recreational club approved by the Commissioner in terms of section 30 and 30A of the Act.

8.2 It is not clear why co-operatives and Collective Investment Scheme are excluded.

8.3 Of particular concern is the exclusion of Section 21 companies, companies that are exempt from tax, and PBO's. The dividend income of these organisations will in all probability decrease by the equivalent of the proposed 10% STC

which the payor companies will have to pay on dividends declared to these organisations. It is recognised that STC is a tax on the company declaring dividends, however, it is noted that the quantum of any dividend declared is determined after taking into consideration any STC liability the company will have to pay. Bearing in mind that dividends often are the only source of funding available for some of these organisations, the reduced dividend income will impact on the noble projects undertaken by these organisations and could potentially result in greater demand on the resources of the Fiscus as a result of increase demands on health care facilities, educational institutions, social welfare etc.

**Deletion of post-31 March 1993 profits and pre-1 October 2001 capital profits exclusion – Clause 55(1)(i)**

8.4 It is stated in the Memorandum that the exclusion of the pre-effective date profits will no longer be compatible with the new regime and must be entirely removed. It is however noted that one of the reasons for the introduction of the pre-effective date exclusions was that, in certain circumstances, to avoid subjecting to tax in the hands of a company amounts earned or accrued before the introduction of either STC and CGT, i.e. to avoid the, albeit indirect, retrospective application of newly introduced taxes on amounts earned or accrued before the introduction of those taxes. The amendment to the dividend definition to remove the exclusion of profits earned during any year of assessment which ended not later than 31 March 1993 and profits of a capital nature earned before 1 October 2001 effectively introduces a tax on profits earned or accrued prior to the introduction of STC and CGT and is clearly of retrospective application.

8.5 It is further noted that although the proposed amendment will only affect distributions made on or after 1 January 2009, not all companies currently planning on being wound-up, liquidated or deregistered or having its corporate existence finally terminated, may be in a position to have distributed its capital profits earned before 1 October 2001 prior to the effective date of the proposed amendment. This may be due to a variety of reasons such as limited cash resources, impracticality of distributing dividends in specie, etc.

8.6 That said, while the proposed delay in the introduction of the retrospective amendment may provide relief to those companies contemplating being wound

up, etc, it does not address the position of companies who may seek to do so in the future and who will now be subject to tax on profits earned or relating to periods prior to the introduction of STC.

**Group exemption limitation – Clause 55(1)(k)**

8.7 It is noted in paragraph B – Profit limitation (section 64B(5)(f)) on page 11 of the Memorandum that the new profit limitation added by way of clause 55(1)(k) of the Bill will "prevent loss to the fiscus". It is further stated that "*(C)ertain taxpayers have created intra-group structures that involve actual intra-group dividends that reduce the profit levels of the distributing intra-group payor without adding additional profits for the shareholder intra-group payee. This stems from the accounting treatment prescribed by IAS 18 (AC 111) in terms of which dividends received out of pre-acquisition profits are not recognised as income but reduce the cost of investment in a subsidiary. The net effect is to turn intra-group relief from a deferral regime to an exempt regime because profits ultimately disappear from the group without STC*".

8.8 The statement made ignores the fact that, in situations where a company acquired ("the acquirer company") the shares in another company ('the investment company"), the price paid by the acquirer company for the shares would be based on the market values of the assets in the investment company, less any liabilities. The price would therefore include any realised or unrealised profits not distributed as dividends. Assuming that the seller held the shares on capital account, the price paid would be "proceeds" for CGT purposes in the hands of the seller and the seller would be liable for CGT on any capital gain realised as a result of the disposal of the shares. The so-called pre-acquisition profits would therefore be subject to CGT (at an effective rate of 14.5% if the seller is a company). There is therefore no loss to the fiscus, in fact, in this scenario the fiscus could potentially collected an additional 4.5% tax! The introduction of this provision will therefore result in a form of double taxation of the same amount.

8.9 The above is illustrated using the following comparative scenarios:

Scenario 1 – Company A disposes of shares in Subco before Subco declares a dividend comprising all its profits

Company A formed a subsidiary company ("Subco") with share capital of R100 in 2003. The R100 is also the base cost of Company A's investment in Subco. Subco used the funds to invest in a property from which it conducted its operations and had distributed profits of R500 at the end of 2007. It had cash in the bank of R700 and the property was worth R1 000 at the end of 2007. It also had liabilities of R200. Company A decides to dispose of Subco to Company B for R1 500, represented by the R700 in cash and the market value of the building of R1 000 less the liabilities of R200.

The CGT implications for Company A on the disposal of the shares are:

8.9.1 Proceeds on the disposal of the shares are R1 500

8.9.2 Base cost of the shares is R100

8.9.3 Therefore, taxable capital gain = R1 400

8.9.4 **CGT payable is R203** (effective rate of 14.5%)

Scenario 2- Subco first declares a dividend of all its profits and then Company A disposes of the shares

The facts are the same as above except for the following:

Before Company A disposes of its shares to Company B, Subco declares a dividend of R500. Subco elects that the group relief provisions will apply to the dividend it declared to Company A;

8.9.5 Due to the fact that Subco's assets are now reduced by R500 – the cash having been used to pay the dividend to Company A, the proceeds for the disposal of the shares by Company A to Company B is reduced to R1 000; and

8.9.6 Company A decides to pay a dividend of R455 to its shareholders. This dividend is however not exempt from STC.

The tax implications for Company A will be:

8.9.7 The STC implications for Company A are:

8.9.8 STC payable on the dividend of R455 calculated at 10% = R45

8.9.9 The CGT implications for Company A on the disposal of the shares in Subco are:

8.9.10 Proceeds on the disposal of the shares are R1 000

8.9.11 Base cost of the shares is R100

8.9.12 Therefore, taxable capital gain = R900

8.9.13 CGT payable is R130.50 (effective rate of 14.5%)

Total tax liability:

**The total tax liability for Company A is therefore R175.50** being the STC payable on the dividend of R500 and the taxable capital gain of R900 (a total of R1 400 which is the same as the amount on which CGT was payable in scenario 1).

8.10 Another way to express the problem is as follows. Clause 55(1)(k) amends section 64B95)(f)(i) as follows:

> "(1) that shareholder is a company forming part of the same group of companies as the company declaring the dividend *and that dividend is included in profits available for distribution of that shareholder*".

8.11 It would seem that it is accepted that a permanent deferral arises if that dividend is not included in reserves due to the accounting treatment of investment in subsidiaries. However, the proposed limitation should be worded as follows: "*to the extent that such dividend is included in the profits available for distribution to that shareholder*". This would provide for the situation where a portion of the dividend wipes out the investment in subsidiary and the balance is included in reserves. Clearly the exemption should apply to the portion of the profit included in reserves.

## 9. PARAGRAPH 11A OF THE FOURTH SCHEDULE TO THE ACT – CLAUSE 59

9.1 Clause 59(1)(c) provides (after subparagraph (ii)) that "*that person* ***and*** *that employer must deduct or withhold from the remuneration payable by them to that employee during that year of assessment,* ***an amount equal to the employees' tax payable in respect of the gain*** *...*". The proposed wording suggests that both parties must withhold the total employees' tax payable in respect of the gain, i.e. if the total gain was say R100, the applicable tax rate was 40% and the employees' tax was R40, then **both parties has** to withhold R40 each from any remuneration payable to the employee. A total of **R80**, i.e. double the actual amount of employees' tax due will therefore have to be withheld. It is proposed that the wording be amended to clarify the situation.

## 10. ANTI-DISTRIBUTION STRIPPING – CLAUSE 71

10.1 The provisions of the proposed paragraph 76A of the Eighth Schedule to the Act in terms of which a person who received a capital distribution from 1 October 2001 to 30 June 2008 (both dates inclusive), will be deemed to have received the capital distribution on 1 July 2008 and accordingly have to account for CGT on the past capital distributions at that date, is a form of retrospective taxation and the affected persons may not be in a position to determine and/or pay any CGT due on the amounts. For example, assume a BB-BEE trust acquired shares in a company on loan account and the company made a capital distribution to the trust before 1 July 2008. Assume further that the company applied the distribution partially towards paying off the loan and distributed the remainder to the black beneficiaries. The trust no longer has funds to settle the CGT retrospectively. As the trustees would not have been aware of this future change in the legislation, they would not have held funds back in order to settle the tax. This change should not be retrospective.

Yours sincerely,
**MALLINICKS INC**

Per

**MARTIE FOSTER**
ASSOCIATE DIRECTOR: TAX