

# SUBMISSION BY THE LAW SOCIETY OF SOUTH AFRICA ON DRAFT TAXATION LAWS AMENDMENT BILL, 2017

## 1. INTRODUCTION

- 1.1. The Law Society of South Africa (LSSA) represents more than 25 000 practising attorneys and almost 6 000 candidate attorneys countrywide. It is the umbrella body of the attorneys' profession in South Africa and its constituent members are the Black Lawyers Association (BLA), the National Association of Democratic Lawyers (NADEL) and the four statutory provincial law societies, namely the Cape Law Society (CLS), the KwaZulu-Natal Law Society (KZNLS), the Law Society of the Northern Provinces (LSNP) and the Free State Law Society (FSLs).
- 1.2. The LSSA hereby makes the following submissions and recommendations to the Income Tax Act, 58 of 1962 (the Act), as contained in the Draft Taxation Laws Amendment Bill, 2017 (the DTLAB) and.

## 2. SECTION 7C

- 2.1. The proposed section 7C(1)(ii) inserts reference to a company which is “a **connected person** in relation to the trust referred to in sub paragraph (l)”.
- 2.2. The mischief which is said to be addressed by this proposal is the circumvention of section 7C by way of loans to companies which are held by trusts. This is explicitly stated in the explanatory memorandum.
- 2.3. The proposed change however goes beyond what is necessary to address this circumvention. It will include also companies which are not owned by trusts but which are merely connected to them. This goes further than is necessary to address the mischief. It would include for example:
  - 2.3.1. A company which is a beneficiary of the trust;
  - 2.3.2. A company which is owned by another beneficiary of the trust; and
  - 2.3.3. a company which is in partnership with the trust.
- 2.4. There are many other examples of companies which are connected to a trust but which are not themselves within the “tax shelter” afforded by the trust structure.
- 2.5. We therefore respectfully submit that the words utilised should be limited to address the advancing of interest free or low interest loans to companies which are owned by trusts.

- 2.6. The wording used is also capable of being interpreted as including loans advanced by one company to another where some or all of the shares of those two companies are owned by a trust. Inter-company loans within a trust setting do not give rise to any avoidance and may give rise to a multiplicity of donations tax consequences where in truth no additional avoidance is involved.

**The proposed section (1A)**

- 2.7. The rationale behind the proposed amendment is clear. However, there may well be an interpretation difficulty with respect to timing.
- 2.8. In the case of a beneficiary which was initially connected to the trust and subsequently acquired a loan claim against the trust (which would often be the case where for example a parent bequeaths to a child a loan against the trust on the parent's death).
- 2.9. In those circumstances, the wording could be interpreted to mean that the child is deemed to have acquired the claim on the date on which the child became connected, which was much earlier than the date on which the child actually acquired the claim. This difficulty would be remedied if the amendment makes clear that its only once both of the conditions are fulfilled (connection and acquisition) that from that time forward the child would be deemed to have held the claim. The alternative explanation gives rise to a form of retrospectivity.

**The proposed clause (f) exemption for share schemes in terms of the proposed section 7C(5)(h)**

- 2.10. The introduction of the proposed exemption is welcomed as it will avoid the inadvertent application of the anti-avoidance rules to bona fide share incentive schemes.
- 2.11. We submit that the following factors might inadvertently limit the scope of this relief:
- 2.11.1. In terms of section 7C(5)(h)(1)(aa) the loan involved could also have been advanced by a natural person;
- 2.11.2. The loan could also have been advanced to a company for purposes of the share scheme;
- 2.11.3. It is possible that the instruments in question are in fact equity shares and not only instruments which relate to or derive their value from underlying shares;
- 2.11.4. It is not entirely clear that the provision includes participation which is extended to become a beneficiary of such a trust when regard is had to the words "offered by the trust";
- 2.11.5. The exclusion from the relief of circumstances where a participant under the scheme is also an owner or connected person in relation to the owner of the

company appears to be unduly conservative and addresses an anticipated avoidance which in practice is likely to ever be encountered. More particularly the exclusion anticipates that the owner of a company would transfer equity to family members by way of including them in a share incentive scheme. In reality this is unlikely to arise. By including equity in a share incentive scheme the owner would subject the benefited family member to income tax at the full rate of 45% in relation to the benefit derived, by virtue of section 8C. No rational taxpayer would transfer shares to their family members in a way which fully subjects the gain to a rate of 45% tax, when they could merely transfer some of their equity to the family member and attract capital gains tax and possibly in addition donations tax at a substantially lower rate. We respectfully submit that this limitation of the welcome inclusion on share incentive schemes will defeat the object in the case of very many small, medium, family owner entrepreneurial companies which are legitimately entitled to include family members who work for their business in their share incentive scheme. Such family members will attract the full rate of tax in terms of section 8C and there is no tax benefit or avoidance achieved by doing so.

- 2.12. We therefore respectfully submit that this carve out to the exemption ought to be eliminated or alternatively that a de minimis should be introduced to avoid the perceived (but not clearly demonstrated) avoidance. As currently drafted the entire scheme would be disqualified from the relief if a family member acquired a tiny portion of the equity offered in terms of the share incentive scheme. This could be mitigated by introducing a de minimis rule, for example, 5% or 10% to be held by family.

### 3. SECTION 9D

- 3.1. The DTLAB proposes to amend the definition of “controlled foreign company” (“CFC”) in section 9D of the Act to include-

*“(b) (i) any foreign company, where one or more persons that are residents hold an interest in a trust that is not a resident... and that trust... directly or indirectly holds more than 50 per cent of the total participation rights in that foreign company or may directly or indirectly exercise more than 50 per cent of the voting rights in that foreign company; or*

*(ii) any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is resident”.*

- 3.2. The DTLAB further proposes to insert the following proviso to section 9D(2):-

*“Provided further that for purposes of applying this subsection the percentage of the participation rights of a resident in relation to a controlled foreign company is equal to the percentage of the financial results of that foreign company that are reflected in the consolidated financial statements, as contemplated in IFRS 10, for the year of assessment of the holding company, as defined in the Companies Act, that is a resident”.*

- 3.3. We hereby submit the following in relation to the above proposed amendments:
- 3.3.1. It is submitted that the proposed paragraph (b) to the CFC definition should be amended to provide that both subparagraphs (i) and (ii) should be applicable in order for an entity to constitute a CFC in terms of paragraph (b) to the CFC definition. In the absence of such an amendment it may be possible for a foreign entity to constitute a CFC in terms of the proposed paragraph (b)(ii) in circumstances where South African shareholders hold less than 50 per cent of the equity shares and/or voting rights in such foreign entity.
- 3.3.2. In addition, in terms of a current reading of the proposed amendment to the definition of a CFC, a foreign company will be a CFC in relation to any person (including natural persons and companies) where such person holds an interest in a trust or foreign foundation and the trust or foreign foundation directly or indirectly holds more than 50% of the participation rights or voting rights in a foreign company.
- 3.3.3. However, there is no definition of what “an interest” in a trust or foundation constitutes and more importantly how the portion of the amount equal to the “net income” of the relevant CFC which should then be included in the income of such person, must be determined. In this regard, we submit that it would be impossible to determine such an interest, for, for example a discretionary beneficiary of an offshore trust.
- 3.3.4. It would therefore not be possible to determine the participation rights of such a beneficiary, and thus the allocation of the “net income” amount of the relevant CFC to the resident beneficiary.
- 3.3.5. In addition, where the person is a natural person (or any other resident that is not a company), any amounts received or accrued from that trust or foundation would also be taxed in terms of section 25BC. Therefore, such amounts would potentially be subject to double tax.
- 3.3.6. However, in any event, it appears from the Explanatory Memorandum that the intention is that the amendment to the definition of a CFC should apply only to resident companies which hold an interest in a trust or foreign foundation as

described above and where the financial results of the relevant foreign company are reflected in the consolidated financial statements as contemplated in IFRS 10.

- 3.3.7. This makes sense, since then the proviso referred to above would determine the basis for the inclusion of the amount equal to net income of the relevant CFC in the company's income (subject to our comments below).
- 3.3.8. As stated above, this would also address the issue identified above that a foreign entity to constitute a CFC in terms of the proposed paragraph (b)(ii) in circumstances where South African shareholders hold less than 50 per cent of the equity shares and/or voting rights in such foreign entity.
- 3.3.9. Based on the above submissions, we propose that the wording of the amendment to the definition of a CFC be amended such that the requirements in (b)(i) and (b)(ii) be read together (ie the "or" should be replaced with "and") and the consequential changes should be made.
- 3.3.10. In addition, the proposed paragraph (b)(ii) to the CFC definition should be amended to clarify that it only applies to subsidiaries (i.e. entities controlled by the holding company) as contemplated in IFRS10. In terms of the current proposed wording, there may be a risk of non-controlled foreign associates of the holding company constituting CFCs. In addition, the current wording of the proposed paragraph (b)(ii) may give rise to an entity constituting a CFC depending on whether South African shareholders are at a majority at shareholder meetings of the foreign entity – which may in turn give rise to a fluctuation in the CFC status of the foreign entity on an annual basis.
- 3.3.11. The wording of the proposed proviso to section 9D(2) as quoted in paragraph 3.2 above may give rise to 100 per cent of the financial results of a foreign company constituting the participation rights which a holding company holds in such foreign company in circumstances where the holding company holds less than 100% of the equity shares and voting rights in the foreign company. In particular, in terms of IFRS10, 100% of the foreign company's financial results would be reflected in the consolidated financial statements of the holding company, and the consolidated financial statements would then draw a distinction between controlling and non-controlling shareholding. Accordingly, the proposed proviso to section 9D(2) should be amended to clarify that the financial results of the foreign company would only give rise to participation rights for the holding company to the extent of the holding company's proportional shareholding in the foreign company.

### The newly proposed section 25BC

3.4. The newly proposed section 25BC states as follows:

***“Distributions by non-resident trust or foreign foundation deemed to be income of resident***

25BC. If—

*(a) any person that is a resident, other than a person that is a company, is a beneficiary in relation to a trust that is not a resident or a foreign foundation; and*

*(b) that trust or foundation holds a participation right as defined in section 9D(1) in a foreign company and that company would have constituted a controlled foreign company as defined in that section had that trust or foundation been a resident,*

*any amount received by or accrued to or in favour of that person during any year of assessment from that trust or foundation by reason of that person being a beneficiary of that trust or foundation must be included in the income of that person.” (underlining added).*

- 3.5. It is submitted that the newly proposed section 25BC needs to be amended to clarify the timing of its application to ensure that the resulting tax could not be triggered twice. The heading to the proposed provisions appears to indicate its application in respect of distributions whereas the body of the provision appears to indicate that it may apply in respect of amounts received by or accrued to or in favour of a person. It accordingly appears as though section 25BC could be triggered upon the vesting by the trust of assets – notwithstanding that the heading of the provision merely makes reference to distributions. The vesting of assets or amounts are already dealt with in section 25B(2A) and paragraph 80(3) of the Eighth Schedule.
- 3.6. The effect of this in addition appears to be punitive in the sense of converting underlying capital, capital gains and exempt income to ordinary taxable income when the amounts are distributed to the South African beneficiaries.
- 3.7. Whilst we understand the desire to bring into the South African tax net the amounts received by or accrued via a company which would be a CFC in the circumstances described in the explanatory memorandum, we submit that the effect could be achieved by aligning the provisions with the current trust rules relating to distributions out of foreign amounts which clearly maintain the source, quality and nature of the underlying amounts when taxing them in the hands of the South African beneficiary. We respectfully submit that the new laws should be aligned with the existing provisions which have an equitable effect.
- 3.8. In addition, in terms of the current wording, there is no causality or link between the amount received/accrued and the fictional CFC which is held by the offshore trust/foundation and the

treatment of the distributions by the trust or foundation. For example, an offshore trust may hold various investments and/or shares in companies or other entities which would not constitute CFCs if the fiction is applied that the trust is a resident, yet the full amount which is received by or accrues to the South African resident beneficiary from such trust/foundation will be taxed in terms of the proposed provision.

- 3.9. It is therefore submitted that the provision should also be amended to introduce a causal link between the distribution/amount which is included in the income of the resident beneficiary and the source of such distribution/amount.

#### 4. **SECTION 10(1)(k)**

- 4.1. Section 10(1)(k)(i) of the Income Tax Act exempts a dividend from income tax. The exemption is subject to various provisos including, *inter alia*, sub-paragraph (ff) which excludes from the exemption a dividend received by or accrued to a company in respect of a share borrowed by that company. As a result of this proviso a dividend received by or accrued to a company on a share obtained in terms of a securities lending arrangement is subject to income tax.
- 4.2. With effect from 1 January 2016 the definition of a “collateral arrangement” was introduced into the Income Tax Act in terms of the Taxation Laws Amendment Act No 25 of 2015. Based on the Explanatory Memorandum to this Act, it was intended that a similar tax dispensation as applies to securities lending arrangements be introduced for the outright transfer of collateral.
- 4.3. However, the provisos to section 10(1)(k)(i) were not expanded to include a proviso that excludes a dividend received by or accrued to a company in respect of a share obtained in terms of a “collateral arrangement” from the exemption.
- 4.4. We recommend that section 14(1)(d) of the draft Taxation Laws Amendment Bill be expanded to include a proviso that excludes a dividend received by or accrued to a company in respect of a share obtained in terms of a “collateral arrangement” from the exemption in section 10(1)(k)(i) of the Income Tax Act.

#### 5. **SECTION 22 AND PARAGRAPH 43A OF THE EIGHTH SCHEDULE**

- 5.1. Clause 33 of the Draft TLAB proposes the substitution of section 22B of the Act which deals with dividends treated as income on the disposal of certain shares held as trading stock. In particular, clause 33 includes the following proposal:

*“[22B](2) Where a company disposes of shares in another company and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or accrued to that company in respect of the shares disposed of must –*

- (a) *to the extent that the exempt dividend is received by or accrues to that company –*
- (i) *within a period of 18 months prior to; or*
  - (ii) *in respect, by reason of or in consequence of that disposal; and*
- (b) *if that company immediately before that disposal held the shares disposed of as trading stock,*
- be included in the income of that company in the year of assessment in which those shares are disposed of or, where that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues.*
- (2) *Subsection (1) is deemed to have come into operation on 19 July 2017 and applies in respect of any disposal on or after that date.”*

- 5.2. Clause 45 of the Draft TLAB proposes the substitution of paragraph 43A of the Eighth Schedule which deals with dividends treated as proceeds on the disposal of certain shares held as capital assets. In particular, clause 45 includes the following proposal:

*“[43A](2) Where a company disposes of shares in another company and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or accrued to that company in respect of the shares disposed of must –*

- (c) *to the extent that the exempt dividend is received by or accrues to that company –*
    - (iii) *which a period of 18 months prior to; or*
    - (iv) *in respect, by reason of or in consequence of that disposal; and*
  - (d) *if that company immediately before that disposal held the shares disposed of as a capital asset (as defined in section 41),*
- be taken into account, in the year of assessment in which those shares are disposed of or, where that dividend is received or accrues after that year of assessment, the year of assessment in which that dividend is received or accrues, as part of proceeds from the disposal of those shares.*
- (2) *Subsection (1) is deemed to have come into operation on 19 July 2017 and applies in respect of any disposal on or after that date.”*

- 5.3. In terms of section 70(2) of the Bill the proposed substitution is deemed to have come into operation on 19 July 2017 and applies in respect of any disposal on or after that date. Paragraph 13 of the Eighth Schedule to the Income Tax Act contains special rules which determine the “time of disposal” for purposes of the Eighth Schedule. It is unclear from the proposed amendments as to whether the time of disposal rules are to apply to the revised



paragraph 43A such that transactions which were entered into prior to 19 July 2017 but which only become unconditional as a result of being subject to certain conditions precedent which are fulfilled after 19 July 2017 are subject to the new paragraph 43A as opposed to the existing law.

- 5.4. Agreements entered into, even if subject to conditions precedent, create binding rights and obligations between the parties and parties can therefore not simply “walk away” from transactions which may now have different tax treatment to the anticipated treatment at the time that the agreements were entered into. For example, where dividends have already been paid and accounted for for tax purposes by taxpayers, they should not now be affected by the proposed law change.
- 5.5. Further, the scope of the substituted paragraph 43A is so wide that it has the effect of taxing ordinary dividends which have no long term effect on the value of the shares and which have been declared in the ordinary course of business where repurchase or a sale of shares may not even be anticipated but which repurchase or sale may materialise within the period of 18 months after the declaration of such dividends.
- 5.6. The draft Explanatory Memorandum makes it clear that the mischief which the substituted paragraph 43A aims to combat is the “*conversion of taxable share sale consideration into exempt dividends*”. It is submitted that the distribution of a dividend in the ordinary course of business where a sale of shares is not anticipated is not the mischief which the legislature intends to target. The mere fact that a sale of shares may take place within a period of 18 months of such dividends being declared does not necessarily “taint” the dividends as contemplated in the substituted paragraph 43A.
- 5.7. We appreciate that the Minister of Finance made mention in his budget speech on 22 February that certain changes to “dividend stripping schemes” and share buy backs would be made and that such may constitute a forewarning. However this “warning” is extremely vague and does not afford taxpayers the necessary forewarning such that they may structure their commercial affairs in a certain manner.
- 5.8. In addition, and not less important, the Bill does not provide the necessary consequential changes required to deal with the revised paragraph 43A. For example, if a company has a year of assessment ending on 31 July of each year, how is it supposed to treat its provisional tax payments if it has received a dividend which under current law would be exempt. If the proposed amendment is ultimately promulgated in its current form then such taxpayers may be liable to a penalty for under estimation and late payment of its provisional tax. Could the failure to deal with the provisional tax consequences indicate that the proposed law is not intended to apply retrospectively and if so, such should be made clear?

- 5.9. Accordingly, our view is that if the proposed substitution of paragraph 43A is to take place, it should only apply at a minimum to agreements which have been entered into on or after the effective date of 19 July 2017 and only to dividends which are received by reason of or in consequence of the disposal (albeit that such a concept is fairly vague in itself).
- 5.10. Whilst we appreciate that National Treasury does not wish to “alert” taxpayers to “loop holes” through the introduction of draft legislation which clearly highlights the “loop hole” such that taxpayers can then enter into transactions to avoid tax prior to the law being promulgated, it should be appreciated that by making the revised law applicable to “*transactions entered into on or after...*” the date of release of the Bill, National Treasury will be protected in this regard.
- 5.11. Further, in our view, as a firm principle, the legislature should steer clear of retrospective legislation as such creates additional uncertainty in an already uncertain tax system with the result that taxpayers are not able to properly plan their affairs for fear of retrospective amendments altering the anticipated tax position. An uncertain tax system is detrimental to investment in an economy.