



**REPUBLIC OF SOUTH AFRICA**

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**EXPLANATORY MEMORANDUM**

**ON THE**

**REVENUE LAWS AMENDMENT BILL, 2007**

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# EXPLANATORY MEMORANDUM ON THE REVENUE LAWS AMENDMENT BILL, 2007

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## INTRODUCTION

The Revenue Laws Amendment Bill, 2007, introduces amendments to the Transfer Duty Act, 1949, the Pension Funds Act, 1956, the Income Tax Act, 1962, the Customs and Excise Act, 1964, the Stamp Duties Act, 1968, the Value-Added Tax Act, 1991, the Uncertificated Securities Tax Act, 1998, the Collective Investment Schemes Control Act, 2002, the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006, and the Taxation Laws Amendment Act, 2007. In addition, the Bill proposes that certain supplies relating to the ICC 20 20 WC (South Africa) be subject to value-added tax at the rate of zero per cent and proposes further the tax-free amalgamation of sporting bodies.

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## ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES (“STC”)

The switch of the STC from a company-level tax to a shareholder-level tax was announced in the 2007 Budget Review. The interim step of base-broadening and simplification was also announced at that time. As a prelude to the overall improvements to the STC base, the proposed legislation makes a number of preliminary adjustments to broaden the base and curb ongoing avoidance schemes. This stage of the base-broadening effort is accompanied by a reduction of the STC rate from 12,5 per cent to 10 per cent.

### 1. Broadening the taxable dividend definition

#### Current legislation

The STC falls on distributions only if those distributions qualify as dividends. In order for a distribution to qualify as a dividend, it must (as a rule) come from profits. The dividend definition is found in section 1 of the Income Tax Act, 1962, but the definition is also assumed to take account of the principles of company law. The rules for the STC with respect to dividend taxation are contained in section 64B (along with the rules for deemed dividends under section 64C).

#### Problem statement

The dividend definition contains many historic anomalies that create unintended inconsistencies. Some unintended inconsistencies give rise to avoidance potential while others simply complicate the dividend calculation and lead to uncertainty. The proposed changes are intended as a step toward streamlining the definition and closing some obvious shortcomings.



Proposed amendment: (Section 1 – “dividend” definition)

**A. Basic principles**

Some confusion exists regarding basic principles in calculating dividends. Firstly, dividends should account for all profits, whether realised or unrealised (even if not reflected in a company’s financial statements). For instance, if a company owns appreciated property and borrows against that property to make a distribution, the dividend calculation should account for the unrealised profits attributable to the property (even though the property remains unsold). Similarly, if an asset is distributed in specie, any unrealised profit associated with that distribution should be taken into account regardless of whether that unrealised profit is reflected in the company’s financial statements. Secondly, current legislation technically excludes distributions of share premium from the dividend definition but is silent as to share capital.

**B. Redemptions (and reconstructions)**

The dividend definition provides special rules for redemptions, reductions or any other acquisition by a company of its own shares (as well as reconstructions). 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. To the extent any difference exists, the difference occurs at a shareholder level (which is fully taken into account as a disposal under the Eighth Schedule). The concept of a nominal value offset for these transactions is accordingly removed.

**C. Removal of transitional calculations**

The dividend definition continues to exclude certain forms of profits pre-dating effective dates when companies make liquidating distributions. The most notable of these exclusions is the exclusion for liquidating dividends to the extent those dividends arise from pre-2001 capital profits. The other exclusion (in section 64B(5)(c)) is for liquidating dividends arising from pre-1993 profits. Consideration is being given to removing the profits concept altogether in the longer-term as part of broader base broadening measures. Therefore, the pre-effective date profit exclusions will no longer be compatible with the new regime and must be entirely removed. This proposed removal will take effect for all distributions on or after 1 January 2009. The delayed effective date will give taxpayers time to plan accordingly.

**D. Allocation of share capital (and share premium)**

Subject to rules specifically contained in a company’s articles of incorporation (and isolated rules within company law), share capital (and share premium) can

be freely allocated to specific share distributions even if that share capital (and share premium) arose from other sources. Taxpayers are seemingly using this free allocation to disguise shareholder sales in the form of shareholder contributions and distributions. In order to prevent this practice, the proposal limits the amount of share capital (and share premium) that can be allocated to any class of shares. More specifically, share capital (and share premium) allocable to a class of shares can no longer exceed the contributions received in exchange for the issue of that class.

*Example. Facts.* Company has two classes of ordinary shares – Ordinary Class A shares and Ordinary Class B shares. Shareholders of the Ordinary Class A shares previously contributed share capital and share premium of R30 000. Before the creation of the Class B Ordinary shares, Company has a value of R1 million. The Class B ordinary shares are then issued in exchange for R1 million (bringing the total value of the company to R2 million). Shortly thereafter, R1 million is distributed to the Class A shares.

*Result.* The share capital (and premium) allocated to the Ordinary Class A shares cannot exceed the R30 000 (the initial contribution for those shares). In other words, the new contribution of R1 million cannot be allocated to the Ordinary Class A shares.

## **E. Collective investment schemes**

The proposed legislation clarifies the treatment of collective investment scheme distributions. The dividend definition specifically excludes collective investment scheme redemptions, thereby leaving redemptions (and similar cancellations) squarely within the capital gains tax regime. Operating distributions by collective investment schemes remain fully within dividend characterisation.

## **2. Simplifying STC intra-group relief**

### Current legislation

Group relief exists for dividends between companies falling within the same group of companies (e.g., having a 70 per cent shareholder connection). In effect, intra-group dividends are exempt. This exemption is based on the premise that the underlying profits will ultimately become subject to the STC once those profits leave the group as dividends. One condition of this exemption is that the intra-group dividends must stem from profits arising while the distributing company was part of the group. Comparable group relief exists for deemed dividends.

### Problem statement

STC relief for intra-group dividends plays an important role in legitimate intra-group restructuring but is also the subject of tax avoidance. Experience with the regime indicates that certain aspects of the relief must be narrowed while some anti-avoidance obstacles create unintended problems without significantly curbing anti-avoidance. The STC regime will accordingly be adjusted to account for these realities.

### Proposed amendment

#### **A. Narrowed group definition (sections 41 and 64B(1) – “group of companies” definition)**

All intra-group relief should essentially operate as a deferral regime. Therefore, exemption cannot be allowed in the case of dividends to group companies falling outside the STC because deferral will be effectively converted into exemption. In view of this reality, fully or partially exempt companies will fall outside the intra-group definition. The proposal also tightens the rules on the shares counting toward the 70 per cent ownership criteria needed for group status. More specifically, the group members involved must genuinely have a permanent association with the group. All of these changes will mirror the narrowed group definition to be used for intra-group relief. The narrowed group definition will equally apply for purposes of determining the exemption for intra-group deemed dividends.

#### **B. Profits limitation (sections 1 (“dividend” definition), 64B(5)(f) and 64C(k))**

As discussed above, intra-group relief applies only to the extent that the intra-group dividend involves profits arising while company members are part of the same group. Relief does not apply to profits arising before a company member becomes part of a group. The same limitation applies to the intra-group relief rules for deemed dividends. While this limitation makes sense as a matter of tax theory, tracing profits to pre- and post-acquisition periods is administratively problematic, especially in the case of deemed dividends (because profits are not actually distributed). The prohibition against pre-acquisition profits is also inconsistent with the intra-group rules, which apply to all intra-group asset transfers even if the asset partially appreciated or depreciated before becoming part of the group. Given these difficulties, intra-group (actual and deemed) dividends will be fully eligible for relief even if those dividends can be traced to pre-acquisition profits.

However, a new profit limitation will be added to prevent loss to the fiscus. Certain taxpayers have created intra-group structures that involve actual intra-group dividends that reduce profits of the distributing intra-group company payor

without adding additional profits for the shareholder intra-group company payee. Intra-group relief is predicated on a presumption of deferral (STC exemption for the distributing company should be matched by additional STC before profits depart from the group). In order to curb this threat to the tax base, intra-group relief for actual dividends will be allowed only to the extent the intra-group company receiving the dividends takes those dividends into account in determining its profits.

With the change, pre-acquisition profits remain an issue via the accounting treatment prescribed by IAS 18 (AC 111). In terms of IAS 18 (AC 111), dividends received out of pre-acquisition profits are not recognised as income but reduce the cost of investment in a subsidiary's shares. This reduction should not fall within the STC regime (via exemption or otherwise) because a reduction in cost is more akin to a share capital distribution. This form of reduction will accordingly be deemed to qualify as a share capital distribution with part sale treatment resulting (see paragraphs 76 and 76A).

Lastly, the exemption for deemed intra-group dividends will follow a similar paradigm as the one discussed above. The old profit tracing system will fall away. Instead, deemed distributions that result in a loss of distributing company profits will result in STC intra-group relief if additional profits are created on the other side (i.e. to the shareholder). Deemed dividends lacking a profit reduction for the distributing company are not subject to this condition.

### **3. Anti-distribution stripping (Pre-sale extraordinary dividends (paragraph 19 of the Eighth Schedule))**

#### Current legislation

Current law seeks to prevent the artificial creation of capital losses stemming from extraordinary dividends. More specifically, taxpayers must disregard losses stemming from the devaluation of any share sold at a loss if the shareholder received an extraordinary dividend within two years after the share was initially acquired. The anti-loss rule does not apply to devaluations caused by extraordinary dividends that are exempt from STC by virtue of intra-group relief.

#### Problem statement

The initial regime was mainly designed to prevent dividend stripping stemming from short-term holdings in shares. In transactions of the type initially envisioned, the taxpayer would purchase a share, receive an extraordinary dividend, and then sell the share at a capital loss shortly thereafter. The capital loss generally stems from the fact that the share lost value due to the loss of cash from the outgoing extraordinary dividend.

The initial regime has two shortcomings. Firstly, the devaluation of shares via extraordinary dividends can equally occur in respect of long-term holdings as opposed to short-term holdings. Secondly, the scheme of using extraordinary dividends to generate capital losses has a particularly high value if the pre-sale extraordinary dividends do not give rise to STC. The current regime fails to reflect this reality, and indeed, provides an escape hatch from the anti-loss regime when the extra-ordinary dividends are exempt by virtue of the STC intra-group relief provisions.

#### Proposed amendment

The Paragraph 19 anti-dividend stripping provisions will be fundamentally revised. Under the new anti-avoidance regime:

- (1) All extraordinary dividends (including dividends exempt by virtue of the intra-group relief provisions or otherwise) will trigger the anti-avoidance charge; and
- (2) The regime will apply whenever extraordinary dividends are distributed within two years before disposal of the share (as opposed to the old rule focusing on extraordinary dividends arising within two years after purchase). Note: Extraordinary dividend amounts arising within a redemption and liquidation context have a similar impact on losses associated with these events (i.e. the two-year rule includes extra-ordinary dividends occurring at the same time as the disposal).

*Example. Facts.* Parent Company has owned all the ordinary shares of Subsidiary since 2000. Parent Company purchased the shares for R20 million. Since that date, Subsidiary has increased in value to R35 million. On 15 March 2008, Subsidiary makes an exempt (section 64B(5)(f) distribution to Parent of R20 million. Parent then sells the Subsidiary shares for R15 million (for a R5 million loss against the purchase price).

*Result.* The exempt dividend is an extraordinary dividend (i.e. exceeds 15 per cent of the R15 million sales proceeds). Therefore, Parent must disregard the R5 million loss (i.e. the extraordinary portion of the dividend exceeds the entire R5 million amount).

#### **4. Capital distributions (paragraphs 76 and 76A of the Eighth Schedule)**

##### Current legislation

Special rules apply for purposes of the capital gains tax regime under the Eighth Schedule when companies make a capital distribution (e.g. a distribution of share capital or share premium falling outside the dividend definition). Under these circumstances, all distributions of this nature arising on or after 1 October 2001

will be added to proceeds upon the eventual disposal of shares (and all pre-2001 distributions reduce expenditure in the share). The outstanding deemed proceeds of this nature can even exceed the shareholder's total expenditure (leaving the shareholder with an effective "negative" base cost).

### Problem statement

The additional proceeds rule for capital distributions was designed as a rule for administrative convenience. The additional proceeds concept had the benefit of avoiding complex calculations for the capital gains tax every time a company distributed share capital or share premium over the life of the share investment. Unfortunately, taxpayers have sought to use this rule of administrative convenience as a mechanism to disguise the sale of shares in order to avoid the imposition of capital gains tax. These mechanisms are especially problematic when the deemed proceeds from the capital distribution exceed the underlying expenditure in the share (i.e. the share is left with an effective negative base cost). In order to avoid eventual gain on the shares, the holder of the share generating the capital distribution merely holds onto the shares without any expectation of further profit from those shares.

### Proposed amendment

#### **A. General rule**

For the reasons outlined above, the tax rules will be changed for capital distributions so that each capital distribution will generally trigger a part-disposal of the share. While this rule requires additional calculations, the new rule is essentially better from a tax policy standpoint and has the advantage of eliminating the avoidance concern.

More specifically, under the new part-disposal rule, the capital distribution will fall under the part-disposal rule of paragraph 33. The allocation of expenditure between the part sold and the total share will be based on the ratio between the amount of the distribution (i.e. the cash and market value of property *in specie*) and the total value of the share. A similar set of changes will also apply for purposes of collective investment schemes in property (paragraphs 67A and 67B of the Eighth Schedule).

*Example. Facts.* Taxpayer holds a share with a value of R200, which was acquired for R120. Taxpayer receives a capital distribution of R20 in cash during July 2009.

*Result.* The capital distribution gives rise to a part sale. Ten percent of the R120 expenditure is allocated to the part sale (R20 capital distribution over R200 total share value). Taxpayer accordingly has R8 of gain on the distribution (R20 proceeds less R12 allocable expenditure).

## **B. Effective dates**

The shift of emphasis from delayed proceeds to part-disposal for capital distributions gives rise to transitional issues. In the main, the issue arises in respect of prior distributions occurring from 1 October 2001. These distributions will have to be brought into the new regime in order to ensure that the deferred gain is eventually recognised on the shares as initially intended by the legislature. Therefore, all distributions occurring before 1 October 2007 will be deemed to trigger a part sale on 1 July 2011.

## **C. Capital distributions, unbundlings and the weighted average method**

In terms of section 46(3) of the Income Tax Act, when an unbundling transaction takes place, a portion of the base cost of the shares in the unbundling company must be allocated to the shares in the unbundled company. Under paragraph 76(1) of the Eighth Schedule, a capital distribution of an asset *in specie* must be treated as proceeds on disposal of the share to which it relates. However, in view of the base cost allocation treatment under section 46(3), it would not be appropriate to treat the capital distribution as proceeds as this would lead to double taxation. It is for this reason that capital distributions received as part of an unbundling transaction are excluded from paragraph 76(1). The problem, however, is that paragraph 76(1) only applies to persons who use the specific identification or first-in-first-out methods. Provision is not made for the exclusion of such capital distributions by shareholders who use the weighted average method under paragraph 32(3A). These shareholders are required to deduct the capital distribution from the base cost of their shares under paragraph 76(2). It is accordingly proposed that a capital distribution of shares in an unbundled company also be excluded from paragraph 76(2).

## **D. Repeal of matching contribution/distribution avoidance rule (paragraph 79 of the Eighth Schedule)**

Under current law, matching capital contributions and capital distributions can trigger immediate capital gains at the shareholder level as if one shareholder sold to another party. This rule is no longer necessary in light of the changes to the capital distribution rules, which automatically now trigger part-sale treatment.

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## **CAPITAL VERSUS ORDINARY SHARES**

### Current legislation

Capital gains and ordinary income are effectively taxed at different rates, but no clear dividing line exists between the two regimes. The facts and circumstances analysis of case law accordingly prevails. The only legislative intervention is section 9B, which treats shareholders of listed company shares as having capital

gain or loss from the sale of listed shares held for longer than 5 years. Shareholders have to make an election that section 9B should apply to their share transactions.

### Problem statement

Although section 9B provides a degree of certainty for the sale of listed shares, this section should be expanded to provide a greater degree of certainty with respect to share transactions on a more generalised basis. Continued reliance on case law often leads to unintended differences of application. The result is that some sectors of the economy are facing one standard while other sectors are facing a different standard. The use of objective rules will eliminate this uneven playing field.

### Proposed amendment

From 1 October 2007, the current 5-year rule (section 9B) will be replaced with a new rule (Section 9C). The new rule will apply to a wider set of “shares” held for at least 3 continuous years.

#### **A. Definitions (subsection (1))**

The definition of “connected person” has a slightly lower threshold in section 9C than the normal connected person test. More specifically, company shareholders will be viewed as connected to the company in which they hold 20 per cent of the shares (even if another shareholder holds a majority interest). This definition plays a role in the 3-year real estate/bare dominium anti-avoidance rule.

The definition of “shares” will include all listed shares on the JSE (domestic and foreign), private company shares, interests in close corporations and certain (i.e. share portfolio) collective investment schemes. However, the share definition excludes certain hybrid instruments (i.e. shares with both equity and debt features), interests in share block companies and unlisted foreign companies. The exclusion for unlisted foreign companies can be justified on the grounds that foreign shares already have many tax differences. For instance, the sale of foreign shares is often completely exempt from tax if of a capital nature (by virtue of the participation exemption under paragraph 64B of the Eighth Schedule); whereas, domestic shares can only benefit from the reduced capital gains tax rate.

Paragraph 12 of the Eighth Schedule contains certain deemed acquisition and disposal events where the effective rate of tax payable upon the potential disposal of an asset changes even though no change in ownership took place. This change in the effective rate of tax may be due a number of reasons including a change in the tax status of the owner (e.g. a resident becoming a non-resident) or the intention of the owner (e.g. trading stock intention to capital



intention). These deemed disposals are also recognised as disposals for section 9C purposes.

*Example: Facts.* A taxpayer acquired shares on 1 January 2005 with an intention to keep these shares as capital assets. The taxpayer's intention changes on 1 Feb 2008 and a deemed disposal (and re-acquisition) is triggered on that date in terms of paragraph 12 of the 8<sup>th</sup> schedule.

*Result.* In terms of Section 9C, the deemed disposal will automatically qualify as a disposal of a capital asset. Any subsequent disposal of those shares by that taxpayer will also be treated as a disposal of a capital asset irrespective of the taxpayer's intention.

## **B. General rule (subsection (2))**

Receipts and accruals from the sale of shares held for the three-year period will be deemed to be of a capital nature. This rule applies equally to gains and losses. The new three-year rule is mandatory (unlike section 9B which is elective).

## **C. Immovable property/bare dominium anti-avoidance rule (subsection (3))**

Concern exists that the new section 9C could create potential for avoidance if shares are held in companies mainly holding real estate (and/or holding bare dominiums), as follows:

*Example: Facts.* Taxpayer owns many shelf companies. Taxpayer plans to buy real estate, followed by resale after six months. To benefit from the new section 9C, Taxpayer provides a guarantee to the shelf company so that the shelf company can buy the real estate with bank loan proceeds. The shelf company has been held by Taxpayer for 3 years. Taxpayer sells the shelf company shares (instead of the real estate) six months after the shelf company purchased the real estate.

To prevent the above avoidance, new section 9C will not apply to equity shares in companies if:

- (i) more than 50 per cent of the total value of the shares of the company can be directly or indirectly linked to the value of immovable property acquired within three years before disposal of the shares; and/or
- (ii) any other asset was acquired within the three years if: (1) encumbered by a lease or license, and (2) the lease or license

payments are wholly or partly received or accrued to someone other than that company within the same three year period.

This anti-stuffing rule prevents the 3-year presumption from applying only for shareholders with a meaningful level of shares in the company and where those shareholders could influence the decision of the company that acquired the immovable property in that 3-year period. To have a meaningful level of ownership, the shareholder must be viewed as a connected person (as defined in subsection (1)) to the company at issue.

The normal facts and circumstances test will apply to gains realised on the sale of shares that do not qualify in terms of the new rule. Failure to satisfy the more than 50 per cent test will not create an ordinary revenue presumption.

#### **D. Timing rules (subsection (4))**

The 3-year time period for section 9C generally takes into account various rollover regimes throughout the Income Tax Act, as well as certain deemed disposals. Rollover regimes taken into account for section 9C purposes include, the Part III reorganisation rollover dates, as well as the share substitution rollover dates (comparable to paragraph 78 of the Eighth Schedule) and the conversion rollover dates (of section 40A and 40B of the Income Tax Act). This date rollover will automatically apply to the 3-year rule, subject to the exceptions listed below.

*Example.* Parent Company owns shares of Subsidiary. Subsidiary owns shares in Company A. The Company A shares were acquired on 1 July 2008. Subsidiary liquidates on 1 November 2009 with Parent Company acquiring the Company A shares. Under these facts, Parent Company is deemed to have held the Company A shares since 1 July 2008.

In the case of the Part III rollover regime, new rules contain exceptions so that the 3-year date rollover will not apply to section 42 asset-for-share transactions (section 42(2)(a)) nor to section 46 unbundlings (section 46(3)). Without this exclusion, concerns exist that both sections 42 and 46 can be used to convert non-three year assets into three year shares. Section 42 is a problem because 3-year non-share trading stock assets can be stuffed into a new shelf company. Section 46 is a problem because a 3-year active company can acquire new assets as trading stock and stuff that trading stock into a Newco that is unbundled with the shareholders being treated as having the Newco shares for the minimum three year period.

The law also clarifies the impact of other rollover regimes. For instance, securities lending transactions should provide a date rollover (section 9C(4)). The sale-repurchase rollover regime for loss and gain shares (paragraphs 42 and 42A of the Eighth Schedule) will have general date rollover rules similar to the Part III reorganisation rules.

## **E. Recoupment (subsection (5))**

The net effect of section 9C may be to turn certain shares claimed to be held as trading stock into capital at point of disposal. For instance, a taxpayer may have claimed interest deductions in respect of shares claimed to be trading stock up until the point of disposal. Under these circumstances, all interest must be recouped at point of the section 9C capital disposal.

## **F. Section 9C(6)**

This paragraph stipulates that where a taxpayer acquired shares at various dates, he will be deemed to have disposed of shares acquired first i.e. the first in first out method for purposes of section 9C. It should be noted that this method is used only to determine the period the shares were held. The base cost of the shares should still determined in terms of any method described in paragraph 32 of the 8<sup>th</sup> schedule.

### *Example*

Taxpayer acquired shares as follows:

- 10,000 shares on 1 February 2002 at a cost of R180 per share;
- 5,000 shares on 15 July 2005 at a cost of R200 per share; and
- 7,000 shares on 1 August 2006 at a cost of R140 per share.

On 1 March 2008, the taxpayer sells 5,000 shares for R210 per share.

### *Specific identification method*

For section 9C purposes the taxpayer is deemed to have disposed 5,000 of the shares purchased on 1 February 2002 i.e. shares were held for longer than 3 years and the proceeds will be regarded as capital in nature. The taxpayer uses the specific identification method and determines the base cost of these shares to be R200 per share. His capital gain is therefore  $(R210 - R200) \times 5,000 = R50,000$ .

## **G. Interaction with the deemed disposal rules for trading stock (subsection (7))**

The deemed capital treatment for disposals under section 9C must work in conjunction with the deemed disposal trading stock rules of section 22(8). In particular, issues exist upon disposal to prevent section 22(8) from undermining the benefits of section 9C. Without special rules, the deemed disposal would trigger ordinary gain upon the deemed capital conversion upon disposal. In order to remedy this problem, taxpayers must only recoup their section 11(a) cost upon the section 9C disposal (the market value recoupment of section 22(8) will not apply).

*Example. Facts.* Taxpayer acquires shares for R150 in 2008. Taxpayer holds the shares as trading stock. In 2013, Taxpayer sells the shares for R290.

*Result.* Taxpayer claims an opening section 22 trading stock deduction of R150 in 2013. The sale triggers a R150 recoupment of the R150 deduction. Taxpayer then calculates capital gain of R140 (R290 minus R150) by virtue of section 9C.

## **H. Rollover provisions due to change in legal form (subsection (8))**

In certain instances, where the legal form of the entity in which the shares are held changed during the period of shareholding, the shareholders will be deemed to have held the same shares for the whole period whilst invested in the entity, irrespective of the legal form of that entity. Examples of how the legal form might have changed include the conversion of a close corporation to a company, a company to a close corporation or a co-operative to a company. In order for the time period to continue to be recognised even though the legal form changed, the investor's interests in the entity before and after the conversion must be identical, and no consideration (other than replacement shares) may pass between the investor and the entity.

### **I. Effective dates**

Section 9C shall come into effect on 1 October 2007 and will apply to qualifying shares disposed of on or after this date. Section 9B will no longer apply for disposals occurring from the same date.

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## **COMPANY REORGANISATIONS**

The South African tax rules for company reorganisations have made significant advancements since the core provisions were introduced in 2001. Nonetheless, certain isolated provisions within the reorganisation rules pose undue compliance and enforcement burdens. In addition, a number of collateral provisions are also a cause for concern. The legislative proposals below address these issues.

### **1. Removal of the financial instrument limitations (sections 42 – 47)**

#### *Current legislation*

The company reorganisation rules provide rollover relief in a variety of circumstances (e.g. asset-for-share transactions, intra-group transfers and unbundlings). However, this relief is generally unavailable if the company reorganisation mainly entails the transfer of financial instruments or companies mainly consisting of financial instruments. The anti-financial instrument

provisions had a two-fold purpose. Firstly, rollover relief should only entail the reorganisation of active operations. Secondly, concerns existed that the reshuffling of financial instruments was often a prelude for tax avoidance transactions.

### Problem statement

Experience indicates that the anti-financial instrument provisions are unwieldy and do not appreciably prevent avoidance. While the movement of financial instruments often can be a predicate for tax avoidance, other practical mechanisms exist to achieve this movement without reliance on the reorganisation rules. The cumbersome nature of these rules has instead added unnecessary compliance costs for legitimate reorganisations with little protection against avoidance.

### Proposed amendment

It is proposed that with effect from 1 January 2007 all of the financial instrument limitations be completely removed from the company reorganisation rollover provisions. All reorganisations contemplated in Part III can now be conducted without regard to any of these limitations. It should be noted, however, that the financial instrument limitations will remain for cross-border transactions. In the context of the controlled foreign company rules (section 9D), the financial instrument rules serve the important function of neutralising offshore treasury operations. In the context of the participation exemption for the disposal of shares, the usefulness of the financial instrument provisions requires further analysis along with the potential tax avoidance that the exemption may cause.

## **2. Repeal of share-for-share relief (section 43)**

### Current legislation

Two sets of rollover provisions exist that are mainly intended to address the transfer of appreciated items to an acquiring company in exchange for the issue of shares by the acquiring company. In the case of a company formation, the transferor transfers appreciated non-share assets to an acquiring company in exchange for the acquiring company's issue of shares. In the case of a share-for-share transaction, the transferor transfers a significant shareholder stake in a target company to an acquiring company in exchange for the acquiring company's shares. Both sets of provisions allow for tax-free rollovers, but the price of this deferred gain is duplication of that gain at two levels.

### Problem statement

No reason exists to have a duplicate set of provisions for two comparable sets of transactions that essentially achieve the same result. The reason for a second

set of rules for share-for-share transactions was to ensure that the target company transferred did not mainly consist of financial instruments. With the financial instrument provisions removed, little reason exists for the special rules associated with share-for-share transactions.

### Proposed amendment

The share-for-share rollover regime will be repealed. All transfers of appreciated assets (including shares) will receive rollover relief under the revised section 42. The appreciated shares transferred need not involve the transfer of shares representing a significant stake in a target company. Any level of shares in the target company will suffice. However, one aspect of the share-for-share regime will be retained. Target shares acquired by an acquiring company will be eligible for market value cost treatment in a listed context (as opposed the general rule of rollover cost treatment).

## **3. Intra-group transactions**

### Current legislation

Transfers between companies that form part of the same group of companies are fully eligible for rollover relief. The object of this relief is to place a single group of companies on par with a single company containing multiple branch operations. The transfer of assets between two branches of a single company should be a non-event for tax purposes. This also applies to the transfer of assets between two companies within the same group.

One price of intra-group relief is the de-grouping charge. The de-grouping charge triggers a deemed disposal if the group companies engaged in the transfer subsequently become severed from one another so that they are no longer part of the same group. This charge again stems from the branch analogy, which would trigger gain if the two branches were no longer part of the same company.

### Problem statement

The group rules have given rise to two sets of difficulties. Firstly, the group definition is overly inclusive, including many companies operating on a different tax plane. This over-inclusiveness has created undue opportunities for tax avoidance. Secondly, the de-grouping charge is often viewed as harsh. Complaints exist that the de-grouping charge arises no matter how many years the de-grouping occurs after the initial intra-group transfer.

## Proposed amendment

### **A. Narrowed group definition (section 41)**

A group of companies eligible for intra-group rollover relief must all operate on the same tax plane (in respect of their potential substantive tax liability and tax enforcement). Therefore, fully or partially exempt companies will now fall outside intra-group relief (including foreign companies falling wholly or partially outside the South African tax net and enforcement). As a result of these changes, the intra-group relief provisions will be mainly limited to fully taxable companies and close corporations. Note: The intention is not to exclude companies from a group merely as a result of that company receiving a particular type of income that is exempt. The intention is to exclude companies if all or every receipt and accrual of that company is exempt. For example, a company will not be excluded from a group merely as a result of the receipt or accrual of an exempt dividend, unless all other receipts and accruals of the company would also exempt.

The proposal also tightens the rules on shares counting toward the 70 per cent ownership criteria needed for group status. The proposal essentially adds two restrictions. Shares held as trading stock will no longer count towards the 70 per cent threshold. These shares are ignored because the shareholder intends to sell the shares at issue (i.e. not to hold the shares as a long-term extension of the group). In addition, shares subject to derivatives that contain rights or obligations of sale are similarly ignored to the extent the amounts paid pursuant to the derivative differs from the market price of the shares at the time of the eventual acquisition. Hence, pre-emptive purchase rights among shareholders (a common practice) would not create an adverse impact under this rule.

It should be noted that this narrowed group definition will have a partially delayed impact for purposes of section 45 until 1 January 2009. Without such a delay, the narrowed group definition may trigger an immediate de-grouping charge for certain parties (see below). The 1 January 2009 date will provide taxpayers with an opportunity to restructure so as to avoid the charge.

### **B. De-grouping charge (section 45(4))**

The proposal eases the de-grouping charge by adding a time limit. Under the new rule, the de-grouping charge applies only if the transferor and transferee companies involved in the intra-group transfer become severed from one another (i.e. no longer form part of the same group) within six years after the intra-group transfer. Group separations after the six-year period are ignored. This time limit is consistent with the U.K. de-grouping charge and is sufficient to protect against normal third party sales being disguised in intra-group form. It is also roughly consistent with the record-keeping rules of sections 73A and 73B. These rules will come into effect when the narrowed group definition comes into effect.

### **C. Prohibition against certain share transfers (section 45(6))**

The intra-group rules will no longer apply to the transfer of assets to a transferee group company if that transferee company issues its own shares in exchange. This prohibition is designed to prevent any overlap with the “asset-for-share” rollover rules of section 42 (which, unlike section 45, trigger a duplication of gain while triggering immediate loss (the latter of which would be clogged in a group context by virtue of paragraph 39 of the Eighth Schedule)).

The intra-group rules will also not apply to the liquidating transfer of assets by a transferor in cancellation of its own shares (thereby preventing any overlap with the section 47 liquidation rules). Similarly, the intra-group rules will not apply to any distribution of shares of a company within the same section 41 group of companies (thereby preventing any overlap with section 46).

### **4. Collective Investment Schemes (sections 42(1), 44(1) and 46(1))**

#### Current legislation

Collective investment schemes have a limited place in the Part III reorganisation rules. At present, explicit relief for collective investment schemes exists only to the extent that one portfolio is merged into another via a section 44 amalgamation.

#### Problem statement

In practical terms, collective investment schemes are more likely to be engaged in section 44 amalgamation-type transactions than any other Part III provision for rollover relief. However, it now appears that collective investment schemes are also engaged in other forms of reorganisations that should similarly receive Part III rollover relief.

#### Proposed amendment

Taxpayers engaged in the transfer of assets to portfolio funds in exchange for the issue of participatory interests in that fund will now be eligible for section 42 relief. The need for this relief most typically arises upon the formation of new funds (by institutional investors such as insurance companies). The division of a single portfolio into two portfolios will also be entitled to section 46 unbundling relief. Application of section 42 and 46 rollover relief to collective investment schemes will mirror that of listed companies (e.g., no 20 per cent ownership threshold will be required).



## **5. Prohibitions against transfers to wholly or partially exempt transferees (section 44(14), 45(6) and 47(6))**

### Current legislation

The section 45 intra-group and section 47 liquidation rollover rules do not apply if transfers are made to companies that are wholly or partially exempt (or fall outside the South African tax base) by virtue of their nature as an entity which is not fully taxable. For instance, rollover relief does not apply if the transferee is an exempt public benefit organisation (or if the transferee is not a resident). The purpose of this prohibition is to ensure that rollover relief is limited to the benefit of deferral for the assets transferred. Rollover relief should not be used as an indirect mechanism to obtain permanent exemption.

### Problem statement

The prohibition against transfers to wholly or partially exempt transferees fails to account for untaxed policyholder funds of a section 29A long-term insurer. The prohibition against transfers to wholly or partially exempt transferees is also missing from the section 44 amalgamation rollover rules even though this form of rollover raises the same policy concerns.

### Proposed amendment

The prohibition against transfers to wholly or partially exempt transferees will be extended to section 44 amalgamation rollovers. The prohibition against transfers to wholly or partially exempt transferees will also be extended to untaxed policyholder funds of long-term insurers in the case of all company reorganisation rollovers.

## **6. Share cross-issues (section 24B)**

### Current legislation

Companies that issue their own shares for assets are subject to three different sets of rules in terms of the assets acquired. As a general matter, the company is eligible for a base cost (or a section 11(a) expenditure) equal to the market value of the asset (section 24B(1)). However, this rule is subject to two exceptions:

- (i) Companies issuing their own shares for assets pursuant to a section 42 rollover will only inherit a base cost (or section 11(a) expenditure) in the asset acquired equal to the cost (or expenditure) in the hands of the former transferor.

- (ii) In addition, a company that issues its own shares in exchange for the issue of shares by another company will receive a zero base cost (or section 11(a) expenditure) in the newly issued shares acquired (section 24B(2)).

All three sets of rules essentially provide the issuing company with a base cost (or section 11(a) expenditure) in the asset acquired equal to the tax cost (or expenditure) of the asset in the hands of the former transferor with upward adjustments for any income or gain realised by the transferor as a result of the transaction.

### Problem statement

The zero base cost (or expenditure) rule of section 24B(2) is sound. However, the rule can create some harsh results in a South African context, especially given the difficulties that certain parties have in obtaining third party financing. In view of these difficulties, certain cross-issue structures have emerged that essentially allow certain investors to obtain financing to acquire a target company without resort to third party lending.

One such structure involves the issue of shares by an operating company in exchange for redeemable preference shares issued by an investor company. The preference shares have a value equal to the value of the operating company shares issued in exchange (but the operating company shares have more growth potential). The investor company then obtains funds via dividends from the operating company or by selling the investor company shares after those shares have appreciated (partly due to the involvement of the investor company). Once the investor company has sufficient funds, the investor company redeems the preference shares, leaving the investor company as an unencumbered holder of operating company shares.

At issue is the redemption of the redeemable preference shares. Under current law, the operating company recognises as gain the full value of the redeemable preference shares. This result is seemingly problematic because the redemption of the preference shares is said to be economically akin to the return of principal on a loan (which should not, as a theoretical matter, give rise to tax). In other words, restoration of deemed lending finance is not an item that should be viewed as taxable gain for the operating company.

### Proposed amendment

The proposal seeks to provide tax relief for operating companies that are essentially receiving repayment of principal on the self-financing of their shares. However, the proposed exception to the zero base cost (or section 11(a) expenditure) rule will be narrowly tailored because the cross-issue of shares can

easily give rise to potential tax avoidance. In view of the above, the exception will apply only if the following three conditions are met:

1. The (operating) company must issue ordinary shares (or preference shares convertible into ordinary shares at the option of the holder) in exchange for the issue of redeemable preference shares by another (investor) company;
2. The preference shares must be held for a period of not less than 5 years; and
3. The triggering event is a redemption (as opposed to other forms of disposition).

If the exception applies, the (operating) company is deemed to have expenditure in the redeemable preference shares equal to the lesser of the market value of those preference shares on the date of initial issue or the amount received or accrued on redemption. The “lesser of” test effectively limits the gain triggered on redemption without allowing for any loss.

*Example 1. Facts.* Operating Company has 4 million ordinary shares outstanding. Investor Company seeks to obtain a slightly greater than 25 per cent interest in Operating Company. Operating Company accordingly issues 1 000 001 ordinary shares to Investor Company. Investor Company issues redeemable preference shares in exchange. The ordinary shares and the preference shares are each worth roughly R2 million. Operating Company redeems the preference shares 10 years later for a price of R2,5 million.

*Result.* Operating Company is deemed to have expenditure of (roughly) R2 million by virtue of the proposal. The gain on redemption is therefore limited to R500 000. Without the proposed amendment, Operating Company would have been taxable on the full R2,5 million amount.

*Example 2. Facts.* The facts are the same as *Example 1*, except that the preference shares are redeemed for only R1,5 million. No gain or loss results from the redemption because the expenditure is limited to R1,5 million (the amount received or accrued).

Other aspects of the rule relate to intra-group transfers. If a holder of the redeemable preference share (i.e. the operating company) transfers the redeemable preference share to another group company via a section 45 intra-group rollover, the recipient group company will be viewed as one and the same as the transferor for purposes of this rule. Hence, the five year rule can be satisfied by taking into account the holding periods of both the transferor and transferee group companies.

## **7. Share buybacks of listed shares (section 42A of the Eighth Schedule)**

### Current legislation

Under current law, the sale of shares at a profit triggers tax, even if identical shares of the same company are repurchased shortly thereafter. On the other hand, the sale of shares at a loss in comparable circumstances does not give rise to an immediate tax loss pursuant to paragraph 42 of the Eighth Schedule (often referred to as the “wash-sale” or “bed and breakfast” anti-avoidance rules). Any loss in the devalued shares is instead subject to deferral, only being realised if the repurchased shares are subsequently sold.

### Problem statement

As a general matter, the split treatment of taxable gain and deferred loss under comparable circumstances can be justified because taxpayers largely have control over when they wish to dispose of their shares. For instance, the “wash-sale” anti-avoidance rules are essentially designed to prevent taxpayers from selling off loss shares at taxable year-end, merely to trigger tax losses (only to repurchase identical shares so that the long-term investment portfolio remains). On the other hand, taxpayers with appreciated shares generally hold those shares as long as desired without any interim sale (because the interim sale would trigger tax).

At issue are circumstances where taxpayers are essentially forced to dispose of their shares, even though they have no desire to ultimately reduce their long-term share investment profile. For instance, shareholders may be forced to surrender their shares via a court order under section 311 of the Companies Act, 1973 (Act No. 61 of 1973). Then, in order to restore their initial level of desired investment, these shareholders (especially management) respond by purchasing other shares in the company from other remaining shareholders outstanding. Without relief, these involuntary sellers will be subject to tax on gains for the short-term cash-out even though they seek to maintain the same level of investment in the long run (by re-using the cash received).

### Proposed amendment

The proposed regime essentially provides for tax deferral comparable to the “wash-sale” loss deferral rules if a taxpayer is forced to undertake an involuntary interim sale and then seeks to restore the same investor profile. More specifically, these gain deferral rules apply if:

1. A taxpayer is forced to dispose of shares pursuant to a court order under section 311 of the Companies Act (Act No. 61 of 1973);
2. The shares disposed of are listed company shares; and

3. The taxpayer acquires (or has entered into a contract to acquire) shares of the same kind or quality within 90 days after the forced disposal.

To the extent these rules apply, the shares disposed of pursuant to the forced sale are deemed sold at cost (i.e. no gain is recognised on the forced sale). However, similar to the “wash-sales”, the deferred nature of the transaction is rolled over into the shares. More specifically, if the repurchased shares have a cost equal to or greater than the gain deferred on the forced disposal of the initial shares, any expenditure for the new share is reduced by the gain deferred. If the repurchased share has a cost that falls below the gain deferred, the repurchased share has an expenditure of nil and gain is immediately recognised to the extent the otherwise deferred gain exceeds the cost of the repurchased share.

*Example 1. Facts.* Taxpayer owns 2 000 ordinary shares in Company X, a company listed on the JSE. Taxpayer is forced to dispose of 25 per cent (i.e. 500) of those shares pursuant to a section 311 court order. The base cost of the disposed of shares is R90 000 and their value is R110 000. Within 40 days after the redemption, Taxpayer repurchases 500 of Company X ordinary shares for R135 000 from other remaining shareholders on the open market.

*Result.* Under the new regime, Taxpayer does not have any gain on the disposal of the 500 ordinary shares. The sale occurred pursuant to a section 311 court order, the shares involved are listed and the repurchase occurred within 90 days. However, the base cost of the newly repurchased shares is only R115 000 (R135 000 less the R20 000 of deferred gain on the redemption).

*Example 2. Facts.* The facts are the same as *Example 1*, except that the Company X ordinary shares are repurchased for R15 000.

*Result.* The Taxpayer has no gain on the initial disposal as described in *Example 1*. However, Taxpayer has a base cost of nil in the new shares, and gain of R5 000 because of the low purchase price of the repurchased shares (i.e. the R15 000 purchase price falls below the R20 000 of deferred gain).

## **8. Connected person transfers of depreciable property**

### Current legislation

The Income Tax Act, 1962, contains a number of identical scattered provisions dealing with the purchase of depreciable property from connected persons. These depreciable property connected persons rules essentially have an anti-avoidance thrust. The purpose of these rules (most of which pre-date capital gains taxation in the Eighth Schedule) is to prevent tax-free or low-taxed sales between connected persons of depreciable property, followed by depreciation

against ordinary rates. Much of this depreciation was of special concern because the depreciable tax cost was often set at artificially high values.

Problem statement

The anti-avoidance rules to prevent connected person sales of depreciable property at artificially elevated values should be uniform, regardless of the depreciable property involved. In essence, the avoidance concern follows the same basic paradigm regardless of the depreciable property.

Also of concern is the fact that these anti-avoidance rules may be overly harsh, especially in view of the fact that connected person sales of depreciable property can no longer occur tax-free due to the introduction of the capital gains tax in the Eighth Schedule. In many instances, the transferor is subject to tax without the base cost of the transferee obtaining any recognition of this new reality.

Proposed amendment

**A. Creation of a new regime (section 23J)**

The proposal eliminates all of the scattered depreciable property connected person regimes in favour of a single regime under one new section. While the old regime limited depreciable cost to the lower of the connected seller's cost or the market value at the time of the connected person sale, the new regime gives credit to intervening taxation arising from the connected person sale. More specifically, the depreciable tax cost for the connected person purchaser will equal the sum of:

- (a) the cost (taking into account any subsequent tax adjustments) of the depreciable asset to the connected person seller; plus
- (b) all ordinary revenue triggered upon the connected person sale as well as any inclusion stemming from the capital gain triggered on the sale.

*Example 1. Facts.* Company X owns 60 per cent of the shares of each Company Y and Company Z. Company Y sells depreciable equipment to Company Z. Company Y initially purchased the equipment for R100 and depreciated the equipment by R30. Company Y sells the equipment to Company Z for R110 (triggering R30 of ordinary recoupment and R5 of taxable income (after taking into account the 50 per cent company percentage inclusion for capital gains)).

*Result.* Company Z has a depreciable cost of R105 despite the fact that Company Z paid R110 for the equipment. This R105 amount is calculated

as follows: R70 depreciation adjusted presale cost to Company Y, plus R30 of recoupment plus the R5 inclusion stemming from the capital gain.

*Example 2. Facts.* The facts are the same as Example 1, except that Company Z immediately resells the depreciable equipment to Company X for R110. Company Z has no gain on the resale because the R110 price equals Company Z's base cost in the equipment immediately before sale.

*Result.* Company X retains Company Z's R105 depreciable cost in the shares because no tax arises from the resale.

Special rules also apply to prevent taxpayers from artificially breaking the connected person share chain. Under these special rules, intervening non-connected person holdings will be disregarded if these holdings interrupt the connected person chain within 2 years before acquisition.

## **B. Depreciable asset definition (section 1: depreciable asset)**

The rule for connected person sales will apply to all depreciable assets (as defined in section 1 of the Income Tax Act). Moreover, the current "depreciable asset" definition (also used in provisions such as section 11(o) and 24M) will be clarified. The new definition will cover assets that: (i) are eligible for a depreciation allowance, (ii) calculated wholly or partly with reference to the cost to the taxpayer or a connected person (so as to account for the depreciable asset connected person rules). Debts owing are excluded (see section 11(i) and (j)).

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## **INTELLECTUAL PROPERTY PAYMENTS**

### **1. Intellectual property arbitrage (section 23I)**

#### *Current legislation*

The development of intellectual property is often fully deductible. The payment of royalties is also deductible for the payor (if the payor is a fully taxable entity within the South African tax net). The receipt of royalties is includible for the payee (if the payee is a fully taxable entity within the South African tax net).

#### *Problem statement*

The Income Tax Act lacks effective mechanisms to prevent tax arbitrage resulting from:

- (i) assigning South African intellectual property to entities with a lower effective tax rate, followed by

- (ii) the licensing of that intellectual property back to fully taxable South African taxpayers.

The disparity in tax rates levied on income between different parties often creates arbitrage opportunities. The purpose of these arbitrage opportunities is to shift income from parties fully within the tax net to parties wholly or partly outside the tax net. In the case of intellectual property, this result is mainly achieved by shifting the intellectual property from a fully taxable party to a party wholly or partly outside the tax net. This shift is usually designed so that the shift triggers little or no tax. After the shift, deductible payments are made from the fully taxable party (now the licensee) to the other party operating wholly or partly outside the South African tax net.

In many instances, the tax benefits have no corresponding impact on cash flow as royalty payments are simply returned to the licensee-payor in the form of dividends. Meanwhile, the tax deductions for the licensee-payor may be so large as to effectively wipe-out the payor's tax base.

#### Proposed amendment

##### **A. Subsection (1)(definitions)**

The proposal targets “affected intellectual property.” This definition has two aspects. First, the property at issue must qualify as “intellectual property,” which is defined widely. Intellectual property includes all South African protected inventions, patents, designs, trade marks and copyrights. Intellectual property additionally covers inventions, patents, designs, trade marks and copyrights protected by foreign laws. Property of a similar nature to that described above is also covered.

The main limitation is the “affected intellectual property” rules, which require the intellectual property above to fall into one of three categories:

- (i) intellectual property that was at any time owned by a resident; or
- (ii) intellectual property that was developed by the taxpayer or a resident who is a connected person in relation to the taxpayer (at the time of development or at the time of the royalty/license payment).

The definition of “connected person” has a slightly lower threshold in section 23I than the normal connected person test. More specifically, company shareholders will be viewed as connected to the (company) taxpayer in which they hold 20 per cent of the shares (even if another shareholder holds a majority interest). This lower threshold matches the new rule for section 31.



## **B. Subsections (2) and (3) (Denial of deductions)**

According to section 23I(2)(a), licensees will be denied deductions in respect of royalty expenditure incurred for the use of affected intellectual property to the extent that the royalty receipts do not constitute income of the licensor. These situations arise where the licensor has tax-exemption in respect of that income or where a foreign person treats that income as falling outside the South African tax net. However, if the payment of royalties for the use of affected intellectual property triggers a section 35 withholdings tax (of 12 per cent), the licensee will be permitted to deduct an amount equal to a third of the royalty expenditure (section 23I(3)). This one-third deduction rule will apply as long as the withholdings tax is not reduced below 10 per cent after taking into account tax treaties.

The underlying rationale for this general denial is that much of the intellectual property created by taxable South African residents is subsidised by government funding, South African tax allowances (such as amortisation allowances under sections 11(gA) and 11(gC) as well as the 150 per cent research and development allowance) and general South African infrastructure. South African subsidised intellectual property should not then be permitted to be used as a tool to erode our tax base. If this erosion tool is left unchecked, the potential loss to the South African company tax base can be massive.

Finally, section 23I(2)(b) prevents taxpayers from circumventing this anti-avoidance provision by simply interposing a third party that converts royalty streams into financial instruments (e.g. promissory notes (PNs) and credit default swaps (CDSs)) and on-routing these payments to entities with lower effective tax rates. This anti-avoidance rule should be interpreted broadly.

*Example 1. Facts.* A resident previously developed an invention, which was assigned to a foreign resident. The foreign resident filed a corresponding patent application in South Africa and now licenses the South African patent to the resident's company in consideration for an annual licence fee of R1 million.

*Result.* Assuming that the royalty payments trigger withholdings tax of 12 per cent (or R120,000), despite the deemed source provisions in sections 9(1)(b) and 9(1)(bA) relating to royalty income, the exemption in s10(1)(l) acts to exclude the royalty receipts in the hands of the licensor from income. Consequently, the deductions available to the South African licensee are reduced by virtue of section 23I(2)(a) from R1 million to R333,333 (i.e. by two-thirds).

*Example 2. Facts.* A licence is concluded between two South African entities. The royalties are "evidenced" by way of promissory notes that are

discounted by the licensor to a tax exempt entity or fund outside the South African tax net.

*Result.* Sections 231(2)(a) and 231(2)(b) will deny the licensee deductions in respect of all royalties payable to the tax exempt entity or fund. Alternatively, where the royalty payments are structured to accrue first to the licensor before being on-paid to the tax exempt entity, the licensor will be denied corresponding deductions in terms of section 231(2)(b).

*Example 3. Facts.* A licence is concluded between two South African entities. The licensor concludes a credit default swap with an exempt or foreign entity in terms of which all royalties received by the licensor are effectively passed on to the exempt or foreign entity.

*Result.* Section 231(2)(b) will deny the licensor deductions in respect of payments made in terms of the CDS to the exempt or foreign entity.

The proposed anti-avoidance rule will take effect for all intellectual property payments occurring from 1 January 2009.

## **2. Cross-border intellectual property transfer pricing**

### Current legislation

The South African tax system, like most tax systems, contains rules to prevent cross-border transfer pricing. These transfer pricing rules prevent various avoidance schemes, including the use of below market sales of intellectual property and royalty free (or discounted) usage of South African developed intellectual property. The essence of these rules is to require recalculation of the transfer at arm's length prices. Because the problem of transfer pricing most frequently arises between parties not dealing at arm's length, the South African transfer pricing rules apply only between connected persons.

### Problem statement

Taxpayers are entering into intellectual property structures that defeat the South African transfer pricing rules by ensuring that both parties to the intellectual property transaction are not technically "connected." For instance, some structures are arranged so that the South African developer of intellectual property transfers that property at artificially low levels to a 49 per cent controlled foreign entity. The other 51 per cent is owned by an outsider, but a side agreement exists so that the South African developer largely retains the benefits of the intellectual property transferred.

Proposed amendment: (section 31)

In order to remedy the above structures, the connected person threshold will be reduced in the case of the transfer pricing rules addressing intellectual property. The definition of “connected person” will have a lower threshold than the normal connected person test. More specifically, company shareholders will be viewed as connected to the foreign company in which they hold 20 per cent of the shares (even if another shareholder holds a majority interest). This reduced threshold will apply for purposes of goods and services associated with intellectual property (including rights for the use of intellectual property).

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**LONG-TERM INSURERS AND CONTROLLED FOREIGN COMPANIES  
 (“CFCs”)**

Current legislation

South African taxpayers with a controlling interest in foreign companies are subject to Section 9D (known as the CFC anti-deferral rules). In terms of this section, income/gains generated by a foreign company are imputed back to the South African taxpayers if they hold a minimum 10 per cent interest (after taking into account holdings of connected persons). Section 9D was introduced to prevent South African taxpayers from transferring investments abroad to avoid South African tax on the growth of these investments (and to prevent certain forms of transfer pricing).

Problem statement

Under the four funds approach, the insurance company is viewed as the owner of all policyholder funds (i.e. the company policyholder fund, the individual policyholder fund and the untaxed policyholder fund) in addition to its ownership of its (shareholder) corporate fund. The insurer is taxed on these policyholder funds under the trustee principle as a proxy for the policyholders. The tax on the insurer is designed to fully approximate the tax that would have fallen on the policy holders as a collective.

At issue is how the four funds approach for local long-term insurance companies (i.e. section 29A) works with the CFC regime. All policyholder assets are held in the name of a long-term insurer and are accordingly regarded as the long-term insurer’s participation rights in the foreign company for section 9D purposes. The net result is that foreign entities (typically collective investment schemes, unit trusts or mutual funds) held in the name of a local long-term insurer are often classified as a CFC subject to section 9D income inclusions, even though the bulk of the underlying interests are held in the name of policyholders (none of

whom would have triggered any section 9D inclusions had they invested in the CFC directly).

In analysing this situation, one must also be cognisant of the fact that long-term insurers offer different types of products to policyholders which can be divided into two distinct categories. The first category is investment-type products with policyholders paying premiums and selecting the investment. In these situations, the investor accepts the risks and benefits of the underlying investments. The second category is risk products with policyholders paying premiums and receiving a fixed payment upon the happening of a risk event (e.g. death or disability). The policy holder is therefore indifferent as to the underlying investment because the insurer bears the risk.

Section 9D income treatment for section 29A policyholder funds creates a much higher level of tax on foreign entity funds than would have arisen had the policyholders invested in the foreign entity directly (violating the policy behind the trustee principle). This result seems especially unfair in the case of investment-type products because the asset allocation and the beneficial ownership of these assets rest not with the long-term insurer, but with the policy holder. A further problem arises as the foreign funds at issue are in many instances open-ended (i.e. shareholders buy and sell shares directly from the company and the company issues and cancels shares on a daily basis). The South African insurer (and other relevant parties) therefore have little control (or knowledge) of their percentage shareholding in the foreign fund.

*Proposed amendment (proviso to section 9D(2)(b))*

The goal is to exclude investment-type policies from the 10 per cent attribution rule. More specifically, participation rights held by a section 29A long-term insurer do not have any section 9D income inclusions to the extent those rights relate to linked policy or market-related policies (as defined in the Long-term Insurance Act, 1998 (Act No. 52 of 1998)). The net result is that any interest associated with investor policies will not trigger any income inclusion for the insurance company, but the controlled foreign entity will remain a CFC. If the long-term insurer otherwise possesses interests in the CFC amounting to 10 per cent (taking into account the policyholder funds), the insurance company will have income attributed to it to the extent of those other (non-investment-type policyholder fund) interests.

The exclusion for investment-type policies applies in full regardless of any potential connected persons. Specific tracing of ownership levels for policyholders with investment-type policies was rejected because this form of tracing is extremely difficult for enforcement as well as for insurance company compliance. However, in order to prevent this rule of administrative convenience from being misused, the wholesale exclusion of investment-type products from section 9D inclusions is subject to a subjective anti-avoidance rule. Under this

subjective rule, taxpayers seeking to misuse this rule to disguise significant policyholder interests will not benefit from the rule.

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## FOREIGN INSTABILITY

With the shift to worldwide taxation, the South African tax system has to account for a new set of realities outside the South African context. These realities include foreign instability. More specifically, South African operations in certain foreign countries may have to account for the reality of hyperinflation. These operations may also have to account for restrictions that prevent the repatriation of funds outside the foreign country at issue. The changes below cover both situations.

### 1. **Hyperinflationary currencies (sections 9D(6), 24I (“local currency” definition) and 25D(2A))**

#### Current legislation

Business operations falling directly or indirectly under South African taxing jurisdiction must account for currency gain and loss when operating outside of their operating currency. More specifically, in the case of a South African company with a foreign permanent establishment, the South African company must separately account for foreign currency attributable to the foreign establishment if that currency differs from the currency used by that establishment for financial reporting purposes. In the case of a South African CFC, a similar conceptual framework exists. A separate accounting is again required for foreign currency attributable to the CFC’s foreign permanent establishment if that currency differs from the CFC’s currency used by that establishment for financial reporting purposes. This conceptual framework essentially seeks to tax only currency gains arising outside of normal operations (because taxation of currency gains within the context of normal operations is too onerous from an administrative and compliance standpoint).

#### Problem statement

The current tax regime for currency gains and losses does not properly account for business operations located in a country with a hyper-inflationary currency. While the hyper-inflationary currency itself is not a problem from a tax perspective (i.e. not being taxed like any other operational currency), at issue are holdings of a non-hyperinflationary currency. As a practical matter, non-hyperinflationary currency holdings are common because businesses subject to a hyper-inflationary currency seek to hold outside currencies as a hedge against the rapid deterioration. The tax system, however, would currently tax this form of hedge without relief, even though the gain is largely illusory (due to its measurement against the rapidly declining hyper-inflationary currency).

### Proposed amendment

The proposed legislation seeks to mitigate the adverse tax effects of hyperinflationary currencies. Taxpayers in this circumstance will be freed from the hyper-inflationary business establishment currency. Hedging currency holdings will instead be measured against the Rand (a measure that eliminates all artificial hyper-inflationary gain). The proposed legislation essentially accomplishes this result by deeming outside (non-hyper-inflationary) currency holdings as not being attributable to the foreign permanent establishment (even if a factual nexus otherwise exists). This legislative change will equally apply to South African owned foreign branches and CFCs.

## **2. Blocked foreign funds (section 9A)**

### Current legislation

Taxpayers are not subject to immediate tax on foreign operations located in a country that prevents the remission of funds back to South Africa. Taxes from these operations are essentially “frozen” until the remission restrictions are removed. This relief measure applies equally to South African controlled operations held in the form of a foreign branch or a CFC.

### Problem statement

While current legislation ameliorates the problem of blocked foreign funds, the legislation only provides for a partial solution. These “frozen” funds cannot be offset by later losses. Subsequent losses are likely in these situations because of the political instability of the foreign country at issue (especially if that country begins imposing more onerous restrictions on those foreign operations).

### Proposed legislation

The proposed legislation reformulates the current deferral rules so that the blocked foreign fund regime operates more akin to sections such as section 24C. In essence, the foreign blocked funds are deducted (i.e. eliminated) from current income and are deemed to re-arise in the subsequent year. This formulation continues to be rolled over until the foreign blockage is removed. This deduction/re-arising of income effectively allows for subsequent losses to be taken into account. The change will equally apply to South African owned operations held in the form of a foreign branch or a CFC.

**3. Foreign financial instrument holding company rules (section 41 (“foreign financial instrument holding company” and “prescribed proportion” definitions))**

Current legislation

Current law contains certain prohibitions for foreign financial instrument holding companies (i.e. foreign treasury operations). Income from companies of this nature is fully subject to current taxation under section 9D. The sale of shares in these foreign companies is also not eligible for the participation exemption under paragraph 64B of the Eighth Schedule. In order for a foreign company to fall within this category, more than half of: (i) the market value or (ii) two-thirds of the actual cost of all assets must consist of financial instruments.

Problem statement

The financial instrument calculation used to determine whether a company qualifies as a financial instrument holding company becomes skewed with hyper-inflationary currencies. In particular, the two-thirds cost test is problematic because actual cost in a hyper-inflationary paradigm falls completely out of line with market value.

Proposed legislation

In view of the problem outlined above, the two-thirds actual cost test will be dropped. The financial instrument holding company test will be determined solely with reference to market value.

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**DEPRECIATION**

The proposals contained in this Bill add additional classes of assets eligible for tax depreciation. The purpose of these new regimes is to ensure that these classes of assets are given parity with other depreciation assets already benefiting from the Income Tax Act.

**1. Rolling stock (section 12DA)**

Current legislation

The Income Tax Act provides for a general depreciation of movable machinery used by taxpayers in the production of income to the extent that the value of such machinery has depreciated by reason of wear and tear. The depreciation rates are intended to be linked to the useful lives of the machinery involved. However, this is not always the case. For example trucks are allowed a write-off period of

three to four years depending on their size. Meanwhile, rolling stock has a useful life of 14 years and accordingly has a 14-year write-off.

In addition to this depreciation regime, certain specific movable business items are afforded special depreciation rates. The rates in this case do not have a bearing on the useful life of the items involved. For example, ships and aircraft are allowed a five-year write-off period.

### Problem statement

The government has an overriding objective of reducing the cost of doing business in South Africa. Research shows that there is a huge imbalance between the South African transportation network and the current status of the economy. In this regard, government intends to encourage investment in the rail transportation industry – a key cost item for primary product sales.

Furthermore, the depreciation rate for rolling stock places rolling stock at a disadvantage vis-à-vis trucks (a less efficient mode of transport for primary products). The 14-year depreciation rate is also unduly long when compared to other large ticket transport items, such as ships and aircraft (both of which are depreciable at 20 per cent per annum over 5 years).

### Proposed amendment

In order to encourage the infrastructural development of rail transportation, it is proposed that rolling stock (e.g. trains and carriages) be allowed accelerated depreciation. Note that railway lines are already subject to a 5 per cent rate of depreciation under section 12D.

#### **A. Subsection 1 (general rule)**

Accelerated depreciation generally applies only to owners of rolling stock that will directly use the rolling stock wholly or mainly for the transport of persons, goods or things. Hence, passenger rail, like rail for goods, will receive the benefit of this new regime. Mere lessors of rolling stock fall outside this regime. However, persons purchasing rolling stock via an instalment credit agreement are treated as owners for this purpose (see also section 11(e) applying the same rule).

#### **B. Subsection 2 (rate)**

The proposed rate of depreciation is 20% of the cost of acquisition (i.e. a 5-year annual straight-line write off period). This is the same rate as used for ships and aircraft.



### **C. Subsection 3 (depreciable cost)**

The cost to be depreciated is the taxpayer's cost of acquiring the rolling stock or arm's length value of the rolling stock, whichever is the lesser. This rule also applies to the cost of the improvements. If the rolling stock is acquired to replace rolling stock that has been damaged or destroyed, the cost will be reduced by the value that has been recovered from the replaced rolling stock to the extent this recovery has not been included in the taxpayer's income.

### **D. Subsection 4 (exemption periods)**

If the taxpayer uses the rolling stock to produce exempt income, the years in which the taxpayer used the asset are discounted for purposes of determining the depreciation. For example, if the taxpayer uses the asset in years 1 and 2 to produce exempt income, the taxpayer will only be allowed a 20 per cent depreciation rate for the following three years when the income produced is taxable.

### **E. Subsection 5 (prior disposal)**

A taxpayer cannot depreciate rolling stock once that rolling stock is no longer owned by that taxpayer in any particular year (i.e. the rolling was disposed of in a prior year).

### **F. Subsection 6 (maximum percentage)**

This subsection makes it clear that the 20 per cent depreciation write-off cannot exceed 100 per cent (i.e. five years).

## **2. Port assets (section 12F)**

### Current legislation

Depreciation of permanent structures is available to certain specific trades and business undertakings. Taxpayers who do not undertake these trades are generally not entitled to any depreciation for their permanent structures despite their business usage.

### Problem statement

Government has an objective of building up the efficiency of the transportation network, including ports. While both aircraft and the underlying airport infrastructure (e.g. aircraft hangers and runways) are tax depreciable, only the ships themselves are entitled to such depreciation. No depreciation for tax purposes exists for port assets.

### Proposed amendment

New and unused port infrastructure assets (as well as supporting structures that form part of port assets) will be depreciable for tax purposes. This depreciation regime is available to taxpayers who carry on business as a port or transport operator (even if engaged in other activities). The proposed regime will be added to the regime for airport infrastructure. The rate of depreciation for port assets will accordingly be 5 per cent per annum.

The overall regime is also being adjusted to cover periods in which both aircraft infrastructure and port infrastructure produce exempt income. As with other depreciation regimes, depreciable cost is fully reduced for these exempt periods.

### **3. Environmental assets and activities (section 37B)**

#### Current legislation

Certain permanent environmental capital expenditures relating to manufacturing are granted depreciation relief under the Act while other permanent comparable expenditures are not. At issue is whether these capital expenditures can qualify as machinery or plant directly used in the process of manufacture. If so, a 40:20:20 rate applies. If not, the capital expenditure is not entitled to any depreciation. As a result, environmental capital expenditure of a permanent nature has for tax purposes tended to be afforded tax depreciation by happenstance rather than by design.

Questions also exist as to the deductibility of environmental costs incurred after closure of a trade. As a technical matter, an ongoing trade and production of income are pre-requisites for business expense deductions. Hence, decommissioning, remediation and restoration costs incurred after cessation of trade are generally not deductible.

#### Problem statement

Much of the tax law pre-dates environmental issues. Environmental capital expenditure of a permanent nature should be entitled to some level of depreciation, even though only ancillary to the process of manufacture. Environmental capital expenditure is a legal precondition for operation and should be encouraged as a matter of sound government policy. Therefore, a new regime for environmental capital expenditure of a permanent nature is proposed. It should be noted that no regime is necessary for environmental moveable equipment because such equipment is depreciable like any other moveable equipment used to carry on a trade (see section 11(e)).

Post-trade environmental expenses (decommissioning, remediation and restoration) should similarly be granted relief. These expenses are not optional.

They represent activities to remedy a potential legal liability arising from a trade. The proposal accordingly seeks to provide deductions for these post-trade environmental expenses.

Proposed amendment

**A. Subsection 1 (definitions environmental treatment and recycling assets)**

Depreciation relief is afforded to environmental treatment and recycling assets and to environmental waste disposal assets (and improvements to both sets of assets). Both sets of assets must be ancillary to the manufacturing process (or process of a similar nature) and be utilised for purposes of fulfilling legal environmental obligations. Environmental waste disposal assets must additionally be of a permanent nature.

Only new and unused waste disposal assets (and improvements) will be depreciable under this provision. Assets that have been used by the taxpayer prior to the effective date cannot be depreciated. Similarly, assets purchased by the taxpayer from a seller who used such assets prior to the sale also cannot be depreciated.

**B. Subsection 2 (rates)**

The new regime provides for two sets of rates.

Environmental treatment and recycling assets are eligible for a 40:20:20:20 rate of depreciation. These assets (e.g. treatment facilities) are effectively on par with other manufacturing machinery and plant (also depreciable at a 40:20:20:20 rate) because they are so closely associated with the manufacturing process. No reason exists to provide environmental production assets of this kind with a lesser rate, especially given Government's increased emphasis on environmental pollution control.

On the other hand, the rate of relief for environmental waste disposal assets is only 5 per cent per annum (i.e. a 20-year straight-line write off period). These assets usually are required to handle resultant pollutants outside the ongoing process. These 5 per cent assets (e.g. dams, reservoirs, evaporation ponds, etc.) are more akin to the longer useful life of a manufacturing building (which is also depreciable at a 5 per cent rate).

**C. Subsection 3 (depreciable cost)**

In respect of an asset, the value depreciated is the cost of the asset to the taxpayer. The depreciable cost of such asset (or improvement) is the lesser of the cost of the asset to the taxpayer or the arm's length price of the asset at the

time of the acquisition. This rule prevents purchasers from artificially tagging-on related costs onto the new acquisition of such an asset.

**D. Subsection 4 (exemption periods)**

A select number of taxpayers may hold environmental assets during a period of exemption. This provision deems depreciation to occur during this period of exemption.

**E. Subsection 5 (prior disposals)**

A taxpayer cannot depreciate a production or post-production asset once that asset is no longer owned by that taxpayer (i.e. the post-production asset was disposed of in a prior year).

**F. Subsection 6**

Many business items eligible for deduction must be part of an ongoing trade and for the production of income. Decommissioning, remediation and restoration generally fall outside the ongoing process of trade and production but represent a legal obligation arising out of a (former) trade. This subsection effectively allows the items contemplated in section 11 (such as section 11(a) trade expenses and section 11(e) machinery) to be deductible as if the initial trade were continuing. Unlike the treatment of pre-trade expenditures and losses under section 11A, these post-trade losses and expenditures are not ring-fenced.

**G. Subsection 7**

Assessed losses arising as a result of expenditure contemplated in F above may be set off against income derived by a taxpayer whether the taxpayer is carrying on trade during the relevant year or not.

**H. Subsection 8**

This section prevails for environmental capital expenditure even if the environmental asset is eligible for depreciation relief under sections 11, 12C or 13 of the Income Tax Act.

**I. Subsection 9**

Deductions allowed in terms of this section may not in aggregate exceed the cost of the relevant asset.

#### **4. Commercial buildings (section 13quin)**

##### Current legislation

Depreciation allowances are generally granted by the Act for movable assets used by taxpayers involved in any form of trade. On the other hand, in the case of buildings and permanent structures, depreciation is greatly dependant on the specific trades or business activities for which the buildings or structures are used (for example, mining capital expenditure is eligible for an immediate 100 per cent write off; whereas manufacturing capital expenditure is eligible for a 5 per cent rate). Taxpayers who do not undertake trades covered by specified depreciation regimes generally are not entitled to any depreciation for their buildings and permanent structures despite their business usage.

##### Problem statement

All buildings and other permanent structures depreciate in value due to their limited useful life. Accounting practice reflects this fact by requiring an annual depreciation write-off for all buildings and permanent structures, regardless of the business for which the building or structure is used. Therefore, no reason exists for the tax system to wholly exclude commercial buildings from potential write-offs for depreciation. The wholesale denial of depreciation for certain business buildings and structures raises the carrying cost of doing business without any meaningful policy rationale.

##### Proposed amendment

In order to level the playing fields, the proposed amendment seeks to allow depreciation for all commercial buildings used by taxpayers in the production of income to the extent those buildings fall outside other available depreciation regimes.

#### **A. Subsection 1 (coverage)**

This provision allows for the depreciation of buildings (and improvements) that are used wholly or mainly in the production of income. However, the provision of residential accommodation is specifically excluded. Therefore, a taxpayer who owns a block of flats for residential lease cannot generally depreciate the building (except for the five unit rule in section 13ter).

The proposed rate of depreciation is 5% per annum (i.e. a 20 year straight-line write-off period). The value depreciated is the cost of the building to the taxpayer.

Only new and unused buildings (and improvements) will be depreciable under this provision. Buildings that have been used by the taxpayer prior to the

effective date cannot be depreciated. Buildings purchased by the taxpayer from a seller who used the building prior to the sale also cannot be depreciated.

**B. Subsection 2 (depreciable cost)**

The depreciable cost of a building (or improvement) is the lesser of the cost of the building to the taxpayer or the arm's length price of the building at the time of the acquisition. This rule prevents purchasers from artificially tagging related costs onto building acquisition.

**C. Subsection 3 (exemption periods)**

A select number of taxpayers may hold commercial buildings during a period of exemption. This provision deems depreciation to occur during this period of exemption.

**D. Subsection 4 (prior disposal)**

A taxpayer cannot depreciate buildings once that building is no longer owned by that taxpayer (i.e. the building was disposed of in a prior year).

**E. Subsection 5 (interaction with other regimes)**

The proposed new depreciation regime for commercial buildings should be viewed as a catch-all provision. If another regime applies, the other regime prevails for purposes of depreciation.

**F. Subsection 6 (maximum percentage)**

This subsection makes it clear that the 5 per cent depreciation write-off cannot in aggregate exceed (100 per cent) the cost of the building (i.e. 20 years).

## **AMALGAMATION OF SPORTING BODIES**

### Current legislation

National sporting organisations typically have a professional arm and an amateur arm. Some organisations have split these two arms into separate entities in order to enjoy public benefit organisation status for the amateur arm.

### Problem statement

In certain cases, the split has proven to be to the organisation's disadvantage. The professional arm's sponsorships and other sources of income are fully taxable. However, the professional arm cannot claim a tax deduction for the development and promotion of amateur sport that will serve as its feeder both

for future fans and professional players. The 2007/08 Budget Review therefore proposed measures to assist in the re-integration of the separate entities.

Proposed amendment

The proposed amendment provides relief for amalgamation transactions between the two arms so both the professional and amateur arms can be combined. In short, the professional arm can dispose of all its assets to the amateur arm on a tax neutral basis and will then cease to exist. The unified entity will be a taxable entity as it no longer complies with the requirements of section 10(1)(cN) of the Income Tax Act, 1962. As the relief is only applicable to a limited number of organisations, it will be available for a limited window-period of two years which will end on 31 December 2009.

Furthermore, in terms of the proposed section 11E, a special deduction is available to the unified entity. It may deduct from its income all expenditure (not of a capital nature) incurred by it on the development and promotion of qualifying amateur sport falling under the same code of sport as the professional sport it carries on. Payments to other entities for the development and promotion of amateur sport will not qualify for the special deduction.

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## **TAX RELIEF FOR CO-OPERATIVE BANKS**

Current legislation

As an alternative to utilising the banking system in South Africa, many people organise themselves into groups to form savings clubs and financial services co-operatives. These organisations are often a result of inaccessible banking facilities for people in the remote and rural areas in the country (or otherwise high cost of banking services). These member-owned financial services co-operatives are generally taxed at the same rate and under the same conditions as commercial banks.

Problem statement

As a general rule, financial services co-operatives have the main objective of providing financial services, not to produce income for their owners (i.e. the structure of co-operatives does not allow for profit-taking shareholders). In many cases, these co-operatives are barely breaking even (especially in the case of rural banking co-operatives).

The Co-operatives Banks Bill seeks to formalise this industry by increased regulation and recognition. In terms of the tax system, the application of standard banking tax rules will only serve to dissuade formalisation. Therefore, some form of relief is required, especially for fledging banking co-operatives.

### Proposed amendment (section 12E)

The proposal seeks to provide relief for financial services co-operatives (referred to as “co-operative banks” in the proposed Co-operative Banks Bill) by extending the small business tax relief. Under this regime, smaller business (i.e. with income not exceeding R14 million), are subject to a marginal rate of less than the normal 29 per cent rate in so far as taxable income does not exceed R300 000. In addition, small businesses are eligible for the threshold exemption for individuals (currently R43 000). Relief of this kind will help to formalise more fragile co-operatives, many of whom have net profits falling below the R43 000 threshold.

#### **A. Subsection (4)(a)(ii)(prohibition against multiple small business companies)**

Membership in co-operative banks by members would not disqualify those members from receiving relief in respect of another small business company. However, such members can hold up to a 5 per cent interest in the banking co-operative not to trigger the disqualification.

#### **B. Subsection (4)(c)(ii)(prohibition against investment income)**

Small business companies are prohibited from having more than 20 per cent of investment income. This prohibition is designed to prevent the small business relief regime from become a simple way for high net worth individuals to store passive wealth at a low tax cost. However, this prohibition will not apply to interest earned by a co-operative bank because this form of interest is active income that is core to the co-operative banking operation.

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## **EXEMPTION OF OCCUPATIONAL DEATH BENEFITS**

### Current legislation

In terms of the Compensation for Occupational Injuries and Diseases Act, 1993 (COIDA), a compensation fund was established. According to this Act, employers must contribute to this fund and payments are made out of this fund to certain employees (or their dependants) if the employees die or become disabled due to an occupational injury. Payments made by the Compensation Commissioner are exempt from income tax in the hands of the recipient.

### Problem statement

The families of an employee who die due to an occupational injury may be entitled to additional “top-up” benefits provided by the employee’s employer. These benefits are currently taxable, even though they are essentially akin to



COIDA benefits. While the estate may be enriched by the payment, the payment does not truly compensate for the lost earning power of the deceased.

Proposed amendment (section 10(1)(gB)(iii))

Under the proposal, all lump-sum benefit payments payable as a direct result of an occupational death of an employee will be exempt. There are three additional criteria for this tax-exemption. The first is that a (tax-exempt) death benefit should be payable in terms of COIDA (i.e. that the benefit must act as a top-up), the second is that only a maximum amount of R300,000 will be exempt and thirdly that the employer must pay this amount. The R300,000 will effectively be reduced by the amount that qualifies for tax exemption (of R30 000) in terms of Section 11(x) as a termination of employment benefit (in other words, total exemptions will be limited to R300 000).

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## **RETIREMENT FUND ISSUES**

Current legislation

The Pension Funds Amendment Act, 2007 (Act No. 11 of 2007) came into effect on 13 September 2007. In terms of this Act, certain court orders (including divorce orders and maintenance orders) became payable by a retirement fund, even though the fund member continues to be a member of the fund. The Act also provides for a retirement annuity fund member to move from one fund to another, including the transfer of a retirement fund interest.

Problem statement

The first problem relates to the recognition of taxable receipts of a retirement fund member. The second schedule to the Income Tax Act only recognises taxable accruals upon the member's exit from the fund or his retirement. A problem arises in that the fund will have to keep record of these payments and recover the tax when the member exits the fund or when the member retires. The fund member will not be able to accurately determine the value of his fund interest because the tax may be significantly more than expected (and may even exceed the member's total fund interest). A second problem arises should the tax be triggered on the date the court order becomes payable as the fund member may not have the cash to settle the tax liability.

The Pension Fund Amendment Act further provides for a non-member in receipt of an amount awarded in terms of a divorce order to transfer this amount to his/her own retirement fund. The Income Tax Act is not clear on how this transfer should be treated for tax purposes and may potentially be subject to double tax.

The definition of retirement annuity fund in section 1 of the Income Tax Act prevents a fund member from moving to another fund after retirement i.e. when receiving income from the fund).

*Proposed amendments (sections 1, 7, 10 and the Second schedule to the Income Tax Act and section 37D of the Pension Funds Act)*

The Second Schedule and the Income Tax Act has been amended to recognise certain early withdrawal benefits (i.e. the amounts payable in terms of a court order whilst the fund member remains a member of the fund). These payments will be taxable in the hands of the fund member as a withdrawal benefit on the date these amounts become payable. The retirement fund has to apply for a tax directive and pay PAYE in terms of the directive. The Pension Funds Act has also been amended to allow the fund to additionally release the amount of the tax payable by the fund member in order to avoid hardship for that member. These amounts will not be taxable in the hands of the actual recipient of the payment.

In the case of a divorce order, the fund member will have a right of recovery of the tax he/she paid on the amount awarded to the non-member spouse in terms of the divorce order. This provision effectively retains the status quo of the right of recovery awarded to the fund member upon full withdrawal or retirement from the fund in terms of paragraph 2B of the Second Schedule.

The amount awarded to a non-member ex-spouse in terms of a divorce order and transferred to that person's retirement fund will now be recognised in the formula in terms of which that person's tax-free retirement lump sum is calculated. This amount will remain tax-free.

The definition of retirement annuity fund has been amended to allow fund members to move from one fund to another, irrespective of whether they are contributing members or members in receipt of a pension from that fund.

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## **OIL AND GAS FISCAL STABILITY**

### *Current legislation*

The fiscal stabilisation contained in the OP26 regime acted as an incentive to invest in what was a 'high risk' exploration region by providing long-term security in terms of tax. Upon the initiation of an oil and gas investment, investors were given a legal guarantee that the 1977 Income Tax regime would not become more burdensome throughout that investment. However, investors could benefit from reduced rates of tax and other tax relief measures introduced subsequently.

With the expiry of the OP26 leases, certain tax incentives were renewed to maintain the incentive to invest in local oil and gas. This renewal came in the

form of the Tenth Schedule of the Income Tax Act, thereby creating transparency and certainty for oil and gas exploration or production. The Tenth Schedule also contains a fiscal stability clause.

Problem statement

While the concept of fiscal stability is not in dispute, close examination of the initial version of the fiscal stability contracts have revealed a number of minor issues of concern to both Government and the taxpayer alike. These issues (though anticipated) must be remedied before the first fiscal stability contracts can be signed.

Proposed amendment: (Tenth Schedule)

**A. Paragraph 1 of the Tenth Schedule (definitions)**

The definition of “oil and gas right” contains an incorrect reference. Exploration and production rights fall within the definition of section 1 of the MPRDA (regardless of whether the right is wholly new or a conversion of a prior right).

**B. Paragraph 8(1) of the Tenth Schedule (entering into fiscal stability)**

The proposal clarifies a number of small issues when concluding fiscal stability. First, the Minister of Finance will conclude these agreements on a geographic right-by-right basis per taxpayer. Second, the Minister of Finance need not wait for an exploration or production right to be issued by the Minister of Minerals and Energy. The Minister can enter into a conditional agreement to be effective as at the date an exploration or production right is granted. However, this fiscal stability agreement will be null and void if the exploration or production right is not granted within twelve months after the fiscal stability agreement was concluded.

**C. Paragraph 8(2) of the Tenth Schedule (assigning fiscal stability)**

The proposal allows for limited rights of fiscal stability transfer. Taxpayers holding a fiscal stability agreement in terms of an exploration right can freely assign the fiscal stability benefits if the underlying exploration right is transferred. This freedom of assignment in respect of exploration rights should assist smaller oil and gas exploration companies who actively engage exploration but who sell mineral rights to larger players once the production stage is reached.

Taxpayers holding a fiscal stability agreement in terms of a production right have limited freedom to assign stability benefits if the underlying production right is transferred. In particular, the assignment of fiscal stability rights is limited to intra-group transfers (i.e. movements within the same group of companies for tax purposes).

**D. Paragraph 8(3) of the Tenth Schedule (change in interests)**

Taxpayers often change their percentage interests in a single oil and gas right over time. These changes reflect changes in tolerance of risk and the need for cash. Multiple players with interests in a single geographical oil and gas right swap interests among themselves as part of their practical dealings. The proposal accordingly allows the fiscal stability clause to remain fully in effect in respect of a single taxpayer even if the taxpayer's proportional interest in a right changes over time (the fiscal stability coverage includes the initial interest as well as any additions).

**E. Paragraph 8(4) of the Tenth Schedule (termination)**

The wording to the termination rules clarify that the elective termination by a taxpayer must not be partial. The termination must cover the entire fiscal stability rights as they related to the underlying geographical interest. The termination will also take effect at the beginning of the following year of assessment after termination notice.

**F. Paragraph 8(5) of the Tenth Schedule (allocations relating to two sets of taxation)**

Some taxpayers may ultimately face a situation where some of their geographical oil and gas rights are benefiting from one version of the Tenth Schedule while others are under a different tax regime. This paragraph requires the taxable income and profits derived from oil and gas rights which are governed by a version of that Schedule to be determined separately.

**G. Paragraph 8(6) of the Tenth Schedule (remedies for breach by state)**

This paragraph adds an explicit breach of agreement rule. If a fiscal stability agreement is not applied as agreed, the taxpayer is entitled to compensation or an alternative remedy that eliminates the full impact of such failure.

**H. Paragraph 8(7) of the Tenth Schedule (assigning fiscal stability)**

This paragraph clarifies two points. Firstly, fiscal stability is available only in terms of exploration and production rights (not related permits). Secondly, the technical wording of the provision is improved to state that an exploration right, any renewal thereof and production rights stemming from that former exploration right (or renewal thereof) are deemed to be one in the same right in the hands of an oil and gas company. Thus, if a taxpayer acquires an exploration right, fiscal stability benefits continue for all subsequent renewals as well as conversion to the first production right.

## **I. Repeal of Schedule 3 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006**

Schedule 3 of the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006 created an interim measure to ensure that holders of OP 26 did not have their tax incentives expire before the new Tenth Schedule was in place. With the enactment of the Tenth Schedule in late 2006, Schedule 3 can be fully repealed as obsolete.

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### **CUSTOMS AND EXCISE**

#### **1. Customs and Excise definitions**

##### *Current legislation*

The Customs and Excise Act, 1964 incorrectly classifies excise duties on imported goods as customs duties. Also, the current definition of excise duties incorrectly restricts the imposition of such duties to goods manufactured locally. It would appear that the reasons for these incorrect classifications are largely historical.

##### *Problem statement*

The incorrect inclusion of excise duties within the custom duty definition, and the resulting incorrect restriction of the imposition of excise duties to locally manufactured goods, has unintended consequences both in terms of revenue estimation and international comparisons of tax revenues. International best practice dictates that excise duties on imports be classified as excise revenues.

##### *Proposed amendment*

The proposed amendments accordingly separate excise duties on imports from the customs duties definition. The proposed amendment will require system changes by SARS and the effective date of implementation therefore will be subject to Presidential Proclamation.

#### **2. Improved control over counterfeit goods**

##### *Current legislation*

Current legislation does not provide the authorities with sufficient teeth to act against the illegal trade in counterfeit goods.

### Problem statement

These proposals are intended to provide legal certainty and address the confusion relating to conflicting provisions in the Counterfeit Goods Act and Customs and Excise Act.

### Proposed amendment

SARS will act as a filter for all counterfeit goods while such goods are under customs control. Customs officers will be responsible for the detention and control of possible counterfeit goods. Once this detention has interrupted the movement of the goods, the intellectual property right holder will be required to apply to court for an order declaring the detained goods to be counterfeit goods.

The proposals are in line with the World Customs Organisation's (WCO) model provisions for national legislation to implement effective border measures by Customs authorities, consistent with the TRIPS agreement. The proposed amendment is further in line with the provisions of section 113(8) of the Customs and Excise Act, 1964, where goods suspected of being imported in contravention with any other law in South Africa are detained and then handed over to another authority etc for further action. In the draft proposed legislation, the goods are handed over for safe-keeping to the Counterfeit Goods Depot Operator as contemplated in the Counterfeit Goods Act, 1997, and further steps must be taken by the holder of the intellectual property right to ensure that the goods are not subsequently released into home consumption.

## CLAUSE BY CLAUSE EXPLANATION

### CLAUSE 1

#### ***Transfer Duty: Amendment of section 3 of the Transfer Duty Act, 1949***

*Subclauses (a) and (b):* The proposed amendment facilitates the electronic payment of transfer duty deposits.

### CLAUSE 2

#### ***Transfer Duty: Amendment of section 9 of the Transfer Duty Act, 1949***

*Subclause (a):* The proposed amendment is consequential upon the proposed amendment in clause 53, which proposes the substitution for the expression ‘company formation transaction’ of the expression ‘asset-for-share’ transaction.

*Subclause (b):* The proposed insertion of section 9(15B) of the Transfer Duty Act is to provide an exemption from duty on property sold in instances where the property forms part of a rental pool as contemplated in section 52(2) of the VAT Act. This exemption from duty is limited to instances where the purchaser elects in writing for that property to remain in the rental pool scheme (i.e. the ownership of the property will change but for VAT purposes, the rental pool will continue to utilise the property for purposes of making taxable supplies in the course or furtherance of that rental pool’s enterprise).

### CLAUSE 3

#### ***Pension Funds: Amendment of section 4C of the Pension Funds Act, 1956***

The proposed amendment is consequential upon the repeal of the provision dealing with marketable securities from the Stamp Duties Act, No. 77 of 1968.

However it is not necessary to provide for any exemption in the proposed Securities Transfer Tax Bill to any person who holds any assets on behalf of a pension fund referred to in section 4A of the Pension Funds Act, or has on behalf of any such pension fund invested any assets in any stock, debentures, securities or financial instruments. This applies where that person—

- (a) transfers those assets into the name of such pension fund;
- (b) takes such steps as may be necessary to ensure that on such stock, debentures, securities or financial instruments issued in his name and in any relevant register such endorsements are made as may be necessary to show that the ownership in such stock, debentures, securities or financial instruments vests in such pension fund; and

- (c) if requested thereto by such pension fund, transfers to such fund the stock, debentures, securities or financial instruments vested in it,

as these transactions would not give rise to a change in beneficial ownership under the proposed Securities Transfer Tax Bill.

#### CLAUSE 4

#### ***Pension Funds Act: Amendment of section 37D of the Pension Funds Act, 1956***

See notes on **RETIREMENT FUND ISSUES**.

#### CLAUSE 5

#### ***Income Tax: Amendment of section 1 of the Income Tax Act, 1962***

*Subclause (1)(a):* See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY**.

*Subclause (1)(b) to (p):* See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: BROADENING THE TAXABLE DIVIDEND DEFINITION**.

*Subclause (1)(q) and (r):* See notes on **RETIREMENT FUND ISSUES**.

#### CLAUSE 6

#### ***Income Tax: Amendment of section 5 of the Income Tax Act, 1962***

A lump sum benefit received or accrued from a retirement fund on retirement or death (defined in section 1 as a 'retirement fund lump sum benefit') is taxed according to a separate schedule of rates. Therefore when determining normal tax in respect of the balance of taxable income other than a retirement fund lump sum benefit it is necessary to exclude the retirement fund lump sum from that calculation. Section 5(10) provides for the calculation of normal tax in respect of, inter alia, lump sum benefits derived on resignation or withdrawal from a retirement fund. However, the 'retirement fund lump sum benefit' was not excluded from this calculation. The proposed amendment corrects this oversight.

#### CLAUSE 7

#### ***Income Tax: Amendment of section 6quat of the Income Tax Act, 1962***

Taxpayers may utilise section 6quat rebates (i.e. tax credits) to offset foreign taxes paid. The purpose of these credits is to prevent double taxation. However,



tax credits are available only to the extent foreign taxes arise on foreign source income, not against domestic source income. Countries are only prepared to surrender primary jurisdiction if the underlying activity (i.e. source) arises outside its border. South Africa is no different in this regard.

It has come to Government's attention that a number of countries are incorrectly claiming source jurisdiction in respect of services occurring within South Africa and accordingly claim that withholding tax is required. While South Africa is not prepared to give section 6quat rebates for South African source activities, South Africa is prepared to treat these foreign taxes as a deductible expense incurred in the production of income. This approach is not out of line with international practice.

In particular, foreign taxes proved to be payable will be deductible. However, this deduction cannot exceed the underlying income giving rise to the foreign tax.

#### CLAUSE 8

##### ***Income Tax: Amendment of section 7 of the Income Tax Act, 1962***

See notes on **RETIREMENT FUND ISSUES**.

#### CLAUSE 9

##### ***Income Tax: Amendment of section 8 of the Income Tax Act, 1962***

The proposed amendment is consequential to the proposed amendment in clause 5(1)(a).

#### CLAUSE 10

##### ***Income Tax: Amendment of section 8B of the Income Tax Act, 1962***

See notes on **CAPITAL VERSUS ORDINARY SHARES**.

#### CLAUSE 11

##### ***Income Tax: Amendment of section 8C of the Income Tax Act, 1962***

*Subclause (1)(a)*: The section has been amended as a result of the introduction of section 9C which provides that the disposal of shares after holding them for a period of 3 years is on capital account. The amendment proposes that the provisions of section 8C take precedence over section 9C.

*Subclause (1)(b) to (d)*: Subsection (3) sets out when an equity instrument is deemed to vest. In the case of disposals contemplated in subsections (2)(a)(i)

and (2)(b)(i) the gain or loss has to be determined having regard to the consideration for the equity instrument and the amount received or accrued for the disposal of that equity instrument. The amount received or accrued in respect of the disposal must be determined when the disposal occurs which is not clear from the present wording. It is proposed that a specific provision be inserted to clarify the position.

*Subclause (1)(e)*: The definition of “consideration” effectively defines the amount that must be taken into account as the amount paid to acquire an equity instrument. In the case of equity instruments acquired in the circumstances set out in subsections (5)(a) and (b) the actual amount paid by the person for the equity instrument is ignored and is replaced by the amount which would have been paid by the taxpayer, who originally owned the equity instrument or performed the services as a result of which the equity instrument was given to the other person, to acquire the equity instrument. Presently the wording also includes equity instrument mentioned in subsection (5)(c) which makes its application too wide. It is proposed that the wording of the section be clarified.

*Subclause (1)(f)*: The restriction was imposed as an additional measure to counter deferred delivery schemes in terms of which delivery of the equity instrument is not given to the taxpayer until the consideration is paid and the consideration can in terms of the scheme only be paid in the future. The present wording of the restriction effectively undermines the purpose of the restriction and it is proposed that the wording be amended accordingly.

#### CLAUSE 12

##### ***Income Tax: Amendment of section 9A of the Income Tax Act, 1962***

See notes on **FOREIGN INSTABILITY**.

#### CLAUSE 13

##### ***Income Tax: Amendment of section 9B of the Income Tax Act, 1962***

See notes on **CAPITAL VERSUS ORDINARY SHARES**.

#### CLAUSE 14

##### ***Income Tax: Insertion of section 9C into the Income Tax Act, 1962***

See notes on **CAPITAL VERSUS ORDINARY SHARES**.

#### CLAUSE 15

##### ***Income Tax: Amendment of section 9D of the Income Tax Act, 1962***

*Subclause (1)(a)*: The proposed amendment provides that paragraphs (a), (b) and (c) of the proviso to the definition of ‘controlled foreign company’ in section 9D are not mutually exclusive.

*Subclause (1)(b) and (e)*: Special rules apply when a foreign company becomes or ceases to be a controlled foreign company. The proposed amendment clarifies that—

- the net income of a company which ceases to be a controlled foreign company during a foreign tax year must be determined from the commencement of the foreign tax year of that company to the day before the company ceased to be a controlled foreign company and not on the date of cessation; and
- the ‘valuation date’ of a company which becomes a controlled foreign company is the day before it becomes a controlled foreign company and not on the date it becomes a controlled foreign company.

This proposed amendment is consistent with paragraph 13(g) of the 8<sup>th</sup> Schedule.

*Subclause (1)(c) and (d)*: See notes on **LONG-TERM INSURERS AND CONTROLLED FOREIGN COMPANIES**.

*Subclause (1)(f)*: The proposed amendment is consequential to the proposed amendment in clause 44(1)(a).

*Subclause (1)(g) and (h)*: See notes on **FOREIGN INSTABILITY**.

*Subclause (1)(i)*: The proposed amendment extends the exemption involving foreign currency gains and losses arising from transactions between controlled foreign companies that are part of the same group of companies (as defined in section 1). Under current law, interest and related financial instruments between these group members are not subject to any section 9D inclusion. At issue is the currency hedging with outside parties to neutralise financial instrument transactions between these group members. The proposed amendment accordingly disregards exchange differences from derivatives if the underlying transaction is exempt due to the offshore intra-group rule. This change is consistent with section 24I(11).

*Subclause (1)(j)*: The provision currently provides that the Commissioner may rule that a controlled foreign company qualifies as having a foreign business establishment where it utilises the employees, facilities and equipment of any other company that has the same country or residence as the controlled foreign company and is part of the same group of companies as the controlled foreign company. The proposed amendment provides that such other company must be a controlled foreign company for purposes of any ruling.

*Subclause (1)(k)*: The provision currently provides that the Commissioner must, before issuing a ruling in terms of the provisions of section 9D(10), be satisfied that any such ruling will not result in an unacceptable erosion of the tax base. This meaning of this provision is not certain. The proposed amendment introduces certainty by requiring that the Commissioner must, before issuing a ruling, take into account the activities and transactions of the persons involved.

## CLAUSE 16

### ***Income Tax: Amendment of section 10 of the Income Tax Act, 1962***

*Subclause (1)(a)*: The proposed amendment corrects grammar.

*Subclause (b) to (d)*: See notes on **EXEMPTION OF OCCUPATIONAL DEATH BENEFITS**.

*Subclause (1)(e) and (f)*: The provision currently provides that foreign dividends are exempt if the shareholder holds at least 20 per cent of the shares in the company declaring the dividend. The proposed amendment provides that foreign dividends paid by collective investment schemes do not qualify for this exemption.

*Subclause (1)(g) to (m)*: Difficulties are being experienced with regard to the application of section 10(1)(o)(ii) to share incentive arrangements and situations where remuneration is received in a year of assessment and the services in respect of that remuneration were rendered over a period longer than that year. In particular, the problem with share option gains and section 10(1)(o)(ii) is that the period to which the remuneration relates is almost always spread over a vesting period (typically 3 – 5 years). Accordingly, even though the services between grant and vesting that give rise to the gain made have been rendered outside of the Republic, only that portion of the gain that relates to services in a qualifying 12 month period when the remuneration accrues (when the options vest) can be exempt in terms of section 10(1)(o)(ii). Situations can arise where the major portion of the services rendered in respect of a share option gain are rendered outside the Republic but as the employee has returned to the Republic when the gain accrues, no portion of the accrual is exempt.

The proposed amendments make it clear that, to the extent that the conditions of section 10(1)(o)(ii) were met, namely, the 183 day and 60 day tests are met in any twelve month period ending or commencing during any year of assessment during which those services were rendered, during the current year of assessment or previous years, the income earned outside the Republic will be exempt. Furthermore it is proposed that the ambit of the exemption be limited to specific types of remuneration for services rendered and not to all the types of income included in the definition of 'remuneration' in paragraph 1 of the Fourth Schedule to the Income Tax Act. As the requirements of the subsection are that the remuneration must be for services rendered while outside the Republic,

amounts, for example, referred to in paragraph (d) of the definition of 'gross income' will not fall within the exemption as they are not paid for services rendered. The proposed amendments also make it clear that if remuneration is paid in one year for services rendered in respect of more than one year, such remuneration will be deemed to have accrued evenly over the period that the services were rendered.

*Subclause (1)(n)*: The proposed amendment deletes an obsolete provision.

*Subclause (1)(o)*: See notes on **RETIREMENT FUND ISSUES**.

## CLAUSE 17

### ***Income Tax: Amendment of section 11 of the Income Tax Act, 1962***

*Subclause (1)(a)*: See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY**.

*Subclause (1)(b)*: The proposed amendment corrects a textual error.

*Subclause (1)(c)*: See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY**.

*Subclause (1)(d)*: See notes on **DEPRECIATION: ROLLING STOCK AND ENVIRONMENTAL ASSETS AND ACTIVITIES**.

*Subclause (1)(e) to (g)*: Capital losses are clogged under paragraph 39 of the 8<sup>th</sup> Schedule. The purpose of these rules is to prevent artificial acceleration of losses through the sale of depreciated assets to parties who are economically connected to one another (so there is no real economic loss). The proposed amendments similarly deny section 11(o) losses to prevent the same artificial acceleration. The proposed amendments further update certain cross references. With regard to the cross references see notes on **DEPRECIATION: ROLLING STOCK AND ENVIRONMENTAL ASSETS AND ACTIVITIES**.

## CLAUSE 18

### ***Income Tax: Amendment of section 11C of the Income Tax Act, 1962***

The proposed amendment repeals the election to deduct foreign withholding taxes on foreign dividends in light of the more general deduction provisions added to section 6*quat*.

## CLAUSE 19

### ***Income Tax: Amendment of section 11D of the Income Tax Act, 1962***

*Subclause (1)(a)*: The proposed amendment corrects certain cross-references.

*Subclause (1)(b) and (c)*: See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY**.

*Subclause (1)(d)*: The proposed amendment will exclude taxpayer's carrying on banking, financial services or insurance business from claiming the 150 per cent deduction in respect of research and development expenditure. Such taxpayers will nevertheless remain entitled to deductions for that expenditure in terms of any other applicable provision of the Income Tax Act.

*Subclause (1)(e)*: Section 11D provides for the deduction of 150 per cent of qualifying research and development expenditure incurred by a taxpayer. Subsection (5B) was introduced for purposes of limiting this deduction to 100 per cent if the expenditure was incurred to defray expenditure incurred by a connected person in relation to the taxpayer. The amendment proposed by this subclause will allow expenditure to be deducted at 150 per cent but only to the extent that the connected person recipient of the funding has incurred expenditure in respect of activities undertaken by that connected person for research and development purposes. In addition, the proposed amendment provides that deductions of expenditure for the use of property, or of expenditure constituting interest, will be allowed in terms of subsection (2), but will be limited to 100 per cent.

## CLAUSE 20

### ***Income Tax: Insertion of section 11E into the Income Tax Act, 1962***

See notes on **AMALGAMATION OF SPORTING BODIES**.

## CLAUSE 21

### ***Income Tax: Amendment of section 12B of the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY**.

CLAUSE 22

***Income Tax: Amendment of section 12C of the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY.**

CLAUSE 23

***Income Tax: Amendment of section 12D of the Income Tax Act, 1962***

See notes on **DEPRECIATION: ROLLING STOCK.**

CLAUSE 24

***Income Tax: Insertion of section 12DA of the Income Tax Act, 1962***

See notes on **DEPRECIATION: ROLLING STOCK.**

CLAUSE 25

***Income Tax: Amendment of section 12E of the Income Tax Act, 1962***

See notes on **TAX RELIEF FOR CO-OPERATIVE BANKS.**

CLAUSE 26

***Income Tax: Amendment of section 12F of the Income Tax Act, 1962***

See notes on **DEPRECIATION: PORT ASSETS.**

CLAUSE 27

***Income Tax: Amendment of section 12G of the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY.**

CLAUSE 28

***Income Tax: Insertion of section 13quin of the Income Tax Act, 1962***

See notes on **DEPRECIATION: COMMERCIAL BUILDINGS.**

## CLAUSE 29

### ***Income Tax: Amendment of section 15 of the Income Tax Act, 1962***

See notes on **DEPRECIATION: ROLLING STOCK, PORT ASSETS AND COMMERCIAL BUILDINGS.**

## CLAUSE 30

### ***Income Tax: Amendment of section 18 of the Income Tax Act, 1962***

A taxpayer can deduct medical expenses of immediate family members from taxable income if these expenses exceed 7,5 per cent of that member's taxable income. These expenses are difficult to verify, but a streamlined verification process potentially exists for medical scheme members and their medical scheme beneficiaries. In these cases, SARS can use the medical scheme certificate to verify these expenses, except that a technical problem exists as medical schemes issue certificates in respect of all medical scheme beneficiaries (wider family) (not only for immediate family members (nucleus family) who are the potential subjects of deductions).

In order to streamline the administration and audit process, it is proposed that the reference to immediate family for medical scheme members be extended to include all medical scheme beneficiaries that are dependants of the taxpayer. This should simplify administration for medical scheme members and their beneficiaries.

## CLAUSE 31

### ***Income Tax: Amendment of section 18A of the Income Tax Act, 1962***

Section 18A allows the deduction of donations to certain organisations, including public benefit organisations and certain other organisations. However, the heading to the section refers to the "Deduction of donations to certain public benefit organisations", thereby implying that the section does not provide for deductions for donations to the other organisations. The proposed amendment will delete the reference to public benefit organisations in this heading and thereby render the same more descriptive.

## CLAUSE 32

### ***Income Tax: Amendment of section 20 of the Income Tax Act, 1962***

Section 20(1)(a)(ii) provides for the reduction of the balance of assessed loss of a person who benefits from a compromise made with or concession granted by



his or her creditors. The balance of that person's assessed loss must be reduced by the amount or value of any benefit received by or accruing to that person—

- resulting from a concession granted by or compromise made with his or her creditors,
- in terms of which his or her liabilities that arose in the ordinary course of trade, have been reduced or extinguished.

It has been argued that this provision applies only if the concession is granted by or the compromise is made with the general body of creditors and not merely by or with one or some of them. It has also been argued that liabilities that are incurred prior to the commencement of trade (e.g. for funding the erection of a factory) do not arise in the ordinary course of that trade and that a concession or compromise in respect of those liabilities need not be taken into account in terms of s 20(1)(a)(ii). Another issue relates to the question whether the liability must be linked to expenditure in respect of which a deduction or allowance was allowed.

The proposed amendments are aimed at clarifying the position in this regard.

#### CLAUSE 33

##### ***Income Tax: Amendment of section 23A of the Income Tax Act, 1962***

See notes on **DEPRECIATION: ROLLING STOCK AND ENVIRONMENTAL ASSETS AND ACTIVITIES.**

#### CLAUSE 34

##### ***Income Tax: Amendment of section 23D of the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY.**

#### CLAUSE 35

##### ***Income Tax: Amendment of section 23G of the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: DEPRECIATION OF ROLLING STOCK AND COMMERCIAL BUILDINGS.**

#### CLAUSE 36

##### ***Income Tax: Amendment of section 23H of the Income Tax Act, 1962***

*Subclause (1)(a):* The proposed amendment provides that section 11D will now be subject to section 23H. The effect is that qualifying research and development

expenditure which is allowable in terms of section 11D(1) will be allowed as a deduction only to the extent that the underlying research and development activities have been executed.

*Subclause (1)(b):* Currently, the subsection allows a deduction of expenditure only when the underlying activities have been executed. However, section 11D does not allow deductions for research and development expenditure, but rather a deduction of an amount equal to 150 per cent of such expenditure. If the proposal to make section 11D deductions subject to the provisions of section 23H is accepted, then it is proposed that section 23H should be amended to accommodate the deduction of amounts equal to 150 per cent of expenditure in addition to the deduction of expenditure in terms of any other provision of the Income Tax Act.

*Subclause (1)(c):* Section 23H apportions expenditure incurred by a taxpayer for services over the period during which the services are to be rendered. The section is, however, silent as to how to deal with cases where the period of the services is not determinable. The proposed amendment provides for the expenditure to be apportioned over the period during which the services are likely to be rendered.

*Subclause (1)(d):* In general, section 23H apportionment does not apply if the benefit connected to the expenditure will be enjoyed by the taxpayer within six months after the end of the year during which the expenditure was incurred. The proposed amendment provides that this exception will not apply in respect of qualifying R and D expenditure under section 11D(1).

#### CLAUSE 37

##### ***Income Tax: Insertion of section 23I of the Income Tax Act, 1962***

See notes on **CROSS-BORDER INTELLECTUAL PROPERTY ARBITRAGE.**

#### CLAUSE 38

##### ***Income Tax: Insertion of section 23J of the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: CONNECTED PERSON TRANSFERS OF DEPRECIABLE PROPERTY.**

#### CLAUSE 39

##### ***Income Tax: Amendment of section 24B of the Income Tax Act, 1962***

See notes on **SHARE CROSS-ISSUES.**

#### CLAUSE 40

##### ***Income Tax: Amendment of section 24I of the Income Tax Act, 1962***

*Subclause (1)(a)*: See notes on **FOREIGN INSTABILITY**.

*Subclause (1)(b), (c) and (d)*: Similar to the changes proposed for section 9D(9)(f), this proposed amendment extends the relief for foreign currency derivatives to cover derivatives arising out of items already receiving relief. In effect, the taxation of the derivative will match the taxation of the underlying gain or loss.

#### CLAUSE 41

##### ***Income Tax: Amendment of section 25D of the Income Tax Act, 1962***

*Subclause (1)*: See notes on **FOREIGN INSTABILITY**.

#### CLAUSE 42

##### ***Income Tax: Amendment of section 28 of the Income Tax Act, 1962***

The proposed amendments provide that the rules for the taxation of short-term insurers will be adjusted to reflect current practice. Firstly, the allowances for reserves will be directly linked to the liabilities contemplated in section 32(1)(a), (b) and (d) of the Short-term Insurance Act, 1998 (Act No. 53 of 1998). In effect, the calculations performed under that Act as accepted by the Financial Services Board will operate as the starting point for liability calculation. The Commissioner can then adjust the amount as already allowed by current law.

The proposed changes also clarify the relationship between the rules under section 28 and the rest of the Income Tax Act. Section 28 generally applies in lieu of section 11(a) in respect of liabilities incurred stemming from reinsurance premiums and any claims in respect of that business. The denial of deductions for reserve funds under section 23(e) is similarly disregarded.

#### CLAUSE 43

##### ***Income Tax: Amendment of section 30 of the Income Tax, 1962***

*Subclause (1)(a)*: Currently, the constitution of a domestic public benefit organisation must provide that upon dissolution its assets will be transferred to some other public benefit organisation or certain other exempt organisations. The proposed amendment provides that the constitution must now provide that such other organisations must be required to use the transferred assets solely for

purposes of carrying on one or more public benefit activities listed in the Ninth Schedule to the Income Tax Act.

*Subclause (1)(b)*: Currently, the constitution of a foreign public benefit organisation with a domestic branch, must provide that on dissolution its assets are transferred to another domestic public benefit organisation or certain other exempt organisations, or to any other person if the branch paid for the assets out of foreign funds. The proposed amendment deletes the abovementioned requirement and replaces the same with the requirement that the constitution of a foreign public benefit organisation with a foreign branch must provide that upon termination of the branch activities the assets of the branch must be transferred in the same way as in subclause (a) if more than 15 per cent of the branch's receipts and accruals within the period of three years preceding the termination arose from a source within South Africa.

#### CLAUSE 44

##### ***Income Tax: Amendment of section 31 of the Income Tax Act, 1962***

*Subclause(1)(b) and (c)*: See notes on **CROSS BORDER INTELLECTUAL PROPERTY TRANSFER PRICING**.

*Subclause (a) and (d)*: The argument has been made that the current formulation of the transfer pricing provisions does not cater for cases where an agreement between residents becomes a cross-border agreement due to a change of residence of one of the participants. The proposed amendments are aimed at ensuring that cross-border suppliers between connected persons are fully subject to the transfer pricing provisions, including in such abovementioned circumstances.

#### CLAUSE 45

##### ***Income Tax: Amendment of section 35 of the Income Tax Act, 1962***

Intellectual property payments to foreign persons are generally subject to section 35 withholding at 12 per cent per annum, subject to limited exceptions. These exceptions are being modernised so that they are more consistent with the exceptions contained in section 10(1)(h) for taxable interest earned by foreign persons. In essence, payments should not be subject to withholding on payments to foreign persons with substantial presence within South Africa should not be subject to withholding. Hence it is proposed that intellectual property payments to a South African permanent establishment of a foreign person will not be subject to withholding. The exception for payments to persons physically present within South Africa for more than 183 days will not be replicated in the intellectual property withholding regime because this cannot be readily determined from the perspective of a withholding payer.

CLAUSE 46

***Income Tax: Amendment of section 36 of the Income Tax Act, 1962***

The proposed amendment is consequential to the proposed amendment of the definition of 'depreciable asset' in clause 5(1)(a).

CLAUSE 47

***Income Tax: Amendment of section 37A of the Income Tax Act, 1962***

The proposed amendment corrects a formatting error.

CLAUSE 48

***Income Tax: Insertion of section 37B of the Income Tax Act, 1962***

See notes on See notes on **DEPRECIATION: ENVIRONMENTAL ASSETS AND ACTIVITIES.**

CLAUSE 49

***Income Tax: Amendment of section 37C of the Income Tax Act, 1962***

The proposed amendment repeals an obsolete provision.

CLAUSE 50

***Income Tax: Amendment of section 37D of the Income Tax Act, 1962***

The proposed amendment repeals an obsolete provision.

CLAUSE 51

***Income Tax: Amendment of heading to Part III of the Income Tax Act, 1962***

The proposed amendment is consequential to the amendment in clause 53 of the definition of 'company formation transaction' as an 'asset for share transaction' and the repeal of share-for-share transaction relief in section 43 in clause 54.

CLAUSE 52

***Income Tax: Amendment of section 41 of the Income Tax Act, 1962***

*Subclause (1)(a),(d), (h) and (i):* The proposed amendments are consequential to the proposed amendments in clause 54.

*Subclause (1)(b):* See notes on **FOREIGN INSTABILITY.**

*Subclause (1)(c):* See notes on **COMPANY REORGANISATIONS: INTRA-GROUP TRANSACTIONS.**

*Subclause (1)(e):* The proposed amendment is consequential to the amendments in clauses 53 and 54. In addition, the proposed amendment provides that a transaction will not qualify for the roll over relief provided in Part III of the Income Tax Act, if the transaction provides for the transfer of an asset to the untaxed policyholder fund of a long-term insurer.

*Subclause (1)(f):* The proposed amendment corrects a textual error.

*Subclause (1)(g):* At the present time taxpayers can freely utilise the Part III reorganisation rules without receiving written advanced approval from the Commissioner. Section 41(5) gave the Minister the power to require such advance approval by regulation if desired. Experience with the reorganisation rules indicates that the requirement of advance approval would be too unwieldy and that the optional advanced ruling procedure is sufficient. This Ministerial power is accordingly proposed to be deleted.

#### CLAUSE 53

##### ***Income Tax: Amendment of section 42 of the Income Tax Act, 1962***

*Subclause (1)(a),(d),(e) and (g) to (w):* See notes on **COMPANY REORGANISATIONS: REPEAL OF SHARE-FOR-SHARE RELIEF.**

*Subclause (1)(b) and (c):* See notes on **COMPANY REORGANISATIONS: COLLECTIVE INVESTMENT SCHEMES.**

*Subclause (1)(f):* See notes on **CAPITAL VERSUS ORDINARY SHARES.**

#### CLAUSE 54

##### ***Income Tax: Repeal of section 43 of the Income Tax Act, 1962***

*Subclause (1):* See notes on **COMPANY REORGANISATIONS: REPEAL OF SHARE-FOR-SHARE RELIEF.**

## CLAUSE 55

### ***Income Tax: Amendment of section 44 of the Income Tax Act, 1962***

*Subclause (1)(a):* See notes on **COMPANY REORGANISATIONS: REMOVAL OF FINANCIAL INSTRUMENT LIMITATIONS.**

*Subclause (1)(b):* The proposed legislation limits rollover relief for transfers within a group under section 45 (and for group liquidations under section 47) by narrowing the group definition. As discussed elsewhere, this narrowed group definition ensures that tax relief of this nature only exists if the parties involved are fully within the tax net from a policy and administrative standpoint. A similar restriction will also be added for amalgamation rollovers. Amalgamation rollover relief will now be limited so that this relief applies solely to situations where the resultant company receiving the amalgamated company's assets is fully within the tax net from a policy and administrative standpoint (i.e. amalgamations rollover relief will be available only if the resultant company is a fully South African taxable company that is registered within South Africa).

## CLAUSE 56

### ***Income Tax: Amendment of section 45 of the Income Tax Act, 1962***

*Subclause (1)(a) and (d):* See notes on **COMPANY REORGANISATIONS: INTRA-GROUP TRANSACTIONS.**

*Subclause (1)(b):* See notes on **COMPANY REORGANISATIONS: REMOVAL OF THE FINANCIAL INSTRUMENT LIMITATIONS.**

*Subclause (1)(c):* See notes on **COMPANY REORGANISATIONS: PROHIBITION AGAINST TRANSFERS TO WHOLLY OR PARTIALLY EXEMPT TRANSFEREES.**

## CLAUSE 57

### ***Income Tax: Amendment of section 46 of the Income Tax Act, 1962***

*Subclause (1)(a):* Under current law, tax-free rollovers involving the unbundling of subsidiaries are permitted only for intra-group transfers and for unbundlings to listed shareholders. Unbundlings outside this context (e.g. in closely held situations) are ineligible for rollover relief because unbundlings can easily be used in this outside context as a mechanism to circumvent the Secondary Tax on Companies (as opposed to facilitating economic restructurings). However, a small amendment will be made so that unbundlings will apply if the unbundled company becomes listed within 12 months of the unbundling. This proposed

change allows a wholly-owned subsidiary of a listed company to be freely unbundled (a frequent non-avoidance form of unbundling in a listed context).

*Subclause (1)(b) and (c):* See notes on **COMPANY REORGANISATIONS: COLLECTIVE INVESTMENT SCHEMES.**

*Subclause (1)(d):* See notes on **CAPITAL VERSUS ORDINARY SHARES.**

*Subclause (1)(e):* See notes on **COMPANY REORGANISATIONS: REMOVAL OF THE FINANCIAL INSTRUMENT LIMITATIONS.**

#### CLAUSE 58

##### ***Income Tax: Amendment of section 47 of the Income Tax Act, 1962***

*Subclause (1)(a):* See notes on **COMPANY REORGANISATIONS: INTRA-GROUP TRANSACTIONS.**

*Subclause (1)(b) and (c):* See notes on **COMPANY REORGANISATIONS: REMOVAL OF THE FINANCIAL INSTRUMENT LIMITATIONS.**

#### CLAUSE 59

##### ***Income Tax: Amendment of section 64B of the Income Tax Act, 1962***

*Subclause (1)(a):* The proposed amendment corrects the dividend cycle rules for determining the Secondary Tax on Companies for long-term insurance companies. The first cycle for a long-term insurer is proposed to commence on the later of 1 July 1993 or the date of incorporation of the long-term insurance company.

*Subclause (1)(b) and (c):* The proposed amendment corrects certain incorrect cross-references.

*Subclause (1)(d):* See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: SIMPLIFYING STC INTRA-GROUP RELIEF.**

*Subclause (1)(e):* The proposed amendment reduces the rate of secondary tax on companies from 12,5 per cent to 10 per cent.

*Subclause (1)(f) to (i):* See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: BROADENING THE TAXABLE DIVIDEND DEFINITION.**



CLAUSE 60

***Income Tax: Amendment of section 64C of the Income Tax Act, 1962***

*Subclause (1):* See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: SIMPLIFYING STC INTRA-GROUP RELIEF.**

CLAUSE 61

***Income Tax: Amendment of paragraph 1 of the Second Schedule to the Income Tax Act, 1962***

See notes on **RETIREMENT FUND ISSUES.**

CLAUSE 62

***Income Tax: Amendment of paragraph 2 of the Second Schedule to the Income Tax Act, 1962***

See notes on **RETIREMENT FUND ISSUES.**

CLAUSE 63

***Income Tax: Amendment of paragraph 2B of the Second Schedule to the Income Tax Act, 1962***

See notes on **RETIREMENT FUND ISSUES.**

CLAUSE 64

***Income Tax: Amendment of paragraph 1 of the Fourth Schedule to the Income Tax Act, 1962***

*Subclause (1):* The proposed amendment is a technical correction to correct the grammar by the inclusion of the word “or” in both the definitions of ‘personal service company’ and ‘personal service trust’.

CLAUSE 65

***Income Tax: Amendment of paragraph 2 of the Fourth Schedule to the Income Tax Act, 1962***

See notes on **RETIREMENT FUND ISSUES.**

CLAUSE 66

***Income Tax: Amendment of paragraph 9 of the Fourth Schedule to the Income Tax Act, 1962***

See notes on **RETIREMENT FUND ISSUES**.

CLAUSE 67

***Income Tax: Amendment of paragraph 11A of the Fourth Schedule to the Income Tax Act, 1962***

Paragraph 11A deals with the withholding or deduction of employees' tax from remuneration in the form of gains contemplated in sections 8A, 8B and 8C which is deemed to become payable to employees. It deems that the person who granted the right to acquire the marketable security or from whom the employee acquired the equity instrument or qualifying equity share, to have paid remuneration equal to the amount of the gain to the employee.

In the majority of cases rights to acquire marketable securities, qualifying equity shares and equity instruments are granted by or acquired by employees from trusts established by employers to provide these benefits. As these trusts only provide benefits in the form of gains they do not pay the employees cash remuneration and as a result the employees' tax liability is not paid during the year of assessment when the gain arises. The same position occurs where the employees are employed by a subsidiary of an international company and the shares are granted or awarded by a body outside the Republic.

It is proposed that in the circumstances where—

- a gain arises in the hands of an employee in a year of assessment;
- the entity granting the right to acquire a marketable security or from whom the employee acquired the equity instrument or qualifying equity share is an associated institution as defined in paragraph 1 of the Seventh Schedule in relation to an employer of the employee;
- the associated institution granting the benefit does not pay remuneration from which the employees' tax on the gain can be withheld;

the associated institution and the employer must withhold an amount from the remuneration payable to the employee equal to the employees' tax payable in respect of that gain and shall be jointly and severally liable for that employees' tax.

Consequential amendments are proposed for the other subclauses contained in the paragraph.

## CLAUSE 68

### ***Income Tax: Amendment of paragraph 9 of the Seventh Schedule to the Income Tax Act, 1962***

*Subclause (1)(a):* The proposed amendment provides that no rental value must be placed on any accommodation provided to an employee by an employer whilst that employer is away from his or her usual place of residence in South Africa in the course of performing his or her duties.

*Subclause (1)(b):* The proposed amendment provides that no rental value must be placed on any accommodation provided by an employer to an employee away from his or her usual place of residence outside South Africa for purposes of the employee performing his or her duties. The proposed rule will apply only if the employee is away from his or her place of residence for a period not exceeding 12 months from the date of arrival in South Africa. This rule will not apply if the employee was present within South Africa for a period exceeding 30 days during the 12 month period immediately succeeding the date of arrival.

These proposed amendments come into operation on 1 March 2008.

## CLAUSE 69

### ***Income Tax: Amendment of paragraph 10 of the Seventh Schedule to the Income Tax Act, 1962***

The proposed amendment is consequential to the amendment to paragraph 9 of the Seventh Schedule.

## CLAUSE 70

### ***Income Tax: Amendment of paragraph 12B of the Seventh Schedule to the Income Tax Act, 1962***

Until 2006, all direct employer-provided medical assistance was fully taxable as a fringe benefit. In 2006, certain exemptions were added to cater for employer-provided medical care in recognition of the fact that certain employers view direct medical provision as a core function, especially for lower-income employees. While the changes in 2006 were viewed as a great step forward, it has come to Government's attention that the exemption did not cover medical services and medicines required of an employer by law. It is accordingly proposed that the exemption be expanded to cover these circumstances.

## CLAUSE 71

### ***Income Tax: Amendment of paragraph 12 of the Eighth Schedule to the Income Tax Act, 1962***

*Subclause (1):* Debt cancellations normally give rise to capital gain because the debtor is essentially enriched by the cancellation of a debt owing. One exception to this capital gain treatment arises in the context of companies within the same group. Debt cancellations within a group are normally exempt because gain for one member is economically offset by a corresponding loss for the other.

The proposed legislation alters this rule by narrowing the relief to companies of a group as newly defined under section 41. The newer (and narrower) definition effectively limits the relief to situations where both parties are fully within the tax system (so that the elimination of a capital gain for a taxable debtor is matched by the elimination of a capital loss for a taxable creditor).

## CLAUSE 72

### ***Income Tax: Amendment of paragraph 19 of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: ANTI-DISTRIBUTION STRIPPING.**

## CLAUSE 73

### ***Income Tax: Amendment of paragraph 20 of the Eighth Schedule to the Income Tax Act, 1962***

*Subclause (a):* Paragraph 20(1)(h)(ii) determines the base cost of an asset that has been subject to fringe benefits tax under paragraph (i) of the definition of 'gross income' read with the Seventh Schedule. It provides that the amount to be added to the base cost of the employee's asset is the value that was included in the employee's gross income. In this way double taxation is prevented in that the amount that was included in gross income will not again be subjected to CGT.

In terms of paragraph 16(1)(b) of the Seventh Schedule an amount will also be included in an employee's gross income if the employer confers the benefit on some other person, whether directly or indirectly. This could happen, for example, if the employer transferred an asset to the employee's family trust or a relative. Under the present wording of paragraph 20(1)(h)(ii)(bb) there is no mechanism by which the other person can achieve a step-up in base cost as this is only granted to an employee acquiring the asset. In order to eliminate economic double taxation, it is proposed that paragraph 20(1)(h)(ii)(bb) be amended to enable the other person to obtain the required increase in base cost.

*Subclause (b):* The proposed amendment corrects a formatting error.

CLAUSE 74

***Income Tax: Amendment of paragraph 42 of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: SHARE BUYBACKS OF LISTED SHARES.**

CLAUSE 75

***Income Tax: Insertion of paragraph 42A of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **COMPANY REORGANISATIONS: SHARE BUYBACKS OF LISTED SHARES.**

CLAUSE 76

***Income Tax: Amendment of paragraph 43 of the Eighth Schedule to the Income Tax Act, 1962***

The capital gain or loss currency rules of paragraph 43 refer directly to section 25D for purposes of currency translation. This cross-reference is causing unnecessary confusion. The proposed amendment directly refers to the underlying rule (without reference to section 25D) as a matter of clarification.

CLAUSE 77

***Income Tax: Amendment of paragraph 64B of the Eighth Schedule to the Income Tax Act, 1962***

*Subclause (1):* The tax system contains a participation exemption in respect of foreign shares. The main purpose of the regime is to encourage the dividend repatriation of funds back to South Africa by removing South African taxes on this dividend repatriation for South African shareholders that have a meaningful say over the affairs of the foreign company declaring the dividend. To achieve this result, current law provides that dividends on foreign shares are exempt from South African tax if paid to a shareholder with a minimum of 20 per cent control over the foreign company making the dividend distribution.

However, current law fails to address comparable distributions. More specifically, repatriations in respect of foreign shares fall outside the exemption if that repatriation comes in the form of a share capital distribution (or other distributions

giving rise to capital gain). The proposed legislation accordingly provides exemption for this latter group of repatriations under essentially the same conditions as the exemption for dividend repatriations.

#### CLAUSE 78

##### ***Income Tax: Amendment of paragraph 65 of the Eighth Schedule to the Income Tax Act, 1962***

The proposed amendment is consequential to the amendment to the definition of 'depreciable asset' in clause 5(1)(a).

#### CLAUSE 79

##### ***Income Tax: Amendment of paragraph 66 of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **DEPRECIATION: ROLLING STOCK AND ENVIRONMENTAL ASSETS AND ACTIVITIES.**

#### CLAUSE 80

##### ***Income Tax: Amendment of paragraph 67 of the Eighth Schedule to the Income Tax Act, 1962***

*Subclause (1):* Paragraph 67 provides roll-over treatment in respect of the disposal of assets between spouses. Under paragraph 67(1)(b) the transferee spouse 'steps into the shoes' of the transferor spouse in respect of any expenditure incurred, dates of acquisition and incurral and usage of the asset by the transferor. Paragraph 67(1)(b) is, however, silent on the treatment of any amount received or accrued to the transferor that would have constituted proceeds had the transferor disposed of the asset to a third party. Logically if the asset is deemed to be acquired on the same date that it was acquired by the transferor, any such proceeds should automatically accrue to the transferee. Nevertheless it is considered desirable to put the matter beyond doubt by deeming such amounts to be received by the transferee. One example of such an amount is a capital distribution from a company received or accrued between valuation date and the date of coming into effect of the proposed amended paragraph 76. Another example arises when the transferor spouse has disposed of the asset under a suspensive sale agreement, received some proceeds, and thereafter transfers the rights under the contract to the transferee spouse in whose hands the condition will be fulfilled.

CLAUSE 81

***Income Tax: Amendment of paragraph 67A of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: CAPITAL DISTRIBUTIONS.**

CLAUSE 82

***Income Tax: Insertion of paragraph 67AB into the Eighth Schedule to the Income Tax Act, 1962***

See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: CAPITAL DISTRIBUTIONS.**

CLAUSE 83

***Income Tax: Amendment of paragraph 74 of the Eighth Schedule to the Income Tax Act, 1962***

*Subclause (1):* The proposed amendment is of a textual nature.

CLAUSE 84

***Income Tax: Amendment of paragraph 76 of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: CAPITAL DISTRIBUTIONS.**

CLAUSE 85

***Income Tax: Insertion of paragraph 76A of the Eighth Schedule to the Income Tax Act, 1962***

See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: CAPITAL DISTRIBUTIONS.**

CLAUSE 86

***Income Tax: Repeal of paragraph 79 of the Eighth Schedule to the Income Tax Act, 1962***

*Subclause (1):* See notes on **ADJUSTMENTS TO THE BASE FOR THE SECONDARY TAX ON COMPANIES: CAPITAL DISTRIBUTIONS.**

CLAUSE 87

***Income Tax: Amendment of paragraph 1 of the Tenth Schedule to the Income Tax Act, 1962***

See notes on **OIL AND GAS FISCAL STABILITY.**

CLAUSE 88

***Income Tax: Amendment of paragraph 7 of the Tenth Schedule to the Income Tax Act, 1962***

*Subclause (1):* The proposed amendment is of a textual nature.

CLAUSE 89

***Income Tax: Amendment of paragraph 8 of the Tenth Schedule to the Income Tax Act, 1962***

See notes on **OIL AND GAS FISCAL STABILITY.**

CLAUSE 90

***Customs and Excise: Amendment of section 1 of the Customs and Excise Act, 1964***

See notes on **CUSTOMS AND EXCISE DEFINITIONS.**

CLAUSE 91

***Customs and Excise: Amendment of section 44 of the Customs and Excise Act, 1964***

*Subclause (1)(a):* This amendment is made as a consequence of the changes to the definitions of “customs duty” and “excise duty” in section 1. This will only come into operation on a date to be fixed by the President by proclamation in the *Gazette*.



*Sub-clause (1)(b):* The subsection presently relates to the liability for duty and proof of due entry where goods are brought into the Republic from a country with which an agreement has been concluded under section 51. Customs union agreements are now concluded under section 49 and the amendment to the subsection is accordingly proposed. The reference to fuel levy goods is deleted in view of the amendment to subsection 1(3). This shall come into operation on the date of promulgation of this Act.

#### CLAUSE 92

#### ***Customs and Excise: Amendment of section 47B of the Customs and Excise Act, 1964***

The commercial cargo clearing facility at the proposed Lembobo-Ressano Garcia one stop border will be situated within the territory of Mozambique. The amendment of section 10(2) by inclusion of a reference to section 50A will allow goods to be deemed imported into the Republic although still in the territory of Mozambique.

#### CLAUSE 93

#### ***Customs and Excise: Amendment of section 65 of the Customs and Excise Act, 1964***

*Sub-clauses (1)(c) to (f):* Section 65(4) and (5) is amended for the same reason as section 47(9). This shall come into operation on the date of promulgation of this Act.

*Sub-clauses (1)(a) and (b) and (g):* These amendments to the heading of section 65 and to subsections (3) and (7) are consequential to the changes made to the definitions of “customs duty” and “excise duty” in section 1. This shall come into operation on a date to be fixed by the President by proclamation in the *Gazette*.

*Sub-clauses (1)(h) and (i):* The amendment to subsection (8)(a) arises from the classification of the duty payable in terms of section A of Part 2 of Schedule No. 1 as excise duty. The reference to item 412.18 of Schedule No. 4 is deleted as the item has been deleted in that Schedule. Subsection (8)(b) specifically relates to matters concerning item 412.18 of Schedule No. 4 and is deleted as a consequence thereof. This shall come into operation on a date to be fixed by the President by proclamation in the *Gazette*.

#### CLAUSE 94

***Customs and Excise: Amendment of section 69 of the Customs and Excise Act, 1964***

*Sub-clauses (1)(a) to (d):* The proposed amendments are effected as a consequence to the changes to the definitions to “customs duty” and “excise duty” in section 1. This shall come into operation on a date to be fixed by the President by proclamation in the *Gazette*.

*Sub-clauses (e) to (h)* are amended for the same reason as section 47(9) and will come into operation on the date of promulgation of this Act.

#### CLAUSE 95

***Customs and Excise: Amendment of section 75 of the Customs and Excise Act, 1964***

*Sub-clause (1)(a) –* Amendments are made to section 75(1)(a) to (d) as a result of the classification of duty levied on imported goods under Section A and Section B of Schedule No. 2 as reflected in the amended definitions of “customs duty” and “excise duty”. This shall come into operation on a date to be fixed by the President by proclamation in the *Gazette*.

*Sub-clause (b) to (o) –* Amendments are made to take out references to Schedule No. 5 as no provision was made in any item of Schedule No. 5 for refunds (on imported distillate fuel) similar to those specified in item 670.04 for locally-produced fuel and to rectify references to the correct items of Schedule No. 6. This shall come into operation on the date of promulgation of this Act, except for sub-clause (1)(k) that is deemed to have come into operation on 1 April 2006.

#### CLAUSE 96

***Customs and Excise: Amendment of section 92 of the Customs and Excise Act, 1964***

Section 92(1) is amended to achieve uniformity with sections 105 and 114. In the past, fines were collected by the Department of Justice and paid over to the Controller, but this practice is no longer followed and the reference to “fine” is therefore deleted as fines are not recovered under the provisions of the Customs and Excise Act, 1964. The proviso is also deleted as awards are no longer paid from such monies. “Fine” would otherwise also have been deleted for the same reason as in the substantive portion.

CLAUSE 97

***Customs and Excise: Amendment of section 94 of the Customs and Excise Act, 1964***

Section 94(a) is amended to achieve uniformity with sections 105 and 114. In the past, fines were collected by the Department of Justice and paid over to the Controller, but this practice is no longer followed and the reference to “fine” is therefore deleted as fines are not recovered under the provisions of the Customs and Excise Act, 1964.

CLAUSE 98

***Customs and Excise: Amendment of section 114 of the Customs and Excise Act, 1964***

Section 114 is amended to achieve uniformity with section 105. In the past, fines were collected by the Department of Justice and paid over to the Controller, but this practice is no longer followed and the reference to “fine” is therefore deleted as fines are not recovered under the provisions of the Customs and Excise Act, 1964.

CLAUSE 99

***Stamp Duties: Amendment of section 7 of the Stamp Duties Act, 1968***

The proposed amendment seeks to delete all provisions relating to marketable securities as those provisions will be catered for in the Securities Transfer Tax Act, which will come into effect on 1 July 2008.

CLAUSE 100

***Stamp Duties: Amendment of section 8 of the Stamp Duties Act, 1968***

The proposed amendment seeks to delete all provisions relating to marketable securities as those provisions will be catered for in the Securities Transfer Tax Act, which will come into effect on 1 July 2008.

CLAUSE 101

***Stamp Duties: Amendment of section 23 of the Stamp Duties Act, 1968***

The proposed amendment seeks to delete all provisions relating to marketable securities as those provisions will be catered for in the Securities Transfer Tax Act, which will come into effect on 1 July 2008.

## CLAUSE 102

### ***Stamp Duties: Amendment of section 28C of the Stamp Duties Act, 1968***

The proposed amendment seeks to delete all provisions relating to marketable securities as those provisions will be catered for in the Securities Transfer Tax Act, which will come into effect on 1 July 2008.

## CLAUSE 103

### ***Stamp Duties: Amendment of item 15 of Schedule 1 to the Stamp Duties Act, 1968***

*Subclause (1)(a)*: The proposed amendment is consequential upon the proposed amendment in clause 53, which proposes the substitution for the expression 'company formation transaction' of the expression 'asset-for-share transaction'.

*Subclause (1)(b)*: The proposed amendment seeks to delete all provisions relating to marketable securities as those provisions will be catered for in the Securities Transfer Tax Act, which will come into effect on 1 July 2008.

## CLAUSE 104

### ***Value-Added Tax: Amendment of section 1 of the Value-Added Tax Act, 1991***

*Subclauses(1)(a) and (b)*: Presently, the Export Incentive Scheme in Regulation GN 2761 regulates indirect exports as contemplated in paragraph (d) to the definition of "exported" in section 1 of the VAT Act. It is proposed that the requirements, which have to be met in order for the direct and indirect export of goods to fall within the definition of exported, be prescribed by Regulation. The proposed amendment will come into operation on a date fixed by the President by proclamation in the *Gazette*.

*Subclause(1)(c)*: The reason for allowing a 'notional input tax' deduction to a vendor acquiring second-hand goods from non-vendors (including vendors who were denied input tax on acquisition of these goods) is to "unblock" the VAT which the non-vendor paid and could not claim as input tax on acquisition of the goods.

It is proposed that second-hand goods sold by a person/ diplomatic/consular mission, as contemplated in section 68 of the VAT Act, to vendors should not result in a vendor being entitled to claim a notional input tax where such person/diplomat/consular mission was entitled to a VAT refund as contemplated in section 68 of the VAT Act. This is due to the fact that no element of VAT is actually borne or trapped in the hands of the person/diplomatic/consular mission.

Accordingly, the price charged by a foreign diplomat or consular mission to a second-hand dealer will not include any element of VAT.

The definition of 'resident of the Republic' in section 1 of the VAT Act, means a 'resident' as defined in the Income Tax Act, 1962 (Act No. 58 of 1962) ('IT Act') and in most cases, foreign diplomats or consular missions do not fall within the definition of 'resident' in section 1 of the IT Act, as they are either specifically or implicitly excluded where the Government of the Republic and the foreign diplomat's country have entered into an agreement for the avoidance of double taxation. However, a foreign diplomat could potentially fall within the definition of 'resident' in the IT Act on the basis of the 'physical presence' test. Accordingly, the proposed amendment also ensures that the defined term 'resident' used within the definition of 'input tax' effectively excludes foreign diplomats or consular missions.

#### CLAUSE 105

##### ***Value-Added Tax: Amendment of section 11 of the Value-Added Tax Act, 1991***

*Subclauses (1)(a),(b), (c) and (d):* The amendment is consequential upon the amendment to the definition of "exported" in section 1 of the VAT Act. The proposed amendment will come into operation on a date fixed by the President by proclamation in the *Gazette*.

#### CLAUSE 106

##### ***Value-Added Tax: Amendment of section 16 of the Value-Added Tax Act, 1991***

The proposed amendment to proviso (i)(ee) prescribes the calculation of the five year on any deduction not previously claimed. In calculating the five year prescription period for claiming deductions, regard must not be had to the prescribed documentary requirements. For example: winnings as contemplated in section 16(3)(d) are paid in tax period 1. The vendor does, however, not yet have the prescribed documents to substantiate the deduction. In tax period 2 the vendor is in possession of the prescribed documents. The five year prescription period is calculated from the end of tax period 1.

The proposed insertion of proviso (ii) in section 16(3) of the VAT Act is intended to clarify that any subsequent deduction of input tax or any other deduction which was not previously claimed by a vendor and such deduction was not deductible in terms of a practice generally prevailing prior to that deduction, that such deduction is limited to six months prior to the tax period in which the deduction is made. The proposed amendment aligns the proviso in Section 16(3) to the

proviso in section 44(3)(a) of the VAT Act which was intended to cater for the limitation of the deduction of input tax or any other deduction.

The calculation of the six month period can be illustrated as follows: a vendor intends to claim input tax in the November 2007 tax period (i.e. a Category B tax period), on supplies which were not previously claimed. However, it was a practice generally prevailing that input tax on such supplies was not deductible. Accordingly, the vendor is entitled to claim input tax on all supplies for a period of six months prior to the November 2007 tax period. Therefore, the vendor can deduct input tax on all supplies that were incurred during the tax period ending June 2007. The vendor, being registered on Category B, would be entitled to claim input tax on all supplies incurred in the May and June 2007 tax period.

#### CLAUSE 107

##### ***Value-Added Tax: Amendment of Schedule 1 of the Value-Added Tax Act, 1991***

The proposed amendment will entitle vendors to import goods used or consumed for agricultural, pastoral or other farming purposes to be exempt from value-added tax on the importation of those goods, subject to the provisions of paragraph 2 of Part A of Schedule 2 to the VAT Act.

#### CLAUSE 108

##### ***Value-Added Tax: Amendment of Schedule 2 of the Value-Added Tax Act, 1991***

The local supply of dried maize for human consumption and animal feed is currently zero-rated in terms of 11(1)(g) and 11(1)(j) of the VAT Act and the importation of dried maize for human consumption is exempt from VAT in terms of paragraph 7 of Schedule 1 to the VAT Act. It follows that the purpose for which the maize is to be used ultimately determines the VAT treatment. This however creates a problem when one is unsure as to what the use of the maize will, be at the time of purchase or importation as this will determine the rate of VAT to be imposed. To overcome the problem of the VAT treatment being dependent on the intended use of the dried maize, an amendment is proposed to zero rate the supply of dried maize locally and provide for an exemption of VAT on importation of dried maize into the Republic.

CLAUSE 109

***Uncertificated Securities Tax: Amendment of section 6 of the Uncertificated Securities Tax Act, 1998***

This amendment is consequential upon the renaming in the Income Tax Act of a company formation transaction to an asset-for-share transaction and the repeal of section 43 of that Act. (Share-for-share transactions).

CLAUSE 110

***Collective Investment Schemes: Amendment of section 99 of the Collective Investment Schemes Control Act, 2002***

The proposed amendment seeks to delete the provisions which grant an exemption from the payment of transfer duty and stamp duty in respect of any endorsement or entry made in terms of section 99(5) of the Collective Investment Schemes Control Act and in respect of the issue of a substituting participatory interest or the transfer of assets as a result of any amalgamation, cession, transfer or take-over by the scheme or portfolio in terms of that section. The company reorganization rules in the Income Tax Act, 1962 will be amended to provide an exemption for such transactions.

CLAUSE 111

***Income Tax: Amendment of section 3 of the Revenue Laws Amendment Act, 2006***

*Subclause (1)(a)*: The proposed amendment is consequential to the amendment in subclause (1)(b).

*Subclause (1)(b)*: The Revenue Laws Amendment Act, 2006, amended the definition of Republic in section 1 of the Income Tax Act, 1962, so as to expand the territorial seas of South Africa. The amendment rendered certain persons who carry on fishing activities within the new territorial seas as residents of the Republic and thus subject to tax in terms of the Income Tax Act. This was an unintended consequence of the said amendment, which was intended to apply mainly for purposes of the taxation of oil and gas companies in terms of the Tenth Schedule to that Act. The proposed amendment will postpone the effective date of this definition for purposes of all provisions of the Income Tax Act to 1 March 2008, except the taxation of oil and gas companies in terms of the Tenth Schedule to that Act. In the latter case the effective date remains 2 November 2006.

CLAUSE 112

***Income Tax: Repeal of Schedule 3 to the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006***

*Subclause (1):* Schedule 3 to the abovementioned Act related to the taxation of oil and gas companies. The proposed provision repeals this Schedule as the taxation of oil and gas companies is now regulated by the Tenth schedule to the Income Tax Act.

CLAUSE 113

***Income Tax: Amendment of section 3 of the Taxation Laws Amendment Act, 2007***

The Taxation Laws Amendment Act, 2007, amended the definition of 'pension fund' and 'retirement annuity fund' in section 1 of the Income Tax Act. The amendment provided for rules that the relevant fund must adopt to determine the circumstances under which a member of the relevant fund may commute the whole of any annuity payable by the fund for a lump sum. The amendments were effective for years of assessment ending on or after 1 January 2008. For administrative reasons the proposed amendment will provide that the said amendments will come into effect on 1 October 2007 and apply in respect of any lump sum benefit accrued on or after that date.

CLAUSE 114

***Income Tax: Amendment of section 15 of the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.

CLAUSE 115

***Income Tax: Amendment of section 54 of the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.



CLAUSE 116

***Income Tax: Amendment of section 56 of the Taxation Laws Amendment Act, 2007***

See notes on **RETIREMENT FUND ISSUES**.

CLAUSE 117

***Income Tax: Amendment of section 64 of the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.

CLAUSE 118

***Income Tax: Amendment of section 67 of the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.

CLAUSE 119

***FIFA World Cup 2010: Amendment of section 112 of the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.

CLAUSE 120

***Diamonds Act: Amendment of section 115 of the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.

CLAUSE 121

***Income Tax: Amendment of paragraph 4 of Appendix I to the Taxation Laws Amendment Act, 2007***

This proposed amendment effects a correction to a cross reference.

CLAUSE 122

***Diamonds Act: Amendment of paragraph 1 of Appendix III to the Taxation Laws Amendment Act, 2007***

*Subclause (1):* This proposed amendment effects a correction to a cross reference.

CLAUSE 123

***Diamonds Act: Insertion of paragraph 1A into Appendix III to the taxation Laws Amendment Act, 2007***

The proposed amendment effects a technical correction.

CLAUSE 124

***Value-Added Tax: Special zero-rating in respect of goods or services supplied by 2007 ICC 20 20 WC (South Africa)***

The payments made by the ICC to the 2007 ICC 20 20 WC (South Africa) in respect of a supply of goods or services by ICC 20 20 WC (South Africa) to the ICC for purposes of staging the ICC's 2007 Twenty 20 over World Championship will be subject to VAT at the rate of zero percent.

CLAUSE 125

***Income Tax: Special rules relating to amalgamation of professional and amateur sporting bodies***

See note on **AMALGAMATION OF SPORTING BODIES**.

CLAUSE 126

***Short title and commencement:***

This clause provides for the name of the Act and the commencement date thereof.