



**NATIONAL
TREASURY**



Office
Commissioner

Enquiries
J J Louw

Telephone
012 422 5155

Facsimile
012 422 5195

Room

Reference

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**THE CHAIRPERSONS OF THE
PORTFOLIO COMMITTEE ON FINANCE
(PCOF) AND THE SELECT COMMITTEE
ON FINANCE (SCOF)**

South African Revenue Service
299 Bronkhorst Street,
Nieuw Muckleneuk, Pretoria
P O Box 402, Pretoria, 0001
SOUTH AFRICA
E-mail jdelarey@sars.gov.za

**RESPONSES TO WRITTEN REPRESENTATIONS BY ORGANISATIONS
TO THE PORTFOLIO COMMITTEE ON FINANCE AND SELECT
COMMITTEE ON FINANCE ON THE TAXATION LAWS AMENDMENT
BILL, 2005 (the Bill)**

1 Introduction

As indicated to you during the hearings on the above-mentioned Bill on 31 May 2005, National Treasury and SARS wish to respond as follows to the various points raised by commentators in their submissions on the Bill.

Abbreviations used in this document:

BASA	Banking Association of South Africa
BUSA	Business Unity South Africa
CHAMSA	Chambers of Commerce and Industry South Africa
ICPA	Institute of Certified Public Accountants
KPMG	KPMG

2 Consultation

SARS and the National Treasury placed the draft legislation as well as the draft explanatory memorandum on their websites on 13 March 2005. After public comments were considered and incorporated where possible, updated versions of the Bill and explanatory memorandum were submitted to your committees on 10 May 2005 and again placed on the SARS and National Treasury websites. This, therefore, happened 13 working days before the informal briefing on the draft Bill on 27 May 2005.

3 Responses to specific issues raised in representations by commentators to the Parliamentary Finance Committees

3.1 *Transfer Duty – rate structure*

The proportionate increase in the upper limits of the 5% category is relatively low, leading to the proportionately higher absorption of duty on properties with values in excess of R330 000. Current property prices indicate that this value no longer represents the high range of residential property prices. It is believed that a culture of home ownership should be encouraged and therefore suggest that consideration be given to increasing the ceiling on the lower rate.

(BASA)

The purchase of real property is subject to transfer duty on a graduated rate basis whereby natural persons in terms of the 2005 Tax Proposals are exempted from the transfer duty liability for properties with values not exceeding R190 000, or alternatively, the first R190 000 of a property transaction is not subject to any transfer duty. Irrespective of the fact that the property market experienced phenomenal buoyancy during the last few years, affordability constraints only permitted Government to increase the second threshold from the R320 000 to the new R330 000 with effect from 1 March 2005. Government however remains committed to stimulate home ownership in the years to come. Needless to say, the best way of achieving broad home ownership is to reduce the unemployment

rate so that more natural persons are put into a position to acquire through the market their own homes and do not depend on Government handouts. Employment creation initiatives will require significant fiscal resources – both on the expenditure side of the budget but also by way of tax expenditures – and the Committee will appreciate that the National Treasury is facing in this instance a delicate policy trade-off. Hence, we envisage a gradual increase of the thresholds with the clear policy intent of primarily stimulating first time home ownership.

3.2 *Tax rate applicable to individual policyholder funds of Long-term Insurance companies*

Request that the taxation on income derived from individual policyholder funds of long-term insurers be reviewed. The rate of 30% will now be higher than the company tax rate and substantially higher than the average rate applicable to individual taxpayers. The harmonisation of tax rates between institutions and individuals in the current environment is believed to be a prerequisite in the deliberations of National Treasury's discussion paper on Retirement Fund Reform.

(BASA)

This comment is not accepted. As the policyholder funds of insurers are taxed according to the trustee principle, there is no reason to harmonise the tax rates. Prior to the reduction in corporate tax rates in 1999 there was a 5 percentage point differential between the rates applying to the company policyholder fund and the individual policyholder fund. At the time the tax rate on individual policyholder funds was not increased to match the company policyholder fund rate. Currently there is still a 10 per cent differential between the maximum marginal rate applicable to individuals and the tax rate applied to the individual policyholder funds of insurers. No change in the maximum marginal tax rate for individuals has been announced in this year's Budget.

It is important to note that the 30% policyholder fund rate was informed by the average individual tax rate. Given the dynamic nature of the taxpayer distribution, further quantitative work is needed to establish the weighted average individual income tax rate.

The long run policy goal is to create more neutrality in the tax treatment on the returns of capital invested by individuals. Clearly, from a tax policy perspective one would like to strive for equity and neutrality in order to create an environment conducive to retirement savings with the maximum utilization of competitive market forces that tend to reduce transaction costs in the long-term savings market, with commensurate higher investment returns for individual policyholders. In conclusion, this matter has been noted but no rate adjustment can

be contemplated at this stage, as this would preempt the recommendations of the retirement fund tax review.

3.3 *Accelerated capital allowances - section 11 of the Income Tax Act*

Enhancing allowances for small businesses will certainly stimulate growth, but access to leasing finance is limited through the ring-fencing effects of section 23A. Much of the desired stimulus of enhanced capital allowances will be lost through the limitations of section 23A. This is particularly true where small businesses finance productive plant and equipment through leasing. Benefits may be lost if the intended beneficiaries are unable to make use of the allowances, because they have no taxable income at the time that the allowance is available. Banks have a role in passing the benefits to small businesses.

(BASA)

Accelerated depreciation of assets was introduced as one of the measures for promoting small businesses. The purpose of this was to alleviate the financial burden on small businesses by reducing tax payable in the tax year in which they acquired the assets.

As the Banking Association rightly points out, small businesses may not have the cash to acquire these assets or to benefit from the tax allowance, as they are not in a taxable income position during their start-up period. Hence they enter into lease financing transactions with banks in order to acquire the assets. As a result, the bank as the owner of the asset is entitled to claim depreciation allowance in respect of the assets. However, such depreciation allowance is limited to the rental income received in respect of the assets. The request to relax the ring-fencing provision in order to allow banks to expand their leasing business so as to stimulate growth in the economy does not form part of this Bill. In addition, the limitations imposed by the ring-fencing provision cannot be said to constitute a negative effect on small businesses as small businesses are allowed to claim as a deduction against taxable income lease payments on the leased assets.

SARS will provide additional clarity in terms of the existing uncertainties stemming from the banking industry's interpretation of section 23A. However, given the serious tax avoidance opportunities available to the banking industry in terms of financial lease arrangements, the National Treasury and SARS will not entertain at this stage any relaxation of the ring fence provisions that seek to limit the annual capital allowances to the annual rental income from leasing. The existing anti-avoidance provisions stem from the concerns regarding the banking industry's low effective tax rate. Further international review will be undertaken if emerging market economies have found alternative ways to stimulate the small

business sector by incentivising through the tax system access to cheap finance or mitigating the liquidity crunch experienced by small businesses during their start-up phase.

In addition, it is important to note that the Banking Association's concerns are not addressing the problem of ongoing capital deepening, which is incentivised through capital allowances. In contrast, what the country really needs are fiscal stimulus measures in support of labour-intensive manufacturing processes. The so-called tax credit account facility could be utilised, if found to be acceptable.

In most instances, the bank is the owner, but not the operator of the asset. If an interpretation is made that the bank, as owner, but not the operator, may not claim allowances, the consequences would be very severe. It is, therefore suggested that the words "acquired by the taxpayer" be followed by "or a lessor, as envisaged under section 12B and 12C..."

(BASA)

The view is held that banks as lessors of assets would meet the requirements of acquiring an asset and using it in their leasing business and would be able to claim wear and tear allowances. An amendment to achieve this result is not deemed to be necessary.

3.4 *Small business corporations – section 12E of the Income Tax Act*

Providers of personal services, excluding personal service companies, are now also allowed tax concessions. However, the prerequisite requirement of at least four non-connected employees, employed on a full-time basis throughout the year of assessment, would exclude most newly established incorporated small businesses and many established small businesses. It is recommended that this provision be amended to rather read – other than personal service companies as contemplated and defined in paragraph 1 of the Fourth Schedule to the Income Tax Act. We believe that this would have a more desirable effect when you consider the intentions of the concession and the extension of the concession to now include 'personal service'.

(ICPA)

The pre-requisite of at least four non-connected employees employed on a full time basis throughout the year is the limitation introduced with the expansion of the small business corporation regime to include small businesses engaged in personal services. The four- employee requirement only applies to those businesses engaged in personal services listed in the Income Tax Act. Small businesses providing personal services not listed in the Act are not required to employ four people in order to be eligible for benefits. Thus companies that provide a number of personal services, e.g. electricians, tourism

operators and plumbers, may already qualify for small business corporation status.

The four-employee test was introduced to ensure that the incentive benefits those businesses engaged in listed personal service activities that stimulate economic growth by providing employment. In addition, this is an anti-avoidance measure aimed at listed personal services as practice has shown that professionals such accountants and lawyers simply avoid PAYE liability by not offering their service as individuals but rather opting to incorporate. Hence, the expansion of the SBC regime is conditional on employment creation and demonstration that the company is not merely a shell for an individual.

Anti-avoidance measures targeted at personal services rendered through incorporated entities are also present in the Australian, Canadian and United Kingdom tax systems. In the case of Australia and the United Kingdom, no exclusion applies where the incorporated entity providing personal services employs a number of persons. In Canada, however, an exclusion applies where the incorporated entity employs six or more full-time employees.

3.5 *Incurral of interest - section 24J of the Income Tax Act*

The use of the wording that such amounts must be taken into account as amounts “receivable by that issuer” is cumbersome. It is suggested that any payments to connected parties be taken into account as amounts in “reduction of amounts payable” by that issuer.

(BASA)

This comment is accepted.

Confusion surrounds the recent amendments to section 24J. The amendments seek to address the tax avoidance inherent in the convertible debenture schemes. The impact of the amendment should be neutral and not punitive. It is proposed that section 24J should be amended to give a logically correct and neutral result and that convertible loan schemes be dealt with in terms of their substance. The amendment to section 24J should not be retroactive.

(BUSBA)

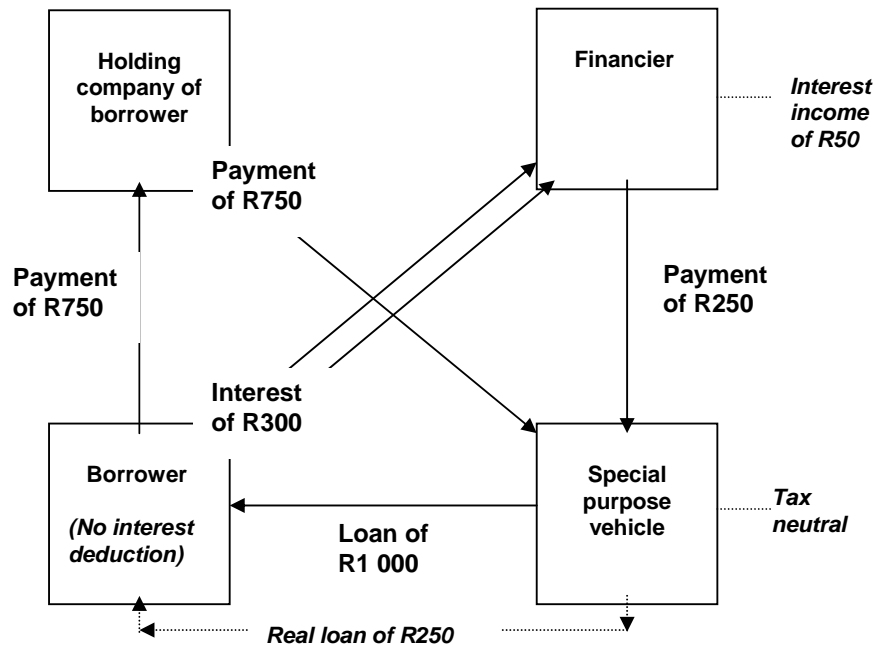
This comment is not accepted.

Section 24J was introduced in 1995 to regulate the timing of interest on interest-bearing arrangements for both the borrower and the lender to these arrangements. In essence a yield to maturity rate is determined based on all the cash flows (inflows and outflows) during

the term of the arrangement from both the perspective of the lender or the borrower. The calculated rate is applied to the funding provided on a compounding basis over the term of the arrangement, taking into account all actual cash flows.

Schemes were identified which are based on the circular flow of funds through a number of related and unrelated companies. In essence the scheme works on the basis that a tax benefit is generated in the hands of the borrower by artificially inflating the amount borrowed. In this way the borrower obtains a tax deduction equal to the interest and capital of the actual financing needs of the borrower. A key element of the scheme is the presence of a compulsory convertible loan. The circular flow of funds occurs on the first day of the arrangement.

Example 1 (Based on BUSA's fact pattern)



Note: The repayment of the loan capital of R1 000 is converted to shares in the borrower at the end of the term of the loan to be ultimately held by the holding company of the borrower.

The BUSA example represents a particularly aggressive scheme where the interest deduction has been increased six-fold, from an interest expense of R50 on a real loan to an inflated interest expense of R300. For these aggressive schemes the limitation of the interest to zero acts as a penalty provision. Where the abuse is less pronounced the interest deduction is limited to a lesser amount.

It is a fact that these financing arrangements have been entered into in this intricate manner in order to benefit from the perceived tax benefits

attributable thereto. There is no commercial justification for inflating the value of the loan other than the tax saving. From a tax policy point of view there is no sympathy for these schemes and it was decided to adjust the tax treatment thereof to discourage taxpayers from entering into similar schemes from 1 January 2005.

Two amendments were introduced last year to section 24J to neutralise these schemes. **Firstly**, the funding on which the borrower's interest is to be determined for tax purposes is limited. In the above scheme the funding would be limited to R250. The R250 represents the real economic value of the loan (R1 000 less R750 circular payment). **Secondly** and in conjunction with that limitation to restrict excessive interest claimable by the borrower, the yield to maturity rate to be applied to the financing is to be determined by taking into account the cash flows to the borrower (R1 000) and by the borrower (R1 300) as well as the cash flow from the connected person (R750).

It is now argued that the provisions providing for the calculation of the yield to maturity rate in the case of the abovementioned scheme is subject to an interpretation which results in an increase instead of the required decrease in the rate.

	<u>SARS interpretation</u>	<u>Alternative interpretation</u>
Payments	1 300	2 050
Receipts	<u>1 750</u>	<u>1 000</u>
Net	(450)	1 050

The limitation of the interest deduction is influenced by the percentage of the total financing obtained by the borrower that relates to the circular flow of funds as well as the duration of the loan.

Example 2

Taxpayer borrows R1 000 at a rate of 10 per cent per annum for a period of 5 years.

% of loan used in circular flow	Total interest generated by scheme	Interest on real loan	Interest allowed to section 24J
5 (i.e. R50)	500	475	398
10 (i.e. R100)	500	450	313
25 (i.e. R250)	500	375	132
50 (i.e. R500)	500	250	0

Example 3

Borrower loans R1 000 at a rate of 10 per cent per annum and R200 is applied in the circular flow of funds

Term of loan	Total interest generated by scheme	Interest on real loan	Interest allowed to section 24J
5	500	400	181
10	1 000	800	468
15	1 500	1 200	716

In order to clarify the provisions of section 24J, but to discourage taxpayers from entering into these abusive agreements, the payments made by a borrower or connected person directly or indirectly to the financier constituting a circular flow of funds, are to be taken into account in a manner to reduce the net cash flow from the perspective of the borrower. The yield to maturity rate used to determine the interest incurred by the borrower would then also be reduced.

Circular flows of funds will be covered more broadly in the proposed review of the general anti-avoidance rules which will be dealt with later in the year.

It is proposed that the effective date of the amendment to the definition of yield to maturity not be retroactive and that it should come into operation on the date of tabling of the Bill and apply in respect of any instrument issued, acquired or transferred on or after that date.

3.6 *Adjustments to deduction of business expenses against motor vehicle allowances*

Motor vehicle allowance adjustments increase effective tax burden on high income earners (CHAMSA)

South Africa subscribes to a progressive income tax system, which seeks to enhance fairness by fully internalizing the horizontal and vertical equity principles. Hence, income earners with high income (including the monetary value of the fringe benefit of motor vehicle use) must pay progressively more tax than low-income earners as they have a greater ability to pay. This informed the motor vehicle allowance adjustments, as a tax system should never be used to incentivise conspicuous consumption. Put differently, should the income tax system incentivise more the use of a car valued at R700 000 than a vehicle with a value of R150 000? Kindly refer to the economic impact discussion provided for the KPMG comments. The argument that higher tax burdens on high income earners will reduce savings are not supported by empirical analysis and one can argue that the higher exemption levels for interest income earned on

domestic portfolio investment increasingly provide significant incentives in support of the propensity to save.

3.7 *Taxation on the fringe benefit value of employer provided vehicles*

KPMG on behalf of some of the South African component and motor vehicle manufacturers makes a number of allegations that the 2005 Budget adjustments of the motor vehicle allowance will have adverse long-term economic and fiscal impacts:

- **Fiscus will lose total tax revenue from the motor industry (lower VAT as consumers buy down, lower company profit tax);**
- **Distortions between motor vehicle allowance and company car scheme;**
- **Divergence between the employee's benefit stemming from the motor vehicle use vis-à-vis the fringe benefit tax cost; and**
- **The economic 'knock on' effect on affected motor vehicle / components manufacturers in terms of overall profitability and employment.**

(KPMG)

National Treasury wishes to comment on the macroeconomic and distributional impacts of the instant fringe benefits tax adjustments. The proposed amendments have become necessary in order to preserve the vertical equity that is an inherent element of our income tax system. The motor vehicle allowance and company car schemes tend to provide disproportional additional tax benefits to higher income individuals. It is also important to look at the combination of fiscal measures that impact on the motor vehicle industry in South Africa, i.e., the provisions which grants substantial tax benefits to individuals who qualify for motor vehicle allowances or have access to a company car for private use and the MIDP which supports the development of the motor industry in the form of import duty credits.

2004 was an exceptional year for the SA automotive industry – one of the best since the mid 1980s. The robust growth in domestic vehicle sales during the past eighteen months can be attributed to lower interest rates, higher disposable income of consumers (in part thanks to significant real personal income tax relief) and the stronger Rand that helped contained price increases.

In comparing the motor industry's performance and growth statistics in 1995 vis-à-vis 2003, it is clear that major structural changes have occurred:

- Imports 1995 - 22 305 passenger car units
 - Imports 2003 - 81 919 passenger car units, an increase of 267%
-

- Local sales 1995: 233 512 passenger car units
 - Local sales 2003: 176 349 passenger car units, decline of 24%
-

- Exports in 1995: 8 976 passenger car units
- Exports in 2003: 114 909 passenger car units, increase by 1 180%

Hence, domestic production, thanks to the MIDP, switched towards exports and imported cars make up a larger percentage of domestic sales.

In 2003, the average retail-selling price, excluding VAT, for domestically produced cars was R138 033 and more than 80% of domestically produced cars were sold for less than R200 000. In the case on imported cars the average retail-selling price was R290 390 and 30% sold for more than R350 000.

An econometric analysis of the local passenger car market suggests that:

- Disposable personal income of consumers is the major determinant in the quantity demanded for new passenger cars;
- Interest rates impact on the affordability of the monthly repayments of cars purchased on installment credit and thus influence quantity demanded in an inverse relationship; and
- Price changes lead to insignificant changes in the quantity demanded (the demand for new passenger vehicle tends to be relatively price inelastic).

With the view to establish the value of the motor vehicle allowance's tax expenditure, preliminary calculations indicate that the—

- The deemed method for claiming business cost / kilometers is estimated to be R13 billion with an estimated tax expenditure value of R4 billion;
- There were approximately 458 000 taxpayers claiming deemed business cost / kilometers, which constitutes 11% of total personal income taxpayers; and
- Sixty per cent of taxpayers claiming 70% deemed business cost have taxable income in excess of R120 000.

In essence the current amendments attempt to achieve three objectives:

- To curb the implicit tax subsidies that accrues to certain taxpayers in relation to their private transport expenses. This is an important equity consideration. It should be noted that where an individual chooses to maintain a logbook of business kilometers traveled this aspect of the proposal will have no negative impact on such an individual;
- Limit the tax subsidies that accrue to individuals with a taste for more expensive vehicles. In a free society an individual may choose how to use his or her money as he or she deems fit. However, the tax system should not unduly encourage or incentivise particular expensive tastes; and
- The inclusion of a residual value in calculating the annual fixed cost of a vehicle is merely an acknowledgment that vehicles do have a significant residual value after a period of five years.

An initial analysis of the economic impact of reducing, over a period of three years, the deemed business cost against a motor vehicle allowance, by adjusting the residual value to 20% (less strict, than the currently suggested 30% residual value), with a fixed cost capped for cars with a value above R300 000 (much harsher than in the current suggested dispensation) and with the tax calculation adjustment of maintenance and fuel costs in accordance with the latest AA values translate into the following outcomes:

- Demand for new and used cars will decline by 0.3% (i.e., 560 locally produced new cars and 260 used cars)
- Prices of new cars will decline by 0.05% (negligible) and loss in revenue for producers is even more negligible at 0.001%.

In the absence of some verifiable quantitative economic analysis conducted by KPMG on behalf of its clients, Government remains skeptical about the assertions of substantial adverse economic impact for the industry of the proposed amendments. This must be read together with the tax expenditures incurred in respect of the MIDP that translate into significant fiscal support to the industry.

KPMG overstates the employment effect, as employment levels in the motor manufacturing sector have been relatively static since 1995.

The predicted revenue loss for Government as consumers purchase down on vehicles is poorly understood, because if consumers purchase down on vehicles, thereby generating a tax saving for themselves, income is freed up for discretionary savings that would be available for investment purposes. Alternatively, it could be diverted into other purchasing decisions, which again would attract VAT. Consequently, the negative fiscal impact suggested by KPMG may not materialise or will be less dramatic.

The fact that higher priced cars attract a higher *ad valorem* excise charge is not discriminatory as governments throughout the world exercise the choice of imposing taxes on the ability to pay principle. This translates into progressive rate structures on income and in some instance on certain consumption expenditures. Some countries with differentiated VAT rates impose higher VAT rates on “non-essential” products such as luxury vehicles. In the case of South Africa, higher *ad valorem* excises could be viewed as a substitute for higher VAT rates as is the practice in other jurisdictions. Again, the alleged negative economic impact of the existing graduated *ad valorem* excise rate structure (no change was announced in the 2005 Budget) appears to be intuitive without disclosing any substantiating arguments.

4 General

The abolition of RSC levies is welcomed but what substitute revenue measures will fill the revenue void for lower sphere governments?

(BUSA)

Noted, and as having stated previously, the National Treasury is currently reviewing possible local government financing options that may include extension of revenue-sharing arrangement of centrally collected tax revenues, the devolution of own revenue instruments and a combination of the above.

Propose the introduction of discretion by the Commissioner in the imposition of penalties and sanction in the unintentional failure to report a reportable arrangement. It is believed that this proposal will create greater balance in the sanction options for failure to report and more certainty in the reporting process.

(BASA)

This matter does not form part of the Bill under consideration. The sanction for failure to report a reportable arrangement is a graduated one. All failures to report result in one of the criteria for applying the provisions of the general anti-avoidance provisions in section 103(1) being deemed to have been met. Where the failure is not willful or reckless and the taxpayer is able to show that the arrangement was entered into otherwise than "solely or mainly for the purposes of obtaining a tax benefit", this deeming provision has no tax effect.

On the other hand, where the failure to report is willful or reckless, additional tax equal to the tax benefit actually derived by way of the unreported arrangement is also levied, unless extenuating circumstances exist. The net effect of this provision is that, barring

extenuating circumstances, the willful or reckless failure to report negates any tax advantage derived by way of the unreported arrangement even if the arrangement was entered into otherwise than "solely or mainly for the purposes of obtaining a tax benefit."

Submission by the Chamber of Commerce and Industry South Africa (CHAMSA)

Most of the comments contained in the CHAMSA submission are statements in support of the 2005 tax proposals and do not specifically refer to the 2005 Draft Taxation Laws Amendment Bill. However, National Treasury wishes to comment as follows:

a. The draft Bill underscores the convoluted nature of the Income Tax Act

There is much to be said for the need of rewriting the Income Tax Act which suffers from inefficiencies such as archaic language use, poor structuring and numbering of provisions and cumbersome or illogical sequencing of the elements of an income tax system. If this were to be addressed it could simplify matters for taxpayers somewhat although today's complex financial transactions will necessitate complex tax law.

Any steps in this regard would have to be balanced against the views expressed by a number of commentators in previous years that substantial changes to the Income Tax Act should be limited for an extended period, so as to enable taxpayers and SARS to absorb the substantial changes that had already been introduced.

b. Tax base-broadening measures and business income tax relief for small businesses plus compliance burden reductions in terms of the VAT Act are welcomed

CHAMSA's support for Government's tax reforms over the last decade is welcomed.

c. More corporate income tax rate reductions *in lieu of* personal income tax relief

In support of stronger economic growth CHAMSA is of the opinion that more CIT rate reductions are needed – this is policy advice for 2006 and beyond and is duly noted but has no bearing on the 2005 Taxation Laws Amendment Bill.

d. Tax reform initiatives in support of economic growth and development are unequivocally supported

Noted.

e. Continued relaxation of foreign exchange controls can yield gains in economic performance

Not relevant for purposes of the 2005 Taxation Laws Amendment Bill.

f. Corporate income tax rate reduction welcomed

Noted.

g. Request to abolish STC as it impedes investment

No comment, this is not a matter covered in the Bill.

h. Tax relief provisions in support of BEE transactions and the empowerment of small business are supported

Further relief measures announced in the 2005 Budget will be addressed in the Revenue Laws Amendment Bill later in the year.

i. Expressed concerns for use of long-term loans to finance current government consumption expenditure (dis-saving by Government)

Not a tax policy matter.

j. A reduction in the tax rate at which retirement savings is taxed is warranted.

Comment is noted, but is not relevant for purposes of this Bill.

k. RSC levy reform should lay to rest efforts by local and provincial governments to raise taxes in contradiction of the National Policy Agenda of minimising the tax burden

Comment is noted, but is not relevant for purposes of this Bill.

Prepared by the National Treasury and SARS