Tax Alert

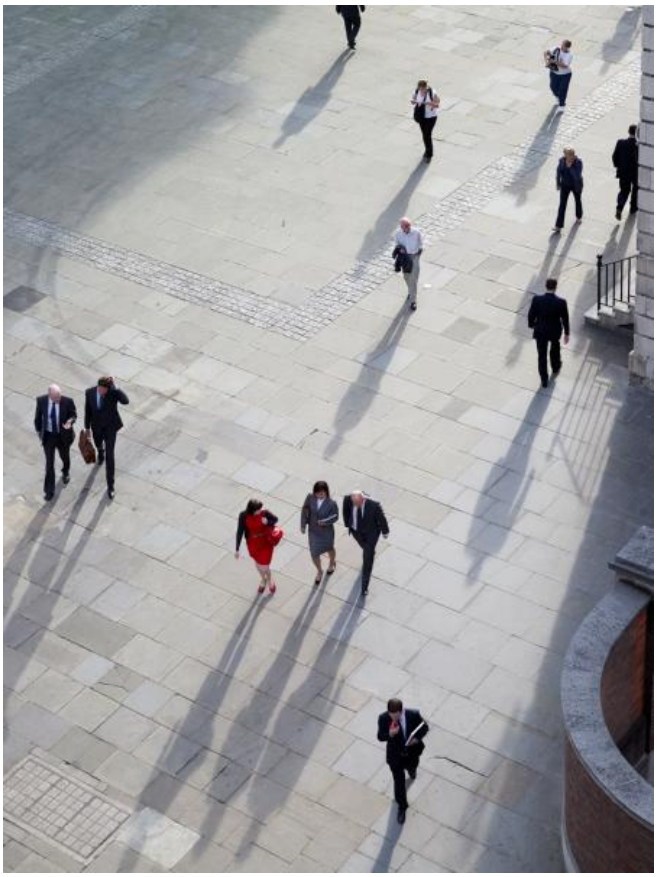
28 November 2011

2011 Tax Amendments

On 23 November 2011 Parliament's National Assembly approved the 2011 Taxation Laws Amendment Bills, after the Minister of Finance formally introduced the Bills on 25 October 2011.

Formal adoption by the National Council of Provinces and signature by the President is still required before the Bills become law.

We present below a summary of some of the main amendments contained in these two Bills, namely the Taxation Laws Amendments Bill and the Taxation Laws Second Amendment Bill.



EMPLOYMENT

Medical Expenditure

The conversion of medical deductions to tax credits is being phased in, with the first changes (from 1-Mar-12) affecting only the medical scheme contributions of under-65s. So the system for persons aged 65 and over remains entirely unchanged for now, and for under65s the position in respect of other medical expenses (i.e. other than medical scheme contributions) is also unchanged.

Also, the ambit of "dependent" is extended to include immediate family members who are not necessarily members of the taxpayer's medical scheme, if the taxpayer is liable for family care and support.

Dividends from employee share scheme shares

For employees holding equity shares that are "restricted equity instruments", the rules on dividend exemptions are more restricted in respect of so-called hybrid shares. On the other hand, the exemption rules are broadened to accommodate shares that are held via employee share trusts.

Employer-owned Insurance Policies

Following on from the attempt in 2010 to address perceived abuse of so-called "key person" insurance policies, the 2011 amendments contain a more comprehensive overhaul of employers' contributions to insurance policies where the insured person is an employee/director.

The four distinct areas addressed in the 2011 amendments are:

- the employer's deduction for the premium payments;

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- fringe benefit taxation (for the employee) in respect of the employer's premium payments;
- the taxation of the eventual insurance proceeds; and
- special rules for cessions of policies.

Other amendments

An additional exemption is inserted for pay-outs from the Road Accident fund. Commuting by judges between work and residence will in some cases be deemed to be business travel, thereby producing a more favourable transport regime for judges. The taxation of severance benefits will now become part of the retirement fund regime (after the announcement and preparatory amendments were made in 2010).

COMPANY DISTRIBUTIONS

Dividends & CTC (Contributed Tax Capital)

Two sets of amendments are made to these rules, with one set being backdated to 1-Jan-11, and the second taking effect on 1-Apr-12 (which is also the probable effective date for the STC-DT transition). The main amendments are that:

- the concepts of dividends and foreign dividends are to be separated, so that the term "dividend" will refer only to distributions from SA-resident companies.
- significantly, the wording of the dividend definition is to be extended/broadened, with a view to obviating the need for specific deemed/disguised dividend rules.
- the exclusion for share buy-backs by listed companies will be limited only to so-called general buy-backs. This means that private buy-backs by listed companies will be dividends, just like all buy-backs by unlisted companies.
- the CTC definition is tweaked to address anomalies.

Returns of Capital (RoC)

The new RoC concept replaces the previous "capital distribution". A RoC essentially means a company's transfer of CTC. The existing regime where the receipt of a RoC triggers a deemed part-disposal for the shareholder, will be terminated on 31-Mar-12. From 1-Apr-12, RoCs will simply reduce the base cost of the shareholder in the shareholder's hands (with the potential for an immediate capital gain in the case of negative base cost).

Foreign Dividends and Foreign Returns of Capital

The existing foreign dividend definition is amended slightly, and a new definition of foreign RoC is introduced. The primary considerations in these definitions are the classification under the tax law in the country where the foreign company is tax resident and the question of whether the distribution is tax-deductible in that foreign country.

A new set of exemption rules is introduced from 1-Apr-12. Some of the existing foreign dividend exemptions are retained, and some new concepts are introduced. Perhaps the three most notable changes are that:

- a general exemption formula is introduced so that foreign dividends (that are not fully exempt already) will only be taxed at a maximum effective tax rate of 10%;
- the existing participation exemption is retained, but the required equity participation threshold is reduced to 10% (from 20%); and
- a new "in-country" exemption is introduced, for dividends received by CFCs from local investments in their country of residence.

STC & Deemed Dividends

As a result of the unintended consequences created by deletion of some of the exemption rules in s64C, an attempt is made to re-instate certain exemptions.

Dividends Tax ("DT")

No formal confirmation of the DT effective date has been made as yet, although 1-Apr-12 is widely expected. Furthermore, several other amendments, refinements and additional rules are added:

The trigger event for the DT liability is set as the payment date (not accrual).

It is confirmed that in specie dividends will indeed be subject to DT. However, the DT liability will fall upon the declaring company (not the recipient shareholder) which makes DT on in specie dividends similar to STC. (In respect of cash dividends, the DT remains a tax on the shareholder.) The exemption rules that apply to cash dividends (e.g. where the shareholder is a SA-resident company) apply equally to in specie dividends.

On the question of deemed dividends, the entire VET (Value Extraction Tax) regime is scrapped. Instead (as mentioned earlier) reliance will be placed on a broader interpretation of the actual "dividend" definition. The only specified deemed dividend will be in the case of low-interest loans to non-company SA-resident connected persons, and the annual deemed dividend amount will be the interest discount for the year (not the capital amount of the loan).

FUNDING & INTEREST

Interest & Debt restrictions for Re-organisation transactions

A new s23K is introduced to prohibit interest deductions, in respect of debt that funds asset-transfers undertaken in terms of the s45 (intra-group) or s47 (liquidation) rules. The only way to obtain an interest deduction is to obtain a SARS directive to dis-apply the s23K prohibition. In considering applications, SARS must be satisfied that the interest deduction (i.e. the issuing of the directive) will not lead to a significant reduction of the aggregate taxable income of the relevant parties.

Furthermore, internal group debt that the funds s45 transfers will have a base cost of Nil in the hands of the lender/creditor, so that an external disposal of that debt will trigger CGT.

In s44 (amalgamations), the assumption of certain types of debt will no longer qualify as acceptable consideration, i.e. if the debt is considered to have directly or indirectly funded the asset-transfers.

Hybrid and Third-party backed Shares

The reclassification of dividend receipts into either deemed interest income or just deemed "income", is the focus of the existing s8E and the newly inserted s8EA.

The two existing categories of "hybrid equity instruments" are largely retained in s8E, including the 3-year exclusion period. However, a third category will be added that will not be subject to any 3-year exemption. This refers to a share with a dividend yield akin to interest (e.g. fixed annual percentage, etc.) and which is secured against a financial instrument (not an equity share).

Where a shareholder of a share expects to receive a specified dividend yield on that share, and the non-achievement of that dividend will trigger a right that allows the shareholder to either dispose of the share or to receive some other compensation, s8EA will classify that share as a third-party backed share.

Dividend Cessions & Borrowed Shares

The dividend exemption is denied (i.e. dividends are taxable) where a dividend is received by a company as a result of a cession. The dividend exemption is also denied for dividends received by a company in respect of any shares borrowed by that company. Where a company owns shares that are identical to shares borrowed by that company, the dividends on those owned share may also be taxable.

Debts with uncertain maturity dates

New rules are included in s24J to address the calculation of the "yield to maturity" in relation to debt instruments with uncertain maturity dates and those repayable on demand, by defining rules as to how the "term" of such instruments is to be determined.

Dividend Stripping

Where it appears that dividends extracted from a company in anticipation of the disposal of the shares in that company have the effect of reducing the disposal proceeds, the certain pre-disposal dividends might be treated as income or as CGT proceeds.

Islamic Finance

A new concept of a "sukuk", or government bond, is introduced. The murabaha rules are broadened to accommodate scenarios where the bank is the borrower (i.e. deposits). The calculation rules for diminishing musharaka transactions are amended slightly, affecting the spread of the non-capital portion of repayments over the term of the deal.

INTERNATIONAL

Headquarter Companies (HQ)

The HQ rules are relaxed in several respects. The requirement that each shareholder must hold at least 20% of the HQ-Co's equity shares is reduced to 10%. Some aspects of the asset test are also relaxed — notably the requisite participation that the HQ-Co should hold in "qualifying" target investments is reduced to 10% (from 20%). The income test is also softened in several respects; two notable amendments being the exclusion of HQ-Cos with a gross income of R5m or less, and the reduction of the minimum threshold for "good" income from 80% down to 50%.

HQ-Cos will however now be subject to an annual reporting requirement. Furthermore, the reclassification of an existing SA-resident company as a HQ-Co will trigger an exit charge, and the disposal of shares in an HQ-Co will not qualify for the CGT participation exemption (although the exemption will apply to the HQ-Co's own disposal of its qualifying investment participations).

Source rules

A new s9 is introduced to codify source rules. This dispenses with the concept of deemed source and also overrides certain existing judicial precedent. The stated objective is to align SA's interpretation of source with OECD principles and international tax treaties. The new rules deal with dividends, interest, royalties, know-how, government employment, pensions and annuities, asset-disposals, and exchange differences.

In the case of interest (for example) the question of where the credit is granted is irrelevant, and instead the primary issues are the tax residence of the borrower and/or the place where the funds are utilised. Similarly, in the case of royalties, the original development of the intellectual property is irrelevant. Services are not specifically covered (apart from retirement pensions and annuities, and government employment), so existing principles continue to apply.

Foreign Tax Rebate for Management Fees

Given that the existing credit rules do not cover foreign taxes on SA-source income, a concession is offered in respect of service fees only —i.e. where the services are rendered from SA but foreign taxes are suffered in the jurisdiction of the foreign client (e.g. withholding tax when the client pays the service fees).

Controlled Foreign Companies (CFCs)

The rules around the determination of CFC "net income" are also amended is several respects, notably the substantial revision of the FBE ("foreign business establishment") rules. As an initial starting point, the FBE must be treated as a distinct and separate enterprise. Thereafter there are seven distinct categories of presumed-tainted income which will remain taxable (i.e. disqualified from the FBE exemption), and these include items like goods and services supplied to SA-resident connected persons, financial instrument income, royalties, rent, etc. However, there are also several exceptions where tainted income might still be exempt, although the rules are now slightly stricter than before (captive insurers and treasury operations being notable casualties).

New concepts are also introduced to extend the CFC rules to catch "protected cell companies".

The corporate re-organisation rules are also extended to permit the roll-over relief for inter-CFC deals. Specifically, the extended rules cover asset-for-share

transactions (s42), amalgamations (s44), unbundling (s46) and liquidations (s47). In the cases where there is already some allowance for CFCs (s46 & s47), attempts are made to expand and relax the provisions. For now, the intra-group regime in s45 is not applicable to CFCs.

Transfer Pricing

The stated objective of the amendments to s31 is to modernise the transfer pricing and thin capitalisation rules in line with the OECD and international tax principles. A new concept of "affected transaction" is introduced, which reconfirms certain existing principles, but also quite clearly covers "indirect" dealings and extends the arm's length inquiry to "any term or condition" (as opposed to just "price"). Notably also, adjustments will no longer be solely dependent upon the discretion/satisfaction of SARS but may also (and, essentially, should) be made by the taxpayer.

A new secondary adjustment concept is introduced, which will deem the primary transfer pricing adjustment to be an interest-free loan—which will trigger notional interest imputations on an annual basis (under the transfer pricing rules).

Ceasing to be SA-resident

The existing so-called exit charge rules (i.e. the CGT deemed disposal upon migration) are extended and complemented by exit-charge rules (a new s9H) that will be housed in the main text of the ITA. This essentially means that taxpayers ceasing to be SA-resident will be subject to normal income tax on the deemed disposal of trading stock and recoupments and CGT on capital assets (as opposed to being subject to only CGT on all assets). The existing exclusions for assets that remain in the SA tax net (e.g. SA fixed property) is preserved.

ALLOWANCES & SPECIAL PROVISIONS

Research & Development (s11D)

S11D ITA is overhauled for the intended purpose of simplifying and streamlining access to the R&D incentive. The incentive is now split into an automatic 100% deduction, and an additional (but separate) 50% allowance which will depend upon the formal approval of the R&D project.

Several amendments are also made to the definition of R&D, the regime for contract-R&D, and excluded activities. The new approval system also necessitates further extensions to the administrative provisions.

Industrial Policy Projects (s12I)

In order to bolster the Industrial Development Zone ("IDZ") regime, the s12I IPP incentive is enhanced to further incentivise new projects to locate in IDZs.

Film Productions

The current deduction/allowance regime for films (in s24F) is phased out and replaced by a new exemption regime (s12O) for income derived from film "exploitation rights". Income could be exempt for up to ten years after the completion of the film.

Venture Capital Companies (s12J)

The VCC incentive rules are softened in order to attract greater participation. The incentive itself remains unchanged— i.e. revenue deduction for the cost of shares subscribed for in a VCC—but many of the requirements and restrictions are relaxed.

VALUE-ADDED TAX

Property developers – Residential letting

For property developers, the deemed change-of-use rules are temporarily suspended if residential property is let out as an interim measure in anticipation of the actual sale of those residential units (trading stock).

De-linking VAT from Transfer Duty

The notional input tax claim for fixed property acquired from non-vendors, will no longer be limited to the Transfer Duty actually paid. Instead, the general rules around 2nd-hand goods will apply.

Unpaid group debt

An exception is introduced to the existing rule that debtors must return VAT inputs if they have not paid for supplies within 12 months. In respect of 100%-owned members of the same group of companies, this input tax "claw-back" will not apply.

TRANSFER DUTY

The separate Transfer Duty rate currently applicable to entities (i.e. companies and trusts) is removed, so that the current sliding scale rates for natural persons will apply across the board.

For more information, please call any of the contacts below:

Johannesburg
Kyle Mandy 011-797-4977
kyle.mandy@za.pwc.com

Pretoria
Bennie Botha 012-429-0292
bennie.botha@za.pwc.com

Cape Town
Osman Mollagee 021-529-2061
osman.mollagee@za.pwc.com

Durban
Jerry Maharaj 031-271 2028
jerry.maharaj@za.pwc.com

Port Elizabeth
Ian Olls 041-391-4474
ian.olls@za.pwc.com

East London
Susan Minnie 043 707 9600
susan.minnie@za.pwc.com

Bloemfontein
Gert Nel 051-503-4222
gert.nel@za.pwc.com