Cliffe Dekker Hofmeyr summarises 2015 Budget

The Minister of Finance, Nhlanhla Nene, delivered the 2015 Budget speech which contains a number of tax proposals that will impact businesses and individuals alike. Cliffe Dekker Hofmeyr has provided a summarised version of certain key tax proposals.

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The influence of the Davis Committee on the Budget proposals

Emil Brincker, director and National Tax Practice Head

Upon perusal of the proposals contained in the Budget, it is clear that the Davis Committee had a significant impact on the policy trends and the suggestions that have been made.

Apart from the fact that the VAT rate was not increased pursuant to the suggestions of the Davis Committee, it is specifically indicated that Government will propose amendments to improve the following tax areas:

- transfer pricing;
- controlled foreign company legislation; and
- digital economy.

The Davis Committee was established in 2013 to advise the government on future refinements to the tax system. The interim report was released towards the end of 2014 on the basis that its recommendations on changes to the turnover tax regime for micro businesses were already included. It is indicated that the final reports of the Davis Committee will be contained in policy proposals for the 2016 Budget.

However, it is clear that the government accepted the proposal to take steps to combat base erosion and profit shifting. This does not only relate to the way in which international tax treaties are to be implemented, but also the removal of tax credits that can be claimed in terms of section 6quat of the Income Tax Act, No 58 of 1962 in respect of services that are sourced in South Africa.

Traditionally African countries have levied withholding taxes on these types of fees even though it may not have been possible in terms of the relevant treaties. The abolition of section 6quin will now result in taxpayers having to negotiate with foreign governments in order to obtain a refund in respect of these withholding taxes on the basis that the source of the fees are in South Africa and not in the foreign country concerned.

The rules pertaining to the taxation of the digital economy also seem to have been accepted by the Government. In principle, the distinction between business to business and business to consumer transactions has been accepted. The suggestion of the Davis Committee that the South African legislation should follow the OECD recommendations has also been accepted.

One of the focus areas of the Davis Committee was to re-examine transfer-pricing documentation. Not only was it suggested that a new interpretation note should be published by the South African Revenue Service (SARS), but also that country by country reporting should be endorsed. The country by country report should require additional transactional data including interest payments, royalty payments and service fees. It was also recommended that a master file, local file and country by country reporting should be compulsory for large multi-national businesses.

One cannot disregard the influence of the Davis Committee on the Budget proposals and trends. Anybody that ignores these proposals will do so at their own peril.

Cancellation of contracts does not result in a reduction in base cost

To the extent that a contract is cancelled, it is expected that the parties to the contract will be restored to the position they were in prior to the entering into of the contract.

However, in terms of current provisions the cancellation of the contract results in a change in the base cost of the asset that was disposed of by the seller to the purchaser. In fact, the wording of the current legislation is that the base cost would reduce to zero, especially in the context of connected persons. This anomaly will be removed so that the original base cost is retained by the seller pursuant to a cancellation of a contract.

Increase in individual tax rates

Ruaan van Eeden, director, Tax

The long anticipated increase in individual tax rates finally materialised in the Budget, but was surprisingly not only targeted at the higher income brackets. The Minister rather chose the more pragmatic approach and spread the 1% increase evenly across all revenue bands, save for those earning below R181,900. The Minister further announced adjustments to account for fiscal drag as expected to the tune of 4.2% across all taxable income bands.

The highest marginal income tax rate will, with effect from 1 March 2015, increase to 41% for taxable income exceeding R701,301. The increase in personal income tax rates will be accompanied by an increase of 1% in the tax rate of trusts to 41%.

Fairer approach

It was widely expected that the Minister would look to target only the highest income tax bracket and raise the marginal rate in excess of 41% to as much as 45% and possibly introduce an entirely new taxable income band. The approach taken in the Budget by the Minister is a fairer approach, essentially forcing all taxable income bands to share the additional tax burden. It does raise the question as to whether the Minister is going to, proverbially speaking, administer a slow poison over the next few years, by steadily increasing the personal income tax rates in the hope that no one is paying attention.

One must remember that the drop in oil prices gave the Minister room to downplay the tax burden increase on individuals. The Minister may not have the same luxury next year, and this could mean that another increase in rates is on the cards, especially if slow economic growth persists and tax revenues decline.

Transfer duty exemption increased

The transfer duty exemption for properties under R600,000 remained largely untouched over the last few years, however, given a slow but steady recovery in the property market the Minister announced an increase in the exemption to R750,000, with effect from 1 March 2015. The relief at the lower end has however resulted in a transfer duty increase at the higher end for properties exceeding R2.25m. Transfer duty in the aforementioned bracket will, with effect from 1 March 2015, be R85,000 plus 11% of the value above R2.25m.

The relief is targeted at the middle income market but one feels that more could have been put on the table. Given the median growth in house prices in South Africa, an exemption of R1m may have been more beneficial, however, considering the Minister's small room to manoeuvre, the R150,000 increase this year could be followed by a further increase in the exemption in the next Budget cycle, depending on the performance of the property market.

Clarification of section 45(3a) of the Income Tax Act for cross-border intra-group transactions

Andrew Lewis, director, Tax

Binding Private Ruling 178 (BPR 178) concerned an applicant seeking clarity on the tax consequences of an international corporate restructuring in terms of section 42 (asset-for-share transaction) and section 45 (intra-group transaction). In particular, the applicant sought clarity whether section 45(3A) of the Income Tax Act will apply to cross-border intra-group transactions.

To the extent that section 45(3A) of the Act applies to an intra-group transaction, the holder of the debt is deemed to have acquired the loan note for an amount of expenditure of nil (which, depending on the circumstances, can trigger adverse tax consequences if distributed or otherwise disposed of at a later stage). The uncertainty whether or not section 45(3A) of the Income Tax Act applied to cross-border intra-group transactions arose because the relevant provisions only referred to a 'group of companies' as defined in section 41 of the Act and not the broader definition of a group of companies contained in section 1 of the Act.

BPR 178 ruled that section 45(3A) will not apply to the cross-border intra-group transaction contemplated in the ruling, presumably on the basis that the debt was not advanced by the same group of companies (as defined in section 41).

Ruling at odds

We have previously indicated that, if the conclusion was reached on the basis that section 45(3A) of the Act does not apply to a loan note issued by a foreign company, which does not form part of a section 41 group of companies, the ruling appears to be at odds with the statements by National Treasury in the Explanatory Memorandum on the Taxation Laws Amendment Bill 2013 (EM) but is in line with a strict interpretation of the provisions. According to the EM, section 45(3A) of the Income Tax Act was amended to clarify that the provision applies to both domestic and foreign corporate reorganisations.

Our concerns appear to be justified as the Minister announced in the Budget that the relevant provision of section 45(3A) was inadvertently not amended to cater for cross-border intra-group transactions. It has therefore been proposed that the relevant provisions will be amended to clarify that this section refers to the same group of companies as defined in section 1 of the Income Tax Act and applies to cross-border intra-group transactions.

The proposal will at least bring some certainty to this issue. It is comforting to see that when the SARS advance tax ruling department issued BPR 178 it applied the legislation as it read at the time and appears to have been influenced by the previous comments by the Minister in the EM. The Minster did not indicate from which date this proposed amendment will be effective.

REIT legislation extended to unlisted property-owning companies

Section 25BB of the Income Tax Act was adopted in South Africa with effect from 1 April 2013 to govern the taxation of real estate investment trusts (REITs). A REIT is a company that owns and operates income-producing immovable property. The definition of a REIT in the Income Tax Act refers to a company that is a South African tax resident whose shares are listed on the JSE as shares in a REIT, as defined in the JSE Limited Listing Requirements.

Consequently the provisions of section 25BB of the Income Tax Act (and other related provisions) only apply to listed REITs, which requires that, inter alia, the REIT:

- own property with a value in excess of R300m;
- maintains its debt below 60% of its gross asset value;
- earns 75% of its income from rentals; and
- must distribute 75% of its taxable earnings available for distribution each year.

To the extent that a company qualifies as a REIT (as defined in the Act), the REIT is effectively allowed to operate on a tax neutral basis. Up until now these provisions did not apply to unlisted property companies. The Minister announced in the Budget that unlisted property-owning companies should qualify for the same tax treatment as listed REITs, provided they become regulated. This news will most likely be welcomed by unlisted property companies, which up until now have not enjoyed the same tax certainty available to listed REITs.

The Minister indicated that the regulations governing unlisted property companies still have to be developed. No doubt the unlisted property company sector will be eager for these regulations to be finalised and circulated for public comment.

The Minister did not specifically indicate whether the regulations will be available for property loan stock companies only or whether they will be available for property unit trusts as well. The Minster did however only refer to unlisted property companies. It is anticipated that not all unlisted property companies will want to conform to the regulations.

If these regulations are similar to the JSE Limited Listing Requirements one can expect there to be substantial report requirements, specific debt gearing ratios and a requirement to make minimum distributions within the year, which will not be suitable for all unlisted property companies.

CFC rules to be amended in the battle against BEPS

Heinrich Louw, senior associate, Tax

A controlled foreign company (CFC) is any foreign company of which more than 50% of the total participation rights are directly or indirectly held, or of which more than 50% of the voting rights are directly or indirectly exercisable, by one or more South African residents.

Section 9D of the Income Tax Act is the anti-avoidance provision aimed at preventing South African residents from excluding tainted forms of taxable income from the South African tax net through investment into CFCs. Prior to 2011, one of the primary targets of section 9D was diversionary foreign business income (from the import of goods, the export of goods and/or the import of services) generated through convoluted structures designed to circumvent South African tax.

The complex diversionary transaction rules sought to deter South African taxpayers from entering into transactions which effectively shifted income from the South African tax base to a jurisdiction with a more favourable, lower tax regime. Unfortunately due to the highly mechanised operation of the diversionary rules, legitimate commercial activities, conducted at arm's length, were on occasion caught within the anti-avoidance provisions, resulting in the generation of tainted income.

Suspect transactions

To redress the above, in 2012 the diversionary rules were simplified and limited in their application. National Treasury was of the view that suspect transactions between CFCs and connected persons could be satisfactorily addressed by applying the transfer pricing arm's length principle embodied in the provisions of s31 of the Income Tax Act.

It appears that the section 31 transfer pricing provisions have not performed adequately, hence the proposed reinstatement of the diversionary rules to the sale of goods by a CFC to a connected person (hopefully in a simpler incarnation). In addition, consideration is to be given to extending the ambit of s9D to allow for the taxation of CFCs held by interposed trusts.

Cross-issue of shares

Generally, the issue of a share by a company does not constitute a disposal for purposes of capital gains tax. However, in 2013, paragraph 11(2)(b) of the Eighth Schedule to the Income Tax Act was amended to the effect that the issue of shares by a resident company for the exchange, whether directly or indirectly, of shares in a foreign company would constitute a disposal.

The reason for the change was that certain companies were entering into transactions involving, among others, the cross-issue of shares between a resident and non-resident company. These transactions would result in a shift of control of the resident company to an off-shore jurisdiction, and effectively a tax-free corporate migration.

By treating the issue of the shares as a disposal by the resident company, it would generate an immediate capital gain for the resident company equal to the market value of the foreign shares (because the shares issued by the resident company would have no base cost). The amendments were therefore introduced as an anti-avoidance measure, and as part of South Africa's broader plan to curtail base erosion and profit shifting.

However, it is now recognised that the anti-avoidance provision has had unintended side-effects, specifically in that it stifles the growth and expansion of South African multinational companies. Without providing much detail, it is indicated in the Budget that the provision would be relaxed, but not necessarily scrapped.

The change is welcomed, and it is a particularly positive indication that the Minister is alert to the constraining effect that certain 'blunt instrument' anti-avoidance provisions can have on legitimate commercial transactions.

Securities lending arrangements

Lisa Brunton, senior associate, Tax

A securities lending arrangement entails a lender advancing shares to a borrower to enable such borrower to on-deliver the marketable security in terms of a sale or on-lending transaction. The borrower is obliged to deliver the equivalent marketable security (in kind, quality and quantity) to the lender within a specified period of the original advance and to compensate the lender for any distributions to which he would have been entitled to during such period.

Often the borrower is required to transfer collateral to the lender to secure the underlying value of the securities lent. The transfer of collateral enhances liquidity in this market but carries the burden of securities transfer tax (STT) and capital gains tax (CGT).

It is proposed that Government review the tax treatment of the temporary transfer of beneficial ownership of collateral with a view to reducing the adverse tax consequences on acceptable business practices such as the provision of collateral security; while simultaneously limiting the potential use of collateral in tax avoidance arrangements, such that STT and CGT consequences may be reserved for the out and out provision of security.

Employee share incentive schemes revisited again

Mareli Treurnicht, senior associate, and Andrew Lewis, director, Tax

The taxation of employee share incentive schemes has been on National Treasury's radar for a number of years now and this year is no different. The Minister announced in the Budget that the interrelationship between the application of section 8C of the Income Tax Act, which includes the taxation of directors and employees on the vesting of equity instruments, the attribution of capital gains to beneficiaries, the income tax exemption of dividends and the employees' tax provision related to the return of capital will be reviewed to remove anomalies.

The main provision in the Income Tax Act that one needs to consider when implementing an employee share incentive scheme is section 8C of the Income Tax Act. However, careful consideration must also be given to a number of other provisions in the Income Tax Act, including section 10(1)(k) dealing with the dividend exemption and the capital gains tax provisions contained in the Eighth Schedule.

Some of the anomalies that have arisen in recent years as a result of amendments to the legislation include the following:

- Amendments were made to section 10(1)(k) of the Income Tax Act to provide that dividends received by participants in respect of certain share schemes should no longer be exempt. However, many of these amendments in section 10(1)(k) now conflict with each other, and dividends are being taxed that should in fact be exempt from tax.
- Amendments were made to the deemed disposal at market value provisions contained in paragraph 38 of the Eighth Schedule to the Income Tax Act, on the basis that the provisions were obsolete. However, as a result of this amendment, adverse tax consequences can arise where the same amount is subject to capital gains tax in the hands of a trust and income tax in the hands of the participants.

  Taxpayers and tax consultants have been lobbying for a number of years for these anomalies to be resolved and hopefully this will be the year it happens.

Withdrawal of rebate in respect of foreign taxes on income

Gigi Nyanin, associate, Tax

By way of background, section 6quin of the Income Tax Act, which was introduced by government in 2011, provides for a rebate in respect of foreign taxes withheld by a foreign government on income from a source within South Africa. The rebate is limited to the lesser of:

- the amount of normal tax attributable to the amount received or accrued; or
- the amount of tax levied and withheld; or
- the amount of tax imposed.

However, taxes imposed on South African residents by some foreign countries for services rendered in SA for clients who were residents in those countries are not in accordance with the provisions of the Double Taxation Agreements (DTA's) between South Africa and these countries, and international tax principles. Accordingly, the Budget has proposed that the s 6quin rebate be withdrawn.

The Minister provides that such withdrawal aims to alleviate the compliance burden on South African taxpayers to apply for a refund of the tax that was incorrectly imposed (by the foreign government). Although the introduction of this relief was well intended, it has been noted that it has resulted in significant compliance burdens for both taxpayers and the South African Revenue Service.

Withdrawal is interesting

This withdrawal is interesting in light of the Davis Tax Committee's (DTC) Interim Report on Preventing Base Erosion and Profit Shifting in South Africa in which a recommendation was made for the reconsideration of s6quin of the Act. The DTC provided that certain foreign jurisdictions, especially in Africa, were incorrectly claiming source jurisdiction on services (especially management services) rendered abroad and yet those services should have been considered to be from sources within SA.

Further, the DTC provided that although s6quin was intended to be a temporary measure aimed at addressing interpretation issues arising out of certain DTAs (where the foreign government did not apply the provisions of the DTAs in respect of services rendered by SA residents in those countries), SA has departed from the tax treaty principles in the OECD Model Tax Convention in its treaties with African countries, in that it has given them taxing rights over income not sourced in those countries.

In essence, the DTC called into question the s 6quin rebate by stating that the rebate effectively relinquishes taxing authority to its fellow African neighbours even though this relinquishment is unwarranted under international tax principles.

As an aside, it is also important to note that the Minister has proposed that 'interest for withholding tax' be defined as this will ensure that there is no confusion with other references related to interest in the Act. Reference has to be made to the report of the Standing Committee on Finance dated 11 September 2013, where it was indicated that the interest withholding tax provisions would apply to common law interest and that 'as a general rule of interpretation, in the absence of a specific definition or cross reference to section 24J, the common law definition will apply'.

This is a welcomed proposal as the scope of the 'interest' definition contained in section 24J of the Income Tax Act extends beyond common law interest and therefore, could widen the scope of interest withholding tax which the legislator did not anticipate.

Foreign electronic services

Bilal Bhamjee, candidate attorney, Tax

In a recent report by the Davis Tax Committee, recommendations were made in order for South Africa to address various problems in relation to e-commerce transactions. With the continuous advancement of technology, it is becoming difficult to track (and tax), the sale of electronic goods and services.

The legislature has recently introduced changes to the Value Added Tax Act, No 89 of 1991, requiring certain foreign suppliers of electronic services to register as vendors, and to account to SARS in respect of Value-added Tax (VAT) on their supplies.

SARS also issued regulations in which various electronic services have been listed, and on which foreign vendors need to account for VAT. However, the regulations are somewhat problematic in that they appear to focus on certain technologies and products, leaving out certain others (for example certain cloud-based services).

The Minister has now proposed that the regulations prescribing electronic services be updated to include software and other electronic services, as well as address some uncertainties.

Section 9C 'safe harbour' rules expanded

Nicole Paulsen, associate, and Andrew Lewis, director, Tax,

Section 9C of the Income Tax Act came into operation on 1 October 2007 and applies to the disposal of 'qualifying shares' on or after that date. Section 9C of Income Tax Act essentially contains a 'safe harbour' provision in terms of *which the gains from the disposal of 'qualifying shares' will be deemed to be of a capital nature if the owner held such shares for a continuous period of 3 (three) years.*

The Minister announced in the Budget that the provisions of s9C of the Income Tax Act do not currently deal with the circumstances where there is a return of capital by the company in respect of 'qualifying shares' and that there is a need to amend the definition of 'disposal' for purposes of this section.

- *The provisions of s9C are triggered upon the 'disposal' of a 'qualifying share'. In the case of a return of capital by a company, there is no 'disposal' of the 'qualifying share' by the shareholder as the shareholder continues to hold the share in the company. In the case of a return of capital, the trigger for the application of s9C therefore cannot be the 'disposal' of the share and has to be amended.*
- *In terms of the current provisions contained in the Eighth Schedule to the Income Tax Act, a return of capital by the company on or after 1 April 2012 will result in a reduction of the base cost of the shares held by the shareholder. To the extent that the return of capital made by the company is greater than the base cost of the shares, the provisions of s9C of the Act do not currently deem that return of capital to be on capital account for the shareholder (ie even if the qualifying shares have been held for a continuous period of three years). In terms of the proposed amendment, this portion of the return of capital will be deemed to be capital in nature and subject to capital gains tax.*

The expansion of the provisions of s9C of the Act to provide a safe harbour for returns of capital will be welcomed by taxpayers. Taxpayers must be aware that the provisions will most likely only apply to 'qualifying shares' as defined in s9C of the Income Tax Act (e.g. a 'qualifying share' does not include most preference shares).