SAIT | Summit Place Business Park | Building 3, Ground Floor
221 Garsfontein Road | Menlyn | South Africa | 0081

www.thesait.org.za

3 December 2021

To: The National Treasury
240 Madiba Street
PRETORIA
0001

The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
PRETORIA
0181

VIA EMAIL:	National Treasury	(2022AnnexCProp@treasury.gov.za)
	SARS	(acollins@sars.gov.za)

Dear Colleagues,

ANNEXURE C PROPOSALS FOR BUDGET 2022: INTERNATIONAL TAX

We attach hereto the proposals from the SAIT International Business Tax Work Group (**the WG**) as pertaining to International Business Tax and related matters. We appreciate and value the opportunity to participate in the legislative process and would welcome further dialogue and engagement where appropriate.

Please do not hesitate to contact us should you need further information.

Yours sincerely

SAIT International Business Tax Work Group

Unless otherwise indicated all references to legislation are to sections of, and schedules to, the Income Tax Act No. 58 of 1962 ("the Act").

1. LIMITING THE APPLICATION OF DIVIDEND EXEMPTIONS IN LOOP STRUCTURES

[Applicable provisions: Section 9D(2A)(d) of the Act]

1.1. The legal nature of the problem

1.1.1. Where a South African (**SA**) individual holds shares in a SA company directly, the individual would be subject to SA dividends tax at a rate of 20% on dividends paid by the SA company to the individual. However, where the SA individual holds shares in a SA company through a Controlled foreign company (**CFC**) in terms of a so-called "loop structure", the rate of dividends tax on dividends paid to the CFC by the SA company may be reduced in terms of SA's tax treaties. Furthermore, foreign dividends received by the individual from the CFC may qualify for an exemption from SA tax in terms of section 10B of the Act. Accordingly, the existence of the "loop structure" would reduce the amount of tax which would ordinarily be payable.

1.1.2. Section 9D was thus amended, apparently to ensure that the SA fiscus does not lose out on dividends tax as a result of a "loop structure". The 2020 Budget Review originally proposed that the amendment would only apply to individuals and trusts who or which hold shares in a CFC, on the basis that an individual or trust would have been subject to dividends tax had such individual or trust directly held shares in the underlying SA company.

1.1.3. However, it appears that the actual amendment went beyond the aforementioned intention and presently also applies to SA companies, which are shareholders in a CFC. Typically, these companies would be exempt from income and dividends tax on dividends received from a SA resident company. Therefore, in many instances the amendment will in fact result in the South African Revenue Service (**SARS**) getting more tax rather than the same tax that would arise where the SA company is held directly by SA shareholders.

1.2. Detailed factual descriptions

1.2.1. For example, it is accepted that if a SA company (**SA Co 1**) holds shares directly in another SA company (**SA Co 2**), dividends received by SA Co 1 from SA Co 2 would be exempt from SA dividends tax. Accordingly, where SA Co 1 holds shares directly in SA Co 2, no tax would be payable in respect of dividends paid by SA Co 1 to SA Co 2.

1.2.2. However, where a CFC is interposed between SA Co 1 and SA Co 2, dividends paid by SA Co 2 to the CFC would be subject to SA dividends tax (albeit potentially at a reduced rate in terms of SA's treaties in certain cases). Accordingly, the existence of the loop structure would result in an <u>increased</u> amount of tax being payable.

1.2.3. In addition, the amendment to section 9D(2A)(d) also has the effect that, in determining the net income of a CFC, any exemption from normal tax in respect of dividends received or accrued as contemplated in section 10(1)(k) must not apply in respect of the portion of an amount of the aggregate amount of dividends received by or accrued to that CFC during any foreign tax year, determined in accordance with the following formula:

> *'A = B x (C - D)*
>
> *where:*
>
> *"A" represents the amount of the dividend to be determined which is not exempt from income tax in the hands of the CFC's South African shareholder;*
>
> *"B" represents the ratio of the number 20 to the number 28;*
>
> *"C" represents the aggregate of dividends received by or accrued to the CFC during its foreign tax year; and*
>
> *"D represents:*
>
> *100% of the amount of any dividend received in respect of which dividends tax has been paid at a rate of 20%;*
>
> *50% of the amount of any dividend received in respect of which dividends tax was paid at a rate of 10%;*
>
> *40% of the amount of any dividend received in respect of which dividends tax was paid at a rate of 8%;*
>
> *37.5% of the amount of any dividend received in respect of which dividends tax was paid at a rate of 7.5%; and*
>
> *25% of the amount of any dividend received in respect of which dividends tax was paid at a rate of 5%.'*

1.2.4. Where dividends tax of less than 20% is imposed, the problem arises because income tax will then be imposed in accordance with the formula, aimed at an effective aggregate SA tax rate of 20%. While we accept that a CFC may be required to pay dividends tax on its dividends paid to that CFC by a SA subsidiary, we see no justifiable basis for also imposing income tax on net income of the CFC resulting from such dividends. As mentioned above, where a SA company holds shares directly in another SA company, no income tax would be payable on dividends paid between the two companies. This should not be any different simply because a CFC is interposed between the two SA companies.

1.2.5. In contrast, where a SA company is held by a SA individual, ordinarily there would be a tax liability where dividends are paid by the SA company to the SA individual shareholder. A SA individual who holds shares directly in a SA company would ordinarily suffer dividends tax at a rate of 20% on dividends received by him or her from the SA company.

1.2.6. Accordingly, if a CFC is interposed between the SA company and a SA individual, the tax payable on a dividend paid by CFC in a "loop structure" should not exceed 20%, i.e. the tax liability which would ordinarily be suffered if the individual were to hold the shares in the SA company directly. This appears to not be the case, where dividends tax is imposed at a rate of less than 20%. This can be illustrated by way of the following example.

1.2.7. Assume that SA individual (**Individual**) holds shares in a CFC, which in turn holds shares in SA Co. SA Co declares a dividend of R100, on which dividends tax of 8% is withheld.

1.2.8. According to the formula in section 9D(2A)(d), the exemption in calculating the net income of the CFC (which may be imputed to and taxed in the hands of the Individual) would not apply to the following amount:

$$A = B \times (C - D)$$

$$A = 20/28 \times (R100 - (40\% \times R100))$$

$$A = R42.86$$

1.2.9. The non-exempt portion of the dividend is R42.86. Accordingly, assuming that Individual is subject to tax at the highest marginal rate, the SA income tax payable on the non-exempt potion of the dividend in Individual's hands would be R42.86 x 45% = R19.29.

1.2.10. The total tax payable in respect of the dividend is:

R8 dividends tax + R19.29 income tax = R27.29 total tax

1.2.11. The inclusion rate of 20 to 28 which is contained in the formula in section 9D(2A)(d) results in an effective tax rate of greater than 20% where the net income of the CFC is imputed to the individual shareholder, as illustrated by the above example. The effective tax rate in this example is approximately 27%, as opposed to 20% (which it otherwise should be).

1.2.12. We submit that the inclusion rate which should be used in respect of individuals and trusts is 20 to 45. Where this inclusion rate is used, the effective rate of tax is 20%. Using the facts set out in the above example, the exemption from income tax in Individual's hands in respect of the dividend would not apply to the following amount:

A = B x (C - D)

A = 20/45 x (R100 - (40% x R100))

A = R26.67

1.2.13. The non-exempt portion of the dividend is R26.67. Accordingly, assuming that Individual is subject to tax at the highest marginal rate, the SA income tax payable on the non-exempt portion of the dividend in Individual's hands would be R26.67 x 45% = R12.

1.2.14. The total tax payable in respect of the dividend is:

R8 dividends tax + R12 income tax = R20 total tax

1.2.15. The total tax payable of R20 is equal to the amount of tax which would be suffered if an individual were to hold shares in a South African company directly, and is therefore correct.

1.3. Impact

1.3.1. Section 9D(2A)(d) subjects the dividend received by a CFC which is held by a SA company to tax at an effective rate of up to 20%, even though, in the absence of a "loop structure", no income tax would have been payable on the dividend paid between two SA companies.

1.3.2. In addition, and as illustrated above, the inclusion rate of 20 to 28 results in an effective tax rate which is greater than 20% where the shareholder of the CFC is an individual or trust.

1.4. The nature of the business / persons impacted

1.4.1. SA companies, SA individuals and trusts that are shareholders in a CFC.

1.5. Proposal

1.5.1. We recommend that it should be clarified that the amendment of section 9D(2A)(d) should not apply in circumstances where the shareholder of a CFC is a SA tax resident company. In other words, the full exemption as outlined in section 10(1)(k) should remain available in such instances.

1.5.2. We also recommend that the inclusion rate of 20 to 28 in section 9D(2A)(d) be replaced with an inclusion rate to 20 to 45 to ensure that shareholders of the CFC which are not SA tax resident companies (i.e. individuals and trusts) are subject to tax at the appropriate effective tax rate.

2. OPERATION OF THE "DEEMED TREASURY OPERATIONS" AND "CAPTIVE INSURER" PROVISIONS WHICH IN ESSENCE WILL DEEM MOST CFCS AS TREASURY OPERATIONS AND/OR CAPTIVE INSURERS AND ACCORDINGLY RENDERS INOPERATIVE THE EXEMPTION CONTAINED IN S9D(9A)(A)(III)(AA) AND (BB)

[Section 9D(9A)(a)(iii)(aa) and (bb) read with section 9D(9A)(b)(iii) and section 9D(9A)(b)(iv)]

2.1. The legal nature of the problem

2.1.1. CFC net income is determined subject to certain exemptions. One of these exemptions, section 9D(9)(b), disregards any amount attributable to a "foreign business establishment" (**FBE**), commonly referred to as the "FBE exemption". Section 9D(9)(b) is, however, subject to the provisions of section 9D(9A), which may negate the FBE exemption where the income derived by the CFC constitutes "mobile passive income" such as foreign exchange gains, royalty income and rental income. In particular section 9D(9A)(a)(iii)(bb) may be interpreted to mean that any exchange differences in respect of financial instrument will continue to be disregarded under section 9D(9)(b) if these differences arise in the ordinary course of the principal trading activities of the FBE (not being a bank, financial services provider or insurer) unless those principal trading activities constitute the activities of a "treasury operation" or "captive insurer".

2.1.2. Section 9D(9A)(b)(iii) and (iv) contains provisions which deem the operations of a CFC to be those of a "treasury operation" or "captive insurer" in certain circumstances.

2.1.3. The application of the aforesaid tests does, however, present some interpretive difficulties. If a purely reductionist approach is applied, entities whose principal trading operations are not those of treasury operations / insurance may be deemed to be "treasury operations" or "captive insurers".

2.2. Detailed factual description

2.2.1. By way of example, we consider the relevant provisions as applicable to a group procurement hub, based in Singapore, procuring widgets throughout Asia and supplied to group trading companies throughout the world.

2.2.2. We apply each of the section 9D(9A)(b)(iii) and (iv) tests:

2.2.2.1. less of those principal trading activities are conducted in the country in which the FBE is located than in any other single country – the procurement hub will procure goods in a region (not Singapore) and sell globally (not Singapore). Therefore, although the procurement hub is based in Singapore, arguably its trading activities are conducted primarily outside Singapore;

2.2.2.2. those principal trading activities do not involve the regular and continuous acceptance of deposits from or the provision of credit / the regular transaction of business as an insurer with / to clients who are not connected persons in relation to that CFC. The principal trading activities of a widget procurement company will not typically involve "regular and continuous acceptance of deposits from or the provision of credit / the regular transaction of business as an insurer"; or

2.2.2.3. less than 50 per cent of the amounts attributable to the activities of the FBE are derived from those principal trading activities with respect to clients who are not connected persons in relation to that controlled foreign company – the procurement hub will derive revenue exclusively from connected group companies.

2.2.3. Based on the above, and applying a reductionist approach, the procurement hub, which cannot be construed as being a "treasury operation" or "captive insurer", will be deemed to be a "treasury operation" and a "captive insurer". Equally illogical is that a *bona fide* bank as contemplated in section 9D(9A)(a)(iii)(aa) will, applying the same reductionist approach, be deemed to be a "captive insurer" and a *bona fide* insurer will be deemed to be a "treasury operation".

2.2.4. Such a result is insensible and lacks commercial rationale and would be contrary to the intention of the legislature as it would effectively nullify the application of both sections 9D(9A)(a)(iii)(aa) and (bb).

2.3. Proposal

2.3.1. In our opinion, effect should be given to the correct contextual application of the deeming provisions in section 9D(9A)(b)(iii) and (iv) should be limited to situations where the principal trading activities of the FBE are substantially similar to those of a “treasury operation” or “captive insurer” in the ordinary sense of the word, but are not regarded as “classic” treasury operations / captive insurance, due to the presence of additional activities e.g. the presence of third party elements or other non-financial instrument related activities.

3. APPLICATION OF THE ENVISAGED LOSS UTILISATION RESTRICTIONS IN SECTION 20 IN CALCULATING CFC NET INCOME

[Applicable provisions: Section 9D(2A) read with Section 20 of the Act]

3.1. The legal nature of the problem

3.1.1. According to the 2021 Taxation Laws Amendment Bill, section 20 will be amended (effective date still to be announced) in order to restrict the extent to which taxpayers are able to set off their balance of assessed losses carried forward from the preceding tax year against their income.

3.1.2. According to the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2021, Government has proposed broadening the corporate income tax base by restricting the offset of the balance of assessed losses carried forward to 80 per cent of taxable income.

3.1.3. The Act contains CFC anti-avoidance provisions in section 9D aimed at taxing South African residents on the net income of a CFC. Whilst the CFC rules raise some revenue, their main aim is to protect the domestic tax base from artificial erosion i.e. to act as a deterrent for tax avoidance.

3.1.4. Section 9D(2A) prescribes the process to be followed in calculating a CFCs "net income". Specifically, section 9D(2A)(b) provides that the "net income" of a CFC in respect of a foreign tax year is an amount equal to the taxable income of that company determined in accordance with the provisions as if that CFC had been a taxpayer, and as if that company had been a resident for purposes of the definition of "gross income", and certain sections as specified, provided that <u>any amount whereby such deductions or allowances or amounts exceed the amount of such income, shall be carried forward to the immediately succeeding foreign tax year and be deemed to be a balance of assessed loss which may be set off against the income of such company in such succeeding year for the purposes of section 20</u>. (emphasis added)

3.1.5. The proposed amendment of section 20 (i.e., restricting the offset of the balance of assessed losses carried forward to 80 per cent of taxable income) will therefore impact the way in which CFC net income is calculated.

3.2. Detailed factual description

3.2.1 The envisaged loss utilisation restrictions in section 20 will therefore have the effect of increasing the "net income" by denying loss utilisation, thus resulting in an increased CFC tax burden, and reducing the international competitiveness of SA multi-national groups. The stated aim of the section 20 amendment (i.e. the broadening of the SA tax base) therefore appears to be at odds with the aims of the existing CFC legislation aimed primarily at anti-avoidance.

3.3. The nature of the businesses impacted

3.3.1 CFC's that are in an assessed loss position.

3.4. Proposal

3.4.1. Whilst the limitation of loss utilisation is aimed at broadening the tax base, CFC rules are not aimed at revenue generation, but anti-avoidance. Thus, in our view, the proposed limitations in section 20 should not apply in calculating CFC net income.

4. APPLICATION OF THE SECTION 9D FBE DEFINITION TO REAL ESTATE INVESTMENT TRUST (REIT) INCOME TAX LEGISLATION

4.1. The legal nature of the problem

4.1.1. The FBE exemption as outlined in section 9D was introduced to exempt any income generated by a CFC from SA income tax, provided the CFC's business is truly active, has some nexus in a country outside SA, and is used for bona fide non-tax business purposes.[1]

4.1.2. Sub-paragraphs (b) to (e) of the FBE definition states that mines, construction sites, farms and fishing operation are deemed to be FBE's without having to satisfy the remaining requirements as set out in the definition of FBE (i.e., the "suitably equipped" requirement and that the FBE is used for bona fide business purposes other than tax avoidance). The rationale for this is that the substance and nexus in countries outside of South Africa of mining operations, construction sites, farms and fishing operations is virtually impossible to fabricate for tax planning purposes.[2]

[1] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006

[2] Explanatory Memorandum on Revenue Laws Amendment Bill, 2002.

4.1.3. However, no provision is made for SA REIT's which primarily own and operate the letting of rental properties situated outside SA.

4.1.4. When the REIT legislation was introduced, reliance was placed on the US REIT and property company business models which in-sourced all maintenance, management and similar functions. The current REIT legislation fails to take into account that typically in the case of property companies or a REIT structure, the majority of the administrative, operational and management functions of these entities are now outsourced to a separate group management company and/or to third party service providers.

4.1.5. The rationale of this practice is to separate the asset holding structure (investment activities) and the asset management structure (non-investment activities). It is a widely accepted industry practice in the REIT industry for a property company to only hold the asset and to appoint an outsourced management company to manage the property maintenance and rental portfolios. This type of operating structure is an established model prevalent both in SA and in foreign countries.

4.1.6. The FBE exemption essentially acknowledges that legitimate business operations established outside SA do not pose a threat to SA's tax base. Arguably, economic substance and locational permanence is at the heart of this exemption.

4.1.7. As with mines, construction sites and farms, property-owning CFC's of a SA REIT will own immovable property and buildings located in a foreign jurisdiction. This will satisfy the economic and locational permanence requirements. Furthermore, the CFC's derive rental income from letting the real properties which will be taxed in that country, often at a rate similar to that in SA. By not including an immovable property and buildings situated outside the Republic where rental activities are carried on by a CFC, it can be said that the REIT industry is being discriminated against in comparison to the mining or construction or agricultural industries.

4.2. Detailed factual description

4.2.1. As mentioned above, typically, in the case of property companies or a REIT structure, the majority of the administrative, operational and management functions of these entities are outsourced to a separate group management company and/or to third party service providers.

4.2.2. The requirement set out in sub-paragraph (a)(ii) "<u>that fixed place of business</u> is suitably staffed with **<u>on-site</u>** <u>managerial and operational employees of that CFC who conduct the primary operations of that business</u>" is therefore unlikely be met. Where a CFC does not have employees and/or outsources the core business functions to third party service providers or cannot rely on the shared FBE proviso to the definition, the CFC will not be entitled to rely on the FBE exemption.

4.3. Proposal

4.3.1. We recommend including "an immovable property and buildings outside the Republic used for rental activities carried on by that CFC" in the sub-paragraph to the definition of FBE.

5. SECTION 25BB(2A)(D) WHICH COMES INTO OPERATION ON 1 JANUARY 2021 AND APPLIES IN RESPECT OF YEARS OF ASSESSMENT COMMENCING ON OR AFTER THAT DATE

5.1. The legal nature of the problem

5.1.1. In terms of the Taxation Laws Amendment Bill (Bill No 27 of 2020), section 25BB(2A) is amended to include paragraph (d) *"where a foreign dividend is received by or accrued to a REIT or controlled company, section 10B(2)(a) must not apply."*

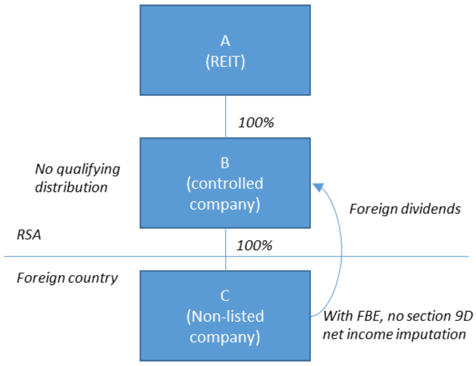
5.1.2. If a controlled company does not have any qualifying distribution in a year of assessment but receives a foreign dividend from a non-listed CFC which has a FBE, the controlled company cannot rely on the foreign dividends exemption. This will result in the controlled company being placed in a disadvantaged position in compared to a normal SA resident company.

5.2. Detailed factual description

5.2.1. <u>Example</u>

5.2.1.1. Company A is a REIT. Company A holds 100% of the equity shares and voting rights in Company B. Company B holds 100% of the equity shares in Company C, a company incorporated and tax resident of a foreign jurisdiction. The shares of Company C are not "listed share" as defined in section 1. Company C has an FBE and there is no net income imputation to Company B's income in FY21.

5.2.1.2. Diagram:



5.2.1.3. Analysis

- When Company B receives foreign dividends from Company C, Company B cannot rely on the following exemption:
  - Section 10B(2)(a) as Company B is a controlled company;
  - Section 10B(2)(b) as Company B is not a foreign company;
  - Section 10B(2)(c) as the amount is previously not included in the income of Company B by virtue of any prior inclusion in terms of section 9D;
  - Section 10B (2)(d) or (e) as the foreign dividend is not in respect of a listed share.

- As the foreign dividends are not exempt from tax in terms of section 10B(2), Company B can only rely on the section 10B(3) partial exemption and the foreign dividends will be subject to tax at 20%. In this example, Company B is also not eligible for a deduction. This will result in the controlled company being placed in a disadvantaged position in comparison to a normal SA resident company.

5.3. Proposal

5.3.1. As the new legislation creates unintended results for REITs and/or controlled companies which do not have qualifying distributions, we propose that section 25BB(2A)(d) be repealed.

6. HIGHER THRESHOLDS FOR RESTRUCTURING IN A FOREIGN GROUP COMPARED TO A LOCAL GROUP

[Applicable provisions: Section 42(1)(b)(i), section 44(1)(c)(ii)(B) and section 45(1)(b)(iii)(bb) of the Act]

6.1. Legal nature of the problem

6.1.1. The corporate reorganisation rules allow for the tax neutral transfer of assets provided that certain requirements are met. In the offshore (CFC) context, the application of certain corporate roll-over relief is *inter alia* dependant on the transferor – transferee CFCs forming part of the same "group of companies" *vis-à-vis* each other **and** forming part of the same "group of companies" as the resident.

6.1.2. In essence, this means that in order to qualify for roll-over relief, transacting CFCs must firstly, be part of the same of group and secondly be part of the same group as the SA resident shareholder. The second requirement is more onerous compared with the domestic equivalent roll-over provisions.

6.2. Detailed factual description

6.2.1. By way of example, a CFC with five SA shareholders each holding 20%, and which in turn holds 100% of its subsidiaries will not currently qualify for section 42, 44 or 45 roll-over relief to the extent that transactions take place between those subsidiaries.

6.2.2. Higher thresholds apply in order to qualify for roll-over relief when restructuring a foreign group compared to a local group.

6.2.3. It is, in our view, inequitable that CFC's engaging in reorganisation transactions have to abide by more onerous requirements in order to benefit from the same relief as SA residents, nor does this distinction appear to be necessary in context of the aim of the relevant provisions.

6.3. The nature of the businesses impacted

6.3.1. Local SA groups that are contemplating or undergoing a restructure.

6.4. Proposal

6.4.1. In our view, similar thresholds should apply to both local and foreign groups in order to qualify for roll-over relief.

7. THE EXCLUSION FROM THE EXTRAORDINARY DIVIDEND PROVISIONS OF ONLY LOCAL SECTION 46 AND SECTION 47 TRANSACTIONS

[Applicable provisions: Paragraph 43A of the Eighth Schedule to the Act read with section 46(1)(b) and section 47(1)(b) of the Act]

7.1. The legal nature of the problem

7.1.1. The income tax legislation currently contains anti-avoidance rules dealing with dividend stripping. It was pointed out in the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2019 that Government has noticed that certain taxpayers had embarked on abusive tax schemes aimed at circumventing the anti-avoidance rules dealing with dividend stripping arrangements in effect at the time.

7.1.2. Such schemes involved, for example, a substantial dividend distribution by the target company to its shareholder company combined with the issuance, by that target company, of its shares to a third party or third parties. The ultimate result was a dilution of the shareholder company's effective interest in the shares of the target company that does not involve a disposal of those shares by the shareholder company. The shareholder company ended up, after the implementation of this arrangement, with a lowered effective interest in the shares it held in the target company without triggering the anti-avoidance rules in effect at the time. This is because the pre-2020 anti-avoidance rules were triggered when there was a disposal of shares while these new structures do not result in an ultimate disposal of the shares but a dilution of the effective interest in the shares of the target company.

7.1.3. Amendments were subsequently made to curb the use of these new dividend stripping arrangements. In order to curb this abuse, the anti-avoidance measures were extended to not only apply in respect of actual disposals of shares but also apply in respect of deemed disposals of shares.

7.1.4. As part of these amendments, the definition of "extraordinary dividend" was updated to read as follows:

> *"**extraordinary dividend**", in relation to—*
>
> *(a) a preference share, means so much of the amount of any dividend received or accrued in respect of that share as exceeds the amount that would have accrued in respect of that share had it been determined with reference to the consideration for which that share was issued by applying an interest rate of 15 per cent per annum for the period in respect of which that dividend was received or accrued;*
>
> *(b) any other share, means so much of the amount of any dividend received or accrued—*
>
> *(i) within a period of 18 months prior to the disposal of that share; or*
>
> *(ii) in respect, by reason or in consequence of that disposal,*
>
> *as exceeds 15 per cent of the higher of the market value of that share as at the beginning of the period of 18 months and as at the date of disposal of that share:*
>
> *Provided that a dividend in specie that was distributed in terms of a deferral transaction must not be taken into account to the extent to which that distribution was made in terms of an unbundling transaction as defined in section 46 (1) (a) or a liquidation distribution as defined in section 47 (1) (a);'* (emphasis added)

7.1.5. According to the Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2019, *in specie* distributions made in terms of unbundling transactions and liquidation transactions involving resident companies (i.e., unbundling transactions contemplated in section 46(1)(a) and liquidation transaction contemplated in section 47(1)(a)) will be disregarded when determining whether an extraordinary dividend accrued to or was received by a shareholder company. This is because these types of transactions are extraordinary dividends that are used by taxpayers to transfer assets to shareholder companies in respect of which tax on their unrealised gains will be collected in future.

7.1.6. It is unclear, however, why the same measures should not also apply in respect of unbundling transactions and liquidation transactions involving CFCs (i.e. unbundling transactions contemplated in section 46(1)(b) and liquidation transaction contemplated in section 47(1)(b).

7.2. Detailed factual description

7.2.1. It is, in our view, inequitable that CFC's engaging in section 46 and/or section 47 transactions cannot benefit from the same relief as SA resident companies, nor does this distinction appear to be necessary in context of the aim of the relevant provisions (i.e., to curb the use of these dividend stripping arrangements).

7.2.2. SA tax residents would, in essence, be penalised for investing in CFC's. Discouraging investment in this manner appears to be short-sighted and potentially detrimental to economic activity.

7.3. Proposal

7.3.1. We recommend that the proviso to the definition of "extraordinary dividend" be amended as follows to simply apply to all unbundling transactions as defined in section 46(1) and/or all liquidation distributions as defined in section 47(1):

'Provided that a dividend in specie that was distributed in terms of a deferral transaction must not be taken into account to the extent to which that distribution was made in terms of an unbundling transaction as defined in section 46 (1) ~~(a)~~ or a liquidation distribution as defined in section 47 (1) ~~(a)~~;'

8. APPLICATION OF SECTION 8E AND 8EA IN RELATION TO NON-RESIDENT HOLDERS OF HYBRID EQUITY INSTRUMENTS

[Applicable provisions: Section 8E and 8EA of the Act]

8.1. The legal nature of the problem

8.1.1. Section 8E and 8EA applies to deem dividends paid in respect of hybrid equity instruments to be an amount of income accruing to that person during that year of assessment.

8.1.2. A non-resident will only be subject to tax in SA where such income is sourced in SA. Section 9(2)(a) provides *dividends* received by or accruing to a person will be sourced in SA. Section 8E and 8EA, however, overrides section 9(2)(a) as it deems the dividend to be an amount of income. Should the intention be for section 9(2)(a) apply the non-resident will be required to register as a taxpayer in SA and submit a tax return.

8.2. Detailed factual description

Company A is a non-resident situated in the United Kingdom. Company A does not have a permanent establishment in SA. Company A holds preference shares in Company B which is a SA resident company. The preference shares terms meet the requirements of a "hybrid equity instrument" and as such any dividends declared will be deemed to be income in the hands of Company A.

8.2.1. The Double Taxation Agreement (DTA) entered into between the UK and SA provides a dividend will mean for purposes of Article 10 " *<u>income from shares</u>, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident and also includes any other item which, under the laws of the Contracting State of which the company paying the dividend is a resident, is treated as a dividend or distribution of a company.*

8.2.2. As legally, the income remitted remains a dividend and given that the distribution amounts to "income from shares", Company A will be entitled to a reduced tax rate under the DTA.

8.2.3. By deeming the dividend to be an amount of income, section 8E and 8EA removes the distribution from the ambit of Part VIII (see section 64F(l)) which provides an exemption from dividends tax applies in respect of any dividends which constitute income of a person.

8.3. Proposal

8.3.1. There is no clarity how section 8E and 8EA must be dealt with given the DTA provisions which provide for a reduced tax rate in respect of income distributed which meets the definition of "dividend" as per Article 10 of the DTA.

8.3.2. We propose that the provision of clarified accordingly.

9. DISCHARGE OF A DEBT BETWEEN A SOUTH AFRICAN RESIDENT PARENT COMPANY AND ITS CONTROLLED FOREIGN COMPANY

[Applicable provisions: Section 9D, section 19 and Paragraph 56 of the Eighth Schedule to the Act]

9.1. Legal nature of the problem

9.1.1. Any recoupment in terms of Section 19 which arises due to a loan waiver between a resident and its CFC will be attributable to the creditor resident shareholder in terms of section 9D and taxed in the creditor's hands, not the debtor as required in terms of paragraph 56 of the Eighth Schedule.

9.1.2. This creates uncertainty regarding the applicability of Paragraph 56(2)(c) of the Eighth Schedule.

9.2. Detailed factual description

9.2.1. Where loans have been advanced to a CFC by a resident entity, the waiver of such loan may result in a recoupment in terms of Section 19.

9.2.2. Paragraph 56(2) of the Eighth Schedule provides that the creditor may in certain circumstances treat the loan waiver as a capital loss provided the debtor has taken such amount into account in calculating its taxable income.

9.2.3. A recoupment in terms of Section 19 will be attributable to the creditor resident shareholder according to section 9D and taxed in the creditor's hands, not the debtor as required (see Paragraph 56(2)(c) of the Eighth Schedule).

9.2.4. We request that this anomaly is rectified as it may not have been the intention of the legislature to disallow the creditor to claim the capital loss and simultaneously be taxed on the recoupment under Section 9D.

9.3. Nature of the businesses impacted by the problem

9.3.1. Corporate taxpayers with CFC's.

9.4. **Proposal**

9.4.1. We request clarity to be provided in relation to the interplay between Paragraphs 12A and 56 of the Eighth Schedule, and Section 19, in the circumstances outlined above.

10. LEVEL OF IMPUTATION OF CFC CAPITAL GAINS

[Applicable provision: Section 9D of the Act]

10.1. Legal nature of the problem

10.1.1. SA tax law distinguishes between amounts of a revenue nature and amounts of a capital nature. Amounts of a capital nature are typically dealt with in the Eighth Schedule to the Act. A taxpayer would calculate its net capital gain (para 8) or assessed capital loss (para 9) by deducting any capital losses incurred in the year and/or deducting any assessed capital loss from the previous year of assessment. Any resultant taxable capital gain is then included in the taxpayer's taxable income (section 26A).

10.1.2. The issue at hand is where a SA shareholder is required to impute an amount relating to a CFC and that amount is capital in nature. The mechanism does not allow for the SA shareholder to deduct any capital losses that it may have against the imputed capital amount. Rather, in terms of the current law, the CFC's net income amount (whether it is of a revenue or capital nature) is imputed directly into to the SA shareholder's "income". Any (revenue) assessed loss of the taxpayer may be deducted against this imputed amount. However, as noted, the mechanism does not allow for the deduction of capital losses.

10.2. Detailed factual description

10.2.1. CFC rules are anti-avoidance legislation by nature. However, there are cases where a CFC finds itself with net income that is imputable to its shareholder resulting from transactions that have no element of anti-avoidance. In this regard, SA has a number of large outbound multinational groups. It is sometimes required to restructure these groups and in certain cases the restructuring does qualify to fall under one of the corporate rules (sections 41 to 47) or the participation exemption (para 64B) as these rules have a number of strict requirements.

10.2.2. Therefore, a restructuring could be carried out that results in a net income amount that must be imputed. There may also not be a foreign tax credit available to shield the amount that is imputable and taxable in SA. This is because the foreign restructuring may have no tax implications in the foreign jurisdictions due to different rules that allow for easier qualification for exemptions. Accordingly, an offshore restructuring that has no implications for SA and has no anti-avoidance element and which qualifies for an exemption in the foreign jurisdiction finds itself taxable in in the hands of the SA shareholder.

10.3. Nature of the businesses impacted by the problem

10.3.1. Corporate taxpayers with CFC's.

10.4. Proposal

10.4.1. Therefore, it is proposed that section 9D should be amended such that any imputable net income amount of a CFC that is capital in nature be imputed into the SA shareholder's tax formula in the Eighth Schedule rather than directly into the SA shareholder's income.

End.