South African Institute of Tax Professionals

24 November 2020

To: The National Treasury
240 Madiba Street
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0001

The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
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Via email: National Treasury (2020AnnexCProp@treasury.gov.za)
SARS (acollins@sars.gov.za)

Dear Colleagues,

RE: ANNEXURE C PROPOSALS, 2020: INTERNATIONAL TAX

We attach hereto the Annexure C proposals from the SAIT International Tax Technical Work Group, as it pertains to International Tax and related matters. We value the opportunity to participate in the legislative process and would welcome further engagement where appropriate.

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

Yours sincerely,

SAIT International Tax Technical Work Group

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

1. FOREIGN IMMOVABLE AND SECTION 9D "FOREIGN BUSINESS ESTABLISHMENT" RELIEF

[Applicable provision: Section 9D]

1.1. Background

1.1.1. Section 9D triggers deemed income for Controlled Foreign Companies but only to the extent of tainted income. The main goal of section 9D is to ensure parity of taxation for certain tainted forms of foreign income where activities can easily be shifted abroad. As a general matter, tainted section 9D income covers wholly mobile income, passive income and diversionary income (i.e. income susceptible to transfer pricing abuse).

1.1.2. Besides the high-tax exemption, the main exemption for section 9D relates to foreign business establishments. As a general matter, foreign business establishments are aimed at providing relief for businesses established abroad mainly for business reasons as opposed to tax reasons (and which face foreign competition). The primary category of foreign business establishment relief is for active foreign businesses with employees and capital having a strong nexus abroad.

1.1.3. In addition to the general relief for active foreign business, section 9D contains a list of activities that are eligible for automatic relief because of their obvious foreign active nexus. This automatic list includes foreign mines, construction sites, farms and fishing operations. Businesses of this nature must be located abroad and compete in their local foreign environment by their very nature. The income for these activities will also inevitably be subject to tax by the foreign source country in the first instance. Any South African tax imposed will accordingly come with section 6*quat* rebates to prevent double taxation. But for mining, all of these activities will generally be subject to the full rate of foreign tax. Even the incentives for mining have diminished in most countries.

1.2. General recommendation

1.2.1. Despite the foreign fixed location of immovable property, no relief for section 9D exists for rental income associated with foreign located real estate. Most of these properties require direct or external contract support, thereby operating as an active business as opposed to a passive activity. Most immovable property rentals are active, consisting of retail commercial space, office space, manufacturing, distribution and other logistic spaces. Residential rental of houses and the like may be passive; whereas, rental of apartment blocks is very active.

1.2.2. The above rentals of immovable property will almost always be subject to tax on a source basis by the foreign local country. Foreign countries will impose tax at top marginal rates. (They also frequently impose monthly real estate charges at a municipal level. Some countries like South African impose a transfer duty, stamp duty or similar tax charge on purchase.) Hence, any South African tax collected should be fairly small after section 6*quat* rebates (credits) are taken into account for foreign local income taxes paid.

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1.2.3. We accordingly recommend that rentals from immovable property receive automatic business establishment relief like construction (and mining, farming, etc.). This relief is especially important for commercial and industrial properties. Residential activities can be perceived as passive in the case of stand-alone houses or apartment units; whereas, complexes require active engagement.

1.3. Note on REITS

1.3.1. The South African REIT industry often finds its foreign rental real estate in the cross-hairs of section 9D due to the unique nature of their structures. REIT offshore activities economically require a substantial amount of foreign activity in terms of foreign-located employees and foreign-located capital and support. Despite this high level of foreign local activity, a problem arises because many foreign REITs utilise the old Property Unit Trust (PUTs) structures to manage their activities, along with independent third-party contractors.

1.3.2. Under the old PUT structure utilised by many foreign countries, management and most employees are located in a separate trust or other vehicle; whereas, the real estate sits within the South African CFC. This separate structure means that the foreign real estate falls outside the foreign business establishment exemption even if fully active in a commercial economic sense.

1.3.3. The net result is the potential application of section 9D to CFCs of a REIT, leaving these REIT-owned CFCs at a disadvantage. These REIT-owned CFCs are subject to dual country taxation despite the fact that these entities are locally competing with foreign local real estate activities only subject to foreign local tax.

2. OVERLY HARSH IMPACT OF THE REPEAL OF THE FOREIGN PARTICIPATION EXEMPTION FOR REITS

[Applicable provision: Section 25BB(2A)(d)]

2.1. Background

2.1.1. The 2020 legislation repealed the section 10B(2)a) participation exemption for foreign dividends in respect of a REIT or a (REIT) controlled company. The stated purpose of this change is to prevent a mismatch previously exempt foreign dividends received, followed by a deductible REIT distribution.

2.1.2. Without reverting to the concerns raised in our prior submission, offshore CFC REITs find themselves in a worse position that domestic REITs. Unlike domestic REITs (and domestic section 25BB controlled companies), offshore REITs do not receive a deduction for the payment of dividends out of rentals. Hence, offshore REIT CFC dividends are not deductible when paid, but these dividends create ordinary revenue on receipt while CFC dividends are both non-deductible when paid and generally exempt (via section 10B(2)(a)) when received.

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2.2. General recommendation

2.2.1. Distributions by offshore CFCs of local REITs should be deductible like domestic qualifying distributions of section 25BB companies. Section 25BB(2)(a), which allows for deductible qualifying distributions, should include section 25BB "controlled companies" that are section 9D CFCs.

3. OFFSHORE DUAL LINKED REIT DEBENTURES

[Applicable provision: Section 25BB]

3.1 Background

3.1.1. Older global REIT structures often use dual-linked debentures. Under these structures, each unit holder holds both a voting share of nominal value and a debenture. The debentures generate variable interest based on rental profits of the offshore REIT. These dual linked debenture structures were often used by pre-existing South African property unit trusts (as described in older versions of section 43).

3.1.2. The problem with these older offshore REIT structures is that they do not conform to the modern system of section 25BB REITs. Dual-linked debentures generate a deduction when paid and income where received. However, domestic REITs and section 25BB companies cannot treat the receipt of debenture interest as section 25BB "rental income" even though the underlying debenture makes payment based on underlying offshore rental yields.

3.2 General recommendation

3.1.3. The yield of dual linked debentures should be treated as section 25BB rental income if at least 75 per cent of the underlying offshore company stems from rental income. This change would place offshore dual-linked debentures on parity with REIT (or section 25BB controlled company) shares.

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

[Applicable provisions: Section 8E and 8EA]

4.1. Background

4.1.1. Section 8E and 8EA treat the yield of hybrid (share) equity instruments "as an amount of income". The term "income does not sit well with certain domestic rules such as source (nor does the term "income" sit well with tax treaties). Under present law, it appears that the yield is neither subject to dividend withholding nor the interest withholding rules (meaning that foreign investors will have to register as a local taxpayer and submit a local South African tax return).

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4.1.2. It is unclear how the yield for hybrid equity purposes should be treated as a matter of source under section 9. Does the yield qualify as a dividend, as interest or as something else. If the form of the instrument is respected, the yield from hybrid equity instruments should be treated as a dividend for purposes of section 9, meaning that the "income" yield is domestic if the equity instrument was issued by a domestic company. If substance governs, the yield from the hybrid equity instrument should be treated as interest.

4.1.3. Presumably, the yield should also be subject to withholding. However, there is no special withholding regime for "income". As a conceptual matter, the yield could be treated as dividends or as interest for withholding

4.2. General recommendation

4.2.1. The yield from section 8E and 8EA instruments should probably be treated as interest income given that the yield of these instruments is more akin economically to interest. This interest treatment should apply for purposes of source, withholding and tax treaties.

5. TAPERED CAPITAL GAIN PARTICIPATION RELIEF

[Applicable provisions: Paragraph 64B of the 8th Schedule]

5.1. Background

5.1.1. The participation exemption for the sale of foreign shares applies only if the seller holds 10 per cent or more of the foreign equity shares immediately before the disposal. These shares must have been held for at least 18 months before sale.

5.1.2. While the 10 per cent threshold is in line with international tax practice, certain sellers of foreign shares may dispose of their foreign shares in a company over a set period of time as opposed to a single sale. For instance, a South African company may own 20 per cent of a foreign company and plan to sell the shares in two installments – first 15 per cent and then the remaining 5 per cent. Assuming all the foreign shares were held for more than 18 months, the first sale of 15 per cent will be eligible for the participation exemption while the remaining 5 per cent will not. Had all the foreign shares been sold at once, the participation exemption would have applied to all 20 per cent.

5.2. General recommendation

5.2.1. Many countries, including the UK, provide for tapered relief in terms of the participation exemption to allow for staggered sales. We would suggest that South Africa offer similar relief as a matter of international competitiveness. One possible approach would be to exempt the sale of foreign shares if: (i) the seller held 10 per cent of more of the same shares for 18 months, and (ii) the final sale occurred within 18 months during the last date in which the 10 per cent or more shares were held by the seller.

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6. INWARD LISTINGS

[Applicable provision: section 1 definition of "foreign dividend"]

6.1. Background

6.1.1. Distributions from a domestic company are generally treated as a dividend unless an election is made to treat the amount as a capital distribution. Buybacks / redemptions are treated the same way unless the buyback / redemption involves shares listed on the JSE. JSE buybacks / redemptions instead trigger capital gains. Capital gain treatment applies in these cases because the seller of the shares often lacks the information to determine whether the sale occurred on the open market to a third-party seller or as a buyback / redemption.

6.1.2. Distributions from a foreign company are generally treated as a foreign dividend unless an election is made to treat the amount as a capital distribution. Buybacks / redemptions are treated the same way even if the shares are inwardly listed on the JSE. The net result is to treat inwardly listed shares on the JSE different from wholly domestic shares listed on the JSE even though all JSE shares face the same practical considerations.

6.2. General recommendation

6.2.1. Buybacks / redemptions on the JSE should be treated the same regardless of whether the JSE shares exist in respect of domestic companies or inwardly listed foreign companies. The definition of foreign dividend should accordingly contain the same exclusion from dividend treatment as domestic shares. All foreign share buybacks on inward JSE listings should be treated as a capital gain.

7. ACQUISITIONS OF IMMOVABLE PROPERTY COMPANIES USING NON-CASH CONSIDERATION

[Applicable provision: Section 35A]

7.1. Background

7.1.1. The cash sale of immovable property (or of an immovable property company) is subject to withholding tax by the purchaser. The withholding rate amounts to 7.5, 10 and 15 per cent depending on the nature of the seller. The purchaser withholds the charge from the cash purchase price. The withholding amount must be paid over to SARS within 14 or 28 days from the purchase depending on the tax residence of the purchaser.

7.1.2. Not all purchases are accomplished with cash however, especially if the seller is disposing of the shares of an immovable property company. The shares of an immovable property can be involved in a share-for-share transaction with the seller swapping the shares of the immovable property company for shares in another company. Many of these share-for-share swaps entail foreign shares. Many of these swaps also fall outside of the rollover relief for South African reorganisations.

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7.1.3. The disposal of immovable property (and of immovable property companies) by way of barter transaction (including a share swap) gives rise to a practical problem. The purchaser often lacks the cash to pay the withholding, especially if the swap arises in respect of a small company or a family context.

7.2. General recommendation

7.2.1. In order to alleviate the cash problem in share-for-share immovable property transfers, the rules relating to security should be relaxed. Under this relaxation, the barter sales consideration to be received by the purchaser should be viewed as explicit useable security. Perhaps more time should be allowed to pay if even if no security is offered (such as a few months).

7.2.2. Another option would be to extend the group relief rules for share-for-share transactions within a section 1 group of companies. None of these transactions involve a cash-out with all shares remaining in the same economic unit.

8. LOOK-THROUGH RATE FOR UNDERLYING TAXABLE DIVIDENDS FROM CONTROLLED FOREIGN COMPANIES (previously proposed in 2019)

8.1. Background

8.1.1. The CFC regime contains look-through rules for CFC capital gains. Individual domestic shareholder inclusions of CFC capital gains give rise of a 40 per cent inclusion; whereas, company domestic shareholder inclusions of CFC capital gains give rise to an 80 per cent inclusion. The net effect of this is that, in applying the CFC rules, the domestic shareholder pays CGT at the same rate as if that shareholder had earned the capital gain directly (e.g. 18% for a natural person and 22.4% for a company). Similar rules do not apply, however, when the CFC derives a foreign dividend where the participation exemption does not apply. In determining the net income of the CFC, one simply applies the exemption ratio in section 10B(3) applicable to a company is 8/28. The effect of this is that where the shareholder of the CFC is a company, its effective tax rate on the foreign dividend is 20%; however, if the shareholder is an individual or a trust, the effective rate increases to 32%.

8.2. General recommendation

8.2.1. Proposal In our view, the domestic rate for dividends is 20% for all shareholders so the formula for trust and individual shareholders should be 25/45 (i.e. resulting in a flat 20 per cent charge).

End.

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