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30 April 2024

**To: The National Treasury**
240 Madiba Street
PRETORIA
0001

**VIA EMAIL**: National Treasury (Nhlanhla.Radebe@treasury.gov.za);

**REQUEST FOR RECONSIDERATION OF PREVIOUSLY SUBMITTED PROPOSALS: CORPORATE TAX**

Dear Mr., Radebe

The SAIT Corporate Tax Technical Work Group has previously submitted commentary and proposals pertaining to Corporate Tax and related matters as part of the Annexure C process. One such submission was made in 2022 for purposes of inclusion into the 2023 Budget. Included in our submission to the National Treasury were comments and proposals pertaining to section 23(c) and section 42(8) of the Income Tax Act, No. 58 of 1962 (**the Act**)[1].

As is common purpose, the National Treasury convened a virtual workshop with stakeholders to discuss Annexure C proposals that were received during that period. During the Annexure C workshop that was convened in December 2022, discussions were held regarding *inter alia* comments and proposals on section 23(c) and section 42(8) of the Act, as these were canvassed and outlined in the 2022 SAIT Corporate Tax submission. During that meeting the National Treasury expressed differing views to those espoused and outlined in 2022 SAIT Corporate Tax submission as pertaining to the aforementioned provisions.

The purpose of this document is to restate the commentary and proposals contained in the 2022 SAIT Corporate Tax submission, and to further provide clarificatory input and factual examples in relation thereto. We have undertaken to address this matter on the basis that the legal nature of the problems identified in the 2022 SAIT Corporate Tax Submission (and indicated below) as pertaining to the above referred provisions, remain challenging.

We proceed to set out below the specific problems and proposals raised, feedback received from the National Treasury during the virtual workshop that was convened in December 2022, and our expanded clarificatory comments.

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

[1] All references to legislation contained in this document relate to the provisions of the Income Tax Act, No. 58 of 1962

## 1. LIQUIDATION AND UNBUNDLING TRANSACTIONS SUBSEQUENT TO ASSET FOR SHARE TRANSACTIONS, INVOLVING THE ASSUMPTION OF DEBT AS CONTEMPLATED IN SECTION 42(8)

[**Applicable provisions**: Section 42(8)]

### 1.1. Legal nature of the problem

1.1.1 In the case of a liquidation transaction in terms of section 47, subsection 5 thereof provides that the holding company must disregard the disposal (or returns of capital received) in respect of the shares in the liquidating company. The rollover relief effect is that neither a capital gain, nor a capital loss is triggered in such instances.

1.1.2 In the case of an unbundling transaction in terms of section 46, the base cost of the unbundled company's shares is not rolled over to the shareholder of the unbundling company; instead, the shareholder must allocate its existing base cost of the unbundling company's shares between the unbundling company's shares retained and the unbundled company shares acquired. If the base cost of the unbundled company was stepped up due to a section 42 transaction undertaken prior to the unbundling, this "stepped-up" base cost is effectively lost when the unbundling transaction takes place.

### 1.2. Proposal

1.2.1. Consequently, the 2022 SAIT Corporate Tax submission included a proposal that the provisions of section 42(8) should not apply where the transferee company is subsequently liquidated in terms of section 47 or unbundled in terms of section 46 of the Act.

### 1.3. Feedback received from National Treasury

1.3.1. National Treasury disagreed with the above-described legal nature of the problem and rejected the proposal made. To substantiate and support the proposal made, the National Treasury requested detailed examples to illustrate the legal nature of the problem.

### 1.4. Further clarificatory remarks

1.4.1. When a taxpayer undertakes a section 42 transaction, the taxpayer would benefit from a "step-up" in the base cost. However, if the same taxpayer undergoes a section 46 or section 47 transaction, directly thereafter, the contemplated "step-up" (as per section 42), effectively falls away and the taxpayer does not actually receive the benefit of the "step-up" in the base cost.

1.4.2. Please refer to Annexure A, which is a detailed workbook example illustrating the above.

1.4.3. We therefore request that the above proposal be re-considered.

## 2. UNINTENDED CONSEQUENCES OF SECTION 23(c) OF THE ACT

[**Applicable provisions:** Section 23(c)]

### 2.1. Legal nature of the problem

2.1.1. Where a taxpayer receives or accrues an amount of compensation (for example, from an insurance policy) that indemnifies that taxpayer from a loss that "*fills a hole in his profits*" then the amount received or accrued would fall into "gross income" as defined in section 1(1) of the Act. This result is based on the principle arising from the case of *Burmah Steamship Company Ltd v IRC* 1931 SC 156, 16 TC 67.

2.1.2. Section 23(c) of the Act prohibits the deduction of any loss or expense, the deduction of which would otherwise be allowable, to the extent to which it is recoverable under any contract of insurance, guarantee, security or indemnity.

2.1.3. Alternatively, where an expense that was previously claimed as a deduction is subsequently recovered or recouped, the amount recovered or recouped must be included in the taxpayer's income in terms of section 8(4)(a) of the Act.

2.1.4. Therefore, for example, where an insurance policy covers the loss of trading stock through theft or damage, section 23(c) would apply to disallow the deduction of the cost of the trading stock. Similarly, where the insurance proceeds covers other expenditure (for example, the cost of repairing damage to property and other assets, or the costs in preparing the insurance claim), the deduction for the expenditure would be disallowed.

2.1.5. An anomaly therefore arises where an amount of insurance compensation is included in "gross income", but the corresponding deduction for the underlying loss or expense that is covered by the insurance policy is not allowed.

### 2.2. Factual description

2.2.1. We are aware of at least one instance in practice where the South African Revenue Service (SARS) has applied the above treatment (i.e., inclusion but no deduction), resulting in the taxpayer being taxed in full on insurance proceeds, and not being allowed a deduction of the corresponding expense.

2.2.2. This matter proceeded to the Tax Board on appeal: the taxpayer lost its appeal, resulting in the full insurance proceeds being subject to tax, and no deduction being allowed for the corresponding expense.

2.2.3. Considering the July 2021 riots, April 2022 floods and the increase in events of force majeure that the country has experienced over the last two years and continues to experience, this issue has become prevalent for a wider range of taxpayers (i.e., trading businesses (sole proprietors, companies, trading partnerships and trading trusts) who are recipients of insurance proceeds under a contract of insurance.

**2.3. Proposal**

2.3.1. We submit that the application of section 23(c) as described above, gives rise to inequitable results. Other tax provisions already provide for the inclusion in income of insurance proceeds that "*fill a hold in profits*", or are characterised as a recovery or recoupment of expenditure incurred. In our view, section 23(c) serves no legitimate anti-avoidance purpose and causes unintended consequences for taxpayers. On the basis of the reasoning provided above, we request that section 23(c) be repealed.

**2.4. Feedback received from National Treasury**

2.4.1. National Treasury was of the view that there should not be an incidence of inequity since deductions are provided for in the legislation. For example:

- Deduction for loss of trading stock is catered for in section 22 of the Act; and
- Cost of repairs – although the loss is not deductible, the expenses incurred to repair are deductible.

**2.5. Further clarificatory remarks**

2.5.1. We attach documents on a real-life example, where SARS applied the provisions of section 23(c) in a manner that was prejudicial to the taxpayer.

2.5.2. Consent was obtained from the taxpayer to share the specific case where the Tax Board applied section 23(c), and the taxpayer's claim of a deduction for trading stock destroyed was disallowed.

2.5.3. Please refer to Annexure B, particularly the document entitled "RULING COMPONENTS – sanitised 23(c)", for further detail.

2.5.4. We therefore request that the above proposal be re-considered.

End.

***Disclaimer***

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