

**EXPLANATORY MEMORANDUM ON THE
INCOME TAX BILL, 1997**

INTRODUCTION

The Bill fixes the rates of normal tax payable by individuals and companies and introduces amendments to the Income Tax Act, 1962 (Act No. 58 of 1962), hereinafter referred to as the principal Act, as well as an amendment to the Income Tax Act, 1996 (Act No. 36 of 1996).

CLAUSE 1 AND THE SCHEDULE

Rates of normal tax

Rates of normal tax are enacted by *clause 1* and the Schedule to the Bill.

Persons other than companies

The rates for persons other than companies apply in respect of the year of assessment ending on 28 February 1998 or 30 June 1998 and are provided for in paragraph 1 of the Schedule.

The rates for natural persons consist of a progressive rate structure ranging between 19 per cent on the lowest income segment (amounts up to R30 000) and 45 per cent which is reached on the income segment above R100 000.

The rates for persons other than natural persons (such as trusts but excluding companies) consist of a progressive rate ranging between 17 per cent on the lowest income segment (amounts up to R5 000) and 45 per cent which is reached on the income segment above R100 000.

The rates for-

- natural persons are provided for in paragraph 1(a) of the Schedule; and
- persons other than natural persons (such as trusts but excluding companies) are provided for in paragraph 1(b) of the Schedule.

Companies

The rates for companies apply in respect of years of assessment, i.e. the financial year of the company concerned, ending during the 12-month period from 1 April 1997 to 31 March 1998, and are provided for in paragraphs 2(a) to (f) inclusive, of the Schedule.

Those rates are as follows:

(a) Taxable income derived otherwise than from gold mining, long-term insurance business, by a foreign company through a branch or agency in the Republic or a qualifying company enjoying tax holiday status: 35 cents per R1, but in the case of a company which mines for gold and which is exempt from secondary tax on companies in terms of an option exercised by it, 42 cents per R1 of its non-gold mining taxable income (paragraph 2(a) of the Schedule).

(b) Taxable income derived by a company from gold mining: an amount determined in accordance with one of the following formulae:

(i) where such company is not exempt from secondary tax on

$$\text{companies: } y = 43 - \frac{215}{x} \text{ ; or}$$

(ii) where such company is exempt from secondary tax on

$$\text{companies: } y = 51 - \frac{255}{x}$$

as provided for in paragraph 2(b) of the Schedule.

(c) Taxable income in the form of "recoupments" of capital expenditure accruing to companies which are or have been gold mining companies: the average rate of tax, determined as provided, or 35 cents per R1, whichever is the higher (paragraph 2(c) of the Schedule).

(d) Taxable income derived from long-term insurance business where such taxable income has been determined under the provisions of section 28 of the principal Act: 45 cents per R1 (paragraph 2(d)(i) of the Schedule).

(e) Taxable income derived from long-term insurance business where such taxable income has been determined under the provisions of section 29 of the principal Act: 30 cents per R1 in respect of the insurer's individual policyholder fund and 35 cents per R1 in respect of its company policyholder fund and corporate fund (paragraph 2(d)(ii) of the Schedule).

(f) Taxable income (excluding from gold mining, long-term insurance business or a qualifying project enjoying tax holiday status) derived by a company which has its place of effective management outside the Republic and which carries on trade through a branch or an agency within the Republic: 40 cents per R1 (paragraph 2(e) of the Schedule).

(g) Taxable income derived by a qualifying company which has been granted tax holiday status in terms of section 37H of the principal Act: zero cents per R1 (paragraph 2(f) of the Schedule).

TAXATION OF INVESTMENT INCOME FROM A SOURCE OUTSIDE THE REPUBLIC

The Katz Commission in its Fifth Report considered the question of whether tax should be imposed on the income of a resident regardless of the source of the income (the residence or world-wide basis) or on the income at source regardless of residence (the "source" basis). As the recommendations of the Commission have far-reaching implications, which require further consideration and analysis, it is proposed to introduce certain interim measures during the shorter term. This is of particular importance in the light of the announcement by the Minister of Finance in his Budget Speech with regard to the relaxation of exchange controls from 1 July 1997. In order to protect the South African tax base the following measures in relation to the taxation of investment income are proposed in two new sections, that is sections 9C and 9D, to be introduced in the principal Act.

The expressions annuity, interest, investment income, permanent establishment, rental income, resident and royalty are defined.

The expression "annuity" follows its ordinary meaning but excludes pensions in consideration of past employment and payments made under the social security system of any other country.

The term "interest" means interest and amounts as contemplated in sections 24J and 24K of the principal Act and also includes certain other income which is subjected to the same treatment as income from money lent, such as for example dividends on affected instruments as contemplated in section 8E of the principal Act.

"Investment income" means any income in the form of annuities, interest, rentals and royalties and any income of a similar nature.

The expression "permanent establishment" follows the meaning assigned to it in terms of the international Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.

"Rental income" means any amount received by or accrued to a person as consideration for the use of, or the right to use, any movable or immovable property.

The term "resident" means any natural person ordinarily resident in South Africa and any person other than a natural person, which has its place of effective management in South Africa. Such other person will include entities such as companies, close corporations, trusts and any other type of corporate entity.

Lastly the term "royalty" means any amount received by or accrued to a person as consideration for the use of, or the right to use, certain intellectual property or information concerning industrial, commercial or scientific experience.

Subsection (2) of section 9C provides that where any investment income is received by or accrued to a resident from a country other than the Republic, such investment income shall be deemed to have been received by or accrued to the resident from a South African source and the resident will accordingly be taxable in South Africa on such income. The same rule will also apply to a non-resident earning such investment income which arises from activities carried on by him or her through a permanent establishment in the Republic.

On the other hand, subsection (3) provides that the aforementioned rules will not apply where the investment income arises from-

- and are an effectively connected to the business activities of a substantive business enterprise carried on by the resident through a permanent establishment in any other country. Such permanent establishment must furthermore be suitably equipped for conducting the principal business of the substantive business enterprise ; or
- assets acquired by a natural person before he or she became ordinarily resident in the Republic for the first time, in respect of the years of assessment ending on 28 February 1998, 28 February 1999 and 29 February 2000.

The ordinary provisions of the principal Act will apply in respect of investment income included in the gross income of any person. Subsection (4), therefore, provides that where a person carries on a trade outside the Republic, such trade shall for the purposes of sections 11, 20 and 28 be deemed to be a trade carried on within the Republic. Furthermore, the principles outlined in Practice Note 31 dated 3 October 1994, in relation to "Interest Paid on Moneys Borrowed", will similarly apply in the case of investment income in the form of interest which is earned by a resident from a foreign source.

The new section 9D introduces certain anti-avoidance measures in relation to income of controlled foreign entities as well as investment income arising from certain donations, settlements or other dispositions.

In subsection (1) the following expressions are defined:

A "controlled foreign entity" is defined as any foreign entity in which residents of the Republic, whether individually or jointly or whether directly or indirectly-

- hold more than 50 per cent of the participation rights; or
- are entitled to exercise more than 50 per cent of the votes or control of such entity.

A "foreign entity" is restricted to persons, other than a natural person, whose place of effective management is outside the Republic. A foreign entity will also include a trust.

The expressions "investment income" and "resident" follow the meaning assigned to them in section 9C.

The term "participation rights" means the right to directly or indirectly participate in the capital or profits of, dividends declared by, or any other distribution or allocation made by the entity.

As mentioned above the provisions of the proposed section 9D are in the nature of anti-avoidance measures to prevent a situation whereby a resident invests capital offshore in passive investments not in the resident's own name, but through an offshore entity whereby-

- taxable passive income is re-characterised and converted into passive income (such as dividends) which is not taxable;
- taxation of income is deferred or avoided by accumulating or capitalising such income in a foreign entity.

On the other hand a resident can simply donate capital resulting in investment income, arising from such donated capital, but not from a source within the Republic, accruing to a non-resident.

The following rules are therefore proposed as anti-avoidance measures in this regard:

Subsection (2) in the first instance provides that there shall be included in the income of any resident in relation to a controlled foreign entity a proportional amount of the investment income received by or accrued to such foreign entity, which is attributable to the participation rights of such resident in such foreign entity. The provisions of the subsection shall, however, not apply to investment income dealt with under subsection (4).

Subsection (3) encompasses a situation where any resident in relation to a controlled foreign entity acquires a vested right to participate in an amount of capital of such controlled foreign entity where-

- such capital arose from investment income of the controlled foreign entity during years of assessment in which the resident only had a contingent right in relation to such investment income; and
- such investment income was not subject to tax in the Republic previously.

Where a resident acquires such a vested right to such an amount of capital, it will be included in the income of the resident in the year of assessment in which the resident so acquires the vested right.

Subsection (4) provides for a situation whereby investment income is received by or accrues to a resident or a non-resident in consequence of a donation, settlement or other disposition made by a resident. In such situations investment income attributable to such a donation, settlement or other disposition shall be included in the income of the donor.

Subsection (5) provides that where an asset is disposed of for a consideration which is less than the market value thereof, the difference between the market value thereof and the consideration received will be deemed to be a donation for the purposes of this section.

Subsection (6) prescribes what exchange rate may be applied in converting to the currency of the Republic an amount apportioned to any resident in terms of the provisions of section 9D.

Subsection (7) obliges a resident to disclose information in relation to any participation or vested right or any donation, settlement or other disposition in his return of income.

The purpose of subsection (8) is to ensure that the provisions of section 11 shall apply in respect of investment income earned by a controlled foreign entity where the investment income arises in the course of the carrying on of a trade outside the Republic. The proviso to the subsection provides, however, that-

- any deduction shall be allowed on an apportionment basis;
- the deductions shall be limited to the investment income; and
- any excess shall be carried forward to the following year.

Subsection (9) provides for situations when the provisions of section 9D shall not apply, namely-

- where the foreign tax paid or payable is more than 85 per cent of the South African income tax payable;

- where the investment income arises from and is effectively connected to the business activities of a substantive business enterprise carried on through a permanent establishment in a foreign country. Furthermore such permanent establishment must be suitably equipped to conduct the principal business of such enterprise;
- in the case of immigrants. Phasing-in provisions apply in respect of immigrants, further details of which are contained in the paragraph hereunder;
- to any investment income which is subject to tax in a country which has been identified by the Minister of Finance by way of a notice in the *Gazette* as a country whose tax on income is determined on a basis and level similar to that of the Republic.

The provisions of sections 9C and 9D provide for phasing-in with regard to the investment income of immigrants and would, therefore, not apply in respect of any investment income arising from any asset acquired by such immigrant, or by the controlled foreign entity in relation to such immigrant, before that immigrant became ordinarily resident in the Republic for the first time. Such income would therefore not be subject to the provisions of sections 9C and 9D for the first three years of assessment ending on or after 28 February 1998.

The provisions of sections 9C and 9D will come into operation on 1 July 1997.

Section 9A is amended to provide that such section and section 9D shall not apply in respect of the same investment income. Any investment income of a controlled foreign company will, therefore, firstly be dealt with under the provisions of section 9D and any investment income to which section 9D applies, will not be dealt with under section 9A.

Subsections (2), (3) and (4) of the deemed source provisions contained in section 9 are deleted in consequence of the insertion of sections 9C and 9D in the principal Act.

The ambit of the rebate to be granted in respect of foreign taxes, contained in section 6quat, has been extended to refer also to taxes in respect of income included in the taxable income of a resident or non-residents referred to in section 9C(2)(b), which income is received from or accrued from another country or is income contemplated in section 9D. The reference to source is deleted as the income will under the new provisions in section 9C and 9D be taxable in the Republic and the normal source rules would therefore not apply in respect of that income. There shall be allowed as a rebate against normal tax any foreign tax payable by the resident or by the controlled foreign entity on the proportional amount of the investment income of such controlled foreign entity, which has under the provisions of section 9D been included in the income of the resident. The rebate will not be allowable in respect of foreign taxes payable which are subject to a right to recovery except where it is a right of recovery in terms of an entitlement to carry back losses.

Example

- A company which is managed and controlled in the Republic invests in a property in Spain, which is rented out. The activities in Spain do not constitute a permanent establishment. During the year of assessment rental income amounting to 10 000 000 pesetas was received and expenses of 2 000 000 pesetas were incurred in the production of the income. In the Republic interest of R100 000 was incurred in the production of the rental income. At the end of the year of assessment none of the profits was remitted to the Republic and the exchange rate was 100 pesetas / R3.

The tax payable in Spain in respect of the rental income, reduced by the allowable deductions is 2 000 000 pesetas (R60 000). The South African taxable income relating to the property in Spain is

$$R140\ 000 [(8\ 000\ 000 \div 100 \times 3) - 100\ 000]$$

and other taxable income in the Republic is R400 000. The company will be entitled to the following credit:

Subsection (1) - maximum amount-

Tax payable to a foreign government,

which is not recoverable: R60 000

paragraph (a) of proviso to subsection (1)-

Foreign taxable income R140 000

Total taxable income R540 000

Total tax payable in the Republic R189 000

$$\text{Limitation of rebate} = (R140\ 000 \div R540\ 000 \times R189\ 000)$$

$$= R49\ 000$$

No amount in respect of the foreign tax may be carried forward in respect of the company's normal tax liability.

Paragraph (b) of proviso to subsection (1)-

Excess of Spanish tax to amount determined in terms of paragraph (a):

= R60 000 - R49 000

= R11 000

Profits attributable to inclusion of rental income:

= R140 000 less the greater of (R60 000 or R49 000)

= R80 000

In terms of the proposed amendment a credit of R10 000 (R80 000 at the STC rate of 12.5%), may be granted against any STC liability in respect of any dividend declared subsequent to the determination of this amount. In any case the credit against STC may not exceed the excess Spanish tax.

Section 6*bis* has as a result of the extension of the provisions of section 6*quat*, been deleted.

CLAUSE 2

Definitions: Amendment of section 1 of the principal Act

Subclause (1)(a): The amendment introduced in terms of this subclause is of a textual nature.

Subclause (1)(b) to (e): The following amendments are proposed to the definition of "connected person" in section 1 of the principal Act. Paragraph (d)(iv) of the definition of "*connected person*" is amended to exclude only a company as defined in the Companies Act. A close corporation, foreign company or any other corporate entity, would therefore be included under such paragraph for purposes of determining whether such close corporation, foreign company or other entity is a connected person in relation to a company. As a close corporation is specifically dealt with in paragraph (d)(vi), the reference to "members interest" is deleted in paragraph (d)(iv) of the definition.

Paragraph (vA) is introduced to provide that two companies would be connected persons where one company is managed or controlled by a connected person in relation to the other company. For example, two companies, one whose shares are held by a trust and the other, whose shares are held by the beneficiary of such trust, will be connected persons in relation to each other.

Paragraph (d)(vi)(cc) is amended to also provide that a close corporation will be a connected person in relation to any other close corporation or company, which is a connected person in relation to any member of the firstmentioned close corporation.

Subclause (1)(f): The amendment introduced in terms of this subclause is of a textual nature.

Subclause (1)(g): In his Budget Speech the Minister of Finance proposed that lump sum payments from public sector funds be dealt with, for tax purposes, on the same basis as lump sum payments from private sector funds with effect from 1 March 1998. This proposal is, however, subject to the protection of the existing rights of members of such public sector funds. Lump sum benefits payable to members of retirement schemes established by law or for the benefit of local authorities (public sector funds) are not taxable under the current provisions of the principal Act, whereas members of private sector funds are liable for tax on lump sum benefits after the deductions allowed in terms of the Second Schedule to the Income Tax Act. It is therefore proposed that paragraph (e) of the definition of "gross income" be amended to also include any pension fund referred to in paragraph (a) or (b) of the definition of "pension fund". The determination of the taxable amount of any lump sum payable by a public sector fund is dealt with under the proposed amendments to the Second Schedule to the principal Act.

Subclause (1)(h): This subclause inserts paragraph (eA) in the definition of "gross income". In his Budget Review, the Minister of Finance proposed certain interim measures in relation to the taxation of benefits transferred from public sector pension funds to provident funds. Such proposals also encompass conversions of public sector pension funds to public sector or private sector provident funds. The proposed paragraph provides for the inclusion of certain benefits in the gross income of any member of a fund, which was established by law or for the benefit of members of local authorities or certain other parastatals (public sector funds), and which provides for annuities on retirement to its members where such a transfer or conversion occurs. The benefit to be taxed amounts to two-thirds of an amount (constituting the benefit of such member in the fund), which is transferred from such a public sector fund, to another fund which allows such member or the dependants or nominees of a deceased member to receive lump sum payments exceeding one-third of the total capitalised value of all the benefits of such a member. The same measures will apply in the case of a conversion from a public sector fund to such another fund.

Subclause (1)(i) and (k): Presently an estate of an insolvent person is not regarded as a person for purposes of the principal Act. The trustee of an insolvent estate would therefore not be liable for any tax on income of such an estate which is received or accrues after date of sequestration. It is therefore proposed that the definition of "person" be amended to specifically include an insolvent estate.

Subclause (1)(j): The amendment introduced in terms of this subclause is of a textual nature.

Subclause (1)(l): This subclause includes in the definition of "representative taxpayer" the trustee or administrator of an insolvent estate. This amendment is consequential upon the amendment of the definition of "person" to include an insolvent estate.

CLAUSE 3

Normal tax rebates: Amendment of section 6 of the principal Act

The primary rebate allowed to all taxpayers who are natural persons is increased from R2 660 to R3 215.

CLAUSE 4

Rebate in respect of foreign income taxes on royalties and similar income: Repeal of section 6bis of the principal Act

See separate explanation on TAXATION OF INVESTMENT INCOME FROM A SOURCE OUTSIDE THE REPUBLIC.

CLAUSE 5

Rebate in respect of foreign taxes on income: Amendment of section 6quat of the principal Act

See separate explanation on TAXATION OF INVESTMENT INCOME FROM A SOURCE OUTSIDE THE REPUBLIC.

CLAUSE 6

Certain amounts to be included in income and taxable income: Amendment of section 8 of the principal Act

Subclause (1)(a): Section 8(1) provides that an amount received as an allowance for *inter alia* travelling expenses on business, which has not been so expended, must be included in the recipient's taxable income. At present, where no record is kept of the use of the motor vehicle for business purposes, a distance of 12 000 kilometres is deemed to be travelled for private purposes. In his Budget Speech the Minister of Finance proposed that the distance be increased to 14 000 kilometres. This amendment gives effect to that proposal.

Subclause (1)(b): Where any amount has in the current or any previous year of assessment been allowed as a deduction and such amount is subsequently recovered

or recouped, such amount is included in a person's taxable income in terms of section 8(4)(a). At present it is uncertain whether amounts not actually recovered or recouped, may be recouped in terms of this section. To remove any uncertainty in this regard, it is proposed that where an amount of any expenditure actually incurred has been allowed as a deduction, but has not yet been paid and the obligation to pay such amount is subsequently reduced or extinguished, by reason of either the termination or variation of an agreement or prescription or waiver of a claim, the amount so reduced or extinguished will, under the provisions of the proposed section 8(4)(m), be deemed to be recovered or recouped for the purposes of section 8(4)(a). The effect of the amendment is therefore that the amount of the obligation so reduced or extinguished will, to the extent that it was allowed as a deduction, be included in gross income for the year of assessment during which the obligation is reduced or extinguished.

CLAUSE 7

Circumstances in which amounts are deemed to have accrued from sources within the Republic: Amendment of section 9 of the principal Act

See separate explanation on TAXATION OF INVESTMENT INCOME FROM A SOURCE OUTSIDE THE REPUBLIC.

CLAUSE 8

Investment income of foreign investment companies: Amendment of section 9A of the principal Act

See separate explanation on TAXATION OF INVESTMENT INCOME FROM A SOURCE OUTSIDE THE REPUBLIC.

CLAUSE 9

Taxation of investment income from foreign sources: Insertion of section 9C in the principal Act; and Investment income of controlled foreign entities and investment income arising from any donations, settlements or other dispositions: Insertion of section 9D in the principal Act

See separate explanation on TAXATION OF INVESTMENT INCOME FROM A SOURCE OUTSIDE THE REPUBLIC.

CLAUSE 10

Exemptions: Amendment of section 10 of the principal Act

Subclause (1)(a): The proposed amendment to section 10(1)(cA) now requires that an institution, board or body must be approved by the Commissioner before the exemption under the provisions of such section will apply. Exempt institutions, boards or bodies currently enjoying exemption must therefore apply for approval before 30 September 1997. The current exempt status of these institutions, boards or bodies will, however, continue to apply until the date of notification of the Commissioner's decision.

Any company registered under the Companies Act, 1973, and a co-operative formed and incorporated under the Co-operatives Act, 1981, are at present excluded from the ambit of section 10(1)(cA). It is also proposed that close corporations and trusts be excluded from the scope of the exemption.

Under the current provisions of section 10(1)(cA), where any institution, board or body which enjoys exemption under such paragraph, holds all the shares in a South African company, such company would also be granted automatic exemption where its operations are ancillary or complementary to the objects of the institution, board or body holding the shares. The amendment to this section now requires that such a company must also comply with the same requirements applicable to the institution, board or body before such a company will become eligible for exemption from tax status.

Subclauses (1)(b) and (c): Section 10(1)(cH) and section 11(hA) have since incorporation in the principal Act been applied in practice with reference to each other. The two sections are interrelated although section 10(1)(cH) does not specifically refer to section 11(hA). It is therefore proposed to limit the exemption provided in section 10(1)(cH) to receipts and accruals arising from amounts deductible in terms of section 11(hA).

In order to bring the application of paragraph (cH) in line with the actual purpose for which the provisions were introduced, the words referring to any law 'relating to' mining operations is substituted by 'which regulates' mining operations, and the reference to pollution 'connected with' mining is substituted by 'due to' mining.

Subclause (1)(d): One of the requirements for the exemption from income tax of a company contemplated in section 10(1)(cl) of the principal Act, is that the sole object of the company should be to acquire, hold, develop or improve land with a view to enabling any community in the Republic, of which at least 75 per cent of the adult members are persons who earn less than R1 500 per month, to acquire such land for residential purposes. It is proposed that the amount of such income criteria be increased to R1 800.

Subclause (1)(e): The exemption under section 10(1)(mA) has been withdrawn due to the fact that compulsory military service has been discontinued.

Subclause (1)(f): A *bona fide* scholarship or bursary granted to enable or assist any person to study at a recognised educational or research institution is exempt from tax. Where such scholarship, however, is paid by an employer to an employee or his relative, the exemption shall not apply if the remuneration of the employee for the year of assessment in which such bursary was granted exceeds R36 000. It is proposed that this amount be increased to R50 000. Furthermore, the exemption would not apply to so much of the scholarship in the case of an employee or his relative as exceeds R1 200. It is proposed that this amount be increased to R1 600.

Subclause (1)(g): In his Budget Review, the Minister of Finance announced that the necessity for the exemptions granted under the principal Act are being reviewed and that the continued exemption of those organisations exempt in terms of section 10(1)(t) will be investigated. The amendment introduced in this subclause withdraws the exemptions of the *South Atlantic Cable Company (Proprietary) Limited*, granted under section 10(1)(t)(iv), and the *S.W.A. Water and Electricity Corporation (Proprietary) Limited*, granted under section 10(1)(t)(vii) with effect from 1 July 1998.

Subclause (1)(h): It is proposed that section 10(1)(zH) be amended to exempt from income tax any grant payable by the State in terms of-

(a) the Simplified Regional Industrial Development Programme, 1993 which came into operation on 1 March 1993;

(b) the Small/Medium Manufacturing Development Programme, 1996 which came into operation on 1 October 1996; and

(c) the Tax Holiday Scheme contemplated in section 37H of the principal Act, which came into operation on 1 October 1996.

These amendments will come into operation with retrospective effect from the date on which the respective Programmes came into operation.

CLAUSE 11

Exemption of capital element of purchased annuities: Amendment of section 10A of the principal Act

In terms of this clause it is proposed that the exemption from normal tax of the capital element of any purchased annuity, also be extended to include an annuity payable to the deceased or insolvent estate of the spouse or surviving spouse of the purchaser of such an annuity.

The definition of "valuator" is also extended to include any valuator as defined in the corresponding provisions of any foreign country. This amendment is consequential upon

the insertion of sections 9C and 9D in the principal Act, which sections provide that certain annuities received from a foreign source will now also be taxable in the Republic.

CLAUSE 12

General deductions allowed in determination of taxable income: Amendment of section 11 of the principal Act

In terms of *subclause (a)*, section 11(hA) is amended to provide that an amount may be claimed as a deduction under such section only if-

- such amount was determined and paid in accordance with the constitution of the company, society or association of persons or in the case of a trust, in accordance with the instrument establishing such trust, and
- such company, society, association of persons or trust was approved by the Commissioner in terms of section 10(1)(cH).

The amendment introduced by *subclause (b)* is of a textual nature.

CLAUSE 13

Deduction in respect of certain machinery, plant, implements, utensils and articles: Amendment of section 12B of the principal Act

In terms of the provisions of section 12B a deduction is allowed in respect of any machinery, implement, utensil or article which is used by a taxpayer in the carrying on of his or her farming operations. The current wording of subsection (1)(f), which refers to the use of such machinery, implement, utensil or article "for farming purposes", could possibly include situations where such items are used for farming purposes while the taxpayer himself or herself does not carry on farming. This implies that the application of this paragraph could be wider than the purpose for which such provision was intended and it is proposed that the wording be amended to require the taxpayer claiming the allowance to carry on farming operations himself or herself.

CLAUSE 14

Deductions in respect of ships: Amendment of section 14 of the principal Act

Following the announcement by the Minister of Finance in his Budget Speech in this regard, it is proposed that the provisions of section 14 be amended to the extent that-

- the provisions of subsection (1A) of that section shall only apply to a parent company, referred to in that subsection, in relation to any assessed loss incurred by a subsidiary company of such a parent company, in so far as such loss arises from the business carried on by the subsidiary company as the owner of any ship acquired in terms of an agreement formally and finally signed by all parties to the agreement on or before 12 March 1997;
- where a parent company contemplated in subsection (1D) of that section made an election as contemplated in that subsection, such a parent company and its subsidiary shall only be deemed to be one and the same company in so far as it relates to any business carried on by such subsidiary as the owner of a ship acquired in terms of an agreement formally and finally signed by all parties to the agreement on or before 12 March 1997.

CLAUSE 15

Set-off of assessed losses: Amendment of section 20 of the principal Act

In terms of the amendment introduced in terms of *clause 2*, the definition of "person" has been extended to include the estate of an insolvent person, and any loss incurred prior to the date of sequestration, may now be set off against the income derived by the insolvent estate. Consequently, it is necessary that section 20 be amended to provide that once the insolvent person is rehabilitated, the amount of the assessed loss which may be carried forward in terms of section 20(1)(a)(i) of the principal Act, shall be the reduced amount of the loss after taking into consideration any income of the insolvent estate which was set off against such loss.

CLAUSE 16

Sale and leaseback arrangements: Insertion of section 23G in the principal Act

This clause introduces provisions relating to sale and leaseback arrangements. During 1993 the provisions of section 23D were inserted in the principal Act. The provisions of that section were introduced as an anti-avoidance measure to limit certain allowances available to a lessor where he acquired certain assets under a sale and leaseback arrangement. Transactions of this nature effectively allowed increased wear and tear allowances on assets which had been revalued as a result of inflation or a devaluation in the currency of the Republic.

Notwithstanding the provisions of section 23D, arrangements are still being structured in such a manner whereby one entity utilises the tax base of another to obtain a benefit. This is achieved, for example, by introducing a tax exempt body as lessor or lessee. As the lessor buying the assets from a non-taxpaying entity is entitled to a deduction in respect of the wear and tear allowances on such assets purchased, the lessor can effectively provide financing at a lower rate to the lessee.

As arrangements of this nature in substance constitute a financing arrangement whereby a lessee in terms of such an arrangement obtains cash to finance either normal business activities or capital projects, the effect of this proposal is that certain sale and leaseback arrangements, where the receipts and accruals of either the lessee or lessor is not included in its income for the purposes of the principal Act, will in substance be treated on the same basis as a loan arrangement.

The effect thereof will be that the deduction available to a lessee in terms of the principal Act in relation to any lease payments due by him in terms of such an arrangement, will be limited to the interest element of such a lease payment. Conversely the lessor in terms of such an arrangement will only be taxable on the interest element of lease payments and the lessor will not be entitled to any wear and tear allowances in terms of the principal Act.

Where a person is, however, a lessor and a lessee in terms of a sale and leaseback arrangement the provisions of subsection (2)(a) will not apply.

This proposed amendment will come into operation on 5 June 1997.

CLAUSE 17

Credit agreements and debtors allowance: Amendment of section 24 of the principal Act

The amendment to section 24 is consequential upon the amendment to section 24J which will have the effect that the interest element of a suspensive sale agreement will now also, in so far as it relates to the holder of such an agreement, be dealt with under section 24J. Previously holders of such instruments were excluded from the provisions of section 24J. This amendment is in accordance with the practice of the Commissioner as described in Practice Note 12 issued on 27 February 1991 in which it is stated in paragraph 3 that:

"Finance charges are considered to be taxable over the period in which these charges are earned based on the amortisation of the said charges over the period of the loan with reference to the outstanding balance of the capital in accordance with generally accepted accounting practice (GAAP).

In essence this approximates finance charges accruing on a day to day basis... This reflects a constant periodic rate of return on the outstanding capital balance at the effective rate of interest applicable".

CLAUSE 18

Gains and losses on foreign exchange transactions: Amendment of section 24I of the principal Act

Clause 18 adds another instance to section 24I(5) where the premium or discount on a forward exchange contract is deemed to have been incurred or accrued on a day to day basis during the term of the relevant forward exchange contract. In such a case the loan, debt or advance must have been recorded at the forward rate in terms of a related or matching forward exchange contract (FEC), but is translated at the end of such year of assessment at the forward rate in terms of another related or matching FEC. This may occur where the first-mentioned FEC is realised and a new FEC is entered into during the year of assessment.

CLAUSE 19

Incurral and accrual of interest: Amendment of section 24J of the principal Act

In terms of *subclause (1)(a)* the definition of "interest" in section 24J(1) is extended to also include-

- the consideration received by a person from the borrower of any interest-bearing arrangement under a lending arrangement, which is equal to and represents the interest on such arrangement, which would have accrued to such person had he not entered into such lending arrangement; and
- in the case of a sale and leaseback arrangement, the absolute value of the difference between all amounts receivable and payable in terms of a sale and leaseback arrangement.

In terms of *subclause (1)(c)* the definition of "instrument" is amended to-

- delete the reference to agreements contemplated in section 24(2). See in this regard the explanation with regard to the amendment effected to section 24 of the principal Act (*clause 17*);
- ensure that sale and leaseback arrangements are not excluded from the ambit of the definition of "instrument".

As certain taxpayers who hold interest rate agreements as trading stock apply a market valuation method to determine the value of such items at the end of a year of assessment, the day to day basis of spreading amounts may not be applicable. In terms of *subclauses (1)(b) and (d) to (i)* the provisions of section 24J(9) are therefore extended to provide that taxpayers who are companies may also elect that the provisions providing for the spreading of amounts on a day to day basis will not be applicable to such interest rate agreements in respect of which it deals in. A definition of an "interest rate agreement" as defined for purposes of section 24K is also inserted in section 24J.

CLAUSE 20

Incurral and accrual in respect of interest rate agreements: Insertion of section 24K in the principal Act

Clause 20 inserts a new section 24K in the principal Act which regulates certain tax consequences of arrangements in terms of which an interest rate or combination of interest rates are applied to a notional amount to calculate any amount receivable or payable in terms of such agreement.

The proposed provisions will not interfere with general tax principles such as the source principle or the capital or revenue nature of amounts accrued or incurred in respect of such agreements, but will only deal with the timing of the incurral and accrual of amounts in respect of such agreements.

An interest rate agreement is defined as any agreement in terms of which a person acquires the right to receive or becomes liable to pay an amount, which may be calculated as follows:

- (a) an amount calculated by applying any rate of interest to a notional principal amount specified or referred to in such agreement;
- (b) an amount calculated with reference to the difference between any combination of rates of interest applied to a notional principal amount specified or referred to in such agreement;
- (c) a fixed amount specified or referred to in such agreement as consideration in terms of such agreement whereunder the obligation is imposed to pay or the right is acquired to receive, any other amount as determined in (a) above; or
- (d) an amount equal to the difference between the fixed amount referred to in paragraph (c) and any other amount as determined in (a) above.

The proposed definition will encompass amounts receivable or payable in terms of interest rate swap agreements or any similar agreements where the cash flows are calculated with reference to a notional capital amount and an interest rate or combination of interest rates.

Once an amount has been determined as prescribed in terms of the definition of "interest rate agreement", subsection (2) governs the timing of the incurral and accrual of amounts in relation to such an agreement. All other ordinary rules of the Act must however, still be satisfied before such amount is to be taken into account in the determination of a taxpayer's taxable income.

Subsection (3), however, provides that where an amount is to be calculated prior to the date of actual payment thereof with reference to the variable rate, such amount shall be calculated with reference to the variable rate applicable on the date such amount is to be calculated to determine all amounts payable or receivable after such date.

The proposed provisions will apply to any interest rate agreement entered into on or after the date of promulgation of the Income Tax Act, 1997.

Example

Interest rate agreement

- A taxpayer enters into an agreement on 9 November 1997 for one year in terms of which he is obliged to pay an amount calculated at 4% based on a notional amount of R5 000 000 at the end of each three month period to the other party to the agreement.

He has the right in terms of the agreement to receive at the end of each three month period an amount calculated with reference to 25% of the 3 month Bank Bill rate as applicable in the market at the end of the three month period. The net amount as calculated is payable or receivable by the taxpayer. The taxpayer's financial year ends on 31 March.

3 MONTH BANK BILL RATE	
Date	%
9 February 1998	15.6
31 March 1998	16.4
9 May 1998	17.2

9 August 1998	16.8
9 November 1998	16.0

SUMMARY OF RECEIPTS IN TERMS OF THE AGREEMENT			
Date	Bank Bill rate x 25%	4%	Net receipts
9 February 1998	195 000	(200 000)	(5 000)
31 March 1998	205 000	(200 000)	-
9 May 1998	215 000	(200 000)	15 000
9 August 1998	210 000	(200 000)	10 000
9 November 1998	200 000	(200 000)	0

Year end - 31 March 1998

Incurral of amount actually paid = R5 000

Incurral of fixed rate liability = $R200\,000 \times 51 \div 89$

= R114 607

Accrual of BB rate linked amount = $R205\,000 \times 51 \div 89$

= R117 472

Net amount incurred = R2 135

Year end - 31 March 1999

Accrual of amounts actually received = R15 000 + R10 000 + R0

= R25 000

Less adjustment for taxed amounts = R117 472 - R114 607

= R2 865

Net amount accrued = R22 135

Instead of using a straight-line method of spreading interest between dates, a compounding accrual basis of spreading interest may also be applied.

CLAUSE 21

Income of insolvent estates: Insertion of section 25C in the principal Act

The insertion of section 25C is consequential upon the inclusion of an insolvent estate of a person in the definition of "person" in section 1. Where the business undertaking of an insolvent person is transferred to the trustee of his insolvent estate, the estate of such insolvent person, prior to sequestration, and the insolvent estate which now vests in the trustee, will for the purposes of the provisions of the principal Act (e.g. the set-off of an assessed loss and transfer of trading stock) be deemed to be the same person.

CLAUSE 22

Definitions: Amendment of section 55 of the principal Act

The amendment of this section is of a textual nature.

CLAUSE 23

Value of property disposed of under donations: Amendment of section 62 of the principal Act

Section 62(2)(a) currently provides that where it is established that the property, which is subject to any fiduciary or usufructuary interest, could not reasonably be expected to produce an annual yield equal to 12 per cent on the value of the property, the Commissioner may determine a reasonable annual yield for the purposes of the determination of the value of any fiduciary, usufructuary or other like interest in the property. These provisions are now extended to allow the Commissioner to also fix the sum representing the annual yield, where the value of the right of ownership in any movable or immovable property which is subject to a fiduciary, usufructuary or other like interest, is to be determined.

CLAUSE 24

Levy on Financial Services: Repeal of section 64A of the principal Act

Section 64A is repealed with effect from 1 January 1998.

CLAUSE 25

Levy and recovery of secondary tax on companies: Amendment of section 64B of the principal Act

In terms of *subclause (1)(a)* the definition of "share incentive scheme" is extended to include schemes in which directors of a company or associated institution also participate.

The amendment introduced in terms of *subclause (1)(b)* is consequential upon the insertion of section 9C. The effect of the amendment is that all income deemed to be from a South African source must also be taken into consideration in the calculation of the ratio in terms of section 64B(6).

CLAUSE 26

Duty of companies to furnish returns: Amendment of section 70 of the principal Act

In his Budget Review, the Minister of Finance announced that greater use should be made of tax reference numbers of individuals and companies in order to assist SARS in countering tax evasion. At present section 70 of the principal Act requires that companies furnish the Commissioner with the names and addresses of persons to whom interest is paid. It was proposed by the Minister that in order to improve efficiency and facilitate cross-checking against income tax records, companies should be required to provide the income tax reference number of individuals and other bodies. There are, however, a vast number of taxpayers under the SITE system, who pay employees' tax, but who are not registered as taxpayers. It is therefore proposed that the provisions of section 70 be extended to require the company paying such interest to any person, to furnish, in addition to the name and address, also the identity number of any natural person or the registration number in the case of a insolvent or deceased estate, company, trust or any other form of corporate entity, to whom interest is paid. Only where a natural person is not in possession of a South African identity document, would another form of identification be acceptable.

CLAUSE 27

Production of documents and evidence on oath: Amendment of section 74 of the principal Act

The amendment is of a textual nature.

CLAUSE 28

Inquiry: Amendment of section 74C of the principal Act

The amendment is of a textual nature.

CLAUSE 29

Search and seizure: Amendment of section 74D of the principal Act

The amendment is of a textual nature.

CLAUSE 30

Appeals to specially constituted court against Commissioner's decision: Amendment of section 83 of the principal Act

The amendments introduced in terms of *subclauses (a) and (b)* are of a textual nature.

In terms of *subclause (c)* the reference to "State President" is substituted by "President of the Republic". This amendment is consequential upon the promulgation of the Constitution of the Republic of South Africa, 1996.

CLAUSE 31

Appeals against decisions of a special court: Amendment of section 86A of the principal Act

The amendments in terms of this section are of a textual nature.

CLAUSE 32

Members of courts not disqualified from adjudicating: Amendment of section 87 of the principal Act

The amendment in terms of this section is of a textual nature.

CLAUSE 33

Determination of day for payment of tax, interest or penalties: Insertion of section 89sex in the principal Act

Section 89sex has been inserted to provide for the payment of taxes, interest or penalties payable under the provisions of the principal Act on the last business day prior to the date specified for payment, where such lastmentioned date falls on a Saturday, Sunday or public holiday.

CLAUSE 34

Collection of taxes under arrangements made under section 108: Amendment of section 93 of the principal Act

The amendments introduced in terms of this clause are twofold-

- In the first instance the reference to territory is deleted in section 93 of the principal Act.
- Secondly, section 93 is amended to bring it in line with the provisions of the Constitution, as International Agreements are now entered into in terms of the Constitution and not under section 108 of the principal Act.

CLAUSE 35

Liability of representative taxpayer: Amendment of section 95 of the principal Act

This amendment is consequential upon the inclusion of an insolvent estate in the definition of "person" in section 1.

CLAUSE 36

Right of representative taxpayer to indemnity: Amendment of section 96 of the principal Act

This amendment is consequential upon the inclusion of an insolvent estate in the definition of "person" in section 1.

CLAUSE 37

Regulations: Amendment of section 107 of the principal Act

In terms of section 107 the Minister may promulgate regulations for giving effect to the objects and purposes of the principal Act. In terms of these regulations fines not exceeding R50 may be imposed. It is proposed that this amount be increased to R1 000.

CLAUSE 38

Prevention of or relief from, double taxation: Amendment of section 108 of the principal Act

This section deals with the conclusion of agreements for the prevention of double taxation and certain procedures in relation thereto. The amendment proposed in terms of this clause is to bring the provisions of section 108 of the principal Act in line with the Constitution.

CLAUSE 39

Application of certain provisions for purposes of provincial ordinances imposing personal and income tax: Deletion of section 110bis of the principal Act

This amendment deletes obsolete provisions.

CLAUSE 40

Determination of taxable income from farming: Amendment of paragraph 19 of the First Schedule to the principal Act

Farmers are entitled to elect to be subjected to tax on a basis whereby the rate of tax on his farming income is based on his average taxable income from farming over a certain period. Where, however, the taxpayer did not carry on any farming operations before the commencement of that period, i.e. new farmers, his average taxable income for that period is deemed to be a specific amount in accordance with the following scale-

- where the taxable income from farming for the relevant period does not exceed R3 000, the amount of such taxable income; or
- where the taxable income from farming for the relevant period exceeds R3 000 but not R4 500, the amount of R3 000; or
- where the taxable income from farming for the relevant period exceeds R4 500, an amount equal to two-thirds of such taxable income.

As a result of inflation it is proposed that the amounts be increased as follows-

- where the taxable income from farming does not exceed R5 000, the amount of such taxable income; or
- where the taxable income from farming exceeds R5 000 but not R7 500, the amount of R5 000; or
- where the taxable income from farming exceeds R7 500, an amount equal to two-thirds of such taxable income.

CLAUSES 41 TO 43

Computation of gross income derived by way of lump sum benefits from Pension, Provident and Retirement Annuity Funds: Amendment of paragraph 1 of the Second Schedule to the principal Act

Paragraph 1 is amended by the insertion of a formula C to determine the taxable portion of lump sum payments from public funds. This amendment is in consequence of the proposal of the Minister of Finance in his Budget Speech that public and private funds be treated equally for tax purposes. The vested rights of members of such public funds are, however, to be protected and only that portion of a lump sum relating to services after 1 March 1998 are to be taxed.

The amount to be taxed is determined by using the formula-

$$A = B/C \times D$$

The symbols in the new formula represent the following-

- Symbol "A" represents the taxable portion of the lump sum to be included in gross income, subject to any further deductions which may be allowable in terms of paragraph 5 of the Second Schedule to the principal Act.
- Symbol "B" represents the number of completed years of employment of the taxpayer after 1 March 1998, including previous or other periods of service approved as pensionable service after 1 March 1998.
- Symbol "C" represents the total number of completed years taken into consideration for the purpose of determining the amount of the benefits payable to him by the fund.
- Symbol "D" represents the lump sum benefit.

Example

A member of the Government Employees' Pension Fund (or any other public sector fund) retires on 31 August 2000.

The member becomes entitled to a gratuity : R500 000

Monthly pension : R8 000

Total number of years taken into account for purposes of determining the gratuity : 40

Total number of completed years after 1/3/1998 : 2

Average annual salary over 5 years : R50 000

Symbol C represents 40 years

Symbol B represents 2 years

Symbol D represents R500 000

Symbol A = $B/C \times D = R25\ 000$

R25 000 is therefore the actual lump sum benefit for tax purposes, which is further reduced by the normal deductions available for private sector retirement funds in the following way:

Formula A:

$40/10 \times R50\ 000 = 200\ 000,$

but not more than Formula B:

Highest of R120 000 or $4\,500 \times 40 = 180\,000$

(limited to actual lump sum of R25 000)

Summary:

Lump sum benefit = R25 000 (after determination of existing right)

Deduction available = R25 000 (in terms of Second Schedule)

Taxable = R Nil

The other amendments introduced in terms of these clauses are consequential upon the measures introduced to give effect to the Minister's aforementioned announcement.

CLAUSE 44

Definitions: Amendment of paragraph 1 of the Fourth Schedule to the principal Act

Subclause (a) amends the definition of "remuneration" to include any amount contemplated in paragraph (eA) of the definition of "gross income".

Subclause (b) amends subparagraph (c) of the definition of "remuneration". Where a taxpayer receives a travelling allowance contemplated in section 8(1)(b) or an allowance in terms of section 8(1)(d), an amount equivalent to 35 per cent of such allowance is subject to employees tax. It is proposed that this amount be increased to 40 per cent.

CLAUSE 45

Employees' Tax: Amendment of paragraph 2 of the Fourth Schedule to the principal Act

The amendment proposed in terms of this clause is consequential upon the inclusion in the definition of "gross income" of amounts contemplated in the proposed paragraph (eA). See *clause 2(1)(h)*.

CLAUSE 46

Employees' Tax: Amendment of paragraph 9 of the Fourth Schedule to the principal Act

Subparagraph (3) provides for the deduction of employees' tax from any lump sum payments made by any fund. The provisions of this subparagraph are extended to make provision for the deduction of the tax payable upon conversion of a fund or transfer of benefits from a pension fund to a provident fund as contemplated in paragraph (eA) of the definition of "gross income".

CLAUSE 47

Employees' Tax: Amendment of paragraph 11A of the Fourth Schedule to the principal Act

Where an employee fails to inform his employer of a gain made by the employee in the exercise of any right to acquire a marketable security in terms of a share option scheme contemplated in section 8A, the employee shall be guilty of an offence and may become liable to a penalty equal to R200. In terms of the proposed amendment the penalty is increased to R2 000.

CLAUSE 48

Standard Income Tax on Employees: Amendment of paragraph 11B of the Fourth Schedule to the principal Act

In terms of the Standard Income Tax on Employees (SITE) system an employee need not render a return where his salary does not exceed R50 000. In terms of the proposed amendment the SITE limit is increased to R60 000.

CLAUSE 49

Fringe Benefits: Amendment of paragraph 2 of the Seventh Schedule to the principal Act

This amendment is consequential upon the amendment of paragraph 9 of the Seventh Schedule.

CLAUSE 50

Fringe Benefits: Amendment of paragraph 7 of the Seventh Schedule to the principal Act

Subclause (1): The value of the first company vehicle made available to an employee which is to be included in his gross income as a fringe benefit, is presently determined at 1,2 per cent per month of the determined value and 2 per cent per month in respect of any other vehicle made available to such employee. It is proposed that these percentages be increased to 1,8 per cent and 4 per cent respectively. It is furthermore proposed that where any employee has the benefit of a company vehicle and at the same time receives an allowance in respect of transport in relation to another vehicle (excluding an allowance contemplated in section 8(1)(b)(iii)), the value of such firstmentioned vehicle will be determined at the rate of 4 per cent per month of the determined value of the vehicle.

CLAUSE 51

Fringe Benefits: Amendment of paragraph 9 of the Seventh Schedule to the principal Act

In terms of *subclause (1)(a)* it is proposed that the percentages which are applied to the formula determination of the taxable values of a housing benefit be increased from 15, 16 and 17 per cent to 16, 17 and 18 per cent respectively, with effect from 1 March 1998.

The value for fringe benefit tax purposes to be placed on holiday accommodation provided by an employer to an employee, is the cost incurred by the employer for the hiring of the accommodation. In any other case the employee is currently taxed at the value of R35 per day. In terms of *subclause (1)(b)* it is proposed that the amount be increased to R100 per day.

Where more than one residential unit is made available to the employee at different places which he is entitled to occupy from time to time while performing his duties, the amount to be included shall be the amount of the unit with the highest rental value. This amendment is consequential upon the introduction of the aforementioned amendments and is introduced in terms of *subclause (1)(c)*.

Subclause (1)(d): This amendment partially gives effect to a proposal by the Minister of Finance in his Budget Speech in relation to the determination of the taxable value of residential accommodation provided by an employer to his employees. It is therefore proposed that paragraph 9 be amended to provide that where any residential accommodation is provided by an employer, or an associated institution in relation to the employer, as a benefit to any employee and the employee has an interest in such accommodation, the rental value of such accommodation to be included in the income of the employee shall be the greater of the value determined in accordance with the formula and the rentals paid by the employer and other expenses defrayed in respect of such accommodation.

Paragraph 10 is amended to provide that an employee shall be deemed to have an interest in the accommodation in question if-

- such accommodation is owned by him/her or a connected person in relation to him/her;
- where any increase in the value of the accommodation accrues to the employee or connected person in relation to him/her; or
- the employee, or connected person in relation to him/her has a right to acquire the accommodation from his/her employer.

CLAUSE 52

Amendment of Section 8 of Act 36 of 1996

Section 10(1)(gB) of the principal Act was amended by section 8(1)(j) of the Income Tax Act, 1996 (Act No. 36 of 1996) to provide for the exemption of compensation paid in terms of the Compensation for Occupational Injuries and Diseases Act, 1993 (Act No. 130 of 1993). Section 8(2) of the Income Tax Act, 1996 provides that the amendment referred to in section 8(1)(j) shall come into operation on the date which section 12 of the Compensation for Occupational Injuries and Diseases Amendment Bill comes into operation. The Compensation for Occupational Injuries and Diseases Amendment Bill was not promulgated in 1996 and such Bill will be passed in 1997. As the provisions contained in *clause 12* of the Compensation for Occupational Injuries and Diseases Amendment Bill are now contained in *clause 13* of the new Bill to be passed this year, an amendment to section 8 of the Income Tax Act, 1996, became necessary.

CLAUSE 53

Commencement of certain amendments

This clause provides that the amendments introduced by this Bill will apply for purposes of assessments in respect of normal tax, except where otherwise stated in the amendment itself or where the context otherwise indicates, as from the commencement of years of assessment ended or ending on or after 1 January 1998.

CLAUSE 54

Short title

This clause provides the short title of the Bill.