REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

REVENUE LAWS AMENDMENT BILL, 2005

NATIONAL TREASURY

[W.P. —'05]

EXPLANATORY MEMORANDUM ON THE REVENUE LAWS AMENDMENT BILL, 2005

INTRODUCTION

The Revenue Laws Amendment Bill, 2005, introduces amendments to the Transfer Duty Act, 1949, the Estate Duty Act, 1955, the Income Tax Act, 1962, the Customs and Excise Act, 1991, the Stamp Duties Act, 1968, the Value-Added Tax Act, 1991, the Tax on Retirement Funds Act, 1996, the Road Accident Fund Act, 1996, the Uncertificated Securities Tax Act, 1998, the Revenue Laws Amendment Act, 2003, and the Second Revenue Laws Amendment Act, 2004

CLAUSE 1

Transfer Duty: Amendment of section 2 of the Transfer Duty Act, 1949

It often occurs that changes are announced in the Budget Review with regard to the rates of transaction taxes with effect from a date (e.g. 1 March) preceding the date on which the legislation introducing that rate change is promulgated. Implementing these changes before the legislation is in place becomes problematic as there is no legislation on which a deeds registrar can rely when registering the transfer of property.

It is, therefore, proposed that a provision be inserted in the Transfer Duty Act, 1949, to address this issue. This will ensure that the proposed changes to the rates apply with effect from the date determined by the Minister in the Budget Review and that the changes lapse at the earlier of the date on which the legislation giving effect thereto is promulgated or, if no such legislation is passed, after 6 months from the date so determined.

CLAUSE 2

Transfer Duty: Amendment of section 9 of the Transfer Duty Act, 1949

Subclause (a): To exempt from transfer duty the transfer of properties owned by Government superannuation funds of the former TBVC states or other similar funds to the Government Employees' Pension Fund.

Subclause (b): The proposed amendment provides for an exemption of transfer duty where fixed property is acquired as a result of a company formation transaction as contemplated in section 42 of the Income Tax Act, 1962. The exemption is limited to fixed property where the supplier and the recipient of that property are deemed to be one and the same person in terms of section 8(25) of the Value-Added Tax Act, 1991. The public officer of the company is required to submit a sworn affidavit or solemn declaration that the provisions of section 8(25) of the Value-Added Tax Act, 1991, apply.

Subclause (c): This clause deletes provisions which have become obsolete.

CLAUSE 3

Transfer Duty: Amendment of section 13 of the Transfer duty Act, 1949

Subclause (a): The proposed amendment aligns the provisions with section 2 of the Act.

Subclause (b): Currently the Commissioner is not limited with respect to the period that he or she may go back to recover unpaid or under declared transfer duty. The proposed amendment limits the period to five years to bring it in line with the Value-Added Tax Act, 1991. This limitation only applies where the person who failed to pay the full amount of duty and any person acting on his or her behalf acted in good faith and on the assumption, on reasonable grounds, that the transaction was not subject to duty.

CLAUSE 4

Transfer Duty: Amendment of section 20 of the Transfer Duty Act, 1949

The proposed amendment will allow excess duty, additional duty and/or interest paid to be refunded to the person who overpaid that amount. The period in which the claim for a refund may be made is limited to 5 years from the date of acquisition of the property. Alternatively, a refund will not be made where the Commissioner is satisfied that the payment of the duty, additional duty and/or interest was made in accordance with the practice generally prevailing and no objection was lodged in respect of the payment in terms of section 18 of the Transfer Duty Act.

CLAUSE 5

Estate Duty: Amendment of section 3 of the Estate Duty Act, 1955

Section 3(3) of the Estate Duty Act, 1955, deems certain property to be the property of the deceased for the purposes of calculating the dutiable amount of the estate. Certain schemes have been developed in terms of which both estate duty and donations tax are avoided. In terms of one of these schemes a donation is made during the lifetime of the donor, subject to the condition of that the donee does not enjoy any benefit until the death of the donor. The value of the assets so donated still forms part of the property in the estate of the deceased, but the donee claims the donation as a debt against the estate.

It is claimed that the effect of the scheme is that the value of the property donated is exempt from donations tax and no estate duty is levied upon that value, as the claim of the donee against the estate reduces the dutiable amount on which estate duty is levied. A case of this nature is presently being tested in the courts. To place the matter beyond doubt, it is proposed that donations which are exempt from donations tax as the donees do not receive benefits until the death of the donor (section 56(1)*(d)*) and property donated under a *donatio mortis causa* (section 56(1)*(c)*), be deemed to be property of the deceased if that property is not otherwise included in property of the estate for purposes of this Act. (See also clause 7 below)

CLAUSE 6

Estate Duty: Amendment of section 4 of the Estate Duty Act, 1955

Section 4 of the Estate Duty Act, 1955, provides that certain deductions may be made from the total value of the property of the estate for the purposes of estate duty.

As a further amendment to clarify the position regarding the avoidance scheme set out in the amendment to section 3 of the Estate Duty Act above, it is proposed that the donations in section 56(1)*(c)* and *(d)* of the Income Tax Act, 1962, be specifically excluded from the deductions that can be made in terms of section 4 of the Estate Duty Act. The effect will be that the property donated in terms of the abovementioned sections will be included as property of the estate and no deduction will be allowed for estate duty purposes. This will ensure that the donations are subject to estate duty.

It is proposed that the amendment should apply to the deceased estates of persons who die on or after 8 November 2005.

CLAUSE 7

Income Tax: Amendment of section 6 of the Income Tax Act, 1962

This amendment deletes obsolete wording relating to a provision of combined taxation of married persons which was repealed a number of years ago.

CLAUSE 8

Income Tax: Amendment of section 6quat of the Income Tax Act, 1962

Currently foreign assets of a resident which are not immovable property and which are not attributable to a foreign permanent establishment of the resident are deemed to be South African sourced assets for purposes of the determination of capital gains or losses. This principle was introduced in the Income Tax Act in 2002. The effect of this rule is that taxes imposed by a foreign tax jurisdiction may not be allowed as a credit against a resident's South African tax liability in respect of the disposal of the assets described above.

As was announced in the 2005 Budget, the sale of foreign shares by South Africans is problematic if the foreign country taxes this form of sale. It is now proposed that the disposal of foreign assets (including shares) which are subject to foreign taxes but are not attributable to a foreign permanent establishment will be treated to be from a foreign source. South Africans will then be entitled to utilise foreign taxes proved to be payable as foreign tax credits against their South African tax liability. It is, however, proposed that the foreign tax credit be limited to the South African tax on the gain and that the excess not be allowed as an offset against other sources of foreign income or to be carried forward to future tax years.

Example

A South African resident invested in shares in a Tanzanian company. The resident has no presence in Tanzania. On disposal of the shares tax of Ts 180 000 (R1 000) was paid to the Tanzanian Revenue Authority. The capital gain on the disposal of the shares is also subject to tax in South Africa. As the source of the capital gain is not deemed to be from a South African source the resident is entitled to utilise the R1 000 Tanzanian tax as a credit against the resident's South African tax liability. If the resident's tax liability attributable to the gain is R900 the R100 excess credit will be forfeited and may not be set off against the tax liability in respect of any other foreign sourced income in the current or future tax years.

CLAUSE 9

Income Tax: Amendment of section 7 of the Income Tax Act, 1962

Section 7(8) of the Income Tax Act, 1962, attributes income of a non-resident back to a resident if the income is derived by virtue of a donation made by the resident to that non-resident. This provision was amended in 2004 to address certain arguments raised, i.e. that it only applied in respect of income of a resident which is derived from a source in the Republic. It was argued that the provision referred to "income" as defined which, in the case of a non-resident, includes only amounts from a South African source. Section 7(8) was, therefore, amended to attribute all the receipts and accruals of a foreign person to the resident, if they would have constituted income had they been received by or accrued by a resident. The effect of this amendment, however, is that receipts and accruals are attributed, but the expenses of the foreign person are not taken into account. It is, therefore, proposed that section 7 be amended to provide that any expenses, allowances or losses incurred by the foreign person must be deemed to have been incurred by the resident.

CLAUSE 10

Income Tax: Amendment of section 8A of the Income Tax Act, 1962

Section 8A applies to equity instruments acquired by an employee as a result of the exercise of any right granted before 26 October 2004. Equity instruments acquired by way of cession or release after section 8C came into operation (i.e. 26 October 2004) fall within the new provisions of section 8C. The effect of this is that equity instruments (rights) acquired by the taxpayer by virtue of his or her employment as consideration for the cession or release of a right as contemplated in section 8A(5) will be subject to the provisions of section 8C.

Where the second right as contemplated in section 8A(5) that is acquired is a restricted right as contemplated in section 8C, the gain will be included in income or the loss will be allowed when a vesting event occurs in relation to that right. Where the second right is unrestricted the gain or loss will be brought to account when it is acquired. The proposed amendment clarifies the position that where the gain is or will be taxable in terms of section 8C the provisions of section 8A(5)(b) do not apply.

CLAUSE 11

Income Tax: Amendment of section 8B of the Income Tax Act, 1962

Section 8B was introduced in the Income Tax Act, 1962, last year to deal with the taxation of broad-based equity plans. To address certain practical issues which have been raised with regard to the application of this section, five main changes to the section are being proposed as well as some lesser amendments.

Firstly, in terms of section 8B any amount received or accrued to an employee on the disposal of a 'qualifying equity share' given or sold by an employer to an employee in terms of a 'broad-based employee share plan' is subject to tax if it is sold within five years from the 'date of grant' of that qualifying equity share. Even if the employee leaves the employ of the employer, the amount should be subject to tax if it is sold before the period of five years. The use of the word "employee" in the different provisions of the section has the effect that employees who leave the employer's service would not be taxable on the amount received or accrued for the disposal of the share before the five year period. It is proposed that this be corrected throughout the section.

Secondly, it had been envisaged that the employer would donate the shares to the employees but the Companies Act requires in certain circumstances that a minimum amount must be paid for the share. It is proposed that provision be made for the deduction of that minimum amount and a definition of "gain" be introduced to achieve this.

Thirdly, there is uncertainty as to what the position is where an employee dies or goes insolvent before the five year period has passed as the Act regards the person and his or her deceased or insolvent estate to be separate persons for tax purposes. Death and insolvency are normally regarded as "no fault disposals" for the purposes of share incentive schemes and it is proposed that tax not be raised in these circumstances.

Fourthly, as a result of corporate actions such as unbundling or issue of capitalisation shares additional shares may be acquired by the person because he or she owns qualifying equity shares. It is proposed that they be deemed to have been acquired on the same date as the qualifying equity shares. The effect would be that if they are sold before the period of five years from the date of acquisition of the original qualifying equity they will be subject to tax. It is proposed that they be included in the ambit of the provisions of section 8B as the unbundling or issue of capitalisation shares will reduce the value of the shares held by the taxpayer.

Fifthly, there is a limit on the value of qualifying equity share that an employee may receive in terms of a broad based employee share plan. It is proposed that the value of shares acquired by an employee as a result of a corporate re-organisation as contemplated in the proposed section 8B(2A) be excluded from the limit.

CLAUSE 12

Income Tax: Amendment of section 8C of the Income Tax Act, 1962

This section was introduced last year to replace section 8A and to deal with executive type share incentive schemes in a more appropriate way.

Subclause (a): In order to fall within the ambit of section 8C the equity instrument must have been acquired by virtue of his or her employment or office of director of any company. It has been contended that certain share schemes fall outside the scope of section 8C. It is proposed that shares acquired by arrangement with the taxpayer's employer also be included in the scope of the section. This phrase is also used in the Seventh Schedule which deals with fringe benefits.

As a result of corporate actions such as unbundling or issue of capitalisation shares, additional equity instruments may be acquired by the person because he or she owns restricted equity instruments. It is proposed that they be included in the ambit of the provisions of section 8C as the unbundling or issue of capitalisation shares will reduce the value of the shares held by the taxpayer.

Subclause (b): One of the exclusions to these provisions is equity instruments acquired as a result of the exercise of an option on which there were no restrictions at the time of disposal. The reason being that the gain on the option would already have been taxed on acquisition if it was unrestricted when acquired or at the time the restrictions were lifted if it was a restricted option. The word "exchange" does not accurately describe the exercise of an option or conversion of a financial instrument and the wording has been clarified by adding references to the exercise or conversion of an equity instrument.

Subclause (c): Subsection (2) prescribes how gains and losses on the vesting of an equity instrument are to be calculated. The main rule is that any consideration paid for the equity instrument must be deducted from the market value of the equity instrument on the date of vesting. There are situations where the taxpayer is compelled to sell the restricted equity instrument for less than market value, for example, when the taxpayer leaves the employment before the period prescribed in the scheme. In these circumstances the method of calculation of the gain or loss is the consideration paid for the equity instrument deducted from the actual consideration received. It is proposed that this method be extended to situations where there is release, abandonment or lapse of an option or convertible financial instrument.

As the amount determined in subsection (4)*(b)* is deemed to be a gain and included in the income of the taxpayer in terms of that subsection it is not necessary to include it in income again in terms of subsection (2)*(a)*(ii)*(bb)*. It is therefore, proposed that the subsection be deleted.

It is proposed that subsection (3) be amended to describe in more precise detail when vesting of an equity instrument takes place and it is proposed that subsection (2)(ii) be consequentially amended to bring it into line with the amendment proposed to subsection (3).

Subclause (d): As subparagraph (3)(ii) read if an employee left employment before the date prescribed in the share incentive scheme and was compelled to sell his or her equity instruments to the employer at the same price he or she had purchased them and which is lower than market value, this would have had unintended consequences. The equity instrument would have vested and the employee would be taxed on a gain which would be the difference between the market value on the date of disposal and the consideration originally paid. It is, therefore, proposed that disposals contemplated in subsection (5)*(c)* which deal with disposals for less than market value be excluded from this vesting event.

It is proposed that subsection (3) be amended to describe in more precise detail when vesting of an equity instrument takes place and the effect of this in item (3)(b)(iii) is that the value must be measured immediately after termination and it will, therefore, be nil.

The second proposed amendment to item (iii) can be illustrated by an example. A scheme provides that the option granted may be exercised after one year and the share acquired as a result of the exercise may not be sold for a period of three years. Prior to the proposed amendment the termination of the option would have triggered a gain while the option actually remained restricted as the share was restricted.

An equity instrument is deemed to have vested immediately before death and concern has been expressed that in terms of some share incentive schemes taxpayers may lose their rights on death and an amount may be taxed even though nothing will accrue to the estate or heirs. It is proposed that the vesting only takes place if the restrictions relating to the equity instrument are or may be lifted on or after death.

Subclause (e): Subsection (4) deals with the situation where an employee exchanges a restricted equity instrument with his employer or associated institution for another restricted equity instrument. This normally happens as a result of a corporate restructuring. A roll-over relief is provided and the new instrument is deemed to have been acquired as a result of employment and is, therefore, taxable.

There are situations where in addition to the exchange of shares the employer pays the employee cash to balance the exchange of instruments. To the extent that the employee receives money he or she has cashed out and the gain made should be taxed. The provisions currently provide that to the extent that the employee receives cash, the full amount is subject to tax. This results in an inequitable situation where the employee is in an overall loss position in relation to the instrument and he or she receives a cash payment which will be fully subject to tax. It is proposed that a portion of the consideration that the employee paid for the original instrument be attributable to the amount which is subject to tax. The employee will be taxed on the cash received less the consideration attributable to the cash received. Thus the actual gain will be taxed or the actual loss will be allowed when the amount of cash is received. The gain or loss made on the vesting of the instrument will be taxed when this event occurs.

Example

As a result of a corporate restructuring an employee disposes of a restricted equity instrument he held to his employer and in return received another restricted equity instrument worth R140 and cash of R60. When the employee had exercised his option to acquire the original equity instrument he paid a strike price of R100 (i.e. the consideration)

The new restricted equity instrument is deemed to be acquired by virtue of the employee’s employment and will be subject to tax when the restrictions on it are lifted. A gain is determined as a result of the receipt of the cash of R60. The portion of the consideration attributable to the cash received is calculated as follows—

Portion of consideration $\frac{R\ 60}{R200}$ x R100 = R30

Gain R60 – R30 = R30

Subclause (f): There are situations where the taxpayer is compelled to sell the restricted equity instrument to his or her employer or a trust administered by the employer for a price equal to the consideration paid for it. For example, when the taxpayer leaves the employment before the period prescribed in the scheme. Subparagraph (5)*(c)* provides that the anti-avoidance rules which target disposals to "connected persons" do not apply in these circumstances. It is proposed that the wording be clarified to make it clear that options which are forfeited, lapse or cancelled are also included.

Unlike listed shares there is not a ready made market in private company shares. Some private companies that introduce share incentive schemes use different methods to determine the acquisition consideration and the value on vesting. These amounts that are determined may be less than the true market value of the shares. As the provisions of the section read at present the market value of the share would have to be used in these circumstances, which is not equitable. It is proposed that all equity instruments which are disposed of for less than the market value of the share be dealt with in the subsection and the method of calculation of the gain or loss on the disposal of the equity instruments described in subsection (5)*(c)* be the consideration paid for the equity instrument deducted from the actual consideration received.

Subclause (g) and (h): In terms of section 8(2)*(b)* of the Revenue Laws Amendment Act, 2004 any right to acquire a marketable security (an option) which is exchanged for another, for example, as a result of a reorganisation, and to which the provision of section 8A(5) would have applied, must be dealt with in terms of the new section 8C. It is proposed that the method of determining the consideration for the acquisition of the right (equity instrument) be the same as if it was acquired in terms of section 8C(4)(a).

Subclause (i), (j) and (k): One of the most popular methods of avoiding the payment of tax under section 8A, which section 8C has replaced, was to use a deferred delivery mechanism to reduce the amount of the incentive to be taxed in the hands of the employee. This was achieved by entering into a binding contract between the taxpayer and the employer or an associated institution in terms of which an equity instrument was sold to the taxpayer but delivery of the instrument would only be given once payment was made and the employee could only make payment after, say, five years. This ensured no gain or a small gain and no fringe benefit on an interest free loan by the employer. While the view is that the existing paragraph (a) of the definition of "restricted equity instrument" in section 8C already covers deferred delivery schemes as a restriction, as they prevent the taxpayer freely disposing of the instrument, it is proposed that the matter be placed beyond doubt.

Subclause (l): The amendment to this subsection is consequential on the amendment to subsection (4)

CLAUSE 13

Income Tax: Amendment of section 9 of the Income Tax Act, 1962

Subclause (a): Currently foreign assets of a resident which are not immovable property and which are not attributable to a foreign permanent establishment of the resident are deemed to be South African sourced assets for purposes of the determination of capital gains or losses. This principle was introduced in the Income Tax Act in 2002. The effect of this rule is that taxes imposed by a foreign tax jurisdiction may not be allowed as a credit against a resident's South African tax liability in respect of the disposal of the assets described above.

As was announced in the 2005 Budget the sale of foreign shares by South Africans is problematic if the foreign country taxes this form of sale. It is now proposed that the disposal of foreign assets (including shares) which are subject to foreign taxes but are not attributable to a foreign permanent establishment will be treated to be from a foreign source. South Africans will then be entitled to utilise foreign taxes proved to be payable as foreign tax credits against their South African tax liability.

Subclause (b): Section 9(2) determines the source of capital gains or capital losses. In the case of immovable property or any interest or right of whatever nature in immovable property, the capital gain or loss is deemed to be from a source in the Republic if the property is situated in the Republic. For purposes of this section, an interest in immovable property includes certain interests in companies or other entities that hold property if at least 80 per cent of the net assets of the company or other entity is attributable to immovable property and where the person holds at least 20 per cent of the equity share capital of the company or other entity.

Certain practical issues have arisen with the application of this provision, especially where foreign companies hold their interests in South African immovable property indirectly through other entities. In a chain of two companies in which the investor holds a direct interest in the first company, assets of the indirectly held foreign company could consist of immovable property which exceeds 80 per cent of the value of all the assets of that company, although the portion of the value of the shares held by non-resident in the first company in the chain of companies which is attributable to the immovable property may be less than 80 per cent. The present wording also does not deal with trusts as it only refers to equity shares in a company or other entity.

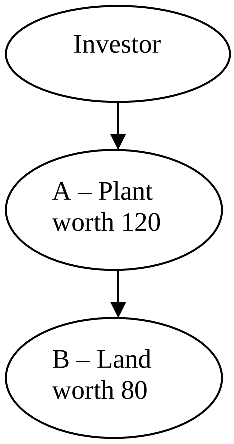
It is, therefore, proposed that this provision be amended to provide that an interest in immovable property includes any equity shares in a company, ownership or right to ownership in any other entity or the vested interest in a trust if—

- 80 per cent or more of the market value of the interest at the time of disposal is attributable to immovable property; and
- the person holds at least 20 per cent of the equity share capital or ownership. The 20 per cent requirement does, however, not apply in respect of the vested interest in a trust.

The effect of the amendment can be illustrated by an example.

Example

A foreign investor owns all the shares in A. A owns all the shares in B as well as plant worth 120. B owns land in the Western Cape with a market value of 80.



Under the current provisions it could be argued that if foreign investor sold the shares in A for 200 that the 80 would be subject to CGT as B has been indirectly disposed of and more than 80 per cent of its the value is attributable to SA immovable property.

The proposed amendment will have the effect that the disposal of the shares in A by the foreign investor will not be subject to CGT as only 40 per cent of the value of the shares in A is attributable to South African immovable property.

CLAUSE 14

Income Tax: Amendment of section 9D of the Income Tax Act, 1962

This section deals with the taxation of net income of controlled foreign companies.

Subclause (a): Currently a foreign company qualifies as a controlled foreign company (CFC) where more than 50 per cent of the participation rights (rights to capital and profits) in the company are held by South African residents. As announced in the Budget voting rights should also be taken into account in determining whether a foreign company is controlled by residents. The proposed amendment has the effect that a foreign company will be a CFC if residents either hold directly or indirectly more than 50 per cent of the rights to capital, profits or reserves in the foreign company, or hold directly or indirectly more than 50 per cent of the voting rights in the foreign company.

In the determination of indirect interests of residents in foreign companies the effective interest is calculated. A resident holding 80 per cent of the equity shares in a foreign company which in turn holds 80 per cent of the equity shares in another foreign company will have the effect that the indirect interest of the resident in the second foreign company is 64 per cent (80% x 80%).

At present indirect voting rights are calculated on the same basis as above. However, a shareholder who is able to exercise more than 50 per cent of the voting rights generally has effective control over the relevant company. It is, therefore, proposed that where indirect voting rights are determined for purposes of determining whether a foreign company is a controlled foreign company the test should be performed in a different manner. Where a resident can, for example, exercise 75 per cent of the voting rights in a foreign company which in turn can exercise 75 per cent of the voting rights in another foreign company, the indirect interest of the resident in the second foreign company is 75 per cent.

Subclause (b): These amendments are consequential upon the introduction of the definitions of “associated group of companies”, influenced company” and “prescribed proportion” in section 41 of the Income Tax Act.

Subclause (c): In some instances it is currently not possible to determine the participation rights in a foreign company, e.g. certain mutual companies, which complicates the application of the CFC regime to those companies. It is proposed that where-

- no person has any right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of a CFC; or
- no rights to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of a CFC can be determined,

the participation rights used to impute an amount of net income of the CFC should be based on the effective voting rights in that company which can be exercised by residents.

Subclause (d): This amendment is consequential upon the introduction of the voting right test to determine whether a foreign company qualifies as a controlled foreign company.

Subclause (e): The amendment to subsection (2A) is consequential upon the inclusion of a foreign company ceasing to be a CFC under paragraph 12(2) of the Eighth Schedule.

Subclauses (f) and (o): Currently, the requirement for the exemption contained in paragraph *(f*A*)* to apply is that the two companies form part of the same group of companies. It is proposed that the exemption should apply where the specified amounts are paid or payable by a CFC to another CFC in the same group of companies. The provisions of section 9D(2A)*(c)* are also aligned to the exemption provisions of section 9D(9)*(fA)*.

Subclause (g): These amendments are consequential upon the introduction of the rules regulating the foreign currency translation of “local currency” in paragraph *(c)* of the proviso to section 9D(6) and the amendment of paragraph 20(1)*(h)* of the Eighth Schedule.

Subclause (h): From a tax policy perspective—

- foreign equity instruments;
- assets where the gains/losses are deemed to be from a South African source; and
- exchange items,

of a CFC, which are **not** attributable to any permanent establishment of the CFC should be taxed on the same basis as if a resident held the items directly. If this was not the case it would encourage residents to transfer those assets to a CFC to avoid being taxed on the exchange differences determined in relation to the Rand. This amendment clarifies the application of this principle to those assets. All exchange gains and losses from the date of acquisition until disposal thereof must be taken into account for tax purposes.

Subclause (i): This amendment clarifies that the amounts contemplated in section 9D(9) must be excluded in the determination of the net income of a CFC. Subsection (9) therefore operates as an exemption provision.

Subclause (j): It is proposed that the exemption of net income attributable to a business establishment be clarified by specifically stating that the disposal or deemed disposal of assets forming part of the business establishment of the CFC will also qualify for the exemption.

Subclause (k): The amendment is of a textual nature.

Subclause (l): It is proposed that foreign currency gains which are attributable to a business establishment of a CFC and which arise in the normal course of business of that CFC (which is not a foreign financial instrument holding company) should not be treated as passive investment income. This has the effect that those gains will be exempt from income tax.

Subclause (m): Currently gains and losses on the disposal of all intangible assets are taxed under the CFC regime even though the asset may be attributable to a business establishment of the CFC. It is proposed that certain intangible assets purchased, devised and developed outside South Africa should qualify for the business establishment exemption. Foreign intangible assets targeted for the relief are those assets which were held by that controlled foreign company for a period of at least 18 months prior to disposal as an integral part of any business conducted by that controlled foreign company and were so disposed of as part of the disposal of that business as a going concern. The reason for excluding South African developed intangible assets from this relief measure is that a group of companies which developed South African intangible assets and received the benefit of tax deductible development costs could otherwise transfer the assets offshore and obtain a tax free amount on disposal thereof. Intangible assets with excellent growth potential should not be able to be transferred offshore and obtain tax-free treatment on the ultimate disposal thereof.

Subclause (n): As announced in the Budget certain CFCs of South African insurance companies earn profits which will eventually be paid to policyholders who do not fall within the South African tax net at all. In order not to tax these profits under the CFC regime, an exemption is introduced for the net income of the CFC which is can be attributed to non-resident policyholders who are not CFCs. An additional requirement for the exemption to apply is that the policy should have been issued by a company which is licensed to issue any long-term policy as defined in the Long-term Insurance Act in its country of residence.

Subclause (p):
The amendment is consequential upon the introduction of an exemption in section 9D(9)*(b)* which allows for the tax free disposal of assets of a CFC forming part of the business establishment of the CFC. Exemptions for the disposal of assets of a CFC are dealt with in two paragraphs of 9D(9), i.e.:

- paragraph *(b)* for assets attributable to the business establishment of the CFC; and
- paragraph *(f*B*)* for assets attributable to the business establishment of another CFC.

It is proposed that the current exemption of net income attributable to the disposal of a business establishment asset of another foreign company be limited to situations where the other foreign company is a CFC and forms part of the same group of companies as the CF which disposed of the asset.

Subclause (q): These amendments are consequential upon the adjustment of the participation exemption threshold to 20 per cent or more of the participation rights as well as the incorporation of a 20 per cent or more voting rights test.

Currently interests held by non-residents who are connected persons in relation to the resident are taken into account to determine whether the required rights are held. However, non-residents are not subject to the provisions of section 9D. A further amendment is proposed that will only allow an election in terms of subsections (12) or (13) where a resident together with any other resident who is a connected person in relation to the first-mentioned resident holds the required rights. The reason for the limitation is that the provisions of those subsections should apply to the persons whose rights are taken into account to determine whether the election may be exercised, i.e. residents and not foreign connected persons.

CLAUSE 15

Income Tax: Amendment of section 9G of the Income Tax Act, 1962

As a foreign equity instrument which constitutes trading stock will be taxed by applying the spot rate on acquisition and disposal of the instrument under section 25D it is no longer necessary to determine the taxable income in respect of foreign equity instruments under a separate section. As a transitional measure all foreign equity instruments acquired before the amendments to section 25D come into affect will still be dealt with under section 9G.

CLAUSE 16

Income Tax: Amendment of section 10 of the Income Tax Act, 1962

This section provides for the exemption of certain persons or certain types of receipts and accruals.

Subclause (a): Section 10 provides for certain exemptions from normal tax. In terms of the general deduction formula income is determined by excluding from gross income all amounts which are exempt in terms of section 10. Currently, section 10 refers to exemption from tax, which could be read as including all taxes imposed in terms of the Act, for example, the new proposed tax on foreign entertainers and sportspersons. It is proposed that section 10 be clarified that the exemption only applies in respect of normal tax.

Subclause (b): Currently the income tax system provides exemption for PBOs engaged in various forms of non-profit activities and includes a small threshold for trading activities. However, certain difficulties were encountered by many PBOs if they exceeded this threshold as their tax exempt status was terminated altogether. This “all-or-nothing” approach is impractical as PBOs need to be self-sustaining in order to survive. Accordingly, it was announced in this year’s Budget Review that a system of partial taxation would be implemented, which means that PBOs which do conduct business activities may continue to do so without losing their exemption for non-profit activities. They will, however, pay income tax on the income from those business activities falling outside the allowable trading rule.

This provision essentially lays the platform for PBOs to be taxed on trading activities by exempting receipts and accruals from non-trading activities such as interest income as well as receipts and accruals–

- o that are integral and directly related to the PBOs sole objective;
- o that are of an occasional nature and undertaken with assistance on a voluntary basis without compensation;
- o from activities which have been approved by the Minister by way of notice in the *Gazette* having regard to certain criteria; or
- o from any other undertaking or activity where the receipts and accruals do not exceed the greater of–
  - ▪ 5 per cent of the total receipts and accruals of that PBO during the tax year; or
  - ▪ R50 000.

The change comes into operation on 1 April 2006 and applies in respect of years of assessment commencing on or after that date.

Subclause (c): The Workmen's Compensation Act, 1941 ("the WCA"), was repealed with effect from 1 March 1994, and replaced by the Compensation for Occupational Injuries and Diseases Act, 1993 ("the COID Act"). Prior to 1 March 1994, the WCA provided benefits similar to what is now provided under the COID Act. However, in terms of the WCA, employees who earned in excess of a specified amount (R55 068 per annum) were excluded from the Act and could, therefore, not become entitled to compensation under that Act. Employers therefore arranged separate insurance policies to cover these employees against disability as a result of injuries and diseases sustained or contracted in the course of employment. The COID Act, on the other hand, covers all employees regardless of their level of earnings, although the benefits payable in terms of this Act are limited. The situation now exists that certain persons who currently receive compensation in the form of a pension, in respect of injuries or disease sustained or contracted before the new Act came into operation, are subject to tax on the amounts received as these amounts are not paid *in terms of* one of those Acts. Had the injury or disease been sustained or contracted by those persons on or after 1 March 1994, these payments would have qualified for the exemption as they would have qualified for benefits under the COID Act. As announced in the Budget Review this year, the exemption provision has been reviewed to ensure that it applies to all disability pensions regardless of the date of injury or disease and the amendment gives effect to this proposal.

Subclause (d): In recognition of the sacrifices made by individuals who were members of liberation movements' armed wings, special pension provisions were introduced for such persons in terms of the Special Pension Act. No 69 of 1996 and Demobilisation Act, No 99 of 1996. Certain individuals qualifying for benefits may receive payments in terms of these Acts. An amendment to the Special Pension Act will introduce a funeral benefit for deceased beneficiaries and it is proposed that this benefit be exempt from income tax.

Subclause (e): A participation exemption is granted for foreign dividends from foreign companies where a more than 25 per cent interest is held in the equity shares of the foreign company. It is proposed that the interest to qualify for the participation interest be reduced to an interest in the equity share capital of at least 20 per cent and that a test be added which will also require voting rights of at least 20 per cent to be held in the company declaring the foreign dividend for the exemption to apply.

Subclause (f): This amendment is of a textual nature and is consequential upon the amendment of section 8E which replaced the reference to affected instruments with the term hybrid equity instruments.

Subclause (g): This amendment is consequential upon the introduction of the tax on foreign entertainers and sportspersons which will constitute a final withholding tax at a rate of 15 per cent. These amounts must therefore be exempt from normal tax.

Subclause (h): Section 10(1)*(n*E*)* exempts from tax any amount received by or accrued to an employee under a share incentive scheme operated by the employee's employer upon the cancellation of a transaction under which the employee purchased shares or upon the repurchase from the employee, at a price not exceeding the selling price, of shares purchased. This is referred to as the "stop loss provision" and allows the employer to extricate employees from share incentive schemes if the value of the shares decreases.

Section 8C unlike section 8A allows losses to be claimed and the "stop loss provision" is, therefore, not required for equity instruments to which section 8C applies. The operation of the "stop loss provision" was restricted to section 8A shares when section 8C was introduced. Section 10(1)*(n*E*)* was, however, also introduced to provide relief for share purchase schemes which fall under the Seventh Schedule as fringe benefits. The restriction of the section to section 8A shares was, therefore, too narrow and it is proposed that its operation be extended to shares acquired in terms of share purchase schemes.

Subclause (i): This amendment is consequential upon the amendment of the Immigration Act, 2002, on 1 July 2005.

Subclause (j): Government has introduced a uniform system of dealing with value-added tax on government grants to public entities and private parties. It was announced in the Budget that the first steps would be taken to introduce a uniform system for income tax.

It is proposed that a definition of "government grant" be introduced and that an enabling provision be introduced which gives the Minister of Finance the power to approve the different government grants as being exempt from tax in terms of a notice in the *Gazette* if they meet the requirements of the section. The requirements are that the grants paid must be in terms of a programme of scheme which has been approved in terms of the national annual budget process and where the programme or scheme meets government policy priorities and objectives in defined areas. The Minister must have regard to the extent to which the programme or scheme will support the listed policy priorities and objectives and the financial implications for the Government should the grants be exempt from tax and whether the tax implications have been taken into account in determining the amount of the grant.

Subclause (k): This clause deletes an obsolete provision.

Subclause (l): The Department of Trade and Industry ("DTI") introduced the South African Film and Television Production Rebate Scheme ("rebate scheme") to incentivise local film production. Current law relating to tax-free State grants are too restrictive (i.e., the recipient of the grant must be the "owner" of the film) and have therefore effectively become obsolete. A more flexible system that encourages local film production in general is appropriate, i.e. where the recipient is a producer of the film as is the case with the DTI rebate scheme. These rebates are, therefore, exempted.

Subclause (m): Section 10(1)*(zI)* of the Income Tax Act, 1962, exempts from tax any Government grant to a Private Public Partnership (PPP) if the grant is used to improve land or buildings owned by Government. The reason for the exemption is that the improvements to land revert to the Government on termination of the concession. A number of the concessions operate on land which the Government does not own but over which it holds a servitude. On termination of the concession, any improvements effected on the land, over which a servitude is held, are for the benefit of the Government. For this reason it is proposed that the grants used to fund these improvements also be exempt.

CLAUSE 27

Income Tax: Amendment of section 10A of the Income Tax Act, 1962

It is proposed that the method of determining the exempt capital amount of an annuity purchased in foreign currency be changed. Where the consideration given for the purchase of the annuity and the annuity payable under the annuity contract are in a foreign currency the exempt capital element is to be determined in the foreign currency. The exempt amount in foreign currency is to be translated to Rand by applying the same exchange rate as the exchange rate applied to translate the annuity receipt or accrual in terms of section 25D.

CLAUSE 18

Income Tax: Amendment of section 11 of the Income Tax Act, 1962

Subclauses (a) and (b): As was announced in the Budget Review, an amendment is proposed to the provisions which deal with depreciation of assets to place beyond doubt that depreciation may only be claimed for tax purposes by taxpayers who own these assets or acquired these assets as a purchaser in terms of an instalment credit agreement. This amendment gives effect to this proposal. An allowance will not be granted to a seller in terms of an instalment credit agreement. Therefore, although the seller strictly speaking remains the owner of the asset until the final payment is made, the purchaser will be entitled to claim the depreciation.

Subclause (c): Section 11*(j)* of the Income Tax Act, 1962, provides for an allowance to be made in respect of debts due to a taxpayer as the Commissioner considers to be doubtful. This allowance must, however, be included in the income of the taxpayer in the following year of assessment. Some taxpayers have recently tried to argue that the allowance in respect of these doubtful debts may be granted even though the deduction would not be allowed if the debt had become bad. It is, therefore, proposed that this provision be clarified to specifically provide that the allowance will only be granted if the debts would have been allowed as a deduction under another provision of Part I of Chapter II of the Act had they become bad.

Subclause (d): In recognition of the sacrifices made by individuals who were members of liberation movements' armed wings, special pension provisions were introduced for such persons in terms of the Special Pension Act. No 69 of 1996 and Demobilisation Act, No 99 of 1996. In terms of these Acts, certain individuals received certain payments that were subject to income tax.

The GEPF rules were changed recently, to allow former Non-Statutory Force (NSF) members to purchase past years of service (for the periods when they were members of the NSF). Should these members elect to purchase past years of service, they have to—

- o repay the gross benefit they received in terms of the abovementioned Acts; and
- o pay an amount of 5% of their income for each year of service that they buy-back.

A problem arises if the member pays back the 5% of income to the GEPF to purchase past years of service as the Income Tax Act only allows an amount of R1,800 per annum as tax deductible during the year in which the payment was made (although the disallowed amount may be carried forward to following tax years). It is proposed that the amount paid to purchase past years of in these circumstances not be subject to the R1,800 limit. This effectively places these former NSF members in the position as if they had been able to contribute to the GEPF while they were members of the liberation movements.

Subclause (e): A concession was introduced for broad-based employee share plans and if the shares granted in terms of the plan are held for at least five years the amount of income from the disposal of the shares may not be subject to tax. As further encouragement to introduce these plans, the employer is entitled to deduct the market value of qualifying equity shares on the date of grant. It is envisaged that the shares would normally be donated by the employer but in certain circumstances the employer may be required by the Companies Act to charge a small amount. It is proposed that where a small amount is charged, the amount allowed to the employer as a deduction be reduced by the amount charged.

Subclause (f): Section 11*(o)* of the Income Tax Act, 1962, provides for the deduction of a loss incurred on the alienation, loss or destruction of certain depreciable assets (the so-called scrapping allowance). The deduction allowed is equal to the difference between the amount received or accrued from the disposal and the cost to the taxpayer of that asset, reduced by any depreciation already allowed for tax purposes in respect of that asset. Where an asset was used by the taxpayer for any period before that taxpayer became taxable, the use by the taxpayer during that non-taxable period is taken into account in determining the depreciation allowable during the years when the taxpayer is subject to tax. It is proposed that the depreciation as a result of use during the non-taxable years should also be accounted for in determining the amount of the allowance under section 11*(o).*

***Example*: (5 year straight-line depreciation)**

X acquires depreciable asset with 5 year useful life for R100 and uses it in non-taxable trade for two years. X becomes taxable in year 3.

The depreciation allowance in years 3 to 5 must be determined as if the allowance had been claimed in previous two years, i.e. only the balance of R60 may still be depreciated.

If the asset is destroyed in year 4, the scrapping allowance is the remaining portion of the depreciation which would have been allowed, i.e. R20 as opposed to R60 which would be the case if the deemed depreciation in the non-taxable years had not been taken into account.

CLAUSE 19

Income Tax: Amendment of section 12B of the Income Tax Act, 1962

Subclauses (a), (b), (c), (e), (f), (g) and (h): As was announced in the Budget Review, an amendment is proposed to the provisions which deal with depreciation of assets to place beyond doubt that depreciation may only be claimed for tax purposes by taxpayers who own these assets or acquired these assets as a purchaser in terms of an instalment credit agreement. This amendment gives effect to this proposal. An allowance will not be granted to a seller in terms of an instalment credit agreement. Therefore, although the seller strictly speaking remains the owner of the asset until the final payment is made, the purchaser will be entitled to claim the depreciation.

Subclause (d): As proposed in the Budget Review this year, the accelerated depreciation for investments in bio-diesel and bio-fuels will be extended to other forms of environmentally friendly energy sources. Renewable energy investment, such as solar energy and windmill technology will also benefit from a tax depreciation write-off of 50:30:20 per cent over three years. The amendment gives effect to this proposal.

CLAUSE 20

Income Tax: Amendment of section 12C of the Income Tax Act, 1962

As was announced in the Budget Review, an amendment is proposed to the provisions which deal with depreciation of assets to place beyond doubt that depreciation may only be claimed for tax purposes by taxpayers who own these assets or acquired these assets as a purchaser in terms of an instalment credit agreement. This amendment gives effect to this proposal. An allowance will not be granted to a seller in terms of an instalment credit agreement. Therefore, although the seller strictly speaking remains the owner of the asset until the final payment is made, the purchaser will be entitled to claim the depreciation.

CLAUSE 21

Income Tax: Amendment of section 12E of the Income Tax Act, 1962

As was announced in the Budget Review, an amendment is proposed to the provisions which deal with depreciation of assets to place beyond doubt that depreciation may only be claimed for tax purposes by taxpayers who own these assets or acquired these assets as a purchaser in terms of an instalment credit agreement. This amendment gives effect to this proposal. An allowance will not be granted to a seller in terms of an instalment credit agreement. Therefore, although the seller strictly speaking remains the owner of the asset until the final payment is made, the purchaser will be entitled to claim the depreciation.

CLAUSE 22

Income Tax: Amendment of section 12H of the Income Tax Act, 1962

Subclause (a): Section 12H of the Income Tax Act, 1962, provides for the deduction of an allowance in respect of learnership agreements when an employer enters into a learnership agreement and a further deduction when a learnership is completed. Section 12H provides that the deduction by an employer upon completion is only allowable if the learnership was entered into between that employer in that year or a previous year of assessment. The section therefore does not make provision for transfer of employees within a group of companies. It is proposed that section 12H be amended to also allow the deduction for completion in these instances.

Subclauses (b), (c) and (d): The deduction in terms of section 12H in respect of a learnership is determined with reference to the annual equivalent of the remuneration of the learner as stipulated in the agreement of employment. The reason for calculating the deduction with reference to the annual equivalent was to ensure that employers get the full deduction in the case where the learnership commences halfway through the year. It was also the understanding at the time when these provisions were introduced that the minimum period for most learnerships would be 12 months, as they required to complete a certain number of hours to comply with the NQF levels on which the learnerships were based. However, it now appears that there are a number of short term learnerships with a duration of less than a year. The effect of this is that the employer could upon entering into a learnership claim a deduction equal to 12 times the monthly remuneration and again upon completion at the end of that month claim 12 times the monthly remuneration as a further deduction. This was not the intention of this provision and it is, therefore, proposed that section 12H be amended to address this anomaly.

CLAUSE 23

Income Tax: Amendment of section 13quat of the Income Tax Act, 1962

Section 13*quat* was inserted in the Income Tax Act, 1962, in 2003 as a tax incentive to encourage investment in identified urban development zones to address the problem of urban decay in these zones and maintain existing infrastructure that was developed at great cost.

Section 13*quat* provides for an accelerated depreciation allowance for the construction of new buildings and refurbishment of existing buildings in identified inner cities within selected municipalities. The allowance is available to taxpayers who own the building, has constructed or refurbished it and uses it solely for the purposes of trade, including the letting of the property. Therefore, if a developer builds in an urban development zone with the intention to on-sell the building, no allowance under this section will be available, since the developer will not use the building. The purchaser of the property will also not be eligible for the allowance as the purchaser has not undertaken the construction or improvements.

It is proposed that the tax incentive be extended to first purchasers that buy from *bona fide* developers. Extending the incentive in this way will allow developers to incur the actual costs of constructing or refurbishing a building in an urban development zone and on-sell the building together with the right to claim the incentive. The first purchaser, although not having incurred the actual costs of construction or refurbishment, will qualify for the tax incentive and be able to claim an allowance on a percentage of the purchase price which is deemed to be attributable to the developer's construction or refurbishment costs.

The current provisions of section 13*quat* also require that the whole building must be used by the taxpayer for purposes of trade. As developers often sell buildings constructed by them on a sectional title basis, it is proposed that the scope of the section be extended to also cover parts of buildings that are constructed or refurbished.

In order to ensure that refurbishments of part of a building are substantial, a requirement for a minimum refurbished floor space of 1000m^2 has been introduced. This minimum floor space requirement does not apply where an entire building is constructed or refurbished.

CLAUSE 24

Income Tax: Amendment of section 15 of the Income Tax Act, 1962

This amendment is consequential upon the introduction of section 11*(g*C*)* in 2003.

CLAUSE 25

Income Tax: Amendment of section 18 of the Income Tax Act, 1962

Taxpayers are currently not taxed on medical aid contributions by their employers that are equal to two thirds or less of their total medical aid contributions and may deduct medical expenses (including medical scheme contributions by the taxpayer) exceeding 5 per cent of taxable income. This approach does not assist self-employed persons or employees not entitled to employer sponsored medical scheme membership.

These taxpayers, and more specifically larger families, will be assisted by allowing a capped tax deduction for medical aid contributions for each person covered by a medical scheme. This benefit is in line with the tax-free benefit provided to employees enjoying employer sponsored medical scheme coverage. The tax-deductible amounts are R500 for each of the first two beneficiaries and R300 for each additional beneficiary. The introduction of a tax deduction for medical scheme contributions up to a capped amount, together with other factors identified, necessitate an increase in the threshold from 5 per cent to 7,5 per cent. The excess medical scheme contributions (i.e. as exceeds the capped amounts) and all other qualifying medical expenses may be claimed to the extent that they exceed the 7.5 per cent threshold.

Persons older than 65 will still be able to deduct all qualifying medical expenses, as will families with a handicapped person as the R500 *de minimis* rule in this regard has been deleted.

These changes come into operation on 1 March 2006 and apply in respect of years of assessment commencing on or after that date.

CLAUSE 26

Income Tax: Amendment of section 18A of the Income Tax Act, 1962

Subclause (a) and (b): Section 18A provides that a deduction will be allowed from the taxable income of a taxpayer in respect of a donation which was actually paid or transferred to a public benefit organisation (PBO), provided that the PBO has distributed or incurred the obligation to distribute 75% of the donations for which receipts were issued in the preceding year of assessment. The intended effect is that 75% of the donations for which tax deductions were granted must be distributed within 12 months following the year of assessment during which the donation was received. It is difficult to monitor this distribution requirement and it also places donors in a difficult position as they do not have access to the financial records of the PBO and are not able to determine whether this requirement has been complied with. It is proposed that section 18A be amended to provide that the criteria must be forward looking and that the PBO undertakes to distribute 75% of the donations within a specified period.

Subclause (c): Section 18A currently provides for a tax deduction of donations made to transfrontier peace parks, subject to certain conditions. One of these conditions is that the donation must be made to the public benefit organisation before 1 August 2005. It is proposed that the sunset date for the tax deductibility of donations to peace parks be extended to 31 March 2010.

Subclause (d), (e), (f) and (g): Under current law, a donor may lose the benefit of a deduction of a donation for tax purposes if the donee organisation fails to satisfy its objects, even though the failure falls outside the donor's control. The result is unfair towards the donor. It was, therefore, proposed in the 2005 Budget Review that the violation by the PBO should rather incur a tax charge in the hands of the PBO, as opposed to disallowing the donor's deduction.

After further consideration it is proposed that graduated levels of penalty measures be applied for continued failure to take corrective steps by PBOs. Separate remedies are proposed for government institutions that are permitted to receive tax deductible donations.

4.3.1 Single institutions

Where the Commissioner has reasonable grounds for believing that any PBO, board or body has issued a receipt, utilised a donation or acted in contravention of the requirements of the Income Tax Act, the Commissioner may notify the PBO, institution, board or body that donations received during the specified tax year will be treated as taxable income. If corrective steps are not taken within a period stated by the Commissioner, any receipt issued by the PBO, institution, board or body from a specified date will not qualify as a basis for a tax deductible donation in the hands of donors.

4.3.2 Groups of institutions

In the case of a group of institutions, boards or bodies who are sharing a common purpose and which are approved as a group, which fails to take certain steps as required by the Income Tax Act, the Commissioner may notify the regulating or co-ordinating body that if corrective steps are not taken within a stated period, receipts issued by PBOs, institutions, boards or bodies in that group will not qualify as a basis for tax deductible donations in the hands of donors.

4.3.3 Public entities and municipalities

It is proposed that separate remedies be introduced in the case of institutions in respect of which the Public Finance Management Act or the Local Government: Municipal Finance Management Act applies. Where the accounting officer or accounting authority of the institution has issued, allowed a receipt to be issued or utilised a donation in contravention of the requirements of the Income Tax Act, the Commissioner must notify the National Treasury and the Provincial Treasury (if applicable) of the contravention. The Commissioner may also notify the accounting officer or accounting authority that if corrective steps are not taken within a stated period, receipts issued by that institution from a specified date will not qualify as a basis for tax deductible donations in the hands of donors.

4.3.4 Intentional contraventions

Lastly, it is proposed that—

- o a person who is in a fiduciary capacity responsible for the management and control of the income and assets of an PBO; or
- o the accounting officer or accounting authority of institutions in respect of which the PFMA or Local Government: Municipal Finance Management Act applies,

who intentionally fails to comply with the relevant provisions will be guilty of an offence and be liable on conviction to a fine or to imprisonment for a period not exceeding 24 months.

CLAUSE 27

Income Tax: Amendment of section 20A of the Income Tax Act, 1962

Section 20A was inserted in the Income Tax Act in 2003 to ring-fence losses incurred by taxpayers in carrying on certain trades (mainly as hobbies). This section, however, only applies where the taxable income of the taxpayer equals or exceeds the amount at which the maximum marginal rate of tax for individuals becomes applicable. In calculating the taxable income for purposes of determining whether the section applies, all assessed losses incurred in that year and the balance of an assessed loss carried forward from the preceding year must be disregarded.

There is, however, some difficulty with the sequence of deductions in calculating the taxable income for purposes of this section. Certain deductions (such as medical expenses and deductible donations) are determined after the losses have been set off. If assessed losses are not taken into account, these deductions therefore also have to be redetermined. It is, therefore, proposed that the sequence of the deductions for purposes of determining whether this section applies to a taxpayer be clarified to avoid a circular calculation.

CLAUSE 28

Income Tax: Amendment of section 23 of the Income Tax Act, 1962

Subclauses (a) and (c): The limitation in section 23 of miscellaneous deductible business expenses incurred by salaried employees, has the unintended impact of denying certain legitimate home office expenses where employees are forced by their employer to bear the cost of maintaining a home office as their central business location. As was announced in the Budget Review this year, the rules will be changed to allow employees to deduct these legitimate expenses should they comply with section 11*(a)* or *(d)* and this amendment gives effect to that proposal.

Subclause (b): Section 23*(m)* was amended in 2003 to provide for the deductibility of income continuation policies to the extent that the premium relates to cover for the loss of income following illness, injury, disability or unemployment. Where a policy therefore provides other benefits (i.e. such a policy also provides life cover) only so much of the premium as relates to the income continuation benefits will be allowed as a deduction. Section 23*(m)*, however, has a further requirement and that is that the amounts payable in terms of the policy must constitute income as defined. The life benefit portion payable in terms of the policy will not constitute income and it was the intention to just refer to the benefits in respect of which a deduction is allowed. It is, therefore, proposed that section 23*(m)* be amended to reflect this intention.

Subclause (d): Section 23*(n)* prohibits any deduction or allowance in respect of an asset to the extent that the asset is acquired with funds granted to the taxpayer by the Government which is exempt from tax. These grants are not always necessarily exempt from tax as they may constitute a receipt or accrual of a capital nature, with the result that they are not included in gross income and the exemptions in section 10 do not apply in respect thereof. It is therefore proposed that section 23*(n)* be reworded to provide that no deduction or allowance shall be allowed where the asset is funded by an amount granted by the Government which is not subject to tax.

Subclause (e): Currently, tax legislation does not specifically address the deductibility of bribes, fines or penalties. As announced in the Budget, the tax treatment of bribes should be addressed as a matter of good governance and to reinforce South Africa's anti-corruption drive. From a policy perspective the deduction of fines and penalties for tax purposes cannot be justified where those payments relate to unlawful activities. The granting of a deduction for fines and penalties would reduce the burden of the penalty or fine and be contrary to the rationale of the law in terms of which it is imposed. It is proposed that a payment should not be deductible for tax purposes if:

- the payment, agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004; or
- the payment is a fine charged or penalty imposed as a result of carrying out an unlawful activity in the Republic or in another country where the activity would be unlawful had it been carried out in the Republic.

CLAUSE 29

Income Tax: Amendment of section 23D of the Income Tax Act, 1962

This amendment is consequential upon the introduction of section 11*(g*C*)* in 2003.

CLAUSE 30

Income Tax: Amendment of section 23G of the Income Tax Act, 1962

This amendment is consequential upon the introduction of section 11*(g*C*)* in 2003.

CLAUSE 31

Income Tax: Amendment of section 24 of the Income Tax Act, 1962

This clause deletes provisions which have become obsolete.

CLAUSE 32

Income Tax: Amendment of section 24F of the Income Tax Act, 1962

Section 24F (which deals with film allowances) was introduced in 1987 to provide special rules to determine the amount and timing of deductions allowable to film owners for tax purposes.

The film industry is an important industry and has shown great potential and growth over the last few years. The film industry, however, also presents difficulties from a tax point of view as it has been the worldwide experience of revenue authorities that special allowances and other tax incentives have been the subject of abuse by promoters and investors in films. This was the South African experience in the 1980s and a tendency in that direction is now being experienced again.

Bearing in mind the need to balance the above considerations the following limited interventions are proposed:

- **In order to encourage the production of South African films, the film allowance will be targeted at expenses incurred and paid/payable in South Africa**

The provisions of the current film allowance do not draw a distinction between foreign and locally produced films. This means that local film owners may benefit from the film allowance for films produced outside South Africa. As was announced in the 2005 Budget Review the tax incentives for films must be refined to achieve their intended goal. The view is held that South African tax expenditure in the form of the film allowance should be focused on South African film productions in order to grow and support the local film industry.

It is, therefore, proposed that the production and post-production costs which may be allowed to a film owner who is using a film in the production of income be limited to expenditure paid or payable in South Africa where the services are rendered in South Africa or the goods are supplied in South Africa. In order to allow for co-productions and the use of foreign talent and expertise the total amount of all production costs or post-production costs actually incurred in connection with a film may be deductible if at least 75 per cent of the total amount of those production costs and post-production costs is paid or payable in the Republic where the services are rendered in South Africa or the goods are supplied in South Africa.

South Africa has concluded co-production treaties with Canada, Germany and Italy. These treaties provide that approved co-productions are entitled to the same benefits as local audiovisual or film productions. It is, therefore, proposed that a further category of allowable production and post-production expenses be introduced which are incurred by film owners in respect of approved co-productions as contemplated in the bilateral treaties entered into by South Africa.

Any production costs or post-productions costs incurred by a film owner in the production of income which do not qualify for a deduction granted for expenditure which relates to South African activities or co-production agreements are allowed as a deduction over a period of time. It is proposed that these amounts be allowed as a deduction on a straight-line basis over a period of 10 years from the year of assessment during which the film is completed.

- **Address the artificial increase of the cost of the acquisition of films from connected persons**

Currently the cost of acquisition of a film is included under the definition of "production cost" and qualifies for the accelerated write-off under section 24F. It has become clear that this allowance is used by some persons who are involved in transactions with connected persons, to artificially increase the value claimed for tax purposes. In order to limit the potential for abuse of the film allowance it is proposed that the acquisition cost of a film acquired directly or indirectly from a connected person be limited to the cost of acquisition of the film by the connected person or the production cost incurred by the connected person in producing the film.

- **Introduction of a time limit on the payment of production and post-production costs**

There is currently no time limit to the period during which the expenditure in respect of production or post-production costs of a film needs to be paid to qualify for an allowance in terms of section 24F. The intention is not to provide a film allowance for expenditure which constitutes a disguised distribution of profit or deferred expenditure. It is proposed that production or post-production expenditure only be allowed as a deduction under section 24F where a binding, unconditional obligation exists to pay the amount of the expenditure within a period of 18 months from the completion date of the film.

- **Treat film owners not to be at risk for loans and credit not payable within 10 years from date of completion of a film**

The effect of the accelerated allowance in terms of section 24F is that a film owner gets the benefit of a tax deduction before the related income from the exploitation of the film is taxed. In order to limit the deduction of expenditure to closer reflect the economic cost to film owners the concept of an at risk rule was introduced.

It has become clear that in a limited number of cases film owners are extending the period within which a loan or credit which is used to finance production or post-production costs of a film is repayable for as long as possible. This has the effect of creating an unacceptably long period between the tax year the expenditure is deducted and the date of settlement of the loan or credit. Most of the income from a film will arise during the first five years after date of completion. Internationally limits are imposed in different forms on the tax deferral by investors in films. In New Zealand a deferred deduction is achieved with reference to the concept of a limited recourse loan, which is a loan where the borrower is not required to make repayments for at least 10 years. Before a new tax credit system for the film industry was introduced in Canada in 1995, deductible cost was limited for film tax shelter investments financed by way of limited-recourse debt. One of the criteria for determining limited-recourse debt was whether the debt and interest thereon would be repayable within 10 years. A proposed limitation of expenditure incurred on films in the United Kingdom applies where guaranteed income in respect of a film will arise more than 15 years after the agreement was entered into.

Although the bulk of the income from a film should be generated during the first five years after completion date and logically most of the expenditure incurred to produce the film should be settled within that five year period, internationally a longer period is allowed for tax purposes. It is proposed that the film owner be treated not to be at risk for purposes of the film allowance to the extent a loan or credit used to finance production or post-production cost is not repayable within a period of 10 years from the completion date of the film.

- **Review of other definitions used in section 24F**

The current definition of "completion date" was introduced in 1987 and does not specifically deal with films other than cinematographic films or with the acquisition of a film. It is proposed that a generic definition of "completion date" be introduced which defines completion date with reference to the stage when a film can be copied for distribution to the general public. In the case of the acquisition of a film the completion date is the date of acquisition thereof.

The definitions of "export", "export country", "film manufacturer", "marketing expenditure" and "South African export film"; which have become obsolete are deleted. These definitions were introduced at the time the exporter's allowance in terms of the now repealed section 11*bis* was granted in addition to the general deduction of expenditure.

The proposed deletion of section 24F(7) is consequential upon the deletion of the definition of "marketing expenditure" and will grant relief in respect of printing costs. The deletion of this subsection will have the effect that the provisions of the Income Tax Act, other than section 24F, will apply to printing costs in relation to a film and that marketing expenditure will no longer be subject to the at risk rule.

CLAUSE 33

Income Tax: Amendment of section 24I of the Income Tax Act, 1962

Subclauses (a) and (b): The amendments to the definition of "ruling exchange rate" are required as Generally Accepted Accounting Practice no longer permits companies to use the forward exchange contract rate to convert exchange items and now requires that they be translated at spot and that the forward exchange contract be marked to market at year end.

Subclause (c): This amendment is consequential upon the introduction of a definition of "spot rate" in section 1 of the Act.

Subclause (d): This amendment is consequential upon the introduction of section 11(gC) in 2003.

Subclause (e): Section 24I(7A) spreads exchange gains and losses on loans and advances of a capital nature between companies which are connected persons over a period of time on a reducing balance basis. As a result of the introduction of further relief measures in 2003 in section 24I(10), exchange differences in respect of exchange items between residents and CFCs are not taxed on an unrealised basis, but only on realisation. These relief measures are further expanded in this Bill and effectively encompass the relief measures applicable to companies to which the spreading of exchange gains and losses would apply. It is, therefore, proposed that the section 24I(7A) spreading principle not be applied to loans obtained and advances granted during tax years ending on or after 8 November 2005. Loans and advances which are currently subject to the spreading principle will continue to be dealt with under the current provisions of section 24I(7A).

Subclause (f): This subclause deletes provisions which have become obsolete.

Subclause (g): Currently exchange differences in respect of exchange items between residents and CFCs are taxed only when the exchange items are realised. This is in contrast with the general rule applying to other exchange items which are taxed on an unrealised market valuation basis.

It is proposed that the relief measures based on the realisation method be extended to encompass the exchange items which would have been dealt with under the discontinued provisions of section 24I(7A), i.e. foreign currency loans and advances between connected persons. The relief measure will also cover exchange items between two foreign companies where both companies are CFCs in relation to the same resident or in relation to two different residents where both residents form part of the same group of companies.

CLAUSE 34

Income Tax: Amendment of section 24M of the Income Tax, 1962

This amendment is of a textual nature.

CLAUSE 35

Income Tax: Substitution of section 25D of the Income Tax Act, 1962

In the Budget Review it was announced that the spot rate will again be allowed for the translation of foreign currency. This will enable businesses to use the exchange rates applied for financial reporting purposes for tax purposes. It is proposed that the definition of average exchange rate be simplified and that it be available for use at the election of individuals and non-trading trusts to translate their foreign income and expenditure. The other category of taxpayers who will continue to be able to use the average rate is taxpayers with foreign permanent establishments. In that case the taxable income must be determined in the currency used by that permanent establishment for purposes of financial reporting and the result must be translated to Rand using the average rate.

CLAUSE 36

Income Tax: Amendment of section 30 of the Income Tax Act, 1962

Subclause (a): Currently the income tax system provides exemption for PBOs engaged in various forms of non-profit activities. Provision was made for certain trading activities carried out on a cost recovery basis or on an occasional basis using voluntary labour as well as a small threshold for other trading activities. However, a difficulty encountered by many PBOs was that if they exceeded this threshold their tax exempt status was terminated altogether. This "all-or-nothing" approach is impractical as PBOs need to be self-sustaining in order to survive. Accordingly, it was announced in this year's Budget that a system of partial taxation would be implemented, meaning that PBOs who do conduct business activities which fall outside the permissible trading rules may continue to do so without losing their exemption for non-profit activities. It will, however, pay income tax on the income from those business activities falling outside the allowable trading rules.

Section 30 has been amended and the trading limits have now been inserted under Section 10(1)*(c*N*)* as an exemption provision, hence the need for their deletion in Section 30.

Subclauses (b) and (c): A transition arrangement is required to cover the period between the repeal of the old "all or nothing" system and the new partial exemption system. This is achieved by extending the period for which a PBO may continue to hold certain business undertakings or trading activities without losing its tax exempt status.

Subclause (d): The proposed amendment is of a textual nature.

Subclause (e): The criminal penalty has been included in section 75 of the Income Tax Act, 1962, and it is therefore proposed that subsection (12) be deleted.

CLAUSE 37

Income Tax: Amendment of section 41 of the Income Tax Act, 1962

Subclause (a): Definitions of "associated group of companies", "influencing company" and "influenced company" are introduced for purposes of applying the rules relating to domestic financial instrument holding company and foreign financial instrument holding companies. The lower threshold of 20 per cent of the equity shares and voting rights is applied to effectively take the underlying assets of influenced companies into account to determine domestic financial instrument holding company (DFIHC) and domestic financial instrument holding company (FFIHC) status of a group of companies. The wider concept of a group is based on the percentage used for international financial reporting where significant influence is presumed.

Subclause (b): The corporate rollover rules in Part III contain anti-avoidance provisions to prevent the shifting of built-in gain or loss assets into a company transferee. Without these anti-avoidance rules, taxpayers could, for example, use the rollover mechanism to shift built-in gain assets into a transferee company with excess losses. These rules provide, broadly, for the ring-fencing of gains or losses in the hands of the transferee where that transferee disposes of assets within 18 months after their acquisition. Transferee companies are thus prevented from setting off any resulting gain or loss against their own losses or revenue or capital gains, respectively. It has been argued that the ring-fencing rules apply only in respect of an actual disposal of an asset within the 18 month period, and not in respect of a deemed disposal. It is therefore proposed that the concept of a disposal be extended to any deemed disposal in terms of Part III. The ring-fencing rules will therefore also apply in respect of gains and losses that arise as a result of a deemed disposal within the 18 month period, for example if a group company to which an asset has been disposed of in terms of an intra-group transaction ceases to form part of the group within 18 months after that transaction.

Subclauses (c): It is proposed that the tests to determine domestic financial instrument holding company status be relaxed by effectively consolidating companies in which at least 20 per cent of the equity shares and voting rights are held. A further concession is introduced by disregarding any financial instrument the market value of which is equal to its base cost. This would exclude most cash and cash equivalents from the calculation.

Subclause (d): It is proposed that the tests to determine foreign financial instrument holding company status be relaxed by effectively consolidating companies in which at least 20 per cent of the equity shares and voting rights are held. A further concession is introduced by disregarding any financial instrument the market value of which is equal to its base cost. This would exclude most cash and cash equivalents from the calculation.

Currently financial instruments arising from the principal trading activities of banks, insurers, dealers and brokers with a licence or registration that allows that foreign company or controlled group company to operate in the same manner as a company that mainly conducts business with clients who are residents in the same country of residence as that company are not taken into account in applying the FFIHC test.

This test created anomalies and unintended consequences and it is, therefore, proposed that the test be changed to exclude financial instruments arising from the principal trading activities of a bank, financier, insurer, dealer or broker that mainly conducts business in the country of residence of that company and–

- o regularly accepts deposits or premiums or makes loans, issues letters of credit, provides guarantees or effects similar transactions for the account of clients who are not connected persons in relation to that company; and
- o derives more than 50 per cent of its income or gains from principal trading activities with respect to those clients.

Furthermore, in order to exclude companies operating in countries which ring-fence certain tax preferences, it is proposed that the above exclusion should not apply to a company that is potentially eligible for preferential tax treatment in its country of residence if—

- o that tax treatment is dependent upon the company conducting business with clients who are not residents of that country; or
- o a prerequisite of that tax treatment is that ownership of more than 50 per cent of the company must be held by persons who are not residents of that country.

Subclause (e): A definition of “prescribed proportion” is introduced in order to allow a simplified determination of the proportionate share of all assets of a company consisting of financial instruments where shares in that company are to be disposed of between members of the same group of companies. The simplified determination entails the use of the book value (as determined for purposes of a company’s most recent audited financial statements) of the assets instead of the requirement to perform a burdensome market valuation of assets on the date of the relevant transaction. The definition also provides that only the portion, equal to the effective shareholding in the company, of the value or cost of the assets of that company be taken into account.

Subclause (f): As announced in the Budget the threshold percentage to qualify for certain tax neutral corporate restructuring transactions will be reduced. This amendment is also consequential upon the introduction of a 20 per cent of equity share and voting right test for purposes of the participation exemption and the definition of associated group of companies.

Subclause (g): The reporting requirements regarding the acquisition or disposal of assets as well as any election in respect of the corporate restructuring transactions are already covered by the general reporting requirements contained in section 65. It is therefore proposed that the reporting requirements for purposes of the corporate restructuring rules be deleted as being superfluous.

Subclause (h): In the case of the disposal of mining assets the Income Tax Act does not provide for a recoupment of allowances previously claimed but includes the full amount of proceeds in gross income. This would be the case even where the proceeds on disposal exceed the historical cost of the asset. In order to allow these mining assets to benefit from the tax deferral rules for corporate restructuring transactions it is proposed that the full amount of the proceeds on disposal of mining assets be deemed to constitute a recovery or recoupment.

In terms of paragraph 76(1)*(b)* of the Eighth Schedule, where a capital distribution of cash or assets *in specie* is received by or accrues to a person in respect of a share on or after the valuation date and that person has not adopted the weighted average method of determining its base cost, that person must treat the amount as proceeds on disposal of that share.

The corporate rules in sections 41 – 45 and 47 do not state what is to become of such capital distributions received by or accrued to a transferor prior to a roll-over transaction conducted in terms of those rules.

It is proposed that the capital distribution must be deemed to be a capital distribution in the hands of any person

- who acquires that share, or
- who acquires any other share in consequence of the disposal of that share.

The proposed rule does not apply to an acquiring company that acquires target shares under a share-for-share transaction subject to section 43(2)*(b)*. In that case, there is no roll-over of expenditure and the acquiring company obtains a step up in base cost equal to market value. A transferor company that disposes of any share in terms of an intra-group transaction in return for another share is also excluded from the proposed rule. The rule also does not apply to unbundling transactions in terms of section 46, since in that case there is also no roll-over, but simply a reallocation of expenditure from the unbundling company shares to the unbundled company shares.

CLAUSE 38

Income Tax: Amendment of section 42 of the Income Tax Act, 1962

Subclause (a): It is proposed that the rollover relief in respect of company formation transactions be extended to trusts and the incorporation of professional partnerships (see below) but that restraints of trade and personal goodwill be excluded from the assets eligible for relief.

Subclause (b): An amendment is proposed in order to enable professional partnerships to utilise the company formation transaction rollover provisions. The relief in respect of company formations will only be available to natural persons who will be engaged on a full-time basis in the business of that company of rendering any service.

Subclause (c): This amendment is consequential upon the extension of the company formation transaction to incorporated partnerships. The unrealised gains on entering into the company formation transaction by a person who qualified on the basis of the service requirement will be triggered where the person ceases within 18 moths of the formation transaction to be engaged on a full-time basis in the business of the company of rendering the service.

Subclauses (d) and (e): The proposed amendments are consequential upon the deletion in 2004 of paragraph 20(3)*(c)* of the Eighth Schedule.

Subclause (f): It is proposed that the provision preventing consecutive company formation transactions within an 18 month period be deleted, thereby allowing relief for consecutive corporate transactions.

CLAUSE 39

Income Tax: Amendment of section 43 of the Income Tax Act, 1962

Subclauses (a) and (c): It is proposed that the rollover relief in respect of share-for-share transactions be extended to trusts It is also proposed that the provision preventing consecutive share-for share transactions within an 18 month period be deleted, thereby allowing relief for consecutive corporate transactions.

Subclause (b): This amendment is of a textual nature.

CLAUSE 40

Income Tax: Amendment of section 44 of the Income Tax Act, 1962

Subclause (a): This amendment limits the amalgamation transaction relief to situations where assets of an amalgamated company are disposed of in exchange for the assumption of debt of that amalgamated company where the debt

- was incurred more than 18 months before the disposal of the asset;
- the aforementioned debt was refinanced within 18 months prior to the disposal; or
- is attributable to and arose in the normal course of a business undertaking disposed of, as a going concern, to that resultant company as part of that amalgamation transaction.

The reason for the limitation is to address situations where the amalgamated company incurs debt shortly before the amalgamation transaction in order to benefit from the rollover provisions for its assets.

Subclause (b): Currently, where an amalgamation transaction is entered into, roll-over relief is provided to the shareholder of the amalgamated company for shares in an amalgamated company which are disposed of in return for shares in the company which acquires all the assets of the amalgamated company. This relief is only available where the market value of the shares in the amalgamated company exceeds the tax value of the shares in the hands of the shareholder.

This limitation does not serve to protect the tax base as an amalgamation transaction does not result in the potential duplication of losses as in the case of a company formation transaction. The rollover of unrealised loss assets is excluded in the case of company formation transactions in order to prevent the creation of an unrealised loss in the shares acquired in the formation company by the person who transferred the unrealised loss assets.

It is, therefore, proposed that these provisions be reworded to allow the rollover to apply to the shares held by the shareholder of the amalgamated company irrespective of whether the market value of the shares exceeds the tax value of the shares or not.

Subclauses (c) and (d): The proposed amendments remove an incorrect reference and effect textual improvements.

Subclause (e): It is proposed that rollover relief in respect of amalgamation transactions be excluded where a resultant company holds at least 70 per cent of the equity shares in the amalgamated company immediately prior to the proposed transaction. The transaction may possibly qualify for the liquidation distribution relief measures.

CLAUSE 41

Income Tax: Amendment of section 45 of the Income Tax Act, 1962

Subclause (a): Currently a deemed disposal of an asset is triggered at market value at the date a transferee and a transferor cease to form part of the same group of companies. This creates the result that unrealised gains or losses are taxed in the hands of the transferee company although the transferee remains owner of the relevant asset. It is proposed that only the gain or loss which was rolled over to the transferee, determined with reference to the market value of the asset when the transferee acquired it, be triggered.

Subclauses (b) and (c): A relief measure which applies when a transferor and a transferee company which previously entered into an intra-group transaction cease to form part of the same group of companies is reintroduced with retrospective effect from 26 October 2004. The relief applies when either the transferor or the transferee is liquidated, wound up or deregistered. The holding company of the transferee or transferor company and the transferee or transferor company are deemed to be one and the same company, which has the result that the link between the transferor and the transferee is not broken on liquidation, winding up or deregistration. The intra-group rollover benefits will, therefore, not be forfeited on liquidation, winding up or deregistration. The proposed amendment in subclause *(c)* is consequential upon the reduction, from 75 per cent to 70 per cent, of the qualifying shareholding required in respect of a group of companies.

Subclause (d): The proposed amendments are consequential upon the amendments proposed in respect of the definitions of “domestic financial instrument holding company” and “foreign financial instrument holding company”.

CLAUSE 42

Income Tax: Amendment of section 46 of the Income Tax Act, 1962

Subclauses (a) to (g): The current reference in section 46 to shares disposed of could create the impression that a disposal of shares for consideration would be covered. However, the rationale for the unbundling provisions was that the shares in the unbundled company should be distributed by way of a dividend to the shareholders of the unbundling company. The references to disposal are changed to distribution. The intra-group transactions already make provision for the transfer of assets between group companies for consideration. The amendments proposed in subclause *(e)* also effect some textual improvements.

The amendments proposed in subclause *(g)* in respect of subsection (7) are aimed at excluding unbundling transactions from rollover relief if those transactions have the effect of a permanent reduction in the tax base.

CLAUSE 43

Income Tax: Amendment of section 47 of the Income Tax Act, 1962

Subclause (a): This proposal is aimed at excluding transactions from rollover relief if those transactions result in a permanent reduction of the tax base, thereby aligning the rules with respect to liquidation distributions with those applying in respect of unbundling transactions.

Subclause (b)): This amendment limits rollover relief in respect of liquidation distributions to situations where assets of a liquidating company are disposed of in exchange for the cancellation, by the holding company, of shares held by it in that liquidating company or in return for the assumption, by that holding company, of eligible debts of that liquidating company. A debt of an amalgamated company will be eligible only if it

- was incurred more than 18 months before the disposal of the asset;
- was refinanced within 18 months prior to the disposal; or
- is attributable to and arose in the normal course of a business undertaking disposed of, as a going concern, to that resultant company as part of that amalgamation transaction.

The proposed rules are similar to those proposed in respect of the assumption, as part of an amalgamation transaction, of debts of an amalgamated company.

CLAUSE 44

Income Tax: Insertion of Part IIIA in Chapter II of the Income Tax Act, 1962

Background

It is an internationally accepted practice that foreign entertainers and sportspersons are liable for income tax in the specific countries in which they perform. South Africa's ability to collect this tax is not as effective as it should be due to numerous practical constraints. One of the main contributors to these constraints is the short period of time for which the non-resident entertainer or sportsperson is physically present in the country. Any failure by South Africa to collect this tax is, in effect, an erosion of its tax base in favour of the countries of residence of the visiting entertainers and sportspersons. These countries are likely to impose tax on the income of the visiting entertainers and sportspersons without the need to give credit for the tax that should have been paid in South Africa.

Proposed solution

Since the bulk of payments to foreign entertainers and sportspersons are made by South African residents that organise the performance, the main feature of the proposed system of taxation is for these residents to withhold tax from the payments. Failure to do so will result in these residents becoming personally liable for the tax that should have been withheld.

Tax base

The withholding tax will apply to all gross payments in respect of the performance in South Africa, irrespective of to whom the payments are made, to ensure that the tax is not circumvented by splitting payments or arranging that payments be made directly to management companies.

Rate

For ease of administration and to overcome the practical constraints arising from the short physical presence of the visiting entertainer or sportsperson, the withholding tax will be a final tax at a flat rate i.e. there is no need to file an income tax return, which means that there will be no opportunity to claim tax deductions. In order to compensate for the inability to claim tax deductions, the rate of tax to be imposed will be at 15%, which is far lower than the existing highest individual marginal rate of 40% and the corporate rate of 29%.

As it is highly likely that these entertainers and sportspersons will be taxed (usually at higher rates) on the same income in their own countries of residence, documentary evidence of tax paid in South Africa will be issued to them so that they can claim the tax relief accordingly.

The 2005 Budget Review proposed that the withholding rate be set at 5% for non-resident residents of African countries and 15% for residents of other countries. The lower rate for African residents was proposed in recognition of the unique nature of South Africa's relationship with other African countries. However, such differentiation could constitute a contravention of the General Agreement on Trade in Services (GATS) as it provides preferential treatment to African countries. It is, therefore, proposed that a flat rate of 15% be introduced in respect of all foreign entertainers and sportspersons.

Payment of tax

In designing the proposed system of taxation, it became clear that the withholding tax would not be effective where payments for performances are made outside the country, as is the case in the international film industry. It is, therefore, necessary for the foreign entertainer or sportsperson to pay the 15% tax where the payment for a performance was not made by a resident.

Withholding tax vs employees' tax

Since the proposed system is aimed at addressing the practical constraints that arise from the short physical presence of the foreign entertainers and sportspersons in South Africa, it is not meant to give unfair advantage to them where they are employed alongside South African residents for long periods of time. It is accordingly proposed that where the non-resident entertainer or sportsperson is employed by a South African employer and that entertainer or sportsperson is physically present in the country for more than 183 days in aggregate in a 12-month period that commences or ends in a year of assessment, these persons will have to pay tax on the same basis as South African residents i.e. at the usual tax rates which may require the submission of a tax return.

Reporting requirement

In order to address the compliance constraints of this system, a reporting requirement is proposed to ensure that the South African Revenue Service is made aware of the performance and will be able to follow up in cases where an entertainer or sportsperson who left the country after a short stay does not settle the tax within the stipulated period. This reporting requirement requires a resident, who agrees to found, organise, or facilitate a performance, to notify the South African Revenue Service of the performance within 14 days of concluding the agreement.

Examples

1. An Australian golfer won a one-week golf tournament that was hosted by a South African resident in August 200X. The prize money that was paid to him amounted to US$1 million. Before paying the prize money to the golfer, the South African host had to withhold tax of US$ 150,000 (15% of US$1 million) and pay this over to the South African Revenue Service (SARS). The golfer was, therefore, given a cheque for US$850,000. The tax was withheld on 14 August 200X, which means that the host had to pay the tax over to SARS before the end of September 200X. The exchange rate on 14 August 200X was R6,30 to the dollar. The amount paid to SARS on 30 September 200X was therefore R945,000 (150,000 x 6,30).

2. A non-resident singer and 7 non-resident band members come to perform in South Africa in April 200X. The total amount payable by a South African promoter for a once-off performance is R2,000,000. Of this amount, R1 million will be paid to an off-shore management company and the balance will be paid to the singer and the band. The singer and the band members agree that the balance of R1,000,000 will be split equally i.e. R125,000 each. Despite these splitting arrangements, the total tax payable will be R300,000 (R2,000,000 x 15%). The resident promoter will have to withhold this amount from the R2,000,000 and pay it over to SARS before the end of May 200X. The net amount paid to the off-shore management company will therefore be

R850,000 (R1,000,000 less 15% tax) and the amounts paid to the singer and band members will be R106,250 (R1,000,000 divided by 8, less 15% tax)

3. An American production company plans on filming part of its movie in Cape Town in South Africa. The entire movie will take 48 weeks to film. The leading actor, who is a resident of the United Kingdom, comes to South Africa to shoot this part of the movie for four weeks ending on 30 November 200X. He will be paid US$12 million by the American production house to appear in the whole of the movie. The US$12,000,000 accrues on a month by month basis on completion of performance. As the proposed legislation stands, he will not be excluded from the 15% withholding tax regime for foreign entertainers and sportspersons since there is no resident employer. This is supported by Article 16 (Entertainers and Sportspersons) of the double taxation agreement between the United Kingdom and South Africa. He will therefore have to pay US$150,000 (4 weeks/ 48 weeks x US$12 million x 15%) tax in South Africa. This tax must be paid to SARS by 30 December 200X and must be accompanied by the prescribed form.

4. The same facts apply except that the actor will be paid by a resident production company. Despite the possibility of him being an employee, he will not be excluded from the 15% withholding tax regime for entertainers and sportspersons since he will not be in South Africa for more than 183 days in aggregate in a 12-month period commencing or ending in the year of assessment. His final tax liability will, therefore, still be US$150,000, which must be withheld by the resident production company and paid to SARS.

5. A non-resident plays football for a South African football club in the domestic league for eight months of the 20XX tax year. He earns R50,000 per month. Since his employer is a resident of South Africa and he will be playing in South Africa for more than 183 days in aggregate in a 12-month period that commences or ends in the year of assessment, he will be excluded from the 15% withholding tax regime. He will have to submit an income tax return on the same basis as a South African resident in order to have the R400,000 assessed for the year of assessment. Assuming that this is his only taxable income for the tax year and that the 2006 tax rates are applicable, his personal tax liability on the R400,000 will be: R119,700 (30% average rate).

CLAUSE 45

Income Tax: Amendment of section 56 of the Income Tax Act, 1962

Subclause (a): In terms of section 56(1)(g) of the Income Tax Act, 1962, donations of property consisting of rights to certain property situated outside the Republic are exempt from donations tax. In 2001 the South African tax system shifted from a source-based system to a worldwide system of taxation and certain exemption provisions contained in section 56(1)(g) which are based on source are in conflict with this change in policy. It is, therefore, proposed that these exemptions be deleted.

Subclause (b): The subsection exempts from donations tax voluntary awards made by employers to employees that are taxed as fringe benefits. It is proposed that the share incentive gains taxable in terms of sections 8A, 8B and 8C also be exempted.

It is proposed that the amendment come into operation on 26 October 2004.

CLAUSE 46

Income Tax: Amendment of section 58 of the Income Tax Act, 1962

Section 58(2) was introduced as a form of anti-avoidance where persons dispose of equity instruments as contemplated in section 8C(5) to connected persons before they have become unrestricted to avoid donations tax and/or estate duty. The section deems that a donation has been made to the connected person on the date that the equity instrument vests equal to the market value of the equity instrument on that date.

The section brings within the ambit of this section all disposals contemplated in section 8(5) but this is too wide as disposals in terms of section 8(5)*(c)* include disposals which employees are compelled to make if they do not comply with the share incentive schemes rules, e.g. they have resigned before the period required by the scheme. It is, therefore, proposed that the provisions be narrowed down to only apply if section 8C(5)*(a)* and *(b)* apply.

CLAUSE 47

Income Tax: Amendment of section 64B of the Income Tax Act, 1962

Subclause (a): The definition of "declared" in section 64B(1) regulates the timing of declarations. The amendment clarifies that the declaration of a dividend in the case of the liquidation of a company means the approval of the payment or distribution by the liquidator of the company.

Subclause (b): This amendment aligns the concept of profits for STC purposes with profits available for distribution in the definition of "dividend".

Subclauses (c) and (e): A company to which a dividend accrues as a result of the distribution, by another company, of certain profits in the course of or in anticipation of liquidation, winding up or deregistration of the latter company, cannot deduct or credit such a dividend in the determination of its own STC liability for the dividend cycle during which the dividend from the other company accrues. The current wording regulating this aspect may give rise to unintended results and is amended to reflect this principle.

Subclause (d): It is proposed that the final termination of the corporate existence of a company be added as an event which would allow the deduction of any dividends contemplated in section 64B(5)*(c)* which accrued during the current or any previous dividend cycle to the relevant company.

Subclause (f): It is proposed that the final termination of the corporate existence of a company be added as an event which would allow a company to qualify for an exemption from STC on the distribution of certain profits.

Subclauses (g), (h) and (i): Dividends declared to a shareholder which forms part of the same group of companies as the company declaring the dividends are exempt at the election of the company. One of the conditions of the exemption is that the dividend must be derived by a company from profits earned during the period it formed part of the same group of companies as the shareholder company to which the dividend is declared. It is proposed that this requirement be changed by requiring that the profits from which the dividend is directly or indirectly derived should originally have been earned by a company forming part of a group of companies during a period when the dividend declaring company and its shareholder formed part of that group of companies. It is also proposed that the intra-group dividend exemption should not apply where the company declares a dividend to its shareholder, where the dividend consists of shares in the shareholder. The limitation would address the situation where the section 64B(5)*(f)* exemption may have the effect of not delaying an STC liability but creating a permanent exclusion from the STC base. An example of this situation is where a subsidiary company bought shares in its holding company (STC free) and subsequently distributed the shares to the holding company as a dividend (again STC free).

Subclause (j): This amendment deletes obsolete wording which related to transitional measures with the introduction of CGT.

CLAUSE 48

Income Tax: Amendment of section 64C of the Income Tax Act, 1962

Subclause (a): An amendment is proposed which treats amounts disallowed as a deduction in applying thin capitalisation provisions in section 31(3) as a deemed dividend as is the case for transfer pricing adjustments. The rationale is that the excessive interest paid is effectively a distribution of profits which should be subject to STC.

Subclause (b): This amendment is of a textual nature.

Subclause (c): This amendment clarifies the principle that where insufficient consideration is paid for an asset transferred or other benefit granted by a company to any of its shareholders, the amount deemed to be a dividend will be limited, for STC purposes, to the portion of the value of the cash, asset or other benefit transferred for no consideration.

Subclause (d): This amendment aligns one of the requirements for utilising the STC exemption in respect of certain benefits granted by a group company to a shareholder or connected person in relation to that shareholder with the similar requirement governing the STC group relief contained in section 64B(5)*(f)*(iii).

CLAUSE 49

Income Tax: Amendment of paragraph 1 of the Fourth Schedule to the Income Tax Act, 1962

Subclause (a): Employers generally compensate their employees by way of advances or allowances to cover subsistence costs for work-related travel where they are required to spend some time away from their usual place of residence. These allowances are not included in the taxable income of an employee to the extent that it is actually expended on subsistence costs. In order to alleviate the administrative burden of retaining and verifying proof of expenses, the Act makes provision for a *per diem* amount which is deemed to have been expended by the employee. Unfortunately some employees and employers are relying on this mechanism in order to artificially reduce employees' tax obligations. It was therefore announced in the Budget Review this year that Government will seek to eliminate this form of salary structuring by requiring a more direct and immediate link between a tax-free subsistence advance and the anticipated travel to which it relates. In order to address this, it is proposed that a provision be inserted to provide that if a subsistence allowance is paid to an employee during any month and that employee does not travel for business purposes by the end of the following month, that allowance will become subject to employees' tax in that following month.

Subclause (b): This amendment is consequential upon the amendment of section 8B to include the gain in the income of the taxpayer as opposed to the market value.

Subclauses (c) and (d): The insertion of the definition of "tax threshold" is consequential upon the introduction of the exemption for natural persons earning non-business taxable income below the tax threshold.

Subclause (e): The amendment provides that the mere receipt of an allowance or advance (e.g. a subsistence or motor vehicle allowance) by an employee will not cause the employee to be a provisional taxpayer.

Subclause (f): As the remuneration of directors of private companies became subject to PAYE from 2002, there is no reason to automatically treat such directors as provisional taxpayers. It is proposed that the specific inclusion of directors as provisional taxpayers be withdrawn.

CLAUSE 50

Income Tax: Amendment of paragraph 2 of the Fourth Schedule to the Income Tax Act, 1962

Section 18 of the Income Tax Act, 1962, is amended to provide for the deduction of medical scheme contributions up to a certain cap. In order to ensure the SITE taxpayers do not need to submit tax returns to claim the deduction, it is proposed that provision be made in the Fourth Schedule that an employer may take into account these contributions made by an employee before determining the amount of employees' tax to be withheld during any month.

CLAUSE 51

Income Tax: Amendment of paragraph 11A of the Fourth Schedule to the Income Tax Act, 1962

These proposed amendments are consequential upon the proposed amendment of section 8B to include the gain in the income of the taxpayer as opposed to the market value of the equity share.

CLAUSE 52

Income Tax: Insertion of paragraph 16 of the Fourth Schedule to the Income Tax Act, 1962

This amendment is of a textual nature.

CLAUSE 53

Income Tax: Amendment of paragraph 18 of the Fourth Schedule to the Income Tax Act, 1962

It is proposed that provision be made for natural persons to be exempt from the payment of provisional tax if they do not derive any business income and their taxable income for the tax year will be below the tax threshold. The current *de minimis* exemption is amended by specifically not allowing the exemption where the individual derives any income from the carrying on of a business. The test to qualify for exemption is simplified by determining whether taxable income in the form of interest, dividends and rental from the letting of fixed property will be R10 000 or less during the year of assessment. It is furthermore proposed that the exemption only applies to individuals below the age of 65 years as older persons already enjoy the benefit of an exemption linked to a taxable income of R80 000 which is higher than the tax threshold.

CLAUSE 54

Income Tax: Amendment of paragraph 19 of the Fourth Schedule to the Income Tax Act, 1962

Persons who are exempt from the payment of provisional tax are no longer required to submit provisional tax returns. This will reduce the compliance burden on that category of individuals.

The taxable income of a provisional taxpayer for a previous year (basic amount) is used to determine the provisional tax obligation of the taxpayer during a tax year. Irregular amounts of taxable income in the form of capital gains derived during a previous year are excluded from the calculation of the basic amount. It is proposed that another form of irregular income, i.e. lump sum payments for the termination of employment or office, also be excluded.

CLAUSE 55

Income Tax: Amendment of paragraph 2 of the Seventh Schedule to the Income Tax Act, 1962

These amendments are consequential upon the amendments to the fringe benefit provisions relating to medical scheme contributions and employer provided medical services.

CLAUSE 56

Income Tax: Amendment of paragraph 7 of the Seventh Schedule to the Income Tax Act, 1962

Subclauses (a) and (b): Paragraph 7 of the Seventh Schedule to the Income Tax Act, 1962, deals with the taxation of the value of a fringe benefit that arises when an employer grants an employee the right to the private use of a motor vehicle that belongs to the employer. Paragraph 7(4)*(a)* specifically quantifies the value of the fringe benefit that must be included in the employee's taxable income and is based on a fixed percentage of the determined value (normally the purchase price) of the vehicle. If only one vehicle is made available to the employee, the percentage is fixed at 1.8% per month of the purchase price. If more than one vehicle is made available, the percentage is fixed at 4% in respect of any such other vehicle. The Minister announced in his Budget Review this year that the percentage in respect of the first or a single vehicle would be increased from 1.8% to 2.5% to align the fringe benefit values with the revised fixed cost tables for travelling allowances introduced earlier this year.

Subclause (c): To avoid the unfair taxation where an employee actually bears a portion of the costs for the private use of the employer's vehicle, the Income Tax Act currently contains a provision that allows the taxable benefit to be reduced as follows:
(a) by R120 per month where the employee bears the cost of all fuel for the purposes of private use of the vehicle; or
(b) by R85 per month where the employee bears the full cost of maintaining the vehicle, which includes cost of repairs, servicing, lubrication and tyres.

It is proposed that the monetary values of these costs be deleted and that the percentage of the value of the vehicle which is taxed as a fringe benefit rather be adjusted.

Furthermore, there is the possibility of a double deduction of fuel and maintenance costs where an employee also receives a travel allowance in respect of the same vehicle that gives rise to the fringe benefit. This double deduction could arise where an employee reduces the taxable portion of the travel allowance by claiming fuel and maintenance costs and also uses the same costs to reduce the taxable benefit of the private use of the employer's vehicle. It is, therefore, proposed that this proviso be amended to prevent the double deduction.

Subclause (d): Paragraph 7(10) provides that the private use by an employee of a motor vehicle shall have no value for purposes of determining the fringe benefit if—
- the vehicle is available to and in fact used by all employees and the private use thereof is infrequent and incidental to its business use; or
- where the nature of the employees duties require from him or her to regularly use the vehicle for performance of his or her duties outside normal hours of work and it is not used for private purposes other than travel to and from work.

In the second instance, no provision is made for infrequent or incidental use and it is proposed that a similar exception be made in this paragraph.

CLAUSE 57

Income Tax: Amendment of paragraph 9 of the Seventh Schedule to the Income Tax Act, 1962

This amendment deletes a reference to a provision which has been deleted.

CLAUSE 58

Income Tax: Amendment of paragraph 10 of the Seventh Schedule to the Income Tax Act, 1962

In terms of the Seventh Schedule to the Income Tax Act, a taxable benefit exists where an employer provides a "free or cheap service" of some sort to its employees and where it is utilised for private purposes. Examples of such services are travel facilities, a garden maintenance service, and so on. In addition to a cash salary, many employers remunerate their employees in kind (i.e. by way of non-cash benefits). In principle, these benefits must be taxed on the same basis as remuneration paid in cash, and this is what the Seventh Schedule seeks to do when it values and taxes services that are provided free or below market value to employees or their dependants.

Therefore, if an employer provides free travel facilities to the relatives of an employee to visit the employee at a place of business of the employer where the employee is stationed, this facility will be taxable in the hands of the employee. It is proposed that where an employee is by virtue of his or her conditions of service stationed at a place in the Republic which is more than 250 km away from his or her main residence where he or she ordinarily resides, any travel facilities granted by the employee to the spouse and minor children of the employee to visit the employee must not be taxable as a fringe benefit. That employee must, however, be required to spend at least 183 days in the year of assessment at the place away from his or her main residence before the exemption applies.

CLAUSE 59

Income Tax: Amendment of paragraph 12A of the Seventh Schedule to the Income Tax Act, 1962

As noted under the amendment to section 18 of the Income Tax Act, 1962, employer contributions towards medical scheme coverage of two thirds or less of the total contribution are not taxed in the hands of the employee. In order to ensure a more equitable regime for medical scheme coverage, this benefit will be limited to R500 for each of the first two beneficiaries and R300 for each additional beneficiary. These amounts are in line with the section 18 limit for individuals who bear the cost for medical scheme coverage for their families themselves and the limit applies to the total contribution irrespective of whether the employer or the employee pays for coverage. These changes come into operation on 1 March 2006 and apply in respect of years of assessment commencing on or after that date.

CLAUSE 60

Income Tax: Insertion of paragraph 12B of the Seventh Schedule to the Income Tax Act, 1962

In order to assist low-income earners and their family members who cannot afford even the most basic medical scheme package but are entitled to employer provided medical care in the form of prescribed minimum benefits, this benefit will not be taxed in the hands of the employee irrespective of where the care is provided. The legislation makes provision for two programmes or schemes offered by employers. The first is where the programme or scheme constitutes the business of a medical scheme. In this instance the benefit will be tax-free provided the programme has been exempted by the Registrar of Medical Schemes from complying with the requirements of the Medical Schemes Act. The second is where the programme or scheme does not constitute the business of a medical scheme. No taxable value shall be placed on this benefit provided that only non-medical scheme members and their families are entitled to this treatment. These changes come into operation on 1 March 2006 and apply in respect of years of assessment commencing on or after that date.

CLAUSE 61

Income Tax: Insertion of paragraph 13 of the Seventh Schedule to the Income Tax Act, 1962

Subclause (a): This amendment is consequential upon the amendment of paragraph 12A of the Seventh Schedule to the Income Tax Act, 1962.

Subclauses (b) and (c): In recognition of the sacrifices made by individuals who were members of liberation movements' armed wings, special pension provisions were introduced for such persons in terms of the Special Pension Act. No 69 of 1996 and Demobilisation Act, No 99 of 1996. In terms of these Acts, certain individuals received certain payments that were subject to income tax.

The GEPF rules were changed recently, to allow ex-Non-Statutory Force (NSF) members to purchase past years of service (for the periods when they were members of the NSF). Should these members elect to purchase past years of service, they have to

- repay the gross benefit they received in terms of the abovementioned acts and
- pay an amount of 5% of their income for each year of service that they buy-back.

A problem now arises as the member has to pay the gross amount of the benefit back to the GEPF but he/she only received a net after tax amount. The GEPF indicated that an amount has been set aside to cover such additional debts but should the shortfall be paid from this set-aside amount, a taxable benefit will be created in the hands of the member. The proposal aims to exempt this benefit from tax in the hands of the member.

CLAUSE 62

Income Tax: Amendment of paragraph 16 of the Seventh Schedule to the Income Tax Act, 1962

This amendment is consequential upon the amendment to paragraph 10 which provides for the exemption from the fringe benefits provisions of travel facilities granted to the spouse and minor children of an employee in certain circumstances.

CLAUSE 63

Income Tax: Amendment of paragraph 1 of the Eighth Schedule to the Income Tax Act, 1962

The proposed amendment is of a textual nature as paragraph *(b)* of the definition of "recognised exchange" was deleted last year.

CLAUSE 64

Income Tax: Amendment of paragraph 2 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 2 provides that the capital gains tax provisions apply in respect of all assets of residents and assets of non-residents that are situated in the Republic or attributable to a permanent establishment in the Republic. Assets situated in the Republic include immovable property and any interest or right of whatever nature in immovable property. An interest in immovable property includes certain interests in companies or other entities that hold property if at least 80 per cent of the net assets of the company or other entity is attributable to immovable property and where the person holds at least 20 per cent of the equity share capital of the company or other entity.

Certain practical issues have arisen with the application of this provision, especially where foreign companies hold their interests in South African immovable property indirectly through other intermediary companies or through a beneficial interest in a trust. It is therefore proposed that this provision be amended to provide that an interest in immovable property includes any equity shares in a company or ownership or right to ownership in any other entity or a vested interest in a trust if 80 per cent or more of the market value of the interest at the time of disposal is attributable to immovable property and where the person holds at least 20 per cent of the equity share capital or ownership. The 20 per cent requirement does, however, not apply in respect of the vested interest in a trust.

CLAUSE 65

Income Tax: Amendment of paragraph 8 of the Eighth Schedule to the Income Tax Act, 1962

See notes on clause 79.

CLAUSE 66

Income Tax: Amendment of paragraph 11 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 11 deals with the disposal and acquisition of assets and paragraph 11(2) provides that certain disposals will not be disposals for the purpose of the Eighth Schedule. Section 8A provides for the taxation of gains made by employees in respect of the rights to acquire marketable securities. In terms of subsection (5) of section 8A, if the right to acquire a marketable security is ceded or released by an employee for a consideration which consists of or includes another right to acquire a marketable security, a roll-over is allowed. The second right is deemed not to be consideration for the first right, the gain made on the second right is taxable and any consideration paid for the first right is deemed to be consideration for the second right. The gain made on the disposal of the first right will effectively be taxed as part of the gain on the second right and it is, therefore, proposed that the disposal of the first right not be a disposal for capital gains tax purposes.

CLAUSE 67

Income Tax: Amendment of paragraph 12 of the Eighth Schedule to the Income Tax Act, 1962

Subclause (a): In terms of paragraph 12(2) when persons cease to be resident they are treated as if they had disposed of their assets at market value on the day they emigrated and the capital gains or losses are determined on that date. Certain assets are excluded from these provisions and it is proposed that rights to acquire marketable securities (i.e. options) contemplated in section 8A also be excluded as the gain made on the exercise, cession or release of the right will be taxable as income in terms of section 8A. Where the right has been exercised but as a result of condition imposed by the employer the employee cannot dispose of the marketable security acquired and section 8A(1)*(b)* applies, the exclusion proposed will not exclude the capital gain from the operation of the provisions of paragraph 12(2).

The revised paragraph 12(2) also restates existing law concerning the treatment of controlled foreign companies. As under old law (by virtue of the reference to paragraph 12 in section 9D(2A) of the Income Tax Act), the shift from CFC status to non-CFC status triggers an exit charge (for the loss of taxing jurisdiction over passive and other tainted assets held by the CFC). This exit charge applies to all passive and other tainted assets that would have been subject to tax had those assets been disposed of during the period of CFC status.

Example

SA Company owns all 100 ordinary shares of CFC. CFC's sole assets consist of portfolio share holdings in various listed companies (none of which hold significant levels of SA immovable property). These shares have a value of R5 million and a base cost of R1 million. CFC issues an additional 100 ordinary shares to Foreign Company (the latter of which is held by foreign individuals).

The issue of ordinary shares eliminates CFC status because SA Company no longer holds more than 50 per cent of the ordinary shares. This loss of CFC status triggers paragraph 12(2) with the exit charge applying to all the portfolio shares, thereby generating R4 million of gain (R5 million proceeds less R1 million base cost).

Subclauses (b), (c) and (d): The purpose of paragraph 12(5) of the Eighth Schedule to the Income Tax Act is to ensure that where a debt is reduced or discharged by a creditor for a consideration which is less than the amount by which the face value of the debt has been reduced or discharged, the debtor is taxed on the amount by which that reduction exceeds the consideration. Concern has been expressed that this provision has unintended consequences in that dormant companies cannot deregister or liquidate because they could be subject to CGT if the creditors reduce or discharge the debts of the dormant companies. It is, therefore, proposed that relief be provided where the debtor is a company and the reduction or the discharge of the debt was made by a connected person in the course of or in anticipation of the liquidation, winding up or deregistration of that company and the amount of the reduction does not exceed the creditor's allowable expenditure in respect of the debt at the time of the reduction or discharge.

If, however, the debtor company has not within six months of the reduction or discharge taken the steps necessary to liquidate, wind-up or deregister the company or has withdrawn the steps or does anything to invalidate the liquidation, winding-up or deregistration, the exclusion of the capital gain will fall away and the capital gain will be subject to tax. Any tax which becomes payable as a result of the withdrawal of the exclusion must be recovered from that debtor company or the creditor who will be jointly and severally liable to the tax.

CLAUSE 68

Income Tax: Amendment of paragraph 20 of the Eighth Schedule to the Income Tax Act, 1962

Subclause (a): Paragraph 20(1)*(h)*(i) provides that the base cost of a marketable security or equity instrument, the acquisition or vesting of which resulted in a gain or loss in terms of section 8A or 8C is the market value of that marketable security or equity instrument that was taken into account when calculating that gain or loss.

Section 8C has been amended and in certain circumstances the market value of the instruments not used to calculate the gain or loss but the amount actually received or accrued from the disposal. It is proposed that this paragraph be amended to cater for the situations where the amount received or accrued is used.

Subclause (b) and (c): The base cost of a marketable security or equity instrument acquired by an employee or director under a share incentive arrangement which is subject to tax under section 8A or 8C, is determined under paragraph 20(1)*(h)*(i). That paragraph provides that the base cost is equal to the market value of the marketable security or equity instrument that was taken into account in determining the section 8A or 8C gain. The same principle applies, amongst others, to an asset which an employee has acquired from his or her employer at below market value and a fringe benefit has been taxed. The same position arises where a person is not an employee, for example, an independent contractor and he or she is paid for services in the form of an asset. It is proposed that where the person is taxed on the value of the asset that the base cost of the asset be the market value of the asset that was taken into account in calculating the amount subject to tax.

Subclause (d): The base cost of a marketable security or equity instrument acquired by an employee or director under a share incentive arrangement which is subject to tax under section 8A or 8C, is determined under paragraph 20(1)*(h)*(i). That paragraph provides that the base cost is equal to the market value of the marketable security or equity instrument that was taken into account in determining the section 8A or 8C gain. Under the general provisions for base cost, the expenditure incurred in acquiring an option which is used to acquire an asset is included in the base cost of that asset in terms of paragraph 20(1)*(c)*(ix). Similarly the strike price that is paid for the asset when the option is exercised is allowable in terms of paragraph 20(1)*(a)*.

However, in the case of a section 8A or 8C marketable security or equity instrument the option cost or strike price has effectively been allowed by allowing the market value on date of acquisition or vesting as the base cost of the marketable security or equity instrument. In addition, in terms of the rules of interpretation the provision which specifically deals with the base cost of marketable securities and equity instruments overrides the general provisions. Some commentators have contended that paragraph 20(3)*(a)* does not exclude the cost of the option or share from the base cost of the marketable security or equity instrument. This interpretation gives a result which departs completely from the economic reality. In order to put the matter beyond doubt it is proposed that a proviso be added to subparagraph 20(1) that were subitems (i), (ii)*(bb)* and *(dd)* apply i.e. the market value is allowed as base cost, any expenditure incurred prior to the date on which the market value is determined is ignored.

Subclause (e): The proposed amendment of paragraph 20(3)*(b)* is of a textual nature as paragraph 20(3)(c) of the Eighth Schedule was deleted in 2004 and the proposed amendment removes an unnecessary reference to the paragraph.

CLAUSE 69

Income Tax: Amendment of paragraph 24 of the Eighth Schedule to the Income Tax Act, 1962

In terms of paragraph 12(4) read with paragraph 13(1)*(g)*(i) persons who become resident are deemed to have disposed of and reacquired their assets at market value determined on the day immediately prior to such persons becoming resident. Paragraph 12(4) deems such market value to be an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1).

Paragraph 24(2) and (3) contain gain and loss limitation rules designed to prevent the creation of phantom gains and losses as a result of the application of paragraph 12(4).

These so-called “kink tests” operate on the basis of a comparison of proceeds, the market value of the asset at the date of becoming resident and the actual pre-residence expenditure.

The reference in paragraph 24(2) and (3) to market value on the date of residence is confusing, since the market value that should be referred to is the one determined on the day before becoming resident. Likewise, the reference to expenditure allowable n terms of paragraph 20 incurred prior to the date of residence is also confusing, since this could be construed as the deemed expenditure equal to market value determined under paragraph 12(4), and not the actual pre-residence expenditure.

It is proposed that paragraph 24(2) and (3) be amended to make it clear that—

- the reference to expenditure is a reference to the actual paragraph 20 expenditure determined without regard to paragraph 12(4); and
- the reference to market value is a reference to market value contemplated in paragraph 12(4).

CLAUSE 70

Income Tax: Amendment of paragraph 30 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 30 contains two sets of formulae for determining the time apportionment base cost of pre-valuation date assets. Paragraph 30(1) and (2) contain the 'standard' formulae, whilst paragraph 30(3) and (4) contain special formulae applicable to assets where expenditure is incurred on or after the valuation date and any part of the expenditure contemplated in paragraph 20(1*)(a)*, *(c)* or *(e)* is or was allowable as a deduction from income.

Subclauses (a) and (b): The symbol "B" as used in the time apportionment formula is presently defined in paragraph 30(1)*(b)* as

"the amount of expenditure allowable in terms of paragraph 20 . . . that is attributable to the period from the date that the asset was acquired to the day before valuation date".

The same symbol as used in the proceeds formula in paragraph 30(2)*(d)* is defined as

"the amount of expenditure allowable in terms of paragraph 20 . . . that is incurred before valuation date".

Some commentators have interpreted "B" as referring to the expenditure incurred before the valuation date reduced by allowances granted only up to the valuation date. Such an interpretation leads to absurd results as illustrated in the example below. The intention always was that in the case of these assets, the symbol "B" referred to the expenditure incurred before the valuation date, reduced by *all* amounts of that expenditure allowed as a deduction under the rest of the Act, regardless of when that deduction was allowed.

***Example* – Determination of "B" in the case of a depreciable asset**

Y bought a machine two years before valuation date for R100 and disposes of it for R100 three years after valuation date. Section 12C allowances were claimed as follows:

Prior to 1.10.01 = R40
On or after 1.10.01 = R60

The capital gain or loss will be determined as follows:

Assuming B = 60 (incorrect interpretation of present wording)

TAB = B + [(P – B) x N/N+T]
TAB = 60 + [(0 – 60) x 2/5
TAB = 60 – 24
TAB = 36
Loss = 0 – 36 = -36!!

Assuming B = 0 (correct interpretation)

TAB = 0 + [(0 – 0) x 2/5]
TAB = 0
Gain = 0 – 0 = 0

Clearly '0' is the correct result because Y sold the asset for an amount equal to its cost price.

The proposed amendment now puts the matter beyond doubt and achieves consistency in the wording of the two definitions of "B" in paragraph 30(1) and (2).

Subclauses (c) and (d): Paragraph 30(3) and (4) contain the special formulae that apply when expenditure is incurred on or after the valuation date. The standard proceeds formula in paragraph 30(2) has the effect that the higher the expenditure after valuation date, the greater the proportion of the overall gain that will be subject to CGT. The expenditure incurred in respect of these assets must be reduced by any capital allowances in terms of paragraph 20(3)*(a).* As a result of this, without these formulae, hardship could be caused because more of the expenditure incurred before the valuation date is likely to have been claimed by way of capital allowances, whilst less of the post-valuation date expenditure may have been allowed at the time the asset is disposed of. The special formulae seek to disregard the influence of capital allowances in determining how a capital gain is spread between the pre- and post-valuation date periods.

Where an asset is sold above cost, there are two ways of determining the capital gain. The normal method used in paragraphs 20(3)*(a)* and 35(3)*(a)* is to reduce the proceeds by recoupments and the cost by capital allowances.

Example

If an asset cost R100, was fully depreciated, and sold for R120, the capital gain would be determined as follows:

	R
Consideration received	120
Less: recoupment	(100)
Proceeds	20
Cost	100
Less: capital allowances	(100)
Base cost	Nil

Capital gain = R20 (proceeds) – 0 (base cost) = R20

The approach taken in paragraph 30(3) and (4) is to disregard the capital allowances and recoupments, that is:

	R
Consideration received	120
Less: cost	(100)
Capital gain	20

Paragraph 30(3) and (4) sought to achieve the latter result by "disregarding" paragraphs 20(3)*(a)* and 35(3)*(a)*. An unintended consequence of this "disregarding" was that certain current costs which are not subject to recoupment (such as interest on funds used to finance the acquisition of an asset, repairs, rates and insurance) were no longer removed from expenditure before ("B_1") and after ("A_1") the valuation date. The result was that while these costs were included in "A_1" and "B_1" they were not added to 'R_1". The special formulae only work successfully when the amount added to base cost is the same as the amount added to proceeds. The imbalance created by not being able to increase the consideration received by these current costs leads to absurd results that were never intended. The proposed amendments ensure that only amounts that are subject to recoupment are disregarded in determining "A_1" and "B_1".

Subclause (e): Where a person has incurred expenditure on or after the valuation date, the proceeds formulae in paragraph 30(2) and (4) will apply. The effect of these formulae is that the greater the expenditure incurred after the valuation date the greater the proportion of the overall gain or loss that will comprise a capital gain or loss for the purposes of the Eighth Schedule. Since selling expenses comprise post-valuation date expenditure in terms of paragraph 20, they will trigger the application of the proceeds formulae. This can have a marked effect on the proportion of the gain or loss that is subject to CGT, especially where the historical cost of the asset is low in relation to the selling costs. This is particularly the case with immovable property which tends to be held for long periods of time and where the selling costs tend to be relatively high (for example, estate agent's commission). In other cases, such as the sale of shares, brokers often simply pay their clients a net amount of proceeds, and these taxpayers are not aware that the proceeds formula applies.

To assist these taxpayers, it is proposed that paragraph 30 be amended by the introduction of a new subparagraph (5) which requires that the selling expenses must be deducted from—

(a) In the case where paragraphs 30(2) and (3) apply, the amounts represented by the symbols "R" and "R_1" respectively, and
(b) in any other case, the amount represented by the symbol "P".

The first scenario ((a) above) applies where the person has incurred qualifying paragraph 20 expenditure on or after the valuation date (e.g. expenditure on improvements). In such a case the proceeds formulae are triggered in the normal way by that expenditure (not by the selling expenses).

The second scenario ((b) above) applies where there is no post-valuation date expenditure, and the proceeds formulae do not apply.

The reduction, where applicable, of the amounts represented by the symbols "R", "R_1" and "P" by the selling expenses applies solely for the purposes of applying the TAB and proceeds formulae. Selling expenses will continue to be treated as post-valuation date expenditure for the purposes of the kink tests in paragraphs 26 and 27, and for the purposes of determining a capital gain or loss under paragraph 25. Furthermore, for the purposes of paragraph 30(3)*(c)* selling expenses must be taken into account. Paragraph 30(3)(c) requires that a person must have an overall gain before the special "depreciable assets" formulae can be applied. In determining whether an overall gain is present, the selling expenses need to be accounted for.

The term "selling expenses" is defined and refers to qualifying expenditure referred to in paragraph 20(1)*(c)*(i) to (iv) incurred directly for the purposes of disposing of an asset. Those expenses are—

(i) the remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered;
(ii) transfer costs;

(iii) stamp duty, transfer duty or similar duty;
(iv) advertising costs to find a seller or to find a buyer;

***Example 1* – Treatment of selling expenses as a reduction of proceeds for the purposes of determining TAB**

Facts:

Z bought her holiday home on 1 June 1980 at a cost of R25 000. She sold it on 1 June 2006 for R850 000. She incurred the following selling expenses:

Estate agent's commission	R48 000
Cost of obtaining electrical compliance and entomologist's certificates	R 2 000

Result:

Before proposed amendment

The proceeds formula is triggered because Z has incurred post-valuation date selling expenses.

P = R x [B/(A + B)]
P = R850 000 x R25 000/(R50 000 + R25 000)
P = R283 333
TAB = B + [(P – B) x N/(N+T)]
TAB = R25 000 + [(R283 333 – R25 000) x 22/27]
TAB = R25 000 + R210 494 = R235 494
Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
Capital gain = R850 000 – R235 494 – R50 000 = R564 506

After proposed amendment

The proceeds formula is no longer triggered because the selling expenses must be deducted from the proceeds as represented by the symbol "P".

P = R850 000 – R50 000 = R800 000
TAB = B + [(P – B) x N/(N+T)]
TAB = R25 000 + [(R800 000 – R25 000) x 22/27]
TAB = R25 000 + R631 481 = R656 481
Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
Capital gain = R850 000 – R656 481 – R50 000 = R143 519

***Example 2* – Determination of TAB where selling expenses plus other post-valuation date expenditure incurred**

Facts:

The facts are the same as in Example 1, except that Z spent R10 000 on 31 July 2003 on installing an electric fence around her property.

Result:

Before proposed amendment

P = R x B/(A + B)
P = R850 000 x R25 000/(R60 000 + R25 000)
P = R250 000
TAB = B + [(P – B) x N/N + T]
TAB = R25 000 + [(R250 000 – R25 000) x 22/27]
TAB = R208 333
Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
Capital gain = R850 000 – R208 333 – R60 000 = R581 667

After proposed amendment

R = R850 000 – R50 000 = R800 000
P = R x B/(A + B)
P = R800 000 x R25 000/(R10 000 + R25 000)
P = R571 429
TAB = B + [(P – B) x N/N + T]
TAB = R25 000 + [(R571 429 – R25 000) x 22/27]
TAB = R25 000 + R445 238
TAB = R470 238
Capital gain = Proceeds – valuation date value (TAB) – post-valuation date expenditure
Capital gain = R850 000 – R470 238 – (R50 000 + R10 000) = R319 762

CLAUSE 71

Income Tax: Amendment of paragraph 33 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 33 deals with part disposals of assets in a CGT environment and subparagraph (3) lists certain circumstances which are not regarded as part-disposals for purposes of the paragraph. Persons who have improved immovable property used for business purposes which they lease from a lessor have claimed capital losses of the bare dominium of the building materials they have permanently affixed to the immovable property in the year in which the materials are so affixed. In the lessee’s hands the lease is a capital asset and any improvements to the immovable property affected by the lessee is an improvement to the lease as the lessee has the use of the improvements until the expiry of the lease. The improvements form part of the base cost of the lease in terms of paragraph 20(1)(e) of the Eighth Schedule. On disposal of the lease, for example, or on expiry of the lease the cost of improvements can be claimed as part of the base cost. The amendment is proposed to ensure that the cost of improvements is only brought to account on the disposal of the lease.

CLAUSE 72

Income Tax: Amendment of paragraph 38 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 38 provides that where an asset is disposed of by way of a donation, for a consideration not measurable in money or to a connected person for a consideration which is not at arm's length, the transaction is deemed to have taken place at market value. Certain transactions are excluded from the provisions of the paragraph to prevent the imposition of both CGT and tax on income.

There is concern that exclusion of transactions relating to share options is not specific enough and that they may be subject to double tax. It is proposed that the wording be amended to make the exclusion more specific.

It is proposed that the amendment apply to disposals on or after 26 October 2004.

CLAUSE 73

Income Tax: Amendment of paragraph 39 of the Eighth Schedule to the Income Tax Act, 1962

Subparagraph (a): Paragraph 39 provides that a person's loss determined in respect of the disposal of an asset to a connected person is ring-fenced (clogged) and may only be set off against capital gains from the disposal of other assets to the same connected person. The taxation of long-term insurers is based on the trustee principle which draws a distinction in the tax treatment of taxable income of the insurance companies attributable to the different categories of policyholders and shareholder interests in these companies. For this reason the four funds of long-term insurers are regarded as separate taxpayers and separate companies for purposes of determining tax on capital gains.

Transfers of assets between the funds as a result of changes in the tax status of policyholders or an annual balancing of assets and liabilities as required in terms of section 29A(6) and (7) of the Income Tax Act are already excluded from the scope of the clog-loss rule. It is proposed that all transfers between the four funds be treated in this manner and that transfers in terms of section 29A(8) also be excluded from the clog-loss rule. Any capital losses made on disposals between funds will, therefore, not be "clogged" but will be taken into account in the year of disposal in determining the taxable income of the relevant fund of the long-term insurer.

Subparagraph (b): Paragraph 39 provides that a person's losses determined in respect of the disposal of an asset to a connected person is "clogged" and may only be set off against capital gains which arise from the disposal of assets to the same person if he is still a connected person. For the purposes of the paragraph the ambit of connected person has been narrowed down.

In many cases share incentive schemes are operated through trusts. Employees of the company who benefit from the scheme become beneficiaries of the trust and "connected persons" in relation to the trust. Any loss that is made by the trust on the disposal of an asset to the beneficiaries can become "clogged". As the trust and the beneficiaries are in these circumstances normally acting at arm's length it is proposed that these capital losses be excluded from the ambit of the paragraph as is the case in paragraph 38.

CLAUSE 74

Income Tax: Amendment of paragraph 42 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 42 provides that if a person sells financial instruments (e.g. shares) and that person or a connected person buys identical financial instruments back within the 45 day period, the seller is treated as having sold the assets at his or her base cost (i.e. no loss allowed) and the purchaser is treated as having acquired it for the sale price less the amount of the loss that the seller would have made. This results in a roll-over of the loss to the purchaser of the identical instruments. Transfers of assets between the funds of a long-term insurer as a result of changes in the tax status of policyholders or an annual balancing of assets and liabilities as required in terms of section 29A(6) and (7) of the Income Tax Act are already excluded from paragraph 42. However, assets can also be transferred between the funds in terms of section 29A(8) of the Income Tax Act. The application of the provisions of paragraph 42 may then result in the unintended consequence that unrealised gains and losses may be transferred between the different funds of a long-term insurer and ultimately be taxed in a tax favourable manner on realisation. In accordance with the trustee principle of taxation applied to long-term insurers and to ensure that the different funds are taxed on the capital gains or losses which arise in the relevant funds it is proposed that the roll-over provisions of paragraph 42 should not apply to transactions between the funds of a long-term insurer.

CLAUSE 75

Income Tax: Amendment of paragraph 43 of the Eighth Schedule to the Income Tax Act, 1962

The amendments to paragraph 43 are consequential upon the reintroduction of the spot rate to translate foreign currency to the currency of the Republic.

CLAUSE 76

Income Tax: Amendment of paragraph 55 of the Eighth Schedule to the Income Tax Act, 1962

It is proposed that the English text of paragraph 55 be amended to bring it into line with the Afrikaans text.

CLAUSE 77

Income Tax: Amendment of paragraph 56 of the Eighth Schedule to the Income Tax Act, 1962

The purpose of this amendment is to align the Afrikaans text with the English text of the Act.

CLAUSE 78

Income Tax: Amendment of paragraph 64 of the Eighth Schedule to the Income Tax Act, 1962

The paragraph provides that where an asset is used to produce amounts which are exempt from tax in terms of section 10 the capital gain or capital loss from the disposal of that asset must be disregarded.

Following on the introduction of the partial taxation of PBOs which are carrying on business activities, it is proposed that where an asset is disposed of by a PBO which has been approved by the Commissioner in terms of section 30(3) and substantially the whole of the use of that asset is directed at carrying on public benefit activities, the capital gain or capital loss may be disregarded.

CLAUSE 79

Income Tax: Amendment of paragraph 64B of the Eighth Schedule to the Income Tax Act, 1962

Subclause (a): This proposal is aimed at—

- limiting the participation exemption to instances where the disposal is effected to non-residents (even if the disposal is performed by a CFC);
- Clarifying existing law so that the participation exemption potentially overrides the exit charge of paragraph 12(2)(a) where applicable;
- Making the required percentage holding of the share capital in the foreign company consistent with corporate reorganisation rules, thereby adopting the new 20 per cent vote and equity share capital test (as opposed to the previous 25 per cent equity share capital test); and
- excluding the disposal of equity shares from the exemption where 80 per cent or more of the market value of those shares is attributable directly or indirectly to immovable property contemplated in paragraph 2(2) of the Eighth Schedule.

The definition of “affected instrument” in section 8E was deleted in 2004 and replaced with a definition of “hybrid equity instrument”. The proposed amendment aligns paragraph 64B(2) with section 8E.

Example 1

SA Company owns all the shares of CFC Holdings and CFC Holdings owns all the shares of CFC Operating. CFC Operating has a total value of R5 million, of which R2 million represents portfolio financial assets that generate section 9D(2A) net income. SA Company has a R2,3 million base cost in the CFC Holding Shares, CFC Holding has a base of R1,7 million base cost in the CFC Operating shares, and CFC Operating has a base cost of R600 000 in the portfolio financial assets generating section 9D(2A) net income. SA Company sells all the CFC Holdings shares for R5 million cash. The sale is to a wholly owned foreign group, thereby eliminating CFC status for both the holding company and the operating companies transferred.

Result. CFC Operating is deemed to sell all of its assets due to its loss of CFC status upon the sale of CFC Holdings (Paragraph 12(2)), thereby generating R1,4 million of gain (R2 Million – R600 000) for SA Company by virtue of section 9D. This gain translates into a base cost increase of R1,4 million for both the CFC Holdings and CFC Operating shares (Paragraph 20(1)(h)(iii). CFC Holdings is similarly deemed to sell the CFC Operating shares due to its loss of CFC status (Paragraph 12(2), but all gain on the sale is exempt by virtue of the participation exemption (Paragraph 64B(2)). The actual sale of CFC Holdings by SA Company is similarly exempt.

Subclause (b): The capital gains participation exemption acts as an analogue to the participation exemption for foreign dividends. The exemption for capital gains was intended to facilitate internal restructurings of offshore foreign subsidiaries. The exemption also allowed for the sale of certain foreign shareholdings to foreign persons with the expectation that the loss of foreign share holdings would be replaced with valuable consideration. However, it appears that some multinationals are seeking to utilise the exemption so as to divest themselves of their foreign subsidiaries with foreign subsidiary ownership transferring abroad with little or no consideration remaining within South African jurisdiction. These transactions further contain schemes that attempt to avoid any STC so the divestiture is wholly tax-free.

In order to remedy the above concerns, it is proposed that the gain disregarded as a result of the participation exemption be treated as a net capital gain in certain circumstances. The treatment of an amount as net capital gain has the effect that no capital losses for the tax year or assessed capital losses for a previous tax year may be set off against the amount. The circumstances when this anti-avoidance measure will apply are as follows:

- an interest in a foreign company is disposed off to a person who is or will be a connected person before or after the disposal;
- the foreign company is a CFC in relation to the taxpayer or to any other company in the same group of companies as the taxpayer;
- the paragraph 64B participation exemption applied to the disposal;
- if —
    - the interest was disposed of for no consideration or for consideration which does not reflect an arm's length price (excluding a distribution as described in the following bullet); or
    - the interest in the equity share capital of the foreign company was disposed of by means of a distribution *in specie*. (The capital gain will not be taxed if—
        - the distribution is subject to STC or where the section 64B(5)*(f)* STC exemption applies); or
        - the distribution is taxed in the hands of a shareholder of the distributing company or is not taxed due to the participation exemption granted in terms of section 10(1)*(k)*(ii)*(dd)*); or
    - the consideration for the disposal of the interest in the share capital of the foreign company was in terms of the same transaction, operation or scheme disposed of—
        - for no consideration or for consideration which does not reflect an arm's length price (excluding a distribution as described in the following bullet); or
        - by means of a distribution *in specie* as contemplated in paragraph 75 by a company. (The capital gain will not be taxed if—
            - ✓ the distribution is subject to STC or where the section 64B(5)*(f)* STC exemption applies); or
            - ✓ the distribution is taxed in the hands of a shareholder of the distributing company or is not taxed due to the participation exemption granted in terms of section 10(1)*(k)*(ii)*(dd)*); and

- o the foreign company in terms of the transaction, operation or scheme ceased to be a CFC in relation to the taxpayer or any other company in the same group of companies as the taxpayer (without having regard to voting rights or to the election to be treated as a CFC).

Where a capital gain has not been taxed in the case of a distribution *in specie* of an interest in equity share capital or of the consideration as described above due to the application of the participation exemption granted in terms of section 10(1)*(k)*(ii)*(dd)*) or the section 64B(5)*(f)* STC exemption, the company to which the distribution was made is deemed to have disposed of the interest in the equity share capital of the foreign company, which qualified for the paragraph 64B exemption. This relief measure enables a group of companies to transfer shares of a CFC in certain instances. The effect will be that the capital gain will be deferred and be taxed in the hands of the recipient company.

Example 2

Facts. Foreign Parent owns all the shares of SA Company. SA Company owns all the shares of CFC. Foreign Parent forms SA NewCo. SA Company has R10 million of corporate profits. CFC has a value of R6 million and SA Company has a base cost of R1,3 million in the CFC shares. All of CFC's business operations are exempt from tax by virtue of section 9D(9)(b). SA Company sells the CFC shares to SA NewCo in exchange for a note issued by SA NewCo. Pursuant to the rollover relief regime of section 45. SA NewCo then distributes CFC to Foreign Parent.

Result. Assuming section 103 and substance-over-form principles do not apply, Paragraph 64B(3) triggers gain pursuant to paragraph 8(b), thereby overriding the Paragraph 64B(2) exemption. Paragraph 64B(3) applies because the full distribution by SA NewCo is not subject to STC due to the lack of corporate profits. SA NewCo accordingly has R4,7 million of gain on the distribution (R6 million – R1,3 million).

Example 3

Facts. The facts are the same as Example 2, except that SA NewCo sells CFC to Foreign Parent is exchange for a note of R6 million. SA NewCo later cancels the note owned by Foreign Parent after receiving interest of R60 000.

Result. Assuming section 103 and substance-over-form principles do not apply, the sale by SA NewCo of CFC for the note is exempt by virtue of Paragraph 64B(2). However, the cancellation of the note triggers gain by virtue of Paragraph 64B(3) due to lack of consideration received in exchange.

Example 4

Facts. The facts are the same as Example 3, except that SA NewCo was previously in existence of many years after having accumulated R5 million of losses.

Result. The result is the same as Example 3. The gain triggered by Paragraph 64B(3) cannot be offset by losses due to the direct inclusion under paragraph 8(b).

Example 5

Facts. Foreign Parent owns all the shares of SA Company 1. SA Company 1 owns all the shares of SA Company 2. SA Company 2 owns all the shares of CFC with a value of R20 million and a base cost of R3 million. All of CFC's business operations are exempt from tax by virtue of section 9D(9)(b). SA Company 2 sells CFC to Foreign Parent in exchange for a note. SA Company 2 distributes the note to SA Company 1 (which is tax-free by virtue of section 64B(5)(f)).

Result. The sale of CFC for the note is tax free by virtue of paragraph 64B(2). The distribution of the note to SA Company 1 does not trigger paragraph 64B(3) because the dividend is exempt under section 64B(5)(f). However, SA Company 1 steps into the shoes ot SA Company 2 for purposes of paragraph 64B. SA Company 1 would accordingly be subject to paragraph 64B(3) if SA Company 1 manages to dispose of the note without any valuable consideration in return and without any corresponding STC.

CLAUSE 80

Income Tax: Amendment of paragraph 72 of the Eighth Schedule to the Income Tax Act, 1962

Paragraph 72 attributes a capital gain back to the donor where—

- o a resident has made a donation, settlement or other disposition to a non-resident (including a non-resident trust),
- o a capital gain attributable to that donation, settlement or other disposition has arisen during a year of assessment, and
- o that capital gain has vested in a non-resident.

Paragraph 2 provides that the Eighth Schedule only applies to a non-resident in respect of the disposal of South African immovable property (including the disposal of shares in certain companies holding South African immovable property) and assets of a permanent establishment in South Africa. The Eighth Schedule, therefore, has a fairly narrow application to non-residents. It may be argued that it is only such South African source gains that can arise in the hands of a non-resident and which can be attributed from that non-resident to a resident in terms of paragraph 72. Such an interpretation would severely limit the scope of this provision and defeat the purpose of the legislature. It is, therefore, proposed that paragraph 72 be amended to make it clear that attribution can occur in respect of an amount that would have constituted a capital gain in the hands of a non-resident had that non-resident been a resident. A similar amendment was effected by the Revenue Laws Amendment Act, 2004 to the equivalent provision in the principal Act (section 7(8)). This ensured that ordinary income from a non-South African source could be attributed from a non-resident to a resident.

CLAUSE 81

Income Tax: Amendment of paragraph 76 of the Eighth Schedule to the Income Tax Act, 1962

This proposal is aimed at clarifying the interaction between the rules governing unbundling transactions and the rules governing capital distributions by companies.

CLAUSE 82

Income Tax: Amendment of paragraph 4 of Part I of the Ninth Schedule to the Income Tax Act, 1962

Currently, the Ninth Schedule to the Income Tax Act lists as a public benefit activity "career guidance and counselling services provided to persons for purposes of attending any school or higher education institution". It is proposed that this provision be amended slightly to ensure that the career guidance and counselling must be provided to persons already attending a school or higher education institution as the guidance and counselling would be provided to scholars for purposes of deciding on a career rather than for purpose of attending a school or higher educational institution.

CLAUSE 83

Income Tax: Amendment of paragraph 10 of Part I of the Ninth Schedule to the Income Tax Act, 1962

These amendments are of a textual nature.

CLAUSE 84

Income Tax: Amendment of paragraph 3 of Part II of the Ninth Schedule to the Income Tax Act, 1962

Currently, the Ninth Schedule to the Income Tax Act lists as a public benefit activity "career guidance and counselling services provided to persons for purposes of attending any school or higher education institution". It is proposed that this provision be amended slightly to ensure that the career guidance and counselling must be provided to persons already attending a school or higher education institution as the guidance and counselling would be provided to scholars for purposes of deciding on a career rather than for purpose of attending a school or higher educational institution.

CLAUSE 85

Customs and Excise: Amendment of section 1 of the Customs and Excise Act, 1964

Section 1 contains the definitions used in the Customs and Excise Act. No definitions exist for "Road Accident Fund levy" and "Road Accident Fund levy goods".

The proposed amendment to section 1 is as a result of the announcement by the Minister of Finance in the 2005 Budget that SARS will become the agency responsible for collecting the Road Accident Fund levy.

A further subsection is inserted after subsection (3) to include the "Road Accident Fund levy" in any provision relating to "fuel levy", and "Road Accident Fund levy goods" in any provision relating to "fuel levy goods".

CLAUSE 86

Customs and Excise: Amendment of section 17 of the Customs and Excise Act, 1964

Section 17(1) relates to State warehouse rent and empowers the Commissioner to charge rent, at a rate fixed by rule, on goods stored in any State warehouse for the period that such goods remain in the warehouse.

When the rate is adjusted during the period that goods are stored in the warehouse such goods can, upon their removal from the warehouse, potentially attract rent at different rates.

The proposed amendment stipulates that the rate to be used will be the rate in force at the time of payment.

CLAUSE 87

Customs and Excise: Amendment of section 18 of the Customs and Excise Act, 1964

Control over the movement of goods in bond through the Republic is important in order to protect the society and the fiscus from such goods illicitly finding their way into the local market. To further combat such diversions, three new amendments are being proposed:

Firstly, subsection 18(3) provides for the facts which must be proved by persons removing goods in bond in order to discharge their liability for the duty in respect of such goods.

The procedures that must be followed by persons to prove that their liability in respect of goods removed in bond had ceased, are not currently stipulated in the rules to the Act.

The proposed amendment thus empowers the Commissioner to prescribe such procedures by rule.

Secondly, subsection 18(4) places an obligation on a person who fails to submit the required proof relating to the termination of a removal in bond to pay the applicable duty due upon demand by the Controller.

No specific provision currently exists in subsection 18(4) concerning the payment of VAT and forfeiture by a person who is called upon to pay the duty as contemplated in subsection (4).

The proposed amendment requires the payment of the duty and VAT, as well as any amount of forfeiture that may be due, in circumstances where goods have been diverted or deemed to have been diverted.

Finally, subsection 18(13) currently prohibits any person from diverting, without the permission of the Commissioner, any goods entered for removal in bond to a destination other than the destination declared on the relevant removal in bond entry, or delivering the goods to a place in the Republic other than into the control of the department at the place of destination.

Recent court cases have also highlighted certain practical difficulties that officers encounter in proving diversion under the current wording of subsection (13).

The proposed amendment now also deems goods removed in bond to have been diverted where the required proof referred to in subsection 18(3) is not produced, or where any such proof produced is the result of fraud, misrepresentation or a false declaration. Failure to comply with the provisions of this subsection will also result in the applicable goods becoming liable to forfeiture.

The proposed amendment to subsection (13) also removes the obsolete reference to “department” and replaces it with a reference to “Controller”.

CLAUSE 88

Customs and Excise: Amendment of section 20 of the Customs and Excise Act, 1964

Subsection 20(5) provides for the payment of the duty on any deficiency found in a customs and excise warehouse.

The current proviso to subsection (5) is, however, also duplicated in item 608.01 to Schedule No. 6 to the Act.

The proposed amendment is consequential to the review of Schedule No. 6 and deletes the obsolete proviso on the basis that it already exists in the abovementioned item.

CLAUSE 89

Customs and Excise: Amendment of section 28 of the Customs and Excise Act, 1964

Subsection 28(2) provides for the ascertaining of the quantity of spirits by measuring the mass or volume thereof.

In storing spirits a certain amount of loss is inevitable given the nature of the product, resulting in the actual amount taken into storage differing from that reflected on the supplier’s invoice. Investigating and administering each such instance is administratively impractical, as well as inaccurate.

The proposed amendment provides for a tolerance of 0,25 per cent (upwards or downwards) when ascertaining the quantity of spirits taken into storage in order to simplify the administration surrounding spirits.

CLAUSE 90

Customs and Excise: Amendment of section 47 of the Customs and Excise Act, 1964

Section 47(1) provides that duty shall be paid for the benefit of the National Revenue Fund on all imported, excisable, surcharge, environmental levy and fuel levy goods at the time of entry for home consumption thereof. No provision currently exists to pay the Road Accident Fund levy into the National Revenue Fund.

The proposed amendment to subsection (1) to pay the Road Accident Fund levy into the National Revenue Fund is as a result of the announcement by the Minister of Finance in the 2005 Budget that SARS will become the agency responsible for collecting the Road Accident Fund levy.

The proposed amendment to subsection (7) is consequential to the amendment of subsection (1).

CLAUSE 91

Customs and Excise: Amendment of section 48 of the Customs and Excise Act, 1964

Section 48 (2) empowers the Minister to amend, withdraw, insert or reduce duties specified in certain Parts of Schedule No. 1 to the Act.

No provision currently exists to allow the Minister to amend the Road Accident Fund levy.

The proposed amendment to subsection (2) is to allow the Minister to amend the Road Accident Fund levy and is consequential to the amendment of section 1 and divides the current Part 5 of Schedule No. 1 into a Part 5A in respect of fuel levy goods and a Part 5B in respect of Road Accident Fund levy goods.

CLAUSE 92

Customs and Excise: Amendment of section 75 of the Customs and Excise Act, 1964

Section 75 provides for specific rebates, drawbacks and refunds of duty. Eight amendments to the section are proposed.

Section 75(1)*(b)* is textually amended to include a reference to the Road Accident Fund levy.

Section 75(1)(c) empowers the Commissioner to pay a refund or drawback of any ordinary customs duty, anti-dumping duty, countervailing duty, safeguard duty, surcharge and fuel levy paid on imported goods described in Schedule No. 5 subject to the necessary compliance with the notes to the Schedule, as well as with the provisions of the applicable item to the Schedule.

The definition of “ordinary duty” was deleted by the Customs and Excise Amendment Act, 1990 (Act No. 59 of 1990) and as a result of the deletion a consequential amendment should have been made to section 75(1)(c) to delete the reference to "ordinary customs duty" appearing in that section and to replace it with a reference to "customs duty".

The proposed amendment now effects the required consequential amendment and further deletes, in view of the current definition of "customs duty" contained in the Act, references in that section relating to anti-dumping, countervailing duty and safeguarding duty.

Furthermore, and consequential to the amendment of section 47(1)(a), provision is made for a rebate, refund or drawback in respect of the Road Accident Fund levy.

Section 75(1)(d) provides for rebates, refunds and drawbacks in respect of excisable goods and fuel levy goods. No provision currently exists that allows the Commissioner to grant a rebate, refund or drawback in respect of the Road Accident Fund levy.

The proposed amendment is consequential to the amendment of sections 1 and 47(1) and empowers the Commissioner to grant a rebate, refund or drawback in respect of the Road Accident Fund levy, provided that such a rebate, refund or drawback will only be granted as expressly provided in Schedule No. 4, 5, or 6 in respect of any item in such Schedule.

Subsection (1A) is amended in view of the collection of Road Accident Fund levy in terms of the Customs and Excise Act.

The proposed insertion of subsection (1D) is a transitional provision and is required in order to deal with the recovery from the Chief Executive Officer of the Road Accident Fund of any Road Accident Fund levies refunded by the Commissioner prior to the date on which the levying of the Road Accident Fund levy in terms of this Act comes into operation.

Subsection (13) makes provision for the approval by the Commissioner of formulas used in the manufacturing of excisable products. These formulas are highly technical chemical formulas which do not add any benefit concerning the control of these products.

The provision is now deleted as a result of the review of the whole of Schedule No. 6.

Subsection (18) provides for a loss allowances on certain excisable products. The current provisions provide for different percentages of loss allowances which unnecessarily differentiate between different excisable products.

The proposed amendment is the result of a review of Schedule No. 6 and now affords excisable products equal treatment as far as possible in respect of transport and actual manufacturing losses.

Subsection (21) provides that, except with the permission of the Commissioner, any goods entered under any item of Schedule No. 3, 4 or 6 must be used for the purpose specified in that item within five years from the date of such entry.

The five year period is not consistent with similar provisions contained in the Act. Section 19(9)*(a)*, for example, provides that goods stored or manufactured in a customs and excise warehouse must be removed from such warehouse within two years from the date of such storage or manufacture.

The proposed amendment aims to achieve uniformity within similar provisions in the Act by amending the five year usage period to a two year period.

CLAUSE 93

Customs and Excise: Amendment of section 105 of the Customs and Excise Act, 1964

Section 105 provides for the levying of interest on any amount outstanding in terms of the Act (excluding penalty and forfeiture amounts) and also for the payment of such outstanding amounts by instalments.

Subsection *(d)* further requires the Commissioner to apply instalment payments received in a prescribed order by first discharging any penalty that may be due followed by forfeiture, interest, duty and any other amounts.

The provisions of section 105 relating to the order within which payments received must be discharged are not in uniformity with similar provisions in the Income Tax Act, 1962, or in this Act.

The proposed amendment aims to achieve uniformity in respect of the order of discharge of payments received with similar provisions contained in the Income Tax Act, 1962, and also amounts recovered in terms of section 114(1)*(b)*(iv) of this Act.

CLAUSE 94

Customs and Excise: Amendment of section 114 of the Customs and Excise Act, 1964

Section 114 deals with the recovery of any duty, interest, fine, penalty or forfeiture incurred under the Act and which becomes a debt due to the State.

Section 114(1)*(a)*(iv)*(aa)* empowers the Commissioner to detain certain categories of goods that belongs to a person by whom a debt is due in respect of any amount of duty, fine, penalty, forfeiture or interest incurred under the Act.

The enforcement of liens in terms of the provisions of section 114(1)*(a)*(iv)*(aa)* are in practice problematic due to the fact that debtors aver that goods do not belong to them in an attempt to escape the operation of a lien.

The proposed amendment substitutes the reference to “belonging to” with “ownership” and places an onus on the debtor who denies ownership of goods that are subject to a lien to prove that he or she is not the owner of such goods.

Subsection (1)*(b)*(iv) requires the Commissioner to utilise any payment received or any amount recovered in terms of this section to discharge any such payment or amount recovered in a particular order.

The proposed amendment is consequential to the amendment of section 105 and aims to achieve uniformity in respect of the order of discharge of payments contained in that section, as well as with similar provisions contained in the Income Tax Act, 1962.

CLAUSE 95

Stamp Duties: Amendment of section 3 of the Stamp Duties Act, 1968

It often occurs that the Minister of Finance announces a change in the rates of certain transaction taxes in the Budget Review with effect from a date which precedes the date on which the legislation which gives effect to that rate change is promulgated. Implementing these changes before the legislation is in place becomes problematic as there is no legislation on which a person can rely when paying the reduced amount of duty in respect of the registration of transfer of a share.

It is, therefore, proposed that a provision be inserted in the Stamp Duties Act to address this issue. This will ensure that the changes proposed apply with effect from the date determined by the Minister and that they lapse at the earlier of the date on which the legislation giving effect thereto is promulgated or, if no such legislation is passed, after 6 months from the date so determined.

CLAUSE 96

Stamp Duties: Amendment of section 7 of the Stamp Duties Act, 1968

Subclauses (a) and (b): As a result of the repeal of stamp duty on the issue of marketable securities with effect from 1 January 2006, subsection (1)*(g)* has become obsolete. The proposed deletion of subsection (1)*(j)* is consequential upon the repeal of stamp duty on instalment credit agreements.

CLAUSE 97

Stamp Duties: Amendment of section 22 of the Stamp Duties Act, 1968

The proposed amendment is consequential upon the deletion of the graduated scale (R0,25, R0,40, R0,55 and R0,70 depending on the period of the lease) and the substitution thereof with a flat rate of 0.5% last year, irrespective of the period of a renewal lease agreement.

CLAUSE 98

Stamp Duties: Amendment of section 23 of the Stamp Duties Act, 1968

Subclause (a): The proposed amendment is consequential upon the deletion of stamp duty on the issue of marketable securities with effect from 1 January 2006.

Subclauses (b) and (i): The proposed amendments are consequential upon the introduction of electronic stamping. Adhesive revenue stamps will be phased out and the defacing of stamps will become obsolete. The proposed amendment will come into operation on a date fixed by the President by proclamation in the *Gazette*.

Subclause (c): The proposed amendment provides relief of the administrative burden on the transferee of marketable securities, in particular where such person cannot make use of electronic stamping on his or her transfer documents. The proposed amendment will apply in respect of each instrument of transfer executed on or after the proclamation of this Act in the *Gazette*.

Subclauses (d), (e), (f), (g) and (h): The proposed amendments aim to simplify the legislation regarding the cancellation and redemption of marketable securities, and clarify the position on the taxation of company share buy-backs. Anti-avoidance legislation is introduced, as a consequence of the deletion of stamp duty on the issue of marketable securities with effect from 1 January 2006.

CLAUSE 99

Stamp Duties: Amendment of item 14 of Schedule 1 to the Stamp Duties Act, 1968

Subclause (a): The proposed amendment is consequential upon the deletion last year of the graduated scale (R0,25, R0,40, R0,55 and R0,70 depending on the period of the lease) and the substitution thereof with a flat rate of 0.5%, irrespective of the period of a renewal lease agreement.

Subclause (b): Where the total consideration payable in respect of a lease or agreement of lease is not quantifiable at the time of execution of that lease, no stamp duty will be payable where the aggregate duty payable on that lease or agreement of lease is R200 or less during a financial year of the lessor. This proposal will give relief on the administrative burden on lessors and to persons who cannot make use of electronic stamping. The proposed amendment will apply in respect of any lease or agreement of lease where that lease or agreement of lease is executed in the year of assessment, as defined in section 1 of the Income Tax Act, 1962, of any lessor who is a taxpayer, as defined in section 1 of the Income Tax Act, 1962, commencing on or after the proclamation of the Revenue Laws Amendment Act, 2005, in the *Gazette*, or in the case of any other lessor, on or after 1 March 2006.

Subclause (c): A further proposed amendment introduces a limit on the amount of stamp duty that will be payable in terms of a long-term lease. The limit is calculated as the amount of transfer duty which a company is liable to pay upon the acquisition of that property. The reason for the 10 per cent limit is that 10 per cent is the highest rate applicable for transfer duty purposes. The stamp duty payable will, therefore, not be more than the maximum transfer duty obligation, were the property itself to be disposed of and be subject to transfer duty. The proposed amendment will apply in respect of any lease or agreement of lease where that lease or agreement of lease is executed on or after 1 January 2006.

CLAUSE 100

Stamp Duties: Amendment of item 15 of Schedule 1 to the Stamp Duties Act, 1968

Subclauses (a) and (b): The proposed amendments are consequential upon the repeal of stamp duties on the issue of shares. The proposed amendments will come into operation on 1 January 2006, and will apply to all marketable securities issued, cancelled or redeemed on or after that date.

Subclauses (c) and (g): The proposed amendments provide relief of the administrative burden on the transferee of marketable securities, in particular where such person cannot make use of electronic stamping on his or her transfer documents. The proposed amendment will come into operation on 1 January 2006 and will apply in respect of the registration or acquisition of any marketable security on or after that date.

Subclause (d): Item 15 provides for an exemption from stamp duties where the marketable securities are transferred in terms of the corporate restructuring rules contained in the Income Tax Act, 1962. In certain instances the public officer of the relevant company must make a sworn affidavit or solemn declaration that the transfer complies with certain requirements. A public officer is, however, defined in the Stamp Duties Act as a reference to certain Government officials. The intention is that the term "public officer" should bear its meaning as defined for income tax purposes and it is therefore proposed that the provision be amended to specifically refer to the public officer for a company as contemplated in section 101 of the Income Tax Act, 1962.

Subclauses (e) and (f): The proposed amendments are consequential upon the deletion of stamp duty on the issue of marketable securities with effect from 1 January 2006, and are intended to clarify the taxation of company share buy-backs, as well as to provide anti-avoidance legislation.

CLAUSE 101

Value-Added Tax: Amendment of section 1 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment is to provide for a definition of "Controller" to align the VAT Act with the provisions of the Customs and Excise Act, 1964.

Subclauses (b), (c) and (e): The proposed amendments will regard a project receiving funds under an international donor fund agreement to which the Government of the Republic is a party, as a "foreign donor funded project" and a "person" as defined in section 1 of the Act. This person will now fall within the ambit of an "enterprise" as defined in section 1 of the Act and accordingly be entitled to register for VAT purposes albeit that it does not generate any income before registration.

Subclause (d): The proposed amendment is to provide for a definition of "licensed customs and excise storage warehouse" for the purposes of supplies of goods at the zero rate in terms of section 13(1) proviso (ii) of the VAT Act. The proposed amendment is to align the VAT Act with the provisions of the Customs and Excise Act, 1964, as entry into a licensed customs and excise storage warehouse is not regarded as an entry for home consumption.

CLAUSE 102

Value-Added Tax: Amendment of section 8 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment will deem the income received from the international donor to be in respect of services supplied by the foreign donor funded project to the international donor to the extent of the international donor funding received from an international donor. The effect will be that the service will be taxable at the zero rate in terms of section 11(2)*(q)* in the hands of the project.

Subclause (b): The proposed amendment is to provide for a deemed supply of goods by a customs controlled area enterprise ("CCAE") where movable goods are temporarily removed from the CCA to a place in the Republic and are not returned to the CCA within a period of 30 days, or a period approved by the Controller, from its removal.

Example
A CCAE removes a facsimile machine, used in the course of making taxable supplies, from the CCA to a supplier in the Republic to have it repaired. The facsimile machine is not returned to the CCA within 30 days of its removal. No alternate arrangement is made with the Controller to extend the 30 day period. The CCAE is liable to account for output tax on the open market value of the facsimile machine on the last day when the 30 day period expired. If the facsimile machine has an open market value of R1 000 on the last day of the stipulated period, the CCAE has to account for output tax of R122,80.

The proposed amendment is to ensure that the transaction entered into between group companies as envisaged by the provisions of section 42 (company formations), 44 (amalgamation transactions), 45 (an intra group transaction) or 47 (liquidation distribution) of the Income Tax Act, 1962, has no VAT consequences for either vendor where the vendors are partially taxable entities. The situation where a partially taxable business is transferred or where business assets that were used in a partially taxable business are transferred or declared as a dividend *in specie*, generally create an unintended VAT cost to the parties involved due to the possible application of sections 16(3)(h) and 18A of the VAT Act. No adjustment in terms of section 16(3)(h) is required by the supplying vendor and no section 18A output tax adjustment will be made by the purchasing vendor. It is proposed that VAT on services acquired for the purposes of the aforementioned transaction will qualify as input tax.

When the purchasing vendor subsequently supplies goods or services, the normal provisions of the VAT Act will apply. Alternatively, when the purchasing vendor applies the goods or services for wholly exempt purposes, the relevant provisions of section 18 will apply. Where the vendor subsequently does not comply with the aforementioned provisions of the Income Tax Act, 1962, the normal provisions of the VAT Act will apply to the original supply.

The insertion of section 8(26) is consequential upon the insertion of section 11(2)*(v)*. This amendment deems the supply of services together with goods provided under any warranty agreement to be the supply of services when the rate of zero percent is applied in terms of section 11(2)*(v)*.

CLAUSE 103

Value-Added Tax: Amendment of section 9 of the Value-Added Tax Act, 1991

The proposed amendment is to cater for the time of supply when a vendor, being a customs controlled area enterprise, is deemed to supply goods as contemplated in section 8(24).

CLAUSE 104

Value-Added Tax: Amendment of section 10 of the Value-Added Tax Act, 1991

The proposed amendment is intended to provide a value for the calculation of output tax to be declared by a vendor, being a customs controlled area enterprise, for the deemed supply provided for in section 8(24).

CLAUSE 105

Value-Added Tax: Amendment of section 11 of the Value-Added Tax Act, 1991

Subclauses (a), (b) and (c): The proposed amendment is to provide specific Customs and Excise references to the relevant goods which may be supplied at the zero rate.

Subclauses (d) and (f): The income received from the international donor will be deemed to be in respect of services supplied by the foreign donor funded project to the international donor. The effect will be that the service will be taxable at the zero rate in the hands of the project.

Subclause (e): The proposed amendment is to ensure that VAT is not a cost to a client who is a vendor, who contracts with a foreign company that is a not a resident of the Republic and not a vendor. This is best illustrated by way of an example.

Example

A foreign company, Company A, is contracted to supply goods to the client. Company A in turn contracts with a local supplier to supply certain goods which goods will be delivered to the client in the Republic. The goods are therefore not imported by Company A into the Republic but are supplied and delivered by the local supplier directly to the client in the Republic.

Current law

- Where Company A agrees to supply goods to the client by making use of the local supplier the benefits of the input tax credit are lost to Company A, because the local supplier will charge VAT at the standard rate on its supply to Company A and Company A cannot claim any input tax thereon.
- This lost credit becomes a cost to Company A, which Company A will pass on to the client.

Proposal

It is proposed that certain goods supplied to a foreign company but which goods are delivered to a registered vendor in the Republic and are used wholly for the purposes of making taxable supplies, be zero-rated.

The local supplier will have to obtain a declaration from the client which states that the goods are used wholly for the purposes of making taxable supplies before the local supplier can make the supply at the zero rate. Where it is at a later stage discovered that a false declaration was made by the client, the VAT that should have been charged at the standard rate on the supply by the local supplier to the foreign company will be recovered from the client in terms of section 61 of the VAT Act.

Subclause (g): This amendment is of a textual nature.

Subclause (h): The current situation is that, where the service of repairing or replacing parts is carried out by a local VAT registered vendor (the service provider) for a non-resident entity (the warrantor) in connection with goods imported into RSA which are under warranty, the VAT charged at the standard rate by that vendor becomes a cost to that warrantor.

.

The proposed amendment is to zero rate the supply of the services under the warranty agreement by the service provider supplied directly to the warrantor, so that the VAT will no longer be a cost to the warrantor.

A consequential amendment has been made under section 8(26) to deem the supply of goods in terms of the warranty contract to be regarded as part of the services so that the application of the zero rate in terms of this section will extend to the supply of those goods as well.

CLAUSE 106

Value-Added Tax: Amendment of section 13 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment is to restrict the zero-rating allowed in terms of this section to goods entered into a licensed customs and excise storage warehouse.

Subclause (b): The current provisions of section 13(6), relating to the importation of goods draw the provisions of the entire Customs and Excise Act, 1964, into the VAT Act. The result is that section 39(4) conflicts with section 13(6) as section 13(6) has the unintended effect of drawing in the penal provisions of the Customs and Excise Act, 1964. The proposed amendment is to ensure that only the provisions of the Customs and Excise Act, 1964, relating to the importation, transit, coastwise carriage and clearance of goods and the payment and recovery of duty will apply to the VAT Act. The levying of penalties and interest will therefore be imposed in terms of section 39 of the VAT Act.

CLAUSE 107

Value-Added Tax: Amendment of section 16 of the Value-Added Tax Act, 1991

Subclauses (a) and (f): The proposed amendment is to ensure that an audit trail exists to verify input tax claims against output tax accounted for. Where a vendor claims input tax more than 5 years after the output tax has been accounted for, no audit trail exists to verify whether output tax in respect of a supply, was accounted for.

Input tax can only be claimed if a vendor is in possession of a tax invoice that complies with section 20(1). From 1 March 2005, section 20(1) requires that a tax invoice must be issued within 21 days of the supply having been made. Prior to the amendment, a vendor had 21 days from the date of the request from the recipient of the supply, to issue a tax invoice.

The proposed amendment ensures that where the recipient vendor has not claimed input tax, that vendor has 5 years from the end of the tax period during which the tax invoice should have been issued as required in section 20(1) to claim the input tax as opposed to when the vendor for the first time was in possession of the tax invoice.

Subclauses (b) and (c): The proposed amendment is to ensure that a vendor, who acquires goods or services which are to be awarded as a prize or winnings, is not allowed to claim input tax on the original acquisition of those goods or services. The vendor will only be allowed to claim the input tax in the period in which the goods or services are awarded as a prize or winnings.

Subclause (d): Section 16(3)*(d)* is intended to limit the input tax deduction on goods or services acquired for the purposes of being awarded as prizes for betting transactions to the actual cost incurred on the initial acquisition of such goods or services. This eliminates the possibility of vendors acquiring these goods or services and claiming input tax on their retail market value rather than their cost to the vendors.

Example

A casino acquires a motor car in an arm’s length transaction at 10% below the retail market value and supplies the motor car as a prize on the outcome of a betting transaction at the market value. The casino is entitled to input tax on the amount paid for the motor car limited to the market value less 10%.

Subclause (e): Section 16(3)*(h)* normally allows a vendor to “claw-back” input tax to the extent that it was previously denied on any goods or services used partially for exempt or private purposes, when those same goods or services are subsequently supplied under a wholly taxable supply in terms of section 8(16)*(a)*. The proposed amendment provides that the input tax credit under section 16(3)*(h)* will not be available on a subsequent supply of those goods or services where they were acquired prior to 1 April 2005 by a public authority or public entity listed in Schedule 3A or 3C to the Public Finance Management Act, 1999, (PFMA) or where an input tax credit was denied to that public authority or public entity under proviso (iv) to section 18(4). The denial of input tax under section 16(3)*(h)* applies whether the subsequent supply is by way of sale, donation, exchange or any other transaction. It will also apply where the public authority or public entity transfers the goods or services from a taxable division/trading account to an exempt division/trading account or a separate entity under its control where an output tax adjustment on the supply is required in terms of section 18(1).

The amendment clarifies that where a public entity or public authority was denied an input tax credit under proviso (iv) to section 18(4), or if it acquired those goods or services prior to 1 April 2005, it is not permissible to claim an input tax credit on those same goods or services on or after 1 April 2005 under another section of the VAT Act. The proposed amendment will come into operation on 1 April 2005.

CLAUSE 108

Value-Added Tax: Amendment of section 17 of the Value-Added Tax Act, 1991

Subclause (a): The proposed amendment is to ensure that all expenditure incurred on which VAT was paid by the international donor funded project can be claimed as input tax, including expenses such as the acquisition of motor cars and entertainment where such expenses were paid out of funds received under an international donor fund agreement to which the Government of the Republic is a party.

Subclause (b): The proposed amendment is of a textual nature.

Subclause (c): It is proposed that the input tax claimable on the VAT incurred on the acquisition of entertainment be limited to vendors who receive bets in respect of the outcome of a race or on any other event or occurrence in term of section 8(13) of the VAT Act, where that entertainment is continuously or regularly supplied as a prize to its clients or customers. The proposed amendment therefore only allows these vendors in the betting and gambling industry to make this deduction.

Subclause (d): The proposed amendment is introduced to allow a vendor to claim input tax on the VAT incurred in respect of the acquisition of a "motor car" as defined in section 1 of the VAT Act, for the purposes of awarding the motor car as a prize to the vendor's customers. Input tax will not be claimable on any motor car acquired and awarded as a prize to any employee or office holder of the vendor or any connected person in relation to that employee, office holder or vendor.

CLAUSE 109

Value-Added Tax: Amendment of section 18 of the Value-Added Tax Act, 1991

Subclauses (a) and (b): Sections 18(2) and 18(5) provide that a vendor is required to make an annual input tax or output tax adjustment in the case of capital goods or services used only partially for taxable supplies. The provisions are aimed at ensuring that where capital goods and services are used for mixed purposes, the input tax which may be claimed, must be in proportion to the extent to which those assets are applied for taxable use in the enterprise over the lifetime of the assets. The adjustments are required where the input tax apportionment percentage applied by the vendor during the year varies by more than 10% from the percentage applied in the previous year.

The proposed amendments provide that the adjustments under sections 18(2) and 18(5) will not apply in the case of a public authority (including public entities listed in Part A or C of Schedule 3 to the PFMA) where:

- the capital goods or services were acquired prior to 1 April 2005; or
- the capital assets were acquired after 1 April 2005, but input tax thereon was denied under proviso (iv) to section 18(4).

Prior amendments to the Act required that public authorities and certain public entities would have to be deregistered for VAT with effect from 1 April 2005. Proviso (iv) to section 8(2) provided those entities with relief from the output tax which would otherwise have been paid on the assets retained upon deregistration. Furthermore, proviso (iv) to section 18(4) was inserted to deny input tax where a public authority or public entity is required (or chooses) to return those same assets to a taxable environment in the future. The reasoning behind this is that the entity would have previously enjoyed the benefit of an input tax credit on those assets (or the equivalent thereof, if the VAT cost was covered in the budget appropriation of that entity), and therefore a further input tax credit would not be allowed on those assets if they are subsequently applied for taxable use. This aspect is particularly complicated where the entity continues to be registered as a partially taxable public authority on or after 1 April 2005.

The effect of the proposed amendment is therefore to treat the capital goods and services used partially for taxable supplies after 1 April 2005 in such a way that the annual variation in the extent of taxable use will not create an output tax or input tax adjustment event in respect of the assets mentioned above. An output tax liability will only arise when the asset is eventually sold, donated, exchanged (which also includes a transfer to an exempt division/trading account or a separate entity under the control that entity).

See also the amendment to section 16(3)*(h)* in clause 107*(e)*.

Example
The exempt division of a partially taxable public authority transfers office equipment which it bought on 1 March 2005 to the head office division on 1 November 2005. The head office will use the assets to administer both the taxable and exempt divisions of the organisation. In this case, the head office will not be required to make any adjustments for those particular assets under sections 18(2) or 18(5) if the extent of taxable supplies of that entity varies by more than 10% from year 1 to year 2. This is because an input tax credit would be denied to the taxable division under proviso (iv) to section 18(4) in respect of the partial application of those assets for taxable use in the enterprise. However, if the asset is sold, or transferred back to the exempt division, output tax must be paid on that supply by the taxable division at the standard rate. The same rules would apply, if the head office had bought the assets prior to 1 April 2005 if it had applied them partially for taxable and partially for exempt supplies.

The proposed amendments are deemed to have come into operation on 1 April 2005.

Subclause (c): An amendment is proposed to provide for an output tax adjustment to be made by a customs controlled area enterprise in respect of goods or services acquired where VAT was levied at the zero rate. This output tax adjustment is applicable only to goods or services in respect of which input tax would have been denied in terms of section 17(2) had the goods or services been subject to VAT in terms of section 7(1)(a), (b) or (c) which was supplied to or imported by any person other than a customs controlled area enterprise.

CLAUSE 110

Value-Added Tax: Amendment of section 22 of the Value-Added Tax Act, 1991

The proposed amendment will ensure that a vendor accounts for output tax where input tax was previously claimed, but not paid within 12 months from the date of the claim and the vendor has either voluntarily or compulsorily been sequestrated, declared insolvent or has entered into an arrangement in terms of section 311 of the Companies Act, 1973, or any other arrangement with creditors. The output tax adjustment must be made in the tax period in which the sequestration or aforementioned agreement was entered into.

CLAUSE 111

Value-Added Tax: Amendment of paragraph 1 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 112

Value-Added Tax: Substitution of paragraph 4 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 113

Value-Added Tax: Substitution of paragraph 5 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 114

Value-Added Tax: Substitution of paragraph 6 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 115

Value-Added Tax: Substitution of paragraph 7 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 116

Value-Added Tax: Amendment of paragraph 8 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 117

Value-Added Tax: Amendment of item 406.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 118

Value-Added Tax: Amendment of item 407.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 119

Value-Added Tax: Amendment of item 409.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 120

Value-Added Tax: Amendment of item 412.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 121

Value-Added Tax: Amendment of item 470.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 122

Value-Added Tax: Amendment of item 480.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 123

Value-Added Tax: Amendment of item 490.00 of Schedule 1 of the Value-Added Tax Act, 1991

The proposed amendment aligns the VAT Act to the provisions of the Customs and Excise Act, 1964, where applicable in respect of the importation of goods.

CLAUSE 124

Tax on Retirement Funds: Amendment of section 1 of the Tax on Retirement Funds Act, 1996

This amendment is consequential upon the substitution of the definition of "lending arrangement" in the Uncertificated Securities Tax Act in 2003.

CLAUSE 125

Road Accident Fund: Amendment of section 1 of the Road Accident Fund Act, 1996

Section 1 contains the definitions used in the Road Accident Fund Act, 1996.

The current definition of "fuel" contained in the Road Accident Fund Act, 1996 is only used in the current section 5(a) and will be replaced in that section by a reference to the Road Accident Fund levy, making the definition of "fuel" obsolete.

The proposed amendment is consequential to the announcement by the Minister of Finance in the 2005 Budget that SARS will become the agency responsible for collecting the Road Accident Fund levy and the introduction of the Road Accident Fund levy under the Customs and Excise Act, 1964.

CLAUSE 126

Road Accident Fund: Amendment of section 5 of the Road Accident Fund Act, 1996

Section 5(1)(a) of the Road Accident Fund Act, 1996 provides that the Road Accident Fund shall procure the funds it requires by way of a fuel levy in respect of all fuel sold within the Republic.

The proposed amendment is consequential to the announcement by the Minister of Finance in the 2005 Budget that SARS will become the agency responsible for collecting the Road Accident Fund levy and the introduction of the Road Accident Fund levy under Customs and Excise Act, 1964.

Subsection (3) of the Road Accident Fund Act, 1996 authorises the Chief Executive Officer of the Road Accident Fund to withdraw money from the Fund in order to repay the Commissioner the amounts of Road Accident Fuel levy refunded by the Commissioner under the Customs and Excise Act, 1964.

This provision will no longer be required after SARS commences with the collection of the Road Accident Fund levy as SARS will deduct refunds of the Road Accident Fund levy and only pay over the net amount into the National Revenue Fund.

CLAUSE 127

Uncertificated Securities Tax: Substitution of section 1 of the Uncertificated Securities Tax Act, 1998

Subclause (a): The proposed amendment is to clarify that a change in beneficial ownership takes place whenever securities are cancelled or redeemed, and whenever there is any acquisition of any of the rights or entitlements attaching to a security. The proposed amendment will apply to every change in beneficial ownership on or after 1 January 2006.

Subclause (b): The proposed amendment is consequential upon the deletion of uncertificated securities tax on the issue of securities with effect from 1 January 2006.

CLAUSE 128

Uncertificated Securities Tax: Substitution of section 2 of the Uncertificated Securities Tax Act, 1998

It often occurs that the Minister of Finance announces a change in the rates of certain transaction taxes in the Budget Review with effect from a date which precedes the date on which the legislation which gives effect to that rate change is promulgated. Implementing these changes before the legislation is in place becomes problematic as there is no legislation on which a person can rely when paying the reduced amount of tax in respect of the issue or transfer of beneficial ownership in a security.

It is, therefore, proposed that a provision be inserted in the Uncertificated Securities Tax Act, 1998, to address this issue. This will ensure that the proposed changes to the rates apply with effect from the date determined by the Minister in the Budget Review and that the changes lapse at the earlier of the date on which the legislation giving effect thereto is promulgated or, if no such legislation is passed, after 6 months from the date so determined.

CLAUSE 129

Uncertificated Securities Tax: Repeal of section 3 of the Uncertificated Securities Tax Act, 1998

The proposed deletion of section 3 of the Uncertificated Securities Tax Act is consequential upon the deletion of uncertificated securities tax on the issue of marketable securities with effect from 1 January 2006. The proposed amendment will come into operation on 1 January 2006.

CLAUSE 130

Uncertificated Securities Tax: Amendment of section 5 of the Uncertificated Securities Tax Act, 1998

The proposed amendment is consequential upon the insertion of section 5A into the Uncertificated Securities Act, and will apply to every change in beneficial ownership on or after 1 January 2006.

CLAUSE 131

Uncertificated Securities Tax: Insertion of section 5A in the Uncertificated Securities Tax Act, 1998

The proposed amendment is to protect the uncertificated securities tax base against changes in beneficial ownership that take place outside the ambit of sections 4 (brokers) and 5 (participants). This would, for example, be the case where a client of an offshore bank sells its South African securities to another client of the same offshore bank. In that case, although there is a change in beneficial ownership, the transaction falls outside the ambit of sections 4 and 5 of the Uncertificated Securities Tax Act as no South African broker or participant is involved. The proposed amendment will apply to every change in beneficial ownership on or after 1 January 2006.

CLAUSE 132

Uncertificated Securities Tax: Amendment of section 6 of the Uncertificated Securities Tax Act, 1998

The proposed deletion of paragraph (1)*(a)* of section 6 of the Uncertificated Securities Act is consequential upon the deletion of uncertificated securities tax on the issue of marketable securities with effect from 1 January 2006.

CLAUSE 133

Uncertificated Securities Tax: Amendment of section 7 of the Uncertificated Securities Tax Act, 1998

Subclause (a): The proposed deletion of paragraph (1)*(a)* of section 7 of the Uncertificated Securities Act is consequential upon the deletion of uncertificated securities tax on the issue of marketable securities with effect from 1 January 2006. The proposed amendment will come into operation on 1 January 2006.

Subclause (b): This amendment is of a textual nature.

Subclause (c): The proposed insertion of paragraph *(c)* into section 7(1) of the Uncertificated Securities Act is consequential upon the insertion of section 5A into the Uncertificated Securities Act, and will apply to every change in beneficial ownership on or after 1 January 2006.

CLAUSE 134

Income Tax: Amendment of section 54 of the Revenue Laws Amendment Act, 2003

The definition of unbundling transactions was amended during 2003 with retrospective effect from 6 November 2002. In terms of the new definition an unbundling company had to distribute all the shares it holds in the unbundled company. The previous definition did allow for partial unbundling transactions. This proposal accommodates unbundling transactions which were effected in the period between 6 November 2002 and the date of promulgation of the retrospective amendment so as to allow an unbundling company to elect that the previous rules be applied to unbundling transactions which took effect within this period.

CLAUSE 135

Customs and Excise: Amendment of section 30 of the Second Revenue Laws Amendment Act, 2004

Section 30(1)(b) of the Act amended section 96 of the Customs and Excise Act, 1964, by making the period of prescriptive extinction relating to the institution of judicial proceedings also subject to the provisions of section 77F(2).

Section 77F(2) provides that the period within which a person may institute judicial proceedings following the consideration of his or her appeal shall commence on the day the Commissioner or chairperson of the committee advises the person concerned of the final decision of the appeal.

Section 77F(2) has now been deleted consequential to an amendment to section 96, which provides for the date of extinctive prescription for instituting judicial proceedings relating to matters decided under the internal administrative appeal, the alternative dispute resolution or settlement procedures.

The proposed amendment deletes subsection (1)*(b)* consequential to the amendment to section 96 and also substitutes subsection (2) which provided for the date which subsection (1)*(b)* would have come into operation.

CLAUSE 136

Short title and commencement

This clause provides for the short title and commencement date of the Bill.