Budget reaction - Cliffe Dekker Hofmeyr tax team

The Cliffe Dekker Hofmeyr tax team have shared their individual reactions to this year's Budget Speech by Finance Minister Pravin Gordhan, covering share schemes, cross-issue of shares, retirement reform, VAT registration of foreign businesses, and more.

Share schemes (Andrew Lewis, senior associate, tax)

Share incentive schemes are, once again, in the spotlight in this year's tax budget proposals. It appears that previous amendments have not satisfied the Treasury's concerns on share incentive schemes. The Treasury indicates that some staff equity schemes are used as a tool to lower overall tax rates for executives and other-high-income earners. Schemes for lower income taxpayers are sometimes subject to anomalies that may give rise to double taxation.

It thus appears that the broad-based employee share plan contemplated in s8B of the Income Tax Act will be reviewed and possibly merged with s8C of the Income Tax Act into a single employee share scheme regime. Section 8B schemes are not used by many taxpayers owing to the onerous requirements. If the s8C and s8B share scheme provisions are combined, it is anticipated that it will be to the detriment of high-nett-worth individuals.

It is also indicated that the interrelationship between employer deductions and employee share scheme income will be examined by the Treasury. It is anticipated that one of the South African Revenue Service's concerns is that taxpayers currently argue that the contributions to the employee share scheme for their employees are deductible (see Provider vs Commissioner of Taxes, 17 SATC 40), while the contributions received by the trust are capital in nature on the basis that the trust is not engaged in a profit-making scheme (see CIR vs Pick 'n Pay Employee Share Purchase Trust 54 SATC 271).

Cross-issue of shares (Andrew Lewis, senior associate)

Section 24B of the Act was initially introduced to deal with the acquisition of assets through the issue of shares. Pursuant to the judgment of CIR vs Labat Africa Limited 72 SATC 75 a company would ordinarily not incur expenditure in connection with the issue of its own shares and, thus, the need for s24B. Section 24B of the Income Tax Act was recently amended only to deal with the issue of shares in exchange to the issue of shares (i.e. the cross-issue of shares), being an "anti-avoidance" provision.

Section 24B(2) of the Income Tax Act provides that if a company acquires shares that are issued to that company "directly or indirectly in exchange for shares issued by that company", that company incurs no expenditure for the acquisition of the shares issued to it. As a result, the subsequent disposal of the shares by the company may trigger a significant tax liability (i.e. the tax liability being determined with no tax base).

The Treasury has recognised that this anti-avoidance rule is impractical in South Africa, because cross-issues are a common feature of many commercially driven share schemes (especially involving black economic empowerment (BEE) parties). For instance, many BEE transactions were implemented on the basis that the empowerment company (BEE CO) would issue preference shares in the empowered company (OPCO) and use the subscription price thereof to subscribe for ordinary shares in OPCO. Section 24B(2) of the Income Tax Act had the effect that the shares in OPCO would have no base cost, triggering significant adverse tax implications for BEE CO on the disposal thereof.

It will be a welcome relief to taxpayers and advisers alike that the proposal by the National Treasury is for these anti-avoidance rules to be reworked. The zero base cost rule will either be eliminated or narrowed. In addition, cross-issues (and share-for-share-transactions) acting as a mechanism to indirectly shift value into tax exempt hands will trigger immediate taxation.

Gateway subsidiary/Treasury company (Andrew Lewis, senior associate, tax)

A very interesting proposal by the Treasury is to allow South African multinationals to treat a single local subsidiary as a non-resident company for South African Reserve Bank (SARB) purposes and, thus, promote the establishment of all its Treasury operations to remain in South Africa. In other words, it appears that it will effectively be exempt from the exchange-control restrictions imposed by the SARB.

The Treasury indicated that it is not uncommon for such South African multinationals to use an offshore subsidiary as a Treasury operation as these offshore treasuries could freely move currency without regulatory approval. The SARB regulations thus created an incentive to move the Treasury operations offshore, or rather, a disincentive to conduct the Treasury operations in South Africa.

It is also indicated that these exchange control-exempt entities will be entitled to use their foreign functional currency (e.g. US dollars), rather than the South African rand, as the starting point for their tax calculations.

Withholding taxes - extended to service fees (Andrew Lewis, senior associate, tax)

Taxpayers have been anticipating the introduction of a withholding tax on interest paid to non-residents for a number of years now. The effective date for the commencement of the withholding tax on interest will be further delayed from 1 July, 2013, to 1 March, 2014. The royalty withholding tax to be imposed at a rate of 15% (which is currently imposed at a rate of 12%) will also be delayed until 1 March, 2014.

Most significantly, it is proposed that a withholding tax, presumably at a rate of 15%, will be imposed on service fees paid to a non-resident (subject to the applicable treaty relief). The withholding tax on service fees will also be effective from 1 March, 2014. It will be interesting to see how the legislature defines "service fees" or "services" to determine how far reaching this amendment will be.

Retirement reform (Alastair Morphet, director, tax)

The Treasury released a further Consultation Paper together with the Budget documentation. The reform Consultation Paper is trying to bring together the strands of thinking that were set out very clearly in the four papers released by the National Treasury in September/October 2012.

From a tax perspective the critical issues are that the government will proceed with the implementation of tax preferred savings and investment accounts (along the lines of the UK's ISA). All returns accrued on these accounts and any withdrawals would be exempt from tax. The account would have an initial annual contribution limit of R30 000 and a lifetime limit of R500 000, which it is intended to put up in line with inflation. These new accounts will be introduced by April 2015.

At present, the current tax-free interest income annual thresholds continue, but with effect from 1 March, 2013, is put up to R34 500 for individuals 65 years and over, and from R22 800 to R23 800 for individuals below 65 years. These thresholds will not be adjusted for inflation in future.

With regard to individuals' contributions to pension and retirement annuity funds, the Treasury is planning to implement legislation, and it is not clear whether this would be effective in March 2014 or some time in 2015, in terms of which employer's contributions will be treated as a fringe benefit. Individuals will be permitted to deduct from their taxable income or their employment income up to 27.5% for a contribution to such fund, up to a maximum of R350 000. Last year they were considering having two different scales depending on your age, and have obviously decided to streamline this with one flat rule.

It is further proposed that the annuitisation requirements of pension funds will start to apply to provident funds from a certain date. Existing balances in provident funds, and the growth on them, will not be subject to annuitisation. This requirement will not apply to provident fund members older than 55 years at the date of implementation of the new legislation. The government's goal is to reduce the complexity of the retirement system. It is proposed that contributions in excess of the annual cap of R350 000 could be rolled over to future years.

The Consultation Paper indicates that the means test for the old-age grant will be phased out by 2016; and the de minimus requirement for annuitisation of retirement funds will be raised from R75 000 to R150 000. It appears from the executive summary that living annuities will be eligible for selection as a default product from a retirement fund, provided that certain design tests set out by the Treasury are met. Trustees who make commission-free financial advice available to members on retirement, paid for out of the fund, will be given some legal protection in respect of the choice of default offered to members.

An interesting point is raised under the heading "Taxpayers with multiple sources of income". These people are often faced with high tax liabilities on assessment, because of the aggregation of their incomes. Individual employers, and particularly pension funds, are typically unaware that there are two or more income streams for an employee or pensioner, and each calculates the PAYE as if there was only one. The government will look to address this during the course of the next year. It is considering either higher levels of withholding by employers (but it acknowledges confidentiality as a concern), holding employees responsible for the PAYE at a higher tax rate to take into account the aggregation effect; SARS informing such taxpayers and suggesting preventative measures, and possibly temporary relief in the case of widows/widowers.

Mineral and petroleum royalties (Alastair Morphet, director, tax)

The Mineral and Petroleum Resources Royalty Act of 2008 has been in operation for three years. SARS has indicated that it is concerned about the appropriate specified condition of mineral extraction acting as a reference point on which to calculate the mineral royalty tax base, and the interaction of the royalty regime rate with the income tax calculation and the information reporting requirements under the Royalty Administration Act. The other issue that has drawn a lot of public concern is that the African National Congress at its Manguang conference wanted the government to consider a resource rent tax as a form of super tax when mining companies earn super profits at the height of a commodity cycle.

As the president had indicated in his State of the Nation address, the government has referred these issues concerning what is an appropriate tax for the mining system in South Africa for a broader review by the National Treasury. The Budget review expressly states that an appropriate mining tax regime must ensure that South Africa remains a competitive investment destination. The document says that the royalty regime has broadened the tax base and has allowed for increased revenue during periods of high commodity prices, while providing relief to marginal mines when commodity prices are low.

VAT registration of foreign businesses (Carmen Moss-Holdstock, associate, tax)

The tax issues associated with e-commerce on the Internet remain largely unresolved. Enforcement of tax compliance is generally reliant or can be pin-pointed to geographical areas; however in cyber space or the Internet world these geographical boundaries do not exist. The underlying question is whether existing direct and indirect principles can be successfully implemented in imposing and enforcing the taxation of e-commerce. E-commerce changes things of fundamental importance from a direct and indirect tax perspective.

It allows a foreign vendor who essentially has no physical presence to sell into another territory and bypass the payment of any local taxes that may have been imposed on a source basis, i.e. the purchase of e-books by a consumer or music, where there are no checks in place from a collection mechanism as opposed to the delivery of physical goods that must bypass customs. E-commerce has created a whole new way of thinking in terms of creating products previously sold in the form of tangible property, intangible property and services. If existing tax rules are applied there can be a significant change from "technology importing countries" to "technology exporting countries". The obvious issue that arises is what if the foreign vendor is based in a tax haven; does the vendor escape taxation altogether?

It was proposed in the budget speech that in order to curtail foreign businesses who supply goods and services essentially in cyber space from escaping the VAT net that all foreign business supplying digital goods and services will be required to register as VAT vendors in South Africa. This line of thinking follows the current trend adopted by the European Union, requiring such suppliers to register for VAT in the country where the consumer resides. The question of whether non-residents need to register as vendors in South Africa has been the subject matter of much debate over the years. Generally, a person would not be regarded as carrying on a business or other activity in a country unless that person either has a physical presence in the country or the person provides goods or performs services in that country personally or through an agent.

VAT is an indirect tax that applies across the board to almost all supplies of goods and services, and is essentially levied at every stage of production and in the distribution chain. The VAT Act provides for the imposition of VAT in respect of the supply of goods and services, and on the importation of goods and services. Persons who make taxable supplies in the course or furtherance of an enterprise conducted wholly, or partly, in South Africa are required to register as vendors, provided the minimum turnover threshold is reached. Vendors collect output VAT from their customers and claim credits for input VAT paid by them.

The immediate problem that arises is enforcement, such as determining the location of the vendor, or where the goods or services were produced or manufactured and/or delivered, establishing what was purchased and where the purchaser is located.

Debt restrictions (Heinrich Louw, associate, tax)

SARS will once again be focussing on restricting interest deductions on certain debt and debt instruments as it was proposed that certain provisions will be introduced in respect of artificial debt, connected person debt and certain acquisitions of debt.

In a previous Bill provisions regarding the re-characterisation of debt instruments with certain equity features (so-called artificial debt re-characterisation) were introduced. These provisions did, however, not make it into the final Amendment Act. It is now proposed, without giving any specifics, that debt instruments that will not realistically be repaid within 30 years, or convertible debt-instruments, will be re-characterised as shares and interest deductions in respect of such instruments would, therefore, not be allowed.

It is noted that these provisions will not apply to banks and insurers, which should provide some relief for those who have issued such instruments in the context of certain funding transactions.

Debt issued to creditors who are connected persons is also to be curtailed in circumstances where the creditor is an exempt entity, such as a public benefit organisation. Ordinarily, the taxpayer would be able to claim an interest deduction, but SARS cannot tax the exempt entity. It is proposed that deductible interest on such debt does not exceed 40% of earnings, after taking into account other interest. Any excess interest can, however, be rolled over for up to five years.

The deduction of interest on acquisition debt will also be limited. Companies can often secure large interest deductions in this regard that effectively eliminates their taxable income over a long period. Exact details were not provided and it will be interesting to see how SARS intends to implement this policy decision.

Unlisted REITS (Alastair Morphet, director, tax)

A Real Estate Investment Trust (REIT) is a listed company or property unit trust that invests in immovable property, receives income from rental and pays it through to its investors. In terms of new legislation, which becomes effective 1 April, 2013, a REIT can deduct such distributions if it resides in South Africa, is listed and at least 75% of its gross income is rental income.

There has been much concern that this regime is going to leave unlisted REITS horribly exposed, particularly when SARS looks to introduce legislation to deal with what is today described as artificial debt. This really relates to the debenture portion of a property-linked unit, where the debt instrument is not likely to be repaid in 30 years. SARS is now looking to re-characterise some of these debt instruments as shares if they have certain stipulated features.

Accordingly, the Budget Review indicates that the REITS legislation will look to extend to unlisted REITS provided they are subject to similar regulation as listed REITS. It does not indicate how this regulation is going to be introduced (currently the JSE Limited is the regulator of listed REITS). The Treasury would want it to be extended to wholly owned entities of private and government pension funds, as well as the long-term insurers. It appears that they may be considering the legislation to deal with property syndication, because it indicates that REITS tax relief would be extended to cover other real estate entities subject to such regulation. Moreover, it indicates that the property syndication legislation needs to protect investors from the Ponzi schemes which we have seen over the last couple of years.

Carbon tax, energy-efficiency savings and the electricity levy (Danielle Botha, associate, tax)

In the 2012/13 Budget, it was proposed, in line with the Climate Change Response White Paper approved by the Cabinet in 2011, that carbon tax would be implemented in 2013/14 at a rate of R120 per ton of CO2 on direct emissions. This rate was to be increased at 10% per annum until 2019/20.The carbon emissions tax would be percentage-based rather than having emissions thresholds.

The 2013/14 Budget proposes implementation of carbon tax effective 1 January, 2015, in accordance with the rates suggested in 2012/13, being R120 per ton of CO2 on direct emissions, increasing at 10% per annum during the first implementation phase. During the first phase of implementation between 2015 and 2020, a basic tax-free percentage threshold of 60% is proposed as previously suggested. Off-set percentages of 5 to 10% aim to incentivise emission-intensive and trade-exposed industries to invest in and develop emission reducing projects outside of their ordinary operations, thus reducing their carbon tax liabilities.

We await the publication of an updated policy paper by the end of March 2013 for comment and consultation. It is further suggested that some of the revenues generated through the carbon tax will be used to fund energy-efficient savings tax incentives. The implementation of the carbon tax envisages the possibility that the electricity levy will gradually be phased out.

The government has proposed an extension of the incentive related to the exemption of income from Clean Development Mechanism projects until 31 December 2020, in light of the second commitment period of the Kyoto Protocol.

Increase in vehicle CO^2 tax emissions, plastic bag and incandescent bulb levies

(Danielle Botha, associate, tax)

This tax encourages consumer to buy vehicles with lower carbon emissions and data shows declining average carbon emissions since its inception. An increase from R75 to R90 for every gram of emissions/km above 120g CO^2/km is proposed. For double-cabs an increase from R100 to R125 for every gram in excess of 175g CO^2/km, effective 1 April, 2013.

Effective 1 April, 2013, it is proposed that plastic bag levies will increase from 4c/bag (since 2009) to 6c/bag; the environmental levy on incandescent light bulbs increasing by R1 per bulb to R4 per bulb.

Public-benefit organisations (Danielle Botha, associate, tax)

Previously, donations up to a maximum of 10% of taxable income, made to PBOs in areas including environmental, welfare and humanitarian activities, were deductible. In order to encourage larger donations, a roll-over of donations to PBOs in excess of 10% of taxable income in any given year is proposed and may be deducted in subsequent years.

Rules regarding the funding of PBOs by other PBOs are also under consideration.

Increase in fuel levies (Nicole Paulsen, associate, tax)

With effect from 3 April, 2013, the government proposes to increase the general fuel levy and the Road Accident Fund Levy by 22.5c/l and 8c/l, respectively.

Notwithstanding the proposed increases, it must be noted that since April 2010, the general fuel levy included an additional levy component of 7.5c/l for a new multi-product pipeline. This additional levy was included in the general fuel levy to help fund the construction of additional pipeline capacity and was introduced for a period of 36 months. This additional levy component will end on 2 April, 2013. Accordingly, the nett increase in the general fuel levy on 3 April, 2013, will only be 15c/l and not the full 22.5c/l. Furthermore, the demand-side levy on 95 octane petrol sold inland will be increased on a date to be determined later this year.

Proposed gambling tax (Nicole Paulsen, associate, tax)

In 2011, the government announced a national gambling tax proposal, that with effect from 1 April, 2012, all gambling winnings above R25 000, including those from the National Lottery, would be subject to a final 15% withholding tax. It was also indicated that similar gambling taxes exist in India, The Netherlands and the United States. According to the Minister the proposed gambling tax would assist in discouraging excessive gambling in South Africa.

In the 2013 Budget Speech, it was announced that a national tax based on gross gambling revenue of casinos would be introduced at a rate of 1% in addition to the provincial rates. Accordingly, any proceeds derived by a taxpayer from gambling will be subject to an additional 1% levy on top of an existing provincial gambling tax base of 1%.

Although it was announced in the 2012 budget that the proposed tax would be introduced from 1 April, 2013, the announcement made in the 2013 budget gives no indication of a specific date, but rather states that the proposed gambling tax is to be implemented before the end of 2013.