

**REPORT ON**

**THE EFFICIENCY OF SOUTH AFRICA'S CORPORATE INCOME  
TAX SYSTEM**

**FOR THE MINISTER OF FINANCE**

Intended use of this document:

*The Davis Tax Committee is advisory in nature and makes recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.*

*As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.*



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**THE DAVIS TAX COMMITTEE**

March 2018

**Dear Minister**

We, as the Members of the Davis Tax Committee, have the honour and privilege to provide you with this report which has been:

**Prepared by:**

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**And the Secretariat for the Davis Tax Committee**

## REVIEW OF THE EFFICIENCY OF SOUTH AFRICA'S CORPORATE INCOME TAX SYSTEM

### (i) THE DAVIS TAX COMMITTEE

Following the announcement by the Minister of Finance in the 2013 Budget to set up a tax review committee, the Davis Tax Committee (DTC)<sup>1</sup> was formed on 17 July 2013 to inquire into the role of South Africa's tax system in promoting inclusive economic growth, employment creation, economic development and fiscal sustainability. The DTC is expected to take into account recent domestic and international developments and, in particular, the long-term objectives of the National Development Plan. The terms of reference required the DTC to (among others) review of the corporate tax system of South Africa with special reference to:

- (a) the efficiency of the corporate income tax structure;
- (b) tax avoidance (e.g. base erosion, income splitting and profit shifting, including the tax bias in favour of debt financing);
- (c) tax incentives to promote developmental objectives and;
- (d) average (marginal) and effective corporate income tax rates in the various sectors of the economy.

With respect to reviewing the efficiency of South Africa's corporate income tax structure the DTC set up a Corporate Income Tax Sub-committee on 31 October 2016,<sup>2</sup> which prepared this report that sets out the DTC's position. It should, however, be borne in mind that:

- (a) corporate income tax issues pertaining to tax base erosion and profit shifting (BEPS) and tax avoidance are dealt with in the DTC Report on BEPS;
- (b) tax administration issues pertaining to corporate tax are dealt with in the DTC report on tax administration;
- (c) corporate income tax issues pertaining to the mining sector have been dealt in the DTC Report on the mining sector.

This report, thus, reviews other aspects of the South Africa's corporate income tax structure that impact on its efficiency and comes up with recommendations for reform

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<sup>1</sup> Chaired by Judge Denis Davis: Members Prof Annet Wanyana Oguttu, Prof Matthew Lester, Prof Ingrid Woolard, Dr Nara Monkam, Dr Tania Ajam, Prof N Padia, Professor Thabo Legwaila and Professor Deborah Tickle. Two officials, one from the National Treasury, Mr Cecil Morden, and Mr Kosie Louw from the South African Revenue Service, serve as ex-officio members in a technical, supportive and advisory capacity. National Treasury and SARS also provide secretarial and logistical support to the Committee.

<sup>2</sup> The Corporate income tax Sub-committee is Chaired by Prof Annet Wanyana Oguttu (College of Law, University of South Africa; Qualifications: LLD in Tax Law - UNISA, LLM with Specialisation in Tax Law - UNISA), LLB - Makerere University, Uganda, H Dip in International Tax Law -University of Johannesburg). Member: Prof Thabo Legwaila (LLD) University of Johannesburg; Prof Deborah Tickle (Chartered Accountant with IRBA and SAICA; Technical advisor to KPMG; Adjunct Associate Professor at UCT; Qualification: B.Com Honours Taxation - University of Cape Town).

where the current structure is considered inefficient (economically and/or administratively), potentially also leading to reduced tax morality.

## **(ii) ACKNOWLEDGEMENTS**

In its review of the corporate tax structure of South Africa, the DTC's Corporate Income Tax Sub-committee consulted with various stakeholders. These included: business representatives, trade unions, civil society organisations, tax practitioners, SARS, National Treasury, members of international bodies (like the World Bank), and academics, all of whom have contributed through submissions of technical reports on various issues pertaining to the corporate tax structure of South Africa. Technical reports on corporate tax were, for instance received from: SACTWU, COSATU, CFO Forum, ASISA, SAIPA, SAIT, SAICA, BDO Tax Services, PWC, KPMG, ENS, Cliffe Dekker Hofmeyr, BASA, SARS, University of Free State, Chamber of Mines of South Africa, BUSA, Doornkraal, the Department of Sports and Recreation and submissions sent by Ms AD Koekemoer (with permission from her supervisor) from her draft PhD thesis 2017, University of Pretoria). The DTC also requested the World Bank, to provide impartial input, on the efficiency of tax incentives in South Africa.

## **(iii) EXECUTIVE SUMMARY**

### **1 Background**

In compiling the Corporate Income Tax (CIT) report and in order to ensure the recommendations are practical, in both the short-term and the long-term, the DTC has borne in mind South Africa's current economic position as well its future outlook. The DTC recognises that a review of the CIT regime cannot be considered in isolation of the current macroeconomic environment which is characterised by weak domestic economic growth, low business confidence, stubbornly high and unsustainable levels of unemployment and inequality, a challenging and uncertain global economic environment and the serious economic consequences of the sovereign ratings downgrades by Standard & Poor's, Fitch and Moodys. In the current context of low economic growth, it is critically important to ensure that taxes are raised in a manner that is, *inter alia*, least disruptive to economic growth and employment. Corporate tax has to comply with the principles of all the principles of good tax system (fairness, simplicity, certainty, efficiency). Consequently, the recommendations in the CIT report are, if implemented, designed to play a significant role in ensuring the efficiency of the corporate tax structure which may, in turn, assist in building confidence in private sector investment and thereby encourage economic growth.

### **2 Review of the efficiency of South Africa's CIT system**

To determine the efficiency of South Africa's CIT system, the report first provides a review of international corporate tax systems as compared to South Africa's CIT system. Then the report considers the impact that the corporate tax system has on corporate decisions, and

how such decisions impact on the efficiency of the system. In particular, the report considers how the choice to distribute profits or capital distributions impacts on the efficiency of the system; and also how the choice of financing companies using debt or equity impacts of the efficiency of the system.

### **3 Review of the efficiency of the corporate income tax rate**

The report then considers the efficiency of the current CIT rate of 28%. This analysis looks, firstly, at arguments in favour of decreasing South Africa's corporate tax rate in light of its potentially reduced competitiveness when compared to South Africa's trading partners (e.g. the UK and the USA) and neighbours (e.g. Mauritius and Botswana) which have reduced their rates to considerably lower than 28%. Thereafter, arguments for not decreasing the corporate tax rate were evaluated, taking into consideration the World Bank Report on the effective burden for South Africa. In determining what an efficient corporate tax rate could be, it is necessary to take a holistic view that takes into account the efficiency of the dividends tax rate and the capital gains tax ("CGT") corporate inclusion rate.

It was determined that any change to the corporate tax rate must be made with the necessary circumspection, as it may not only require one to look at the applicable rate used by trade partners but also to take into account the different allowances and exemptions regimes (incentives). The World Bank Report on "Effective Tax Burden & Effectiveness of Investment Incentives in South Africa",<sup>3</sup> did exactly that, concluding that while South Africa's statutory corporate tax rate may be somewhat higher than that in other countries, the system overall is not a major deterrent to investment. Some common obstacles to investment noted across sectors were the reliability of electricity supply, labour relations, and policy uncertainty and it is only once these factors are addressed that a decreased CIT rate may viably assist in attracting investment and thereby stimulating growth.

It was also established that countries that attract foreign direct investment by offering lower tax rates are not necessarily more competitive than countries with high tax rates. The competitiveness of a tax system cannot, therefore, only be judged by rates, incentives or even by reference to the overall tax burden.<sup>4</sup>

In order to have a tax system that contributes to a competitive economy, it is necessary to focus on the quality of the tax system by ensuring that tax evasion is reduced and that the principles of efficiency and neutrality are adhered to in the treatment of corporate groups.<sup>5</sup>

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<sup>3</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015).

<sup>4</sup> European Commission *Press Release: Competitive Tax Policy and Tax Competition in the EU (2011)*. Available from: [http://europa.eu/rapid/press-release\\_SPEECH-11-712\\_en.htm?locale=en](http://europa.eu/rapid/press-release_SPEECH-11-712_en.htm?locale=en) [Accessed: 2016-10-12].

<sup>5</sup> Ibid.

Overall, and taking into account the findings of the World Bank reports for the DTC on the cost-benefit of some tax incentives offered to corporates (see section 6 below), it was concluded that, whilst a reduction in the CIT rate on its own cannot be sustained under the current economic climate in South Africa, a detailed review of the cost-benefit of each tax incentive currently provided through the mechanism of the CIT system with a view to removing inefficient incentives that do not achieve their objectives, could effectively be used to reduce the overall CIT rate or other tax handles.

#### **4 Review of the efficiency of the dividends tax rate**

With effect from 1 March 2017, government increased the dividend withholding tax rate from 15% to 20%, effective 22 February 2017. Insofar as the efficiency of the 20% dividends tax rate and CGT inclusion rate is concerned, it was determined that the 20% dividends tax rate gives rise to certain negative outcomes. In particular the impacts on BEE policy objectives and investment decisions were highlighted.

The DTC recommends that the dividends tax rate be reduced back to 15%. Policy makers should ensure that taxes are not increased merely for the purposes of satisfying revenue collections. It is furthermore recommended that consideration be given to allowing investors in foreign shares to deduct the costs they incur in generating taxable dividends.

#### **5 Review of the efficiency of the CGT corporate inclusion rate**

The CGT inclusion rates of less than 100 per cent of net capital gains in taxable income were designed to provide relief from the effects of inflation on capital gains.<sup>6</sup> In effect, though, the CGT inclusion rate regime did not provide an appropriate mechanism for the impact of inflation on the increase in an asset's value over time.<sup>7</sup> In addition, as a revenue raising technique, over the last four years, the CGT inclusion rates for corporates have been increased dramatically from 50% to 66.6% to 80%, without consideration of the impact of inflation. The combined result of the absence of an appropriate mechanism to exclude the impact of inflation on the increase in an asset's value over time and the increasing inclusion rates, imply that nominal gains are taxed without sufficient recognition of the dramatic effect of inflation on an asset's base cost in real terms. This is particularly relevant in an inflationary environment such as our current one in which inflation hovers around 6%<sup>8</sup>.

The DTC, thus, recommends that the policy perspectives regarding the levying of CGT need to be balanced, that the CGT regime be reviewed and that the inclusion rate be reduced to levels which adequately compensate for the effects of inflation or, alternatively, that an indexation system be considered whereby an asset's base cost is stepped up to

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<sup>6</sup> BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4.

<sup>7</sup> BASA Technical Report on Corporate Tax submitted to the DTC (30 March 2017) para 5.

<sup>8</sup> The Reserve Bank targets a 6% inflation rate.

compensate for the effects of real inflation in any particular sector, so as to better approximate real gains.<sup>9</sup> Although complex to apply, the DTC favours an indexation formula in order that assets that are held for a short time are not favoured over those held for a very long time, as is the case with the inclusion rates.

## **6 Effective tax burden and effectiveness of corporate tax incentives**

The DTC requested the World Bank to review a list of key tax incentives which are available to corporate taxpayers through the South African income tax legislation, so as to determine the effectiveness of the investment incentives on encouraging investment. The World Bank issued three reports for the DTC. In the first report issued in 2016 on 'South Africa: Sector Study of Effective Tax Burden and Effectiveness of Investment Incentives in South Africa – Firm Level Analysis',<sup>10</sup> the World Bank referred to incentives in general, but did not conclude on the efficiency of particular incentives. Its overall conclusion is "that tax incentives may not be effective in all sectors because there may be other fundamental factors that restrict the growth of the sector that the tax incentive on its own cannot fix. However when properly targeted there is positive impact on investment as they lower the cost of investment encouraging investment in those sectors that are primed for growth when fundamental economic factors are conducive". The World Bank subsequently issued a second report for the DTC in 2017 on the Research and Development incentive<sup>11</sup> wherein it was concluded that the section 11D research and development incentive may be seen as a successful tax incentive".<sup>12</sup> Details of the analysis are in the main Report.

In January 2018, the World Bank submitted a third report to the DTC on the effectiveness of the specific incentives related to Small Business Corporations and the specific incentives targeting property investment.<sup>13</sup> The World Bank found that "the reductions in user cost of capital through investment incentives aimed at increasing property investment has a positive impact on investment in all sectors except Mining".<sup>14</sup> On the impact of tax incentives aimed at SBCs in the form of a graduated rates of corporate tax reaching a maximum at the normal corporate income tax rate as well as incentives aimed specifically at investments by SBCs, the World Bank found that "incentives have some impact on investment but only for certain sectors".

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<sup>9</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 3.3; BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4.

<sup>10</sup> Issued June 2016

<sup>11</sup> Section 11D, inserted in November 2006 into the Income Tax Act (No58 of 1962) as amended.

<sup>12</sup> World Bank "Effectiveness of the Research and Development Incentive in encouraging investment" issued October 2017.

<sup>13</sup> World Bank - Southern Africa Country-level fiscal policy notes – "South Africa: Effectiveness of Investment Incentives in South Africa – Small Business Incentives and Section 13 Incentives" October 2017.

<sup>14</sup> World Bank - Southern Africa Country-level fiscal policy notes – "South Africa: Effectiveness of Investment Incentives in South Africa – Small Business Incentives and Section 13 Incentives" October 2017 at 7.

In light of the three World Bank reports the DTC recommends that National Treasury and SARS review each and every tax incentive through commissioned studies to determine why each incentive is justified; which incentives do not achieve their objectives; and the cost-benefit of retaining the incentive(s) versus an overall reduction in the corporate tax rate based on the reduced cost of eliminated incentives (see section 3 on corporate tax rates, above).

Thus, in conducting this review, the DTC suggests that Treasury and SARS consider the option, which is currently being adopted in many other countries, of removing some or all targeted incentives and replacing them with an overall corporate tax reduction aimed at incentivizing all businesses (those identified and those not yet conceived of, as well as small businesses) simultaneously.

## **7 Reviewing of the corporate restructuring rules**

The DTC's review of the corporate restructuring rules found that:

- (a) The rules-based nature of the provisions makes them very mechanical and thus not user friendly or necessarily achieving their objectives;
- (b) The asset-for-share transaction relief effectively leads to the imposition of double taxation and is thus not necessarily effectively achieving its objectives;
- (c) The roll over rules are riddled with complex anti-tax avoidance provisions which hampers their efficacy;
- (d) The fragmented anti-avoidance rules cause unnecessary complexity;
- (e) The use of section 46 of the Act is limited for unlisted companies which inhibits the ability of that section to achieve the objectives of the corporate rules; and
- (f) Consideration should be given to the cross-border application of group restructuring rules.

Based on these findings the DTC makes the following general recommendations regarding the group restructuring rules:

- (a) Consideration should be given to replacing the rules-based nature of the provisions to be more principle based;
- (b) Amendment is required to ensure the asset-for-share transaction relief does not effectively lead to the imposition of double taxation;
- (c) A review of the anti-tax avoidance provisions is recommended, to remove those that hamper the efficacy of the corporate rules. This review would be aimed at removing complexity and relying on the general anti-avoidance provisions of the legislation. The aim with those specific anti-avoidance provisions that remain would be to simplify those aspects which make them difficult to understand and apply;
- (d) Consideration could be given to expanding section 46 of the Act to more unlisted companies;



- (e) Aspects of the corporate rules dealing with offshore funds should be reconsidered by SARS and Treasury, but bearing in mind that the restructuring group rules are designed only to defer tax and not to eliminate it altogether; and
- (f) Consideration be given to loss transfers based on the conclusions reached on group taxation (see below).

## **8 Will the introduction of group company taxation enhance the efficiency of South Africa's tax structure?**

The shortcomings of the corporate rules led the DTC to question whether the introduction of group company taxation might rather enhance the efficiency of South Africa's corporate tax structure and, if so, in what format might it do this? In answering these questions the objectives and advantages of group taxation were reviewed, together with the drawbacks to introducing group taxation. Global group taxation models were similarly evaluated against policy considerations that underpin group tax systems.

Based on the review performed, the DTC recognises the attractiveness of a full group tax system for South Africa and it recommends that if group taxation were to be introduced in South Africa, a "group relief or loss transfer" model (which was the first option thought ideal by the both the Margo and Katz Commissions) would be the best option. A phased approach could be considered, starting with the addition of the set off of assessed losses to the corporate rules, which would thus largely be a simple adjustment to what South Africa currently has i.e.:<sup>15</sup>

- The current elements of "group taxation" set out in the Act (the corporate rules), principally those that permit the tax-free transfer of assets between group members, should be retained, on the basis that they continue to be refined;
- Provision could be made for loss sharing between "group" members to a tax neutral position, i.e. losses transferred may not create a loss in the transferee company, and pre-existing losses may only be set off against the company's income and not the group's;
- The "group" for the purposes of the legislation should exclude non-resident companies. However, consideration could be given to including South African companies which are held by non-resident holding companies in the definition of "group" in order to determine which South African companies qualify to be included in the South African group for the purposes of the 'group tax' legislation. Although not favoured, later consideration could be given to including 100% held non-resident companies in the 'group tax' regime;
- The regime could be operated on a compulsory or an elective basis. If elective, election should be made on a "one in, all in" basis (i.e. all members of the group must participate, so that all group members with losses must transfer those losses to group companies with taxable income), for a minimum period of e.g. three years, with three year roll over periods.

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<sup>15</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

The DTC, however, submits that the timing of the introduction of such a system would need to be aligned with a more positive economic environment in South Africa, together with a determination as to whether SARS is adequately resourced to handle group taxation. In the meantime, the corporate restructuring rules should be reviewed and expanded upon if situations are discovered in which the rules do not provide adequate relief (see section 7 on corporate rules above)- there is a strong case for the need for tax-neutral restructuring rules if South Africa is to be a business-friendly jurisdiction. As indicated above, the corporate restructuring rules could, for example, be supplemented with a loss transfer rule at election, for companies that are 100% held, once it is considered that the economy is strong enough to withstand such a change.

## **9 Review of the policy rationale for certain corporate tax provisions that impact on the efficiency of the system**

Finally, the DTC performed a review of the policy rationale for certain corporate tax provisions that further impact the efficiency of the system:

- (a) Ring-fencing of assessed losses from trades carried on outside the Republic: The DTC believes that the policy rationale of protecting the South African tax base remains, and thus the ring-fencing provisions should remain.
- (b) Concerns about troubled companies: It is recommended that the one year non-trading rule which results in the removal of brought forward of assessed losses should be repealed.
- (c) Consideration of the distortion in tax treatment of foreign branches vs Controlled Foreign Companies (CFCs): The DTC recommends that consideration be given to aligning the tax treatment of CFCs and foreign branches to the extent that this is practicable.
- (d) Distortions in qualifying for depreciation allowances for intellectual property: goodwill and trademarks. It is recommended that the absence of capital allowances for purchased trademarks and goodwill should be reconsidered.
- (e) The Headquarter company regime: The DTC recommends that National Treasury re-visits this regime in light of the challenges of applying the current rules.

## **10 Ensuring the administrative efficiency of the corporate tax system by simplifying the tax structure**

This section of the CIT report considers the challenges posed to the efficiency of the corporate tax system by the complex tax structure. The DTC acknowledges that simplifying the Corporate tax system will not be “quick fix”. A comprehensive rewrite of the Act would be an extremely difficult process to embark upon. Such a process would require an investment of highly skilled and experienced resources over a fairly extended period of time, and would, of necessity, require extensive planning and public consultation.

The DTC recommends that consideration could be given to aligning more of the legislation to International Financial Reporting Standards (IFRS) where suitable as this could assist in simplifying the process of determining taxable income based on financial statements. It must, however, be emphasized that a complete alignment between tax and IFRS is neither practical nor desirable. However, there are potentially areas where alignment may be appropriate, for example, in the tax treatment of hedging arrangements.

## **11 Financial services**

The DTC considered the various elements of taxation within the financial sector in compliance with its terms of reference contained in the 2013 Budget Review (page 63). The aspects relating to financial services have been dealt with in various DTC reports including the BEPS report, and in particular Action 2 titled “Neutralise the effects of hybrid mismatch arrangements” and Action 4 titled “Limit base erosion via interest deductions and other financial payments” and the Value-added Tax report. The remainder of financial services related issues cut across the corporate tax arena and are therefore covered in the corporate tax report. The report acknowledges the submissions received from various stakeholders on other corporate tax aspects pertaining to financial services.

## **REVIEW OF THE EFFICIENCY OF SOUTH AFRICA'S CORPORATE INCOME TAX SYSTEM**

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## 1 INTRODUCTION

In 1987 the “Margo Commission of Inquiry into the Tax Structure of the Republic of South Africa” remarked that:

“[t]he Republic has an open economy that seeks to create an environment that will attract investment and facilitate trade. A hospitable fiscal environment is seen as an integral part of such endeavours. Transnational corporations are making valuable contributions to the growth of developing countries through their inputs of expertise and capital, and they should be encouraged.”<sup>16</sup>

The 1997 “Fifth interim Report of the Katz Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa” noted that although the democratisation of South Africa had triggered a dramatic increase in the reintegration of the South African economy with the global economy,<sup>17</sup> as a developing country, South Africa is likely to remain a net capital importer for a considerable period. South Africa will be subject to the international phenomenon of mobility of capital, as international technological and electronic developments have made financial and human capital much more mobile than ever before.<sup>18</sup>

To ensure that South Africa attracts foreign direct investment, with a view to stimulating growth and generating employment opportunities, it needs to develop an efficient corporate tax system that does not hamper economic development. Efficiency is one of the principles of a good tax system (these principles are: fairness, simplicity, certainty, efficiency).<sup>19</sup> Efficiency requires that there are minimum distortions in the allocation of resources; and that raising revenue is done in a manner that does not detriment economic growth, investment and job creation. Efficiency is lost if the corporate tax system distorts corporate finance and investment behaviour. Efficiency also requires accountability for taxes, as this affects tax morality.

This is in line with South Africa’s constitutional imperatives and its 2030 National Development Plan (NDP) – published in 2011,<sup>20</sup> which sets the country’s overall economic strategy and policy. The NDP requires that South Africa develops fiscal and economic policies that encourage foreign direct investment (FDI) to foster economic growth. It is therefore important that South Africa’s corporate tax structure and fiscal policy supports the economic vision in the NDP. In the 2017 Budget Review, the Minister of Finance affirmed National Treasury’s commitment to ensuring the efficiency of South Africa’s tax system,<sup>21</sup> noting that “the budget plan must promote the efficient and effective use

<sup>16</sup> Margo CS (Chairman) *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (1987) in para. 26.2.

<sup>17</sup> Katz MM (Chairman) *Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) in Para 2.2.1.

<sup>18</sup> The Katz Commission in Para 2.2.4.

<sup>19</sup> RM Sommerfeld, SA Madeo, KE Anderson & BR Jackson *Concepts of Taxation* (1993) at 10; WA Raabe & JE Parker *Taxation Concepts for Decision Making* (1985) at 14.

<sup>20</sup> National Planning Commission *National Development Plan Vision for 2030* (2012)

<sup>21</sup> National Treasury *Budget Review* (2017) at 38.

of resources, based on evidence and rational deliberation.”<sup>22</sup>

However, the trajectory of the economic developments in South Africa over the last decade shows that there have been various setbacks to the process for achieving the 2030 National Development Plan. This DTC report on CIT reviews aspects of South Africa's corporate income tax structure that impact on its efficiency in fostering economic development. In reviewing the efficiency of the corporate income tax structure, a distinction has to be made between issues that relate to economic efficiency and those that relate to administrative efficiency. Both of these matters are dealt with in this report. Since the efficiency of the corporate income tax structure has been considered in the light of the economy in which it operates, it is important to understand South Africa's current economic environment and its outlook, as the recommendations in this report have taken these short- and long-term views into consideration.

Between the years 2000 and 2008, South Africa's economic outlook improved steadily on the strength of a commodity boom and robust domestic investment. The economy expanded rapidly and created jobs. When the global financial crisis broke in 2008, the healthy state of the public finances enabled the government to intervene decisively to support the economy.<sup>23</sup> In 2011, South Africa's Real GDP growth was at a peak of 3.2% and it was in that year that the National Development Plan was published. However, in 2011 the rise in commodity prices had begun to turn, signaling deeper shifts in this global economy. Commodity exporting countries like South Africa were vulnerable to the sudden reversal of fortunes.<sup>24</sup> By 2012, South Africa lost almost four percentage points of GDP growth as a result of low commodity prices at the end of the commodity super cycle. In 2014, the GDP growth had slowed down to 1.5% and then to 1.3% in 2015. Drought, electricity constraints, political instability, declines in commodity prices and global demands for raw materials all contributed to slowed growth in 2015. This was further fuelled by political uncertainties and looming rating agency downgrades which lowered confidence in the system, negatively affecting investor and consumer confidence. Private investment contracted and consumption growth weakened. The slowdown in growth put pressure on the fiscal and current account deficits. The fiscal deficit and gross debt burden of the general government stood at 3.7% and almost 47% of GDP, respectively.<sup>25</sup>

The year 2016 marked the third year in a row of declining economic growth for South Africa; subdued private investment, rising fiscal and external deficits and high unemployment.<sup>26</sup> Although there has been some limited recovery during 2017, with growth just over 1% and still further growth envisioned for 2018, it is not enough to bring South Africa's growth in line with the global economy's growth or many other developed or

<sup>22</sup> National Treasury *Budget Review* (2017) at 5.

<sup>23</sup> National Treasury *Budget Review* (2017) at 2.

<sup>24</sup> National Treasury *Budget Review* (2017) at 3.

<sup>25</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 16.

<sup>26</sup> OECD's “Economic Outlook for South Africa” (2016) National Treasury “Budget Review” (2017) at 3.

developing countries.

Over the last few years, South Africa has also enjoyed a level of fiscal sustainability through a steady growth in taxes, at a rate far in excess of economic growth.<sup>27</sup> Net consolidated tax revenues are projected to increase from 26.4% of GDP in 2007/2008 to a forecast of 28.5% of GDP in 2018/2019. South Africa now has one of the highest levels of taxation globally when social security taxes are excluded, with taxation levels on an upward trend.

The DTC is of the view that despite the various challenges that South Africa faces, the country still has many advantages that can support its transition to a more dynamic economy. The 2015/16 “Global Competitiveness Report” published by the World Economic Forum found that South Africa ranked 32 of 140 countries in both the capacity of businesses to innovate and companies’ spending on research and development. South Africa has multiple strengths on which to build.

South Africa is a small, open economy reliant on trade and capital flows. Its development rests on a fair, rules-based global trading and financial system. The implications of international developments on South Africa’s economic trajectory need to be carefully considered. Over the medium term, pressure on the world economy is likely to increase with various economies taking different stands on their economic policies. The uncertainty in the global economic recovery is also likely to impact on South Africa’s economic development.<sup>28</sup>

The recommendations in this DTC report on the review of South Africa’s corporate tax structure are, if implemented, designed to play a role in ensuring the efficiency of the corporate tax structure which will, in turn, build confidence in private sector investment and thus encourage economic growth.

In order to contextualise the discussion that follows, a short overview of Corporate Income Tax (CIT) in South Africa is provided in the Annexure.

## **2 THE ECONOMIC EFFICIENCY OF SOUTH AFRICA’S CORPORATE INCOME TAX SYSTEM**

A discussion on whether South Africa’s CIT system is economically efficient requires an understanding of the different corporate tax systems applied internationally and their impact on economic efficiency. The pros and cons of the different systems are reviewed below in order to determine whether South Africa’s corporate tax system may be viewed as structured to ensure economic efficiency.

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<sup>27</sup> National Treasury *Budget Review* (2017) at 1.

<sup>28</sup> National Treasury *Budget Review* (2017) at 3.



## 2.1 International corporate income tax systems

Although the CIT system has been a feature of tax regimes around the world for over a century, some critics argue that CIT should be abolished because it poses economic inefficiency. The basis of this argument revolves around the assertion that CIT causes economic double taxation as the same income is taxed in the hands of different persons. The company itself is taxed on its taxable income and its shareholders are then taxed on the same income when dividends are distributed by the company. The concern is that, although CIT is levied on corporations, ultimately it is people that pay the taxes.<sup>29</sup>

The extent to which countries address these concerns depends on the system they have in place for taxing companies and their shareholders. Thus, countries' corporate tax systems are often classified by reference to how they interact with the personal income tax and how they relieve double taxation on distributed profits. The systems employed vary from country to country. On one extreme are countries that apply the "classical system", whereby they treat the company as a completely separate entity from its shareholders. On the other extreme are countries that apply the "full imputation system" whereby they allow shareholders a full credit for taxes suffered at the corporate level.<sup>30</sup> In between these two extremes some countries have modified their systems to relieve double taxation.

Under a "pure classical system" no relief is granted for distributed profits at either company or shareholder level. The profits of companies are taxed twice, firstly when made by the company and secondly the post-tax profits are again taxed at shareholder level - when distributed to the shareholders as dividends.<sup>31</sup> Tax at the shareholder level is often enforced by a flat-rate withholding tax.<sup>32</sup> A pure classical system is a clear form of economic double taxation, which encourages retention of profits in the company, It affects share values and investment flows; and discriminates against the incorporation. Because of these disadvantages, pure classical systems are being abandoned, as many countries have adopted "modified classical systems" which contain shareholder relief provisions aimed at reducing the full economic double taxation that applies under a pure classical system. Shareholder relief systems may be implemented at either the company or shareholder level or both, by providing for a dividend exclusion, a credit or a reduced tax rate, respectively. The USA for example, applies a shareholder relief system.<sup>33</sup>

Under the "imputation system", an individual receiving a dividend becomes entitled to an income tax credit representing the corporation tax already paid by the company paying the dividend. This system thus requires shareholders to only pay the difference between the corporate rate and their marginal rate. The extent to which the shareholder is allowed to

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<sup>29</sup>

Ibid.

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A Ogley *The Principles of International Tax: A Multinational Perspective* (1992) 16–17; and Vann 'International aspects of Income Tax' in Thuronyi *Tax Law Design and Drafting* (1998) 769–71.

<sup>31</sup>

L Oliver & M Honiball *International Tax: A South African Perspective* (2011) at 76.

<sup>32</sup>

Ibid.

<sup>33</sup>

Ibid.

access the corporate tax, for a tax credit or rebate purposes, varies from country to country.<sup>34</sup>

In “full imputation systems” the entire tax paid by the company on its distributed profits is credited against the shareholder’s personal income tax liability. This eliminates the double taxation of dividends in full. Australia applies a full imputation system; which almost fully removes the double taxation of domestic income for domestic shareholders. The “full imputation system” also applies in Germany. Because of administrative difficulties, a full imputation system is usually reserved for resident shareholders.<sup>35</sup> Full imputation may also be achieved by exempting dividends from taxation. This is sometimes referred to as the dividend exclusion system, or the corporate level system, in other words, it is regarded as a completely separate (third) method of taxing companies and their dividends.<sup>36</sup>

Other countries apply “partial imputation systems” that allow part of the corporate tax or shareholder withholding tax paid on distributed profits to be credited against the resident investor’s personal income tax liability, for example, where a credit is only given for withholding taxes.<sup>37</sup> Many European countries have tended to move away from full imputation systems to systems where dividends are taxed at lower rates at the personal level. In the United Kingdom, a company must, when it pays a dividend, make a prepayment of its corporate tax liability as advance corporation tax (ACT). Residents in receipt of such dividends are subject to income tax on the gross dividend, then a tax credit is obtained against the individual’s tax liability for the credit on the dividend.

Apart from the above methods (the classical systems and imputation systems, with their variations) some countries apply systems which provide some relief at company level rather than the shareholder level. For example, there is

- the “dividend-deduction method” whereby a deduction is made from the corporate tax base in assessing tax to be paid on profits. This system is for example applied in Spain;
- the split-rate method, which provides for a lower rate of tax on distributed profits than on retained profits. This system is for example applied in Germany; and
- the zero-rate method, where no corporation tax is charged at all on distributed profits. Greece for example applies this system.

## **2.2 South Africa’s corporate tax system**

In South Africa, dividends are exempt from normal income tax in the hands of the recipient. They are however subject to a 20% withholding tax (“Dividends Tax”) at the point they are received by natural persons and trusts (as well as foreign companies, subject to

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<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> Oliver & Honiball at 77.

<sup>37</sup> Oliver & Honiball at 76.

relevant double tax treaty provisions). Although, it may be argued that this gives rise to double taxation, the purpose of the withholding tax is to partly ensure parity between the CIT rate (28%) and the marginal individual and trust tax rates (45%), as the combined CIT and Dividends Tax Rate amounts to 42.4%.

South Africa has followed the exemption system for the taxation of dividends since 1990. Tax credits are given for foreign taxes paid in respect of those foreign dividends which are not exempt where foreign tax was paid or payable.<sup>38</sup>

Section 1 of the Income Tax Act defines “dividend” as any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied (a) by way of a distribution made by; or (b) as consideration for the acquisition of any share in, that company.

Paragraph (k) of the definition of gross income in section 1 includes in gross income any amount received or accrued by way of dividends or foreign dividends. However, section 10(1)(k)(i) exempts from normal tax dividends (other than dividends paid or declared by a headquarter company) received by or accrued to any person. There are however exceptions to this exemption, for instance in the case of: dividends in respect of restricted equity instruments; dividends distributed by a company that is a REIT. Section 10B, specifically deals with exemptions of foreign dividends and dividends paid or declared by headquarter companies. Subject to section 10B(4), section 10B(2) lists the circumstances when foreign dividends received by or accrued to a person will be exempt from income tax. This includes the so called “participation exemption”.

Apart from the exemptions in section 10, there are also exemptions that apply with respect to Dividends Tax in sections 64D to 64N of the Act which are intended to relieve double taxation. The dividends withholding tax provisions have been synchronised with the provisions that relate to dividends in general. Under section 64G(2) a company is exempted from the requirement to withhold the withholding tax, if the person to whom the dividend payment is made has furnished the distributing company with a declaration from the beneficial owner that the dividend is exempt from the dividends tax; there is a dividends tax exemption for intra-company dividends within a domestic group, without the requirement for such a declaration; a dividends tax reduction/exemption if there is a lower/nil tax treaty rate; and also if dividends tax is paid to a regulated intermediary. These exemptions from the requirement to withhold arise largely from the fact that certain specified persons and entities are exempted from dividends tax itself. These include a person that is a the beneficial owner and is: a resident company; the Government, a provincial administration or a municipality; public benefit organisations; rehabilitation trusts; bodies such as the Water Board, Tribal Authority etc.; pension/provident/retirement annuity and benefit funds; shareholders in a registered micro businesses; a non-resident beneficial

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<sup>38</sup> Olivier & Honiball at 81.

owner of a dividend declared by a non-resident company listed on the JSE.

From the discussion above, although South Africa appears to follow a form of full imputation system for certain categories of recipients, it is clear that this is not exactly so. Section 10B of the Act lists the circumstances under which foreign dividends will be either partially exempt or fully exempt from income tax. Again, as indicated above, this implies that elements of economic double taxation may still remain. This is especially so when the ultimate recipient is an individual with a marginal tax rate lower than 45%.

Even though, like other countries, South Africa has measures in place to alleviate economic double taxation (for example the exemption of dividends from taxation); the system still influences corporate decisions that impact on economic efficiency. It, for instance, impacts on the following corporate decisions which are discussed below:

- the choice to distribute profits or capital distributions;
- decisions on where a given company chooses to invest;<sup>39</sup>
- the decision whether to hold on to the dividends and reinvest them or to distribute them to the shareholders; and
- the choice to finance companies using debt or equity.

## **2.3 The impact of the corporate tax system on corporate decisions and how this impacts on the efficiency of the system**

### **2.3.1 The choice to distribute profits or capital distributions**

Dividends theoretically represent the corporate payment of profits; whereas, capital distributions theoretically represent return of initial capital paid by the shareholders into the company. The tax consequences of each type of payment differ.

- Dividends paid to individuals trigger a 20% dividend withholding tax charge (increased from 15% to 20% in 2017). Dividends paid to companies are wholly exempt.
- Capital distributions can either result in no tax or a capital gain. Capital distributions reduce the base cost in shares, thus increasing the taxable capital should some or all of the shares be sold; once the base cost in the shares are reduced to nil, further capital distributions trigger capital gain. The result is the same regardless of whether the shareholder is an individual versus a company.

Example: Individual owns shares with a base cost of R80. If Individual receives a capital distribution of R90, the base cost in the shares is reduced to zero with an additional R10 of capital gain. South Africa individual shareholders generally prefer capital distributions over dividends because the reduction of base cost in shares is preferred over an immediate 20% dividends tax. Once base cost is gone, individual shareholders are largely indifferent

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<sup>39</sup> OECD 1991 at 168.

because the maximum capital gains tax charge is 18%<sup>40</sup> versus the dividend tax of 20%. Company shareholders absolutely prefer dividends because company-to-company dividends are exempt whereas capital distributions reduce base cost and/or trigger immediate capital gain.<sup>41</sup>

In South Africa, the current tax distinction between dividends versus capital distributions is almost wholly elective. If no taxpayer election is made, all distributions are treated as dividends. Taxpayers may alternatively seek to withdraw capital distributions to the extent tax capital was previously contributed to the company. Tax capital equals the total cash/assets contributed to the company in exchange for shares issued by that company.

In terms of company law, all distributions in respect of shares are simply viewed as distributions (not dividends nor capital distributions). The key requirement is that companies can only make distributions if the distribution does not trigger asset or liquidity insolvency. Current tax law enables a company to distribute its total permitted value as dividends even when these arose solely as capital contributions (or as borrowings). As indicated above, company shareholders have a tendency to choose dividends (despite the lack of profits) because company-to-company dividends are wholly tax-free. The issue is whether this ability to choose dividends should continue when retained earnings of the paying company are insufficient. As this matter has no particular detriment to the fiscus or the taxpayer the DTC comments no further on this matter.

### 2.3.2 The choice of financing companies using debt or equity

There are essentially two ways in which a company may be financed; debt (loan capital) or equity capital.<sup>42</sup> The tax treatment of a company and its financiers differs fundamentally depending on whether it is financed by loan or equity capital.<sup>43</sup> If capital is loaned by a parent company to its subsidiary, the subsidiary company will have to pay interest to the parent company, which in most jurisdictions (including South Africa) is regarded as an expense incurred in earning profits and is, subject to certain limitation rules, deductible by the payer of the interest in computing its taxable income.<sup>44</sup>

If the parent company were to subscribe for shares in its subsidiary in another jurisdiction, dividends would be distributed by the subsidiary to the parent company. In most jurisdictions the dividends would be not be deductible when calculating the subsidiary's

<sup>40</sup> 2017/2018 rates

<sup>41</sup> Recommendation adopted from SAIT's Technical Report to the DTC "Corporate Tax Reforms Initial Comments" (19 January 2017).

<sup>42</sup> AW Oguttu "Curbing Thin Capitalisation: A Comparative Overview with Specific Reference to South Africa's Approach - Challenges Posed by The Amended Section 31 of The Income Tax Act" (2013) Vol 67 Issue No 6 *Bulletin for International Taxation* at 312; RA Sommerhalder 'Approaches to Thin Capitalisation' *Bulletin for International Fiscal Documentation* (March 1996) at 446.

<sup>43</sup> Sommerhalder at 82.

<sup>44</sup> K Huxham & P Haupt *Notes on South African Income Tax* (2013) at 80.

taxable income since these are distributions of profits that have been taxed.<sup>45</sup> Thus financing a company with debt, at a commercial interest rate, which is a deductible expense, is more effective in reducing tax where the recipient is not taxed, or taxed at a lower tax rate, than it is with equity financing where a distribution of dividends on shares is not deductible.<sup>46</sup> Thus companies may attempt<sup>47</sup> to engage in thin capitalisation schemes where a company is financed with more debt than it could have borrowed on its own resources, because it is borrowing either from or with the support of connected persons.<sup>48</sup> The economic inefficiencies that can result as a result of the distinction between a company paying dividends and deductible payments (e.g. interest and services) to shareholders - from a South African corporate tax perspective is as follows:

### Dividend payment to individuals

Example: A single individual owns all of the shares of Company X. Company X earns R500 000 of taxable income for the year and seeks to pay the full R500 000 to the individual (whose top marginal bracket is 45 per cent).

Outcome:

- Dividends: If the company pays the amount as a dividend, the full R500 000 will have been subjected to a 28 per cent rate (with the dividend being non-deductible). The R360 000 remainder (R500000 – R140000) will be taxed at 20 per cent when paid to the individual (i.e. R72 000). Total net taxes paid equal R212 000 on the R500 000 net profit that the company earned (a 42.4% effective tax rate).
- Deductible Payments (Services/Interest): If the company pays interest/service fees instead, all payments, subject to the various anti avoidance provisions, are deductible, thereby reducing the company taxable income to zero. Assuming the person has no deductions against the interest received and already has other income putting him/her at the 45% marginal tax rate, the individual pays 45 per cent on the full R500 000 received, resulting in taxes payable of R225 000 (a 45% effective tax rate).

Hence, in a domestic context, dividend payments to individuals result in slightly reduced taxes, meaning that a slight incentive exists to pay dividends over services/interest. The net result is the combined company tax/shareholder tax that is less than the top marginal individual rate. This is an unusual feature of the South African tax system (countries like the United States have the reverse problem with dividends having a distinct disadvantage over deductible interest/dividends). The net result may be a slight incentive to keep funds

<sup>45</sup> Sommerhalder at 82.

<sup>46</sup> BJ Arnold & MJ McIntyre *International Tax Primer* (2002) at 72-73; Olivier & Honiball at 649.

<sup>47</sup> Sections 31 (transfer pricing) and 23M are designed to counter this type of avoidance where the recipient is a non-resident or not subject to tax in South Africa, respectively.

<sup>48</sup> G Richardson, D Hanlon & L Nethercott "Thin Capitalization: An Anglo-American Comparison" *The International Tax Journal Spring 1998 Vol 24 Iss 2* at 36.

within a company, especially if dividends are deferred (thereby delaying the 20% charge)<sup>49</sup>

### Dividend payment to companies

For companies there is no significant difference for dividends versus deductible interest/services because companies all have the same tax rates. In a few cases, the Operating Company may have an incentive to pay interest/services over dividends if the Holdco has excess assessed loss carryovers. On the other hand, if Operating Company has excess losses, dividends are preferred because net income can be absorbed by the losses at the operating company level.<sup>50</sup>

## **3 THE CONTRIBUTION OF CORPORATE INCOME TAX TO REVENUE COLLECTION IN SOUTH AFRICA**

A review of CIT requires an analysis of the overall place of CIT in the tax mix in order to determine its impact on economic growth (relative to other taxes). Before doing so, it is worthwhile to first have an idea of the number of companies registered for CIT in South Africa.

### **3.1 Companies registered for corporate tax in South Africa**

Every company incorporated in or that has a place of effective management in South Africa is required to register with SARS as a taxpayer.<sup>51</sup> On 31 March 2017, SARS had over 3.7 million companies on its tax register, mainly as a result of the interactive link between SARS and the Companies and Intellectual Property Commission (CIPC) that automatically registers all companies for tax as and when they are registered with the CIPC.<sup>52</sup> SARS' initiatives in "the broadening of the tax base, through education, outreach and enforcement initiatives" have also contributed to the increase in the number of companies. However, most of the companies on register were inactive or dormant, and only 884 459 were expected to submit returns for the 2016 tax year.<sup>53</sup>

According to National Treasury and SARS' statistics for 2017, the number of companies expected to submit returns was at its highest at 932 719 in 2014 with a lower expectation of 884 459 in 2016. For 2014, 82.6% of the companies expected to submit returns had been assessed by June 2017 while only 57.4% of the companies expected to submit returns in 2016 were assessed.<sup>54</sup>

<sup>49</sup> Recommendation adopted from SAIT's Technical Report "Corporate Tax Reforms Initial Comments" sent to the DTC (19 January 2017).

<sup>50</sup> Recommendation adopted from SAIT's Technical Report "Corporate Tax Reforms Initial Comments" sent to the DTC (19 January 2017).

<sup>51</sup> Section 1 of the Income Tax Act 58 of 1962; SARS "Corporate Income Tax". Available at <http://www.sars.gov.za/TaxTypes/CIT/Pages/default.aspx> accessed 6 October 2016.

<sup>52</sup> National Treasury and SARS *2017 Tax Statistics* (2017) at 1.

<sup>53</sup> National Treasury and SARS *2015 Tax Statistics* (2017) at 123.

<sup>54</sup> SARS "Legal & Policy Product Oversight Report: Corporate Income Tax" (2016-17) at 10.

Year	Companies Registered	Percentage growth in register
2004/05	933 136	
2005/06	1 054 969	13.1%
2006/07	1 218 905	15.5%
2007/08	1 584 002	30.0%
2008/09	1 834 009	15.8%
2009/10	1 878 856	2.4%
2010/11	2 078 182	10.6%
2011/12	2 034 719	-2.1%
2012/13	2 195 883	7.9%
2013/14	2 685 405	22.3%
2014/15	2 935 385	9.3%
2015/16	3 278 708	11.7%
2016/17	3 732 416	13.8%

### 3.2 Contribution of CIT to revenue collection in South Africa

According to National Treasury and SARS 2017 statistics, CIT has been the third largest contributor to total tax revenue for the past decade, after personal income tax and value added tax.<sup>55</sup> It briefly surpassed VAT in 2008/09, but slipped back after the global financial crisis which impaired many companies' profitability.<sup>56</sup> The main sources of tax revenue (PIT, VAT and CIT) account for about 80% of total tax revenue.<sup>57</sup>

Although CIT has maintained its status as the third largest tax contributor, between 2000/01 and 2008/09 corporate tax revenue grew strongly in line with economic growth, the commodity boom, improved compliance and measures to limit tax avoidance. CIT revenue moves in line with the overall economy. Thus improving economic growth results in a higher contribution from this, as well as the other sources of tax.<sup>58</sup> CIT's relative contribution declined from a peak of 26.7% in 2008/09, to 17.9 in 2017/18.<sup>59</sup> The decline from 2008 was as a result of the post 2008 global financial crisis. Thereafter, the country

<sup>55</sup> National Treasury and SARS 2017 Tax Statistics (2017) at 1.

<sup>56</sup> National Treasury and SARS 2015 Tax Statistics (2017) at 9.

<sup>57</sup> National Treasury and SARS 2015 Tax Statistics (2017) at 6.

<sup>58</sup> National Treasury Budget Review (2017) at 39.

<sup>59</sup> National Treasury and SARS 2017 Tax Statistics (2017) at 133.



saw a 4.2% decline in revenues in the 2009/10 fiscal year. Tax revenues recovered in subsequent years, albeit at a reduced Compound Annual Growth Rate (CAGR).

CIT accounted for much of the contraction in the overall tax-to-GDP ratio that occurred after the 2008 global financial crisis as company profits waned in the face of declining global and domestic demand; as well as unforeseen disruptions to the economy such as the labour disputes in the mining sector during 2014/15. This was exacerbated by the sharp drop in tax contributions from the mining and manufacturing sectors as a result of the deterioration in the prices of commodities particularly iron ore, platinum and oil.<sup>60</sup> This analysis reveals how quickly corporates respond to declining economic conditions in terms of decreased income, increased losses and a resultant decline in CIT.

Although South Africa's tax-to-GDP ratio increased during the past 20 years from a low of 21.9% in 1995/96 to 26.0% in 2016/17;<sup>61</sup> this increase was driven by increased contributions from PIT and VAT. The contribution of PIT to total tax revenue increased from 34.0% in 2012/13 to 37.2% in 2016/17. The contribution of VAT has declined from 25.7% in 2012/13 to 23% in 2016/17.<sup>62</sup> Growth in CIT remained at around 5.0% as a result of assessed losses incurred by companies during the financial crisis, leading to CIT revenue only surpassing pre-crisis collections five years later in 2013/14.<sup>63</sup>

According to National Treasury and SARS' statistics for 2017, National CIT collections increased from R110.1 billion for the 2006 tax year to R176.6 billion in the 2015 tax year, showing an increase of a CAGR rate of 5.4%.<sup>64</sup> SARS' statistics for 2017, show that this increased tax collection is attributed to 267 473 common company taxpayers, which are the determining factor in the growth of tax revenue over the period post 2006. This is due to more established companies showing an improvement and resilience despite the prevail economic challenges.<sup>65</sup>

The table below shows that CIT collections have been steadily decreasing relative to other taxes as a percentage of total tax collections. Reduced business confidence due to political instability has also contributed reduced real FDI and has caused many companies to restrict their reinvestment policies and rather hold on to cash.

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<sup>60</sup> National Treasury and SARS *2015 Tax Statistics* (2017) at 134.

<sup>61</sup> National Treasury and SARS *2017 Tax Statistics* (2017) at 6.

<sup>62</sup> National Treasury and SARS *2015 Tax Statistics* (2015) at 6.

<sup>63</sup> National Treasury and SARS *2015 Tax Statistics* (2017) at 8-9.

<sup>64</sup> National Treasury and SARS *2017 Tax Statistics* (2017) at 146.

<sup>65</sup> National Treasury and SARS *2017 Tax Statistics* (2017) at 146.

### 3.3 Corporate taxes as a percentage of total tax revenue

Corporate Taxes: % of Total Tax <sup>66</sup>						
Year	R million				%	
	STC/Dividends Tax (DT) <sup>67</sup>	Corporate income tax (CIT)	Total Corporate Taxes	Total Tax Revenue	STC/DT as % of Total Taxes	CIT as % of Total Taxes
2005/06	12 278	86 161	98 438	417 196	2.9%	20.7%
2006/07	15 291	118 999	134 290	495 549	3.1%	24.0%
2007/08	20 585	140 120	160 705	572 815	3.6%	24.5%
2008/09	20 018	165 539	185 557	625 100	3.2%	26.5%
2009/10	15 468	134 883	150 351	598 705	2.6%	22.5%
2010/11	17 178	132 902	150 080	674 183	2.5%	19.7%
2011/12	21 965	151 627	173 592	742 650	3.0%	20.4%
2012/13	19 739	158 947	178 686	813 826	2.4%	19.5%
2013/14	17 309	177 460	194 769	900 015	1.9%	19.7%
2014/15	21 247	184 924	206 171	986 295	2.2%	18.7%
2015/16	23 934	191 152	215 086	1 069 983	2.2%	17.9%

The table below shows that CIT collections, as a percentage of GDP, have also decreased from a high of 7.7% in 2007/08 to 4.7% in 2015/16. If taxes on dividend distributions (STC and dividends tax) are also taken into account the percentages would be 8.7% (2007/08) and 5.3% (2015/16), respectively.

<sup>66</sup> SARS "Legal & Policy Product Oversight Report: Corporate Income Tax" (2016-17) at 11.

<sup>67</sup> Note that dividends tax is not a tax on companies. It is a tax on the shareholders. It has been included in the table for consistency.

### 3.4 Corporate taxes as a percentage of GDP

Corporate Taxes: % of GDP <sup>68</sup>						
Year	STC Dividends Tax (DT)	Corporate income tax (CIT)	GDP (Rm)	Total Tax as % of GDP	CIT as % of GDP	STC / DT as % of GDP
2005/06	12 278	86 161	1 682 271	24.8%	6.1%	0.8%
2006/07	15 291	118 999	1 911 150	25.9%	7.3%	0.8%
2007/08	20 585	140 120	2 171 014	26.4%	7.7%	1.0%
2008/09	20 018	165 539	2 408 661	26.0%	7.2%	0.9%
2009/10	15 468	134 883	2 551 315	23.5%	5.3%	0.6%
2010/11	17 178	132 902	2 826 072	23.9%	4.7%	0.6%
2011/12	21 965	151 627	3 080 887	24.1%	4.9%	0.7%
2012/13	19 739	158 947	3 327 628	24.5%	4.8%	0.6%
2013/14	17 309	177 460	3 609 843	24.9%	4.9%	0.5%
2014/15	21 247	184 924	3 843 778	25.7%	4.8%	0.6%
2015/16	23 934	191 152	4 073 200	26.3%	4.7%	0.6%

In the 2016/2017 tax year, CIT receipts marginally increased as a result of higher commodity prices and labour stability in the mining sector along with stronger performance in the financial sector.<sup>69</sup>

### 3.5 Capital Gains Contribution to Corporate Income Tax

Collections as a consequence of Capital Gains Tax (CGT) are included in income tax collections and hence, for CGT on corporates, are reflected as part of CIT collections. With the increase in CGT inclusion rates for companies from 50% to 66.6% in 2015 (now to 80%), the maximum effective tax rate was increased from 14% to 18.6% (now 22.4%), appears to have resulted in increased collections from the disposal of assets. The Table below shows capital gains contribution to CIT collections from the 2007/8 tax year to the

<sup>68</sup> SARS "Legal & Policy Product Oversight Report: Corporate Income Tax" (2016-17) at 12.

<sup>69</sup> National Treasury *Budget Review* (2017) at 43.

2015/16 tax year.<sup>70</sup>

CGT Contributions as % of Corporate Tax Collections				
Year	R million			%
	CGT	Normal	Total CIT	
2007/08	2 494	137 626	140 120	1.78%
2008/09	4 136	161 403	165 539	2.50%
2009/10	6 023	128 860	134 883	4.47%
2010/11	7 049	125 853	132 902	5.30%
2011/12	5 263	146 364	151 627	3.47%
2012/13	5 008	153 939	158 947	3.15%
2013/14	4 633	172 827	177 460	2.61%
2014/15	6 135	178 789	184 924	3.32%
2015/16	9 155	181 997	191 152	4.79%

### 3.6 Challenges to corporate tax collections

Reasons for the decreasing CIT collections to total revenue and CIT to GDP are varied but, as indicated above, are primarily economic in nature, e.g. a decrease in global demand for goods and services. Other factors include substantial increases in domestic electricity prices as well as increases in the cost of labour, in particular in the manufacturing and mining sectors.

As alluded to above, the other factor has been a cumulative build-up of assessed losses, which were largely instigated by the 2007/2008 global financial crisis. According to National Treasury and SARS' 2017 statistics, the number of companies reporting assessed losses, as well as the value of assessed losses, increased sharply during the global financial crisis.<sup>71</sup> SARS' 2017 statistics point out that: "The value of assessed losses for companies with losses greater than R10 million continues to grow, albeit at a slower rate of 9.4% in 2015 compared to 17.9% in 2014. The value of assessed losses for companies in the R1 to R10 million range, however, declined by 3.5% in 2015 from a

<sup>70</sup> SARS "Legal & Policy Product Oversight Report: Corporate Income Tax" (2016-17) at 14.

<sup>71</sup> National Treasury and SARS 2017 Tax Statistics (2017) at 147.

growth rate of 0.7% in 2014. The number of assessed losses incurred by companies with losses greater than R10 million decreased from 2014 to 2015, while the number of assessed losses for the companies in the R1 to R10 million range decreased from 2011 to 2015.”<sup>72</sup>

Assessed tax losses for companies may not only include losses incurred during a specific tax year but sometimes include assessed losses brought forward from previous tax years. If a company, therefore, had a taxable profit for the year, it is possible that it could still be in an assessed loss position if the taxable profit for the year was insufficient to clear the assessed loss that had been brought forward.<sup>73</sup>

The South African tax system has a fairly simple set of rules for assessed losses. Assessed losses can be carried forward indefinitely. They cannot be shifted from one company to another, and income cannot be shifted into a loss company for tax avoidance purposes (see section 103(2) in terms of the anti-avoidance rule). At issue is whether the rules are sufficient or whether groups should be permitted to access losses of other companies within the group (this is addressed below in section 9 dealing with group taxation).

It needs to be considered whether companies involved in certain re-organisations (e.g. mergers) should qualify for the shifting of losses. For instance, if a target company merges into an acquiring company, should the losses of the target company shift to the acquiring company because the two companies become one? At present, skilled advisors can avoid this limitation by simply having the profitable company merge into the acquiring company (because pre-existing losses of the acquiring company largely remain intact provided that the sole or main purpose of the merger is not the utilisation of the assessed loss (i.e. but for section 103(2) and that the 18 month rule is recognized if the corporate rules have been used).

While section 103(2) theoretically prevents transactions mainly aimed at loss trafficking, the trigger is fairly open-ended and vague. The concern is whether this rule is a viable threat under the existing case law and/or whether the rule creates unnecessary uncertainty for legitimate transactions. In other words, the essential question is whether the anti-avoidance rules should be shifted from a wholly subjective approach to a more objective approach.<sup>74</sup>

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<sup>72</sup> National Treasury and SARS *2015 Tax Statistics* (2017) at 147.

<sup>73</sup> National Treasury and SARS *2015 Tax Statistics* (2015) at 136.

<sup>74</sup> SAIT's Technical Report "Corporate Tax Reforms Initial Comments" sent to the DTC (19 January 2017).

#### 4 REVIEW OF THE EFFICIENCY OF THE CORPORATE INCOME TAX RATE

In 1997, when South Africa largely applied the source basis of taxation, the Katz Commission noted that:

“South African multi-nationals trading in the world economy will only contribute to the wealth of this country for as long as they remain South African based. In a post-exchange control era, and in a world of mobile capital, a relatively higher South African tax rate may have a real potential to become a contributing factor to an emigration of financial capital and human skills through relocation of the ultimate holding location. The Commission received evidence from a broad range of South African businesses, both individually and through organised business structures, that such an emigration of resources would be a likely result of a residence based system for as long as our rates exceeded those in alternative jurisdictions.”<sup>75</sup>

Thus the Katz Commission concluded that, “while our tax rates exceed those of material trading and investment partners, a residence based system will carry a real danger of promoting the export of South African financial and human capital, and contribute towards an under-developed South African multi-national sector”.<sup>76</sup> The residence basis of taxation was introduced in South Africa from the years of assessment commencing 1 January 2001.<sup>77</sup> In terms of the definition of “resident” in section 1 of the Income Tax Act, a person other than a natural person is resident if incorporated, established or formed in the Republic or if they have a place of effective management in the Republic and they are not resident in another country by virtue of the terms of a double tax treaty. Although this definition appears to be very wide, the requirements of this definition are considered, alternately. This means, for example that, subject to relevant double tax treaty provisions, a company which is incorporated in South Africa is also a resident irrespective of where its place of effective management is. Conversely, again subject to relevant double tax treaty provisions, a company which has its place of effective management in South Africa is a resident irrespective of where it is incorporated.<sup>78</sup> With the increase in globalisation and the mobility of capital, the concept of place of effective management can be manipulated, with the result that company residence is a matter of deliberate choice rather than circumstance (especially in the digital economy).<sup>79</sup> This implies that if the corporate income tax rate is high, this could motivate companies to move their place of effective management to countries with lower tax rates, many of which are now developed countries (e.g. UK) and not countries which were traditionally viewed as ‘tax havens’. Adoption of the multi-lateral instrument (“MLI”), recommended by the OECD in Action 15 of its BEPS initiative (to which countries (including South Africa) signed up in December 2016),<sup>80</sup> to mitigate treaty related BEPS risks may address this risk as the determination of the residence of companies is given to the revenue authorities of the countries which are party

<sup>75</sup> Katz Commission in para 3.1.3.1.

<sup>76</sup> Katz Commission in para 3.1.3.2.

<sup>77</sup> Ushered in by the Revenue Laws Amendment Act 59 of 2000.

<sup>78</sup> Meyerowitz *Meyerowitz on Income Tax* (2008) in para 5.19.

<sup>79</sup> Kohl-uta ‘The Horror-scope for the Taxation Office: The Internet and its Impact on “Residence” (1998) 21 No 1 *The University of New South Wales Law Journal* at 436.

<sup>80</sup> OECD “Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting” (2016).

to the relevant double tax agreement. However, the efficiency and effectiveness of this methodology remains to be tested.

The corporate tax rate is essentially a measure of the burden of taxes a company must pay in relation to its commercial profit. Currently, the South African statutory company tax rate is fixed at 28%. However, some companies are liable for CIT at different rates depending on the sector; with specific tax dispensations and deductions. For example;

- Gold mining companies are taxed according to specific formulas. Gold mining is addressed separately in the DTC's mining report and is, therefore, not addressed here.
- Life insurance companies are obligated to follow the "four-funds approach" with policies divided into four funds, depending on the nature of the beneficiary. Each fund is then allocated assets according to the risk carried by the fund. Funds are treated as separate taxpayers and taxed at four separate rates. These rates are 30% for individual policyholder funds, 0% for untaxed policyholder funds, 28% for company policyholder funds, and 28% for corporate funds (the company itself). With effect from January 2016, a fifth fund was introduced, the Risk Policy Fund, to cater for changes to the taxation of the risk business of long-term insurance companies. The Risk Policy Fund is also taxed at a rate of 28%.<sup>81</sup>
- Small business corporations (SBCs) (with only natural persons as members/owners with limited shareholding, and with gross income of not more than ZAR20 million, qualify for graduated income tax rates (progressive taxation), rather than the fixed tax rate of 28%. Currently, SBCs are taxed at 0% on the first ZAR 75,000 of taxable income earned, 7% on the amount above ZAR 75,000 but not exceeding ZAR 365,000, 21% on the amount above ZAR 365,000 but not exceeding ZAR 550,000, and 28% on the amount exceeding ZAR 550,000.<sup>82</sup> (The DTC report on SBC's has, however, recommended this be removed and a rebate system be introduced. Again, as a specific DTC report addresses these types of businesses they are not addressed further here).

The table below, taken from SARS statistics shows the historical corporate tax rates since 1994.<sup>83</sup>

<sup>81</sup> Pwc "South Africa: Taxes on Corporate Income". Available at <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/South-Africa-Corporate-Taxes-on-corporate-income> accessed 6 October 2016.

<sup>82</sup> Pwc "South Africa: Taxes on Corporate Income". Available at <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/South-Africa-Corporate-Taxes-on-corporate-income> accessed 6 October 2016.

<sup>83</sup> National Treasury and SARS *2015 Tax Statistics* (2015)

Historic Corporate Tax Rates (%): 1994 - 2016		
Year	Company	STC / Dividends tax
1994	40	15
1995	40	15
1996	35	25
1997	35	12.5
1998	35	12.5
1999	35	12.5
2000	30	12.5
2001	30	12.5
2002	30	12.5
2003	30	12.5
2004	30	12.5
2005	30	12.5
2006	29	12.5
2007	29	12.5
2008	29	10
2009	28	10
2010	28	10
2011	28	10
2012	28	15
2013	28	15
2014	28	15
2015	28	15
2016	28	15

The corporate tax rates for 2017 remained as for 2016, but for the 2018 fiscal year the dividends tax increased to 20%. Thus, while certain countries are reducing corporate tax, South Africa's effective rate is increasing (see table of international corporate tax rates below).



As indicated above, it should be noted that corporate income tax collections respond quickly and negatively to declining economic conditions. South Africa's declining economic conditions since 2008 have been propelled by drought, labour strikes, electricity constraints, declines in global commodity demands, process and global demands for raw materials. Political uncertainties and rating agency downgrades have also lowered confidence in the system; affecting both investor and consumer confidence. The declining economic outlook of South Africa has prompted calls for the optimal corporate income tax rate for South Africa to be re-considered. This has been further prompted by the fact that South Africa's current corporate income tax rate is still high<sup>84</sup> compared to many of its trading partners, especially those in Europe and the OECD countries, which could impact on the competitiveness of South African companies.

The table below shows the corporate tax rates around the world; and the average rates in different regions.<sup>85</sup>

LOCATION	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Afghanistan</b>	20	20	20	20	20	20	20	20	20	20	20
<b>Albania</b>	20	10	10	10	10	10	10	15	15	15	15
<b>Algeria</b>							25	19	23	26	26
<b>Andorra</b>											10
<b>Angola</b>	35	35	35	35	35	35	35	35	30	30	30
<b>Anguilla</b>											0.00
<b>Antigua and Barbuda</b>											25
<b>Argentina</b>	35	35	35	35	35	35	35	35	35	35	35
<b>Armenia</b>	20	20	20	20	20	20	20	20	20	20	20
<b>Aruba</b>	28	28	28	28	28	28	28	28	25	25	25
<b>Australia</b>	30	30	30	30	30	30	30	30	30	30	30
<b>Austria</b>	25	25	25	25	25	25	25	25	25	25	25
<b>Azerbaijan</b>											20
<b>Bahamas</b>	0	0	0	0	0	0	0	0	0	0	0
<b>Bahrain</b>	0	0	0	0	0	0	0	0	0	0	0

<sup>84</sup> This was also acknowledged by the Minister of Finance in his 2018 Budget Speech

<sup>85</sup> Table adopted from KPMG "Corporate tax Rates Table". Available at accessed 21 July 2017 <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>

<b>Bangladesh</b>	30	30	27.50	27.50	27.50	27.50	27.50	27.50	25	25	25
<b>Barbados</b>	25	25	25	25	25	25	25	25	25	25	25
<b>Belarus</b>	24	24	24	24	24	18	18	18	18	18	18
<b>Belgium</b>	33.99	33.99	33.99	33.99	33.99	33.99	33.99	33.99	33.99	33.99	33.99
<b>Benin</b>											30
<b>Bermuda</b>	0	0	0	0	0	0	0	0	0	0	0
<b>Bolivia</b>				25	25	25	25	25	25	25	25
<b>Bonaire, Saint Eustatius and Saba</b>						0	0	0	0	0	25
<b>Bosnia and Herzegovina</b>	10	10	10	10	10	10	10	10	10	10	10
<b>Botswana</b>	25	25	25	25	22	22	22	22	22	22	22
<b>Brazil</b>	34	34	34	34	34	34	34	34	34	34	34
<b>Brunei Darussalam</b>											18.50
<b>Bulgaria</b>	10	10	10	10	10	10	10	10	10	10	10
<b>Burkina Faso</b>											27.50
<b>Burundi</b>											30
<b>Cambodia</b>				20	20	20	20	20	20	20	20
<b>Cameroon</b>									33	33	33
<b>Canada</b>	36.10	33.50	33	31	28	26	26	26.50	26.50	26.50	26.50
<b>Cayman Islands</b>	0	0	0	0	0	0	0	0	0	0	0
<b>Chile</b>	17	17	17	17	20	18.50	20	20	24	24	25.50
<b>China</b>	33	25	25	25	25	25	25	25	25	25	25
<b>Colombia</b>	34	33	33	33	33	33	25	25	25	25	34
<b>Congo (Democratic Republic of the)</b>											35
<b>Costa Rica</b>	30	30	30	30	30	30	30	30	30	30	30
<b>Croatia</b>	20	20	20	20	20	20	20	20	20	20	20
<b>Curacao</b>					34.50	27.50	27.50	27.50	22	22	22

<b>Cyprus</b>	10	10	10	10	10	10	12.50	12.50	12.50	12.50	12.50
<b>Czech Republic</b>	24	21	20	19	19	19	19	19	19	19	19
<b>Denmark</b>	25	25	25	25	25	25	25	24.50	22	22	22
<b>Djibouti</b>											25
<b>Dominica</b>											25
<b>Dominican Republic</b>	25	25	25	25	29	29	29	28	27	27	27
<b>Ecuador</b>	25	25	25	25	24	23	22	22	22	22	22
<b>Egypt</b>	20	20	20	20	20	25	25	25	22.50	22.50	22.50
<b>El Salvador</b>						30	30	30	30	30	30
<b>Estonia</b>	22	21	21	21	21	21	21	21	20	20	20
<b>Ethiopia</b>											30
<b>Fiji</b>	31	31	29	28	28	28	20	20	20	20	20
<b>Finland</b>	26	26	26	26	26	24.50	24.50	20	20	20	20
<b>France</b>	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.30	33.33
<b>Gabon</b>											30
<b>Gambia</b>											31
<b>Georgia</b>							15	15	15	15	15
<b>Germany</b>	38.36	29.51	29.44	29.41	29.37	29.48	29.55	29.58	29.72	29.72	29.79
<b>Ghana</b>							25	25	25	25	25
<b>Gibraltar</b>	35	33	27	22	10	10	10	10	10	10	10
<b>Greece</b>	25	25	25	24	20	20	26	26	29	29	29
<b>Grenada</b>											30
<b>Guatemala</b>	31	31	31	31	31	31	31	28	25	25	25
<b>Guernsey</b>	0	0	0	0	0	0	0	0	0	0	0
<b>Honduras</b>	30	30	30	25	35	35	35	30	30	30	25
<b>Hong Kong SAR</b>	17.50	16.50	16.50	16.50	16.50	16.50	16.50	16.50	16.50	16.50	16.50
<b>Hungary</b>	16	16	16	19	19	19	19	19	19	19	9
<b>Iceland</b>	18	15	15	18	20	20	20	20	20	20	20
<b>India</b>	33.99	33.99	33.99	33.99	32.44	32.45	33.99	33.99	34.61	34.61	30
<b>Indonesia</b>	30	30	28	25	25	25	25	25	25	25	25
<b>Iraq</b>							15	15	15	15	15

<b>Ireland</b>	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50	12.50
<b>Isle of Man</b>	0	0	0	0	0	0	0	0	0	0	0
<b>Israel</b>	29	27	26	25	24	25	25	26.50	25	25	24
<b>Italy</b>	37.25	31.40	31.40	31.40	31.40	31.40	31.40	31.40	31.40	31.40	24
<b>Ivory Coast</b>											25
<b>Jamaica</b>	33.33	33.33	33.33	33.33	33.33	33.33	25	25	25	25	25
<b>Japan</b>	40.69	40.69	40.69	40.69	40.69	38.01	38.01	35.64	33.86	30.86	30.86
<b>Jersey</b>	0	0	0	0	0	0	0	0	20	20	20
<b>Jordan</b>	25	25	25	14	14	14	14	14	20	20	20
<b>Kazakhstan</b>	30	30	20	20	20	20	20	20	20	20	20
<b>Kenya</b>						30	30	30	30	30	30
<b>Korea, Republic of</b>	27.50	27.50	24.20	24.20	22.00	24.20	24.20	24.20	24.20	24.20	22
<b>Kuwait</b>	55	55	15	15	15	15	15	15	15	15	15
<b>Kyrgyzstan</b>											10
<b>Latvia</b>	15	15	15	15	15	15	15	15	15	15	15
<b>Lebanon</b>							15	15	15	15	15
<b>Libya</b>	40	40	40	40	20	20	20	20	20	20	20
<b>Liechtenstein</b>					12.50	12.50	12.50	12.50	12.50	12.50	12.50
<b>Lithuania</b>	15	15	20	15	15	15	15	15	15	15	15
<b>Luxembourg</b>	29.63	29.63	28.59	28.59	28.80	28.80	29.22	29.22	29.22	29.22	27.08
<b>Macau</b>	12	12	12	12	12	12	12	12	12	12	12
<b>Macedonia</b>	12	10	10	10	10	10	10	10	10	10	10
<b>Madagascar</b>											20
<b>Malawi</b>						30	30	30	30	30	30
<b>Malaysia</b>	27	26	25	25	25	25	25	25	24	24	24
<b>Malta</b>	35	35	35	35	35	35	35	35	35	35	35
<b>Mauritius</b>	22.50	15	15	15	15	15	15	15	15	15	15
<b>Mexico</b>	28	28	28	30	30	30	30	30	30	30	30
<b>Moldova</b>									12	12	12
<b>Monaco</b>											33.33
<b>Mongolia</b>											25

<b>Montenegro</b>	9	9	9	9	9	9	9	9	9	9	9
<b>Morocco</b>							30	30	31	31	31
<b>Mozambique</b>	32	32	32	32	32	32	32	32	32	32	32
<b>Myanmar</b>											25
<b>Namibia</b>					34	34	33	33	33	32	32
<b>Netherlands</b>	25.50	25.50	25.50	25.50	25	25	25	25	25	25	25
<b>New Zealand</b>	33	30	30	30	28	28	28	28	28	28	28
<b>Nicaragua</b>											30
<b>Nigeria</b>	30	30	30	30	30	30	30	30	30	30	30
<b>Norway</b>	28	28	28	28	28	28	28	27	27	25	24
<b>Oman</b>	12	12	12	12	12	12	12	12	12	12	15
<b>Pakistan</b>	35	35	35	35	35	35	35	34	33	32	31
<b>Palestinian Territory</b>											15
<b>Panama</b>	30	30	30	27.50	25	25	25	25	25	25	25
<b>Papua New Guinea</b>	30	30	30	30	30	30	30	30	30	30	30
<b>Paraguay</b>	10	10	10	10	10	10	10	10	10	10	10
<b>Peru</b>	30	30	30	30	30	30	30	30	30	30	29.50
<b>Philippines</b>	35	35	30	30	30	30	30	30	30	30	30
<b>Poland</b>	19	19	19	19	19	19	19	19	19	19	19
<b>Portugal</b>	25	25	25	25	25	25	25	23	21	21	21
<b>Qatar</b>	35	35	35	10	10	10	10	10	10		10
<b>Romania</b>	16	16	16	16	16	16	16	16	16	16	16
<b>Russia</b>	24	24	20	20	20	20	20	20	20	20	20
<b>Rwanda</b>											30
<b>Saint Kitts and Nevis</b>											33
<b>Saint Lucia</b>											3
<b>Saint Vincent and the Grenadines</b>											32.50
<b>Samoa</b>	27	27	27	27	27	27	27	27	27	27	27
<b>Saudi Arabia</b>	20	20	20	20	20	20	20	20	20	20	20
<b>Senegal</b>											30

<b>Serbia</b>	10	10	10	10	10	10	15	15	15	15	15
<b>Sierra Leone</b>								30	30	30	30
<b>Singapore</b>	20	18	18	17	17	17	17	17	17	17	17
<b>Sint Maarten (Dutch part)</b>					34.50	34.50	34.50	34.50	34.50	34.50	34.50
<b>Slovakia</b>	19	19	19	19	19	19	23	22	22	22	21
<b>Slovenia</b>	23	22	21	20	20	18	17	17	17	17	19
<b>Solomon Islands</b>											30
<b>South Africa</b>	36.89	34.55	34.55	34.55	34.55	34.55	28	28	28	28	28
<b>Spain</b>	32.50	30	30	30	30	30	30	30	28	25	25
<b>Sri Lanka</b>	35	35	35	35	28	28	28	28	28	15	28
<b>St Maarten</b>									24.50	34.50	34.50
<b>Sudan</b>	30	15	15	15	35	35	35	35	35	35	35
<b>Suriname</b>							36	34.50	34.50	34.50	36
<b>Swaziland</b>											27.50
<b>Sweden</b>	28	28	26.30	26.30	26.30	26.30	22	22	22	22	22
<b>Switzerland</b>	20.63	19.20	18.96	18.75	18.31	18.06	18.01	17.92	17.92	17.92	24.41
<b>Syria</b>	28	28	28	28	28	28	22	22	22	22	28
<b>Taiwan</b>	25	25	25	17	17	17	17	17	17	17	17
<b>Tanzania</b>			30	30	30	30	30	30	30	30	30
<b>Thailand</b>	30	30	30	30	30	23	20	20	20	20	20
<b>Trinidad and Tobago</b>						25	25	25	25	25	25
<b>Tunisia</b>	30	30	30	30	30	30	30	25	25	25	25
<b>Turkey</b>	20	20	20	20	20	20	20	20	20	20	20
<b>Turkmenistan</b>											20
<b>Turks and Caicos Islands</b>											0
<b>Uganda</b>	30	30	30	30	30	30	30	30	30	30	30
<b>Ukraine</b>	25	25	25	25	25	21	19	18	18	18	18
<b>United Arab Emirates</b>	55	55	55	55	55	55	55	55	55	55	55
<b>United Kingdom</b>	30	30	28	28	26	24	23	21	20	20	19

<b>United States</b>	40	40	40	40	40	40	40	40	40	40	40
<b>Uruguay</b>	30	25	25	25	25	25	25	25	25	25	25
<b>Uzbekistan</b>										7.50	7.50
<b>Vanuatu</b>	0	0	0	0	0	0	0	0	0	0	0
<b>Venezuela</b>	34	34	34	34	34	34	34	34	34	34	34
<b>Vietnam</b>	28	28	25	25	25	25	25	22	22	22	20
<b>Yemen</b>	35	35	35	35	20	20	20	20	20	20	20
<b>Zambia</b>	35	35	35	35	35	35	35	35	35	35	35
<b>Zimbabwe</b>	30.90	30.90	30.90	25.75	25.75	25.75	25.75	25.75	25.75	25.75	25
<b>Africa average</b>	30.56	28.65	28.75	28.38	28.55	29.02	28.29	27.85	27.97	27.46	28.21
<b>Americas average</b>	29.27	28.84	28.82	28.28	29.28	28.67	28.35	27.96	26.96	27.86	28.29
<b>Asia average</b>	28.46	27.99	25.73	23.96	23.10	22.89	22.05	21.91	21.78	21.46	21.28
<b>EU average</b>	23.97	23.17	23.11	22.93	22.70	22.51	22.75	22.39	22.20	22.09	21.51
<b>Europe average</b>	22.99	21.95	21.64	21.46	20.81	20.42	20.60	20.42	20.09	20.48	19.71
<b>Global average</b>	26.95	26.10	25.38	24.69	24.50	24.40	24.09	23.88	23.52	23.47	24.29
<b>Latin America average</b>	28.30	27.96	27.96	27.52	28.83	28.30	27.96	27.52	26.33	27.29	27.98
<b>North America average</b>	38.05	36.75	36.50	35.50	34	33	33	33.25	33.25	33.25	33.25
<b>Oceania average</b>	30.20	29.60	29.20	29.00	28.60	28.60	27	27	27	26	28.67
<b>OECD average</b>	27.00	25.99	25.64	25.70	25.40	25.15	25.32	24.98	24.84	24.81	24.27
<b>South America average</b>	28.30	27.96	27.96	27.52	28.83	28.30	27.96	27.52	26.33	27.29	27.98

#### 4.1 Prevailing arguments in favour of decreasing the corporate tax rate

The KPMG table above indicates that South Africa's corporate income tax rate (28%) is generally slightly higher than the regional averages and that it is fairly close to the 2017 African average of 28.21% and the Latin American average of 27.98%; it is nevertheless

significantly higher than the EU average of 21.51% and the OECD average of 24.27%.<sup>86</sup> It is also higher than some of its neighbours or competitors, including Mauritius (15%), Botswana (22%).

The SADC Community report 2016 (set out above) also demonstrates that, whereas South Africa collects largely profits tax from corporates, its neighbours and competitors tend to actually collect less profits tax than South Africa as a proportion and more labour taxes and other taxes from corporates.

The KPMG table also shows that, over the years, there has been a trend by many countries to reduce the corporate income tax rates. The UK, which is one of South Africa's main trading partners, had a 30% rate in 2007. This was reduced gradually over the years, standing at 20% in 2016 and 18% in 2017/2018. The USA, also one of South Africa's trading partners, has, over the years, had a very high corporate tax rate (35%) but this has been sharply reduced in recent times. Since January 1st 2018, the effective corporate tax rate in the United States of America is a flat 21 percent due to the passage of the "Tax Cuts and Jobs Act" on December 20th, 2017.<sup>87</sup> Indeed, due to the previous high rate, many US companies had moved their residence to other countries like Canada, Britain, Ireland, China and Mexico that have lower tax rates.<sup>88</sup> The latter countries had to reduce their rates to ensure competitiveness of their economies, and attractiveness to both local and global companies.

In an increasingly integrated world economy, international tax competition has pressured jurisdictions to lower their company tax rates in order to attract multinational corporate groups. When countries like the UK and Canada reduce their corporate tax rates it puts significant pressure on countries like South Africa to follow suit<sup>89</sup> if South Africa is to maintain and attract local business and foreign direct investment, respectively.

Countries that rely heavily on direct and indirect foreign investment often consider reducing the corporate tax rate in the hope that, by so doing, they can attract FDI. With increased FDI, there are other knock-on benefits, such as increased employment.<sup>90</sup>

It is also argued that when the corporate tax rate is lowered, there is less incentive for corporates to shift profits outside South Africa and thereby erode the tax base. This, again, means that greater tax revenues can be collected, while increasing South Africa's

<sup>86</sup> National Treasury *Budget Review* (2017) at 40.

<sup>87</sup> Trading Economic "United States Federal Corporate Tax Rate" (2018). Available at <https://tradingeconomics.com/united-states/corporate-tax-rate> accessed 30 January 2018.

<sup>88</sup> Dermont Gaffney, KPMG "New Corporate Tax Regime to attract multinationals back to the US" (2006). Available at <https://www.sablog.kpmg.co.za/2016/11/new-corporate-tax-regime-attract-multinationals-back-us/> accessed 16 November 2016.

<sup>89</sup> KPMG "New Corporate Tax Regime to attract multinationals back to the US" (2017) Available at <https://www.sablog.kpmg.co.za/2016/11/new-corporate-tax-regime-attract-multinationals-back-us/> accessed 20 May 2017.

<sup>90</sup> SAIPA Technical Report on Corporate Tax submitted to the DTC (29 March 2017) at 3



international competitiveness, and requiring less resources and interventions to counter anti-avoidance schemes.<sup>91</sup> There is also empirical evidence that shows that the general level of compliance and the amount of tax revenues collected is directly correlated with low tax rates.<sup>92</sup>

The then Minister of Finance acknowledged, in the 2017 National Budget, that the current corporate rate of 28% is relatively high by global standards and, more particularly, by sub-Saharan standards. Furthermore, he acknowledged that the relative severity of this rate acts as one of the disincentives for foreign investment and therefore results in a decline in CIT revenue over the long term. Relatively high rates of CIT only result in short term increases in tax revenues.<sup>93</sup> From this perspective, it is important that the CIT rate is not only considered from its relevance as a revenue generator but also its relevance to economic growth. From the latter perspective, lowering the CIT rate presents an opportunity to encourage foreign direct investment and to stimulate companies based in South African to invest back into the economy, thereby leading to long term increases in tax revenue, as opposed to looking for opportunities to invest offshore.<sup>94</sup> A lower tax rate would also be instrumental in assisting in ensuring the competitiveness of South Africa's companies and also assist in incentivising them not to move their residence or profits offshore. Considering the current low economic growth, high inflation and high borrowing costs, this may be an attractive option.

A low corporate tax rate would also go a long way in enhancing South Africa's head-quarter company regime, in terms of which the country is positioning itself as a head office, finance or management company location for investment into Africa north of its borders due to the country's relatively developed financial structure and other infrastructural advantages.

## **4.2 Prevailing Arguments for not decreasing the corporate tax rate**

As much as the arguments for reducing the corporate tax rate may sound convincing, there are also arguments against decreasing the rate (under the current circumstances) which have to be considered. A reduction in the corporate tax rate (in an environment where, as indicated above, corporates contribute a significant fraction of the revenue collection) implies that there will need to be some level of certainty that the reduced rate will be effective in stimulating growth and, thus, increasing the overall tax base and corresponding overall collection of taxes as, if this is not the case, the resultant reduction in revenue will have to be compensated for elsewhere. Other tax measures will be needed to balance any deficits. The risk South Africa will run if it reduces corporate tax is that other policy measures (e.g. immigration laws, ability to guarantee electricity and water supplies, security of tenure, reduced corruption), together with political and social uncertainty, will

<sup>91</sup> SAIPA Technical Report on Corporate Tax submitted to the DTC (29 March 2017) at 3

<sup>92</sup> SAIPA Technical Report on Corporate Tax submitted to the DTC (29 March 2017) at 3

<sup>93</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 8.2.

<sup>94</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 8.2.

continue to act as disincentives for further, or new, investment in South Africa. . SARS is of the view that:

“a comparison of international tax rates reveals that by and large corporate tax rates have moved substantially lower over the last number of years, despite levelling out in recent times, and in some cases increasing again marginally. In this light, retaining the current 28% corporate tax rate appears to be a sober approach, especially in view of the already existing uncertainty precipitated by the recession, and compounded by recent sluggish growth over most of the globe. Further, the increased capital gains rates and higher dividends tax rates introduced in the 2012 and 2017 Budget further militate against additional invasive rate tampering in the near future”.<sup>95</sup>

Internationally, governments appear to be trapped between the need for tax revenue and trying to support their ailing economies. For most countries, the chosen path was to do nothing, leaving headline rates unchanged, but under the surface much work was done in order to deliver on both aspects. Tax authorities are, from a corporate tax perspective, focusing their efforts on “examining and widening tax bases, restricting deductions and allowances and bringing new forms of income into the tax net. The effect has been to maintain or increase government revenues while leaving rates untouched.”<sup>96</sup> In South Africa, National Treasury also appears to have taken this stance. In the 2017 Budget review it is noted that “corporate tax revenue can be increased by broadening the tax base. This can involve removing tax incentives, and introducing measures to curb tax avoidance. Government is re-evaluating existing items that narrow the corporate tax base, including tax incentives and deduction for excessive debt financing”.<sup>97</sup> A few of these tax incentives are evaluated in this report.

### 4.3 The World Bank Report on the effective burden for South Africa

In 2015, the World Bank conducted a “Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa”,<sup>98</sup> (both full reports have been published by the Davis Tax Committee) which shows how South Africa’s tax system impacts on Marginal Effective Tax Rates (METRs) and on capital investment. It, thus, sheds light on the impact of the tax system on investments in South Africa.<sup>99</sup> The World Bank Report explains that, “the METR is a measure of the burden of tax on the marginal investment for a profit maximizing firm and determines the scale of a project. A higher METR means small size projects and fewer investments. As a result, the METR is an important parameter to keep in mind when designing tax policy”.<sup>100</sup> The analysis of the METRs on capital helps assess how taxes can affect the rate of return required by investors on capital expenditure. Investors are assumed to undertake a given investment

<sup>95</sup> SARS “Legal & Policy Product Oversight Report: Corporate Income Tax” (2016-17) at 94.

<sup>96</sup> SARS “Legal & Policy Product Oversight Report: Corporate Income Tax” (2016-17) at 56.

<sup>97</sup> National Treasury “Budget Review (February 2017) at 40.

<sup>98</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015).

<sup>99</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 2.

<sup>100</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 2.

only if the expected earnings and/or capital gains generate a rate of return on their equity that is at least as high as what they could earn from alternative uses of their funds, usually taken to be an investment in relatively risk-free government bonds. If the overall effect of corporation income taxes, withholding taxes, and other taxes, is to reduce the return on equity below what is available on new investments elsewhere, then investment is discouraged.<sup>101</sup>

The METR measures the wedge between the before-tax rate of return and the after-tax rate of return on marginal investments. The marginal investment is the last “piece” of investment made by a profit maximizing firm. This means that the return on the marginal investment would be just equal to the opportunity cost of that investment (which is some combination of investing in the bond and stock market). In the case of investments that generate above-normal after-tax returns (i.e. infra-marginal investments), the Average Effective Tax Rate (AETR) is more appropriate. This is because investments generating above-normal returns are, by definition, profitable and therefore not likely to be deterred by the tax system unless the tax rates are egregiously high. For highly profitable investments however, the corporate tax rate is more relevant than the METR.<sup>102</sup>

In a highly competitive world economy, most investments have little economic rent and thus are likely to be sensitive to the METR (rather than AETR which is relevant when there are economic rents to extract). In principle, it is possible to design a tax system that yields positive tax revenues while generating an METR equal to zero, implying that all viable investments would be undertaken. Such a system would collect tax revenues only from the investments enjoying above-normal returns with the marginal investment generating zero tax. It is also possible for the METR to be negative. This would imply that the tax system subsidizes, implicitly, investments that would otherwise not be undertaken. Hence the METR is very useful in determining the impact of the tax system on real investment decisions of taxpayers.<sup>103</sup>

The World Bank Report on “Effective Tax Burden & Effectiveness of Investment Incentives in South Africa”<sup>104</sup> showed that “across all sectors examined, the METR on capital is on average lower than the statutory CIT rate of 28%. Although the Report noted that there is substantial variation in the METR across sectors, with the METR on capital varying between 31.9% for iron ore mining, 23% for the electricity sector, 19.6% for manufacturing, and 19.7% for chrome mining, the analysis of the METR across all sectors suggests that the tax system is not a major deterrent to investment. So, while the statutory rate may be somewhat higher than that in other country comparators, accelerated depreciation

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<sup>101</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 16.

<sup>102</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 17.

<sup>103</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 18.

<sup>104</sup> World Bank “South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015).

schedules, investment allowances, and interest deductibility work to reduce the effective burden considerably".<sup>105</sup> The sectors that do benefit from accelerated depreciation allowances and/or rely heavily on debt to fund their investment bear a significantly lower tax burden on their capital investment than what is implied by the standard CIT rate.<sup>106</sup>

The study showed that incorporating the METR on labour into the overall METR facing investors does not fundamentally alter the finding that the overall burden is still lower than the statutory CIT tax rate. The ability to deduct interest from taxable income reduces the METR considerably even in sectors that receive no specific incentive. The study noted that high inflation has a big impact on the METR mainly due to its effect on the burden on inventory under First in First Out (FIFO) accounting. This raises the METRs in those sectors in South Africa that have a high proportion of inventory such as manufacturing.<sup>107</sup>

Overall, the World Bank found that the tax system was not among the major problems facing investors in South Africa. The challenges to growth are primarily non-tax issues related to the business environment.<sup>108</sup> As indicated above, some common obstacles to investment noted across sectors were the reliability of electricity supply, labour relations, and policy uncertainty. Some sectors such as tourism faced specific concerns about potential impact of new regulations (such as the tightening up of tourist visas and travel with children) on the growth of the sector.<sup>109</sup>

#### **4.4 DTC recommendations on the corporate tax rate for South Africa under the current economic circumstances**

Any change to the corporate tax rate must be made with the necessary circumspection as it may not only require one to look at the applicable rate used by trade partners but also to take cognisance of our neighbouring States. However it is important that this is done in a holistic manner, taking into account the different allowance and exemptions regimes (incentives). It also requires one to consider South Africa's reliance on foreign indirect investment and its socio-economic challenges. The World Bank Report on "Effective Tax Burden & Effectiveness of Investment Incentives in South Africa",<sup>110</sup> did exactly that, concluding that while South Africa's statutory corporate tax rate may be somewhat higher

<sup>105</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 5.

<sup>106</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 6. It should be noted that legislation limiting interest deductions has been recently implemented in line with the OECD BEPS Project.

<sup>107</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 9-11.

<sup>108</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 4.

<sup>109</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015) in para 12.

<sup>110</sup> World Bank "South Africa Country-level fiscal policy notes: Sector Study of Effective Tax Burden & Effectiveness of Investment Incentives in South Africa-Part I (Report No: AUS12595, 2015).

than that in other countries, the system overall is not a major deterrent to investment.

The European Commission notes that, when a government lowers company tax rates to increase tax competition, this may not necessarily lead to an increase in its productivity or efficiency in applying its resources. It only means that companies located in that country may increase their after-tax profits. Countries that attract foreign direct investment by offering lower tax rates are not necessarily more competitive than countries with high tax rates. The competitiveness of a tax system cannot, therefore, only be judged by rates, incentives or even by reference to the overall tax burden.<sup>111</sup>

In order to have a tax policy that really contributes to a competitive economy, it is also necessary to focus on the quality of the tax system by ensuring that tax evasion is reduced and that the principles of efficiency and neutrality are adhered to in the treatment of corporate groups.<sup>112</sup>

Taking all the above information into account, bearing in mind that other policy changes would need to be reviewed in order for tax to be a factor that might assist in promoting economic growth and with current economic growth expectations continuing to be pedestrian, it is not recommended that National Treasury should consider a corporate tax decrease at the present time. This is despite the fact that many of South Africa's trading partners have been decreasing their corporate tax rates, to remain competitive. It is also important to note, as indicated above, that a reduction of the rate will not attract additional investment without other policy changes with respect to labour, immigration, power supply, security of tenure etc. However, a review of the tax rate should be made on a regular basis and should other factors change and policy decisions be made, which may promote growth, then the level of the corporate tax rate should be reconsidered. At that point, consideration should be given to the level at which the corporate tax rate could be set bearing in mind the following factors:

- Through the conduct of a detailed study, it could be established whether any of the existing incentives within the income tax legislation are not 'fit for purpose'. See also recommendations in section 7 below relating to incentives.
- Establish the extent to which removal of incentives that do not necessarily achieve their policy objectives could be offset by a reduction in the corporate income tax rate;
- Consider the extent to which removal of incentives simplifies the prevailing tax legislation and the attendant benefits thereto.
- Consider the extent to which the resultant potential reduction in tax rate might incentivise businesses not previously identified for incentives e.g. small businesses, innovation businesses as well as foreign direct investment.

It is submitted that at the current speed of technological change, it is difficult to anticipate

<sup>111</sup> European Commission *Press Release: Competitive Tax Policy and Tax Competition in the EU (2011)*. Available from: [http://europa.eu/rapid/press-release\\_SPEECH-11-712\\_en.htm?locale=en](http://europa.eu/rapid/press-release_SPEECH-11-712_en.htm?locale=en) [Accessed: 2016-10-12].

<sup>112</sup> Ibid.

what the nature of the next “great” businesses may be. This in turn makes it very difficult to choose appropriate tax incentives and to implement them fast enough to have a positive impact.

## 5 REVIEW OF THE EFFICIENCY OF THE DIVIDENDS TAX RATE

Until February 2017 the dividend withholding tax was levied at a rate of 15%. After accounting for corporate income tax, which is paid before a distribution of dividends, the combined tax rate on income paid in the form of dividends was 38.8%. This meant that South Africa's combined statutory tax rate on dividend income fell above the OECD average income tax rate which is 24.29%, but per National Treasury, below the combined rate with dividends taxes included, which is over 40%.<sup>113</sup> National Treasury reasoned that, to reduce the difference between the combined statutory tax rate on dividends and the top marginal personal income tax rate (increased to 45% with effect from 1 March 2017) government increased the dividend withholding tax rate to 20%, effective 22 February 2017, and the exemption and rates for inbound foreign dividends was adjusted in line with the new rate, effective for years of assessment commencing on or after 1 March 2017.<sup>114</sup> The concern though is whether this increase impacts on the efficiency of South Africa's corporate tax structure.

The increased dividends tax rate may however create unintended consequences when viewed from the perspective of lower income earning individuals. It, for instance, directly impacts on resident shareholders that are individuals or recipients of the dividends that benefit from BEE share incentives structures. These individuals typically do not fall into the higher marginal tax rate brackets.<sup>115</sup> The increased rate is therefore in direct contrast to the policy objective, articulated in the 2017 Budget Review, that South Africa needs broad-based economic transformation that boosts income growth for all citizens, and is contrary to the intention to tax residents in proportion to their income.<sup>116</sup> This also goes contrary to “vertical equity”, as the foundational principle of a good tax system which requires that all residents contribute to the fiscus based on their ability to pay.<sup>117</sup>

The increase in the dividends tax rate has also created some distortions in the tax system. Many individual shareholders, particularly in closely held private companies (where the potential for arbitrage exists), do not pay tax at the marginal rate. This has the effect that such individual shareholders would, if dividends were paid to them, be taxed at a higher

<sup>113</sup> National Treasury *Budget Review* (2017) at 46. It is, however, not clear which year this relates to.

<sup>114</sup> National Treasury *Budget Review* (2017) 46.

<sup>115</sup> Chamber of Mines Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 2.3.

<sup>116</sup> National Treasury “Budget Speech” (2017) 22.

<sup>117</sup> Chamber of Mines Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 2.3.

rate than they would be if they elected to rather pay the profits of the company to them in the form of, for example, directors' fees or remuneration.<sup>118</sup>

The increase in dividends tax has also called into question the policy of taxing foreign dividends in circumstances where the participation exemption in section 10B does not apply. The current policy is to tax such dividends at the withholding tax rate, as income, but no deductions are allowed in respect thereof in terms of section 23(1)(q) of the Act. The appropriateness of this outcome is questionable if the income received is actually being taxed. It is therefore important that the policy applying to the taxation of foreign dividends in full, where such dividends are taxable in South Africa, be evaluated.

The increase in the dividends tax rate has also had the effect that the higher rate mainly impacts South African resident individuals, rather than non-residents, due to the relief provided in the double taxation treaties (DTAs) that South Africa has with other countries, which generally reduces the rate to 15% - which is the same rate as the previous rate, or below.<sup>119</sup>

The other downside of the rate increase is that it only results in short term revenue as it does not increase the base of available taxpayers. This could also distort investment decisions and promote avoidance schemes (e.g. South African investors who wish to retain their shares may sell their share portfolios into companies in order to benefit from the dividend exemption until they need the dividends paid out, rather than holding them in their own names- such a course of action, however, needs to be measured against the increased effective capital gains tax rate borne by a company on realisation of shares held for investment purposes).

The increased rate is also a disincentive for investment.<sup>120</sup> The combined increase in dividends tax and the increase in the top rate of income tax to 45% for individuals may, over the longer term, have detrimental consequences. As indicate earlier, it may be appropriate to re-evaluate these increases once economic stability has been achieved<sup>121</sup>

Even in the current context of low economic growth, it is critically important to ensure that taxes are raised in a manner that is least disruptive to economic growth and employment. It is therefore recommended that the dividends tax rate be reduced back to 15%. Policy makers should ensure that taxes are not increased merely so as to satisfy revenue collection needs without consideration of the long term fiscal impacts of the whole tax system. The table below shows the international dividends tax rates, which should also be taken into consideration before a change in the rate is effected; so as to ensure that the country remains competitive internationally.

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<sup>118</sup> PWC Technical Report on Corporate Tax submitted to the DTC (31 march 2017) at 33.

<sup>119</sup> BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 3.

<sup>120</sup> BASA Technical Report on Corporate Tax submitted to the DTC (30 March 2017) para 8.

<sup>121</sup> BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 3

Country	Rate	Country	Rate	Country	Rate
Albania	15%	Guatemala	5%	Norway	25%
Algeria	15%	Guernsey	0%	Oman	0%
Andorra	0%	Guinea Conakry	10%	Pakistan	10%
Angola	10%	Hong Kong (Local)	0%	Palau	0%
Antigua and Barbuda	25%	Hungary	0%	Palestinian Territories	10%
Argentina	10%	Iceland	18%	Panama	10%
Armenia	10%	India	0%	Papua New Guinea	15%
Aruba	10%	Indonesia	20%	Paraguay	15%
Australia	30%	Iraq	0%	Peru	4.10%
Austria	27.50%	Ireland	20%	Philippines	30%
Azerbaijan	10.00%	Isle Of Man	0%	Poland	19%
Bahamas	0%	Israel	25%	Portugal	35%
Bahrain	0%	Italy	26%	Puerto Rico	10%
Bangladesh	20%	Jamaica	33.33%	Qatar	0%
Barbados	25%	Japan	15.32%	Romania	16%
Belarus	12%	Jersey	0%	Russia	15%
Belgium	27.00%	Jordan	0%	Rwanda	15%
Benin	15.00%	Kazakhstan	15%	Saudi Arabia	5%
Bermuda	0%	Kenya	10%	Senegal	10%
Bosnia	5%	Korea	22%	Serbia	20%
Botswana	7.50%	Kosovo	0%	Seychelles	15%
Brazil	0%	Kuwait	15%	Singapore	0%
British Virgin Islands	0%	Laos	10%	Slovakia	35%
Brunei	0%	Kyrgyzstan	10%	Slovenia	15%
Bulgaria	5%	Latvia	0%	Solomon Islands	30%
Burkina Faso	12%	Lebanon	10%	South Africa	20%
Burundi	15%	Lesotho	25%	South Sudan	10%
Cambodia	14%	Liberia	15%	Spain	20%
Canada	25%	Libya	0%	Sri Lanka	10%
Cayman Islands	0%	Liechtenstein	4%	St Kitts & Nevis	10%
Chad	20%	Lithuania	15%	St Lucia	0%
Chile	35%	Luxembourg	15%	St Vincent & The Grenadines	0%
China (A-, B-, H-Shares)	10%	Macao SAR	0%	Swaziland	15%
China (P, Red Chips)	0%	Macedonia	10%	Sweden	30%
Colombia	5%	Madagascar	0%	Switzerland	35%
Congo (DRC)	20%	Maderia	35%	Syria	0%
Côte d'Ivoire	10%	Malawi	10%	Taiwan	20%
Croatia	12%	Malaysia	0%	Tanzania	10%
Curacao	0%	Maldives	0%	Thailand	10%
Cyprus	0%	Malta	0%	Trinidad & Tobago	10%



Country	Rate	Country	Rate	Country	Rate
Czech Republic	35%	Marshall Islands	0%	Tunisia	5%
Denmark	27%	Mauritania	10%	Turkey	15%
Ecuador	0%	Mauritius	0%	Turkmenistan	15%
Egypt	10%	Mexico	10%	Turks & Caicos	0%
Estonia	0%	Moldova	6%	U.K. (Corporations)	0%
Faroe Islands	35%	Morocco	15%	U.K. (REITs)	20%
Finland	30%	Mozambique	20%	U.S.	30%
France	30%	Myanmar	0%	Uganda	15%
Gabon	20%	Namibia	20%	Ukraine	15%
Gambia	15%	Nauru	0%	United Arab Emirates	0%
Georgia	5%	Netherlands	15%	Venezuela	34%
Germany	26.38%	New Zealand	30%	Vietnam	0%
Ghana	8%	Nicaragua	17%	Zambia	15%
Gibraltar	0%	Nigeria	10%	Zimbabwe	10%
Greece	10%				

## 6 REVIEW OF THE EFFICIENCY OF THE CGT CORPORATE INCLUSION RATE

CGT was introduced in South Africa in October 2001 - over 15 years ago - representing a fundamental policy shift. The CGT regime which was adopted was relatively simple to implement, as it was premised on the building blocks of defined terms such as “proceeds”, “base cost” and “asset”. The CGT rate was intended to be relatively low, not only in order to compensate for the effects of inflation on the computations of capital gains, but to also limit the negative economic impact on entrepreneurs who would see a decrease in the capital growth of their enterprises.<sup>122</sup> Thus, a fractional inclusion rate was applied to the net capital gains for a year, which was then taxed at the statutory tax rate, resulting in a relatively low amount of CGT being payable.

As indicated above, the inclusion rates of less than 100 per cent of net capital gains in taxable income provided relief from the effects of inflation on capital gains.<sup>123</sup> In effect, though, the CGT inclusion rate regime did not provide an appropriate mechanism for the impact of inflation on the increase in an asset's value over time.<sup>124</sup> In addition, as a revenue raising technique, over the last four years, the CGT inclusion rates for corporates have been increased dramatically from 50% to 66.6% to 80%, without consideration of original intention of the low inclusion rate compensating to some extent for the impact of inflation. The combined result of the absence of an appropriate mechanism to exclude the impact of inflation on the increase in an asset's value over time and the increasing inclusion rates, imply that nominal gains are taxed without sufficient recognition of the dramatic effect of inflation on an asset's base cost in real terms. This is particularly

<sup>122</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 3.3.

<sup>123</sup> BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4.

<sup>124</sup> BASA Technical Report on Corporate Tax submitted to the DTC (30 March 2017) para 5.

relevant in an inflationary environment which officially hovers around 6%, and in many areas is, in fact, greater. The effect of this is that taxpayers are taxed on capital gains which actually represent inflationary growth and not real growth.<sup>125</sup> This result does not align with the legislature's policy intent when CGT was introduced in 2001. The high CGT rate has thus contributed to the current situation where capital is "trapped".

### **DTC recommendations on the CGT inclusion rates**

The DTC recommends that the policy perspectives regarding the levying of CGT need to be balanced. It is important that the focus placed on CGT as a revenue-raiser should not lose sight of the original policy objectives. It is therefore recommended that the CGT regime be reviewed; that the inclusion rate be reduced to levels which adequately compensate for the effects of inflation, or alternatively that an indexation system be considered whereby an asset's base cost is stepped up to compensate for the effects of real inflation in any particular sector, so as to better approximate real gains.<sup>126</sup>

## **7 EFFECTIVE TAX BURDEN AND EFFECTIVENESS OF CORPORATE TAX INCENTIVES**

### **7.1 The Philosophy behind providing targeted incentives through tax legislation**

Even though a country may want to raise taxes so as to fund the building of its infrastructure and to fund the provision of government services, it may also want to design its fiscal policies so as to attract local and foreign direct investment ((FDI) which can contribute to a country's overall economic development. Indeed, some empirical studies have found, for example, positive correlations between inward FDI and economic growth, even though conclusions about causality remain contentious.<sup>127</sup> A country may therefore use its tax codes to attract local investment and FDI in designated development areas by granting "tax incentives" to local and foreign investors to develop certain development objects in specific sectors of the economy,<sup>128</sup> thus giving up tax revenue maximization for the sake of achieving those developmental objectives.<sup>129</sup>

Tax incentives have been defined as "any tax provision granted to a qualified investment project that represents a favourable deviation from the provisions applicable to investment

<sup>125</sup> BASA Technical Report on Corporate Tax submitted to the DTC (30 March 2017) para 5.

<sup>126</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 3.3; BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4.

<sup>127</sup> S Adams "Foreign Direct Investment, Domestic Investment, and Economic Growth in Sub-Saharan Africa" 31 (2009) *Journal of Policy Modeling* 939-949.

<sup>128</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 6.

<sup>129</sup> SM Bwalya "Foreign direct investment and technology spillovers: Evidence from panel data analysis of manufacturing firms in Zambia" 81 (2006) *Journal of Development Economics* 514-526.

projects in general".<sup>130</sup> Although tax incentives can cover a broad range of direct or indirect taxes, this report concentrates on investment tax incentives that relate to corporate income tax. This excludes tax incentives pertaining to value added tax or other trade tariffs; grants, in-kind benefits or loan guarantees. Corporate tax incentives can take several forms. Examples include: tax free zones (designated areas in which specified businesses are exempt from taxes); tax holidays (complete exemption from tax for a limited duration) and preferential tax rates (reduced tax rates or tax credits for certain investment expenditures).<sup>131</sup>

Although the economic theory is that tax incentives act as a tool for encouraging local investment and FDI and there are empirical studies on the relationship between effective tax burdens and such investment, studies which look at effective tax burdens and FDI, for example, conclude that host country taxation significantly affects investment.<sup>132</sup> These studies refer mainly to investments in developed countries. In developing countries, the effects of tax on investment is generally smaller<sup>133</sup> and tax incentives have been noted to distort resource allocation leading to sub-optimal investment decisions which are harmful to long term economic growth. Distortions can also result in competitive disadvantages for non-incentivized investments. Diversion of labour and capital to the incentivised firms in response to discriminatory tax treatment can distort the allocation of resources and can damage economic growth.<sup>134</sup> The tax foregone as a result of granting tax incentives can narrow a country's tax base.<sup>135</sup> It should also be noted that resources are required to ensure that businesses comply with the requirements of granting tax incentives.<sup>136</sup> Where administrative capacity is limited, scarce resources might be diverted away from core aspects of a country's tax administration so as to administer tax incentives, which undermines other efforts to mobilise revenues.<sup>137</sup>

Granting tax incentives to, for example, foreign investors can also discourage domestic investors in a similar field since this gives foreign investors a competitive advantage over small and medium enterprises that operate at domestic level.<sup>138</sup> Where tax incentives are only granted to foreign investors; this may encourage domestic investors to abuse the tax

<sup>130</sup> The G-20 Development Working Group by the IMF, OECD, UN and World Bank "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 7.

<sup>131</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 8.

<sup>132</sup> De Mooij, A Ruud & S Ederveen "Corporate Tax Elasticities: A Reader's Guide to Empirical Findings," 24 (2008) *Oxford Review of Economic Policy* 680-97

<sup>133</sup> S James & S Van Parys "Investment Climate and the Effectiveness of Tax Incentives" (2009) World Bank Group.

<sup>134</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 19.

<sup>135</sup> IMF "Kenya, Uganda, and United Republic of Tanzania: Selected Issues" IMF Country Report No. 08/353 (2008) in para 15.

<sup>136</sup> IMF "Kenya, Uganda, and United Republic of Tanzania: Selected Issues" IMF Country Report No. 08/353 (2008) in para 15.

<sup>137</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 16.

<sup>138</sup> A Klemm & S Parys, "Empirical Evidence on the Effects of Tax Incentives" 19 (2012) *International Tax and Public Finance* 393-423.

incentive regime. For example, local firms may use foreign entities to route their local investments in order to qualify. Tax incentives could result in rent-seeking and other undesirable abusive activities.<sup>139</sup> Tax incentives can also create unintended tax-planning opportunities leading to further revenue leakages. Similarly, tax incentives enable opportunities for profits and deductions to be artificially shifted across entities with different tax treatments either domestically or internationally.<sup>140</sup>

Despite the widespread use of tax incentives for investment, in general there is inadequate analysis of their costs and benefits in a national context to support government decision-making. In addition, information on the lists of tax incentives is not readily available, nor is there reporting on who the beneficiaries are.<sup>141</sup>

In 2011, the IMF, OECD, UN and World Bank issued a Report which pointed out that effective tax systems have to ensure efficient and effective use of tax incentives for investment.<sup>142</sup> In 2015, the G20 Development Working Group in conjunction with the OECD, the IMF and the World Bank, published a “Toolkit for tax incentives”<sup>143</sup> which points out that a tax incentive is efficient and effective if its ultimate aim is to contribute to a country's development and improve living conditions for its citizens i.e. if it impacts on new job creation and reduces unemployment and boosts productivity that spills over in the domestic economy.<sup>144</sup> Tax incentives become counterproductive if their costs exceed the social benefits.<sup>145</sup> This could be the case where a tax incentive is redundant, in that the investments would have occurred without the incentive. A tax incentive is efficient if its objectives are achieved at low social costs. The costs of inefficient tax incentives include: revenue loss for government due to redundant tax incentives; potentially increased administrative and compliance costs; opportunities for rent seeking and corruption; and distortion of resource allocation.<sup>146</sup>

<sup>139</sup> A Klemm & S Parys, "Empirical Evidence on the Effects of Tax Incentives" 19 (2012) *International Tax and Public Finance* 393-423.

<sup>140</sup> OECD "Principles to enhance the transparency and governance of tax incentives for investment in developing countries" (2014) at 2.

<sup>141</sup> OECD "Principles to enhance the transparency and governance of tax incentives for investment in developing countries" (2014) at 2.

<sup>142</sup> IMF, OECD, UN and World Bank 2011, "*Striking the right balance between an attractive tax regime for domestic and foreign investment, by using tax incentives for example, and securing the necessary revenues for public spending, is a key policy dilemma.*" (2011).

<sup>143</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 6.

<sup>144</sup> IMF "Kenya, Uganda, and United Republic of Tanzania: Selected Issues" IMF Country Report No. 08/353 (2008) in para 8.

<sup>145</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 9.

<sup>146</sup> The G-20 Development Working Group "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment" (2015) at 10.

## 7.2 The World Bank Review of South Africa's Key Tax Incentives

The DTC requested the World Bank to review a list of key tax incentives which are available to corporate taxpayers through the South African income tax legislation, so as to determine the effectiveness of the investment incentives on encouraging investment. The World Bank, in its 2016 report on 'South Africa: Sector Study of Effective Tax Burden and Effectiveness of Investment Incentives in South Africa – Firm Level Analysis'<sup>147</sup> referred to incentives in general, but did not conclude on the efficiency of particular incentives in South Africa's suite of tax incentives:

"The research concludes that the effectiveness of tax incentives is mixed. While tax incentives lower the cost of capital for all sectors to between 3% and 6.5%, it is only in the Agriculture, Construction, Manufacturing, Trade and Services sectors that we see that lower cost of capital as a result of tax incentives translates into higher investment. On the other hand for the Mining, Real Estate, Transport and Utilities we do not find evidence that tax incentives were effective in encouraging investment. For the firms for which we have observations for all the years, overall tax incentives encouraged an additional investment of 2.1 billion rand each year between 2006 and 2012. The most additional investment was in the manufacturing sector where on average of 865 million rand in additional investment each year since 2006.

The revenue foregone as a result of the lower tax as a result of the tax incentives is about 4.5 billion rand each year over the seven year period. The revenue foregone was about 4 billion rand in 2012 with about a quarter of that is due to tax incentives for the Small Businesses Corporations. However this is lower than the peak of 6.8 billion rand in 2010. The Transport and Logistics and Utilities constituted most of the revenue foregone primarily as a result of huge investments made in these sectors and not necessarily that these sectors were targeted by the tax incentives. Revenue foregone for the mining and manufacturing sector has been about 400 million rand each over the period.

In terms of jobs, the tax incentives have resulted in 34,000 additional jobs. However it has not come cheap costing an average of about 116,000 rand of revenue foregone for each job. It cost the government nearly 170,000 rand of revenue foregone for each job created in Small Business Corporations. For manufacturing however, the cost was about 54,000 rand for each job.

Overall the message of this paper is that tax incentives may not be effective in all sectors because there may be other fundamental factors that restrict the growth of the sector that the tax incentive on its own cannot fix. However when properly targeted there is positive impact on investment as they lower the cost of investment encouraging investment in those sectors that are primed for growth when fundamental economic factors are conducive".

The World Bank subsequently issued a further report to the DTC (in 2017) on the Research and Development incentive<sup>148</sup> wherein it was concluded:

"while the paper does not have answers to the wider impact of the R&D as a result of the R&D incentive it attempts to answer if the 11D incentive increased R&D spending. By exploiting the fact that while many companies do invest in R&D a subset of them apply for the 11D incentive with a further subset of them actually granted the incentive we are able to use a simple methodology to estimate the impact. We find that companies that get the 11D incentive spend an additional R4 million on R&D as compared to those who do not get the R&D incentive. This positive impact is true for most of the sectors while certain prominent sectors in the South African economy (autos and

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<sup>147</sup> Issued June 2016

<sup>148</sup> Section 11D, inserted in November 2006 into the Income Tax Act (No58 of 1962) as amended.

mining) do not show any positive impact of the incentive. The paper also finds that while revenue foregone as a result of the 11D Tax Incentive is nearly R7 billion between 2008 and 2015, the additional R&D spending is nearly 13 billion. This implies that for every one rand of revenue foregone, companies spent an additional R 1.83 into R&D. In this regard the 11D incentive may be seen as a successful tax incentive".<sup>149</sup>

In January 2018, the World Bank submitted another report to the DTC on the effectiveness of the specific incentives related to Small Business Corporations and the specific incentives targeting property investment.<sup>150</sup> The following are the World Bank's findings:

Table 1 shows the various capital allowances for physical capital investment for different sectors that is used to calculate the present value of capital allowance deductions and the User Cost of Capital. In the case of property incentives the World Bank examined the Urban Development Zone (UDZ) allowance.

**Table 1: Special Tax regimes for capital investment for the different sectors**

Sector	Special Treatment	Remarks
<b>Small Business Corporations (SBC)</b>	<ul style="list-style-type: none"> <li>- 100% capital allowance of Plant and Machinery used in manufacturing;</li> <li>- Capital allowance of Plant and Machinery of 50%, 30%, 20% for non-manufacturing activities.</li> <li>- Taxation at graduated rates with the maximum rate being that for Large Corporations</li> </ul>	SBCs are defined as corporations with turnover below a threshold and includes certain restrictions as provided under Section 12E of the Income Tax Act. (1962). In 2006-07 the threshold was raised to 14 million rand.
<b>Sector Wide Urban Development Zones (UDZ)</b>	<ul style="list-style-type: none"> <li>- The incentive is available for the erection or improvement of commercial or residential buildings in areas in need of urban renewal. The UDZ allowance takes the form of both additional and accelerated depreciation allowances. Depending on the nature of the erection or improvement, such allowance can be as high as 25% per annum on the cost of such erection or refurbishment.</li> </ul>	In the case of erection of a new building the allowance is equal to 20% for the first year and 8% of the cost for 10 succeeding years. For improvements the allowance is 20% for five years.

Source: Tax laws, Republic of South Africa

On the impact of Incentives on Property Investments, the World Bank estimated the elasticity of investment to user cost of capital. As tax incentives lower the user cost of capital, the World Bank examined if such changes bring about positive changes in the capital invested. The World Bank found that "the reductions in user cost of capital through investment incentives aimed at increasing property investment has a positive impact on investment in all sectors except Mining".<sup>151</sup> As in the case of the analysis using all capital,

<sup>149</sup> World Bank "Effectiveness of the Research and Development Incentive in encouraging issued October 2017.

<sup>150</sup> World Bank - Southern Africa Country-level fiscal policy notes – "South Africa: Effectiveness of Investment Incentives in South Africa – Small Business Incentives and Section 13 Incentives" October 2017.

<sup>151</sup> World Bank - Southern Africa Country-level fiscal policy notes – "South Africa: Effectiveness of

the World Bank found that investment in property positively corresponds to sales but not to reductions in user cost of capital through incentives.

On the impact on tax incentives aimed at SBCs in the form of a graduated rates of corporate tax reaching a maximum at the normal corporate income tax rate as well as incentives aimed specifically at investments by SBCs, the World Bank found that “incentives have some impact on investment but only for certain sectors”. When the World Bank did the cost-benefit analysis of these incentives it found that “on average the government loses revenue of about R120,000 as a result of these incentives for each job generated by these incentives”.<sup>152</sup>

From the above World Bank Reports, it can be deduced that a detailed review of each corporate incentive would benefit South Africa as it would establish the ongoing viability of the incentives.

The DTC does not propose to perform further work in this regard at this time but recommends, in light of the recommendations above regarding the corporate tax rate, that National Treasury and SARS review each and every incentive through a commissioned study which covers all incentives and bears the following in mind:

- Why each incentive is justified;
- Which incentives do not achieve their objectives;
- The cost-benefit of retaining the incentive(s) versus an overall reduction in the corporate tax rate based on the reduced cost if the incentive is eliminated (see section 4 on corporate tax rates, above)

In conducting this review, the DTC suggests that Treasury and SARS also consider the alternative option, which is currently being adopted in many other countries, of removing targeted incentives and replacing them with an overall corporate tax reduction or reduction in the rate associated with other tax handles.

## **8 ENSURING THE EFFICIENCY OF THE COMPANY TAX STRUCTURE BY REVIEWING THE CORPORATE RESTRUCTURING RULES**

Group restructuring is the corporate management term for the act of reorganizing the legal, ownership, operational or other structures within a group of companies with the objective of making a group more profitable, or better organised for its present exigencies.

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Investment Incentives in South Africa – Small Business Incentives and Section 13 Incentives” October 2017 at 7.

<sup>152</sup> World Bank - Southern Africa Country-level fiscal policy notes – “South Africa: Effectiveness of Investment Incentives in South Africa – Small Business Incentives and Section 13 Incentives” October 2017 at 7.

Restructuring embraces the reallocation of assets, businesses, or functions within a group of companies; the reorganisation of ownership of companies within a group; and/or the reorganisation of debt and/or financial restructuring within a group.<sup>153</sup>

The corporate restructuring rules were introduced in 2001<sup>154</sup> with a policy objective of competitiveness and to promote domestic restructuring of South African groups in order to promote growth.<sup>155</sup> In order to remain competitive, South Africa has to ensure that corporate groups on the Johannesburg Stock Exchange enjoy the same benefits as corporate groups on the stock exchanges of New York, London and other parts of the world.<sup>156</sup> The other objective of introducing corporate restructuring rules was to alleviate unintended hardships caused by the enactment of the capital gains tax which was also introduced in 2001.<sup>157</sup> Internationally, a corporate restructuring regime acts as a standard measure to reduce the potential cascading effect of capital gains tax on the disposal of assets in multi-tiered groups.

The introduction of the restructuring rules in South Africa ensured tax neutrality by preventing tax considerations from discouraging the incorporation of a business. Thus sections 41-47 of the Act - the so called "roll-over relief" rules - provide relief that is similar to the relief provided by group taxation regimes by deferring tax on the transfer of assets until the assets are disposed of to a third party.<sup>158</sup> The rules were based on the view that where the group or the shareholders have retained a substantial interest in the asset transferred, it is appropriate to allow for the tax-free transfer of assets to the entity where the assets can most efficiently be used for business purposes. This policy objective is clearly in line with the neutrality principle.<sup>159</sup>

The rules do not only provide capital gains tax relief to groups in South Africa, together with related rules in other tax laws, they defer the incidence of income tax, donations tax, dividends tax, transfer duty, securities transfer tax and value-added tax and can therefore be considered to be a unified and comprehensive structure of relief, for example, in circumstances where a merger, acquisition or restructuring does not economically facilitate a contribution to revenue by the parties to the relevant transaction. The corporate restructuring rules are widely used and relied upon for corporate restructuring.

The rules are contained in sections 41 to 47 of the Act, with section 41 providing the relevant definitions. The rules provide relief for only the following transaction:

<sup>153</sup> Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC "Corporate Income Tax: Group Restructuring" (7 March 2017).

<sup>154</sup> Introduced by the Second Revenue Laws Amendment Act No. 60 of 2001.

<sup>155</sup> The Finance Standing Committee of South Africa held a briefing on 17 October 2001 on the Second Revenue Laws Amendment Bill (Parliamentary Monitoring Group, 2001).

<sup>156</sup> The Finance Standing Committee of South Africa held a briefing on 17 October 2001 on the Second Revenue Laws Amendment Bill (Parliamentary Monitoring Group, 2001).

<sup>157</sup> The Finance Standing Committee of South Africa held a briefing on 17 October 2001 on the Second Revenue Laws Amendment Bill (Parliamentary Monitoring Group, 2001).

<sup>158</sup> National Treasury, Explanatory Memorandum on the Revenue Laws Amendment Bill, 2007.

<sup>159</sup> (National Treasury, 2001:6).



- asset-for-share transactions (section 42);
- substitutive share-for-share transactions (section 43);
- amalgamation transactions (section 44);
- intra-group transactions (section 45);
- unbundling transactions (section 46); and
- liquidation, winding-up and de-registration transactions (section 47).

Corporate restructuring is however subject to certain anti-avoidance rules in terms of transactions between connected persons. The roll over rules do not apply with respect to section 24BA (transactions where assets are acquired as consideration for shares issued, and the value of the assets differs from the value of the shares issued); section 80A – L (GAAR); section 103(2) (the anti-tax avoidance provision pertaining to assessed losses); and paragraph 11(1)(g) of the Eighth Schedule (value-shifting arrangements which constitute disposals).<sup>160</sup> In addition, they don't apply to transactions in terms of which assets are disposed of to a long-term insurer as defined in section 29A of the Act if such assets are to be held in the insurer's untaxed policyholder fund as defined in section 29A(4)(a).<sup>161</sup> Annual refinements of the roll-over rules have occurred over the years to clear uncertainties about the how the rules apply. The main drawback to the rules (as explained below) is the volume of anti-avoidance rules that apply to them, which create unintended hindrances to certain usual commercial transactions.

### **8.1 The rules based nature of the rules makes them very mechanical**

The corporate reorganisation rules are structured in such a way that they are “rules-based” rather than “principles-based” in the sense that if a taxpayer does not meet the detailed and specific requirements of the provisions, relief is not available, which is as an impediment to restructuring transactions. Although South African taxpayers have benefited from the certainty created by virtue of the “rules based” regime, it is nevertheless very mechanical (as opposed to conceptual), thus giving rise to unintended difficulties, especially when they interact with sections outside the reorganisation provisions. The mechanical nature of the rules also implies that they are restrictive and extremely complex, as they attempt to cater for every scenario that might arise in the context of a corporate reorganisation.

An example of a shortcoming of the provisions is that they deal only with assets and provide very specific relief in relation to those assets. Currently, the provisions do not cater for liabilities in the context of corporate restructurings, with the result that other provisions within the Act that deal with liabilities (such as the debt reduction rules of section 19) still

<sup>160</sup> Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC “Corporate Income Tax: Group Restructuring” (7 March 2017).

<sup>161</sup> An untaxed policyholder fund is the fund of a long-term insurer in which are housed assets having a market value equal to the liabilities determined in relation to business other than business relating to a risk policy carried on by the insurer with; and any policy other than a risk policy, of which the owner is a pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or benefit fund.

apply. The fact that the roll-over relief does not address liabilities, and that general principles have to apply, can also be used to obtain a tax advantage i.e tax abuse.

It should be noted that issues pertaining to contingent liabilities also arise with respect to other businesses and not just for group reorganisations, for which clarity is needed. While SARS has attempted to address some of these shortcomings through interpretation notes and rulings, this is unsatisfactory as it is the legislation which requires amendment in order to address the shortcomings.

The fundamental principle underlying the corporate re-organization provisions is that, in a corporate re-organization, the transferee should “step into the shoes of” the transferor. It would therefore be more appropriate to reformulate the rules so that they are principle-based (as opposed to being rule-based), in the sense that the provisions should (instead of trying to cater for every possible scenario) set the framework within which the underlying principles must be allowed to operate and develop through interpretation and practice. How such a principle-based approach is legislated should be examined with a view to streamlining the rules and making them more flexible and adaptable, so that they achieve the objective that the tax profile of the transferor should simply be assumed by the transferee. This was the basis on which the rationalization provisions which preceded the corporate restructuring provisions operated.

## **8.2 Concerns that asset-for-share transaction relief effectively leads to the imposition of double taxation**

To the extent that a transaction qualifies as an “asset-for-share transaction” in terms of section 42 of the Act, the transferor is deemed to receive the shares issued to it at the original base cost of the asset transferred to the transferee company. In addition, in terms of an “asset-for-share” transaction, the transferee company also receives the asset at the original base cost of the transferor. Since the rollover base cost of the assets are also allocated to the shares in the target company, an “asset-for-share” transaction effectively results in there being two assets where, prior to the reorganisation there was only one. On disposal of the shares and assets, economic double tax will arise.<sup>162</sup> Although this can be planned against, it is submitted that this was surely not the intention of the provisions, which are designed simply to defer the tax on the disposal of the asset until it is disposed of out of the ‘group’.

## **8.3 The roll over rules are riddled with complex anti-tax avoidance provisions which hamper their efficacy**

While the corporate rules play a valuable role in facilitating business transactions within the group context, they are unnecessarily onerous and cumbersome, given South Africa’s desire to foster economic growth and create employment. Over the years, the rules have been the subject of many amendments and refinements designed to prevent their abuse

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<sup>162</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) para 2.6.

for tax avoidance purposes. National Treasury has indicated that the “ongoing tax avoidance schemes” were the reason for the numerous amendments to the corporate restructuring rules so as to close loopholes in respect of the corporate restructuring relief.<sup>163</sup> However, the numerous amendments since the introduction of the corporate restructuring regime seem to be an indication of serious structural problems. The numerous anti-avoidance provisions also make it difficult to comply with the requirements of the roll over rules which leads one to question whether the legislature has not unduly hampered their efficacy for fear of their abuse.<sup>164</sup> The rules are quite onerous and complex; posing an administrative burden for both the taxpayer and SARS. The complexity of the rules implies that situations inevitably arise where the rules cannot be easily applied or where there are unintended and unwelcome consequences.

The most burdensome of the anti-avoidance rules are in section 45 of the Act which deals with intra-group transactions where an asset is disposed of by a company to another company in the same group of companies. Transfers between companies that form part of the same group of companies are fully eligible for rollover relief in the form of a tax-free transfer of assets between the two companies within the same group of companies by allowing the transferor company to dispose of its assets for proceeds equal to its base cost to another qualifying group member, the transferee company. This means that no gains are realised on the transfer of assets between group members. Because the base cost is rolled over, the capital gain is only taxed once the asset is sold by the transferee company to a third party outside the group (section 45(2)(a) of the Act). Not only is the base cost rolled over but the transferor company and the transferee company are seen to be “one and the same person” thus, capital allowances and deductions claimed by the transferor on allowance assets are only be taxed as a recoupment in the hands of the transferee upon disposal to a third party (45(3)(a) of the Act). Trading stock transferred is treated in a similar manner, as the transferor is deemed to have disposed of it at cost to the transferee. The cost is rolled over to the transferee and there are no immediate tax implications for the transferor. The two companies are also deemed to be the one and the same person for tax purposes with regard to certain contracts transferred as part of the business as a going concern.

However, section 45 of the Act has been utilised in several avoidance schemes over the years, especially debt push down schemes involving the claiming of substantial interest deductions which led to extreme tax losses. Thus from the onset, the provisions were embedded with anti-tax avoidance measures. As other avoidance schemes later emerged, the initial anti-avoidance rules were amended and new anti-avoidance rules were introduced. Currently, there are two main types of anti-avoidance measures that apply with respect to the intra- group relief provision in section 45 of the Act.

- (a) Firstly, section 45 of the Act provides for an 18-month deemed sale rule which prevents abuse of the roll over relief measures where schemes are employed to

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<sup>163</sup> National Treasury (2008b:1-3).

<sup>164</sup> Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC “Corporate Income Tax: Group Restructuring” (7 March 2017).

utilize the assessed losses of the transferee company.

- Where the transferee company disposes of an asset within 18 months after acquiring the asset in terms of an intra-group transaction,<sup>165</sup> section 45(5)(a)(i) of the Act provides that where the “asset” constitutes a capital asset, the portion of the capital gain that relates to the period before the intra-group transaction is recognised immediately as a capital gain, and is included in the taxable income of the transferee at the inclusion rate. No set-off against any assessed loss, balance of assessed loss, capital loss or assessed capital loss of the transferee company is permitted. Only the growth in the value of the asset after it was transferred may be set off against any loss.
- Where the asset constitutes trading stock and the transferee sells the trading stock within 18 months after the intra-group transaction, the portion of the profit the transferee makes that relates to the period before the intra-group transaction cannot be set-off against any assessed loss or balance of assessed loss, unless the trading stock is of a kind that is regularly and continuously disposed of by the transferee company.
- Where the asset constitutes an allowance asset and the transferee sells the asset within 18 months after acquiring it, the portion of the recoupment calculated as if the disposal had been made at the date of the intra-group transaction is deemed to be attributable to a separate trade of the company and may not be set off against any assessed loss or balance of assessed loss of the transferee company (section 45(5)(b)(i) of the Act). Therefore, only the portion of the recoupment relating to the growth in the value of the asset since it was transferred, may be set off against any assessed loss or balance of assessed loss.

Effectively the 18-month anti-avoidance rule results in a “deemed sale” on the date of the intra-group transaction. The profit from the “deemed sale” is taxed and may not be set-off against any loss. Any capital gain in the case of capital assets, profit in the case of trading stock or recoupment in the case of allowance assets that relates to the growth in assets after the intra-group transaction, is dealt with according to the normal income tax provisions.<sup>166</sup>

Concerns about the 18-month deemed sale rule: Taxpayers perceive the 18-month anti-avoidance rule as unnecessarily strict, unfair, and harsh and regard it as not contributing to fiscal neutrality.<sup>167</sup> In situations where this anti-avoidance provision is triggered, taxable income is raised in the transferee company. The taxable income cannot be offset against

<sup>165</sup> Section 45(5) of the Income Tax Act 58 of 1962. Similar anti-avoidance rules exist in terms of asset-for-share transactions (section 42(7)); amalgamation transactions (section 44(5)); and liquidation, winding-up and de-registration transactions (section 47(4)). These provisions are not applicable where the asset is disposed of in terms of an involuntary disposal as contemplated in par 65 of the Eighth Schedule.

<sup>166</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

<sup>167</sup> SN Middelman *A study of the applicability of a system of group taxation in South Africa*. (2003) at 27, Unpublished master's dissertation. Pretoria: University of Pretoria.

any possible assessed loss or assessed capital loss of the transferee or transferor companies. On the other hand, the period of 18 months has been criticised as being too long and unrealistic in a modern world where business opportunities emerge at an accelerated pace.

(b) Secondly, section 45 contains de-grouping rules or claw-back provisions which were introduced to prevent corporate groups from using the corporate restructuring rules to defer taxation and then to de-group shortly thereafter. The de-grouping charge triggers a deemed disposal if one of the group companies engaged in the intra-group transaction subsequently leaves the group or is no longer part of the same group of companies. The de-grouping charge protects the fiscus against third party sales being disguised in the form of section 45 intra-group transactions.<sup>168</sup> There are two types of de-grouping provisions: a six-year de-grouping rule (section 45(4)) and a two-year de-grouping rule (section 45(4B)).

The six year de-grouping charge: This de-grouping charge applies if the transferee company ceases to be a group member in relation to either the transferor company or a controlling company, if within six years of the intra-group transaction, the transferee still holds the asset (section 45(4)(b) of the Act). An exception to this de-grouping rule applies if the transferor company or transferee company (45(4)(bA) of the Act) is liquidated, wound up or deregistered and the resident holding company holds at least 70% of the equity shares of that company which is liquidated, wound up or deregistered. In this case the resident holding company steps into the shoes of the company that is liquidated, wound up or deregistered. Since the resident holding company remains within the group there is then no need for de-grouping provisions and consequently de-grouping does not take place.

The two-year de-grouping charge: In addition to the six-year de-grouping provision, a two-year de-grouping charge (section 45(4B) of the Act) applies to counter specific avoidance schemes where consideration received by the transferor from the intra-group transaction leaves the group as part of a series of transactions in schemes to transfer assets 100% tax free. This two-year de-grouping rule applies where the consideration received for the asset by the transferor in respect of the intra-group transaction leaves the group in terms of a transaction, operation or scheme within two years from the intra-group transaction date. In such a case it is deemed that the transferor and transferee company have ceased to form part of the same group of companies and the same tax implications as for the six-year de-grouping rule will then apply.

Concerns about the de-grouping charges: Effectively, the six-year and the two-year de-grouping charges are aimed at preventing the use of the section as a mechanism to

<sup>168</sup> National Treasury *Explanatory Memorandum on the Revenue Laws Amendment Bill, (2007)* at 23. Available from: <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2007-01%20-%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202007.pdf> [Accessed: 2016-12-17].

enable a tax-free cash-out of investments. The de-grouping charges trigger a deemed disposal if one of the group companies engaged in the transfer subsequently leaves the group or is no longer part of the group. However, these provisions have been criticised for inhibiting commercial activity and, in many respects, imposing undue burdens on taxpayers. The de-grouping charges are considered to be the main provisions in the corporate restructuring rules that cause the most difficulties for taxpayers.<sup>169</sup> The legislators should adopt a purposive approach to the rules, rather than a rules based approach. The primary areas of concern include the following:

- The de-grouping charges have a negative impact on a company's cash flow, because the company becomes liable for cash outflows in respect of a tax liability which should only be incurred in the future (if they have broken the rule). The standard de-grouping charge in section 45(4) of the Act which applies in a period of six years from the date of the intra-group transaction is considered inordinately long in that it locks groups into a structure for six years and makes it difficult for taxpayers to plan whether a transaction may have adverse implications in the future as a result of changes which may not have been contemplated or foreseen by taxpayers when entering into the transaction. In addition, this presents complexities in the calculation of the amount on which the tax should be paid.
- In the modern commercial environment, it is simply not possible for any group to plan six years in advance, and it is simply not possible to extend any scheme to cash-out an investment over such a long period of time. The lengthy period is presumably intended to prevent "abuse" of these provisions by companies which can, for example, seek a step up in base cost of certain assets. However, the vast majority of transactions which seek to use the provisions of section 45 of the Act are "legitimate" commercial deals. Concerns about tax avoidance are acknowledged and it is appropriate that a minimum "restraint" period as an anti-avoidance measure is included in the provisions. However, the 6-year threshold has not kept pace with the increased dynamism in the world of corporate transactions. The spike in innovation and alliances, together with the harsher economic environment means that it is unreasonable to expect major groups to remain static for extended periods.
- The six-year trigger period for a de-grouping charge is also much longer than other trigger periods contained in the other corporate restructuring rules. For example, in order not to be subjected to similar charges in terms of section 42 asset for share transactions, a "qualifying interest" as defined needs to be retained in the transferee company for a period of 18 months post the asset for share transaction.<sup>170</sup> Due to the length of time required for retention of the group in order not to trigger the de-grouping charge in section 45 of the Act and the risk of incurring tax due to de-

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<sup>169</sup> N Hunter *Unintentional de-grouping (2010)*. Available from: <http://www.thesait.org.za/news/111910/Unintentional-de-grouping.htm> [Accessed 2016-12-17].

<sup>170</sup> BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4,

grouping within this extended period, taxpayers often opt to structure the disposal of an asset to a company in terms of section 42 of the Act rather than section 45. It has been suggested that all corporate rules should have the same anti-avoidance rules to maximise application.<sup>171</sup> However, the reason for the extension of the de-grouping charge to six years was due to the fact that SARS identified many situations where tax was avoided when moving assets outside the group because the de-grouping charge required the relatively short period of 18 months.

- The DTC is of the view that from a policy perspective the degrouping charge is in line with the underlying policy. Thus, the DTC cannot support the proposal that the period be reduced to 18 months but recommends that a shorter period than six years be considered. It is therefore recommended that the period for the de-grouping charge be reviewed in order to ensure that the degrouping rule does not render the section, to some extent, redundant.
  - The DTC acknowledges that the calculation relating to de-grouping charge are quite complex and may need to be simplified.
- It is also important to note that much as complex transactions require complex record retention, SARS should take cognisance of the fact that taxpayers find it extremely difficult to comply with the administration and application of the de-grouping charge in section 45, especially in the case of multiple roll-overs within the same group of companies. The six-year de-grouping rule presents difficulties with regard to keeping track of the date of the intra-group transaction, or dates in the case of multiple intra-group transactions, and other details pertaining to the specific assets. The two-year de-grouping rule is also problematic as assets need to be traced and assigned to the funds generated from a specific intra- group transaction. This may prove challenging as proceeds start to lose their specific identity over time.<sup>172</sup> This further necessitates the simplification of the calculation.

A literal interpretation of the de-grouping charge could result in de-grouping charges being triggered in scenarios that were never intended to be captured by the legislation. A change in shareholding further up the corporate structure could, for instance, trigger a de-grouping lower down the corporate structure where the group of companies, as was originally required for section 45, is still intact.<sup>173</sup> It could never have been the intention of the legislator that a de-grouping charge should be triggered in circumstances where no abuse was intended or resulted.<sup>174</sup> This highlights the importance of ensuring that the rules are purposive in nature and not merely rules based.

<sup>171</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) para 2.5.

<sup>172</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

<sup>173</sup> J Visagie *The reach and implication of section 45(4)(b) of the Income Tax Act 58 of 1962 (2016) at 54-57*. Mini Dissertation. University of Pretoria: Pretoria. Available at [http://repository.up.ac.za/bitstream/handle/2263/53207/Visagie\\_Reach\\_2016.pdf?sequence=1&isAlloved=y](http://repository.up.ac.za/bitstream/handle/2263/53207/Visagie_Reach_2016.pdf?sequence=1&isAlloved=y) accessed 23 June 2017.

<sup>174</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

The de-grouping charge also extends to circumstances where a transferee company ceases to form part of any group of companies in relation to not only the transferor company but also in relation to a controlling group company in relation the transferor company.

While the reason for this extension was entirely valid, it has resulted in severe (and presumably unintended) implications because of the manner in which it has been interpreted and applied in practice. This is because the way in which it is applied by SARS results in its application not only to the immediate controlling company of the transferor, but also to any controlling company up the chain of ownership. The result is that corporate activity high up in the chain of ownership of the sub-group in which the intra-group transaction took place can also trigger the de-grouping charge.

Apart from the above anti-avoidance provisions, another anti-avoidance provision was introduced in section 45(3A) in 2011. This provision has the effect that any debt or preference shares issued by a group company for the purpose of directly or indirectly funding an intragroup transaction are deemed to have a base cost of nil in the hands of the holder who is part of the same group of companies. The purpose was to prevent the subsequent sale of the debt or preference shares to a third-party (thereby realising a cash-out of the investment) on a tax-free basis. The provision may prevent limited “abuse” of the provisions, but they prejudice a significant number of legitimate transactions. This provision has simply added to the plethora of anti-avoidance provisions surrounding intra-group transactions.

- It is therefore recommended that section 45 of the Act should be revisited with a view to allowing and encouraging group restructures. This assists with a more liquid commercial market. Any “abuse” can be countered using, for example, the general anti-avoidance provisions of section 80A-L of the Act.<sup>175</sup>

In addition to the above, section 45(4B) of the Act deems a de-grouping to take place if any consideration from the intra-group transaction or more than 10% of any amount derived from the consideration is distributed out of the group of companies within two years as part of a scheme of which the intra-group transaction is a part.

- It is recommended that “abuse” be attacked using, for example, the general anti-avoidance provisions of section 80A-L of the Act.

#### **8.4 Concerns about the fragmented anti-avoidance rules**

The fragmented nature of the anti-avoidance measures in the roll over rules, for instance those relating to section 45 intra-group merger rule, needs to be addressed. The practice of National Treasury in recent years has been to introduce new measures based on a perception of the consequences of specific transactions. Often the provisions are incremental in the sense that a certain practice is initially targeted with a generic provision and then additional measures are introduced to refine the generic provision's

<sup>175</sup> Peter Dachs Technical Report on Corporate Tax submitted to the DTC (23 March 2017).



applicability. The additional measures may themselves be “stand-alone” provisions and not amendments to the original provision (e.g. section 24K and section 23N of the Act).<sup>176</sup> The fragmentation of the provisions increases the risks to business in completing income tax returns accurately as it adds complexity and requires deep professional knowledge and understanding of the law to identify the potential provisions that may find application to the income derived by the business.<sup>177</sup>

- The DTC recommends that the rules should be more accommodating of business and commercial exigencies.

Because of a combination of the high pecuniary value typically associated with mergers, acquisitions and group restructuring, the onerous compliance burdens imposed on taxpayers seeking to employ the corporate restructuring rules and the dexterity required to negotiate the anti-tax avoidance provisions woven into the corporate rules, SARS is inundated with requests for binding private rulings to ensure certainty regarding SARS's interpretation of the corporate rules as they apply to proposed transactions, prior to taxpayers assuming the tax risks of embarking upon them.<sup>178</sup>

## **8.5 Issues limiting the use of section 46 of the Act in relation to unlisted companies**

In order for section 46 of the Act to find application in cases where the company to be unbundled is not listed (i.e. the company distributing all of its equity shares to any of its shareholders), the shares being unbundled must be distributed to a company in the same group of companies. This places an unnecessary restriction on the application of section 46 of the Act in the context of unlisted companies. In addition, in respect of unlisted companies, more than 50% of the shares of the unbundled company (if unlisted) must be distributed for section 46 of the Act to apply. In many cases, such percentage shareholdings are prohibitively high, often resulting in section 46 of the Act not being utilised by taxpayers.

It has been suggested that the unbundling rules should be made wider and more flexible in order to allow for a proper functioning of the corporate market and to facilitate commercial deals which rely on unbundling of shares by a company to its shareholders. The reason presented being that the provisions only allow a rollover of the existing base cost and therefore there is only a tax deferral, i.e., tax will still be paid at a future date. There have therefore been calls that the corporate rules should allow for a wider set of transactions than is currently the case.<sup>179</sup>

<sup>176</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>177</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>178</sup> Currently, there are over thirty binding private rules on corporate restructuring rules. Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC “Corporate Income Tax: Group Restructuring” (7 March 2017).

<sup>179</sup> Peter Dachs Technical Report on Corporate Tax submitted to the DTC (23 March 2017).

- The DTC recommends that SARS and Treasury review section 46 of the corporate rules to determine whether they should be given wider application.

## **8.6 Issues regarding the cross border application of group restructuring rules**

The group restructuring rules in sections 41 to 47 are not wide enough in respect of cross-border transactions as the rules only deal with very specific aspects relating to cross-border transactions. The rules are too specific in terms of which party and which asset is required to be a local or a foreign asset, or a local or foreign party, to allow for the cross-border application of the rules in practice. In addition, the group restructuring rules do not cover all types of asset transfers which unnecessarily limits the cross-border application thereof. It is important that concerns about “abusive” transactions where the tax base may be exported from South Africa or where permanent differences may be created do not hamper “legitimate” cross border transactions. For example, in relation to fund investments, South African investors are not limited to only investing in local funds, where “roll over relief” from CGT for investors is enjoyed when such funds are re-structured. It has thus been suggested that consideration should be given to extending this relief to South African investors who have invested in offshore funds<sup>180</sup> and that the corporate restructuring rules be applied equally to cross border transactions.<sup>181</sup>

- The DTC recommends that aspects dealing with offshore funds should be reconsidered by SARS and Treasury, bearing in mind that the restructuring group rules are designed only to defer tax and not to eliminate it altogether.

## **8.7 DTC general recommendations regarding the group restructuring rules**

From the above, it is clear that, although the corporate restructuring rules are often used in practice, the application of the rules appears to create numerous difficulties. Not only is this evident from the numerous amendments made to the provisions since their inception but also the compliance difficulties they impose on taxpayers.

Despite the above shortcomings, the DTC thus recommends that the group rollover relief provisions should be retained, on the basis that it does not recommend the implementation of a full group tax regime at present (due to the country's unsuitable economic state – see discussion on group taxation in section 9 below). It is however recommended that the rules be extended to include greater coverage of cross border scenarios, where appropriate.

The DTC further recommends appropriate amendments to the group restructure rules in order to allow for a wider transfer of assets (and potentially liabilities) between related parties on an initial tax-free basis (i.e facilitating deferral), as indicated above. In addition, if a tax loss could be transferable in terms of the corporate restructure rules, South Africa

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<sup>180</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) para 2.5.

<sup>181</sup> Peter Dachs Technical Report on Corporate Tax submitted to the DTC (23 March 2017).

could achieve a hybrid form of group taxation through the corporate restructure rules<sup>182</sup> (see discussion below).

## **9 WILL THE INTRODUCTION OF GROUP COMPANY TAXATION ENHANCE THE EFFICIENCY OF SOUTH AFRICA'S TAX STRUCTURE?**

Company law and general tax principles have historically recognised companies as separate legal entities. The policy rationale for this approach is that: focusing on the company as a unit of taxation both corresponds to the legal definition of a company as a unitary corporate entity, which gives effect to fundamental company law concepts such as limited liability and separate juristic personality, and recognises that the each 'person' must be taxed.

However, with globalisation and the rise of multinational companies that have multi-tiered corporate structures, corporate tax rules have been developed that recognise multinational groups of companies as operating as a single economic unit. Consequently, many countries have introduced formal group tax systems that recognise the corporate group as a consolidated tax unit. Group company taxation comprises special rules that are applicable to members of a group of companies which is broadly assimilated for tax purposes to a single company or entity.<sup>183</sup> This assimilation is expounded by an adoption of special rules used to offset the losses and profits of companies within a group. In essence, the system of group taxation allows sharing of both revenue and capital losses between group companies.

Group taxation recognises that the affairs of companies that are centrally owned or controlled are frequently integrated, and that the economic activities of the group should be subject to tax on the basis of its transactions with parties outside the group. As such, the group is recognised as a unitary taxpayer, and its operational results are aggregated for tax purposes, after eliminating intra-group transactions.<sup>184</sup>

### **9.1 Objectives and advantages of group taxation**

The major advantage of group taxation, for corporate taxpayers, is the loss sharing within groups of companies with the effect that they would, in effect, not be penalised for conducting trades that may produce positive taxable income or tax losses in different legal entities. This enables companies to set profits off against losses in other group companies while preserving corporate advantages of conducting trades in separate legal entities, for example limited liability, regulatory requirements. It also reduces the costs of doing business by allowing groups to organise themselves in terms of pure economics rather than being overly concerned about tax structuring.

<sup>182</sup> Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC "Corporate Income Tax: Group Restructuring" (7 March 2017).

<sup>183</sup> IBFD International Tax Glossary definition of "group treatment".

<sup>184</sup> Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC "Corporate Income Tax: Group Restructuring" (7 March 2017).

The system also avoids the need to operate as a single legal entity with divisions or branches, for tax purposes, which might have other commercial disadvantages. Group taxation neutralises the taxation within the group of companies, as a gain on transfer of capital assets is ignored and only accounted for in the tax system when the assets are transferred to persons who do not form part of that group.<sup>185</sup>

According to a Canadian Department of Finance Consultation Paper, “The Taxation of Corporate Groups” (“Canadian Consultation Paper”),<sup>186</sup> the policy objective of the taxation of corporate groups is the enhancement of efficiency, “without distorting corporate decision making”. In this regard, efficiency is enhanced and promoted “when the unit of taxation more closely matches the economic reality of a corporate group that is an economically integrated unit.” By giving effect to the principle that “corporate groups with a similar or equivalent structure should be taxed in a similar way”, a tax system can be made more fair and efficient.

The tax policy behind group taxation is to encourage economic growth (it is also can also positively influence other factors that are part of a good tax system such as fairness and simplicity). Group taxation can be attractive to corporate taxpayers since it gives flexibility to organize their business activities and engage in internal restructurings and asset transfers without having to worry about tax implications. In addition, corporate taxpayers are able to compute the tax liability of related corporations on a consolidated or combined basis.

Since in group taxation corporate groups are treated as consisting of economically integrated units, there could be improvements to the overall efficiency of the tax system brought about by “moving to a larger unit of taxation” as it “better reflect[s] the economic unit” being taxed.<sup>187</sup> Accordingly, the Canadian Consultation Paper contends that a tax system “ought to provide at least some recognition of the relationship between the members of a corporate group”.<sup>188</sup>

Group taxation is also said to improve the competitiveness of a jurisdiction in attracting foreign direct investment as multinational groups find it more attractive to invest in jurisdictions that allow for the offset of profits and losses within the group. This is because the risk of losses, especially in the start-up period, is high. Enacting group taxation rules therefore gives an impression that a country intends to take an active role in promoting the competitiveness of its companies. The competitiveness of Canada as an investment destination was indeed one of the policy objectives that moved the Canadian government

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<sup>185</sup> Rohatgi Basic International Taxation (2005) 256.

<sup>186</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 3. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

<sup>187</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 3. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

<sup>188</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 4. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

to investigate the implementation of a group tax system in 2010.<sup>189</sup>

It is precisely for the above reasons that, in 2011, the European Commission proposed a Directive on a Common Consolidated Corporate Tax Base (CCCTB) (which is still pending) which would allow multinational companies to be treated as one within the union for the purpose of corporate tax and, thereby, facilitate their cross-border activity and promote trade and investment.<sup>190</sup> The CCCTB is considered a sound approach to taxation of multinationals, by treating them in accordance with their business reality as unitary firms. The CCCTB aims to identify the tax base of the whole corporate group, disregarding internal transactions between the affiliates, and to apportion the taxable profit according to factors reflecting the firm's real activity (sales, assets, employees) in each country. This approach is considered the most effective way to end both competition between states to offer tax incentives, and tax avoidance by MNEs shifting income between affiliates to minimise tax.<sup>191</sup>

## 9.2 Examples of group taxation models

There are four main models of group tax regimes that have been implemented: the Organshaft model; the group contribution model; the group relief/loss transfer model; and the consolidation model (each of which are briefly explained below). Each of these four models of group taxation attempts to fulfil at least one of the two objectives of group taxation: (1) the tax-free movement of assets between the members within a group and (2) the set-off of profits and losses within the group.

The Organshaft model: This model treats the subsidiaries as organs of the holding company, and together they are treated as one body. Profits of the subsidiaries are attributed to the parent, and transferred or reimbursed to subsidiaries in the group that are in a loss position. This model does not cater for the deferral of gains and losses arising from the intra group transfer of assets. This model is the oldest of all the group tax models; and has been adopted in Germany and Austria.<sup>192</sup> In terms of the German "Organschaft" system, after the income or loss of each of the subsidiaries participating in the system is determined, it is a requirement that the income or loss of such subsidiaries be rolled-up to the parent company. It is also a requirement that the parent company and each of the parent company's subsidiaries that wish to be subject to the group taxation system, sign a

<sup>189</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

<sup>190</sup> European Commission "Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base" 2016/0336 (CNS).

<sup>191</sup> BEPS Monitoring Group "The European Commission's Proposals for a Common and Consolidated Corporate Tax Base" (16 May 2017). Available at <https://bepsmonitoringgroup.wordpress.com/2017/05/16/the-european-commissions-proposals-for-a-common-and-consolidated-corporate-tax-base/> accessed 26 May 2017.

<sup>192</sup> Y Masui *Group Taxation. International Fiscal Association, (2004) Cahiers de Droit Fiscal International* (Volume 89b) at 29. Amersfoort: International Fiscal Association.

profit/loss transfer agreement. In order for a subsidiary to be eligible to participate, the parent company must own at least 50% of the subsidiary.

The Group Contribution model: Under this model, the profit making companies in the group make a contribution to the loss making companies, and can deduct that contribution. This is an effective transfer of wealth from one company to another. Each group member is a separate taxpayer. The transfer of profits is not only allowed between the subsidiaries and their parent, but also between the subsidiaries themselves. This model has been adopted in Finland, Sweden and Norway. Under Finland's "group contribution" system, shifting of taxable income, utilised for intra-group payments, is permitted. The payer company may deduct such transfers from its taxable income whilst the recipient company includes such transfers in its taxable income. A 90% ownership threshold is applied in order to determine membership of a corporate group.

The Group Relief or Loss Transfer model: Under this model, losses are transferred from one company to another to the point that there is a neutral position (i.e. losses are not created in the transferee company). Each company submits its own tax return. This model enables a transfer of losses from a loss-making group member to a profit-making member within the group.<sup>193</sup> The model has been adopted mainly in common law systems; for example in the UK, the Netherlands, New Zealand and Singapore. The UK's system allows for the aggregation of group losses against group income. Certain losses attributable to unprofitable entities in the group may be transferred to more profitable entities within the same corporate group. A 75% ownership threshold is applied in order to determine membership of a corporate group. In the Netherlands, the fiscal unity system is applied whereby a group of companies file as one entity, much like the system for accounting.

The Consolidation model: This is the most commonly implemented model, although it is applied in different forms in different countries. A group of companies is treated as a single entity for tax purposes. It involves corporate income being computed at the corporate level, but being combined at group level for tax purposes. The parent company pays the tax for the whole group and intra-group transactions are ignored. The regime has been adopted in Australia, France, Denmark, Italy, Japan and the USA.<sup>194</sup>

- In Australia, the separate identity of each subsidiary entity within a corporate group is disregarded, with income and losses at the subsidiary level not recognised. Transactions entered into by an entity within the group are taxed on the basis that the parent company entered into the transaction. The parent company must elect to be subject to the group taxation rules, whereupon it becomes irrevocable and obligatory for all the wholly-owned subsidiaries of the parent company.

<sup>193</sup> Y Masui *Group Taxation. International Fiscal Association, (2004) Cahiers de Droit Fiscal International* (Volume 89b) at 30. Amersfoort: International Fiscal Association.

<sup>194</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 8-9. Available from: <http://www.fin.gc.ca/activity/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15]; PwC *Worldwide Tax summaries* (Group Taxation) (2017) (accessed online)

- In the United States, at the federal level, each member within the corporate group prepares its own federal tax return, whereafter a single consolidated return is prepared for the whole group. The consolidated return reflects *inter alia* the income and losses of each member of the group. The system taxes the group as a single economic entity based on its consolidated return and retains the separate entity of each member of the group by requiring each such entity to prepare a separate return. The parent company must elect to be subject to the group taxation rules, whereupon the subsidiary in which it holds a high percentage of ownership/control (around 80%) becomes subject to such rules.
- In France, under the optional “tax integration system”, the parent company, on an annual basis, decides which of its subsidiaries should be included in the corporate group, subject to the requirement that the parent company holds a minimum of 95% of the ownership/control in the subsidiary. The parent company may decide, every five years, whether to participate in the “tax integration system”.
- In Japan, a consolidated group, which may be formed by a domestic parent company and its wholly-owned domestic subsidiaries, may pay income tax on a consolidated basis. A generally irrevocable election must be made and filed by the taxpayer if it wishes to pay income tax on a consolidated basis. It is mandatory for such an election to include all of the parent company’s wholly-owned subsidiaries.
- In Denmark, Danish corporate groups are subject to an obligatory consolidated reporting system where the entities in the corporate group have a common ownership of at least 50%.

None of these four group tax models can be regarded as a perfect model of group taxation as each of them has its challenges. Basically the four models lie on a spectrum, with one extreme being the “consolidation model” (where the group is seen as one taxpayer, allowing for the elimination of all intragroup transactions as well as the offset of losses between group members) and on the other extreme the “loss-transfer model” (allowing only the offset of losses between group members, while group members remain separate taxpayers).<sup>195</sup> Of all four models, however, the “consolidation model” appears to represent the best model of group taxation in that it caters for the two objectives of group taxation i.e. it allows for the offset of profits and losses within the group; and it also provides for the tax-free movement of assets between the members within a group. The “consolidated model is preferred by most countries that wish to introduce group taxation rules.<sup>196</sup> The downside of the “consolidation model” is that it is quite complex in its application. The complexities often arise from conflicts in the application of principles relating to group taxation and yet the general tax system may still be treating the subsidiaries as separate legal entities.

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<sup>195</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 11-13. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

<sup>196</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 29. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

### 9.3 Policy Considerations that Underpin Group Tax Systems

Jurisdictions that have introduced group tax systems highlight the fact that an appropriate group tax system should adhere to the principles of a good tax system i.e. equity, neutrality, efficiency and simplicity.<sup>197</sup> However, the optimal design of an effective group tax regime, may create certain tensions that may require certain trade-offs. For example achieving fairness may be at the expense of having a simpler policy.

**Equity:** Adam Smith wrote in the *Wealth of Nations*, that a fair tax system was a system where the subjects “contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state”.<sup>198</sup> It requires imposing equal tax burdens on taxpayers with equal income, without reference to the source of the income, and by making those burdens commensurate with the ability of taxpayers to pay. Equity also requires that a country should ensure that it gets its fair share of revenue from cross-border transactions. This implies that the potential for evading and avoiding tax should be minimized.<sup>199</sup> Group taxation rules have to ensure that multinationals pay their fair share of taxes; and that they do not avoid taxes by devising corporate group schemes, by distributing losses among members, or deferring tax in intragroup transfers.<sup>200</sup> Australia for instance made it clear that anti-avoidance was one of the main policy objectives of its consolidation regime.<sup>201</sup> Australia’s Income Tax Assessment Act, 1997 states that the objectives of the consolidation system are “to prevent double taxation of the same economic gain realised by a consolidated group; and to prevent a double tax benefit being obtained from an economic loss realised by a consolidated group; and to provide a systematic solution to the prevention of such double taxation and double tax benefits.”

**Neutrality:** The ideal tax system should be neutral between the different forms of business activities. A neutral tax system treats similar economic activities in similar ways for tax purposes, so that decisions are based on economic merits and not on tax consequences.<sup>202</sup> Neutrality diminishes the negative effects of taxation on corporate

<sup>197</sup> RM Sommerfeld, SA Madeo, KE Anderson & BR Jackson *Concepts of Taxation* (1993) at 10; WA Raabe & JE Parker *Taxation Concepts for Decision Making* (1985) at 14.

<sup>198</sup> Adam Smith *An Inquiry Into the Nature and Causes of the Wealth of Nations* (1776) 1043.

<sup>199</sup> OECD Fundamental principles of taxation. In: *Addressing the Tax Challenges of the Digital Economy* (2014) at 30. Paris: OECD Publishing. Available at: <http://dx.doi.org/10.1787/9789264218789-5-en> [Accessed: 2016-10-07].

<sup>200</sup> Y Masui *Group Taxation International Fiscal Association*, (2004) *Cahiers de Droit Fiscal International* (Volume 89b) at 26. Amersfoort: International Fiscal Association.

<sup>201</sup> A Ting *The Taxation of Corporate Groups under Consolidation: An International Comparison* (2013) at 63. Cambridge: University Press.

<sup>202</sup> OECD Fundamental principles of taxation. In: *Addressing the Tax Challenges of the Digital Economy* (2014) at 30. Paris: OECD Publishing. Available at: <http://dx.doi.org/10.1787/9789264218789-5-en> [Accessed: 2016-10-07].



decisions based on resource allocation. With regard to corporate groups, this means that a corporate group should be entitled to optimally allocate its resources. A neutral tax system minimises economic distortions due to tax discrimination between economic activities.<sup>203</sup> Economic distortions could occur if the system for taxing corporate groups provides different treatment for corporate structures that are functionally equivalent, for example branches and subsidiaries.<sup>204</sup> If a company has two local branches, both branches are considered as part of one single corporation, the losses arising from one branch can be offset against the profits earned by the other. Transfer of assets between the two branches is also ignored for tax purposes, as it is considered an internal asset realignment within the same corporation, without having legal consequences in relation to parties outside the corporation. The tax consequences for a company with two subsidiaries however differ even though the functions are equivalent. If a holding company has two subsidiaries, the business losses of one subsidiary cannot be offset against the business profits of another, since the two subsidiaries are separate legal entities. The transfer of assets between the two subsidiaries is taxable event.<sup>205</sup> A group tax system ensures neutrality as it treats subsidiaries in the same way as branches for tax purposes.

Efficiency: Efficiency requires minimum distortion in the allocation of resources. Efficiency of a tax system implies that the tax system is designed to raise revenues in an economically efficient manner.<sup>206</sup> Efficiency should be viewed from the viewpoint of the taxpayer and from the viewpoint of the government. For the taxpayer an efficient tax system would therefore mean that the resources of the business should be allocated optimally with minimal taxation cost. The compliance cost of calculating taxes and completing and submitting returns should be limited as far as possible. In the context of corporate groups, efficiency is enhanced when the unit of taxation more closely matches the economic reality of a corporate group that is an economically integrated unit.<sup>207</sup> For the government, efficiency means minimum loss of revenue and that the costs of administering the tax system are minimised as far as possible.<sup>208</sup> An efficient tax system requires that adequacy of revenue is safeguarded. Thus, although many countries have

<sup>203</sup> J Mirrlees *Tax by design: The Mirrlees review* (2011) at 333 New York: Oxford University Press.

<sup>204</sup> Y Masui *Group Taxation. International Fiscal Association, (2004) Cahiers de Droit Fiscal International* (Volume 89b) at 34. Amersfoort: International Fiscal Association.

<sup>205</sup> Y Masui *Group Taxation. International Fiscal Association, (2004) Cahiers de Droit Fiscal International* (Volume 89b) at 34. Amersfoort: International Fiscal Association.

<sup>206</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 2. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

<sup>207</sup> Ibid.

<sup>208</sup> OECD Fundamental principles of taxation. In: *Addressing the Tax Challenges of the Digital Economy* (2014) at 30. Paris: OECD Publishing. Available at: <http://dx.doi.org/10.1787/9789264218789-5-en> [Accessed: 2016-10-07].

introduced group tax systems, others are reluctant to introduce formal group tax regimes because of the potential loss of revenue which may impact on the efficiency of tax system.<sup>209</sup> Group tax systems are normally elective for the taxpayer and will therefore only be elected by multinational groups to lower overall group taxes, which will lead to a loss of tax revenue for the authorities. It is clear that the price for increasing competitiveness by introducing a group tax system comes at the potential cost of lost tax revenue. However other countries have introduced group taxation on the reasoning that it creates an efficient tax system providing a more competitive environment for businesses, which may lead to an increase in foreign investment, ultimately leading to a broadening of the tax base. An efficient tax system focuses on the quality of the tax system. It ensures that tax evasion is reduced. By introducing a group tax system, the efficiency of the tax system can be improved.<sup>210</sup>

Simplicity: Simplicity requires that corporate tax laws are not too complex. The legislation should be clear and unambiguous, easy to administer and to comply with and such that taxpayers are able to understand the tax system. Although simplicity is a desirable attribute of a good tax system, whenever there is a conflict between simplicity and any other tax objectives such as fairness or efficiency, simplicity is often sacrificed.<sup>211</sup> A simple tax system is likely to be relatively transparent. Thus, any decision to introduce more complexity into the tax system must be strongly justified, given that administration and compliance costs matter a great deal and impose significant limitations on tax design.

The complexity of group tax systems often results from the conflicts in application of the traditional doctrine of separate entities that still exists in many tax systems and consolidated approach under group tax regimes. Tension arises where certain parts of a tax system were designed for the separate entity approach while other parts apply the consolidation of groups approach. For example, even though a company may be taxed as part of a group under a group tax regime, it will still be recognised as a separate entity for double tax treaty purposes.<sup>212</sup> The taxation mismatches between the two systems not only create complexities but also tax avoidance opportunities. To counter tax avoidance jurisdictions with group tax systems have to introduce complex anti-avoidance measures which have complicated their tax systems.

In 2013, the Canadian Minister of Finance announced that the Government had decided to abandon the introduction of a formal system of corporate group taxation because of the

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<sup>209</sup> Canada, Department of Finance *The taxation of corporate groups: Consultation paper* (2010) at 2. Available from: <http://www.fin.gc.ca/activty/consult/tcc-igs-eng.asp> [Accessed: 2015-05-15].

<sup>210</sup> Ibid.

<sup>211</sup> S James, A Sawyer, & T Budak *The Complexity of Tax Simplification: Experiences From Around the World* (2016) at 27. New York: Springer.

<sup>212</sup> J Sasseville "Treaty recognition of groups of companies" in Maisto, G. (ed.) *International and EC tax aspects of groups of companies* (2008) at 130, Volume 4 of *EC and International Tax Law series*, Amsterdam: IBFD.

perceived complexities of a group tax system.<sup>213</sup> It was feared that a new system for the taxation of corporate groups would introduce new rules for complying with the system and consequential changes to ensure the integrity of the tax system, which would ultimately increase complexity.<sup>214</sup>

Overview of policy considerations: The policy considerations when adopting a group taxation regime should take into consideration the principles of a good tax system. It is however crucial for policy-makers to understand that the introduction of a group tax regime may require a compromise between conflicting policy objectives, with simplicity often sacrificed for other policy objectives. For example, the Canadian government abandoned the introduction of group taxation in 2013 because it felt that a suitable group tax model should be relatively simple, flexible, should promote compliance and also prevent inappropriate tax avoidance. In the end the Canadian government decided not to introduce a group tax system because it did not want to compromise on any of the principles of a good tax system.<sup>215</sup> Undoubtedly, there are numerous policy objectives that first need to be considered by a country if it is to introduce group tax regime. Simplicity, is one objective that is often difficult to achieve.

#### 9.4 Group taxation in African countries

Some African countries provide for group taxation rules which apply in very select or restricted cases. For example:

- In Botswana, the assessed losses incurred only by a wholly owned subsidiary of a Botswana Development Corporation Limited may be deducted from another subsidiaries' taxable income, provided a written notice is delivered to the Commissioner General of the revenue authority.
- In Mauritius, losses may be transferred by certain tax incentive companies located on the Island of Rodrigues, as well as manufacturing companies upon their take-over. There are no generally applicable group taxation rules.
- In Tunisia, provided that certain requirements are satisfied, companies which belong to the same corporate group may apply to the Ministry of Finance if they elect to be subject to the tax consolidation regime. In terms of this regime, the participating group entities may determine their taxable profits or losses by applying a formula in order to determine the group's consolidated tax liability. The regime applies for a minimum of five years, whereupon the group may tacitly agree to renew its election to be subject to the regime for a further five years.

<sup>213</sup> Canada, Department of Finance *Budget 2013: Annex 2 - Taxation of Corporate Groups* (2013). Available from: <http://www.budget.gc.ca/2013/doc/plan/anx2-eng.html#a0-Annex-2:-Tax-Measures:-Supplementary-Information-and-Notices-of-Ways-and-Means-Motions> [Accessed: 2015-05-15].

<sup>214</sup> Canada, Department of Finance *Budget 2013: Annex 2 - Taxation of Corporate Groups* (2013). Available from: <http://www.budget.gc.ca/2013/doc/plan/anx2-eng.html#a0-Annex-2:-Tax-Measures:-Supplementary-Information-and-Notices-of-Ways-and-Means-Motions> [Accessed: 2015-05-15].

<sup>215</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

## 9.5 The position on group taxation in South Africa

At present South Africa does not have a system of group taxation. The cases of *CIR v Niko*,<sup>216</sup> *CSARS v Wooltru Property Holdings (Pty) Ltd.*,<sup>217</sup> and *Ackermans Ltd. v CSARS*,<sup>218</sup> illustrate that the economic reality of transactions that take place in groups of economic units is not recognised in South Africa.<sup>219</sup>

In 1997, the Margo Commission<sup>220</sup> considered the viability of group taxation in South Africa. The Commission was in favour of the concept, but it did not believe South Africa was ready to introduce group taxation at the time. The 1997 Katz Commission recommended a gradual introduction of group taxation.

It should be noted that the findings of the Margo and Katz Commissions must be viewed against the economic background of the country during the periods of their reports.<sup>221</sup> The Katz Commission, which favoured a gradual adoption of a group tax system, reported during a period of good economic prospects in contrast to the Margo Commission which reported during difficult times, at the end of the Apartheid era. It appears therefore that the introduction of a formal group taxation system is judged more positively during times of good prospects and growth.

Both Commissions favoured introducing group taxation using the “group relief regime” that is applied in the UK, given the similarities between the South African tax system and the UK tax system. This model requires each member company to submit its own tax return, while the matching of economic reality with fiscal reality is catered for through a netting off of the profits and losses within a group through “loss transfers”. The principal benefits of the adoption of such a model would include a reduction of the economic and business distortions associated with the single entity approach, as well as a minimization of the need for internal planning and a discouragement of avoidance arrangements that are otherwise encouraged by the single entity approach.<sup>222</sup>

However, due to the various complexities of applying this method, both the Margo and the Katz Commissions recommended the use of the “consolidation method”.<sup>223</sup> Since the consolidation method requires complex tax accounting, especially where ownership interests of less than 100% are involved, and since the method seems more suited to first

<sup>216</sup> 1940 (AD) 416 (11 SATC 124).

<sup>217</sup> 2008, 70 SATC 223.

<sup>218</sup> 2010, 73 SATC 1.

<sup>219</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

<sup>220</sup> Margo Commission Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa 1986.

<sup>221</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

<sup>222</sup> PWC Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 31.

<sup>223</sup> Katz Commission at 24

world economies, the Katz Commission proposed a “simplified consolidation method” along the following lines:

- “(a) For the purposes of qualifying for group tax relief, a group should comprise a holding company and all its wholly owned subsidiaries. The term “wholly-owned” should be defined to refer to both direct and indirect interests held by the holding company, determined on the equity share capital of the companies concerned, with allowance for equity shares to be held by full-time employees, including executive directors, in terms of share incentive schemes, not exceeding 10% of the company’s equity share capital.
- (b) The consolidation tax liability of a group will be calculated from sub-returns required for each member company in which taxable income or assessed loss will be determined on the basis of the current tax regime, save for a number of limited proposed adjustments.
- (c) The initial assessed losses of the member companies will be ring-fenced, and any loss incurred by a company in the group in a subsequent year of assessment will only be available to be set off against income from another company in the group in the same year of assessment.”

The assumption was that the proposed simplified consolidation method would not be overly complex and could be implemented by SARS and taxpayers alike. The Katz Commission recommended that a simpler group tax model be employed first and then later another, more comprehensive, group tax model, following an evaluation of the impact of the introduction of the initial simpler group tax system could be adopted.<sup>224</sup> The Katz Commission also recommended that specific anti-avoidance legislation should be considered, together with the application of the existing general anti-avoidance measures. It further recommended that progress towards a full consolidation system should be based on principles of loss offset and adjustments to taxable income, which are widely followed internationally, and should be deferred until the impact of the shift to group taxation on the fiscus can be evaluated and the problems of administration have been identified and addressed.<sup>225</sup>

However, the recommendation of a gradual move to group tax was not implemented due to other priorities at the time, and concerns regarding some of the aspects of group tax, specifically loss of revenue to the fiscus, inadequate resources at SARS and tax avoidance. What has, however, evolved is legislation that contains various elements of “group tax”, but not a fully operationally recognised group tax system.

The first set of tax provisions was introduced in 1988, as a result of the Margo Commission’s report. The provisions were only temporary and provided relief where a corporate group went through a process of rationalisation, in order to ease administrative burdens relating to an excess number of companies, in the period beginning 17 June 1988 until 30 June 1991. The rules applied to a qualifying group of companies that elected for the application of the rationalisation relief measures. Where rationalisation relief was granted, the assets that formed part of the rationalisation could be transferred tax-free between group members. The regime was, however, problematic because it did not provide for entry and exiting provisions when moving between the general tax system, that was designed to cater for the separate entity doctrine, and the rationalisation relief rules,

<sup>224</sup> AD Koekemoer *A Critical Evaluation of the Taxation of Corporate Groups in South Africa*. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

<sup>225</sup> Katz Commission at 24

that adhered to the single enterprise doctrine. The problem with these temporary rationalisation group tax relief measures was revealed in *CSARS v Wooltru Property Holdings (Pty) Ltd.*<sup>226</sup> Because the members of the corporate group were taxed as separate entities before the rationalisation process, and then as a single enterprise during the rationalisation process, only to be taxed again as separate entities after the rationalisation process, certain mismatches were created.<sup>227</sup>

The second set of tax provisions that recognised economic unity within corporate groups in South Africa are the corporate restructuring rules, which were introduced in 2001 and are currently set out in sections 41 – 47 of the Act.<sup>228</sup> These provisions, discussed above in part 9 of this report, provide for rollover provisions for assets and certain other allowance provisions<sup>229</sup> in the corporate restructuring rules, thereby avoiding all the problems at entry and exiting points, experienced with the preceding rationalisation regime.

Other provisions in the Act that contain elements of group taxation include: the connected persons definition in section 1; section 9D which deals with CFC legislation; section 24O which provides for the deduction of interest incurred in acquiring shares in certain restructuring transactions; certain donations tax exemptions in section 56; the dividends tax provisions; and also paragraph 12(5) of the Eighth Schedule to the Act. All these separate tax provisions suggest that the South African government recognises and desires to adhere to the doctrine of economic unity within corporate groups.

Despite the above provisions, there have been calls for the full introduction of group taxation in South Africa for the following reasons:

- Many listed (and other widely held) companies often have multiple subsidiaries, mainly to separate risks and to segment management. This separation is not driven by tax but the tax system treats each subsidiary within the group as a fully independent taxable person. The business concern for larger South African groups is that the group operates as a single economic unit yet the tax system treats the group in a fragmented way.<sup>230</sup> Group taxation allows flexibility, in that it allows businesses to organise themselves in the best way from a pure economic perspective, without worrying whether the structure is the most efficient from a tax perspective.
- South Africa is at a competitive disadvantage when it comes to attracting investment when compared to countries with a group tax regime which allows transfer of losses between group companies,. Group taxation would, potentially,

<sup>226</sup> [2008] (70 SATC 223).

<sup>227</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

<sup>228</sup> Introduced by Second Revenue Laws Amendment Act No. 60 of 2001.

<sup>229</sup> Sections 24(1) and 24C

<sup>230</sup> Keith Engel (SAIT) Technical Report on Corporate Tax submitted to the DTC (19 January 2017).

act as an incentive to attract multinationals to South Africa, which would also result in a larger tax base.<sup>231</sup>

- South African multinationals have to compete for capital and bank funding with international players from other jurisdictions, many of which have group taxation. The effective tax rate within a group headquartered in South Africa is negatively affected by the ring-fencing of individual companies for tax purposes, which adversely affects the yields that investors may expect from their share participation or that banks may find available to service debt.<sup>232</sup>
- Tax policy should be designed to support economic growth, rather than to simply raise revenues for the fiscus. In times where the fiscus is estimating a significant shortfall in revenues and a budget deficit much greater than it has been for many years, it has to be borne in mind that when economic recession arises, groups are prejudiced when they pay tax in one company but have losses in others. The tax cash outflow can, unnecessarily result in the demise of groups, essentially 'killing the goose that will lay the future golden egg' for the fiscus.<sup>233</sup> Introduction of a group tax regime would enable the set-off of profits against losses between group companies, yet preserve business and legal advantages of a separate company e.g. limited liability. Similarly, capital gains/losses may be able to be set-off across group companies.
- Group taxation allows and encourages leveraged acquisitions, in that it potentially provides for off-set of acquisition interest expenses against operational profits. Similarly, unproductive interest leakage could be mitigated where the holding company borrows externally at a higher interest rate to lend to the subsidiary company at a lower rate.
- Intra-group transactions carry minimal tax leakage e.g. deemed dividend issues, capital gains, local inter-group transfer pricing arrangements are largely neutralised through redundancy and, thus, meticulous record keeping avoided etc.
- Since gains and losses are only economically realized with parties outside the group, the combined treatment of the group as a single entity would benefit the revenue authority because all entities within the group would be filed as one, thereby allowing the revenue authority to review a more complete picture.<sup>234</sup>
- Group taxation reduces the number of provisional tax payments and reduces tax cash outflows where there are loss-making companies within the group. In this regard it can thus reduce administrative costs for SARS as well as compliance costs for corporate companies.<sup>235</sup>
- Although one of the reasons given against group taxation was loss to the fiscus, the Margo Commission noted that clever tax planning often achieves the same result as transfer of losses. Since group taxation was mooted in 1987 by the Margo Commission, SARS has become much more sophisticated in its ability to address

<sup>231</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>232</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>233</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4.

<sup>234</sup> SAIT Technical Report on Corporate Tax submitted to the DTC (19 January 2017).

<sup>235</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

tax avoidance. Tax avoidance could further be addressed by ensuring loss transfer rules are incorporated in the anti-avoidance provisions. Suggested provisions would include the ring fencing of pre-group losses; three-year “one-in-all-in” rules i.e. once the regime has been elected all the companies in the group must be included for a minimum of, say, three years; all group companies can be assessed at the same tax office (a SARS’ large business centre equivalent); specific rules can be provided for special types of companies e.g. insurance, farming; as well as rules to attribute CFC income to one offshore company in the group.

- One of the reasons why group taxation was not introduced since it was mooted in 1987 by the Margo Commission, was inadequate resources at SARS. Arguments have been raised that since SARS has reorganised itself in the last 10 years to be a much more efficient organisation, and with the advent of e-filing many more resources have become available, it can be able to handle group taxation.
  - The DTC submits that despite these developments, SARS may still not be adequately resourced to handle group taxation. The alternative is for technology and an equivalent of SARS’s former “large business centre” to be resourced to handle group filing – a measure which also has cost implications.

## **9.6 Proposal of key structural features for a framework of group tax system in South Africa**

The common structural features in the group tax statutes of the jurisdictions that have introduced group tax legislation contain the following features:

- the rules to calculate a qualifying group’s tax liability on a consolidated or combined basis;
- the definition of the corporate group (eligibility requirements);
- the participation rules (whether participation is mandatory or voluntary, applies for a minimum period and applies to all entities that qualify);
- the treatment of unused tax attributes (upon entering into the group, as well as upon leaving the group) and other practical considerations.

Apart from these common structural features, there are various structural elements and differences in the application of the countries’ group tax regimes. These differences may be as a result of the different policy objectives and legal systems of those different jurisdictions. A proposal for the features of a group tax structure for South Africa would therefore have to be adjusted to suit the South African fiscal policy objectives.

If group taxation is to be introduced in South Africa, the DTC is of the view that a “group relief or loss transfer” model (which was the preferred option by both the Margo and Katz Commissions), would be the best option. Below are some proposals to take into consideration if group taxation is to be adopted.



What should be covered by the regime?: Under a “group relief or loss transfer” model two systems that seem reasonable/relatively simple to adopt is the United Kingdom system, which allows for the aggregation of group losses against group income; and the fiscal unity system of the Netherlands which allows groups to file as one entity, much like the system for accounting.<sup>236</sup> A phased approach can be considered, starting with the set off of assessed losses, which would largely be a simple adjustment to what South Africa currently has i.e.<sup>237</sup>

- The current elements of “group taxation” set out in the Act, principally those that permit the tax-free transfer of assets between group members, should be retained, on the basis that they continue to be refined;
- Provision could be made for loss sharing between “group” members to a tax neutral position, i.e. losses transferred may not create a loss in the transferee company.

What should constitute a "group"? The term "group of companies" is defined in section 1 of the Act to include local and foreign companies that are 70% owned. The definition of the term in section 41 is narrower and, essentially, excludes foreign companies (albeit that the provisions do permit roll over where controlled foreign companies are involved, in limited circumstances). The definition of “group of companies” as is currently set out in section 1 of the Act i.e. to include companies held at or above a 70% level, but excluding specified types of companies (specifically non-residents for the present). This level of shareholding is designed to ensure that BBBEE initiatives are not affected.<sup>238</sup> The most likely scenario would be to make the benefit available to local companies first, to test it out and clear any glitches and then, later on, make it available to multinationals. If, however, this is considered to create too much risk for SARS, a requirement of a 100% shareholding of subsidiaries could be initially considered for multinationals. This would make set-offs easier as it would not be complicated by smaller minority holdings.

How will foreign entities be included? As indicated above, one must consider whether group tax will only apply to South African resident companies or whether it will include foreign companies as well. Most countries that have group taxation provisions allow tax consolidation for resident companies, for example, Finland,<sup>239</sup> the Netherlands<sup>240</sup> and the UK. However, some countries offer world-wide tax consolidation, for example Austria,<sup>241</sup> Denmark,<sup>242</sup> Italy<sup>243</sup> and France.<sup>244</sup> Non-resident companies could be taken into account

<sup>236</sup> SAIT Technical Report on Corporate Tax submitted to the DTC (19 January 2017).

<sup>237</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>238</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>239</sup> Snellman (2009) An Overview of Corporate Tax in Finland

[http://www.linexlegal.com/content.php?content\\_id=83182](http://www.linexlegal.com/content.php?content_id=83182) (accessed 18 Sept 2009).

<sup>240</sup> Kavelaars & Willeme (2008) Netherlands Tax Alert –Fiscal Unity Rules on Cross-border Group Taxation referred to ECJ [http://www.deloitte.com/view/en\\_GX/global/services/tax/internationaltax/article/bf91ebf4c52fb110VgnVCM10000ba42f00aRCRD.htm](http://www.deloitte.com/view/en_GX/global/services/tax/internationaltax/article/bf91ebf4c52fb110VgnVCM10000ba42f00aRCRD.htm) (accessed 18 Sept 2009)..

<sup>241</sup> Austrian Holding Companies <http://www.lowtax.net/lowtax/html/offon/austria/austriahold.html> (accessed 18 Sept 2009).

<sup>242</sup> Smith (2008) Group Taxation in Denmark <http://www.equinor.eu/pdfs/GROUPT~1.pdf> (accessed 18 Sept 2009).

when determining whether companies form a group of companies without providing such non-resident companies with any tax benefits arising from the group taxation system.<sup>245</sup>

Where the group of companies consists of companies that are not resident in the country which grants group taxation, the non-residence of such companies may result in three different group tax outcomes for resident companies in the group.

- Firstly, non-resident companies can be considered in order to determine whether companies form a group. For example, if a non-resident company owns numerous subsidiaries that are resident in the group taxation jurisdiction, such subsidiaries could be seen to be a group regardless of the fact that their common holding company is not resident. In this case group taxation would apply to subsidiaries and not to the holding company. The holding company's purpose would be to make the subsidiaries a group.
- Secondly, a non-resident holding company could be ignored when determining whether a group exists, resulting in subsidiaries failing to pass the group tax primarily due to the fact that the holding company is not resident.
- Thirdly, a non-resident holding company could be considered to both enable subsidiaries to constitute a group and in order for the holding company to benefit from group taxation on its income that is sourced in the group taxation jurisdiction.<sup>246</sup>

If group taxation is to apply to non-resident companies:

- Consideration should be given as to whether imputable CFC's should be included in the group tax regime.
- Consideration should also be given as to how the income/losses of foreign entities are to be set-off as they are calculated in terms of different rules. Would the foreign entities' tax calculation need to be re-calculated in some way (e.g. using South African tax laws)? This should be avoided or minimised as far as possible, as it would make the regime more burdensome and, therefore, less likely to be taken up.
- If losses of foreign entities are set off, there would need to be a recoupment if those losses are utilised in a subsequent year in that foreign country. This benefit could apply to foreign countries that have tax information exchange agreements with SARS.
- Intra group charges should be as per financial statements of individual companies. Transfer of losses should mitigate local transfer pricing using inter-group charges. However, the purpose for which funds are borrowed would be looked at on a group

<sup>243</sup> Gianni, Origoni, Grippo & Partners (2003) Italy: How company groups are taxed in Italy [://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12608&SID=469849&TYPE=20](http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12608&SID=469849&TYPE=20) (accessed 18 Sept 2009).

<sup>244</sup> Wiman "Equalising the income tax burden in group of companies" (2000) *Intertax* 352–359

<sup>245</sup> Rohatgi 256.

<sup>246</sup> Thabo Legwaila "Intermediary holding companies and group Taxation" *De Jure* (2010) at 317

basis i.e. interest will be deductible provided used in the group to fund operations, regardless of how the funds reach their destination.

In order to ensure that the South African tax base is not eroded the DTC recommends that, if implemented, group tax and, in particular, loss transfer only apply to South African companies. Thus, even where a non-resident holding company may assist in determining which South African companies fall within a group, the group tax regime should only apply to the South African companies within that group.

Rules on setting off losses: Rules would need to be introduced to cater for the acquisition of companies with assessed losses. There could be valid commercial motives behind such acquisitions but this could also create tax avoidance opportunities.

- Rules can be set to ring-fence losses on joining a group.
- The rules can be set to cater for the situation when a company ceases to form part of the group. There should be a deemed transfer from the group to the company using rules similar to the corporate rules.<sup>247</sup>
- The rules should clarify how foreign losses will be dealt with; i.e. if they will be limited to local taxable income. Losses regarding foreign entities will require complex rules and, if adopted, would best be implemented using a phased approach.<sup>248</sup> In cross border loss off-set situations, countries like the UK allow companies to claim foreign tax losses of its, say 75% or more, owned subsidiary or a permanent establishment in the European Economic Area. To prevent loss to the fiscus, initially, non-South African losses could be ring-fenced, and South Africa could apply similar rules for losses in the Common Monetary Area or SADC region in the future.

How should the election process work? Group taxation rules normally work on the basis that they apply automatically unless the taxpayer elects out of the regime. The holding company (or the company that makes the election to pay opt in or out of group tax) should be a resident. This is the common feature in most regimes. The election process for group tax would depend on the regime. If companies are only allowed to set off assessed losses, then the taxpayer could be allowed to make the election annually. However, for a more complex regime, an election is generally made once and continues to apply going forward.<sup>249</sup> Election should be made on a “one in, all in” basis (i.e. all members of the group must participate, so that all group members with losses must transfer those losses to group companies with taxable income), for a minimum period of e.g. three years, with three year roll over periods.

Impact on other taxes: There is also a need to clarify if the group tax treatment will be for all tax types or different treatment for different tax types. A group could be treated as a

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<sup>247</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>248</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

<sup>249</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

single entity for some tax purposes, but as separate entities for other tax purposes. In some jurisdictions, an entity is treated as a group for purpose of income tax but as separate for purposes of VAT.<sup>250</sup>

Treatment of special taxpayers: A simplistic view to the application of a group tax regime in circumstances where the structure of the tax computation of certain trades deviates from the normal tax computation structure, is that if the remainder/taxable income calculated is subject to tax at the corporate tax rate, currently 28%, then that trade should be included in the group tax regime<sup>251</sup>. Thus, the most suitable group tax regime would be the “loss transfer” regime for the following reasons:

- The taxable income or tax loss of each trade must be determined in accordance with the tax principles applicable to that trade;
- The tax losses can then be transferred to the operations with taxable income then the net tax liability is determined.

The “loss transfer” can apply equally to companies with special tax treatment in terms of current tax legislation. This is illustrated below:

- *Long term insurers:* Long-term insurers are taxed in terms of section 29A of the Act, based on the four-fund principle. The funds comprise the untaxed fund, individual policy holder fund, company policy holder fund and the corporate fund. The corporate fund comprises returns and assets which are not attributed to the other three funds. The returns and assets attributable to the untaxed fund, individual policy holder fund and company policy holder fund are attributable to the policy holders, whereas the shareholders of the long-term insurer can enjoy the benefits of the assets attributed to the corporate fund. As such the four funds do not comprise a group of companies for tax purposes. With reference to the “loss transfer” regime, a long-term insurer which forms part of a group of companies would calculate its tax based on the principles provided for in section 29A of the Act. Any taxable income or tax loss attributable to the corporate fund can then be applied against the taxable income or tax losses of any of the other operations of that group of companies.
- *Farming operations:* Group of companies with farming operations within the group should also be able to participate in a group tax regime. The taxable income or tax loss of the farming operations could be calculated before taking into account any adjustments in terms of paragraph 12 of the First Schedule to the Act. Paragraph 12 allows a deduction of certain farming development expenditure to the extent that there is taxable income from the farming operations. Any excess development expenditure is carried forward and may be deducted against future farming taxable income. Currently companies which have farming operations as a division within their overall operations must perform a separate tax computation in respect of their farming operations in order to determine the deduction of the farming development expenditure incurred. It should also be possible to incorporate this methodology in

<sup>250</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017); SAIPA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 3.

<sup>251</sup> This would effectively eliminate e.g. gold mining companies and companies in SEZ's from the regime.

- a group tax regime. The aggregate of farming development expenditure may be deducted from the aggregate of the taxable income from all the farming operations. The same limitations can also apply but at the aggregated farming operations level. Special provisions may be required to deal with situations where farming operations with unclaimed farming development expenditure are disposed of during a tax year.
- *Toll road operations:* As is the case with farming operations, section 24G of the Act limits certain expenditure to the taxable income attributable to toll road operations. The same principles as proposed in respect of farming operations should also apply to toll road operations.
  - Due to the specific tax regimes relating to mining and oil and gas (which both incorporate loss limitation provisions and ring-fencing rules), it is recommended that these industries, be excluded from any group tax regime.

## 9.7 Drawbacks to introducing group taxation

While the group taxation proposition has had some pull within government, the pressure of other work has consistently kept this issue off the table. Some of the drawbacks to introducing group taxation include the following:

- Group taxation will bring further complexity to an already complex tax system. Real group integration systems, like those found in Australia and the United States, are highly complex and extend to hundreds of pages of legislation.
- Distortions in the taxation of corporate groups can arise if conflicts exist between business structures and efficient tax measures as functionally equivalent corporate structures could result in inconsistent tax treatment.
- Group taxation can also be administratively burdensome. Making elections and effecting set-offs may be administratively burdensome to the group.
- If group taxation applies to foreign entities, it can result in taxation mismatches, especially where countries apply different tests to tax companies (i.e. place of incorporation or place of effective management). A company that may be regarded as a part of a group in the Republic may also be regarded as part of a group in a foreign jurisdiction. This creates a possibility of double taxation, and a corresponding possibility of double non-taxation and tax evasion.
- The assessed losses within the group may result in anomalies. This may create opportunities for aggressive tax planning.<sup>252</sup> The creation of flawed rules could easily lead to avoidance, uncertainty and unfairness. Group taxation could pose increased transfer pricing risks as corporates transact globally.
- The implementation of a group taxation model in South Africa could also have an adverse effect on revenue collection. Although this effect could be ameliorated by, for example, not allowing the set off of historical losses (i.e. losses from years of assessment prior to the introduction of group taxation) this could be a disadvantage particularly in an environment in which there are pressures on tax revenues.

<sup>252</sup> SAIPA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 3.

- Even though group taxation has been found beneficial for groups where some entities are profitable and others are not, group taxation may not be beneficial for the banking industry where the group may have subsidiaries which may or may not use the same accounting systems. The implementation of a group tax system for banks may therefore not be beneficial, save for those banks that use the same accounting system. The level of complexity in attempting to “fit” various entities within a banking group into one group tax model outweighs any potential benefit. The level of skill required by SARS in order to understand the manner in which such groups have been consolidated could place an unduly onerous burden on SARS. In addition, the cost of changing IT systems in order to transition into such a new system appears to outweigh the potential benefit.<sup>253</sup>

## 9.8 DTC recommendation on group taxation for South Africa

The introduction of a group tax system must be motivated by implications for the economy including stimulating economic growth, simplicity, tax administration and compliance (for taxpayers and for SARS), rather than with reference to the potential for a once-off adverse impact to revenue collections.

Although the introduction of group taxation using the “group relief or loss transfer” model could place South Africa at a competitive advantage and also support economic growth; given the radical amendments that a group tax system would require and the changes to, for example, the recently developed tax return, IT issues, re-education of tax professionals and SARS personnel, the DTC does not favour introducing a group taxation system in the current economic circumstances. The group taxation ultimately advantages loss-making companies, which opt in to the regime and stay for three years or opt out when it does not suit them. Essentially the regime works as a tax incentive that takes money out of the fiscus.

In the current sluggish economic circumstances, introducing such a regime is not beneficial to the economy considering that companies are currently not re-investing back in the economy due to the general lack of confidence in the system. Thus even if the group taxation would be introduced to allow transfer of losses, there are other economic policies that do not encourage investment in the economy and thus the system could result in double loss to the fiscus. Thus despite the recommendations of the Katz Commission report which (the DTC agrees with), the DTC is of the view that a formal group tax regime should only be introduced when the economy is strong enough to withstand such a drastic change that may initially lead to loss of tax revenue.<sup>254</sup>

As stated above, no other African jurisdiction has a comprehensive system of group taxation. Although South Africa does not have a formal group taxation regime to enable a

<sup>253</sup> BASA Technical Report on Corporate Tax submitted to the DTC (30 March 2017) para 9.

<sup>254</sup> AD Koekemoer A Critical Evaluation of the Taxation of Corporate Groups in South Africa. Draft PhD manuscript (2017). Pretoria: University of Pretoria.

group of companies to consolidate its tax reporting and/or to facilitate the intra-group offset of profits and losses, it nevertheless already has corporate restructuring rules (discussed above, which provide limited relief on restructuring that is akin to group taxation) thus fulfilling this role, albeit to a considerably limited extent. The corporate restructuring rules attempt some measure of alignment between taxation and economic reality within the group context.<sup>255</sup>

Thus, the DTC recommends that, instead of introducing group taxation at this time, the corporate restructuring rules should be reviewed and expanded upon if situations are discovered in which the rules do not provide adequate relief. There is a strong case for the need for tax-neutral restructuring rules if South Africa is to be a business-friendly jurisdiction. The corporate restructuring rules can be supplemented with a loss transfer rule at election for companies that are 100% held once it is considered that the economy is strong enough to withstand such a change.

## **10 REVIEW OF THE POLICY RATIONALE FOR CERTAIN CORPORATE TAX PROVISIONS THAT IMPACT ON THE EFFICIENCY OF THE SYSTEM**

### **10.1 Ring-fencing of assessed losses from trades carried on outside the Republic**

Paragraph (b) of the proviso to section 20(1) of the Act effectively ring-fences assessed losses and balances of assessed loss incurred in the carrying on of any trade outside the Republic. This provision was initially intended as an interim measure that was aimed at protecting the South African tax base following the transition from a source to a residence basis of taxation. It appears, from the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (which introduced the provision), that the primary rationale for its introduction was to prevent losses (the magnitude of which were not known at that time), incurred by South African residents in respect of trades carried on outside the Republic before the advent of the residence basis of taxation, from being brought onshore and offset against future income.

Although the residence basis of taxation has been in existence in South Africa since 2000, and the primary rationale for this provision no longer exists, the DTC believes that the policy rationale remains and the limitations, as set out in sections 20 and section 9D of not allowing foreign losses to be offset against domestic profits, should continue to stand in order to prevent erosion of the South African tax base.

### **10.2 Concerns about troubled companies**

The tax system only partially recognizes the need for relief when the debt of a company is cancelled or reduced by creditors as part of an effort to revive the company. The main set

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<sup>255</sup> Lisa Brunton (Cliffe Dekker Hofmer) Technical Report on Corporate Tax submitted to the DTC "Corporate Income Tax: Group Restructuring" (7 March 2017).

of rules associated with this relief are paragraph 12A of the Eighth Schedule to the Act and section 19 of the normal tax. Paragraph 12A effectively reduces tax attributes when debt is reduced if the initial loan funds were used to invest in capital assets. Section 19 relates to ordinary asset investments. Both sets of rules require indebted taxpayers to reduce tax attributes (e.g. losses and/or tax cost in assets) in lieu of capital/ordinary gain.

The issue is whether these debt cancellation/waiver rules fully work as intended. The ordinary debt cancellation rules provide far less relief than the capital debt cancellation rules. Given the new nature of both sets of rules, many anomalies need to be eliminated. Questions also exist whether these rules provide sufficient relief to revive a bankrupt company and whether a more favourable dispensation should be provided (especially for companies under formal business rescue).

Another important issue is the trading limitation. If any company (including a troubled company) ceases trading for a complete year, all assessed losses are eliminated. This rule appears excessively punitive, especially when a troubled company is temporarily forced to shut-down operations by creditors (and/or government) and subsequent efforts are made to revive the troubled company<sup>256</sup>. It is thus recommended that this rule be eliminated as SARS can, in any event, rely on the section 103(2) anti-avoidance provision as a backstop for misdemeanours in this area.

### 10.3 Reconsider the distortion in tax treatment of foreign branches vs CFCs

There is a distortion with respect to the difference in tax treatment between foreign branches and controlled foreign companies (CFCs). CFCs enjoy a variety of relief measures with regard to the taxation of their income in the hands of a resident shareholder. The most common of these are the so-called foreign business exemption (FBE) and high tax exemption. These exemptions effectively result in the residence-based system of taxation being switched off for qualifying CFCs, particularly when considered in conjunction with the foreign dividend and CGT participation exemptions.

However, a foreign branch of a resident taxpayer enjoys no such relief: A branch is fully within the South African tax net. This results in a significant distortion in favour of the establishment of CFCs rather than foreign branches, notwithstanding that in many instances it may be more economically efficient to establish a branch in the absence of the tax distortions.

- The DTC recommends that consideration be given to aligning the tax treatment of CFCs and foreign branches to the extent that this is practicable.<sup>257</sup>

<sup>256</sup> SAIT Technical Report on Corporate Tax submitted to the DTC (19 January 2017).

<sup>257</sup> PWC Technical Report on Corporate Tax submitted to the DTC (14 March 2017) at 14.



#### **10.4 Distortions in qualifying for depreciation allowances for intellectual property: Goodwill and trademarks**

In order to eliminate distortions and promote efficiency in any tax system, it is generally acknowledged that assets held on capital account should qualify for depreciation allowances over the period of their useful lives. Generally, the South African corporate tax regime makes provision for such capital allowances. These allowances are generally based on the useful life of the relevant asset or a proxy thereof, and applicable principles have been developed through legislative amendment and SARS practice over time.

A notable exception to the above exists in the context of trademarks and goodwill (“intangibles”), two types of capital assets in respect of which no capital allowances are available for expenditure incurred in the acquisition thereof. It is understood that this situation exists primarily because of avoidance concerns, since it is difficult to objectively establish values of such assets, and there is a potential for tax-motivated manipulation of these values for tax purposes should such depreciation allowances be available. Whilst these concerns are appreciated, it must be acknowledged that the absence of depreciation allowances for intangible property such as goodwill and trademarks leads to a number of distortions (and therefore inefficiency) in the corporate tax system.

For example, distortion arises as a result of the fact that certain companies (e.g. technology companies) have a greater proportion of assets that are intangibles than other companies, resulting in differential treatment from an overall tax perspective. Moreover (and largely as a result of developments in commerce and technology and the advent of the “digital age”), the value of intangibles (as a percentage of the total value of all of the assets of companies) is on the increase.

Not only is there a distortion operating against intangibles in comparison to other capital assets, but there is also a distortion that is created against purchased intangibles relative to self-developed intangibles. This is because the costs of self-developing trademarks and goodwill generally take the form of normal operating expenditure (such costs could, for example, be classified as salaries and marketing costs) and are often treated as fully tax deductible. This creates further inefficiencies in the tax system.

Whilst there have, in the past, been valid concerns for not granting capital allowances for purchased trademarks and goodwill due to the potential to erode the tax base through inflated values being assigned to such assets, that potential has been greatly reduced with the introduction of capital gains tax, and even more so with the increase in the inclusion rate to 80 per cent for companies in recent times.

It is thus recommended that the absence of capital allowances for purchased trademarks and goodwill should be reconsidered.

## 10.5 The Headquarter company regime

In 2011, legislative amendments were made to introduce a headquarter company regime in South Africa. The purpose of introducing the regime was to promote South Africa to multinationals as a jurisdiction of choice for investments into Africa, by reducing fiscal and other regulatory barriers that otherwise detract from the attractiveness of South Africa as a location for headquarter companies. Although headquarter companies are subject to South African corporate income tax at the standard rate of 28%, they are exempt from dividends tax and generally exempt from capital gains tax. Furthermore, they are not subject to South Africa's transfer pricing and thin-capitalization, as well as the controlled foreign company rules. As a resident of South Africa, a headquarter company is also entitled to benefit from the country's wide tax treaty network. In addition, from an exchange control perspective, headquarter companies are subject to limited restrictions in terms of the Exchange Control Regulations.

For a number of reasons, the regime has proved not to be as attractive as was hoped, and very few multinationals have made use of the regime. The principal reasons for the lack of uptake of the regime appear to be difficulties in complying with the requirements of the regime from a practical and compliance perspective, as well as the fact that there are a number of other regimes provided by other countries (for example, Mauritius and Kenya) that are more attractive and, in particular, user friendly.

The value and importance of a headquarter company regime must not be understated. An appropriately designed regime (which is not only attractive from a tax perspective in terms of tax benefits and ease of compliance, but which also takes into account BEPS concerns) can be an extremely valuable tool in attracting investment and skills into South Africa, thereby contributing to economic growth.

- The DTC recommends that National Treasury re-visits this regime in light of the challenges set out above.

## 11 ENSURE ADMINISTRATIVE EFFICIENCY OF THE CORPORATE TAX SYSTEM BY SIMPLIFYING THE TAX STRUCTURE

The determination of a company's taxable income can be a matter of considerable complexity and complication. Tax practitioners and corporate taxpayers, almost without exception, consider that South Africa's income tax system in relation to companies requires substantial simplification. The Act was promulgated in 1962, and has been amended considerably over a period of 55 years. There is a plethora of inconsistencies in the Act relating to, *inter alia*, layout, ordering, style and language. One requires considerable experience to simply be able to find all the relevant provisions within the Act which pertain to a particular set of circumstances.<sup>258</sup>

<sup>258</sup> PWC Technical Report on Corporate Tax submitted to the DTC (14 March 2017) at 14.

## 11.1 Challenges posed by the complex tax structure

The complexity in the Act is manifest in many of the individual provisions on a stand-alone basis and certainly also in the statute as a whole. The Act has evolved over the last half-century (since its last consolidation in 1962) as a patchwork of specific provisions to address specific technicalities and transactional developments - with insufficient regard for overall policy and structure objectives or the desire to retain simplicity.<sup>259</sup>

The complexity of the Act has been mainly due to the general approach by the legislators, in recent years, of introducing new measures based on perceived concerns about specific tax avoidance practices. Thus South Africa's corporate tax regime has, in recent years, seen a proliferation of specific/targeted anti-avoidance rules, rather than the application of general anti-avoidance principles. Often, such "targeted" provisions are in fact extremely broad and are not sufficiently tailored to the mischief involved. This exacerbates the problem of complexity and renders the anti-avoidance initiatives uneconomic i.e. when comparing the marginal revenue collection to the burden and complexity of policing them.<sup>260</sup>

The complexity is often compounded by the fact that these targeted provisions often attack harmless legitimate transactions, where there is no intention to avoid tax. In response, further amendments are drafted to cater for such harmless transactions which results in the unintended consequence of complicating the legislation further. Frequently, the amendments are effected incrementally i.e. a certain practice is initially targeted by way of a general provision, and in subsequent legislative cycles additional measures are introduced in order to refine the application of the general provision. Often, the additional measures take the form of new "stand alone" provisions (and not amendments to the original provision). The overall effect of all of the above is that the Act has become extremely fragmented and complex.

Examples of the enactment of such rules include the anti-diversionary rules contained in sections 10B(4) and 9D of the Act, as well as the hybrid rules contained in sections 8F and 8FA of the Act and other interest limitation rules in e.g. section 23M of the Act. These rules are overly broad and excessively complex, which results in often unintentional non-compliance by taxpayers and lack of enforcement by SARS..<sup>261</sup>

Overall, complexity of South Africa's corporate tax structure poses the following general drawbacks:

- The fragmented and complex provisions increase the risks and costs for companies in performing their compliance obligations and increases the administrative burden on SARS to properly enforce the legislation. The resulting complexity requires deep

<sup>259</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 1.3.

<sup>260</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 4.1.

<sup>261</sup> PWC Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 13.

professional knowledge and understanding of the law to identify the potential provisions that may find application.<sup>262</sup>

- It increases the risk of errors and inadvertent non-compliance;
- It increases interpretational disputes;
- It fosters the incidence of aggressive tax-avoidance schemes, and several other negative outcomes that detract from the efficiency of the tax system.<sup>263</sup>

## 11.2 DTC recommendations to simplify South Africa's tax structure

There is substantial commentary (in academia, professions, policy forums, etc.) emphasising simplicity as one of the fundamental pillars of a good tax system. Although tax laws should be drafted simply, this may not always be adequate to address complex situations, as simple rules might undermine ease of administration. Simplicity should not be an end in itself and it should not come at an unacceptable cost in relation to other policy objectives.<sup>264</sup> A balance must be struck. Care should be taken to note that simplicity is not easily taken advantage of by sophisticated taxpayers.

With a view to simplifying the CIT regime and generating efficiencies, consideration should be given to reviewing aspects of the Act, with the key objective of reducing the cost of compliance for businesses through wholesale simplification. Whilst recognising that specific proposals would require a more substantial focus on the Act itself, overall simplification would serve to reduce misinterpretations, errors and non-compliance, which has the potential to facilitate revenue collection.<sup>265</sup>

To prevent the proliferation of "targeted" anti-avoidance practices more reliance should be placed on general principles, as well as the GAAR; and the "targeted" anti-avoidance provisions considered as an absolute last resort, after a comprehensive assessment of any existing applicable law (including both legislation and case law) has been performed.<sup>266</sup>

Tax laws and amendments are often written in convoluted and complex wording. This leads to a lack of clarity and certainty in the interpretation and application of tax laws. The 2009 Budget Speech made reference to simplification of the wording of the Act, but to date there has not been any significant progress on that front.<sup>267</sup> In interpreting a provision, the plain meaning must be considered to determine the intention of the legislation. However, where the meaning of the words used may give rise to ambiguity or uncertainty, this could make the interpretation of taxation statutes a difficult task. In many instances the wording of amendments is so complex that reliance is placed on

<sup>262</sup> PWC Technical Report on Corporate Tax submitted to the DTC (14 March 2017) at 14.

<sup>263</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 1.2

<sup>264</sup> Report of the Task Force 'International Tax Reform' 59 *Tax Lawyer* (2006) at 662. Also available at <http://www.abanet.org/tax/pubs/taskforceintltaxreform.pdf> (last accessed on 15 September 2009).

<sup>265</sup> BUSA Technical Report on Corporate Tax submitted to the DTC (31 March 2017)

<sup>266</sup> PWC Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 10.

<sup>267</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017).

explanatory memoranda. However, this practice may raise issues as the legality of explanatory memoranda is not provided for in statutory law and nor have they been ruled upon by our courts.<sup>268</sup>

Simplifying the Corporate tax system will however not be “quick fix”. A comprehensive rewrite of the Act would be an extremely difficult process to embark upon. Such a process would require an investment of highly skilled and experienced resources over a fairly extended period of time, and would, of necessity, require extensive planning and public consultation. Several considerations have been proposed in this regard. Some of them are more radical and far-reaching than others:

- One radical suggestion has been that the Act should be re-written and re-structured in its entirety.<sup>269</sup> Such a rewrite would undoubtedly result in a rearrangement of the provisions of the Act into a more coherent logical sequence. This may enhance the efficiency of the compliance environment of taxpayers. Such a re-write could take into consideration industry-specific provisions, which may in some cases be simplified or in other cases be withdrawn completely (either because the general principles are in fact adequate, or because the complexity simply results in large-scale misunderstanding, errors and non-compliance).
- Another suggestion to simplifying the tax system, which is considered more easily achievable, is by adopting the policy of “tax-follows-accounting” in select cases. It is generally accepted that the differences between tax and IFRS principles are diverging. This is largely due to the fact that IFRS is driven by economic substance, while tax has historically been driven by legal form. This situation is resulting in increasing complexity in the performance of compliance obligations as the divergence between tax and accounting treatment increases.<sup>270</sup> However, many industry-specific matters are subject to stringent accounting rules, so it may be appropriate for our tax law to simply accept the accounting position in some scenarios. For example, with the introduction of section 24JB, recognition has been given in the Act to IFRS principles in the context of financial assets and liabilities of financial institutions.

Financial reporting has developed considerably over the past 20 years, which has significantly enhanced the reliability of financial statements as an indication of the value of assets and liabilities and of the profits or losses derived by companies. On the other hand, the Act has (in many respects) retained, without significant amendment, provisions that date back to the 1962 enactment. To the extent that the principles applied under IFRS may be found to be acceptable to National Treasury as a reliable measure, there should be no necessity to enact taxing provisions that achieve the same outcome. This would reduce the compliance burden on taxpayers in fulfilling their compliance obligations, by reducing the volume of adjustments that are invariably required in order to compute taxable income.

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<sup>268</sup> CFO Forum Technical Report on Corporate Tax submitted to the DTC (31 March 2017”).

<sup>269</sup> PWC Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 10.

<sup>270</sup> PWC Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 15.

It must, however, be emphasized that a complete alignment between tax and IFRS is neither practical nor desirable. However, there are potentially areas where alignment may be appropriate, for example, in the tax treatment of hedging arrangements. It is recommended that consideration be given to this approach in relation to other specialised industries. Some examples that may be considered include: the treatment of foreign exchange differences in section 24I;<sup>271</sup> and the treatment of trading stock in general. The tax treatment of construction contracts illustrates the issue more acutely. Construction contractors are at present subject to complex trading stock provisions and “income received in advance” calculations, under subsections 22(2A), 22(3A) and 24C of the Act, which are not aligned with the treatments in IFRS and with no apparent policy rationale for this non-alignment. Section 24C of the Act should be retained in its current form; but a proviso should be included to the effect that its principles should not apply to income and expenditure arising from construction contracts, but that these should be dealt with in terms of accounting principles.<sup>272</sup>

## 12 FINANCIAL SERVICES

The DTC considered the various elements of taxation within the financial sector in compliance with its terms of reference contained in the 2013 Budget Review (page 63). The aspects relating to financial services have been dealt with in various DTC reports including the BEPS report, and in particular Action 2 titled “Neutralise the effects of hybrid mismatch arrangements” and Action 4 titled “Limit base erosion via interest deductions and other financial payments” and the Value-added Tax report. The latter dedicates Annexure B to the implications of value added tax on financial services. The remainder of financial services related issues cut across the corporate tax arena and are therefore covered in this corporate tax report.

Having said that, the below-mentioned submissions are worth mentioning based on the specificity of their contents. The Association for Savings and Investment South Africa (ASISA) made a submission that provides a comprehensive analysis of the current uncertainty within the South African market and international treatment of financial instruments from a capital versus revenue perspective, as well as a number of suggested ways available for handling this issue. ASISA concludes as follows:

- There is no conceptual difference between buying a financial instrument (like a share) and entering a derivative contract that replicates ownership.
- Derivatives are financial instruments in their own right and gains or losses therefrom might be capital or revenue.
- Ordinary principles of interpretation should be applied, with due regard to what the parties contracted, within the context of their commercial agreement.

<sup>271</sup> SAICA Technical Report on Corporate Tax submitted to the DTC (31 March 2017) in para 1.4.

<sup>272</sup> BDO Technical Report on Corporate Tax submitted to the DTC (31 March 2017) at 4.

- The nature of derivative instruments is not defined by 'hedging'.
- There is no conceptual difference between a long and a short position. Facts and circumstances associated with those positions determine their nature.
- Multi-derivative or hybrid strategies should not be unbundled, but considered as a unitary intent subject to ordinary principles.
- Transactions within a portfolio should not be viewed in isolation of each other, but within the entirety of the investment mandate.

In so far as collective investment schemes are concerned ASISA recommends that because such schemes are regulated and may not "trade" *per se*, their proceeds should all be treated as capital. Any other than an investment policy behaviour would give rise to a fine from the Financial Services Board and this would alert South African Revenue Service to the non-investment intention.

Along the same lines Mr Marco Da Silva submitted that long term private investors are at a disadvantage from a capital gains tax perspective where they buy and sell shares, because such transactions trigger a capital gains tax event. He proposes that capital gains tax be deferred to only take effect upon the divestment from ones "Share Trading Account". This, Mr Da Silva submits, would create an even tax treatment with "unit trusts and other more financially acute institutions".

ASISA's recommendation is that a focus group between industry, the South African Revenue Service and National Treasury should be set up to reach some final views from a policy perspective. The DTC supports the formation of a focus group and has forwarded the ASISA and Mr Da Silva's submissions to the National Treasury for further consideration. Mr Riaz Tayob made a submission requesting special tax treatment for Islamic banking and its products. The DTC acknowledges this submission and notes that the Income Tax Act 58 of 1962 provides for specific tax dispensation for Sharia compliant instruments.

The DTC acknowledges the submissions from the South African Institute of Tax Professionals, South African Clothing and Textile Workers Union and the Congress of South African Trade Unions that made reference to financial services. The content of their submissions fit within the corporate tax sphere and are dealt with in the BEPS report, the corporate tax report as well as in the VAT report as earlier stated.

## CORPORATE INCOME TAX IN SOUTH AFRICA – AN OVERVIEW

Corporate Income Tax (CIT) is a tax imposed on companies. Section 1 of the Companies Act<sup>273</sup> defines a “company” to mean a juristic person incorporated in terms of this Act, and refers to a domestic company or close corporation registered in terms of this Act. The Income Tax Act<sup>274</sup> (“the Act”) regulates corporate income tax. For income tax purposes, section 1 of the Income Tax Act, defines a “company” to include:

- any association, corporation or company (other than a close corporation) incorporated or any body corporate formed or established or deemed to be formed in the Republic; or
  - any association, corporation or company incorporated or any body corporate formed or established under the law of any other country; or
  - any co-operative; or
  - any association formed in the Republic for the benefit of the public; or
  - any portfolio in an investment scheme carried on outside the Republic or a portfolio of a collective investment scheme in property that qualifies as a REIT; or
  - a close corporation;
- but does not include a foreign partnership.

In South Africa, a company is recognised as a legal entity separate from its shareholders. Investing in a company affords shareholders the benefit of limited personal liability to the extent of their interest in the juristic entity.<sup>275</sup> Being a legal entity, the company itself, and not its members, is taxable on its taxable income (as determined in accordance with the Act). When a company distributes dividends to its shareholders out of taxed income the shareholders are also taxed on those dividends.

The taxation of corporates is significantly impacted by the Companies Act, which contains provisions relating to governance and reporting standards that bring the South African Companies legislation in line with international best practice. The Tax Administration Act (No 28 of 2011), which became effective as of 1 October 2012, also contains provisions which significantly impact on the collection of CIT.

### Normal Corporate Income Tax

CIT is imposed on companies resident in the Republic of South Africa (i.e. incorporated or effectively managed in the Republic) on their worldwide income. Non-resident companies are subject to CIT in South Africa on income they earn from a source within the

<sup>273</sup> Companies Act (No 71 of 2008).

<sup>274</sup> Act 58 of 1962.

<sup>275</sup> SARS “Legal & Policy Product Oversight Report: Corporate Income Tax” (2016-17) at 1.



Republic.<sup>276</sup> Where an applicable double tax treaty exists South Africa's ability to tax non-resident companies, to which the treaty applies, may be limited to situations where they operate through a permanent establishment within the Republic. The "taxable income" of a company is determined by first determining a company's gross income; then deducting from gross income any exempt income (section 10 of the Act) as well as permissible deductions and allowances (principally sections 11 to 19 of the Act), and any assessed losses brought forward from the previous year (section 20 of the Act). Specific provision is made for specified expenses of a capital nature and for allowances which are made not deductible. A company is subject to normal tax at a rate of 28% on its taxable income. Special rules apply to certain types of transactions or industries; such as in the mining industry, farming, Real Estate Investment Trust companies and the insurance industry.<sup>277</sup> Many of the rules pertaining to interest and financial-type transactions also have particular relevance to the banking industry, although not restricted thereto. Matters pertaining to the efficiency of the 28% corporate tax rate in South Africa, in light of other countries with lower tax rates, are addressed in section 4.

Capital gains tax (CGT) is not levied separately from CIT. The taxable portion of capital gains is included in the CIT taxable income calculation. Capital gains tax is payable on a capital gain in respect of an asset disposed of during a year of assessment. Taxable capital gains are determined in terms of the Eighth Schedule to the Act. The Eighth Schedule only applies to disposals on or after 1 October 2001. In order to calculate a capital gain or loss there must be an asset, a disposal, a base cost and the proceeds of the disposal of an asset.

Both resident and non-resident companies are subject to capital gains. However, paragraph 2 of the Eighth Schedule provides that residents pay tax on the capital gains resulting from the assets situated anywhere in the world whereas non-residents are taxed only on gains made from the disposal of any immovable property or any interest or right in immovable property situated in the Republic, or any asset of a permanent establishment of the non-resident through which a trade is carried on in the Republic. In order to ensure the payment by non-residents of capital gains tax owed on the disposal of immovable property, purchasers of properties from non-residents are required to retain a withholding tax and pay it to the South African Revenue Service. The taxable portion of a calculated capital gain is included in CIT taxable income at an inclusion rate of 80%. Matters pertaining to the efficiency of the CGT corporate inclusion rate are discussed in section 6.

## **Dividends tax**

From years of assessment commencing 1 April 2012 a dividend tax was introduced under sections 64D to 64N of the Income Tax Act. In terms of the dividends tax provisions, the

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<sup>276</sup> The definition of "gross income" in section 1 of the Income Tax Act 58 of 1962; SARS "Corporate Income Tax". Available at <http://www.sars.gov.za/TaxTypes/CIT/Pages/default.aspx> accessed 6 October 2016.

<sup>277</sup> SARS "Legal and Policy Product Oversight Report: Corporate Taxation (2016-2017) at 1.

shareholder as the 'beneficial owner' of the dividends (the one entitled to the benefit of the dividend attaching to a share) is the one who is liable for the dividends tax. The duty to withhold dividends tax is however imposed at the corporate level. Dividends tax provisions require South African resident companies (other than a headquarter company) or non-resident companies listed on the Johannesburg Stock Exchange, that declare dividends, to withhold the dividends tax on payment and pay it over to SARS by the end of the month following the month in which the dividend was paid to the shareholder. Where the dividend consists of a distribution of an asset *in specie*, the company itself is liable for dividends tax on the market value of the asset distributed. Although the obligation to withhold dividends tax falls on the company declaring the dividend, the company paying the dividend is exempted from withholding the tax under three circumstances:

- If the person to whom the dividend payment is made has furnished the distributing company with a declaration from the beneficial owner that the dividend is exempt from the dividends tax or is subject to a lower rate in terms of applicable double tax treaty (section 64G(2)(a)).
- If the beneficial owner forms part of the same group of companies as the company paying the dividend (section 64(G)(2)(b)).
- If the payment is made to a regulated intermediary (section 64(G)(2)(c)).

Section 64K(3) provides that where a company or intermediary fails to withhold the tax, or withholds the tax but fails to pay it to SARS, it becomes liable for payment of the tax as if it were a tax due by itself. Such company or intermediary will be relieved of this liability only if the tax is paid by another person (for example, the beneficial owner). South African resident companies are exempt from the dividends tax.

Before February 2017, the dividends tax was imposed at 15 per cent. In the February 2017 Budget speech, the Minister of Finance announced an increase in the dividends tax rate from 15% to 20%.<sup>278</sup> This rate increase took effect on 22 February 2017. Matters pertaining to whether this increase impacts on the efficiency of South Africa's corporate tax system are addressed in section 5.

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<sup>278</sup> National Treasury "Budget Speech" (2017) 12.