

27 May 2005

BUSA Comment to the Parliamentary Portfolio Committee Hearings on the Draft Taxation Laws Amendment Bill

1. Introduction

This commentary has been prepared by a joint BUSA/SACOB Taxation committee. BUSA and SACOB represent organized business at the national and international level and represent the views of a broad Business constituency.

2. General Commentary

As a general comment, the Draft Taxation Laws Amendment Bill is a procedural piece of legislation that gives effect to the announcements made by the Minister of Finance in his presentation of the Annual Budget. Business welcomes the reduction in the company tax rate but looks forward to the eventual elimination of the secondary tax on companies. While noting that it is the intention to abolish Regional Service Council levies, it is apparent that this will leave a revenue void that will have to be financed by other measures. BUSA / SACOB will be addressing this issue separately. Business also welcomes the various taxation measures that are designed to lower the compliance costs for small business. Concern has been expressed by Business over some of the seemingly severe penalties applicable to vague interpretations of disclosure requirements. In its examination of the proposed amendments, one specific issue is submitted for the consideration of the Committee and SARS. This is set out separately under Para 3.

3. Specific Comment in respect of Clause 10 (amendment of section 24 J of the Act)

Confusion surrounds the recent amendments to Section 24J of the Income Tax Act. The amendments seek to address the tax avoidance inherent in the convertible debenture schemes. These are schemes where an affiliate of the borrower (issuer) effectively buys back the face value of the debenture at the beginning of the loan period, at its discounted present value.

In the 2004 Revenue Laws Amendment Act, amendments (effective from 1 January 2005) were made to the definitions “adjusted initial amount” and “yield to maturity”. However, at a recent seminar by Huxham and Haupt (March 2005), it was pointed out (pages 5 of their lecture notes) that these amendments did not have their desired effect. Instead of the claimable interest being reduced (in order to combat the avoidance inherent in the scheme) it appears that the S24J interest has been increased.

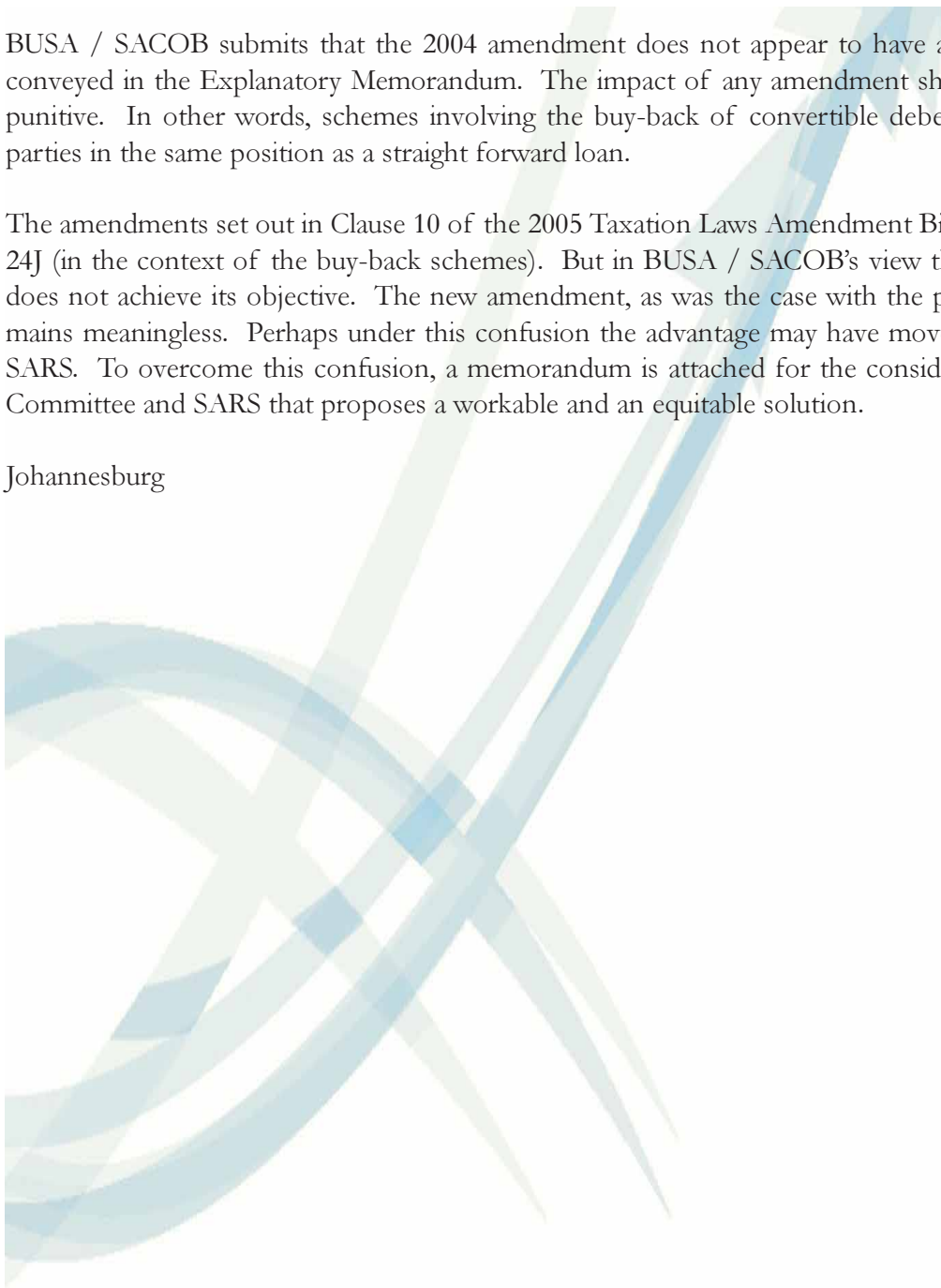
This was not the intention conveyed on page 22 of the Explanatory Memorandum on the Revenue Laws Amendment Bill 2004, which reads, “In order to address the tax avoidance element of schemes which are based on the circular flow of funds to which more than one company in a group of companies are party to it is proposed that the interest claimed by a group company be limited to the net amount borrowed in terms of the scheme by the group of companies...”

BUSA / SACOB submits that the 2004 amendment does not appear to have achieved its objective as conveyed in the Explanatory Memorandum. The impact of any amendment should be neutral and not punitive. In other words, schemes involving the buy-back of convertible debentures should leave the parties in the same position as a straight forward loan.

The amendments set out in Clause 10 of the 2005 Taxation Laws Amendment Bill, again amends Section 24J (in the context of the buy-back schemes). But in BUSA / SACOB's view the new amendment still does not achieve its objective. The new amendment, as was the case with the previous amendment remains meaningless. Perhaps under this confusion the advantage may have moved from the taxpayer to SARS. To overcome this confusion, a memorandum is attached for the consideration of the Portfolio Committee and SARS that proposes a workable and an equitable solution.

Johannesburg

May 2005



Annexure 1. MEMORANDUM

Clause 10 of Taxation Laws Amendment Bill, amending S24J

Amendment of section 24J of Act 58 of 1962

10. Section 24J of the Income Tax Act, 1962, is hereby amended by the substitution in subsection (1) for the words in the second proviso to the definition of “yield to maturity” following paragraph (b) of the following words: “must be taken into account as amounts **[payable]** receivable by that issuer for purposes of determining that rate of compound interest”.

The above amendment does not properly address the problem of circular flows of funds described on page 22 of the Explanatory Memorandum to the Revenue Laws Amendment Bill of 2004. Logic dictates that the amount paid to the bank should be deducted from (not added to) the amount borrowed, and in addition that the capital balance (“bullet payment”) be adjusted/eliminated accordingly.

Take, as an example, Subsidiary [S] which borrows R1000 from bank on 1 January 2005, at 10% interest payable annually in arrears, the capital of R1000 to be repaid on 1 January 2008 (i.e. in 3 years). On 1 January 2005, Parent of subsidiary [P] buys (in effect) the face value of the loan from the bank, at its present value in 3 years time, which is approximately R750; P therefore pays the bank R750 on 2 January 2005 and the bank on the same date sells forwards its right to receive the capital amount of the loan at the termination of the loan period.

In economic terms, the borrower group [P and S] have borrowed R250 (R1000 – R750) from the bank and are to repay this in 3 equal instalments of R100 per annum on 31 December each year, starting on 31 December 2005.

How does S24J treat the borrowers? Before the amendment proposed in Clause 10 of the Taxation Laws Amendment Bill of 2005, S was treated as having borrowed 1000 and having to pay 750, 100, 100, 100 and 1000 (the 1000 being the capital (bullet) payment at the end of the 3 year period). That is, the S group was regarded as having borrowed 250 (1000 – 750) but then as having to pay not only the instalments of $100 \times 3 = 300$ but also the capital sum of 1000, i.e. 1300 in total. This is an absurd result, as the total amount of interest the borrower will pay is $1300 - 250 = 1050$. This is out of proportion to the 250 effectively borrowed.

Does the proposed amendment remedy this? Unfortunately, no! In terms of the proposed amendment, S is treated as having borrowed $1000 + 750 = 1750$ and as having to pay $100 \times 3 = 300 + 1000 = 1300$. This creates negative interest of 450 [$1750 - 1300$] - another absurd result!

How should S24J be amended to give a logically correct and neutral result?

In the first place, it should be recognised that S and P (as a group) have borrowed 250, i.e. the original loan of 1000 less the buy-back of the face value (bare dominium) for $750 = 250$; The repayments are $100 \times 3 = 300$; There is no further repayment of the capital value of the loan – as such capital value was effectively extinguished when P acquired it upfront for 750; The net result (in our example) is a loan of 250 repayable in 3 equal annual instalments of 100 each.

In the second place, the loan buy-back by P should be ignored; That is, P should not be taxed per S24J on the increase of 1000 over 750, (i.e. 250) as the transaction has effectively been substituted with a loan of 250 over 3 years. The interest is 50, payable by S and spread (per the principles of 24J) over the 3 year period.

Finally, equivalent treatment should be accorded the bank. The bank has not, per the proposed treatment, actually lent 1000 and then lost 250 on its sale of the bare dominium; The bank has in effect loaned only 250, and should recognise the interest thereon, per S24J, over the 3 years period of the loan.

In other words, the borrower group [P and S] claims interest of 50 [$300 - 250$] and the bank recognises interest income of 50 [$300 - 250$].

Note that this result can be proved as follows. Prior to these amendments to S24J, S would have claimed interest of 300 [-1000 loan +300 interest + 1000 repayment]; The bank would have recognised effective interest income of 50 [-1000 loan + 750 sale of bare dominium + 300 interest] and P – were the principles of S24J to be applied to the substance of the transactions – would recognise income of 250 [1000 – 750] i.e. P and S together would recognise a net expense of 50 [300 – 250]; This is a correct result, and equal to the income recognised by the bank.

Note that it makes no fundamental difference which of the two approaches is adopted; The present proposal is that the substance be recognised, namely that the net borrowing was only 250 and interest is 50; The alternative approach could also be used, but this creates an artificial situation where the bank makes a loss of 250 [1000 – 750] and only recognises the interest over 3 years [3 x 100]; P would recognise income of 250, while S claims interest of 300, thus splitting the transaction into separate components that make little business sense.

The proposal is therefore that the convertible loan schemes be dealt with in terms of their substance, namely a net amount is borrowed, and the interest treatment, for all parties, follows accordingly. In particular, all or part of the capital amount of the loan is extinguished, to recognise the buy-back.

Note that the actual schemes do not take the simplistic approach detailed above; Instead, the bank is required to subscribe for shares in S at the end of the period; The price of the shares (1000) is paid to S by the bank; S then repays the loan; It is thus the future shares that are purchased by P, up front, for 750 which - it is argued - takes the transaction out of the ambit of S24J, insofar as P is concerned. However, if the consolidated approach is to be taken [combining P and S], this problem falls away.

It remains to consider the tax treatment of those schemes which have already run their course and those still under way.

It is not proposed that the amendment to S24J be retrospective; Instead it is proposed that the tax treatment be as follows: Leave intact schemes that have already run their course; For schemes still in their cycle, apportion the tax benefits according to the stage in the cycle when S24J was first amended (for this purpose) by the 2004 Revenue Law Amendment Bill. For example, if the scheme period was 7 years, and started in 2000, 4/7 of the benefits would be retained by the taxpayer [2004 – 2000 = 4] with the balance surrendered to SARS [The benefit of 3/7 so surrendered is the impact of applying S24J to the holder of the bare dominium, i.e. the shares to be issued, for the period 2004 – 2007].

Note that any amendment to S24J should apply both to the definition of “yield to maturity and to “adjusted initial amount”.

In order to deal with past transactions, (i.e. instruments issued before 1 June 2005) it is proposed that a practice be developed by SARS together with the banking industry along the lines set out above.