DLA CLIFFE DEKKER HOFMEYR

13 JULY 2012

TAX ALERT

THE INTRODUCTION OF REITS

One of the welcomed aspects that is dealt with in the latest draft of the Taxation Laws Amendment Bill, 2012 (Bill) is the introduction of the long-awaited Real Estate Investment Trusts (REITs). Should one consider the current structure that is used by property investment vehicles, it either comprises of:

- a property unit trust (PUT);
- property loan stock (PLS); or
- variable loan stock (VLS) structures.

The majority of the property structures in South Africa currently make use of the PLS/VLS structure in circumstances where investors acquire a so-called linked unit, that comprises of a share and a debenture that is issued by the company. In the draft explanatory memorandum to the Bill, it is indicated that there are currently over 20 listed entities operating as a PLS and less than 10 entities that operate as a PUT.

A PUT is a portfolio of investment growth properties that is held in the form of a trust and managed by an external company, being the manager. The PUT is governed by the trust deed in circumstances where investors acquire units in the trust. The holder of a PUT does not have any voting rights and the management of a PUT can only be changed with the assistance of the Financial Services Board (FSB). From a tax perspective, a PUT acts as a conduit on the basis that the investors are taxed on the distributions on the basis of these distributions constituting ordinary revenue. The net effect is that the rental income received by the PUT is effectively only taxed in the hands of the investors.

Should one compare a PUT with a PLS/VLS, the latter is a company on the basis that investors hold a linked unit on the basis that the debenture element of the linked unit comprises 99% of the value attributable to the debenture. The terms of the debenture are incorporated in a debenture trust deed and the trust deed provides for the distribution of most of the rental income of the PLS/VLS by means of 'interest'. Effectively, the interest deduction that is then claimed by the PLS/VLS results in the PLS/VLS not having substantial net income. The downside of making use of a PLS/VLS, is that the effective interest rate in respect of the debentures can sometimes be very high, and it creates the risk that the interest deduction is not allowed in the PLS/VLS on the basis of it being excessive. In the explanatory memorandum to the Bill it is indicated that the

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"excessive level of interest" makes this form of interest questionable in tax terms. The on-going acceptance of the dual linked structure is also problematic from a tax policy perspective.

In order to cater for the introduction of REITs, the entity must be listed with the JSE. In order to obtain such REIT listing, the following criteria must be met:

- The REIT must have a minimum amount of assets comprising interest in immovable property, interest in a lease relating to immovable property, interest in a property subsidiary or holdings in another REIT.
- The REIT must solely invest in immovable property assets and collateral debt instruments and hedges used to reduce the risk associated with property-related loans.
- The REIT must distribute most of its profits on an annual basis.
- The REIT must not have excessive borrowings in relation to the total gross asset value of immovable property held by it.

Given that a unified regime for property investments is now proposed, the tax consequences will be that a REIT will be exempt from capital gains tax. The holders of the interests in the REIT will be subject to tax (generally a capital gain). Receipts and accruals in respect of a financial instrument such as dividends, the disposal of shares and bonds and derivatives will be taxed as ordinary revenue. No regard will be had to any exemption that would otherwise apply. The distributions made by the REIT will be fully deductible from the ordinary revenue thereof on the basis that the recipients will be taxed thereon. The deduction will only be allowed if the distribution arises from income and receipts earned by the REIT within the current or the immediately prior year of assessment. The deduction will only be allowed to the extent that the total gross rentals received or accrued by the REIT is at least equal to 75% of the total gross receipts or accruals. If not, the distribution is treated as a dividend.

It is noted that no specific provisions have been inserted dealing with the conversion of a PUT or a PLS/VLS into a REIT. It is trusted that this legislation will also be introduced as it is expected that the property industry will immediately make use of this kind of structure. Effectively, investors will be taxed on the net rental income received by the REIT on the basis that the REIT would operate in a similar fashion than a portfolio of a collective investment scheme in securities, such as being exempt from capital gains tax.

Emil Brincker

THE RE-CHARACTERISATION OF DEBT

The introduction to this discussion needs to start with the fact that the National Treasury (Treasury) intends to insert a definition of 'debt' in s1 of the Income Tax Act, No 58 of 1962 (Act) with effect from 1 January 2013. While there has been a lot of legal authority as to what constitutes a debt, the Treasury has decided to deal with this expressly by defining it as "any amount owing to or by a person". This is an incredibly broad definition and I have struggled to understand why they felt this was necessary.

The reasons given for the change is that various provisions of the Act deal with the concept and seek to encompass the various ways in which a debtor/creditor relationship may be created. Because the Treasury feels that the Act has become burdened with cumbersome formulations, they decided to insert this definition. However, given such a broad definition, the fact that I am late in paying an account, means a debt in terms of the Act has come about. However, this can be a simple account with no provision for interest to accrue. The very fact that one person has an IOU from another person will fall within this definition. There is now no need to advance an amount or provide goods on credit.

The insertion of this definition seems to be linked to the expansion of the hybrid debt re-characterisation rule in s8F. That provision says that if a debt instrument is convertible into shares in the debtor within three years of the date of issue; or can be repaid within three years by the issue of shares in the debtor; or within three years the issuer can compel the creditor to subscribe for shares, then the Act will disallow the interest deduction on those debt instruments from the date on which they became or are 'hybrid' in terms of this Section.

The Explanatory Memorandum (EM) then sets out that the proposed change to "reduce the scope for the creation of equity that is artificially disguised as debt" will be based on a twofold test – rules to analyse the nature of the instrument itself and a second set of rules to focus on the nature of the yield on the instrument. It states that the proposal is aimed at domestic companies that issue debt instruments so as to artificially generate interest deductions.

Section 8F has been totally rewritten to come into operation on 1 January 2014. So the definition of 'hybrid debt' will now mean any debt if the issuer of the debt is not entitled to repay that debt in full within 30 years of the date of issue; or is entitled to exercise any

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option by reason of which the issuer will be obliged to convert or exchange that debt for shares in the issuer in the company or any company which forms part of the same group of companies. Or, if the holder of the debt is obliged to convert or exchange that debt or receive repayment of that debt in the form of shares in the issuer (or any company in the same group of companies). If on a balance of probabilities the debt will not be repaid in full within 30 years of its date of issue or the obligation to make payment of the debt is conditional on the solvency of liquidity of the issuer, it will still fall within hybrid unless the market value of all of the assets do not exceed R10 million (that's the small business relief provision) or the company is a bank as defined in the Banks Act (SARS are concerned about these provisions impacting the raising of Tier 2 Capital in terms of the Basel Standards). Any hybrid debt issued by a domestic company is in relation to the issuer deemed to be a share (other than an equity share), and for the holder of the hybrid debt it is deemed to be a share as well. In terms of s8F(3) any amount paid or incurred by the issuer of the hybrid debt is deemed to be an amount paid or incurred by the issuer or any amount received or accrued by the holder of such debt is deemed to be an amount received or accrued by that holder in respect of a share other than an equity share. Sub section (4) provides that for the purposes of the definition of 'contributed tax capital' the amount referred to above is an amount equal to the amount outstanding in respect of that debt at the time that the debt becomes a hybrid debt as defined.

Where the instrument is re-characterised by reason of its lack of redemption features, the Act will now seek to treat the distribution in the hands of the issuer as well as the recipient as a distribution. Accordingly there will be no deduction for the issuer and no inclusion in the hands of the recipient if the distribution is similar to a dividend. Repayments or disposals in respect of these instruments will be treated as repayments or disposals in respect of shares (non equity shares).

Now s8F will need to be read in conjunction with the new s8FA, which will come into effect on 1 January 2014. This provision defines 'hybrid interest' as interest paid by the issuer of a debt if the amount of the interest is not determined with reference to the time value of money; the obligation to pay that interest is conditional upon the solvency or liquidity of the issuer; or the issuer is obliged or entitled to exercise any option to make payment of the interest in the form of shares in the issuer or any company in the same group of companies. Effectively, the instrument re-characterisation provisions will be contained in the s8F, and the yield re-characterisation provisions will be contained in s8FA. If what the issuer pays falls within this definition of 'hybrid interest', the yield is deemed to be a dividend. In this case, the issuer may not deduct the yield, and the dividend is exempt from normal tax in the hands of the recipient. But in the case of s8FA the instrument itself retains its characterisation as debt (unless it falls within the hybrid debt provisions) and other payments would need to be tested separately for their characterisation. One needs to note that where the yield is re-characterised, it is deemed to be a dividend *in specie*, where in terms of s64F the obligation to pay the dividends tax is on the company paying the dividend. Also, in terms of s8FA(2)(b)(i) the dividend is deemed to have been paid on the earlier of the date on which the amount is received by or accrues to the holder of the hybrid debt.

SARS do say in their EM that where investors effectively sacrifice some of their yield in exchange for an upside stake in the growth of the company that convertible feature is not seen as an anti avoidance technique or as a non commercial transaction.

Alastair Morphet

NEW RELIEF IN RESPECT OF SHARE BLOCK

Under share block, a company holds immovable property and in turn, the shareholders hold shares in the company and a right to use some or all of that property exclusively for a specified period in every year.

Although share block is less popular now, many share block companies are still in operation.

The Share Blocks Control Act, No 59 of 1980 regulates share block. Among other things that act provides for a company to convert share block into sectional title. Provided certain requirements are met, the conversion does not trigger any transfer duty, capital gains tax (CGT) or value-added tax (VAT) consequences for the shareholders or the company.

However, no similar tax relief was available if the company simply transferred 'freehold' property or sectional title properties (otherwise than as a result of a conversion) to its shareholders. The draft Bill proposes that the relief now be extended to cover those cases.

It is proposed that, to qualify for the relief, the shareholder must acquire a specified part of the immovable property to which that

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person had a right of *exclusive* use. Further, for the transfer duty relief to apply, the initial acquisition of the shares in the company must have been subject to transfer duty.

As to CGT, the base cost of the shares in the hands of the shareholder effectively becomes the base cost of the part of the immovable property acquired.

The transfer will also be free of dividends tax in the hands of the shareholder.

For example: A share block company owns a number of plots of seafront land. A house was built on each plot. Each shareholder of the company has the right to exclusively use one of the houses. The company would be able to transfer each plot (with the house) to the shareholder holding the exclusive right of use in respect of that plot free of CGT, dividends tax and VAT. The transfer would, however, only be free of transfer duty in the hands of the shareholder if the shareholder was liable for transfer duty when he acquired the share initially. If not, the shareholder would now have to pay transfer duty when he acquires the plot.

It appears as if the proposed relief ties into the policy of the Government to reduce the number of companies that purely hold residential type immovable property and the related tax relief provided to persons who wish to remove residential property from companies and close corporations (that are not share block companies), which endures until 31 December 2012.

The further relief takes effect on 1 January 2013. So, while persons who want to take advantage of the relief can start planning, they must wait until then to implement any steps.

Ben Strauss

PROPOSED CHANGES TO THE ISSUING OF DEBIT AND CREDIT NOTES

An amendment has been proposed in terms of the Taxation Laws Amendment Bill 2012 (TLAB) relating to the issuing of debit and credit notes under s21(1) of the Value-Added Tax Act, No 89 of 1991 (Act). The Explanatory Memorandum (EM) to the TLAB sets out the rationale for the proposed changes.

Background

Under s16(2) of the Act, a vendor can only claim an input deduction if he is in possession of a tax invoice or debit note or credit note. It is important to appreciate the distinction between the terms 'tax invoice' and 'invoice' as defined in s1 of the Act. A 'tax invoice' is a document that needs to meet the requirements of s20(4) and s20(5) of the Act in order for the vendor to claim an input deduction. An 'invoice' on the other hand is a 'document notifying an obligation to make payment' and the issuing of which may affect the timing of supply.

In terms of s20(1) of the Act, a registered vendor must within 21 days of the date of supply issue a tax invoice which complies with the requirements under s20(4) and s20(5) of the Act. It is unlawful to issue more than one tax invoice for each taxable supply.

Where a vendor has accounted for an incorrect output tax, he can issue a debit or credit note in order to make an adjustment in calculating the tax payable by him where the supply was either cancelled, or where there was a fundamental variation or alteration in the nature of the supply, or due to an alteration of an agreement or where the goods or services supplied are returned.

The issue

The problem arises when a vendor has either issued a tax invoice for an incorrect amount or has omitted certain information on the tax invoice as required by s20(4) and s20(5) of the Act. The vendor is unable to simply re-issue a tax invoice reflecting the correct amount by way of a debit or credit note under s21(1) of the Act, or to correct any information omitted on the tax invoice in order to comply with s20(4) and s20(5) of the Act. Vendors may have incorrectly issued debit and credit notes that may not technically have been in line with the Act.

The proposal

The Commissioner for SARS has issued a proposal under the draft EM to eliminate the anomalies arising from issuing credit or debit notes under the circumstances not contemplated under s21 of the Act, and to allow for the correction of incorrect tax invoices. These corrections will cover credit notes (for incorrect overcharges) and debit notes (for incorrect undercharges) and to correct information omitted on the tax invoice so as to comply with the requirements

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under s20(4) and s20(5) of the Act. Two new circumstances are contemplated that permit a vendor to issue debit or credit notes:

- Where an error has occurred in the consideration as reflected on the tax invoice.
- There is an omission of one or more of the particulars required to be present on a tax invoice.

These two amendments will make it easier for vendors to correct simple errors on tax invoices.

Carmen Moss-Holdstock

REDUCTION IN INCOME TAX RATE FOR FOREIGN COMPANIES

The latest draft of the Taxation Laws Amendment Bill, 2012 (TLAB), released for public comment last week, contains a large number of proposed amendments to the Income Tax Act, No 58 of 1962. One of such proposed amendments is the harmonisation of the income tax rate applicable to resident and non-resident companies.

Under the former secondary tax on companies (STC) regime (which was deleted with effect from 1 April 2012 when the new dividends tax regime came into operation) a resident company was, in addition to tax on its income at a rate of 28%, also liable for secondary tax on companies at the rate of 10% of dividends declared by the company to its shareholders. With income tax and STC combined, a resident company was thus subject to an effective tax rate of 34,5%.

As non-resident companies were not subject to STC, the income tax rate of non-resident companies was increased to 33% following the introduction of STC, so as to place non-resident companies on par with resident companies.

Following the introduction of dividends tax on 1 April this year, resident companies pay tax at a lower rate than non-resident companies. The reason is that insofar as cash dividends are concerned, the person liable for dividends tax is the beneficial owner of the dividend and not the company declaring the dividend. If the company is not liable for dividends tax its effective rate of tax is 28%.

The result is that following the introduction of dividends tax, non-resident companies are subject to tax at an additional 5%, being the difference between the rate at which it is taxed (33%) and the rate applicable to resident companies (28%). As with STC, dividends tax is not payable in respect of paid declared by non-resident companies except if the dividend is a cash dividend and is paid in respect of a share listed on the JSE.

The question that arises is whether it is viable or justifiable to tax non-resident companies at the higher rate. In its explanatory memorandum on the TLAB, the National Treasury states that there are arguments that retaining the additional 5% rate on non-resident companies will be in contravention of tax treaty non-discrimination provisions and that in the absence of STC the retention of the additional 5% will be a violation of the bona fide undertakings made to South African treaty partners during tax treaty negotiations. On this basis, it is proposed that the rate at which non-resident companies is taxed be reduced to align it with the rate applicable to resident companies.

The reduction of the rate of income tax applicable to non-resident companies from 33% to 28% means that it is more tax efficient for a foreign company to conduct its South African operations through a branch located in South Africa, than to establish a South African subsidiary. The reason is that dividends paid by a resident subsidiary to a non-resident company will be subject to dividends tax, although the rate of dividends tax may be reduced in terms of an applicable treaty.

In closing, it is noted that the amendment, if brought into operation, is proposed to take effect from the years of assessment beginning on or after 1 April 2012, being the same effective date applicable to the new dividends tax regime.

Andrew Seaber

NEW DEFINITION OF A 'SHARE'

The Taxation Laws Amendment Act No 24 of 2011 added the definition of 'share' to s1 of the Income Tax Act, No 58 of 1962 (Act). With effect from 1 April 2012 a 'share' was therefore defined as "in relation to any company, any share or similar equity interest in that company".

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The reason for the introduction according to the South African Revenue Service (SARS) was "to clarify that the term 'share' includes 'similar' equity interests (mainly to better account for a variety of foreign ownership interests)".

The draft Taxation Laws Amendment Bill, 2012, proposes an amendment to the definition of a 'share'.

According to SARS, the reason for the proposed change is twofold. Firstly, the previous definition is circular and self-referential in that it refers to a 'share'. Secondly, the previous definition technically includes non-profit entities, which in economic terms makes no sense.

With effect from 1 January 2013 a share will be defined as follows:

> "'share' means, in relation to any company contemplated in paragraph (a), (b), (e) or (f) of the definition of 'company', any unit into which the proprietary interest in that company is divided;"

The reference to paragraphs (a), (b), (e) and (f) of the definition of 'company' means that locally incorporated companies, foreign incorporated companies, foreign portfolios a collective investment schemes in participation bonds, securities or property, and close corporations are included. It also means that co-operatives and local associations formed to benefit the public are excluded.

According to SARS, this definition is also more aligned with the Companies Act, No 71 of 2008.

It is also proposed that the definition of 'equity share' be amended. Currently an equity share is defined as "any share in a company, excluding any share that neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution".

The new definition is to read as follows:

> "'equity share' means any share in a company unless:
>
> (a) the amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to the time value of money;
>
> (b) the issuer of that share is obliged to redeem is obliged to redeem that share in whole or in part; or
>
> (c) that share may at the option of the holder be redeemed in whole or in part."

SARS says that the reason for the amendment is that the current definition of equity share is not aligned with the Companies Act. SARS also says that the new definition will clearly link the definition of equity share to common commercial practices that separate ordinary shares from preference shares.

The new definition also fits in with SARS's proposed amendments to the anti-avoidance provisions dealing with the re-characterisation of certain instruments as either debt or equity where attempts are made to disguise their true nature.

Heinrich Louw

DELETION OF THE PASSIVE HOLDING COMPANY REGIME

With the abolition of secondary tax on companies, and the introduction of the new dividends tax regime, there existed an incentive for individual investors to hold dividend-producing shares (and other investments producing a 'passive income') in a company rather than in their personal capacities. The underlying rationale for shareholders to hold their dividend-producing shares in a company and not in their personal capacities was due to the fact that the new dividends tax regime created an arbitrage opportunity for the individual taxpayer. This is owing to the fact that dividends tax is (for the most part) not levied on the company but on the recipient shareholder. Resident companies receiving dividends are also exempt from dividends tax. Furthermore, the combined effective tax rates on corporate earnings were lower than the marginal rates applicable to the individual taxpayer.

This mechanism used by the individual taxpayer would eventually lead to the erosion of the tax base as the holding of dividend-producing shares in companies in essence constituted an avoidance of dividends tax to be levied on the individual. It is for this particular reason that the South African Revenue Service (SARS) proposed

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the passive holding company regime. The passive holding company regime was proposed as an anti-avoidance measure used to counter the arbitrage of income tax rates between individuals versus the combined effective tax rates on corporate earnings. In this regard, the combined effective tax rates on corporate earnings refer to the corporate income tax rate of 28% and the dividends tax.

However, at the time of proposing the passive holding company regime, it was anticipated that dividends withholding tax would be introduced at the rate of 10% and therefore the arbitrage opportunity for the individual taxpayer between the individual rates and the combined company rates appeared to be quite high. However, in terms of the 2012 budget, SARS increased the rate of tax under the dividends tax from 10% to 15%. This increase in the dividends tax rate substantially minimised the arbitrage opportunity between individual rates and combined company rates to the extent that the effective tax rates for company profits are now 38,8%, whereas the marginal rate of tax for the individual is 40%. What is important to note in this regard is that the combined company rates are very close to the individual tax rates and for this particular reason there is no longer an incentive for an individual to hold his dividend producing shares in a passive holding company. Therefore, with the introduction of dividends withholding tax at the rate of 15%, the necessity for the passive holding company regime has been nullified.

For the said reasons the proposed passive holding company regime is to be scrapped and will accordingly never come into effect.

Nicole Paulsen

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