

An investigation of the Resident Based Tax system and its  
impact on the general scheme of the Income Tax Act No.  
58 of 1962

By

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**03 February 2005**

**TO WHOM IT MAY CONCERN**

**RE: CONFIDENTIALITY CLAUSE**

Due to the strategic importance of this research it would be appreciated if the contents remain confidential and not be circulated for a period of five years.

Sincerely

S.Naidoo



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## CHAPTER 1

### INTRODUCTION OF RESEIDENT BASED TAX

#### 1.1 INTRODUCTION

##### COMMISSIONS OF INQUIRY

Several commissions of inquiry into the South African tax system have addressed whether South Africa should retain a source principle of taxation or move to a residence principle.

In 1951, in light of the complexity involved in a move to a residence principle of taxation and the fact that not much additional revenue would have been obtained thereby, the Steyn committee recommended that the source principle be retained. The Franzsen committee made the opposite recommendation in 1970. The reasons advanced for the recommendation were that more income was beginning to flow into South Africa without being taxed, South Africa's major trading partners were spread worldwide, which enhanced the individual's ability to pay, and the Act had already deviated from a pure source basis through the introduction of various deeming provisions. Although the government had in principle accepted the recommendation, subject to further research the intention to move to a worldwide basis of taxation was never pursued.

*(Commission of Inquiry into the Fiscal and Monetary Policy:1970)*

In 1987 the Margo Commission recommended that the source principle be retained, subject to the broadening of the existing deeming source provisions. The recommendation was based on the arguments that the administration of residence basis of taxation would generate insignificant additional revenue as, due to international convention, South Africa would have to grant credit for foreign taxes already paid; and the fiscal benefits that might be derived from a



worldwide basis of taxation would be reduced as and when South African tax rates were reduced. Again the government accepted the recommendation.

The latest commission on inquiry, the KATZ commission, recommended in 1997 in principle that the source principle be retained, but that a distinction should be made between passive and active income. Broadly speaking, passive income refers to investment income such as interest or royalties, and active income to income derived from active trade or commerce. Passive income should be taxed on a worldwide basis and active income on a source basis. The recommendations were accepted and resulted in the introduction of section 9C and 9D into the Income Tax Act No.58 Of 1962 (Income Tax Act).

*(Report of the Commission of Inquiry into the Tax structure:1987)*

Its thus seems strange that barely three years later it was announced that South Africa would move to a residence principle of taxation. However, the announcement has to be seen in light of the fact that during 1999 the department of finance invited several eminent overseas tax experts to study the different reports of the Katz commission and share their views at a symposium. These speakers made it clear that South Africa is out of line with the rest of the world as far as the principle on which tax is levied is concerned.

*(First Report of the Committee of Enquiry :1951)*

## **THE AMENDMENT**

The Income Tax Act, Act No 58 of 1962 (The Income Tax Act), was structured on the basis that income of a capital nature and income from a foreign source would be exempt from taxation.

During South Africa's isolation most of the rest of the world implemented residence based taxation (RBT) and capital gains tax (CGT). Little was done in South Africa to follow this trend.

The Katz Commission of Enquiry into the structure of the South African tax system considered both CGT and RBT. Both concepts were placed on the back



burner as the commission considered that the concepts were far too complicated to be administered and enforced.

On 22 February 2000 the Minister of Finance, Trevor Manuel, announced that South Africa would implement both CGT and RBT over a two-year period. As CGT was seen as being a wealth tax, its implementation received far greater attention than RBT. Now that CGT has been implemented, it is being found that the level of CGT exposure in South Africa is minimal. However, numerous practical problems are being encountered with RBT on a virtually daily basis.

*(Budget Review: 2000)*

From 1962 until 1997, the Act was structured on the basis that income that was not of a South African source was not subject to taxation. Deeming provisions were contained in Section 9 of the Income Tax Act to provide clarity in specific circumstances.

In 1997 Trevor Manuel relaxed foreign exchange allowances for South African resident taxpayers of good standing. This led to the implementation of "old" sections 9C and 9D and was not a part of the introduction of RBT, but rather an attempt to recover taxation. Old sections 9C and 9D specifically exempted foreign income from taxation in South Africa if generated by way of active foreign trade or foreign capital. At the time of implementation Trevor Manuel announced that the provisions of section 9C and 9D would be reconsidered after a period of 3 years.

Most taxpayers were only too grateful to have offshore investments to consider the potential for implementation of RBT after 3 years.

*(Katz: 1997)*

## **1.2 RESIDENCE BASED TAXATION (RBT) IMPLEMENTATION**

Full blown RBT was implemented for companies and trusts with years of assessment commencing on or after 1 January 2001 and for individuals with effect from 1 March 2001 i.e. the 2002 year of assessment.



In most instances the full effect of RBT is contained in section 1 of the Income Tax Act.

Prior to 1 January 2001 the gross income definition contained in section 1 of the Income Tax Act could be summarised as follows:

- Any taxpayer, in any period of assessment
- The total amount
- In cash or otherwise
- Received or accrued
- From a source within the Republic
- Excluding receipts of a capital nature

Post January 2001 the emphasis of the gross income definition changes as follows:

- Any resident in any period of assessment (Changed)
- The total amount (unchanged)
- In cash or otherwise (unchanged)
- Received or accrued (unchanged)
- From a source within the republic (deleted)
- Excluding receipts of a capital nature

But including

- Capital gains tax income as determined in terms of the eighth schedule to the Income Tax Act with effect from 1 October 2001.

It is also important to note that the gross income definition has also been widened so as to impose taxation on non-residents. The gross income definition applying to a non-resident may be summarised as follows:

- Any person other than a resident in any period of assessment
- The total amount
- In cash or otherwise
- Received or accrued
- From a source within the Republic



- Excluding receipts of a capital nature
- But including capital gains determined in terms of the eighth schedule

*(Huxham and Haupt:2004)*

### **1.3 THE CHANGE FROM SOURCE TO RESIDENCE BASED TAX**

Residence Based Tax is not a new tax that is being introduced, but an extension of the base of income on which a resident of the Republic is liable for taxation.

Prior to the change the determination of “gross income” was based primarily on the source principle of taxation. All income which had its source within the Republic, or which was deemed to be from a source within the Republic was subject to Income Tax.

This basis has now been changed to tax residents on their world-wide income and non-residents on their South African source or deemed source income. In essence the change is from a source plus basis to a residence minus basis of taxation.

Some of the more important reasons for changing to the residence basis of taxation are:

- To place the Income Tax System on a sounder footing thereby protecting the SA tax base from exploitation;
- To bring the SA tax system more in line with international tax principles;
- The relaxation of exchange control and the greater involvement of SA companies off-shore;
- To more effectively cater for the taxation of e-commerce.



Any person who is a resident as defined in section 1 of the Income Tax Act will be taxed on their world-wide income, while certain categories of income and activities undertaken outside South Africa (SA) will be exempt from tax.

There is no definition for a non- resident and non-residents will still be taxed on their SA sourced income. The normal source principals apply as determined and developed by our courts. The source case law is therefore still relevant and cannot be ignored. Certain deemed source rules are still applicable to non-residents.

To avoid the impact of double taxation where a foreign country taxes income in the hands of a resident, the foreign tax paid will be allowed as a credit against the SA tax liability. However it must be noted that foreign tax credits can never exceed SA tax payable on the total amount of foreign income received by a resident during a year of assessment – section 6 *quat* of the Income Tax Act.

The period for prescription in the case of assessments where a foreign tax credit can be claimed or had been allowed was amended to extend the general prescription period of 3 to 6 years from the date of assessment.

The foreign income and taxes payable must be converted to the equivalent SA Rand value – section 6 *quat* (4) of the Income Tax Act.

The main exclusions from Resident Based Tax are:

International Headquarter Company;

- “Natural person” residents performing offshore services;
- Social security fund pay-outs;
- Foreign pension income (reviewed in a few years time);
- Foreign dividends received from a CFE that is exempt under the designated countries (27%) rule.



## 1.4 OTHER MAJOR CHANGES TO THE LEGISLATION

The following are other important changes to the legislation:

- The definition of “resident
- Active income of a Controlled Foreign Entity (CFE). Section 9D provides for the imputation of passive income of a CFE to any resident in the same ratio as the participation rights of the resident. A CFE includes any foreign entity in which residents hold more than 50% of the participation rights or votes or control of the entity. This will be discussed in more detail later in this document.
- Residents earning employment income abroad. Section 10(1)(o) was extended to exempt residents who are outside the Republic for or on behalf of their employer (whether such employer is a resident or not) for a continuous period of 183 days or longer during any period of 12 months.
- The deductibility of expenses under section 11(a) of the Income Tax Act was extended to expenses relating to foreign trade. Various sections of the Income Tax Act provide for the write-off of certain assets used by a taxpayer for the purposes of his or her trade.
- The provision pertaining to wear and tear allowances have been amended to make provision for a notional reduction of the tax values. This will ensure that allowances are allowed only for remaining period over which the assets are normally written off.
- Any assessed loss that results from activities or income from foreign sources will not be allowed to be set-off against taxable income generated in the Republic.
- The introduction of the residence basis of taxation creates certain practical difficulties with the application of section 25B of the Income Tax Act due to the fact that the residence of the trust or beneficiaries and the source of the income affect the taxability of the trust, the beneficiaries and the deductibility of expenses.



This resulted in the amendment of section 25B and the inclusion of sections 7(8), (9) and (10) of the Income Tax Act.

*(Income Tax Practice: 2003)*

## **1.5 THE PRINCIPLES ON WHICH RESIDENCE BASED TAX WILL OPERATE**

- The tax base includes the world-wide gross income of residents of South Africa, subject to certain exemptions.
- Foreign taxes paid by residents will be allowed as a credit against the SA tax liability.
- Foreign residents (non-residents) will continue to be taxed on their income from a South African source or deemed to be from a South African source.
- The provisions of Sec 9D are extended to attribute all income of CFE's to residents with an interest in such entities.
- The income of a CFE, which is a company, will not be taxed if the income was subject to tax in a designated country at a statutory rate of tax of at least 27%, or if the income complies with certain business tests.
- The business profit of a Foreign Branch of a resident will also not be taxed if the income was subjected to tax in a designated country at a statutory rate of tax of at least 27%.

*(Matthews: 2002)*



## CHAPTER 2

### RESIDENTS AND NON RESIDENTS

#### 2.1.1 THE FOLLOWING PERSONS ARE DEFINED AS BEING A RESIDENT

- A natural person who is “ordinary resident” in South Africa;
- A natural person who is not at anytime during the year of assessment “ordinary resident” in the Republic, but who is physically present in the Republic for certain periods.
- A person other than a natural person which has its place of effective management in the Republic.

#### 2.1.2 DEFINITION OF A RESIDENT

‘Resident’ means any-

- (a) natural person who is-
  - (i) ordinarily resident in the Republic; or
  - (ii) not at any time during the year of assessment ordinarily resident in the Republic, if such person was physically present in the Republic-

Fictitious or artificial persons such as deceased estates, trusts, clubs and associations are capable of having a residence and being resident, *CIR v Jagger & Co (Pty) Ltd 1945 CPD 331, 13 SATC 430 and Nathan’s Estate v CIR 1948 (3) SA 866 (N), 15 SATC 328*

#### 2.1.3 ORDINARILY RESIDENT

- Each case must be defined and based on its own facts;
- It is not possible to lay down rules and policies;
- The concept must not be confused with terms such as domicile (home/dwelling) or nationality;



- One must cover a sufficient period for an examination in determining whether or not a natural person can be considered an “ordinary resident”.

The following 2 requirements need to be present to determine ordinary resident:

1. An intention to become ordinary resident in a country; and
2. Steps indicative of this intention having been or being carried out.

The factors that are considered to determine if a person is ordinarily resident:

- What is his/her most fixed or settled place of residence
- What is his/her habitual mode; e.g. routines
- What is his/her place of business
- What is the location of his/her personal belongings
- What and where is his/her family and social contacts (e.g. school, church, and sports club)
- Has he/she applied for permanent residence (of one country in particular)
- What are his/her periods travelled abroad, and what is normally the nature of the visit

*(Interpretation Note 3: 2002)*

The term ordinarily resident has no special or technical meaning, *Levene v IRC [1928] AC 217, 13 TC 486*

Non residents are taxed at source.

The reason for source as the basis of liability to tax for non – residents is that if the natural resources of a country or the activities of its inhabitants produce wealth, that country is entitled to share in that wealth no matter where its recipient may live, *Cf Kerguelen Sealing and Whaling Company Ltd v CIR 10 SATC 263 380.*



#### 2.1.4 PHYSICAL PRESENCE TEST

- Also known as the day test or time rule;
- Is based on the number of days a natural person is physically present in the Republic;
- A day is counted irrespective of the nature of or reason for the visit;

The application of the physical presence test is done annually and consists of 3 requirements:

That the person must be physically present in the Republic for a period exceeding:

1. 91 days in aggregate (total) during the year of assessment;
2. 91 days in aggregate during each of the three years of assessment preceding the current year of assessment; and
3. 549 days in aggregate during the three preceding years of assessment.

All 3 of the above requirements must be met before a person is regarded to be a resident.

- A day begins at 00h00 (midnight);
- In calculating the days present in the Republic, one must note that a day need not be an entire 24 hours. It need only be part of a day. In other words, if a person arrives at Johannesburg International Airport at 23h50, he/she would be regarded to be present in the Republic for a full day, even though they were only in the Republic for 10 minutes of that day

If a taxpayer is satisfied that a person can be considered to be an ordinary resident do not apply the physical presence test



### **2.1.5 WHEN A RESIDENT CEASES TO BE A RESIDENT**

From the day on which he/she ceases to be physically present in the Republic, provided that

He/she is physically absent from the Republic for a continuous period of at least 330 days immediately after the day of departure.

- The period of 330 full days must be continuous;
- A person is taxed as a resident until the day of ceasing to be a resident.

A person who is “ordinarily resident” in the Republic will never cease to be a “resident” because the physical presence test does not apply to ordinary residents.

*(Interpretation Note 4:2002 and 2004)*

### **2.2.1 IMPLICATIONS FOR RESIDENTS WHO LIVE AND WORK IN RSA**

The change to RBT did not affect the position of residents normally living and working in South Africa. Residents will still be taxed as in the past as they are ordinarily resident in the RSA in accordance with the new definition of a resident.

### **2.2.2 IMPLICATIONS FOR RSA RESIDENTS WHO RECEIVE INCOME FROM ABROAD**

Any foreign income received by or accrued to an individual who is a resident will be taxable in his or her hands and a foreign tax credit will be granted in respect of any foreign taxes which are proved to be payable. Active and passive income is included. There are, however, a number of exemptions which will be dealt with in detail in another unit:



Foreign income of a resident company, for example income attributable to a foreign branch, will generally be subjected to tax. However, branch income will be exempt if such income was subject to tax in a designated country at a statutory rate of at least 27%. Any income which was not taxed at that rate (27%) in a designated country, will be taxable in SA and a credit will be granted in respect of any foreign taxes which are proved to be payable in respect of such income in terms of section 6 *quat* of the Income Tax Act.

All income, of a CFE, active and passive, will be imputed under RBT.

A non-resident will be liable for tax under domestic laws on his SA sourced income, unless the DTA overrides it.

## **2.3 IMPLICATIONS FOR NON RESIDENTS RECEIVING ANY INCOME FROM A SA SOURCE**

Non-residents remain liable for normal tax on income that is from a source within or deemed to be within the Republic.

## **2.4 IMPLICATIONS FOR NON RESIDENT COMPANIES / TRUSTS THAT RECEIVE INCOME FROM SA SOURCE**

A non-resident company is generally regarded as a branch for purposes of determining the rate of tax. The only important issue to look at is the Double Taxation Agreements (DTA) between SA and the resident country. It is highly unlikely that we have not entered into a DTA with any country that SA regularly trades with.

The term DTA is used extensively in this document. It is used as an abbreviation of the Agreement for the avoidance of double taxation.

Let's look at two examples to reinforce the physical presence test:



## Example 1

Mr. B is a citizen of Canada, and employed by a South African company, who also has a branch in Canada. He never visited the Republic before 29 June 1998, and is not considered ordinarily resident in the Republic. Mr. B was physically present in the relevant countries for the following periods:

### YEAR OF ASSESSMENT

1999

01/03/1998 to 28/06/1998 in Canada (120 days)

29/06/1998 to 28/02/1999 in South Africa (245 days)

2000

01/03/1999 to 21/05/1999 in South Africa (82 days)

22/05/1999 to 19/02/2000 in Canada (274 days)

20/02/2000 to 29/02/2000 in South Africa (10 days)

2001

01/03/2000 to 30/06/2000 in Canada (122 days)

01/07/2000 to 28/02/2001 in South Africa (243 days)

2002

01/03/2001 to 01/06/2001 in South Africa (93 days)

02/07/2001 to 31/07/2001 in Canada (60 days)

01/08/2001 to 30/11/2001 in South Africa (122 days)

01/12/2001 to 28/02/2002 in Canada (90 days)

2003

01/03/2002 to 31/10/2002 in Canada (245 days)

01/11/2002 to 30/11/2002 in South Africa (30 days)

01/12/2002 to 28/02/2003 in Canada (90 days)

We need to determine the following:



1. Whether Mr. B is regarded as a resident in respect of the 2002 year of assessment (without taking into consideration the information regarding the 2003 year of assessment).
2. The date from which Mr. B is regarded to be resident.
3. The date from which Mr. B is deemed to have ceased to be a resident.
4. Whether Mr. B is regarded as a resident for the 2003 year of assessment.

## SOLUTION

### Part 1

#### First Requirement:

Number of days, in aggregate, physically present in the Republic during the current year of assessment.

93 days + 122 days = 215 days (more than 91 days)

Therefore, first requirement has been met.

#### Second Requirement:

Number of days, in aggregate, physically present in the Republic during each year of the three years of assessment preceding 2002.

1999: 245 days (more than 91 days)

2000: 92 days (more than 91 days)

2001: 243 days (more than 91 days)

The second requirement is therefore met.

#### Third Requirement:

Number of days, in aggregate, physically present in the Republic during the three preceding years of assessment



$245 + 92 + 243 = 580$  days (more than 549 days)

The third requirement is therefore met.

Conclusion:

As all three requirements have been met, Mr. B is regarded as a resident of the Republic, notwithstanding the fact that he is not ordinarily resident in the Republic.

## Part 2

Due to the physical presence test, Mr. B became a resident on the first day of the 2002 year of assessment (01/03/2001), and will be liable for tax on his world-wide income received or accrued during the year of assessment.

## Part 3

Mr. B is out of the Republic for a continuous period of 335 days (01/12/2001 to 31/10/2002). This is therefore more than 330 full days. Mr. B is thus deemed NOT to be a resident from the beginning of the period he left the Republic, i.e. 01/12/2001. If he has been taxed on world-wide income after this date (01/12/2001 to 28/02/2002), his original assessment will have to be revised. Proof of his physical absence is a prerequisite before the assessment can be reviewed.

It is important to note that individuals rendering a service in a foreign country for (or on behalf of) the South African Government, will be liable for tax in South Africa. This is in accordance with the deeming provisions in section 9(1)(e) of the Income Tax Act. The section 10(1)(o) exemption does not apply to this individual, as it is specifically indicated that employees contemplated in s 9(1)(e) are excluded from the exemption.



## Example 2

Mr. Pillay is the South African ambassador to Kenya. He was appointed for a period of 4 years, after which he and his family will return to South Africa. He sold his house in Pietermaritzburg when he left for Kenya. However, most of his furniture and appliances are stored in a warehouse in Pietermaritzburg. The SA Government will remunerate Mr. Pillay during his employment in Kenya. We need to determine if he will be taxed in SA on the income he earns in Kenya

## Answer

Yes. Mr. Pillay appears to be ordinarily resident in South Africa. The remuneration paid to him by the SA Government. is thus included in his SA "gross income".

### 2.4.1 BRANCHES

The taxable income of a branch of a company that has its place of effective management outside South Africa is currently subject to tax at the rate of 35% under domestic legislation. These companies are furthermore exempt from STC.

The taxation of a non-resident company under DTA's will depend on whether it carries on business through a "permanent establishment" (PE), as defined in the relevant DTA, or not. This concept will be discussed later. At this stage it suffices to say that the determination as to whether a non-resident company has a "permanent establishment" in SA or not, does not differ from the principles applied to any other business entity.

The other point of interest with regard to the taxation of a branch is the fact that the tax rate of 35% is higher than that imposed on a resident company (30%). Most DTA's contain an Article which is intended to prevent tax



discrimination against any nationals or enterprises of the foreign country with which the DTA has been concluded. In order to ensure that the taxation of a branch at a higher rate of tax is not construed as discrimination against a foreign enterprise, it is often specifically covered in the DTA.

#### **2.4.2 BUSINESS PROFITS**

The taxation of business profits is covered under Article 7 of the Organisation for Economic Co – operation and Development (OECD) Model. Paragraph 1 provides that the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a “permanent establishment” situated therein. This paragraph therefore provides an exclusive right of taxation to the residence state unless the enterprise carries on business in the other Contracting State through a permanent establishment.

Whether or not the enterprise may be taxed in the other State will therefore depend on the definition of “permanent establishment”. This concept is defined in Section 31 of the Income Tax Act.

##### **Article 5 of the OECD Model**

Permanent establishment means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.”

For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

*(Silke:2003)*



## CHAPTER 3

### SOURCE

There is no definition in the Act for the term source, there is no doubt that it is not possible to define satisfactorily the qualities that will determine the source of income in all circumstances. The judge pointed out that the legislature was probably aware of the difficulty in defining the words source within the Republic and therefore gave no definition, *CIR v Epstein 1954 (3) SA 689 (A)*, *SATC 221 at 231*.

The Dictionary definition for source is: a starting place or resource.

Definition of gross income in section 1 of the Income Tax Act says,

gross income, in relation to any year or period of assessment,  
means—

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic...

(*Broomberg:1998*)

In *CIR v Black 1957(3) SA 536 (A)*, *21 SATC 226*, it was accepted that if it could be shown that the only true and reasonable conclusion on the facts found was that the dominant, or main or substantial or real and basic cause of the accrual of income was to be found in South Africa, the source of that income would be in South Africa.



The word source has several possible meanings. When used in relation to the receipt of money, one possible meaning is the origination cause of the receipt of that money. One could also look at what actually gave rise to that income, and the location of its origin. Regard may be had to the dominant or main source of the income; the source may thus lie in the country in which the main activities have taken place.

The principle test of source was formulated in *CIR v Lever Brothers and Unilever Ltd (1946 AD)*,<sup>14</sup> SATC 12, a case which involved an interest payment made by a South African company, within a group of companies, to an overseas creditor. The court was called upon to decide whether the receipt of the interest by the creditor constituted income from a South African source.

As was indicated by Watermeyer CJ, who delivered one of two majority judgements of the Appellate Division of the Supreme Court (Schreiner JA dissenting) in *CIR v Lever Bros & Unilever Ltd*, it is probably an impossible task to formulate a definition that would furnish a universal test for determining when an amount is received from source within the Republic.

'The word source has several possible meanings. In this section it is used figuratively, and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipts of the money, another possible meaning is the quarter from which is it received.'

The court felt therefore felt that two factors had to be established:

- The originating cause of the income, that is what gives rise to the income; and
- The location of the originating cause.

The overall approach to be adopted is indicated by the following passage:



*'Source means not a legal concept but something which the practical man would regard as a real source of income. The ascertaining of the actual source is a practical hard matter of fact.'*

*Nathan's Estate v CIR*

Regard may instead be had to be the dominant or main source of such income: the source may therefore lie in the country in which the main activities may have taken place.

### **3.1 APPORTIONMENT**

Difficulties may arise in locating the source of income if the activities that result in the income being received are performed in the Republic and in one or more other countries. In such circumstances the whole or part or no part of the receipt might be regarded as constituting income from a source within the Republic.

*Millin v CIR 1928 AD 207, 3 SATC 170*

Although the Special Court for the Hearing Income Tax Appeals has authorized the apportionment of the source of income derived from services, it is doubtful whether the courts will readily resort to the apportionment of a particular amount of income according to the various sources from which it may have been derived.

*Transvaal Associated Hide and Skin Merchants v Collector of Income Tax, Botswana (Court of Appeal Botswana) (May 1967) 29 SATC 97 at 103, 108–9 and 111*

Regard may instead be had to the dominant or main source of such income: the source may therefore lie in the country in which the main activities may have taken place, *ITC 1103 (1967) 29 SATC 35*.



### 3.1.1 ANNUITIES

A contractual annuity, that is, an annuity that arises when one person agrees to pay another an annuity, will be derived from a South African source if the contract is made form a Republic, the contract being the originating cause.

In ascertaining the source of a purchase annuity, for example, an annuity bought from an insurance company, South African Revenue Services (SARS) regards the situation of the source as the place where the contract, in terms of which the company undertook to pay the annuity, was entered into. The place where the proposal was accepted by the company is held to be the situation of the source.

*Boyd v CIR 1951 (3) SA (A), 17 SATC 366*

The practice of SARS does not recognize the view that the originating cause of a purchase annuity is the employment of the capital with which the annuity is acquired, or the view that, if the capital is employed in the Republic, the source of the annuity is the Republic irrespective of the place where the proposal is accepted by the insurance company.

On the interpretation of SARS, all annuities payable under contract taken out with the South African branch of a foreign company are not taxable in the Republic in circumstances where it is a requirement that the proposal be accepted at the foreign head office.

The originating cause of an annuity is the investment.

And the location is where the contract was signed or entered into.

Let's illustrate the above point by using an example:

If Miss A purchased an annuity from an insurance company in South Africa. The contract was finalised in South Africa.

The location of the investment is therefore South Africa, and the source is thus South African.



### 3.1.2 DIRECTOR'S FEES

It has been held that a director's services in his capacity as such are deemed to be rendered at head office at the company where the board of director's ordinarily transacts the business. Consequently, if the head office is in the Republic, the fees are derived from a South African source, irrespective of the place where the director resides and perform the services.

*ITC 77 (1927) 3 SATC 72*

A director who is ordinarily resident outside the Republic would therefore be liable to South African tax on his fees if the board of directors meets in the Republic. If she shares his fees with an alternate director in the Republic, he will be liable to tax on the portion accruing to him. A director ordinarily resident outside the Republic may be paid a fee for services rendered outside the Republic as a member of a local board or committee set up outside the Republic.

On the same principles, if a director resident in the Republic receives a fee from a company with its head office, where the board ordinarily transacts its business, outside the Republic, The income is from a non-South African source.

The originating cause is where the services are rendered.

And location is where the board of directors ordinarily conducts business activities.

Let's illustrate this point by using an example:

Mr. G is a director of Aches and Pains South Africa (Pty) Ltd.. Mr. G is not ordinarily resident in the Republic and the Board of Directors meets in Pretoria.

The location of the meeting is South Africa, and thus the source is South Africa. Mr. G will therefore be taxed on his director's fees earned in South Africa.



### 3.1.3 DIVIDENDS

The source of income from dividends is the shares given rise to the dividends, and that the shares are situated where they are registered, that is, where they can be effectively dealt with, irrespective of the source from which the company derives its income

In *Boyd v CIR 1951 (3) SA 525 (A)*, 17 SATC 366 it was held that the source of income from dividends is the shares giving rise to the dividends, and that the shares are situated where they are registered, that is, where they can be effectively dealt with, irrespective of the source from which the company derives its income.

The originating cause is the Shares.

And the location is where the shares are registered.

### 3.1.4 EMPLOYMENT AND SERVICES RENDERED

The source of the remuneration would be located at the place where the services are rendered.

The salary of a employee who is stationed outside the Republic to render services there on behalf of a South African employer is not taxable in the Republic, being from a source outside the Republic, even if the contract of employment was concluded or the salary was payable in South Africa.

*Cot v Shein 1958 (3) SA 14 (FC)*, 22 SATC 12

Conversely, if a foreign employer sends his employee to the Republic to buy trading goods and the employee is stationed here for that purpose; the salary he receives is from a South African source, the services being rendered in the Republic.

It matters not that the employer is abroad or that the employee's salary is not remitted to the Republic. It should be pointed out that in terms of double taxation agreements negotiated with certain other countries; residents of



those countries are exempt from South African tax on remuneration derived from services rendered in the Republic if certain requirements are fulfilled.

*ITC 100 (1927) 3 SATC 250, ITC 266 (1932) 7 SATC 151, ITC 396 (1937) 10 SATC 87, ITC 938 (1960) 24 SATC 375, ITC 1088 (1966) 28 SATC 202, ITC 1104 (1967) 29 SATC 46*

The originating cause is the Services delivered.

And the location is where such services are delivered.

Let's illustrate this point by using an example:

Miss Z (a New Zealand resident), is sent by her New Zealand employer to South Africa to purchase trading goods.

The salary which Miss Z receives from her New Zealand employer is from a South African source, as her services were delivered in SA.

### **3.1.5 PARTNERSHIP ACTIVITIES**

Where a partnership the members of which carry on their business activities in two different countries, the income of partnership is derived from two sources. When one of the partners carries on his business activities in the Republic his income from the partnership is derived from a source within the Republic, while the income of the other partner is derived from a source in the foreign country. The income that the partner who carries on his business activities in the Republic receives is the quip pro quo for the services he rendered in the Republic to the partnership.

*CIR v Epstein*

The originating Cause is the Business Activities.

And the location is where such business activities take place.



### 3.1.6 RENT

The asset the use of which gives rise to the rent, and that the place the asset is used by the lessee necessarily determines the situation of the source of the rent. Regard must be had to the nature of the property let, the nature of the lessor the source is located where the property is used.

*Cot v British United Shoe Machinery (SA) (Pty) Ltd 1964 (3) SA 193 (FC), 26 SATC 163*

The originating Cause is the property or asset.

And the location is where the property or asset is let/rented/leased.

### 3.1.7 ROYALTIES

If the inventor applies his wits, labour and resources in the Republic, the income accruing to him from the exploitation of his rights is from a source in the Republic. It is also considered that the registration of patent rights in a country merely provides protection for the holder and does not constitute the real source of the royalty.

Other considerations apply when the royalties are derived by a person who is not the original author or inventor, e.g., by a person who has acquired a copyright from the original author or patent rights from the original the inventor, since the royalties would then be derived not from the wits, labour or intellect of the recipient but from the ownership of the copyright or patent rights.

*Millin v CIR*

The source or originating cause of the royalties may be the business of the owner of the rights, the employment of the capital invested in the acquisition of the rights, the contract providing for the earning of the royalties from the exploitation of the rights or, in appropriate circumstances, and, the use of the rights.

In the consideration of the taxation of royalties derived by South African residents from sources in other countries and the royalties derived by non-



residents from sources in the Republic, the effects of any double taxation agreement between the Republic and the foreign country concerned must be in mind.

The originating Cause is Wit, labour, intellect and skills.  
And the location is where the above were utilised.

Let's illustrate this point by using an example:

Mrs. F is the British author of "Women in Africa". The bulk of her research took place in South Africa, and she composed most of her writing here.

Answer: As her wits, labour and skills were mainly employed in South Africa, any Royalties she receives will be taxable in South Africa as the source of the income is South Africa.

*(Silke: 2003)*

## **3.2 DEEMED SOURCE**

Although there is no definition of the expression source within the Republic, the Income Tax Act is helpful, in that it distinguishes certain receipts or accruals that are deemed to be from a source within the Republic, irrespective of their actual source.

Section 9 of the Income Tax Act sets out the various items of income that are deemed to be from a source within the Republic.

### **3.2.1 ALIMONY AND MAINTENANCE**

An amount will be deemed to be derived by a person from a source within the Republic if it has been received by or has accrued to or in favour of that person by virtue of a judicial order or written agreement of separation or an order of divorce if the taxable income of the recipient's spouse or former spouse has been reduced by the amount of the payment in terms of section 21 and section 9(1)(h) of the Income Tax Act, if the written agreement was entered into not later than 21 March 1962.



### **3.2.2 DIVIDENDS ON AFFECTED INSTRUMENTS**

Section 8E of the Income Tax Act deems a dividend declared by a company on an affected instrument to be an amount of interest received by the recipient from a source within the Republic.

### **3.2.3 PENSIONS : GOVERNMENT SERVICES**

An amount will be deemed to be derived by a person from a source in the Republic if it has been received by or has accrued to him or in his favour by virtue of any pension or annuity granted to him, no matter where payments is made or the funds from which payment is made are situated (or his services have been rendered), by the government or a provincial administration or by a local authority in the Republic.

In certain circumstances, such a pension or annuity may be exempt from tax.

### **3.2.4 PENSIONS : NON –GOVERNMENT SERVICES**

An amount will be deemed to be derived by a person from a source in the Republic if it has been received by or has accrued to or in favour of him by virtue of any pension or annuity granted to him no matter payment is made or the funds from which payment is made are situate (or his services have been rendered) by any person, whether residing or carrying on business in the Republic or not, if the services in respect of which that pension or annuity was granted were performed in the Republic for at least two years during the ten years immediately preceding the date on which the pension or annuity first became due.

Only a portion of such a pension or an annuity will be deemed to have been derived from a South African source if that pension or annuity was granted in respect of services that were rendered partly within a party outside the Republic. Such a portion of the pension or annuity must bear to the total pension or annuity the same ratio as the period during which the services



were rendered in the Republic bears to the total period during which the services were rendered.

The portion received by or accrued to a resident for services rendered outside the Republic, that is not deemed to be from a source within the Republic, qualifies from the exemption from tax in South Africa .

Services performed outside the Republic, the resultant income of which is deemed to be from a source in the Republic under section 9(1)(fA) of the Income Tax Act are deemed to have been rendered in the Republic for the purposes of section 9(1)(g)(ii) and section 9(1A) of the Income Tax Act. Accordingly, if a pension or annuity accrues partly as a result of these services rendered outside the Republic, the period thereof must be included in the period of services rendered in the Republic for purposes of apportioning the pension or annuity. These provisions do not apply to pensions or annuities payable by the government or a provincial administration or by a local authority in the Republic, which, in terms of section 9(1)(g)(i) are wholly deemed to be from a source within the Republic.

### **3.2.5 SERVICES RENDERED ABROAD FOR GOVERNMENT AND OTHER BODIES**

An amount will be deemed to be derived by a person from a source in the Republic if it has been received by or accrued to him or his favour by virtue of:

- Services rendered by him to or work or labour done by him for or on behalf of an employer in the national or provincial sphere of government, including a local authority in the Republic, or a national or provincial public entity if not less than 80% of the expenditure of the entity is defrayed directly or indirectly from funds voted by Parliament even if the services are rendered or the work or labour is done outside the Republic



- The holding of a public office to which such person has been appointed or is deemed to have been appointed in terms of an Act of Parliament, notwithstanding that such public office is held outside the Republic.
- The gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangements;
- So much of the amount payable by a borrower to a lender in respect of a lending arrangement representing compensation for any amount to which the lender would have been entitled but for the lending arrangement;
- The absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement 'as contemplated' in Section 23G of the Income Tax Act throughout the full term of the arrangement to which that person is a party

The place of utilization or application of the funds will, unless the contrary is proved, be deemed to be the following:

In the case where the funds are utilized or the credit is applied by—

- a) A natural person, the place where such person is ordinarily resident; or
- b) A person other than a natural person, its place effective management

In essence, the place where the debtor is ordinarily resident, or the place of effective management where the debtor is a juristic person, is the determining factor. If the funds are utilized or the credit is applied by a natural person who is ordinarily resident, or a person other than a natural person who has its place of effective management, in South Africa, the interest will be deemed to have been received from a source within the Republic.



Factors such as the place where the agreement between the parties is concluded and the performance by the creditor of his obligations under the agreement are of no relevance in determining the source of the interest.

The burden of proof that the interest is not from a source within the Republic rest on the taxpayer. If it can be shown that the borrowed funds or credits obtained was utilized or applied outside the Republic even though the debtor is ordinarily resident, or has its place of effective management, in the Republic, the onus would have been discharged and the amount will not be subject to tax.

### **3.3 DEEMED SOURCES THAT WERE DELETED**

The following deemed source provisions became obsolete and were removed following the change to RBT:

- Amounts derived by virtue of contract made within the Republic for the sale of goods;
- Amounts derived from the use or right of use in the Republic of, or the grant of permission to use in the Republic of, a patent, design, trade mark, copyright, model, pattern, plan, formula, process or similar property or certain motion picture films, video tapes, disc, sound recording or advertising matter;
- Amounts derived from the imparting of or the understanding to impart certain know-how for use in SA;
- Amounts derived from a business carried on by a person ordinarily resident in the Republic of a domestic company, as owner or charterer of any ship or aircraft, or the disposal of commodities connected with the operation of the ship or aircraft;



- Amounts derived from a business carried on by a person ordinarily resident in the Republic of a domestic company, as the lesser of certain containers;
- Certain amount derived from services rendered by a person in the carrying on in the Republic of a trade;
- Amounts derived by a person ordinarily resident in the Republic from services rendered outside the Republic during a temporary absence from the Republic for or on behalf of an employer by whom such person is employed in the Republic;
- Amounts derived by a person ordinarily resident in the Republic from services rendered as an officer or crew member of a ship or aircraft owned or chartered by a person ordinarily resident in the Republic or a domestic company;
- A gain by a person other than a company ordinarily resident in the Republic or a domestic company on the maturity or disposal of a banker's acceptance or similar instrument to be from a source within the Republic;
- Amounts from the investment income of certain foreign investment companies in neighbouring countries deemed to be derived from a source within the Republic;
- Amounts derived from direct passive income  
(Divaris and Stein: 2000)



## **CHAPTER 4**

### **IMPLICATIONS**

#### **4.1 RESIDENTS WHO LIVE AND WORK IN THE RSA**

The change to RBT did not affect the position of residents normally living and working in South Africa. (SA) Residents will still be taxed as in the past as they are ordinarily resident in the RSA in accordance with the new definition of a resident.

#### **4.2 RSA RESIDENTS WHO RECEIVE INCOME FROM ABROAD**

Any foreign income received by or accrued to an individual who is a resident will be taxable in his or her hands and a foreign tax credit will be granted in respect of any foreign taxes which are proved to be payable.

Active and passive income is included. There are a number of exemptions:

- Residents earning employment income abroad
- Foreign pension payments

SA has entered into Double Taxation Agreements (DTA's) with 50 foreign countries and is in the process of negotiating and finalizing a further 33. DTA's are intended to eliminate double taxation with regard to certain classes of income by allocating the taxing rights between the two contracting countries. This allocation may be done on an exclusive taxing right basis for either the country of source or the country of residence.



Alternatively, it may provide that the source country may tax a certain class of income in which case the country of residence will be obliged to take into account the tax paid in the source country.

An integral part of all these DTA's is a definition of resident of a Contracting State.

This term was taken from the (Organisation for Economic Co – operation and Development's) OECD Model. This concept is of particular importance in determining to which taxpayers the DTA will apply and in solving cases where double taxation arises as a result of dual residence or double taxation arises as a result of taxation in the State of residence and taxation in the State of source.

Where a taxpayer is a resident of a Contracting State other than South Africa for the purpose of a DTA, it will be necessary to take into account the provisions of the Agreement (Treaty) before taxing any income.

The definition of "resident of a Contracting State" is dealt with in Article 4 of the OECD Model.

Paragraph 1 provides a general definition for the Agreement and refers to the concept of residence for the purposes of domestic legislation.

#### **4.2.1 RESIDENT OF A CONTRACTING STATE**

Any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.

This term, however, does not include any person who is liable to tax in that state in respect only of income from sources in that State or capital situated therein.



Clearly cases will arise where a taxpayer will be regarded as resident in both Contracting States for the purposes of domestic legislation and it is therefore necessary to provide some other means for determining the resident State.

Paragraph 2 provides solutions to cases where individuals are resident in both Contracting States and sets out a step by step method of determining in which State the individual is resident.

**4.2.2** Where by reason of the provisions of paragraph 1 an individual is a resident of a resident of both Contracting States, then his status shall be determined as follows:

- (a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
- (b) If the State in which he has centre of vital interest cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
- (c) If he has an habitual abode States or in neither State or in neither of them, he shall be deemed to be a resident only of the State of which he is a natural;
- (d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

Paragraph 3 provides a solution where a person other than an individual is resident in both States.



**4.2.3** Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

### **4.3 NON - RESIDENTS**

There is no definition for a non-resident any person that is not a resident as defined, is automatically a non-resident. Non-residents remain liable for normal tax on income that is from a source or deemed to be within the Republic.

#### **4.3.1 SALARY INCOME**

All salary income received by or accrued to an individual who is a resident is gross income in his or her hands. It does not matter where the income was generated.

Let's use an example to illustrate this point.

A professor at the University of SA is seconded to the University of Hong Kong for a three year period, after which he intends returning to South Africa to continue his work at the University of SA. He visited his family in SA every four months for two weeks. The University of Hong Kong pays him during the period of his service in Hong Kong. The services rendered in Hong Kong are not on behalf of the University of SA.

It seems evident that the professor is a resident of South Africa, being ordinarily resident in South Africa. The salary earned while in Hong Kong is therefore included in his gross income in SA. Section 10(1)(o)(ii) is applicable – the services are rendered for or on behalf of any employer for a period exceeding 183 days and for continuous period exceeding 60 full days.

All salary income received by or accrued to an individual who is not a resident does not form gross income in his or her hands if the income was derived



from a source within South Africa or deemed to be from source within South Africa.

For example

An artist performed a concert on Durban's central beach during his stay in South Africa. He earned 500 000 pounds for the performance, deposited as AMB Amro bank in London. He stayed in SA for a period of two months after which he returned to his London residence. He resides in London when he does not perform.

It seems evident that the artist is a non-resident for SA tax purposes. It must therefore be determined whether the amount earned by him is from a SA source or deemed source. The performance (service rendered) was in SA and the true source is therefore in SA. It follows that the 500 000 pounds is included in SA gross income. As an artist, Article 15 of the DTA between SA and the UK would confirm SA's right to tax him on this income.

Section 9(1)(e)(i) of the Income Tax Act reads as follows:-

“ any services rendered by such person to or work or labour done by such person for or on behalf of any employer in the national or provincial sphere of government or any local authority in the republic or any national or provincial public entity if not less than 80 per cent of the expenditure of such entity defrayed directly or indirectly from funds voted by the parliament, notwithstanding that such services are rendered or such work or labour is done outside the Republic, provided such services are rendered or such work or labour is done in accordance with a contract of employment entered into with the Government or local authority or national or provincial entity; or

(ii) The holding of a public office to which such person has been appointed or is deemed to have been appointed in terms of an Act of Parliament, notwithstanding that such public office is held outside the Republic



The source and deemed source principles only apply in relation to a non-resident. It follows that any income of the nature described in section 9(1)(e) of the Income Tax Act is included in the gross income of a non-resident.

It is important to note that most individuals rendering a service in a foreign country for or on behalf of the SA government will be residents of South Africa. This means that the income earned by them will in any event be included in gross income.

The application of this section will therefore probably be limited to circumstances where a foreign national is employed in a foreign country by the SA government.

The profile of the employee as described in this section will be important for purposes of section 10(1)(o)(ii) of the Income Tax Act. The exemption provided by this section does not apply in respect of an employee or the holder of an office described in section 9(1)(e) of the Income Tax Act.

Let's use an example to illustrate this point.

Mr A is the SA ambassador to Sweden. He was appointed for a period of 4 years, after which he and his family will return to SA. He sold his SA house when he left for Sweden. And will purchase another house in SA when he returns. Most of his furniture is stored in a warehouse in Pinetown, SA.

It seems evident that Mr A is a resident for SA tax purposes. The remuneration paid to him by the SA government is, therefore, included in his SA gross income. No need for the application of the deeming provisions contained in section 9(1)(e) of the Income Tax Act.

Section 10(1)(o)(ii) of the Income Tax Act prohibits the application for the exemption in respect of remuneration derived from the holding of an office or from services rendered on the basis contemplated by section 9(1)(e) of the Income Tax Act.



Although section 9(1)(e) of the Income Tax Act played no role in the determination of Mr A's gross income, the type of office / services rendered by him conforms with the type contemplated by section 9(1)(e) of the Income Tax Act and it follows that the section 10(1)(o) of the Income Tax Act exemption does not apply.

Let's use an example to illustrate this point.

A lady was borne in Finland and lives in Helsinki. She is employed and paid by the SA embassy in Helsinki in Rands. Her annual remuneration package is made up of R100 000 cash salary and a R30 000 allowance to defray expenditure associated with her official duties.

It seems evident that she is a non-resident. It must therefore be established whether the source rule would include her income in gross income for South African tax purposes. The true source of income is where the services were rendered (Finland), but the deeming provisions of section 9(1)(e) of the Income Tax Act would be relevant. In terms of this section the cash portion of her package would be included in South African gross income, while the allowance portion would remain a source outside SA.

#### **4.3.2 PENSIONS**

Section 9(i)(g) of the Income Tax Act reads, any pension or annuity granted to such person, where so ever payment of that pension or annuity is made and where so ever the funds from which payment is made are suitable-

- i) by the Government, any provincial administration, or by any local authority in the republic; or
- ii) by any person, whether residing or carrying on business in the Republic or not, if the services in respect of which that pension or annuity was granted were performed within the Republic for at least two years during the ten years immediately preceding the date from which the pension or



annuity first became due: Provided that if the pension or annuity was granted in respect of services which were rendered partly within and partly outside the Republic, only so much of such person or annuity as bears to the amount of such pension or annuity the same ratio as the period during which the services were rendered in the Republic bears to the total period during which the services were rendered, shall be deemed to be derived from a source within the Republic: Provided further that any services rendered in the territory of the former Republic of Transkei, Bophuthatswana, Venda, or Ciskei shall be deemed to have been rendered within the Republic.

For the purposes of paragraph section 9(1)(g)(ii) of the Income Tax Act the services referred to in paragraph (fA) shall be deemed to have been performed within the Republic.

Section 9(1)(g) only applies in circumstances where the recipient of the annuity or lump sum payment is a non-resident. Where the recipient is a resident the payments are in any event included in gross income. The application of this section will therefore in practice be limited to circumstances where:

- A non-resident receives a payment from the Government, a provincial administration or a local authority; or
- A non-resident rendered services in South Africa for a period exceeding two years during the ten years immediately preceding the date from which the payment became due.

Section 9(1)(g) refers to the deeming of pensions and annuities to non-residents. The application of this section will be limited to:

A non-resident who receives payment from the Government, provincial administration or local authority; or



A non-resident who rendered services in South Africa for a period of at least 2 years during the 10 years immediately preceding the date on which the payment became due.

The above point can be illustrated by the next two examples

A general worked for the South African Defence Force and retired from the Government Employees' Pension Fund on 30 April 1996. For the period 1 January 1970 until 31 December 1980 he rendered services in Namibia on behalf of the South African Defence Force. He retired in Hermanus, SA.

- It seems evident that he is a resident for SA tax purposes.
- The retirement income is, therefore, included in his SA gross income.
- The new DTA between the RSA and Namibia confirms this position.
- The provisions of section 9(1)(g) play no direct role in the determination of the gross income of the particular taxpayer, but play an indirect role in determining whether or not section 10(1)(gC) of the Income Tax Act affects his taxable position.
- Although not for gross income purposes, the retirement income is deemed to be from a source within SA in terms of section 9(1)(g)(i) and it follows that section 10(1)(gC) of the Income Tax Act is not applicable in the circumstances of this case.
- The result, full taxability in SA on the total income.

A colonel of the American Marines was seconded to the South African Defence Force with effect from 1 January 1997. He rendered services in SA for a period of 5 years on behalf of the USA Marines after which he retired and returned to his family in the USA. His 2002 assessment in respect of his pension income from the USA government needs to be calculated.

It is evident that the Colonel is a resident for South Africa tax purposes. In accordance with the time rule he was:



- Present to South Africa for more than 91 days during the 2002 year of assessment;
- He was present in South Africa for the periods exceeding 91 days in each of the preceding three years of assessment;
- He was present in South Africa for the total period exceeding 549 days during the past three years of assessment.
- On 28/02/02 he was not outside of the RSA for a period exceeding 330 days.

It is clear that the retirement income earned by the Colonel that is attributable to the services rendered in South Africa is included in gross income for RSA tax purposes and that the deeming provisions of section 9 played no role in determining this fact.

Section 10(1)(gC) is applicable to a resident, but in respect of the retirement income from a source abroad. In the Colonel's case the true source is South African and the section does, therefore, not apply.

Article 18(1)(b) [read with article 19] of the DTA between SA and the USA provides for the taxation of the pension in the USA only.

*(Huxham : 2004)*



## **CHAPTER 5**

### **EXEMPTIONS**

#### **5.1 SOCIAL SECURITIES AND FOREIGN PENSIONS**

Section 10 (1)(gC) of the Income Tax Act reads any-

- a) amount received by or accrued to any resident under the social security system of any other country; or
- b) pension received by or accrued to any resident from a source outside the Republic, which is not deemed to be from the source in the Republic, in consideration of past employment outside the Republic;

Currently foreign pensions and current security payments are exempt from income tax although it is international practice for a country of resident to tax foreign pensions. This exemption will be revisited in 2 years time.

All social security payments by foreign governments are exempt, as such as exemption is encountered in similar junctions.

#### **5.2 SERVICES RENDERED BY A RESIDENT ON BEHALF OF ANY EMPLOYER OUTSIDE OF RSA**

Section 10(1)(o) of the Income Tax Act was extended to include a resident who is outside the Republic for purposes of rendering foreign services for or on behalf of any employer, for a period which in aggregate exceeds 183 full days in a 12 month period commencing or ending during a year of assessment including a continuous period exceeding 60 full days during such 183 day period.



*"any remuneration as defined in paragraph 1 of the Fourth Schedule*

- (i) ...*
- (ii) received by or accrued to any person during any year of assessment in respect of services rendered outside the Republic by that person for or on behalf of any employer, if that person was outside the Republic-*
- (aa) for a period or periods exceeding 183 full days in aggregate during 12 months period commencing or ending during that year of assessment; and*
- (bb) for a continuous period exceeding 60 full days during that period of 12 months,*

*and those services were rendered during that period or periods: Provided that-*

- (A) for a purpose of this subparagraph, a person who is in transit through the Republic between two places outside the Republic and who does not formally enter the Republic through a port of any as defined in the immigration Act, 2002 (Act No. 13 of 2002), shall be deemed to be outside the Republic; and*
- (B) the provisions of this subparagraph shall not apply in respect of any remuneration derived in respect of the holding of any office or from services rendered for or on behalf of any employer, as contemplated in section 9(1)(e);"*

Remuneration is specifically defined in paragraph 1 of the Fourth Schedule to the Income Tax Act received by or accrued to any person during any year of assessment in respect of services rendered the term "received by or accrued to" retains its meaning for income tax purposes.

The remuneration that is covered by the exemption relates to remuneration received or accrued in the year of assessment in which the 12 month period



commences or ends. If, for example, remuneration accrues in the 2005 year of assessment but the remuneration is in respect of services rendered outside the Republic during a 12 month period commencing or ending in the 2002 year of assessment, the exemption will not apply.

Payments in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment or of any appointment are not covered by this exemption.

### **Outside the republic**

This literally means services rendered outside the borders of the Republic of South Africa. It must be noted that the borders of the Republic include territorial waters, which is a belt of sea within 12 nautical miles (roughly 22, 2 kilometres) beyond the coastline of the country. Remuneration from services rendered beyond the coastline of the Republic will therefore only be exempt if the services are rendered outside the territorial waters.

### **For or on behalf of any employer**

“any employer” means an employer which could either be an employer operating in South Africa, or a non-resident employer.

### **For a period or periods exceeding 183 full days in aggregate**

“full day” means 24 hours (from 0h00 to 0h00). The 183 days do not have to be consecutive or continuous, but a total of 183 days must be exceeded.

### **During any 12 months period commencing or ending during that year of assessment**

Each month in the 12 month period, is a “month” as defined in the Interpretation Act, 1957 i.e. a calendar month. The period must therefore commence on the first day of a particular month, and end on the last day of the twelfth calendar month thereafter.

The 183 day period mentioned above must fall within a period of 12 consecutive calendar months. The 12 month period is not necessarily a year



of assessment, or a calendar year; it is any 12 month period that commences or ends in the year of assessment in which the remuneration in question may be taxed or exempted.

To identify the 12 month period it is necessary to identify the period during which the services were rendered to the employer and to fit the 12 month period so as include (or as much of it as can fit) during which the services were rendered.

### **Practical application**

In identifying the possible 12 month periods that may be used, it is advisable to first identify the period during which the services were rendered to the employer (employment period). A first twelve month period can then be determined by working forward 12 months from the first day of the calendar month in which the first day of the employment period falls.

If this 12 month period fails to meet the requirements for the exemption, another 12 month period may be used by working back 12 month from the last day of the calendar month in which the last day of the employment period falls. As can be seen, there is an option of making use of any one of two 12 month periods.

### **For a continuous period exceeding 60 full days during that period of 12 months**

There must be an absence of more than 60 continuous days in the same 12 month period mentioned above.

### **And those services were rendered during that period or periods**

The services that generated the income to be considered for exemption must have been rendered during the 183 day and 60 day periods mentioned above.

### **In transit between two places outside the Republic**



This means that the point of departure and the point of destination of the specific journey that is being undertaken must be outside the borders of the Republic, as described above.

The provisions of this subparagraph shall not apply in respect of my remuneration derived in respect of the holding of any office or from services rendered for or on behalf of any employer, as contemplated in section 9(1)(e) of the Income Tax Act

The exemption does not apply to employment income earned by persons mentioned in section 9(1)(e) of the Act.

Let's look at two examples to illustrate this section.

#### Example 1

A lady was seconded by a SA holding company to a subsidiary in Hong Kong for the period 1/3/2001 to 30/9/2001. According to her employment company she would be remunerated by the SA company and that she will not be permitted to return to SA during the secondment period.

- 1) If she remained in Hong Kong for the entire period, she would be out of SA for a continuous period of 214 days. Therefore she will qualify for the exemption
- 2) If the employer is satisfied the S10(i)(o) applies he may elect not to deduct PAYE.

#### Example 2

Mrs J is employed at SAA. Due to her special used knowledge in aviation she was seconded to the Hawaii subsidiary on 1/6/01 until 31/12/01. The Hawaii branch remunerated her during this period.

She returned to SA during the following periods:

= 27- 31/7/01            (5 days)



= 5 - 9/9/01           (5 days)  
= 11-15/11/01       (5days)  
= 21-31/12/01       (11days)

Periods employed in Hawaii:

1 / 6	-	26 / 7	=	56 days
1 / 8	-	4 / 9	=	35 days
10 / 9	-	10 / 11	=	62 days
16 / 11	-	20 / 12	=	<u>35 days</u>
				188 days

Mrs J was absent from SA for more than 183 days during a 12 month period and 60 days or more was continuous. Therefore the income from Hawaii will be exempt from income tax.

**5.3 GOVERNMENT SERVICES / PUBLIC ENTITY**

Section 10 (1)(p) of the Income Tax Act reads as follows:-

“Any amount received by or accrued to any person who is not a resident for services rendered or work or labour done by him outside the Republic for or on behalf of any employer in the national or provincial sphere of government or any local authority in the Republic or any national or provincial public entity if not less than 80 percent of the expenditure of such entity is defrayed directly or indirectly from funds voted by Parliament, if such amount is chargeable with income tax in the country in which he is ordinarily resident and the income tax so chargeable is borne by himself and is not paid on his behalf by the government, the local authority concerned or such public entity.”

In terms of this section an amount will only be exempt from income tax for services rendered, work or labour done outside the Republic for, or on behalf of any employer who is;-

- In the national or provincial sphere of government; or
- Any local authority in the Republic; or



- Any national or provincial public entity.

The exemption would not apply if:-

- Less than 80% if the expenditure of such entity is defrayed directly or indirectly from funds voted by Parliament; or
- The remuneration is not chargeable with income tax in the country in which such person is ordinarily resident; or
- The employer pays the tax chargeable in the other country on the taxpayer's behalf.

In conclusion the above exemptions provides relief for residents, exempt income is tax free. SARS would have no problems in taxpayers disputing their residency when earning exempt income.

*(Silke :2003)*

*(The Revenue Laws Amendment Act :2002)*



## CHAPTER 6

### FOREIGN INVESTMENT INCOME RECEIVED BY A RESIDENT

#### 6.1. TYPES OF INVESTMENT INCOME

- Interest
- Dividends
- Royalties
- Rental income
- Annuities

##### 6.1.1 INTEREST INCOME

###### **Residents (section 24J and K of the Income Tax Act)**

There is no change in the taxability of interest received by a resident. A resident will remain to be taxable in respect of all types of interest income.

###### **Non-resident (sec 10(1)(hZ) of the Income Tax Act)**

Non-resident are only taxable on interest income from a source within or deemed to be within the Republic. It is important to remember that the interest is deemed to be derived from a source within the Republic if it is derived from the utilisation or application of the funds in the Republic.

The exemption previously contained in section 10(1)(hA) of the Income Tax Act is now limited to non-residents. For the purposes of the exemption, persons who are residents of the common monetary area are deemed to residents and are not qualify for the exemption.



## 6.1.2 RENTAL INCOME

### **Resident**

All rental (local and foreign) received by a resident is taxable. Section 20 of the Income Tax Act was amended to ring fence losses in respect of any trade income derived from foreign source. Foreign losses can't be set off against SA income.

### **Non-resident**

Non-residents are taxable only on income from a source within the Republic. Income from the rental of movable property is regarded where the property is utilised on a day to day basis. Non-residents will therefore be subjected to tax on rental income which arises in SA.

## 6.1.3 DIVIDENDS

### **Residents**

Dividends from foreign companies are subject to Income Tax in the hands of residents. Local dividends remain to be exempt from Income Tax.

### **Non-residents**

Foreign dividends is not subject to tax in the hands of non-residents

## 6.1.4 ANNUITIES

### **Residents**

Residents remain taxable on annuities that accrued from a world-wide source. Even though section 9C of the Income Tax Act has been deleted the gross amount of an annuity will now be included in terms of the definition of gross income.

### **Non-residents**

Non-residents will only taxable on annuities from a SA source





### **6.1.5 ROYALTIES**

#### **Residents**

Residents are subject to Income Tax on the Royalties from a world-wide source. The provisions of section 20 were amended to now effectively ring-fence losses in respect of any trade income derived from foreign sources. The provisions of section 11(gA) of the Income Tax Act have been extended to also include patents, copyright, etc. registered under the laws of any foreign country.

#### **Non-residents**

A non-resident is not required to register for income tax purposes if a royalty is paid or becomes payable from a deemed South African source. The tax referred to in section 35 of the Income Tax Act is now a final withholding tax. The rate has been fixed at 12% of the gross royalty.

The non-residents do not have any obligation to submit a tax return if the royalty income is the only income from a South African source. Exemption is granted from normal tax for royalties subject to tax in terms of section 35. The description of a royalty previously contained in section 9(1)(b) and (bA) of the Income Tax Act is now contained in section 35.

### **6.1.6 FOREIGN DIVIDENDS**

Foreign dividends became taxable with effect from 23 February 2000. Section 9E of the Income Tax Act was introduced to regulate the taxation of foreign dividends.

## **6.2 DEDUCTIONS**

### **6.2.1 MEDICAL AID CONTRIBUTIONS**

Section 18 of the Income Tax Act was extended to include contributions made to any medical scheme which is registered under any similar provisions



contained in the law of any other country where the medical scheme is registered.

### **6.2.2 GENERAL DEDUCTIONS**

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as a deduction from the income of such person so derived-

- (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature

As residents will now be taxed on their world-wide income, they can claim their world-wide deductions against such income. The losses occurred abroad couldn't, however, be set off against any South African trade income.

### **6.2.3 DEDUCTIBILITY OF INTEREST AGAINST FOREIGN DIVIDENDS**

#### **6.2.3.1 INTEREST DEDUCTION**

In terms of section 9E(5A)(a) of the Income Tax Act a resident will be allowed a deductions from taxable foreign dividends derived during any year of assessment, any interest actually incurred in the production of foreign dividends as defined in section 9E of the Income Tax Act.

This will apply notwithstanding the provisions of sections 11(a) and 23(g) of the Income Tax Act, but subject to certain limitations and conditions.

- a) The amount of interest deductible for a particular year of assessment is limited to the amount of income derived from foreign dividends during that year of assessment.
- b) The excess interest may qualify as a deduction in the following year of assessment against taxable foreign dividends. The excess amount



must, however, first be reduced by the amount of exempt foreign dividends that accrued during that year. The amount remaining after the deduction of the exempt foreign dividends is carried forward to the following year of assessment and qualifies as interest actually incurred during that year of assessment.

- c) If for any year of assessment the amount of exempt foreign dividends is equal to or greater than the amount of excess interest, then the assessment is equal to R Nil.

#### **6.2.3.2 INCOME DERIVED FROM FOREIGN DIVIDENDS**

Will be equal to the amount of gross foreign dividends less the amount of foreign dividends exempt from tax in terms of provisions of sections 10(1)(i)(xv) and 10(1)(k)(i) of the Income Tax Act.

#### **6.2.3.3 FOREIGN DIVIDENDS**

Taxable foreign dividends and foreign dividends is exempt from tax in terms of section 9E (7) of the Income Tax Act and is included in "gross income" in terms of paragraph (k) of the definition of "gross income".

#### **6.2.3.4 EXEMPTIONS**

Foreign dividends which are taxable in terms of section 9E of the Income Tax Act are excluded from the exemption for dividends in terms of section 10(1)(k)(i).

A natural person is entitled to a basic exemption in respect of interest and foreign dividend income which would otherwise not be exempt from tax.

For the 2004 year of assessment the basic exemption amounts to R10 000 for natural persons under 65 years of age and R15 000 for natural persons who are 65 years of age or older.



The basis on which the basic exemption will apply has been amended from the commencement of assessment years ending on or after 1 January 2003. The consequences of the amendment are as follows:

- The exemption applicable to foreign sourced interest and dividends is limited to R1 000.
- The R1 000 exemption must first be applied to foreign dividends and the balance, if any, to foreign sourced interest
- The exemption applicable to locally sourced dividends and interest which are not otherwise exempt from tax, R15 000 (in the case of persons aged 65 and older at the end relevant tax year) or R10 000 (in the case of persons not yet 65 years of age at the end of the relevant tax year), as the case may be, must be reduced by the R1 000 referred to above (if fully allowed) or such portion thereof allowed as an exemption against foreign sourced dividend and interest income. The reason for this deduction is because the total exemption may not exceed R10 000 or R15 000, as the case may be.

The following exemptions provided for in section 9E(7) are of particular importance to a resident that is a natural person and a portfolio investor:

- Shareholding of less than 10% in a company listed on the Johannesburg Stock Exchange
- Foreign dividends declared from profits already subject to normal tax in the hands of the shareholder
- Foreign dividends declared from profits that arose from dividends declared by a South African resident company



- Foreign dividends declared from profits that were derived from foreign dividends exempt in terms of section 9E(7)

The above principles can be illustrated by the following example:

2003 Year of assessment

A lady is ordinarily resident in SA, 50 years of age and unmarried. She elected to be taxed on the net amount of her foreign dividends i.e. the amount of the dividends received by her after the deduction of foreign withholding tax.

	Total income
Gross foreign dividends (taxable and exempt)	10 000
Basic investment income exemption (s10(1)(xv)(aa))	1 000
Foreign withholding tax i.r.o. foreign dividends	0
Exempt foreign dividends (FD)	1 000
Interest income earned	0
Interest actually incurred in the production of FD	15 000

Calculation of the amount of interest deductible in terms of section 9E(5A)(a):-

	Total income
Interest expenditure	15 000
+ Balance of interest b/f from previous year	0
= Total amount of interest available for deduction in the current year of assessment	15 000
Less: Allowable interest (LTD to FD income see note)	<u>(8 000)</u>



Excess interest	7 000
Less: Exempt dividends (1000 + 1000)	<u>(2 000)</u>
Balance of interest c/f to the 2004 year	5 000

Calculation of taxable income from foreign dividends:

	Total income
Gross foreign dividends (taxable and exempt)	10 000
Less: Basic investment income exemption (s10(1)(xv)(aa))	(1 000)
Less: Gross Foreign dividend exemption (s10(1)(k))	(1 000)
Income derived from foreign dividends	8 000
Less: Interest expenditure	(8 000)
= Taxable income from foreign dividends	0

**Note:-**

Calculation of income derived from foreign dividends

	Total income
Gross foreign dividends (taxable and exempt)	10 000
Less: Basic investment income exemption (s10(1)(xv)(aa))	(1 000)
Less: Gross Foreign dividend exemption (s10(1)(k))	(1 000)
Income derived from foreign dividends	8 000



In conclusion all investment income is included in gross income. Some of the investment income is exempt in terms of section 10. The Income Tax Act treats residents and non residents differently with respect to each type of investment income.

*(Explanatory memorandum on the Revenue Amendment Act :2002)*



## **CHAPTER 7**

### **FOREIGN BUSINESS DEDUCTIONS, ALLOWANCES AND ASSESSED LOSSES**

#### **7.1 DEPRECIATION**

The Income Tax Act contains various provisions in terms of which certain assets used by a taxpayer for the purpose of his trade may be written off. If the income was not taxed in SA, the asset/s could not be written off for income tax purposes

As a result of RBT the provisions have been amended to provide that where the assets was used by the taxpayer for the purposes of his or her trade outside the Republic, the period of use of such asset during the previous years must be taken into account in determining the amount by which the asset may still be written off. This will ensure that the portion of the cost / value to be depreciated, which relates to the period after the commencement of RBT (when foreign income is subject to tax) will be allowed.

The above mentioned general provisions are applicable in respect of the depreciation/wear and tear of all qualifying assets. The depreciation/wear and tear in respect of the previous years is deemed to have been allowed for SA tax purposes in order to calculate the balance of the depreciation allowance.

The balance of the depreciation allowance represents the amount that may be allowed for SA tax purposes as a deduction over the remainder of the write-off for the relevant asset.

Where buildings (outside the Republic) were used by taxpayer for either carrying on therein a process of manufacture, conducting the



business of hotelkeeper or residential building erected in terms of a bona fide housing project, such previous period of use must be taken into account in order to determine the remaining portion which may be allowed for SA tax purposes.

The amended provisions regarding building allowances are therefore in principle the same the provisions in respect of machinery, plant, etc.

For example

A SA resident erected a hotel building in Swaziland in 1992 at a cost of R1,000, 000 and leased the building to another taxpayer who conducted the hotel business. (The Hotel business commenced in October 1992.) the resident's year of assessment ends on 28 February. The balance of the allowance for SA tax purposes is as follows:

Cost of erection	R1 000 000
Allowance (1000 000 x 5% x 9years)	
50 000 x 9	(R450 000)
Balance for SA tax purposes	R550 000
Building allowance 2002 tax year 5%	R50 000
Building allowance 2003 tax year 5%	R50 000

**7.2 SECTION 11(gB) OF THE INCOME TAX ACT**

Section 11(gB) provides for a deduction in respect of expenditure incurred in obtaining the extension of the term of a patent, design or trade mark. Due to the fact that the income derived from any foreign patent, design or trade mark will now be taxable in the hands of the resident, the provisions have now been extended to allow a



deduction in respect of expenditure incurred in registering any patent, design or trade mark under any similar law of any other country.

### **7.3 SECTION 11 (gC) OF THE INCOME TAX ACT**

Section 11(gC) which specifically provided for expenditure incurred by an exporter in obtaining the registration of any patent, design or trade mark in an export country has therefore been deleted.

### **7.4 SECTION 8(4) OF THE INCOME TAX ACT– RECEIPIENTS**

Where an asset, in respect of which a deduction was allowed, is sold a taxpayer, any amount recovered or recouped is included in the income of the taxpayer in terms of the provisions of section 8(4).

Due to the fact that only the portion of the depreciation, which relates to the period that the income is subject to tax, is allowed, the amount thereof recovered or recouped cannot exceed the amount actually allowed as a deduction. Although the previous years depreciation is deemed to have been allowed, the amounts were not allowed in such previous years as contemplated in section 8(4). The application of section 8(4)(a) is limited by section 8(4A) to the amounts actually as a deduction in the determination of taxable income.

For example

A SA resident and owner of a manufacturing concern in Angola purchased new machinery in August 1999 for R100 000. The machinery for the purposes of SA tax qualifies for a section 12C allowance as the income will now be subjected to tax in SA. The company's year-end is December. The machinery is sold in December 2002 for R70 000.



Cost	R100 000
W/T (1999 TY – Angola)	(R20 000)
W/T (2000 TY – Angola)	(R20 000)
Balance for SA tax purposes	R60 000
W/T (1999 TY – SA)	(R20 000)
W/T (2000 TY – SA )	(R20 000)
Balance	R20 000
Selling price	(R70 000)
Recoupment	R40 000
(R50 000 limited to R40 000)	

As a result of residence based taxation, taxpayers are entitled to write off certain assets that were previously used by them in a trade carried on outside South Africa. Special provisions have been introduced to ensure that, if an asset was used previously in a trade, the income of which was not taxable in South Africa, but now becomes taxable, the full depreciation allowance cannot be claimed. Only the proportion of the depreciation allowance that relates to the period, in which the income derived from the asset is subject to South African tax, is allowed.

Similarly, if the asset is sold, a recoupment only arises under section 8(4)(a) to the extent that the allowance was actually granted, but not on any deemed allowance in a year of assessment prior to that in which income derived from an asset became taxable in South Africa.

## **7.5 ASSESSED LOSSES**

Section 20 of the Income Act provides for the set-off from any trade carried on by any person of any assessed losses incurred by such person. However, foreign losses incurred by an individual or



company may not be set-off against the SA income of the individual or company.

This was introduced to protect the existing tax base, and will also limit the possibility of a person starting a foreign operation in a branch in order to utilise the losses against the SA income and then converting the branch to a separate subsidiary company when it becomes profitable.

The losses may be carried forward and be set-off against income from a trade carried on outside the Republic in a subsequent year of assessment

*(Silke : 2003)*

For example

2003 Year of Assessment

Local Interest Received	R13000
Foreign Trade Loss Incurred	(R10000)
Local Trade Profit	R25000

2004 Year of Assessment

Local Interest Received	R15000
Foreign Trade Profit	R35000
Local Trade Profit	R12000

If one had to calculate the taxable income for each year of assessment. Assume the taxpayer is a resident, an individual & aged 42.

2003 Year of Assessment



Local Interest Received	
R13000 less R6000 exemption	R 7000
Foreign Trade Loss	
Section 20 limitation ("ring-fenced" and C/F to 2004)	R nil
Local Trade Profit	
Remains as is	<u>R25000</u>
TAXABLE INCOME	<u>R32000</u>

#### 2004 Year of Assessment

Local Interest Received	
R15000 less R10000 exemption	R 5000
Foreign Trade Profit	
R35000 less R10000 loss b/f from 2003	R25000
Local Trade Profit	
Remains as is	<u>R12000</u>
TAXABLE INCOME	<u>R42000</u>

In conclusion foreign losses may not be set off against South African income but can be carried forward and set off against future foreign income.



## **CHAPTER 8**

### **DOUBLE TAXATION AGREEMENTS**

#### **8.1 INTRODUCTION TO DOUBLE TAXATION AGREEMENTS (DTA's)**

Most countries tax residents on world-wide income and tax non-residents on income which arises in the country. A resident of a country who derives income from a foreign source may be taxed in the foreign country and pay tax on the same income in the country of residence. This double taxation of the same income in two different countries will obviously seriously hamper trade and investment and it is therefore normal for countries that engage in trade to enter into Agreements for the Avoidance of Double Taxation.

These Agreements are intended to eliminate double taxation with regard to certain classes of income by allocating the taxing rights between each country. This allocation may be done on an exclusive taxing right basis for either the country of source or the country of residence. On the other hand, the Agreement may provide that each country may tax a certain class of income in which case the country of residence will be obliged to take into account the tax paid in the source country.

Although DTAs have played a relatively insignificant role in the case of most taxpayers, their importance was once again emphasised with the introduction of a residence based tax system in South Africa with effect from 1 January 2001. The reason for the foregoing is that a DTA, once properly approved and adopted, has the force of law and to that extent overrides the provisions of local South African fiscal legislation. In this context section 108 of the Income Tax Act provides that South Africa (the National Executive) may enter into DTAs with the governments of other countries whereby arrangements are made with those governments with a view to the prevention, mitigation or discontinuance of the levying of tax in respect of the same income, profits or



gains under the laws of South Africa and of the other country concerned. The practical effect of the foregoing is that, even if tax is payable in South Africa or that only part thereof is payable. South African tax is thus not payable to the extent to which an exemption from tax is granted in terms of a DTA. There has been some argument that, from a constitutional point of view, the provisions of the Act and DTA will have to be interpreted in such a way that effect is given to the objects and purpose of the relevant provisions. Thus, especially in the case of so – called anti – avoidance provisions, the argument is that such anti – avoidance provisions will prevail over a specific DTA in the event of conflict. In my view, however, such argument is tenuous and it is unlikely that effect will be given thereto.

The possibility of double taxation is dealt with in two ways:

- a. Unilateral relief, granted by one jurisdiction without any link with another jurisdiction.

Example in the United States of America, provisions exist for the granting of credits in respect of foreign tax paid on income which is subject to United States tax. Similarly, section 6 *quat* of the Income Tax Act provides for a rebate in respect of foreign tax paid on foreign sourced income which is deemed to be from a South African source.

Unilateral relief can also take the form of a total exemption from tax granted by one exemption, or a qualified exemption.

- b) Bilateral relief, on a basis agreed upon between two governments, in the form of double taxation agreements.

The State president is empowered to enter into agreements with the government of any other country or territory, whereby arrangements are made with that government for –

- i. The prevention, mitigation or discontinuance of the levy of tax by both governments in respect of the same income, profit or gains, or donations; or
- ii. The rendering of reciprocal assistance in the administration and collection of taxes under the laws of the two territories.



The duty of preserving secrecy in respect of tax matters does not prevent the disclosure to an authorised officer of the territory with whom an agreement has been entered into, of facts and knowledge which it is necessary to disclosure-

- a. In order to determine whether immunity, relief or exemption ought to be given under the agreement, or
- b. In order to render or receive assistance under the agreement.

The State President has, in the exercise of these powers, entered into a number of agreements which fall into two classes:

- a. Comprehensive agreements, covering a number of different types of income; and
- b. Restricted agreements, dealing only with income from shipping and aircraft business.

#### Nature of DTAs

DTAs are international agreements which are generally governed by the Vienna Convention on the law of treaties of 23 May 1969. There are, in principle, three model agreements, which were developed over time.

Objectives of double taxation agreements:

- a. The avoidance of double taxation;
- b. The prevention of fiscal evasion and
- c. The exchange of information

## **8.2 BASIC PRINCIPLES FOR TAXING RIGHTS IN ANY DTA**

International consensus has been reached on the taxation of income where there is a conflict of interests between the residence and the source State.

These principles are as follows:

- the source State has the prior right of taxation;



- the source States right to tax limited, especially with regard to passive income;
- the residence State has an obligation to relieve double taxation.

All salary income received by or accrued to an individual, who is a non-resident, will be taxed in his/her hands only if the income was derived from a source within (or deemed to be within) the Republic.

For example

A lady performed a cabaret at Durban's Yardbarn Theatre during her stay in South Africa. She earned R500000 for this performance, and the payment was deposited into her bank account in London. She stayed in SA for 1 month, after which she returned to her permanent UK residence.

It appears that she is a non-resident. We thus look at the source of the income. The true source was indeed South Africa, being services rendered in South Africa. It follows that the R500000 will be included in Dame Andrews' "gross income" in South Africa. The next step is to determine whether there are DTA implications. Indeed there are - Article 16 of the DTA (signed 17/12/2002) between SA and the UK would confirm South Africa's rights to tax her on this income earned.

### **8.3 THE EFFECT OF DTA'S ON RESIDENTS**

SA has entered into DTA's with 47 foreign countries and is in the process of negotiating and finalising a further 33. DTA's are intended to eliminate double taxation with regard to certain classes of income by allocating the taxing rights between the two contracting countries. This allocation may be done on an exclusive taxing right basis for either the country of source or the country of residence. Alternatively, it may provide that the source country may tax a



certain class of income in which case the country of residence will be obliged to take into account the tax paid in the source country.

An integral part of all these DTA's is a definition of resident of a Contracting State. This term was taken from the OECD Model. This concept is of particular importance in determining to which taxpayers the DTA will apply and in solving cases where double taxation arises as a result of dual residence or double taxation arises as a result of taxation in the State of residence and taxation in the State of source.

Where a taxpayer is a resident of a Contracting State other than South Africa for the purposes of a DTA, it will be necessary to take into account the provisions of the Agreement (Treaty) before taxing any income.

Paragraph 1 provides a general definition for the Agreement and refers to the concept of residence for the purposes of domestic legislation. This paragraph reads as follows:

A resident of a contracting state means, any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that state in respect only of income from sources in that State or capital situated therein.

Definition of resident of a contracting state as defined in Par 1 of Article 4 of the OECD Model

Clearly cases will arise where a taxpayer will be regarded as resident in both Contracting States for the purposes of domestic legislation and it is therefore necessary to provide some other means for determining the resident State.

Paragraph 2 provides solutions to cases where individuals are resident in both Contracting States and sets out a step by step method of determining in which State the individual is resident. It reads as follows:



Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

- (a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
- (b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
- (c) if he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
- (d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

#### Par 2 of Article 4 of the OECD Model

Paragraph 3 provides a solution where a person other than an individual is resident in both States. It reads as follows:

Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

The problem of international double tax arises because of the different ways in which different countries levy tax. The purpose of DTA's is to resolve the conflict arising from source and residence, determine the taxing rights of



parties and set maximum levels of tax in situations where double tax is permitted.

*(Huxham : 2004)*



## CHAPTER 9

### REBATE FOR FOREIGN TAXES

#### 9.1 INTRODUCTION

Section 6quat of the Income Tax Act makes provision for a foreign tax credit for South African residents against their South African normal tax. These provisions have recently been extended and Interpretation Note 18 has been issued by SARS to clarify certain matters. With all the changes to the South African taxpayer's 'playing field' it is important for one to refresh oneself on the workings of this relevant section of the Income Tax Act. Section 6quat grants relief from double taxation by allowing a credit against the South African tax liability for taxes payable to a foreign government. The relief is limited to residents, as defined in section 1 of the Income Tax Act, and will only apply in respect of income actually derived from a source outside the Republic which is not deemed to be derived from a source within in the Republic.

According to the Explanatory Memorandum the question of whether income arises from a South African or foreign source remains important despite the introduction of the worldwide basis of taxation. Only foreign tax paid on foreign source income is eligible for section 6 quat rebate, even though South African residents are subject to tax on a worldwide basis.

Investment income includes, dividends, interest, rental, royalties and annuities other than purchased annuities. Where foreign dividends are discussed, these are limited to foreign dividends where the individual has a less than 10% share.



## **9.2 CONDITIONS GOVERNING THE GRANTING OF A REBATE**

The sum of foreign taxes payable may qualify for a rebate against the normal tax payable by a resident if the following conditions are met.

### **9.2.1 THE TAXES MUST BE PAYABLE ON INCOME**

Internationally taxes payable on capital gains are regarded as taxes on income. Thus any reference to taxes payable on income includes taxes payable on capital gains. A liability for interest, fines, penalties or any other similar obligation imposed in terms of the laws of a foreign country is not regarded as tax on income and does not qualify for a rebate.

### **9.2.2 THE TAXES MUST BE PAYABLE TO FOREIGN GOVERNMENT**

A government has many different levels, for example, national, state, provisional, local or any other level of government. Taxes imposed by any level of a foreign government will be regarded as taxed payable to a foreign government.

### **9.2.3 THE TAXES SHOULD BE PROVED TO BE PAYABLE IN RESPECT OF AN EXISTING FOREIGN TAX LIABILITY**

The rebate is not only granted for foreign taxes actually paid, but also in respect of which a legal obligation to pay exists.

### **9.2.4 THE TAXES MUST BE PAYABLE WITHOUT ANY RIGHT OF RECOVERY BY ANY PERSON**

The taxpayer must not be able to recover the taxes proved to be payable. An example of a right of recovery is where a resident may claim relief from foreign taxes in terms of an agreement for the avoidance of double taxation / tax liability.



### 9.3 QUALIFYING AMOUNTS OF INCOME DERIVED FROM FOREIGN SOURCES

In order to qualify for a rebate in terms of section 6quat the foreign taxes must be payable in respect of any of the following types of income derived from a foreign source which has been included in the resident's taxable income:

- a) Income received by or accrued to a resident from any source outside the Republic (other than a foreign dividend) which is not deemed to be from a source within the Republic or foreign dividends contemplated in section 9E of the Income Tax Act.
- b) An amount equal to a proportionate amount of the net income of a foreign company that is expressly included in the income of a resident in terms of section 9D of the Income Tax Act.
- c) Income derived by a resident in the form of foreign dividends.
- d) A taxable capital gain derived by a resident from a foreign source.
- e) Any amount dealt with in paragraphs (a) to (d) which has accrued to or has been received by a particular person, for example a trust, but which is deemed to be derived by another person (the resident).
- f) An amount dealt with in paragraphs a) to d), which forms part of the capital of trust established in a foreign country, which is regarded to be derived by a resident for either income tax or capital gains purposes.

In terms of section 6quat(1)(f)(iii) the gross amount (i.e. the taxable amount before the deduction of foreign taxes) in respect of income derived from a foreign source must be included in the taxable income of a resident.

The only exception is in respect of foreign dividends in which case a resident may elect to be taxed on the net amount (amount after the deduction of withholding taxes) rather than being taxed on the gross amount (amount before the deduction of withholding taxes) .



If a resident elects to be taxed on the amount of a foreign dividend any withholding tax paid in respect of that dividend is forfeited as a foreign tax credit.

Royalties received from the right to use or from the use of intellectual property (of a foreign source) in the Republic, are deemed in terms of section 35 of the Income Tax Act (with effect from years of assessment commencing on or after 13 December 2002) to be from a South African source. No foreign tax credit will be allowed in respect of foreign taxes paid on these amounts.

In cases where South Africa may tax foreign income (in terms of a Double Tax Agreement), the foreign tax paid can be taken into account for section 6quat so long as no relief has been granted in terms of the Double Tax Agreement.

#### **9.4 CALCULATION OF THE REBATE**

The gross amount of foreign income before the deduction of foreign taxes must be included in the taxable income of the resident, the only exception to this rule is in respect of foreign dividends where the resident may in terms of section 9E(6) of the Income Tax Act elect to be taxed on the net amount (after withholding taxes). In this case the foreign tax credit is forfeited.

As the rebate may only be claimed in respect of amounts that are included in the resident's taxable income, an amount that is fully or partially exempt, will result in the credit, in respect of the foreign tax paid or due, being forfeited in proportion to the exempt amount.

The rebate in terms of section 6quat is the *pro rata* amount of normal tax relating to the inclusion of foreign income in South African taxable income. The Income Tax Act calls for a limitation in the Foreign Tax Credit claimed for the year under review. This formula is as follows:



Taxable Income from foreign sources (A) x Normal Tax Payable (B)

Total Taxable Income (B)

1

Normal tax refers to South African tax calculated on taxable income before the deduction of section 5 of the Income Tax Act rebates (i.e. primary and age rebates)

A new proviso added to section 6 *quat* of the Income Tax Act provides that when calculating the foreign tax credit, the taxable income from the foreign source must take into account any deductions claimed in terms of contributions to retirement annuity funds in terms of section 11(n) of the Income Tax Act, donations to public benefit organisations in terms of section 18A of the Income Tax Act and medical deductions in terms of section 18 of the Income Tax Act apportioned on a pro rata basis between the income derived from the foreign source and the South African source, respectively. This effectively means that the foreign income included in taxable income must be reduced with the relevant *pro rata* share of these deductions.

Foreign investment income may be reduced by section 10 (1)(i)(xv) of the Income Tax Act interest exemption, however, this section now provides that for years of assessment commencing on or after 1 January 2003, only R 1 000 of the exemption may be utilised to exempt foreign investment income. Section 10(1)(i)(xv)(aa) provides further that the R 1 000 exemption must first be utilised against foreign dividends, then against foreign interest and lastly against South African interest income.

It must be also remembered that where spouses are married in community of property that all passive income must be shared 50/50 between them before the interest exemption is utilised. This split will also be applicable to the foreign taxes paid or due.



## 9.5 CARRY FORWARD OF FOREIGN TAX CREDITS

Where the sum of foreign taxes payable exceeds the amount of the rate the excess amount may be carried forward to the immediately succeeding year of assessment to rank as a foreign tax credit available for set off against the normal tax payable on foreign income in that year of assessment [section 6 quat (1B)(a), proviso(ii)(aa)].

The amount of the foreign tax credits which relates to the taxable foreign income derived during a year of assessment must firstly be utilised against the normal tax payable in that year before the balance of exceeds foreign taxes brought forward from the preceding year may be utilised against the remaining balance of normal tax payable.

Any foreign taxes paid in respect of foreign income that is exempt are prohibited from being carried forward and are forfeited. An excess amount not to be carried forward for more than 7 years calculated from the year of assessment when it was first time carried forward.

According to Interpretation Note 18, where a determination of an excess amount of foreign taxes is made for more than one year of assessment the excess amount determined for each year of assessment must be recorded separately and applied on a first – in – first – out basis against the normal tax payable in future years of assessment.

Where a resident has claimed a foreign tax credit in terms of section 6quat of the Income Tax Act in a previous year of assessment, and at a later date it is proved that the actual foreign taxes paid are more or less than the amount originally claimed, a revised assessment may be issued within 6 years from the date of the assessment in terms of which the rebate was first allowed (unless the amount was incorrectly reflected due to fraud or misrepresentation or non – disclosure of material facts).



## **9.6 THE RIGHT OF A RESIDENT TO CHOOSE BETWEEN THE RELIEF PROVIDED FOR IN EITHER SECTION 6 *QUAT* OR A TREATY**

In terms of section 6 *quat*(2) of the Income Tax Act a rebate may be granted in substitution but not in addition to any relief to which a resident is entitled under a treaty concluded with the foreign country concerned.

Some treaties specifically provide that relief may be granted for foreign taxes. A taxpayer may elect not to claim a rebate in terms of section 6*quat* but rather the relief provided for by the treaty. Where the relief provided for in a treaty is chosen none of the other relief granted in terms of section 6*quat*, for example the carry forward of the excess credit, will be applicable.

If no election is made the provisions of section 6*quat* of the Income Tax Act will be applied.

## **9.7 HOW SECTION 6 *QUAT* AFFECTS TRUSTS**

A resident trust is entitled to the same relief from double taxation as any other resident taxpayer. A proviso has been added to section 6*quat*.(1A) which provides that where a resident is a beneficiary of a trust which is resident in any other country, and the trust is taxed as a separate entity in that country, the proportional amount of tax which is payable by the trust which relates to the resident beneficiary's interest in the income of the trust, shall be deemed to have been payable by the resident beneficiary. The resident will therefore be entitled to claim a proportional amount payable by the trust as a foreign tax credit.

## **9.8 THE CONVERSION OF FOREIGN TAX CREDITS TO Rands**

Before the amendment of section 25D of the Income Tax Act on the 13 December 2002, all foreign income received or accrued was translated to Rand by applying the ruling exchange rate at the time that the income was received or accrued. Section 25D of the Income Tax Act now provides that depending on the circumstances, the foreign income must



be converted into Rands by applying the average exchange rate for the year of assessment in which the income was earned. It follows therefore, that the investment income will not be converted into Rands on the day that it accrued but rather at the end of the year of assessment, at the average exchange rate for the year of assessment.

In terms a new proviso, section 6quat(4), the foreign tax paid must also be converted to Rand on the last day of the year of assessment by applying the average exchange rate for that year of assessment.

In terms of the new proviso, section 6quat(4), the foreign tax paid must also be converted to Rand on the last day of the year of assessment by applying the average exchange rate for that year of assessment.

The average exchange rate is defined in section 1 of the Income Tax Act and can be calculated by using either:

- The closing spot rates at the end of daily, weekly or monthly intervals during that year of assessment
- The weighted average determined by using the closing spot rates at the end of daily, weekly or monthly intervals during the year of assessment during which the income was received or accrued. The average must be based on the net amount of receipts and accruals during such period.

The choice of methods must be applied consistently within that year of assessment. According to the Explanatory memorandum, by using the average exchange rate for a year of assessment, most currency gains or losses that arise during the year of assessment are diminished and some are not subject to tax.

South Africa, now a full force in the global economy, is involved in frequent trading activities (importing and exporting) with certain nations. Moreover, many international companies (e.g. McDonald's, Compaq,



and Nike) have flooded our economy and many more of our own businesses (e.g. Telkom, Vodacom, and Sasol) are flooding international economies. It is for this reason that we are required to know a lot more about foreign currencies because we are increasingly requested to convert foreign currencies to Rands - especially now that South Africa has adopted a "residence basis" of taxation policy. Many of our own businesses are now opening branches across the world, and it is a requirement that certain employees are assigned to overseas posts in order to expand their businesses. A frequent question raised by SARS clients, is "will I be taxed on my foreign income" or "am I considered to be a resident". Upon deciding whether or not these clients can be considered "residents", we may further be requested to convert their foreign income to South African Rands.

Below is a list of countries with whom South Africa trades frequently. Their currencies and Rand values (as at 11 September 2003) have been specified for your information.

*(Interpretation Note 18: 2003)*

## **9.9 CONVERSION RULES**

The rules that should be applied to convert foreign income to the South African Rand are as follows:

- Foreign Dividends: The conversion date is the date that the foreign dividend(s) accrued.
- Net Income of a Controlled Foreign Entity (CFE): The conversion date is the end of the financial year of the CFE.
- Other income: On the last day of the year of assessment (this is specified in section 25D of the Income Tax Act)
- Foreign Tax Credits: The conversion date is the date on which the tax was paid. Foreign Tax Credits attributable to a foreign dividend are converted on the date of accrual of the foreign dividend.



## EXAMPLE

A Lady, considered a 'resident' as defined, received a salary from France, amounting to €9500. This was for services rendered during the period 01/03/2002 to 31/12/2002. The average ruling exchange rates for the R/€ for the above period was:

$$€1 = R8.50$$

Required to convert the salary to Rands before the 2004 Income Tax Assessment can be finalised.

As the lady received a salary (other income), s25D of the Income Tax Act states the amount should be converted to Rands on the last day of the year of assessment. The calculation would therefore be as follows:

$$€9500 \times 8.50 = R80\,750$$

We would therefore include R80 750 in the lady's 2004 Income Tax Assessment (as foreign income).

An example showing the application of section 6 *quat* is as follows:

Mr. B is a South African resident. During the year ended 29/02/2004, he had SA Taxable Income (non-retirement funding) of R250 000 (before accounting for RAF). Mr. B contributed R30 000 towards a RAF during the year. He also received foreign income of R125 000 from Norway. Since the tax rate in Norway is quite high, Mr. B paid R40 000 tax to the Inland Revenue of Norway on his foreign income. Calculate his tax liability for 2004.



ANSWER

	SA Income	Foreign Income	TOTAL
Income	250000	125000	375000
RAF	-20000	-10000	-30000
Taxable Income	230000	115000	345000
Normal tax on R345000			110 100

Calculation of s 6quat Rebate

Amount claimed	R40 000
Limitation (see below)	<u>R36 700</u>
Balance carried forward to 2005	<u>R 3 300</u>

Tax Liability Calculation for 2004

Normal tax Payable	R110 100
Less Primary Rebate	<u>-R 5 400</u>
R104 700	
Less s 6quat credit	<u>-R 36 700</u>
DUE BY YOU	<u>R 68 000</u>

Limitation

Taxable Income from foreign sources (A) x Normal Tax Payable (B)

Total Taxable Income (B) 1

= R 90 000 x R 110 100

R 270 000 1

= R36 700



In conclusion section 6 *quat* is a section which is aimed at providing relief against double tax, by allowing as a rebate against South African tax, any foreign tax paid in respect of the same income or subject matter. The rebate is, however limited to the South African tax arising from the foreign income.

*(De Hart: 2004)*



## CHAPTER 10

### OTHER RELATED PROVISIONS

#### 10.1 TRUSTS

In terms of the act, a trust is treated as a person. The definition of “trust” was inserted after it was held in *CIR v Friedman NNO 1993 1 SA 353 (A)* that as the trust is not a person under the common law, it is also not a person for Income tax purposes. Section 25B(2) of the Income Tax Act provides that where, in a particular year of assessment, the income of the trust vests in the beneficiaries due to the provisions of a trust deed or the exercise of discretion by trustees, it is taxed in the hands of beneficiaries. Where the beneficiaries are not entitled to trust income, the trustees are liable for tax on the income in their capacity as representatives of the trust.

Similarly, the beneficiaries or the trust are permitted deductions and allowances to the extent that the trust income is taxable in the hands of the beneficiaries or the trust. However, as a result of an apparent abuse of trusts, sub – sections 4 to 6 of section 25B were introduced in 1998 to limit trust losses for beneficiaries up to the amount of the trust income which accrued to them.

According to the explanatory memorandum, the introduction of the residence basis of taxation could create practical difficulties with regard to the application of section 25B. This is due to the fact that the respective residences of the trust and its beneficiaries create many possibilities.

To counter the manipulation of residency by beneficiaries, initial drafts of the bill proposed the repealing of most of section 25B, which would have resulted in common law principles being applicable. In addition, a specific provision would have been inserted to ensure that trust losses did not flow through to the trust’s beneficiaries. Much criticism was leveled against the proposed



provision, as it effectively produced more questions than answers. Amongst other things, the proposal would have resulted in losses incurred under a vested trust never being deductible.

The amendment act does not repeal section 25B. Instead, the section is amended to ensure that beneficiaries who acquired a vested right either due to the exercise of a discretion by trustees or the provisions of a trust deed, will not be entitled to claim a deduction of expenditure or allowances to which the trust would have been entitled. The result is that the flow – though principle will only be applicable to beneficiaries with discretionary rights as far as trust income is concerned and not as far as trust deductions or allowances are concerned.

When dealing with discretionary trusts, deductions and allowances can only be claimed by the trust. The impression is thus gained that the amendment is aimed at forcing trustees to retain trust income and pay tax at the higher rate applicable to trusts other than special trusts (currently 32% on the first R 100 000 of taxable income and 42% on income in excess of this amount). The question of whether trust income distributed to trust beneficiaries in a subsequent year of assessment retains its character as income remains unanswered. In *SIR v Rosen 2 SATC 249* it was held in passing that when income is not distributed in the year in which it is received by or accrues to the trust, it loses its character. It may be argued that such income forms part of the trust capital. The result is that the beneficiary is not liable for income tax on the distribution in subsequent years. The distribution will also not be subject to capital gains tax. (CGT) from 1 April 2001, as CGT will not be levied on cash dispositions.

However, our courts have never properly tested the proposition laid down in the Rosen case. The result is that the SARS can argue that a beneficiary is also subject to tax on distributions by the trust in years of assessment subsequent to the year in which income is derived. Although strictly speaking this will amount to the same income being taxed twice, it is not defined as double taxation, since two different taxpayers are involved.



As a beneficiary with discretionary right cannot make use of trust deductions or allowances, it follows that the limitation on losses that may be claimed by beneficiaries is only applicable to beneficiaries who acquired vested rights can never claim a deduction of any trust expenditure, allowance or loss to which the trust might have been entitled.

Specific rules regulate distributions from non – resident South Africa trusts. Section 25B(2A) provides that where a South African resident beneficiary acquired a vested right to capital is deemed to be income of the South African resident trust, the capital is deemed to be income of the South African resident if it is paid out of income of the trust to which the South African resident had a “contingent right” in previous years and the trust income was not taxed in South Africa. The result is that it can never be argued that income distributed by a foreign trust in a year subsequent to that in which it accrued to or was arrived at by the trust, is excluded from income. Uncertainty exists as to whether the beneficiaries will be entitled to a pro rata portion of trust deduction and allowances.

An interesting amendment to the relief provisions in section 6 *quat* has been introduced. Under this amendment if a resident is a beneficiary of a non South African resident trust and the trust is taxed in that country, he may claim a credit of the proportional amount of tax paid by the trust. At first sight this amendment seems difficult to reconcile with the CFE provisions (section 9D). However, it seems as if trusts will no longer fall under CFE legislation. This is due to the definition of a foreign entity in section 9D is no longer applicable in the determination of which trust income will be attributable to a South African resident beneficiary. The only question which need to be answered is whether the distribution forms part of the beneficiary’s taxable income either because it is part of his or her gross income or because it falls under the provisions of section 25B(2A). If it is included, the beneficiary will be entitled to a proportional amount of the tax paid by the non – South African resident trust.



In addition, two further amendments dealing with the taxation of trust income were introduced. First, where a trust beneficiary with a vested right does not have sufficient income in a particular year to offset deductions and losses, and the trust is not subject to tax in South Africa, the beneficiary can claim a deduction in the immediate succeeding year of assessment.

Secondly, where a beneficiary with a vested right is not subject to tax in South Africa, the limitation on deductions is not applicable. This amendment is difficult to understand, as it is not up to the South African legislature to decide on the extent of deductions that may be taken into account in determining tax liability in a foreign jurisdiction.

It is clear that the last word on the taxation of trust income has not been heard. What is also clear is that denying beneficiaries with discretionary rights the right to claim a proportional deduction of trust expenses and allowances, will severely curtail the use of discretionary trusts.

## **10.2 ROYALTIES AND SIMILAR PAYMENTS**

Previously, section 35 provided for a 12% withholding tax on certain royalty payments to non – residents. In the case of corporate taxpayers, the withholding tax exceeds the actual tax payable, as the section provided that 30% of the royalty income is taxable. This means that the tax rate was 9% (30% of the royalty income taxable at a 30% company rate). Non – residents were entitled to submit a tax return and claim the excess back.

The section has been amended to provide for a 12% final withholding tax on royalties.



## 10.3 SECONDARY TAX ON COMPANIES (STC)

### 10.3.1 DIVIDENDS

STC is only payable by any company that is a resident. The net amount of a dividend in respect of which secondary tax on companies is payable, is:-

- the amount by which the dividend declared by a company exceeds the sum of any dividends (other than any dividends contemplated in subsection (5)(b), (c),(d) and (f); any foreign dividends as defined in section 9E, but including foreign dividends which are exempt in terms of section 9E(7)(c), (d) (e)(ii), (iii) or (iv) or (f), or section 9E(8A), which have during the dividend cycle in relation to such first mentioned dividend accrued to the company.

This provision came into operation on 23 February 2000, and shall apply in respect of any foreign dividend.

- (i) received by or accrued to any company on or after that date; or
- (ii) received by or accrued to a company before 23 February, but which is received on or after that date:

Provided that the provisions of this paragraph shall not apply in respect of any foreign dividend which was declared by a company before 23 February 2000, where

- a. the company declaring the dividend is listed on a recognised stock exchange ; or
- b. in any other case, the chief executive officer, and
  - A. an external auditor of the company declaring the dividend; or
  - B. where the company declaring the dividend is situated in a country which does not require compulsory appointment of an external auditor, a registered public accountant of the same standing as a qualified chartered accountant, have declared under oath or affirmation that such dividend was



actually declared by the company before 23 February 2000.

If a dividend subject to STC has been declared by a company which derives profits from sources within and outside the Republic, the secondary tax on companies in respect of that dividend shall be calculated on an amount which bears to the net amount of that dividend the same ratio as the sum of the net annual profits of the company derived from

- (i) sources within or deemed to be within the Republic in terms of section 9 and
- (ii) sources outside the Republic which are not deemed to be from a source in the Republic and which are not exempt from tax in terms of the provisions of section 10(1)(kA).

### **10.3.2 DEEMED DIVIDENDS**

“Recipient” previously referred to:

- (a) any shareholder of a company;
- (b) any relative of the shareholder of the company;
- (c) any trust of which the shareholder of the company or his relative is a beneficiary.

The term has now been extended to refer to:

- any shareholder of a company;
- any connected person in relation to a shareholder.

Any loan granted in respect of which a rate of interest not less than the “official rate of interest”, as defined in paragraph 1 of the Seventh Schedule is payable by a recipient would not be regarded as a “deemed dividend”, irrespective of whether it is denominated in the currency of the Republic or in a foreign currency.



Any loan granted to a recipient which is a company by any other company which holds for its own benefit, whether directly or indirectly, any of the equity share capital of such recipient company, would not be regarded as a "deemed dividend", provided that such recipient company does not hold any of the equity share capital in such other company.

### **10.3.3 FOREIGN TAX CREDITS**

An excess foreign tax credit determined after the set-off of foreign taxes against normal tax may not be set-off against STC

No rebate will be allowed to any resident:

- ◆ or resident company, which together with any other company in a group of companies of which the resident company forms part, holds for its own benefit less than 10 % of the equity share capital in the company distributing the dividend.
- ◆ company which does not have a qualifying interest in the company distributing the foreign dividend. This is an interest of at least 10 % in the equity of a company, (called, say, Company A), and includes an interest held by Company A of at least 10 % in the equity of any other company, and so on. Thus, if Company A holds 10 % of Company B, which holds 10 % of Company C, all three fall within the definition.
- ◆ who has made an election in terms of section 9E(6)

In order to cater for situations where the foreign tax liability has changed after the initial crediting of such tax, a provision has also been inserted to allow for the issue of reduced or additional assessments for a period of up to 7 years from the date of the original assessment, to give effect to such adjustments. An example of a situation where the foreign tax liability will change is where the taxpayer has objected to his assessment in another country, and a reduced assessment is issued.

*(The Income Tax Act : 1962)*



## **CHAPTER 11**

### **CONTROLLED FOREIGN ENTITY**

#### **11.1 INTRODUCTION**

Exactly how complicated and controversial residence based taxation is, becomes clear when dealing with controlled foreign entities (CFE's). The concept of CFEs was first introduced in the Income Tax Act during 1997 in terms of section 9(1) of the Income Tax Act 28 of 1997. In the absence of the relevant provisions, South African income tax on foreign income could potentially be avoided by having the income accrue to and be retained by a separate foreign entity, such as a company. But if the entity is South African resident controlled, its income will be subject to South African income tax under section 9D of the Income Tax Act, proportionately in the hands of South African Income Tax under section 9D, proportionately in the hands of South African resident controllers.

Until the latest amendments, section 9D provided for the taxation of passive or investment income only. Under the new legislation the definition of CFE will not be amended, but all foreign income, including active income, will be included in the tax net.

The term participation rights is defined in section 9D(1) of the Income Tax Act as "the right to participate directly or indirectly in the capital or profits of, dividends declared by, or any other distribution or allocation made by, any entity". From this definition it is clear that the definition is extremely broad and includes, for example preference shares.

A CFE exists where South African residents, whether individually or jointly, directly or indirectly, hold more than 50% of the participation rights or are entitled to exercise more than 50% of the votes or control of the foreign entity.



## **11.2 COMPUTATION**

The income imputed to the resident is equal to the proportional amount of the net income of the CFE, calculated in the same ratio as the participation rights of the resident in the CFE. In this regard, the net income of a CFE is the amount that equates to what the CFE's taxable income would have been had the CFE been a South African resident.

In calculating the net income of the CFE, available deductions and allowances are restricted to the income of the CFE, that is ringfencing applies. However, no deduction is allowed for interest royalties or rental paid by one CFE to another. To the extent that the CFE would have had a tax loss, had all available allowances and deductions been granted, the South African resident to whom the CFE's income is imputed cannot use the loss, but it may be carried forward to be offset in future years of assessment. The result is that the assessed loss may not be set off against income derived from other trades carried on outside the Republic, but has to be carried forward to be offset against future income of the CFE. It is clear that as far as assessed losses are concerned, CFE's are in a worst position than other entities. Although foreign deductions may generally not be offset against income derived from another foreign trade. For example, if a South African resident has a CFE in Singapore in respect of which an assessed loss is made, this loss cannot be offset against income derived from a CFE that the resident has in Ireland.

However, had the foreign entities not been CFE's the loss could have been offset against the income. CFE's are thus in a sense penalised twice: firstly by attributing the income to the South African resident and secondly by not allowing losses to be offset against other foreign income.

## **11.3 EXCLUSIONS**

### **11.3.1 THE 10% RULE**

An exclusion applies in that income of a CFE is only imputed to a South African resident to the extent that he, she or it, together with any connected



person, holds in aggregate at all times during the foreign year of assessment at least 10% of the participation and voting rights in the CFE. Holdings of less than 10% are not imputed to the South African resident. For example:

- If nine South African resident unconnected persons each hold a 9 % interest in a CFE. It is still a CFE, but its income is not imputed to them;
- If three South African resident unconnected persons hold a 40%, 9% and 6% interest respectively. The income of the CFE is only imputed to the resident having the 40% interest. As the 10% requirement is applicable to the entire foreign year of assessment, an increase to above 10% in either the voting or participation rights for even a short period during the year results in the income being imputed to the South African resident.

### **11.3.2 DESIGNATED COUNTRY**

Where a CFE is a company and has income that has been or will be subject to tax in a designated country at a statutory rate of least 27% (after taking into account the possible application of a double tax agreement) and the designated country taxes such income on a similar basis to South Africa, the income of the CFE is not imputed to the South African resident participants.

Not to undo this exclusion, dividends declared by the CFE are also regarded as exempt income of the South African resident shareholders, in accordance with section 9E. The reason why subsequent dividends will also be exempt from tax is because the underlying profits out of which the dividend is declared will already have been subject to tax in the designated country at a rate of at least 27%.

### **11.3.3 BUSINESS ESTABLISHMENT**

Income of a CFE, which is a company, and which is attributable to a legitimate business establishment carried on outside South Africa, is not imputed to the CFE's resident participants / shareholders. In these instances, the tax is deferred until a dividend is declared.



Complicated and lengthy provisions have been introduced to establish whether the exclusion is available. A three step approach is followed:

**The first step: objectively determine whether there is a business establishment, that is:**

- i. An office, shop, factory, warehouse, farm or other structure that was used or continued to be used by the CFE for a period of at least one year;
- ii. A mine, oil or gas well, a quarry or any other place of extraction of natural resources; or
- iii. A site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude that lasts for at least six months;

Though which business is carried on, and provided that:

- a. The place of business is suitably equipped with on – site operational management, employees, equipment and other facilities for the purposes of conducting its primary business, and
- b. The place of business is maintained in a country outside South Africa for *bona fide* business purposes (other than tax avoidance, postponement or reduction).

From the above requirements it is clear that the exemption is not available if the foreign business merely exists in paper and not in substance. It is not sufficient to have employees who cannot take management decisions at the foreign business: persons who take the day to day management decisions (operational) also need to be present, *SIR v Downing* .

In deciding whether business is conducted outside the Republic for *bona fide* business purposes, the commissioner need not have regard to the requirements of the general anti – avoidance section, section 103(1). It is sufficient if, on the facts, the reason for moving the business outside the borders of South Africa is to avoid, postpone or reduce tax.



**Second step: determine whether the business establishment is excluded from the exclusion**

These exclusions cover transactions where the possibility for transfer pricing exists between a CFE, which is a company, and South African resident connected persons and certain types of income, as regulated by the provisions of section 31 of the Income Tax Act. Broadly speaking there are three different categories (one being divided into three sub – categories):

- i. category one: transactions for the sale of goods or the rendering of services between a CFE, and a South African resident connected person, unless the consideration for the transaction is at arm's length and consistent with section 31;
- ii. category two:
  - a) a sale of goods by a CFE to a South African resident connected person, unless the CFE purchased the goods in the country in which it is resident from an unconnected person; the creation, extraction, production, assembly, repair or improvement of goods undertaken by the CFE amounts to more than minor assembly or adjustment, packaging, repackaging and labelling or the CFE sells a significant quantity of similar goods to unconnected persons at comparable prices;
  - b) a sale of goods by a CFE to persons other than South African resident connected persons, where the CFE initially purchased the goods or tangible intermediary inputs from one or more South African resident connected persons, unless the goods or tangible intermediary inputs purchased amount to an insignificant portion of the total tangible intermediary inputs of the goods; the creation, extraction, production, assembly, repair or improvement of goods undertaken by the CFE amount to more than minor assembly or adjustment, packaging or repackaging, or the products are sold by the CFE to unconnected persons for delivery within the country in which the CFE is resident,
  - c) a service performed by a CFE for a South African resident connected person, unless the service is performed outside South



Africa and relates to the creation, extraction, production, assembly repair or improvement of goods utilised within one or more foreign countries, or relates directly to the sale or marketing of goods of a South African resident connected person and are sold to unconnected persons for delivery in a country in which the CFE is resident;

- iii category three: income in the form of dividends, interest, royalties, annuities, rental, insurance premiums or income of a similar nature, except if the receipts and accruals are less than 5% of the total receipts and accruals of the CFE; or arise from the principal trading activities of any banking or financial services, insurance or rental business, except if the income is received from a South African resident connected person; or from a resident as part of a scheme for the avoidance of taxes, duties or levies.

The exclusion granted for taxpayers conducting banking, financial, insurance or rental activities under the second step will significantly help these taxpayers if they operate in a low tax jurisdiction (tax rate lower than 27%)

**Third step: in relation to category two under step two, the exclusion from section 9D of the Income Tax Act may be reinstated if the minister:**

- i. by general notice in the Gazette treats one or more foreign country as one, provided that the foreign countries reflect a single economic market and the treatment does not lead to an unacceptable erosion of the tax base, or
- ii. in consultation with the commissioner, waives the application of the subsection to the extent that its application will unreasonably prejudice national economic policies or South African international trade, provided that the waiver does not lead to unacceptable erosion of the tax base.



#### **11.3.4 SOUTH AFRICAN TAXABLE INCOME**

Logically, the income of a CFE is not imputed to a resident if the CFE itself is already subject to South African tax, for example where the income is derived from an actual or deemed South African source.

#### **11.3.5 DIVIDENDS**

Dividends declared to a CFE by another CFE (in relation to a South African resident) are also not imputed to the resident.

#### **11.3.6 INTEREST, ROYALTIES OR RENTAL**

Likewise interest, royalties or rentals paid to a CFE by another CFE (in relation to the South African resident) are also not imputed to the resident. As section 9D(2A)(c) of the Income Tax Act will specifically prohibit the deduction of interest, royalties or rentals paid by one CFE to another, it is only fair that the interest, royalties or rentals paid by one CFE to another, it is only fair that the interest, royalties or rental received by the latter should not be imputed to the South African resident.

### **11.4 REPORTING IN TERMS OF SECTION 72A OF THE INCOME TAX ACT**

Strict reporting of both the participation rights of South African residents in a CFE and the income of the CFE, have been introduced. These apply to a South African resident who:

- i. Directly or indirectly holds 10% or more of the participation rights or voting rights or control in a CFE; and
- ii. Together with any connected person in relation to the resident, holds more than 50% of the total participation or voting rights or control in a CFE.

Some relief exists in that the reporting requirements are only applicable to the resident who holds the greatest percentage of the participation rights in the CFE.

The following information about the CFE will have to be provided:



- i. Its name, address and country of residence;
- ii. A description of the various classes of its participation rights;
- iii. The percentage and class of participation rights held by the resident, whether directly, indirectly or together with connected persons;
- iv. The percentage and class of participation rights held by any other South African resident (who is a connected person in respect of the resident) who directly or indirectly holds 10% or more of the participation rights in the CFE;
- v. A description of the receipts and accruals of the CFE that are included in and exempt from the income of the South African resident under section 9D; and
- vi. A description of any amount of tax paid by the CFE to the government of any other country on income, including particulars relating to the country in which the tax was paid and the underlying profits to which the foreign tax relates.

As if this were not enough, the South African resident must also provide some of the relevant information to any connected person who is a South African resident and who holds at least 10% of the participation rights in the CFE. On receiving the information, the other resident must then also submit it to the commissioner. In addition, if so requested, the South African resident must submit an income statement and balance sheet of the CFE prepared in pursuance of either the laws of the country of which the CFE is a resident, or of internationally accepted accounting practice.

Failure to comply with the reporting requirements shall result in certain of the exclusions to the imputation of the net income of CFE to a South African resident being inapplicable.

*(National Treasury detailed explanation to S 9 D: 2003)*



## **CHAPTER 12**

### **INTERNATIONAL ASPECTS OF SOUTH AFRICAN LEGISLATION**

**12.1** From the perspective of the South African tax advisor, international tax involves no more than understanding how the South African tax system will interact with that of a foreign country, either when cross – border investment occurs, or when there is a flow of funds in some or other form between the two countries. This cross – border investment could take place without any form of presence in the foreign jurisdiction, especially in this day and age of the Internet and e – commerce (for example, the sale of goods, the distribution of a product, the franchising of a concept, the licensing of intellectual property, the rental of movable property or a portfolio fund investment)

Alternatively, an investment may require some form of presence, for example, a branch, subsidiary, joint venture or partnership. This more active form of investment usually also necessitates the cross – border transfer of individuals who will work and earn remuneration outside South Africa, their usual country of residence with potential tax consequences, as well as planning opportunities, in both South Africa and the host country.

The interaction of the South African tax system with that of a foreign country will usually need to be considered in the following two circumstances:

- i. Where South African resident companies and individuals derive income from foreign countries (outward trade/ investment) – in this case an understanding of the South African provisions for the taxing the foreign income of resident taxpayers is essential; and
- ii. Where non – resident companies and individuals derive income from South Africa (inward trade/ investment) – this brings into operation the provisions for taxing the domestic source income of non – residents.



South African companies (and individuals) have historically operated on the assumption that, because of the source basis of taxation and the exemptions for dividend income and capital gains, offshore profits they earned would be subject, at most, to one level of taxation – in the foreign jurisdiction. The combination of the recent introduction of the world – wide basis of taxation for South African residents, together with the taxation of foreign dividends and the potential attribution of all the profits of a controlled foreign entity, whether or not distributed, to its South African resident shareholders, the extension (some would say limitation) of the foreign tax credit provisions and the introduction of capital gains tax (CGT) have all resulted in a significant review of the international tax planning strategies of many South African companies with cross- border operations or transactions. As far as non – residents are concerned; the source basis remains intact, unless varied by a tax treaty.

In order to identify the appropriate structure for inward investment into a foreign country, the South African tax advisor cannot be expected to have a perfect knowledge of the foreign tax system in question, but the needs to be in a position to raise the questions which will enable him to identify the foreign tax issues which may impact the cross – border transaction in question, for example, what is the basis for the imposition of tax in a foreign jurisdiction? If residence and / source are relevant, how are these terms defined? Does the choice of legal entity affect the foreign tax proposed business activity? In an acquisition scenario, should shares or assets be purchased? Will there be any foreign capital gains tax consequences on the disposal of the investment has been identified from a foreign perspective, this need to be co- ordinated with the most appropriate structure from the South African perspective for outward investment.

The domestic taxing provisions of both the tax systems, however may also be significantly restricted by a tax treaty concluded between the treaty partners (from a South Africa perspective, there are presently some 80 such treaties either in force or at various stages of signature, ratification or negotiation). These treaties, for example, may require a certain threshold of activity in the source country before a tax liability is incurred there or may reduce domestic



withholding taxes on pre or post – tax income remittances to the investor recipient or may oblige one country to grant a credit for the full notional foreign tax that would have been payable by the resident, in the absence of particular tax incentives afforded by the foreign country to the South African ‘resident’ (known as ‘tax sparing’).

A financial director in South Africa now requires answers to a plethora of important questions in his endeavours to minimize his company’s worldwide tax burden in order to enhance shareholder value, for example:

- In light of the company’s present effective South African tax rate, is the best strategy to retain post – tax profits offshore (exchange control permitting) or remit them back to South Africa, and in which foreign countries is foreign tax reduction now paramount
- Where foreign tax reduction is a priority for the South African entity, issues which will merit consideration include the identification of tax efficient suitable locations for a company’s business activities and the potential for the ‘arms length’ geographical fragmentation of activities and risks (where there is operational flexibility) so as to maximize opportunities for the locating profits in tax advantageous jurisdictions, the use of debt finance to leverage foreign operations (subject to thin capitalization – debit/ equity – restrictions in that country), the selection of an appropriate legal vehicle through which to conduct business, maximizing the use and preservation of losses (especially during the start up phase of a business), the effective utilisation of third country intermediate special purpose vehicles to extract foreign profits, whether in the form of tax deductible payments or after tax distributions, with the lowest tax cost;
- How do the provisions subjecting foreign dividends and profits to tax and the relevant exemptions (section 9E and 9F of the Income Tax Act) and those granting a credit for foreign taxes against South African tax payable (section 6 *quat*) impact the company’s ability to repatriate profits to South African tax efficiently and also its overall effective tax rate





- In what circumstances is it still possible to deter South African tax on income (and potentially also on capital gains) in a tax haven or low tax subsidiary off shore until a dividend is paid back to South Africa in light of the controlled foreign entity provisions (section 9D). The use of such a subsidiary could be particularly effective where tax deductible payments can be made to it from subsidiaries in foreign countries with high tax rates.
- May losses incurred in respect of foreign operations be set off against South African income (or vice – versa) or may losses incurred in foreign countries only be set off against income from foreign sources
- In light of the differential rates applicable to income and capital gains, would be preferable to convert income into capital, for example, to hold an offshore subsidiary directly from South Africa, rather than through an offshore holding company which may on disposal, remit its capital proceeds by way of a fully taxable dividend
- When will the transfer pricing provisions contained in section 31 of the Act adjusting the non arms length pricing of transactions with related entities in foreign jurisdiction lead to double taxation.
- What is the most tax – efficient manner now in which to structure and finance an offshore operation/ acquisition, bearing in mind the potential taxability of foreign profits/ dividends but the limitations on the deductibility of interest expense incurred in connection therewith

South African resident individuals, too are far from immune from the cross – border interaction of the South African tax system. The relaxation of exchange controls and the use of Reserve Bank approved foreign direct currency transfers by local insurance companies and unit trust funds have led to the investor being exposed indirectly to a multitude of offshore portfolio investment vehicles – open ended or closed ended mutual funds structured as investment companies, trusts, partnerships or other transparent entities (most of which would fall outside the South African controlled foreign entity provisions). In some cases income is paid either by way of dividends or other forms of distribution such as the redemption of preference shares (via share



capital or share premium) or the repurchase of such shares. In some cases income is rolled up while in other cases foreign income is wrapped in an investment products will have South African tax consequences for the investor, which will be further complicated where, for example, the investment has been routed via an offshore trust. Once the investor has addressed the challenge of introducing the funds into the trust with no adverse South African tax consequences, the potential income tax and capital gains tax liabilities for the trust itself and / or resident beneficiaries will now need to be weighted against the traditional estate duty saving.

International tax planning, similar to tax planning in the domestic context, presents opportunities for legitimate tax avoidance, however, there has recently been an increase in the anti-avoidance legislation enacted by countries to deal with certain forms of tax avoidance. South Africa, for example, has a general anti-avoidance provision in the form of section 103(1) of the Income Tax Act however, whether the South African Revenue Services (SARS) would be successful in attempting to apply this provision to international transactions within the ambit of a tax treaty supported by the concepts of substance over form and sham transactions which would allow SARS to reclassify a transaction so as to deny the intended tax benefits.

Specifically in the context of international transactions, the transfer pricing and thin capitalization provisions, the CFE rules and the imputation of income provisions also need to be considered. Planning is made even more complex by the fact that such provisions must be interpreted in the light of any tax treaty that may exist between South Africa and the country in question which may itself contain its own anti-avoidance provisions. The particular articles of each individual treaty must always be examined, on a case-by-case basis, to ascertain whether the treaty contains its own anti-avoidance provisions to prevent 'treaty shopping' by restricting the benefits afforded by the treaty to bona-fide residents of the treaty countries, who, in certain cases, may also have to beneficially receive the income in question. In addition, certain entities with domestic tax favoured status, although resident, may be expressly excluded from the ambit of the tax treaty, while the exchange of information article can be effective in policing full disclosure. Let



us also not forget that the present system of exchange controls is also effective, to a degree, in controlling tax avoidance in the international context.  
(*Eskinazi : 2002*)



## **CHAPTER 13**

### **CONCLUSION**

The year 2001 saw the replacement of a source basis of taxation with a resident basis. In the 2000 budget it was announced that for years of assessment commencing on or after 1 January 2001, South African residents would be subject to income tax on their worldwide income. This applied to natural persons from 1 March 2001 and for other taxpayers for financial years commencing after 31 December 2000.

The above proposal was the subject of much discussion and at least seven drafts, and doubt existed as to whether parliament would accept the relevant legislation before its commencement date. The Revenue Laws Amendment Act 59 of 2000 (the amendment act), which amended the Income Tax Act 58 of 1962 (the act), was finally accepted by parliament on 9 November 2000.

In line with most foreign countries with residence based taxation, South African non – residents could remain taxable on their South African actual or deemed source income. However, most of the existing deemed source provisions have been repealed, either due to the fact that residence based taxation would make them redundant, or because to retain them would impose too wide a liability on non – residents.



The amendment Act introduced far – reaching amendments and the tax net has been significantly broadened.

A residence base of taxation is usually justified on the basis that as a resident enjoys the protection of the country in which he/ she resides, even if the income is earned outside the state. The source basis of taxation, on the other hand, ignores a person's place of residence and levies tax on income derived from its natural resource or from activities conducted within its borders.

Source as a basis of taxation is usually adopted by developing and net capital importing countries, and that of residence by developed and net capital exporting countries.

Countries usually do not apply either of the two principles in a pure form, but modify them to find some common or middle ground. Countries that adopt a residence basis of taxation adopt an element of the source principle in that they tax non – residents on income generated within their domestic economy. Likewise, countries that adopt a source principle have extended their tax nets by deeming certain income derived by their residents to be from a domestic source.

The problem is that many taxpayers are of the opinion that SARS is not in a position to apply the RBT provisions or detect foreign income and capital. Unfortunately that is not the point.



The onus is now on the resident to disclose foreign income and capital. Failure to do so will result in the imposition of penalties, interest and, in some cases, criminal charges if or when SARS uncovers undisclosed foreign income and structures. As SARS gathers strength and the international community brings more and more pressures on the tax havens, the prospects of detection will become far greater. Thus, foreign investments within the tax havens have the potential to become "grey money" if not disclosed in the 2002 year of assessment.

It is submitted that an integral aspect of any investment strategy is immediate and uncontrolled access to investments. Access to grey money is inevitably going to become more difficult and therefore one must reconsider its inherent worth.

Gone are the days that the taxpayer can wiggle a way out of a non-disclosure problem with SARS by applying a few rugby test tickets or a 'bottle of alcohol. The enhanced penalty provisions of the Act will be applied on a "take no prisoners basis". Given that the onus in all tax matters is on the taxpayer and not SARS, this means that a transgression of the Act made today may result in horror in the future.

### **Section 6 *quat***

The section 6 quat of the Income Tax Act is described by SARS as being a key component in any worldwide tax system. The treatment of allowing South African taxpayers to claim the rebate on all levels of income tax paid to the



foreign government should assist in putting South African taxpayers on a level playing field with taxpayers in a foreign country.

### **Double Taxation Agreements**

In the circumstances it is thus clear that South Africa has a long way to go with reference to the implementation of the Double Taxation Agreements (DTAs) concluded by it. Not only is it of paramount importance that the older DTAs based on the Organisation for Economic Co – operation and Development's (OECD) model be renegotiated, but there is a dire need to implement an appropriate mechanism with reference to South Africa's neighbours.

The move to a residence base of taxation will have a dramatic impact on every South African resident taxpayer who derives foreign income. Although foreign income will in future fall within the South African tax net, the income may qualify for an exclusion or exemption. However, to figure out the exact tax position is no easy task.



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