

**The source of income in South African income tax law and the
inward and outward structuring of investments into and out of
South Africa**

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**Thesis presented in partial fulfilment of the requirements for the
degree of Master of Laws at the University of Cape Town.**

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Executive Summary

South Africa will shortly be a full member of the international community. This will result in both inward and outward investment. The South African income tax system is based on the source of income. There is a limited reliance on the residence principle. It is essential to understand the scope of the source principle in both inward and outward investment. This thesis attempts to discuss these issues. It is a fascinating part of tax planning which will become more and more prevalent over time. Brief reference is made to the jurisprudential basis for income tax as also a comparative survey of other jurisdictions where reliance is placed on the source principle.

Acknowledgements

I wish to express my gratitude to Prof. D Davis (under whose chairmanship the 1990 LLM (Tax) programme at the University of Cape Town took place) for most of what I learnt about income tax including, but not limited to, conceptualising tax issues.

I also wish to thank my wife, Tina, for her patience, who has grown used to seeing me reading mostly tax literature.

Corrigenda

- (1) Chapter 1 ends on page 37. Chapter 2 begins on page 35. There is accordingly an overlap of these two pages.

- (2) Footnote 38 must appear with the reference of Firestone's case on page 68, not with Lehmann and Coleman on the same page. The reference to Lehmann and Coleman should be to page 883 of their work.

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- South African fiscal jurisdiction

An introduction to sovereignty

1. States have virtual unlimited jurisdiction to regulate the affairs of persons and things within their territory. Jurisdiction is mostly called into dispute when States exert their authority extra-territorially. Fiscal jurisdiction lends itself to extra-territorial effect and application. The latter is mostly resolved by mutual agreement between States by way of the double tax treaty network.
2. The following issues have been identified as being of interest to a broad discussion of fiscal jurisdiction:
 - 2.1 An introduction to sovereignty;
 - 2.2 The classifications of sovereignty;
 - 2.3 The constituent elements of jurisdiction;
 - 2.4 Basic concepts of the doctrine of jurisdiction;
 - 2.5 The basis of the jurisdiction to tax;
 - 2.6 The fiscal law relationship;
 - 2.7 Fiscal attachment;
 - 2.8 The source verse residence principle;
 - 2.9 South African fiscal jurisdiction.
3. **RSJ Martha** in her study "**The Jurisdiction to Tax in International Law**" states the following at page 7:¹

"The thesis of this study is that if jurisdiction is an attribute of sovereignty - on which there does not seem to be any disagreement - it follows that the tax jurisdiction of states is confined to events that are within this sovereignty, and it will be necessary to identify the limits of sovereignty"
4. The learned authoress at page 13 further states that:²

¹1989 Kluwer Law and Taxation Publishers, Deventer Boston

²This excerpt is from Chapter 1 of her Study. In this chapter, she examines existing views on international law and taxation. Prior to this excerpt, she examines the views of Dr A Knechtle and Bühler on the subject of sovereignty and jurisdiction. They do not distinguish between the two concepts. Knechtle at page 34 of his study "Basic Problems in International Fiscal Law", 1979

"However, as **Mann**³ formulated it, 'jurisdiction is an aspect of sovereignty, it is coexistent with it, and indeed, incidental to but also limited by, the State's sovereignty.' Thus, he asserts that jurisdiction should be conceptually distinguished from sovereignty, because the doctrine of jurisdiction deals with the question of whether and under what circumstances a State has the right of regulation, and sovereignty is the concept by virtue of which

Kluwer, states that:

"Tax (or fiscal) jurisdiction, i.e. sovereignty in the sphere of fiscal law, means "the non-derivative sovereignty of a State" which in principle, internally as well as externally unlimited, and which manifests itself vis-a-vis other States in exercising sole (exclusive) authority in respect of acts of legislation, administration and justice within its territorial power sphere. Thus tax jurisdiction is a consequence of a State's territorial sovereignty i.e. of territory of the body politic".

According to Martha at page 16, a second remarkable aspect of the above statement is the alleged unlimitedness (internally and externally) of the fiscal jurisdiction within its territorial sphere. She states that it seems to be an axiom for fiscalists (Knechtle, Vogel, Norr and Hoorn) that no rule of general international law prohibiting international double taxation exists. It should be noted that she describes herself as a supporter of the Vienna School of Law led by Kelsen at page 23. According to this school sovereignty is limited. By extension for purposes of international fiscal law, Martha can be described as a non-fiscalist.

At page 17 of her study, she notes that fiscal jurisdiction may be determined in one of the following two ways:

1. a posteriori, that is fiscal jurisdiction may be determined with reference to the existence of concurrent jurisdiction or double taxation; or
2. a priori, that is rules of international law concerning the basis and scope of fiscal jurisdiction.

It should be noted that at page 2 of her study, she states that the purpose thereof is essentially to ascertain the naked rules of objective or general international law in matters of fiscal jurisdiction i.e. the rules that would apply in the absence of a tax treaty. Thus she seeks to identify the relevant principles of jurisdiction as a matter of general international law, in the field of taxation.

³The Doctrine of Jurisdiction in International Law III RdC 1964 1 page 30.

jurisdiction is exercised, as **Lord MacMillan** said, jurisdiction is 'an essential attribute of sovereignty'."

3. According to her sovereignty is a *conditio sine qua non* for fiscal jurisdiction. She further states that⁴ the award in the **Santa Clara Estates Claim** is authority for this contention. In this matter the taxpayer, a British juristic person, carried on business in the Orinoco district of the Republic of Venezuela, effectively occupied by the revolutionary regime of General Matos, from May 1902 to May 1903. In its control over the district, the regime imposed taxes on the inhabitants. The taxpayer was taxed as well on income derived in the district. After his defeat General Matos fled to the Island of Curacao where in June 1903 he declared an end to the war. The Venezuelan Government reclaimed the district. It thereafter retroactively exercised sovereignty, including the collection of taxes, for the period during which the Matos regime had been in control of the district. The British Venezuelan Claims Commission ruled that the Government was unable to do so due to the absence of sovereignty during the period for which the taxes were claimed.
4. In view of the above, fiscal jurisdiction cannot exist without sovereignty. **Martha** succinctly formulates the following norm:⁵

"Jurisdiction is based on sovereignty and extends only as far as sovereignty exists."

The Classifications of Sovereignty

5. Sovereignty comprises of the following constituent elements:

- 5.1 Personal Sovereignty⁶

By virtue of its personal sovereignty a state may regulate the conduct of its subjects and attach legal consequences to their acts wherever they may be. The operative connecting factor in this instance is the nationality of the subject.

- 5.2 Territorial Sovereignty⁷

⁴9 R. Int'l Arb. Awards 455 (1903)

⁵Supra at page 16. She is of the view that States do not just possess a power with respect to persons and things that is of incognizable origin and scope of power, but rather a competence that can be traced back to a basic legal norm. In casu, the norm formulated.

⁶Op.cit. supra at page 43.

⁷Op.cit. at page 44.

In this instance a State may invoke and exercise its sovereignty over all subjects and objects within its territory.

5.3 Functional Sovereignty⁸

Functional sovereignty is a new concept and is a direct result of developments during the present century in the law of the sea. According to **Riphagen**⁹:

"A sovereign state being traditionally considered to be composed of a "government", "subjects", and a "territory"; one is naturally inclined to look for application of a concept of "functional sovereignty" in those cases where there is said to be stateless "domain", and in situations where there seems to be some form of "government" but not territory, ie. in the case of international organisations, enjoying a measure of "independence". Indeed, in both cases, there are all sorts of legal phenomena which could be covered by the notion of "functional sovereignty."

6. **Martha** terms the above constituent elements the conceptual antecedents of the fiscal jurisdiction of States¹⁰.

The constituent elements of jurisdiction

7. The majority of writers who have studied the subject of jurisdiction divide it into a number of constituent elements¹¹. Some of these views are set out below:

⁸Op.cit. at page 45.

⁹Quoted by Martha at page 45. This excerpt is from an article by Professor W Riphagen, "Some Reflexions on 'Functional Sovereignty'" Neth. Y.B. Int'l L 227 et seq (1974).

¹⁰Op.cit. at page 46.

¹¹These views are discussed by Martha at page 59 to 64. It is also discussed by E Danziger "The Territoriality Principle in Income Tax Law" 1983 Unisa LLM Thesis, in Chapter 1. These writers are not all in agreement.. Some of their views are:

1. Beale, "A Treatise on the Conflict of Laws" 3 Vols, New York 1935 at 274. He distinguishes between legislative jurisdiction lato sensu and legislative jurisdiction strictu sensu.
2. Jennings, "The Limits of State Jurisdiction, 32 Nordisk Tidsskrift for International Ret 209 (1962) at 212. He distinguishes between executive, legislative and curial jurisdiction.
3. Harris, "Cases and Materials on International Law" 2nd Edition, London (1983) at 210. He distinguishes between prescriptive and enforcement jurisdiction. For him, the latter includes both adjudicatory and executive competence.

8. **Akehurst**¹² distinguishes three branches of jurisdiction, namely:
 - 8.1 Executive jurisdiction; being the "power of one state to perform acts in the territory of another state";
 - 8.2 Judicial jurisdiction; being the "power of a state's courts to try cases involving a foreign element", and
 - 8.3 Legislative jurisdiction, being the "power of a State to apply its laws to cases involving a foreign element.

9. **Mann**¹³ defines jurisdiction as "the State's right under international law to regulate conduct in matters not exclusively of domestic concern." He also distinguishes¹⁴ between executive, judicial and legislative jurisdiction. He regards legislative jurisdiction as the most common and it "designates a State's international right to make legal rules."¹⁵

10. The **1964 American Law Institute** in its "**Restatement, Second, Foreign Relations Law of the United States**" distinguishes between prescriptive competence on the one hand and executory and adjudicatory functions on the

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4. Cheng, "Crimes on Board Aircraft" 12 Current Legal Problems 1959 177 at page 181. He introduces two new terms in regard to the doctrine of jurisdiction, namely jurisfaction and jurisaction. The former encompasses legislative jurisdiction, the latter both the administration of justice and the enforcement thereof.

The above references are from Martha at page 60 to 61.

¹²"Jurisdiction in International Law" Brit Y.B. Int'l L 1972-1973 page 145.

¹³"The Doctrine of Jurisdiction in International Law" 1964 (1) VIII Recueil des Cours 9.

¹⁴As quoted by both Martha at page 61 and Danziger at page 5.

¹⁵According to Martha at page 61 Mann's concept of executive jurisdiction would then be reserved for the international right of a state to enforce the laws so enacted by non-adjudicatory means in certain circumstances. Finally, according to her, Mann's concept of judicial jurisdiction would then mean a State's right to confer power upon Courts to hear cases. She holds that what distinguishes Mann's approach from Akehurst is that he does not introduce the requirement of a "foreign element".

other hand¹⁶. The **1981 Restatement** introduced a third category of jurisdiction, namely the "jurisdiction to adjudicate."¹⁷

11. **Martha** states that¹⁸:

"In summary, it can be said that jurisdiction, as an essential attribute of sovereignty, is the right, or rather the competence, of States under International Law to create internal law (the prescriptive or legislative jurisdiction). It also gives States the right to take executive action pursuant to or consequent to the making of law (executive jurisdiction) and/or upon decisions of courts (adjudicative jurisdiction)."

12. **Knechtle** holds that¹⁹:

"In the fiscal sphere it can be subdivided into the legislative, the revenue and the administrative jurisdiction."

13. He accordingly identifies jurisdiction relative to a particular subject matter, in casu fiscal jurisdiction. This being the right of a state to create fiscal laws under international law.

Basic Concepts of the Doctrine of Jurisdiction

14. Accordingly to **Martha** as international law demarcates a State's jurisdiction, it is possible to determine the fundamental a priori rules for (fiscal) jurisdiction²⁰. These are:

14.1 The Temporal Sphere of Validity; A state assumes sovereignty upon its creation. The norms of its legal order only has validity during sovereignty,

¹⁶Paragrah 6 of the Restatement defines "jurisdiction" as "the capacity of a State under international law to prescribe or to enforce a rule of law". According to a commentary in the Restatement prescriptive jurisdiction refers to the capacity of a State under international law to make a rule of law.

¹⁷The 1981 draft. Martha at page 62.

¹⁸Martha at page 62.

¹⁹Op.cit at 34.

²⁰Op.cit at page 32 and following. Martha is of the view that by accepting the concept that international law demarcates a State's jurisdiction, it is possible to establish these a priori rules.

- 14.2 The Personal Sphere of Validity; The norms of a national legal order are applicable to its nationals,
 - 14.3 The Spatial Sphere of Validity; The norms of a national legal order are applicable in this instance to all persons and objects within its territory,
 - 14.4 The Material Sphere of Validity; In this instance the national legal order may regulate a subject matter which is not exclusively nor positively regulated by international law.
15. The norms of a sovereign state is valid for a determinate period of time, over identifiable subjects and objects and also over identifiable space.

The basis of the jurisdiction to tax

16. Several theories have been advanced in regard to the legal justification of the right to tax under international law. These are:

16.1 The Power Theory²¹

According to this theory, fiscal jurisdiction is based on the power of the taxing state over either the tax subject or object. The power to tax is accordingly an attribute of sovereignty.

16.2 The Protection Theory²²

This is the oldest theory. It states that should a state afford protection to tax subjects or objects, it may tax their activities. This theory was approved in **S B Joel and J B Joel v CIR**²³. The court held that as the taxpayers, who carried on business in South Africa, enjoyed the protection of the laws of it, they were liable to be taxed.

16.3 The Contract Theory²⁴

According to this theory taxation is the payment for goods and services received from the taxing state on the basis of a contract between the State and the tax subject.

²¹Danziger at page 53 and Martha at page 19.

²²Danziger at page 54. This theory has widespread support in English and American case law. These are extensively discussed by Danziger. Wurzel, 1934 Columbia Law Review 809 is highly critical of this theory.

²³1922 WLD 29.

²⁴Martha at page 21 and Danziger at page 60.

16.4 The Ethics Theory²⁵

This theory states that tax is a reimbursement by the taxpayer for benefits received from the taxing state. The amount of tax is determined by his capacity to pay and the benefits received.

16.5 The Sovereignty Theory²⁶

This theory states that taxation is justified on the basis that it is an expression of the sovereignty of the state. It is however restricted by international law.

The Fiscal Law Relationship

17. According to **Knechtle**²⁷ there is a special legal relationship between the holder of the fiscal jurisdiction and the tax subject, namely the fiscal law relationship. It is a tax liability relationship between the tax creditor, who claims the tax, and the tax debtor, who is liable to pay it²⁸. The relationship comes into being when there are fiscal facts in existence. These are dependant upon the incidence of connecting factors.
18. Connecting factors are special factual and legal relationships of a personal or economic nature that establishes the fiscal law relationship between the tax jurisdiction and the tax subject²⁹. Fiscal attachment arises as a consequence of such relationships.

Fiscal Attachment

19. This can take one of two forms, namely:

19.1 Personal Attachment

This stems from the personal sovereignty of a State over its nationals. According to **Martha**³⁰:

²⁵Danziger at page 61 and Martha at page 19.

²⁶Danziger at page 62 and Martha at page 22.

²⁷Op.cit. at page 35.

²⁸Id.

²⁹Id.

³⁰Op.cit. at page 47.

"This concept of 'personal sovereignty' affords to States the legal title to prescribe conduct, impose obligations, and confer rights to their subjects, even when they are outside the spatial sphere of validity of the national legal order"

It is generally accepted that in the case of natural persons, residence³¹, domicile and nationality³², and in the case of juristic persons, the place of incorporation and management, cause personal attachment. The taxing State taxes the tax subject on his worldwide income and assets. Personal attachment accordingly triggers off full or unlimited tax liability.

According to **Knechtle**³³:

"Thus, in this case the tax jurisdiction, although emanating from territorial sovereignty, breaks the territorial bounds of the state and extends to tax objects beyond its national territory. This spatial extension of tax jurisdiction is possible, because States can bring to bear the whole pressure of their administrative machinery on residents in their State territories. Such comprehensive subjection of the property and income of a tax subject is regarded by the holders of the tax jurisdiction as legitimate by virtue of the fact that the owner of the taxable property or recipient of the taxable income is resident in their territories (residence, universality, totality-principle)."

It has been suggested³⁴ that fiscal attachment based on residence is only relevant with respect to aliens. As attachment by nationality relates

³¹Residence depends on the facts of each case and is determined by the individual's presence in a country, his purpose for being there and how long he intends to remain there. Domicile is the country which an individual regards as his natural home and the place to which he will return should he go abroad. There is a very good discussion of residence in our law in (1990) 29 Income Tax Reporter 195 and in E. Danziger "International Income Tax" 1991 Butterworths Chapter 3.

³²Nationality has frequently been criticised as a basis of nationality. It is interesting to note that Knechtle op.cit. at page 36 considers nationality "possibly" as a basis for taxation. This issue is thoroughly discussed by Martha at pages 66 to 81 and Danziger LLM Thesis Chapter 5.

³³Op.cit. at page 36.

³⁴Op.cit. at pages 50 to 53 and pages 90 to 98.

to citizens, attachment by residence refers to aliens. They are subject to the tax laws of a tax jurisdiction by virtue of the territorial sovereignty thereof³⁵.

19.2 Economic Attachment

In this case the taxing state taxes only income derived from sources within its territory. This is called the source or origin principle or principle of territoriality³⁶. It accordingly results in limited tax liability³⁷.

Anglo American and Continental European fiscal jurisdictions apply taxation by way of personal and economic attachment. Romanic fiscal systems rely mainly on the source principle. Most South American States apply this system³⁸.

20. Certain classifications of taxes bear a relation to the territoriality principle. These are³⁹:

20.1 Real and Personal Taxes

According to this classification personal taxes is based on the qualities or circumstances of the taxpayer. It is akin to the residence principle. Real taxes has regard to the object of taxation. It is akin to the source principle.

³⁵Martha at page 88, Section X.

³⁶Knechtle states in footnote 88 on page 36 that this term has three meanings:

1. Synonym for source - i.e. origin principle;
2. Antonym to nationality principle;
3. Limitation of the validity of the fiscal legislation to domestic fiscal facts.

³⁷Martha at page 54 distinguishes between the following types of limited liability:

1. Territorial link (personal fiscal attachment, short of residence);
2. Territorial link (economic attachment);
3. Functional link.

In regard to the last link, she fully discusses the right of States to tax activities taking place in their Exclusive Economic Zone.

³⁸This is apparent from the survey of tax jurisdictions in Volume LXV b Cahiers de droit fiscal international 1980.

³⁹Danziger LLM Thesis at page 65 et seq.

20.2 The source and residence principles

In this case taxes are distinguished according to whether they are based on the source of income or the residence of the taxpayer.

20.3 Global and Schedular tax systems⁴⁰

In the global system all income is taxed the same way, irrespective of its source. The connecting factor is the personal status of the taxpayer. In the schedular system, different types of income tax subjected to different types of tax treatment. The connecting factor in this instance is the source of the income.

The source verse residence principle

21. According to **Knechtle**⁴¹ there are no externally imposed legal limits on the fiscal jurisdiction of States in public international law. The only exception is the principle of extra-territoriality, on which the tax privileges of the diplomatic and consular services are based⁴². In the absence of unilateral measures such as foreign tax credits and exemptions, and bilateral measures such as double tax treaties, a conflict between the various tax jurisdictions result. The same income can be taxed by the State of residence and by the State of source.
22. There has been much debate as to which of the two principles are to be preferred. Countries have also in various ways sought harmonization and co-ordination of national assertions of jurisdiction in order to minimise international double taxation. Bilateral treaties, model treaties and guidelines of international organisations such as the United Nations, the Organisation for Economic Co-operation and Development, the European Economic Community and the International Fiscal Association has sought to be of assistance⁴³.

⁴⁰There is a very good discussion by Plasschaert in "The Design of Schedular and Global Systems of Income Taxation - The International Dimension" 1981 Bulletin of the International Bureau of Fiscal Documentation 409.

⁴¹Knechtle op.cit. at page 37.

⁴²The international law rules relating to the exemption from taxation of diplomatic personnel is currently contained in the Vienna Convention on Diplomatic Relations 1961(50) UNTS 95.

⁴³S.S. Surrey "Reflections on the allocation of income and expenses among national tax jurisdictions" Law & Policy in International Business (1978) 409 at 410.

23. It is interesting to note that recommendations by the above bodies concerns two important factors, namely⁴⁴:

23.1 The proper scope and extent of source jurisdiction. Detailed rules have been proposed with regard to various classes of income;

23.2 The recognition to be given by the country of residence to the tax imposed by the source jurisdiction.

24. There are two major treaty models, namely the **OECD model** and the **UN model**. The former is restrictive on the extent of source jurisdiction. It either eliminates such jurisdiction or reduces the rate of tax to be applied. The **UN model** favours source jurisdiction and imposes fewer restraints on it. Both models are however in agreement that the country of residence must eliminate double taxation through appropriate recognition of the source country's proper assertion of jurisdiction. It must either do so through exemption or a foreign tax credit⁴⁵.

25. According to **Knechtle**⁴⁶ the dispute over principles has occupied the literature for a long time. He further notes that there is much support for the source principle. **Endriss**, a German tax writer, argues that limited tax liability is fiscal discrimination. He states that⁴⁷:

"The unfavourable treatment of taxpayers who are subject to limited taxation is ex definitione a glaring breach of equality of taxation."

26. **Knechtle** comments and develops the statement⁴⁸:

"It is caused by the fact that in their case personal circumstances such as special expenditure, extraordinary charges, family status, age etc. are largely disregarded. This leads nearly always to substantially greater tax charges, owing chiefly to the omission of personal allowances."

⁴⁴Op.cit. at page 410.

⁴⁵Op.cit. at page 411.

⁴⁶Op.cit. at page 38. Unfortunately all his references are German. These references are provided in footnotes 94 to 104 in Chapter 4.

⁴⁷Quoted by Knechtle op.cit at page 39.

⁴⁸Id.

27. Another German tax writer, **Debatin**⁴⁹, argues that, according to international law, fiscal discrimination takes place only if taxpayers are treated differently in equal circumstances. He states that:

"The precondition of equal circumstances is, however, missing if the taxpayer is in the one case resident within the country and, in the other case, resident abroad. Hence it is totally accepted internationally that the differential treatment of income taxation when the taxpayer is resident within the country and when he is resident abroad, does not constitute discrimination."

28. **Debatin** concludes his argument that the distinction between full and limited tax liability is justified by the facts pertaining to these two principles. In the case of the former, taxation takes place because the recipient has his centre of vital interests within the country of residence. In the case of limited tax liability, the tax claim arises because incomes, originating in the source country, are so closely related to that country that it cannot relinquish its right to tax them. According to **Knechtle**, this view reflects the present position of State practise⁵⁰.

29. One tax writer, **Irish**, is highly critical of the **OECD model**. He notes that it limits the source country to tax rates of between nil (patent and copyright royalties) and 25 percent (dividends paid). He states that⁵¹:

"There appear to be several reasons for the emphasis on residence in tax agreements between developed countries. Probably the fundamental reason is that the emphasis on residence represents the more favourable alternative for the country with the stronger bargaining position. Frequently countries have an interest in capital, technology and services possessed by the taxpayers of other countries. In such instances, the "interested" country is the potential source country and the other is the potential residence country. As between the two countries, the potential residence country thus has the stronger economic position and the evidence indicates that it has used its superior position to "persuade" the source country to forgo tax revenues so as to insure availability of the desired capital, technology and services."

⁴⁹Id.

⁵⁰Id.

⁵¹C R Irish "International Double Taxation Agreements and Income Taxation at Source" Vol. 23 International and Comparative Law Quarterly 292 at page 294.

30. He is furthermore highly critical of the international tax treaty practises of developed nations. He is of the view that it has caused substantial revenue losses to developing countries. He is greatly in favour of the UN model and advocates that it should be used more.

South African fiscal jurisdiction⁵²

31. Section 30 of the Republic of South Africa constitution Act, no 110 of 1983, provides that Parliament shall have the powers to make laws. It accordingly has the power to adopt fiscal legislation. The Income Tax Act, no 58 of 1962, is the primary source of income tax in our fiscal system.
32. "Republic" is defined in Section 1 of the Income Tax Act as "the Republic of South Africa". The areas included in the Republic are the four provinces and the territorial waters. It should be noted that the fishing zone and the continental shelf does not form a part of the Republic for purposes of the Income Tax Act.
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⁵²There is an excellent discussion by E Danziger, International Income Tax, 1991 Butterworths, Chapter 2, paragraph 2.4.3 on this subject.

- Connecting factors in South African Tax Law
- The background to the source principle
- Guidelines for determining the source of income
- The deemed source provisions of the Income Tax Act
- Principles of source and the case law
- Apportionment
- The meaning of residence, carrying on business and trade

Connecting factors in South African tax law

1. The **Income Tax Act, No. 58 of 1962**, levies income tax on income which has, or is deemed to have, a South African source. Section 5(1) of the **Act** levies income tax in respect of the taxable income received by or accrued to or in favour of any person.
2. "Taxable Income" is in turn defined in Section 1 of the **Act**. It refers to "income". That phrase is itself defined. It in turn refers to "gross income". This is defined as:

"In relation to any year or period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed within the Republic, excluding receipts or accruals of a capital nature."
3. It is clear from the above definition that the source of income in South African Tax Law is the primary connecting factor. The residence status of the taxpayer is not material for purposes of this definition. It is trite that the status of the taxpayer is of great importance vis-a-vis Double Tax Treaties. The residence status of the taxpayer in a transaction with or without an international element may become indirectly material vis-a-vis the gross income definition. This is so due to Double Tax Treaties concluded with South Africa and the provisions of Section 108 of the **Income Tax Act**.
4. Residence is therefore an important secondary connecting factor. The use of this as a connecting factor is of particular importance in regard to the deeming provisions of Section 9 of the **Act**¹. Our income tax system is predominantly premised upon domestic source income with an important contribution by residence base taxation.
5. The following issues have been identified as being material to this part of the discussion:
 - 5.1 The background to the source principle;
 - 5.2 Guidelines for determining the source of income;
 - 5.3 The deemed source provisions of the Income Tax Act;
 - 5.4 Principles of source and the case law;
 - 5.5 Apportionment;
 - 5.6 The meaning of residence, carrying on business and trade.

¹Danziger, International Tax at page 13.

The background to the source principle

6. According to **Danziger** the first reference to the source principle in South African tax law was employed in the **Additional Taxation Act, No. 36 of 1904 (Cape)**². The source principle was adopted in the first Union income tax legislation³, the **Income Tax Act, 28 of 1914**. It was thereafter preserved in subsequent Union legislation, until eventually it was incorporated into the **Income Tax Act, no. 58 of 1962**, being the **Income Tax Act** currently in force.
7. The **1951 Committee of Enquiry into the Income Tax Act** (the Steyn Committee) did not come out in favour of the source principle. It did not however recommend residence-basis taxation on the grounds that such legislation would be complex and that the gain to the fiscal authorities would be small. The **1970 Commission of Enquiry into Fiscal and Monetary Policy in South Africa** (the Franszen Commission) was of the view that the source principle was outmoded. It recommended that it be replaced by the residence principle. These proposals were however not implemented. The **1987 Commission of Enquiry into the Tax Structure of the Republic of South Africa** (The Margo Report) was silent on this issue.

Guidelines for determining the source of income

8. The term "source" is not defined in the Act. Guidance must therefore be sought from the courts. In **Lever Bros and Another v CIR 1946 AD 441**, **Watermeyer CJ**, who delivered one of two majority judgments, held that it is probably an impossible task to formulate a definition that would furnish a universal test for determining when an amount is received from a source within the Republic⁴. In **CIR v Epstein 1954 (3) SA 689 (A)**, **Centlivres CJ**, in delivering the majority judgment, held that the legislative was probably aware of the difficulty in defining the words "source within the Republic" and therefore gave no definition⁵. Each case must therefore be decided upon its own facts.
9. The ratio in **Lever Brothers** established the following important guideline⁶:

²Op.cit.

³The Income Tax (Consolidation) Act, 41 of 1917; The Income Tax Act, 40 of 1925 and the Income Tax Act, 31 of 1941.

⁴At page 454.

⁵At page 699.

⁶At page 449.

"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 receipt of the money, another possible meaning is the quarter from which it is received. A series of decisions of this Court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Act elsewhere have dealt with the meaning of the word "source" and the inference, which, I think, should be drawn from those decisions is that the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these."

10. According to this case the following guideline applies⁷:
 - 10.1 What is the originating cause of the income;
 - 10.2 Is the originating cause in the Republic.
11. **Danziger**⁸ is of the view that the guidelines by the courts have taken on the appearance of tests for the determination of the source of income in particular cases. He submits that these guidelines are of limited value as they are vague and difficult to apply. He has therefore adopted a "rule" approach, in terms whereof income is categorised and rules for the formulation of the source of the various categories of income are set out. It should be noted that none of the other writers⁹ have developed such rules, but rather discuss source on a casuistic basis.
12. According to **Danziger** the following guidelines have been laid down by the courts:

⁷C Divaris and M Steyn, "Silke on South Africa Income Tax", (11 ed) at page 5.4.

⁸International Tax at page 87.

⁹Meyerowitz at paragraphs 176 to 284 and Silke in chapter 5. This is especially so in the case of DJM Clegg "Tax Law through the Cases" 1991.

12.1 *The place where capital is employed*

In **COT v William Dunn & Co. Limited 1918 AD 607**, the taxpayer acted as the London agent of certain South African traders. It shipped goods to South Africa and invoiced the traders for the costs, freight and commission, together with interest on the amount due from time to time. It was the source of interest that was in dispute. The court held that the source of the interest was the place where the capital was employed which produced the profits. The court found that¹⁰ the source was the taxpayer's English business. It employed its own capital in carrying on its own business in England and by so doing earned the interest in question.

In **Overseas Trust Corporation Ltd. v CIR, 1926 AD 446**, the court confirmed the principle established in Dunn's case¹¹. It found that dividends paid and the proceeds of the sale of shares of companies incorporated outside South Africa were from a South African source, because the taxpayer who received the amounts had employed its capital in South Africa in acquiring the shares.

In **Rhodesian Metals Limited (in liquidation) v COT 1940 AD 432**, the taxpayer, managed and controlled in London, bought and then resold certain mining claims and other assets in Zimbabwe. The contracts were concluded and finance was arranged in London. The court approved of "The Place where capital is employed" test and held at page 248 that:

"At any rate, in the present case whatever may be the right view of the source of receipts derived from trading in commodities, their Lordships find themselves dealing with a case where the sole business operation of an English company is the purchase of immovable property in Southern Rhodesia and its development in that territory for purposes of transfer in that territory at a profitable price. The company never adventured any part of its capital except on that or those immoveables. As a hard matter of fact the only proper conclusion appears to be that the company received the sum in question from a source within the Territory, viz the mining claims which they had acquired and developed there for the very purpose of obtaining the particular receipt".

This test has been criticised. **Atkin LJ in Liquidator, Rhodesia Metals Limited (in liquidation) v COT, (1940) AC 774 (PC)**, was of the view that the test was of little practical assistance. He seems to suggest that it must be

¹⁰At page 612.

¹¹At page 452.

incorporated in the "place of business" test. **Danziger** is of the view that the failure of the courts to define the term "capital" in relation to the test makes it difficult to apply¹².

12.2 *The place where business is carried on*¹³

This test was applied together with the employment of capital test in **Dunn's** case. It was rejected by **Atkin LJ** in the **Rhodesia Metals** case. The test was considered on three occasions by **Schreiner JA**.

In **Lever Brother's** case at page 17 it was held that:

"Generally it may be said that a source of income is either (a) some personal activity of the taxpayer, or (b) some property over which he has rights, or (c) a combination of both."

The learned judge continued on page 18:

"The class of case coming under (c), in which goods are manufactured or bought and thereafter sold, the taxpayer, deriving a profit in the process, is, of course, extremely common. It normally involves the making of numerous contracts over a period and the taxpayer who gains his income in this way is generally said to carry on business. The frequency of this type of income production, coupled perhaps with the long established use of the word "business" in the British Statutes, has led to the extension of the notion of a "business" over a large part of the income tax field. The tendency has been to seek the taxpayer's "business" and to treat it as the source of any income obtained by him in connection therewith; and this tendency is to be found even in cases dealing with statutory provisions which, like our own, do not make the profits of a business, as such, a basis of taxation. Care must be taken lest its use in connection with our Act obscure the latter's true foundations. In particular, if income is really derived from the use by another of the taxpayer's property, clarity will generally be better preserved if the concept of "the business of a property owner" is avoided. The income will, no doubt generally, if not invariably, be provided in terms of some contract, but the contract must not be treated as the source of the income by reason merely of the fact that it was a

¹²International Tax at page 92.

¹³Op.cit. at page 93.

business transaction and was entered into in furtherance of the taxpayer's business."

In **Epstein's** case the learned judge in a minority judgment held that:

"What is very relevant and may be crucial is where he carries on the business from which the income in question is derived."

It is apparent from the above that the learned judge according to **Danziger** "softened" his previous opposition to the test.

The same judge in **CIR v Black 1957 (3) SA 536 (A)**, held that certain share dealings conducted by the taxpayer constituted a share dealing business in England. It was found that the taxpayer had earned income by way of a series of transactions of purchase and sale, which together constituted a business in the United Kingdom, even though he exercised control of the transactions in South Africa.

There are several cases in Zimbabwe which support this test. The latest case is that of **CW v COT, 1990 (2) SA 245 (2H)**, where the court held that the share dealing activities of the taxpayer on the Johannesburg Stock Exchange was located in Zimbabwe, as he carried on his investment-dealing activities in that country.

12.3 *The location of activities test*¹⁴

This test was formulated in the **Lever Brother's** case. It was criticised in the minority judgment of Schreiner JA. The test was again applied in Epstein's case.

12.4 *The practical man test*¹⁵

This test was developed by the High Court of Australia in **Nathan v COT, (1918) 25 CLR 183**. At page 189 it was held that:

¹⁴Op.cit. at page 98. The Court a quo in Epstein's case attributed the partnership's activities in selling the moveables to the taxpayer and thus located the taxpayer's income-earning activities outside South Africa. Applying the same test, the Appellate Division located the activities where the taxpayer himself functioned as a member of the partnership.

¹⁵Op.cit.at page 100.

"The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact. The Act, on examination, so treats it."

This test was applied by the court in **Rhodesia Metals Limited (in liquidation)**. It was criticised by **Schreiner JA** in the **Lever Brother's** case. The learned judge stated the following with regard to the reasonable man:

"... it is not unlikely that, while expressing a tentative layman's view ..., he would indicate that the obvious thing to do would be to ask a lawyer."

12.5 *The place of contracting test*¹⁶

This test looks to the place at which the taxpayer concludes the contracts which gives rise to the income in issue, to establish the source of that income.

12.6 *The place of exercise of control test*¹⁷

This test regards the place from which control is exercised as the source of any income. In the **Overseas Trust** case it was held that as certain share transactions had been controlled from South Africa, it was the source of the proceeds of share sales. The Commissioner for Inland Revenue advanced this argument in **CIR v Black 1957 (3) SA 536 (A)**. The court rejected it. This case is discussed below.

13. The above case law illustrate these guidelines broadly. Some of the more important cases will be discussed in more detail below.

The deemed source provisions of the Income Tax Act

14. Section 9 of the **Act** sets out various items of income that are deemed to be from a source in South Africa. In addition the following sections in the **Act** also contain deeming provisions:

¹⁶Op.cit. at page 102. This test was formulated by Wilson J in **Lovell and Christmas Ltd v COT, (1908) AC 46**. The majority judgment in **Lever Brother** at page 456 quoted from Lovell's case with approval.

¹⁷Op.cit. at page 105.

- 14.1 Paragraph (e) of the gross income definition deem certain lump sum benefits to be from a source in South Africa;
- 14.2 Paragraph (k) of the same definition deems dividends from sources outside the Republic received by or accrued to a person other than a company who is ordinarily resident in South Africa to be from a source within the Republic;
- 14.3 Paragraph (n) of the same definition deems all recoupments arising from the application of Section 8(4) to be from a source in South Africa;
- 14.4 Section 8E deems dividends declared by a company on an "affected instrument" to be from a source in South Africa;
- 14.5 Section 22A(2) deems the proceeds of the disposal of assets or an interest in an asset consisting of trading stock acquired under a scheme of arrangement or reconstruction of a company to be from a source in South Africa;
- 14.6 Section 24A(3) deems amounts, benefits and advantages derived from the disposal of shares acquired in an exchange of certain assets to be from a source in South Africa;
- 14.7 Section 30 relating to the taxable income of persons carrying on business extending beyond the Republic;
- 14.8 Section 32 relating to the taxable income of persons carrying on the business of transmitting messages to places outside the Republic by submarine cable or by wireless apparatus;
- 14.9 Section 33 relating to the taxable income of persons other than those ordinarily resident in the Republic or domestic companies who or that embark passengers or load livestock, mails or goods in the Republic as the owner or charterer of a ship or aircraft;
- 14.10 Paragraphs 1A and 6(1) of the **Sixth Schedule** relating to "insurance benefits" and amounts arising on the cession of an insurance policy derived in certain circumstances.
15. Section 9 contains the following deemed source provisions:
 - 15.1 Sale of goods

Section 9(1)(a) of the **Act** deems the proceeds from a contract concluded in South Africa, for the sale of moveable goods, to be from a South African source, irrespective where the goods are to be delivered.
 - 15.2 Royalties

Section 9(1)(b) deems any income resulting from the use, or right of use, or the grant of permission to use in the Republic, of any patent, trade mark, copyright, or any model, pattern, plan, formula or process (films are included) irrespective of where such patent etc. has been produced or made, to be from a South African source. This is in contrast to the general rule that the source of royalties is the place where the property for the use of which the royalty is paid, is created or developed. The royalty source rule was formulated in **Millin v CIR, 1928 AD 207**. In this case it was held that the source of the taxpayer's royalty income from writing books was in South Africa, as this was where she had employed her wits and labour in producing or writing the books.

15.3 Ships and aircrafts

Section 9(1)(c) deems income which accrues in respect of any business carried on by a South African resident or a domestic company, as the owner or charterer of any ship or aircraft to be from a South African source. Section 9(1)(f) deems payments for services to South African residents as the crew of such ships or aircraft to be from a South African source.

15.4 Containers

Section 9(1)(cB) deems income resulting from the lease of containers to be from a South African source if the lessor is a person ordinarily resident in the Republic or a domestic company.

15.5 Services rendered

Sections 9(1)(d) and 9 (1)(d)bis are deeming provisions aimed at deeming income in respect of services rendered to be from a South African source in certain circumstances. The first subsection deems income earned in the carrying on of a South African trade outside South Africa to be from a source in South Africa. This subsection is mainly aimed at independent services. The second subsection is geared towards dependant services. It deems remuneration for services rendered outside the Republic, during a temporary absence, to be from a South African source if the person rendering the service is ordinarily resident in the Republic and the service is rendered on behalf of an employer by whom such person is employed, irrespective where and by whom the payment is made.

15.6 Pensions

Section 9(1)(g) deems any pension or annuity granted to a person to be from a source in South Africa if granted by the government or local authority or by any person if the services in respect of which the payment is made were performed in the Republic for at least two years during the ten years

immediately preceding the date from which the pension/annuity first became due.

15.7 Building Society and Bank interest

Section 9(2) and (3) deems interest from building societies and banks which is received by or accrues to a person who is ordinarily resident in South Africa to be from a South African source.

15.8 Interest derived from a neighbouring country

Section 9(4) deems interest accruing from certain neighbouring countries to South African residents to be from a South African source. This rule does not apply to interest which is effectively connected with a business carried on by the South African resident or company through a permanent establishment in the source country.

15.9 Investment income of foreign investment companies

Section 9 A of the **Act** is an anti-avoidance measure designed to prevent the avoidance of South African tax by the diversion of income from South African sources into companies or trusts formed in neighbouring countries, thereby converting the income into non-South African source income. The section therefore taxes the undistributed investment income of foreign investment companies, as defined, in the hands of the South African resident shareholder of those companies.

16. The above provisions deem foreign income to be from a local source. This may result in the income being taxed both in South Africa and in the foreign tax jurisdiction. Section 6 quat of the **Act** provides that a South African resident may deduct from his income tax payable in South Africa all foreign taxes paid on the same income.

Principles of source and the case law

17. The writers identify many circumstances which have established different classes of the source of income¹⁸. Only the more prevalent will be discussed here. These are set out below.

¹⁸Silke identifies annuities, director's fees, dividends, immovable property, interest, partnership activities, rent, royalties, trading commodities and shares in chapter 5. Meyerowitz in chapter 7 identifies as many. Danziger in chapter 8 also does likewise.

17.1 *The sale of immovable property*

In **Rhodesia Metals Limited (Pty) Limited (in liquidation)** the court established that the source of income resulting from the sale of an immovable asset will be determined by the location of the asset. In this case the taxpayer was incorporated and resident in London. Its principal asset comprised certain mining claims in Zimbabwe, which the company sold. **Stratford CJ** in one of two majority judgments held that¹⁹:

"What was instrumental in producing the profits in this case? Put shortly was it the capital employed or was it the brains of the company. The plain truth is that Rhodesia Metals made an extremely fortunate purchase in Rhodesia by employing its capital there In the circumstances of the present case I regard the fact that the companies were resident in London and that the contracts were made there as having very little, if any, bearing on this question of the source of the income.

The conclusion to which I came, therefore, is that the profit was made by the productive employment of the company's capital in Rhodesia, that this profit was income liable to tax and that it was derived from a source in Rhodesia."

It is interesting to note that **Stratford CJ** also applied the dominant source test. It was held that the dominant cause of the earning of the income was the employment of capital rather than the activities of the company's directors. This decision was upheld by the Privy Council.

17.2 *Sale of movables*

Several tests have been applied by the courts in determining the source of income in regard to the sale of movables. There is no authoritative judgment on this issue. Several criteria is used, such as where the seller productively employs his capital and exercises his activities, the place where the property is purchased, produced, processed or sold and the place from where the business activities are controlled²⁰.

In **Epstein's** case the taxpayer, resident and carrying on business in South Africa, entered into a partnership agreement with an Argentinean Company in terms of which the former would purchase asbestos from a supplier in South Africa and ship it to the latter, who would sell it in Argentina. Any profits so

¹⁹At page 370 of the SATC.

²⁰Danziger, International Taxation at page 115.

derived was divided equally between the partners. The majority judgment delivered by **Centlivres CJ** applied the activities test and came to the conclusion that the income arose to the taxpayer primarily as a result of the sale of the asbestos in Argentina. The court referred to the dictum in **Lever Brothers**, where it was held that the originating cause of income is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for what he gets paid. The court also referred to the dictum in **Millin's** case, where the source of her income was the place where she exercised her wits and labour that produced the royalty income in question.

In regard to the taxpayer's business activities the court held at page 232 that²¹:

"There can, in my opinion, be no doubt that the respondent's profits in connection with his dealings in asbestos were received from a source within the Union. He carries on business in Johannesburg. He renders no services and spends no money outside the Union in connection with his association with Hendrickse and Company and he uses his own banking account for the purpose of financing the transactions in respect of asbestos. All of the activities of the respondent were carried on in the Union and it was as a result of these activities that he earned the profits were received from a source within the Union. The source of the respondent's profits derived from his association with Hendrickse and Company was within the Union, whatever the source of the profits accruing to Hendrickse and Company may have been. In taxing the respondent the Legislature looks at his activities and ascertains whether those activities were exercised within the Union; if they were, then he is taxable in respect of any profits resulting from such activities."

In Transvaal Associated Hide and Skin Merchants v Collector of Income tax, Botswana, 29 SATC 97, the company was incorporated in Johannesburg, where it was also managed and controlled. It bought hides from an abattior in Botswana, salted them and bound them into bales. Its head office in Johannesburg marketed and concluded sales agreements. The goods would then be despatched from Botswana. The majority judgment located the source in Botswana where the curing had taken place. Roper P in a dissenting judgment found that the source was located in South Africa where the selling had taken place. The majority judgment, one of which was delivered by **Maisels JA**, found that the curing of the hides was the dominant cause of the

²¹Schreiner JA in a dissenting judgment approved of the "place of sale" test. According to this test, formulated in **COT v D&W Murray Ltd, 42 CLR 332**, the place of sale in Epstein's case was clearly Argentina. This was accordingly the place of sale.

accrual as it rendered the hides saleable and was as essential to the taxpayer's business as the sale of the hides. **Schreiner JA**, who delivered the other majority judgment, agreed. **Schreiner JA** held at page 107 that:

"It follows, therefore, that in those cases in which all the activities of a business are performed in the same country, the determination of the locality of the source presents no problem. As Mr Gould, however, points out the position is different when the activities of a person are performed in two or more countries. In such cases, it would appear that the locality of the source must be determined by reference to those of the activities which constitute 'the dominant or main or substantial or real and basic cause' of the accrual of the income."

Schreiner JA later continues:

"It seems to me that the curing of the green hides is more truly essential to the gaining of profit than the sale of wet salted hides ... In my view, the curing is dominant over the selling. It is more basic or more truly the main or substantial or real or basic cause of the accrual of the income."

The courts have also applied a "place of manufacture" test²². According to Danziger, the court in the **Overseas Trust** case, applied both the "place of purchase" and the "place of control of sales" tests²³.

17.3 *Interest*

The principle case dealing with the source of income on a loan is **Lever Brother's**. This case is also important as it illustrates general source principles very clearly. The taxpayer concluded an agreement with Mavibell and the Whitehall Trust in 1937, in terms whereof it sold certain shares to Mavibell. In consideration Mavibell became liable to **Lever Brother's** for a sum of 11 000 000 pounds payable in 1961. Interest at the rate of 3,5% was payable on this loan. In 1939 a company was incorporated in South Africa, owned by **Lever Brother's**, which stepped into the shoes of Mavibell as far as its prior agreements with **Lever Brother's** were concerned. The South African company was Overseas Holdings. The interest due to **Lever Brother's** in accordance with the loan agreements was thereafter paid by Overseas

²²In ITC 81, 3 SATC 136 Where income derived by a South African company from the sale of goods which were both produced and sold outside South Africa was held not be from a South African source.

²³Danziger, *International Tax* at page 120.

Holdings out of monies received by it in the United States of America as dividends from certain American shares held by it. None of the agreements whereby Overseas Holdings bought the interests of Mavibell and became substituted for the latter vis-a-vis **Lever Brother's** was entered into in South Africa. The Commissioner for Inland Revenue claimed that the interest paid by Overseas Holdings to Levers was taxable in South Africa.

The court held that there were two questions before it:

- 17.3.1 What was the originating cause of the income ie. what gave rise to the income;

In this regard the court held that the source or originating cause of interest payable on a loan of money was not the debt but the services that the lender performs to the borrower namely the supply of credit, in return for which the borrower, pays interest. The true source of interest on a loan is therefore the provision of credit.

- 17.3.2 What is the location of the originating cause, being the source of the income.

In this regard the court held that where the supply of credit takes place in South Africa, the source of interest is in South Africa. Hence where money is made available to the debtor in the Republic, the source of the interest is in the Republic, no matter where the debtor resides, the debtor productively employs the capital, the interest is payable or the contract of loan is concluded. On the facts the court found that there was no link to South Africa of any manner and that the interest was not sourced in South Africa.

In a dissenting judgment, **Schreiner JA**, held that the income was derived from property owned by **Lever Brother's** in South Africa, namely, the debt owed to it by the South African company.

In **Dunn's** case the court held that the source of interest on trade debts was located where the business that paid the interest was carried on. In **ITC 958, 24 SATC 640**, it was held that the source of mortgage interest is the place where the mortgagee makes the loan available, and not the place where the mortgage is registered or the mortgaged property is situated. In **ITC 1021, 25 SATC 416**, it was held that the source of interest derived by a participant in a participation bond was the place where the participant rendered the service of providing credit to the mortgagor.

17.4 *Dividends*

In **Boyd v CIR 1951 (3) SA 525 (A)** and **Lamb v CIR 1955 (1) SA 270 (A)** it was held that the source of dividends is the location of the share register on which the shares in respect of which the dividends are paid, are registered.

17.5 *Rent*

The source of rental income from immovable property is the place where the property is situated²⁴. In regard to movables the source is either²⁵:

17.5.1 The place where the property is used by the lessee, if such place of use is in one place and the lease period is substantial; or

17.5.2 The place where the business of the lessor is carried on, in the case where the leased movables are either transferred frequently from country to country, or are leased for short periods to different lessees in different places.

17.6 *Franchise fees*

In **ITC 1491, 52 SATC 115**, the taxpayer granted franchise rights to a British company. The subject matter of the franchise agreement had been developed by the taxpayer in South Africa where it carried on business. The Receiver of Revenue assessed the taxpayer on the franchise fees it received from the British company on the basis that it was derived from a South African source. The taxpayer had established an office in the United Kingdom. It thereafter concluded an agreement with the British company in London in terms whereof the latter obtained certain franchise rights to operate a business utilising the taxpayer's formulas and processes. The franchise only applied in the United Kingdom.

The court applied the test formulated in **Lever Brothers**, that is:

17.6.1 What is the originating cause of the income;

17.6.2 Is the originating cause in the Republic?

It found on the facts that the originating cause of the income was the "know how" of the taxpayer which was used in the United Kingdom. It found that the fact that the "know how" in question was acquired by the taxpayer in South

²⁴Op.cit. at page 130.

²⁵Op.cit. at page 131. See ITC 170, 5 SATC 164 and **COT v British United Shoe Machinery (SA) (pty) Ltd., 1964 (3) SA 193 (FC)**.

Africa was clearly a subsidiary causal factor, the dominant cause of the accrual of the income was the imparting thereof in the United Kingdom, coupled with the use thereof in that country. It accordingly found that the dominant cause of the income was the activities of the taxpayer in the United Kingdom.

Apportionment

18. The Income Tax Act contains no provision for the apportionment of a receipt or accrual between two or more sources. The courts have discussed the problem but there is no authoritative judgment on the issue. The writers have adopted different approaches.
19. **Meyerowitz**²⁶ is of the view that though as **Schreiner JA**, in **Epstein's** case, held that theoretically it is possible to locate the sources in every place in question, it is not always practical to do so. He is of the further view that, in two instances, viz. that of what is called the source of incidental income and that of the main or dominant source there is practically only one source.
20. Apportionment has been discussed by the courts in several cases. In **Millin's** case the court referred without disapproval to Australian decisions which had applied apportionment. Had the taxpayer pleaded apportionment and submitted supporting facts the courts may have applied it.
21. In **Lever Brother's**, **Watermeyer CJ** held the following in regard to apportionment²⁷:

"It is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries, and consequently, after the activities which are the source of the particular "gross income" have been identified the problem of locating them may present considerable difficulties, and it may be necessary to come to the conclusion that the "source" of a particular receipt is located partly in one country and partly in another ... Such a state of affairs may lead to the conclusion that the whole of a receipt, or part of it, or none of it, is taxable as income from a source within the Union, according to the

²⁶At paragraphs 185 to 194. He states in paragraph 192 that in the absence of establishing the dominant source, each must be treated independently. **Silke** is of the view in paragraph 5.4 that apportionment is not permissible because the Act does not authorise it. **Emslie and Jooste in 1988 SALJ 292** argue that apportionment is permissible.

²⁷At page 541.

decision which has laid down clearly what would be the governing consideration in such a case."

22. In the **Transvaal Hide and Skin** case, **Schreiner JA**, dismissed the possibility of apportionment because the taxpayer had failed to include apportionment as one of its grounds of objection.
23. In **Epstein's** case the same judge held that²⁸:

"In regard to the suggestion of apportionment, this, in the absence of any statutory guide to its operation, would be practically unworkable in a case of this kind. Where work has been done in producing or improving raw material which is sold elsewhere by the same person, it might be possible to apportion, and even in a case like the present, had there in the tax years been profits from the purchase of Central and South American goods and their sale in South Africa there might also have been room for the principle."

24. Apportionment has been applied by the courts in relation to income from the rendering of dependent services, where the employment contract requires the employee to render services in more than one country²⁹. The question is whether the courts will apply apportionment to other types of income. On the other hand where a taxpayer's activities in different countries are of such a nature that his business in the Republic may be regarded as having extended to such other countries, Section 30 will apply. This section lays down a formula for the determination of taxable income from South African sources in such circumstances.
25. **Emslie and Jooste**³⁰ have developed an argument in regard to the apportionment of income from various sources. Details are:

25.1 **Lever Brother's** holds that to determine the source of income the originating cause must be determined. The so called quid pro quo test, formulated in **Lever Brother's** was approved by **Corbet JA** (as he then was) in **Tuck v CIR, 1988 (3) SA 819 (A)**, a case dealing with the

²⁸At page 234 of the SATC Reports.

²⁹Danziger, International Tax, at page 108. See Silke also at paragraph 5.4. The cases in which apportionment have been applied are, **CIR v Kirsch 1961 (3) SA 93 (T)**, **COT v Shein 1958 (3) SA 14 (FC)** and **CIR v Nell 1961 (3) SA 774 (A)**.

³⁰1989 SALJ 292.

distinction between revenue and capital. The learned writers approve of the distinction between factual causation and legal causation for income tax law. They contend that in a case where apportionment is pleaded by the taxpayer in his objection and appeal, the courts must then apply a legal causation test as opposed to the factual test.

25.2 Apportionment has been approved in our law for purposes of the distinction between revenue and capital, that is in **Tuck's case**, and also in cases dealing with Section 11(a) of the Act³¹.

25.3 In view of the obiter dicta in the cases (quoted above) dealing with source, the learned writers are of the view that had the taxpayers pleaded apportionment the courts would have applied it. In such an event the onus of proof would fall upon the taxpayer.

26. It should be noted that for planning purposes taxpayers must, as far as possible, enter into separate contracts where apportionment difficulties may arise.

The meaning of residence, carrying on business and trade

27. The questions whether a person is ordinarily resident, carrying on business or a trade in the Republic is of importance in the determination of his income tax liability. Though our income tax system is based on source, the above criteria are important secondary connecting factors.

28. The Act does not define the terms "resident" or "ordinarily resident" and guidance must therefore also be sought from the case law. **Danziger**³² draws the following guidelines from **Robinson v COT, 1917 TPD 542** and **H v COT, 1960(2) SA 695 (SR)** in regard to the requirements for residence:

- "1. A taxpayer may be resident in more places than one.
2. Residence is not to be equated with domicile, and a taxpayer may be resident for tax purposes and domiciled at different places.
3. The question whether 'residence' status has been acquired is a factual one, and the cumulative effect of factors which do not by themselves give rise to such status may lead to the conclusion that 'residence' status has been established.

³¹International Taxation on page 36.

³²International Tax at page 33.

4. A taxpayer must be physically present at a place before he can be resident there, but need not be physically present at that place for the whole of a tax year or even the major part of it, nor need the presence be during the tax year in issue.
5. The meaning of "residence" for tax purposes differs from its dictionary meaning, which is "permanent home".
6. In determining whether a taxpayer is resident in a country, the court may look to the taxpayer's mode of life both before and after the tax year in issue.
7. Casual or temporary presence does not constitute "residence", but physical presence for a lengthy period may justify an inference of residence, and periodical visits, over several tax years, forming part of the taxpayer's mode of life may indicate the acquisition of "residence" status.
8. The taxpayer's subjective intention regarding his place of residence is irrelevant, unless supported by objective factors; thus the intention to depart from the country of residence at some future date will not negate an inference of "residence" status based on physical presence for a lengthy period.
9. The availability of accommodation in a country together with occasional use of that accommodation may justify an inference of "residence", but the mere availability of accommodation without physical presence will not. On the other hand, an individual does not necessarily need to have accommodation available to him before he can be said to be resident.
10. The following factors may be considered in deciding whether a taxpayer has acquired "residence" status:
 - Physical presence in a country to attend to business interests, even though compelled by the needs of a business or conditions of employment; on the other hand frequent visits to attend to business will not necessarily give rise to "residence" status, because a person can carry on business in a country without being resident there.
 - Lengthy physical presence with no fixed date set for departure.
 - Occupation of accommodation even as a guest.
 - The setting up of a home or similar establishment.
 - The operation of a bank account.

- The availability of office accommodation."

29. In **Soldier v COT, 1943 SR 130, Tredgold J** at page 133 held the following in regard to the distinction between "residence" and "ordinary residence":

"It remains to consider how far "ordinary residence" can be distinguished from "residence". There are dicta which indicate that the distinction between the two expressions in income tax is slight (*Levene v Commissioners (1928) AC 217 at 225*). But, as is pointed out in *Farnsworth on the Residence and Domicile of Corporations*, p17, not only do the English Acts appear to imply a distinction, but the weight of authority supports the view that "ordinary residence" must be accepted as a narrower term than "residence" simpliciter. In *Levene's case* at 232 it was suggested that "ordinary residence" was residence in accordance with the way in which a man's life is usually ordered. Placed at its lowest it seems to me the use of the word "ordinarily" serves to emphasize that the residence must be settled and certain and not temporary and casual."

30. In an unreported 1989 Cape Special Court decision³³, it was held that the legislature intended "ordinary resident" not to mean the same as "resident". The former term conveys a residence more settled than the latter.
31. The terms "carrying on business" is also not defined in the **Act**, and guidance must also be sought from the courts. In **Stephan v CIR, 1919 WLD I**, it was held that:

"Anything which occupies the time and attention and labour of a man for the purpose of profit, is business"

32. The profit criteria was approved in **Platt v CIR, 1922 AD 42**. Several cases have emphasized the importance of the continuity or repetition of transactions. The profit test may conflict with the dictum of **Corbet JA**, as he then was, in **De Beers Holdings (Pty) Limited v CIR, 1986 (1) SA 8 (A)**. It was held for purposes of Section 23(g) that the absence of a profit in a particular transaction does not necessarily fall foul of the requirement that expenditure must be incurred wholly or exclusively for the purpose of trade. Where a taxpayer normally carries on business by buying and selling goods at a profit, then a transaction entered into with the purpose of not making a profit must be justified on grounds of commercial expediency or indirect facilitation of trade

³³1989 Taxpayer 147. This case was confirmed on appeal. See *CIR v Kuttel* 1992 (3) SA 242 (A).

so as to justify the conclusion that despite the lack of profit motive the transaction was carried out wholly and exclusively for the purposes of trade.

33. The term "trade" is defined in Section 1 of the **Act**. It is defined to include every profession, trade, business and the like, including the letting of property. The courts have attempted to reconcile the term "carrying on a business" and the term "trade". The distinction is subtle and will depend on the facts of each case.

Conclusion

34. It is clear from the above discussion that there are still several lacunae in our law relating to the source of income. Principles relating to the source provisions in our law are far from clear, though there are clearly important cases in our law that have dealt with the concept. These cases have established important guidelines. Issues dealing with the source of income must by implication be dealt with on a case by case basis. This is not to say that this part of our tax law is wholly wanting.
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CHAPTER 3

COMPARATIVE SOURCE

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Introduction

1. The majority of tax regimes, found in either domestic legislation or treaty practise, involve distinctions as to whether the income and expenses of taxpayers are domestic or foreign. The basis for taxation is usually stated in terms of an economic or factual connection of activities or property with a geographical location. The second purpose for utilizing rules of geographic origin is as an aid for relieving double taxation. The countries either impose tax on the basis of one or more criteria of residence, citizenship, domicile, or the origin of income or source. Most Latin American countries such as Argentina and Columbia apply the source of income as a basis of income taxation. This basis for taxation is also applied in Hong Kong and Mexico. The source basis is also applied by the United Kingdom and Australia in regard to the taxation of income derived by non-residents from the United Kingdom or Australia. Literature on United Kingdom and Australian Income Tax Law is more readily available in South Africa than say for instance that of Latin American countries. In addition our income tax system is historically linked to the English system. It is therefore useful to compare the rules of source as found in Australia with those applied in South African Tax Law. G...
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2. The following issues have been identified as relevant to this part of the discussion:
 - 2.1 The source provisions found in Australian income tax law;
 - 2.2 The source provisions found in Hong Kong income tax law;
 - 2.3 The source provisions found in double tax agreements per the "Permanent Establishment" concept.
3. It may be useful to have regard to the source provisions found in other jurisdictions in cases of doubt in South African tax law. In addition a comparative approach will maintain the elasticity of the source concept found in our tax law. It may even be vital insofar as it concerns the vigorous development of the South African tax law.

Australian income tax source rules

Introduction

4. The liability for Australian income tax¹ arises from the Australian Income

¹Y Grbich et al, Revenue Law Cases and Materials Butterworths 1990
E F and J E Mannix, Leading Cases on Australian Income Tax, Butterworths
(6th ed) 1990.

Tax Assessment Act of 1936 ("the Act"), regulations thereunder and the decisions of the courts. There are no specific rules laid down by the Act as to whether gross income is from sources within Australia or sources outside Australia. There is also no definition of the word "source" in the Act. The rules developed in Australia for determining whether income has an Australian or foreign source are essentially those evolved by the Courts. This is of course similar to the position in our law. Comparison is therefor possible.

5. According to **EF** and **JE Mannix**², the question of the source of income is important for two major reasons, namely:
 - 5.1 Non-residents are only taxed on Australian sourced income;
 - 5.2 Under some conditions, residents are exempt from foreign sourced income, which was subject to tax in the source country.
6. Section 25(1) of the Act states that the income of a taxpayer shall include income from all sources where the taxpayer is a resident, and from sources in Australia where the taxpayer is non-resident. There are a number of instances in which Section 25(1) do not apply in that dividends paid to non-residents by Australian resident companies are subject to withholding tax, irrespective of the source of the profits earned by the Australian company. Section 6C of the Act gives an extended definition of the Australian source of royalties paid by Australian residents to non-residents and deem it to have a source in Australia. The Australian sourced income of non-residents is taxed either by a withholding tax or at ordinary rates.
7. According to **Lehmann**³, the Act uses "source" to denote "from what, rather than where the income has its origin". He is of the view that it is more accurate to ascribe the source of income, to a particular transaction, asset or activity rather than locating it geographically.
8. As in our law, the Australian Courts have established a body of source rules on a casuistic basis. The text books contain a very good discussion thereof. The following source determinations have, inter alia, come before the Courts:
 - 8.1 The source of payments for services and employment;
 - 8.2 The source of interest;

²Op.cit at 176

³Op.cit et 852.

- 8.3 The source of dividends and royalties;
 - 8.4 The source of rental income;
 - 8.5 The source of income from the sale of shares;
 - 8.6 The source of income from the sale of real property;
 - 8.7 The source of insurance profits;
 - 8.8 The source of natural resources income;
 - 8.9 The source of business income.
9. Several legislative provisions have an impact on the source of income. These are:
- 9.1 Sections 38 to 43 of the Act permits the Commissioner to apportion income to more than one source;
 - 9.2 Double tax treaties provide source rules;
 - 9.3 Section 4(2) of the International Agreements Act, 1953, provides that treaty provisions will enjoy precedence over Australian Domestic tax laws when the latter is inconsistent with treaty provisions.
10. The latter Act also provides that the double tax treaties entered into by the Australian Government shall have the force of law. Australian double tax treaties are largely based on the **OECD Model Double Taxation Convention on Income and Capital**. These treaties contain provisions determining the source of income and the residence of taxpayers. In general they provide that where income is sourced and taxed in one country and derived by a resident of another state, such other country will allow a credit for tax paid in the country of source when taxing its resident on this income. The treaties limit the tax rate levied by the country of source on royalties, dividends and interest paid to a resident of the other unless effectively connected with a permanent establishment in the country of source.
11. The primary rule for determining source is set out in **Nathan v FCT (1918) 25 CLR 183 at 189 to 190**, which has been quoted with approval many times. In this matter **Isaacs J** held that:
- "The legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact"

12. **Lehmann**⁴ is of the view that there are mainly two difficulties in determining the source of income. These are:
 - 12.1 Income from commercial activity may occur in a number of countries. In such cases, the problem is one of apportionment;
 - 12.2 There may be a choice between two or more potential sources, one of which is the sole source. In such cases the problem is one of identification of the actual source. Income may arise as a result of an agreement entered into in one country relating to property in another country. The question arises as to whether the agreement or the property is the source of the income.
13. The following criteria have been applied in Australian income tax law to establish the source of income:
 - 13.1 The location of the prime income-earning activity or locating the main income-earning structure that gives rise to the income;
 - 13.2 The place where the contract was entered into;
 - 13.3 The place where payment was made;
 - 13.4 The location of the funds from which payment was made.
14. The above criteria are very similar to those found in South African income tax law. The essential element in each of these criteria or rules is the existence of some form of property - whether tangible or in the form of rights or activities - from which the income arises. That property is the source and the locality of that property determines the locality of the source. Where the property has a physical existence, such as land, this presents few problems. In other cases, such as contractual rights or business or employment activities, the location of the source may be more difficult to determine. Factors, such as the place where the contractual rights arose or can be enforced, where the activity takes place or the location of the funds from which the income is paid, must all be taken into account.

The source of payments for services and employment

15. The source of payments for services and employment will generally be the place where the work is performed. Other factors taken into account by Australian courts are the place where the contract is entered into and the place where payment is made. In determining the source, it is also important to distinguish between:

⁴Op.cit at 853.

- 15.1 Contracts of employment where the employee does not hold an office;
 - 15.2 Contracts of employment for an office; and
 - 15.3 Contracts to be performed by an independent contractor.
16. According to **Lehman**⁵ et al on the basis of the judgment of **Dixon CJ** in **French's** case, the place of work is progressively less important in 13.2 and 13.3 According to these learned authors⁶:

"an office holder occupies a post which exists independently of the person who holds it. An office implies permanence and continuity, so that successive office-holders may be seen to occupy it. Employees are distinguished from independent contractors chiefly by the employer's capacity to control".

17. In **Commissioner of Taxation (NSW) v Cam and Sons Limited (1936) 36 SR (NSW) 544**, the taxpayer owned a number of trawlers which were involved in fishing operations off the coasts of New Zealand and Victoria. The crews were engaged in New South Wales at the ship's side on the morning of the cruise which lasted between nine and twenty five days, and were paid off in New South Wales at the completion of the cruise and before the unloading of the catch, which was done by stevedores.
18. The Court applied apportionment and held that the wages earned should be apportioned in proportion to the time spent inside and outside territorial waters. The wages relating to service outside territorial waters were not income as defined for the purposes of Australian income tax legislation, whilst the wages derived during the period inside territorial waters were **prima facie** subject to tax.
19. In regard to the three factors listed earlier, **Jordan CJ** held at page 544⁷:

"The taxpayer employed men on trawlers. Trawling was carried out in the open sea, both within and outside the territorial waters of New South Wales. The men were engaged in New South Wales on the morning of each cruise which lasted from nine to twenty five days. They were paid in New South Wales on their return. The place

⁵At page 854.

⁶Op.cit.

⁷This quote noticed in Lehman et al at page 854.

where work was performed was held to be the source of the payments. Wages for work performed within New South Wales territorial waters were subject to New South Wales tax. Wages for work performed outside those waters were not".

20. At page 547 **Jordan CJ** held that:

"Now a source may, and commonly does, consist of several factors. The character of the source may depend upon which of the factors is dominant."

21. Later in the same judgment at page 548 it was held that:

"It is well established that, where the criterion of liability to tax is derivation from a source in the State, and income is derived from a multiple source, it must be apportioned and only so much of it as is attributable to the source within the State is liable to be taxed. Whether an apportionment is called for depends upon the facts of each particular case ... Thus, if the source of income consists substantially in the making of contracts, the place where the contracts are made may be regarded as the only significant factor. If it consists in first making contracts and then substantial factors in the source, an apportionment must be made ... If the making of the contract is an insignificant factor, and the only substantial element is its performance, the place of performance is the only relevant locus of the source..."

22. It is clear that the Court applied a "dominance test". It is very similar to the test applied by **Schreiner ACJ** in **CIR v Black, 1957 (3) SA 536 (A)**. He said that, inter alia, the source could be located by identifying the dominant factor in earning the income, that is, "the main, the real, the dominant, the substantial source of the income".

23. In **Federal Commissioner of Taxation v French (1957) 7 AITR 76**, the taxpayer, a resident of Australia, was employed as an engineer by an Australian company carrying on business in Australia and New Zealand. There was no written contract of employment. During each year since 1943, the taxpayer spent two or three weeks in New Zealand as the inspecting engineer for the company in its New Zealand business. For many years the taxpayer's salary was paid monthly into his bank account in Sydney. During the end of the tax year in question he was in New Zealand for seventeen days on his employer's business. The taxpayer's salary for the period amounted to 110 pounds and was included by the Commissioner in computing his tax liability. The Commissioner contended that the source of the amount of 110 pounds was in Australia.

24. At page 85 it was held that:

"For the purposes of section 25(1) of the Act, the locality of the source of "income from property" or "income derived from property" must be the place where the property is situated. For the same purposes the locality of the source of income derived from personal exertion in the capacity of employee or in relation to any services rendered surely must be where such personal exertion took place, and the locality of the source of the proceeds of any business where the activities of the business are carried on."

25. This decision was however not followed in **FCT v Mitchum (1965) 9 AITR 559**. In this case, the taxpayer was a film actor resident in the United States. He concluded a film contract with a Swiss company, the terms whereof were that:

25.1 He would render services as a production consultant; and

25.2 He would star in two movies at such places where the company might designate.

26. The Swiss Company thereafter contracted with Warner Bros, a United States resident company, in terms whereof it would provide the services of Mitchum as production consultant and actor, in a film which was partly shot in Australia. Mitchum spent 11 weeks in Australia on location. The Swiss company then assigned its rights to Warner Bros and Mitchum was paid by the latter in the United States. Such payment included services rendered in regard to the film shot in Australia and certain options in regard to future films in which Mitchum was to star. The Commissioner assessed Mitchum on \$ US 37 500, being 11 weeks remuneration out of a global sum of \$ US 50 000 received by him, as being derived from a source in Australia. The Commissioner argued that a rule of law could be extracted from **French** that the source of remuneration for services rendered or the performance of work was the place at which the services were rendered or the work was done unless there were special circumstances warranting a conclusion to the contrary⁸.

27. The court held that the source of income is a matter of fact. It was not bound by the decision in **French** to hold that in every case where work forms the consideration for wages or salary paid, the source of the income is in the place where the work is done. At page 407, it was held that:

⁸Lehmann at page 855.

"The conclusion as to the source of income for the purposes of the Act is a conclusion of fact. There is no statutory definition of "source" to be applied, the matter being judged as one of practical reality. In each case, the relative weight to be given to the various factors which can be taken into consideration is to be determined by the tribunal entitled to draw the ultimate conclusion as to source. In my opinion, there are no presumptions and no rules of law which require that that question be resolved in any particular sense".

28. In South African income tax law, the source of remuneration for personal services is the place where the services are rendered. It is therefore the same as the rule in Australian income tax law.

The source of interest

29. Interest payments earned by non-residents in Australia are taxed on a withholding basis. Under the foreign credit provisions, the source of interest may become relevant where there is a loss from a particular source. In such a case the loss cannot be offset against interest income from other sources, but may be carried forward and offset only against interest if it comes from the same source. Source rules therefore become important to determine whether interest has a foreign source or an Australian source.
30. In **IRC (NZ) v N V Phillips Gloeilampenfabrieken (1954) 6 AITR 59**, a New Zealand company owed money to a Dutch company for goods supplied. The New Zealand company had agreed to pay the Dutch company in Holland, from where the goods were imported. The Dutch company refused to extend time for payment. It sent the New Zealand company a cheque which the New Zealand company re-endorsed back to the Dutch company. In this way the trade debt became a loan. The New Zealand company executed an agreement of loan under seal which was returned to Holland. In coming to the conclusion that the source of the interest was not in New Zealand but in Holland, the court quoted **Lever Brother's** case with approval. On the facts it found that:
- 30.1 The loan monies were provided from a company abroad;
 - 30.2 The debt arose from business transacted abroad;
 - 30.3 Principal and interest were payable abroad; and
 - 30.4 The Dutch company was bound to accept payment from whatever funds the debtor could command, whether from New Zealand or elsewhere.

31. This case went on appeal, where the court upheld the court a quo. The court held that the most significant factor was not the location of the debtor or the debt, but the location of the transaction out of which the debt arose.
32. In an Australian High Court decision in **Studebaker Corporation of Australasia v COT (NSW) (1921) 29 CLR 225** a trade debt arose from importing motor cars into Australia. Under the agreement interest became owing if payment did not occur within the fixed period. Since all of the business was carried out in the United States, the source of the interest was held to be there, and not where the debtor was.
33. In South African tax law, the source of interest on a loan is the place where the amount of the loan is made available by the lender to the borrower. There is thus a close similarity between the Australian interest source rules and those found in South African tax law.

The source of royalties

34. Section 6C of the Act provides that income derived from royalties paid in specified circumstances to non-residents is deemed to be derived from a source in Australia. The case discussed below therefore no longer correctly states the law. It does however illustrate the factors to be taken into account in determining the source of any income.
35. In **FCT v United Aircraft Corporation (1943) 2 AITR 458**, the taxpayer had its principal place of business in the United States where it was incorporated. It manufactured aircraft engines and parts. It licensed an Australian company to manufacture and sell these parts in Australia. The agreement included the right to use within Australia all designs relating to the engines covered by letters patent owned by the taxpayer company within Australia. The Australian company in consideration agreed to pay certain royalties to the taxpayer, payment whereof was to take place in New York. In fact, the taxpayer did not hold patent rights in Australia. The Australian company accordingly did not exercise any rights in respect of any proprietary rights held by the taxpayer in Australia.
36. The court held that the source of the corporations income was not Australian. At page 536 it was held that:

"Property is one possible source of income. The work of persons or acts done by persons are other possible sources of income. I do not forget that in Commonwealth income tax law the distinction between income from property and income from personal exertion is largely a matter of terms. Income derived from property is defined so as to include all income which is not income derived from personal exertion. Companies are taxed under the

Income Tax Acts upon their income with no distinction between income derived from personal exertion and income derived from property. I have not been able to think of any sources of income other than property and acts done. If a person has rights over property or in relation to property he may derive income from that property. The American company had no such rights in Australia. If a person by himself or by servants or agents does work of some kind or acts in some way, he may derive income from that work or act, but the American company did nothing in Australia. Income derived from property means, in my opinion, income derived from the property of the person sought to be taxed as having derived the income. So also the income of a person derived from acts done is income derived by that person from his own acts or from the acts of his servants or agents. If such a person, being a company, has no servants or agents in Australia, it cannot, in my opinion, derive income from any acts done in Australia. A person who neither owns anything in a country nor does nor has done anything in that country cannot in my opinion, derive income from that country."

The source rules for other income

37. In **Tariff Reinsurances Limited v COT (Vic) (1938) 1 AITR 280**, a contract of reinsurance was made in England between an insurance company carrying on business in Victoria and a reinsurance company incorporated in the United Kingdom, which had not appointed a representative in Victoria and was not registered as a foreign company therein. The contract provided that when the Victorian company effected an insurance the reinsurer reinsured it in respect of such insurance in the proportion of two-thirds of the risk so accepted. A commission was allowed to the Victorian Company in reduction of the premiums payable by it to the reinsurer, together with a further commission of 10 per cent on the reinsurer's nett annual profits under the contract. The contract provided for the payment of such profits into the reinsurer's bank account in Victoria. The Victorian company had no control over this account. The court held that the profits of the reinsurer were not earned or derived in or from Victoria. At page 217 of the judgment it was held that:-

"Nothing in the present case was done in Victoria by the appellant and nothing was done there on its behalf except the receipt by the bank of monies paid to its account. The transaction out of which the receipts taxed as income arose was the acceptance in London of a reinsurance treaty negotiated in London as an ordinary incident of a reinsurance business there carried on. Upon the question where the profit was derived or earned, the place of actual

payment has, in this case, but very slight bearing. It is a matter only of banking and business convenience. All the other matters mentioned by **Romer J**, as making up reinsurance business were carried out or done in London. There the bordereaux, the accounts and lists of losses were received, the correspondence was written and the negotiations and interviews leading to the treaty took place."

38. In **Cliffs International Inc. v Federal Commissioner of Taxation (1985) 16 ATR 601**, the taxpayer was a company and incorporated in the United States with its central management and control in that country. It carried on operations in Australia as a joint venturer in a mining project. In return for assigning its mining rights over certain sites the taxpayer was paid a royalty on iron ore produced and sold by its joint venturers. It also represented the joint venturers throughout the world and received a commission on realised sales from contracts which resulted from its efforts. The court held that the source of the commission was outside Australia as all negotiations for the contracts took place overseas. In addition the technical expertise used in negotiating the contracts came from the United States parent company of the taxpayer. The fact that the taxpayer had an Australian office and its contracts were executed in Australia was not sufficiently important to outweigh the factors referred to. At page 619 of the judgment it was held that:-

"The overseas sales representation agreements, under which the commission became payable, were made in Australia, and the contracts of sale were executed here by the participants, at least on some occasions, it would seem, after they had been executed by the buyers, although, in the absence of any evidence as to the mode of notification of acceptance, it does not necessarily follow that even these contracts were made here. The sales of iron ore appear, with one exception, to have been made in Australia, having been made on a fob basis and it is not being questioned that property passed thereunder in the usual way. Payment of the commission, although not of the sale price, was made in Australia, and Cliffs carried on business here."

39. Later in the same judgment it was held that:

"The weight of the majority of these factors is unquestionable; but, in the end, I have formed the view that they do not outweigh the remaining factors, and that, as a "practical, hard matter of fact", the source of the commission paid to Cliffs was overseas. To the extent of which it is possible for me to put myself in the place of a

practical man, I do not believe that he would regard the real source of the income as having been in Australia. Cliffs is a company controlled in the United States, which was engaged by the participants by reason of the expertise which it had, or which was readily available to it, through its parent company, in negotiating sales of iron ore with prospective overseas purchases. All of those negotiations took place overseas. The great bulk of the technical information which was used by Cliffs in those negotiations came either from the United States or from Japan. By the time that Cliffs had concluded its negotiations and secured offers to purchase iron ore, its work in obtaining contracts of sale effectively was done. All that remained was to submit the offers to the participants for their acceptance, which would appear to have been almost automatic, because the negotiations themselves were conducted within broadly pre-determined limits, and, in some cases, to complete the documentation. There is nothing to suggest that any contract submitted for approval to the Australian participants was ever the subject of further negotiations. When the negotiations were concluded overseas, the execution of the contracts in Australia was, it seems to me, on the evidence, to have been very much a formality."

40. The rules applied in these cases are similar to those applied in our tax law. These rules have also developed on a casuistic basis as in our law. In view of the similarity between Australian source rules and those in our law comparison is possible. In cases of uncertainty in our law, Australian case law will stand as good authority.

Apportionment

41. When goods are traded between countries there are often activities in each country that are a source. Sub-division C of Division 2 of Part III, being sections 38 to 43 provides rules for determining the profits from the sale of goods where the source may be from two or more countries including Australia. Where goods manufactured outside Australia are imported into Australia and are sold there by the manufacturer - either before or after importing them - the manufacturer will be assessable for Australian tax on the selling profit. This is determined by deducting from the sale price:-
 - 41.1 The price for which equivalent goods could be purchased by a wholesale buyer in the country of manufacture; and
 - 41.2 The expenses incurred in transporting the goods and selling them in Australia.

42. Prior to the statutory provisions there were several cases dealing with apportionment. The early cases did not attempt to establish the basis on which profits from sales by a manufacturer from one country into another should be apportioned. They merely established that they should be apportioned. In **Commissioner of Taxation v Kirk [1900] AC 588**, the Privy Council applied a practical test in regard to the assessability of income from mining activities in New South Wales where the finished products were sold entirely outside the colony. It divided the operation into four stages:
- 42.1 Extracting ore from the soil;
 - 42.2 Manufacturing it into a saleable product;
 - 42.3 Selling it;
 - 42.4 Receiving monies arising from the sale.
43. The court held that all four operations were necessary stages and a profit should be attributed to each stage after deducting the expenditure attendant upon each stage. The principle established in **Kirk's** case was confirmed in later cases. Two broad basis for apportioning profits were applied:-
- 43.1 The formula basis. This distributes the profit proportionately between sources being the ratio of the expenditure in each source to the overall expenditure;
 - 43.2 The added value test.
44. In **FCT v Lewis Berger & Sons (Australian) Ltd. [1927] 39 CLR 468**, goods were manufactured in Australia and sold in New Zealand. The Commissioner apportioned the profit having a New Zealand source upon the basis of the following formula:
- Profit from NZ sales x NZ expenditure/by total expenditure.
45. This test was rejected by the court and in its stead applied the "fifty fifty" test. So-called "Unitary Tax" systems which have existed in some states in the United States, implement an approach which is similar to, but more sophisticated than the formula basis. These systems determine the profits of the local enterprise as a proportion of worldwide profits on the basis of the ratio of local assets employed to worldwide assets, local expenditure to worldwide expenditure, local turnover to worldwide turnover or a combination of these approaches.
46. In **COT (WA) v D & W Murray Ltd. (1929) 42 CLR 332**, the value added test was established. The taxpayer was a company incorporated in the

United Kingdom. It purchased goods there and carried on the business of wholesale softgoods warehousemen in Australia. It was held that the activities of the taxpayer in the United Kingdom did not give added value to the goods and the profits were wholly sourced in Australia. In **FCT v W Angliss and Company (Pty) Limited (1931) 46 CLR 417**, animal products were exported from Australia to the United Kingdom. Some of the goods produced by the taxpayer in Australia could not be sold in Australia either for home consumption or export. The court held that as the goods had no value at the moment of exportation beyond the cost of production, no part of the profit was attributable to an Australian source.

47. Our Courts have on occasion applied apportionment. This has mostly been in the case of the rendering of dependent services. In **Millin's** case the Court referred without disapproval to Australian cases where apportionment had been applied. As this is a part of our law which is still undeveloped the principles enunciated in Australian cases will be of great assistance in resolving such questions locally.

Hong Kong income tax source rules

Introduction

48. Income tax in Hong Kong consists of four categories⁹. These are:

- 48.1 Property tax;
- 48.2 Salaries tax;
- 48.3 Profits tax;
- 48.4 Interest tax.

49. The general rule for determining the liability of a person to profits tax is contained in Section 14 of the **Hong Kong Inland Revenue Ordinance**. It provides that:

"... profits tax shall be charged ... on every person carrying on a trade, profession or business in the colony in respect of his assessable profits arising in or derived from the Colony ... from such trade, profession or business ...".

50. The key element is "profits arising in or derived from". In the event that income arises in or is derived from trade or business carried on in Hong Kong, it will be domestic and hence taxable. In **Commissioner of Inland Revenue vs the Hong Kong and Whampoa Dock Company Ltd.**

⁹Gammie UK, National Report in "Rules for determining income and expenses as domestic or foreign" 1980 Cahiers de Droit Fiscal International 62 65 B.

(1960) HKTC 85, the Hong Kong Supreme Court considered this phrase. It held that income will be sourced where "the operations takes place from which the profits in substance arise". This is the so-called "operations" test. The place of such operations will always be a question of fact and every situation will of course be different.

Business income

51. The basic rule to be derived from Hong Kong income tax case law is that the source of income will be determined by the so-called "operations" test. That is, where did the operations take place from which the profits in substance arose. Hence in determining source, factors such as the location of negotiations, the location of the signing of contracts, the location of the performance of services and so on will be of primary importance.

Salaries

52. Salaries tax is charged in respect of all salary income arising in or derived from Hong Kong from any office or employment. Employment income has its source where the employment is fundamentally located¹⁰. The location of employment is determined under a three-fact test:
- 52.1 Where was the employment contract made, that is, where was it negotiated and where is it enforceable;
- 52.2 Where is the employer resident, that is, in the case of a corporation where is its central management and control located;
- 52.3 Where is the employee's compensation is paid.

Interest income

53. Interest income is sourced in Hong Kong if the provision of credit to the borrower was made in Hong Kong¹¹. This is normally understood to mean that interest income is sourced in Hong Kong if the borrower first obtained and took control of the loan funds for his own account in Hong Kong. Hence, the taxability of interest income depends upon the place

¹⁰The CCH Journal of Asian Pacific Taxation November/December 1988 at page 14 by A Halkyard and J P van der Wolk.

¹¹Inland Revenue Department *Departmental Interpretations, Practice Notes* No 13 (revised) paragraph 2 and 14, 3 May 1986. Noted from Kwock and Wan in the CCH Journal of Asian Pacific Taxation November/December 1988 at page 33.

where the loan funds are physically given without restrictions to the borrower.

54. The "provision of credit" test was apparently abused by Hong Kong financial institutions. As a result, the Hong Kong fiscal authorities amended the **Hong Kong Inland Revenue Ordinance**. Section 15(1)(i) extends the taxation of financial institutions beyond the normal source rules so as to encompass all interest income arising from the carrying on of business in Hong Kong. The legislation did not however give any guidance as to what constituted "arising from the carrying on of business in Hong Kong". The following factors are accordingly important in deciding this question:

54.1 The location of staff engaged in canvassing and accepting deposits;

54.2 The location of staff engaged in borrowing;

54.3 The location of staff engaged in canvassing, arranging and approving loans;

54.4 The place where the money was borrowed;

54.5 The place where the money was lent;

54.6 The place where the interest was receivable;

54.7 The currency of the transaction;

54.8 The place where the transaction was entered in the books of the financial institutions.

55. As a result of considerable uncertainty, the Hong Kong fiscal authorities proposed a pragmatic approach which looks at only two factors, namely:

55.1 Where the loan was initiated; and

55.2 Where the loan funding was raised¹².

¹²Inland Revenue Department "Unofficial and Without Prejudice Proposal to Financial Institutions for Settlement of Outstanding Cases" 1987. Op.cit. at page 35.

Case law

56. In **Sinolink Overseas Ltd. vs CIR (1985) 4 HKTC 24¹³**, the taxpayer traded in plywood and paper. It bought these products from manufacturers in Hong Kong and overseas and sold it to its customers also in Hong Kong and China. The taxpayer apportioned 75% of its sales as being sourced in China and accordingly not taxable in Hong Kong. Its personnel travelled to China to obtain orders where the contracts were negotiated and concluded. These orders were fulfilled mainly from plywood the taxpayer bought from suppliers in Singapore and Europe. The Court found that as the taxpayer's administrative office which controlled the Chinese sales were located in Hong Kong the source of the proceeds of the Chinese sales was also sourced in Hong Kong. ✓
57. In **Hong Kong Board of Review case number D15/82¹⁴**, the agent of the taxpayer negotiated purchasing contracts with manufacturers outside Hong Kong. The taxpayer would thereafter receive an order from customers in the United States in Hong Kong. It would place this order with the manufacturer via its agent. The goods would be inspected by the agent on completion and he ensured timeous delivery to the customer. The United States customer would thereafter be invoiced by the taxpayer. It would receive payment by letter of credit negotiated through Hong Kong bankers. The Board of Review found on the facts that the source of the income was the operations of the agent outside Hong Kong and the country in which the manufacturer was located. It did not accord the signing of the contracts of sale much significance. The Court considered the following factors as important indications in the determination of the source of income:
- 57.1 The pre-contract preparation of management;
 - 57.2 The conclusion of contracts of purchase;
 - 57.3 The conclusion of contracts of sale;
 - 57.4 Post-contract performance and management.
58. According to **Davis and Horak¹⁵** what emerges from these cases is the guideline that, provided that most of the activities above are carried out outside Hong Kong, the source of the income will not be in Hong Kong. Even though the company maintains an office in Hong Kong to carry out certain administrative functions, such as the preparation of invoices in case number D15/82, such activities would only be regarded as being ✓

¹³This is discussed by Horak and Davis (1988) 1 *Juta's Foreign Tax Review* 57.

¹⁴Also discussed *op.cit.*

¹⁵*Loc.cit.*

ancilliary in nature and would not result in Hong Kong income tax liability.

59. In **Excon Chemical International Supply SA vs CIR (1989) 3 HKTC 57¹⁶**, the taxpayer sold group products to both affiliated companies and independent parties. It claimed that profits from sales to affiliated companies were not sourced in Hong Kong.
60. When an affiliated country purchased products from the taxpayer it would send a telex to it in Hong Kong. The taxpayer upon receipt of the telex would retransmit it to an agent, being another affiliated company in the United States. The agent would then place the order with the supplier. The taxpayer took no part in any of the required steps to process the order. All documentation and arrangements for transportation were effected by the taxpayer's agent. The agent did not however have any authority to negotiate or conclude sales on behalf of the taxpayer. It did not maintain any sales staff to deal with the sales to the affiliated company. It did however employ product line managers who were based in Hong Kong and who travelled throughout Asia. These managers were responsible for sales to the affiliated company. The Court found that the profits from sales to affiliated companies were sourced in Hong Kong. The reason being that the taxpayer's agents had no independent authority and relied on the expertise of the taxpayer's product line managers to do so. As such the originating cause of the taxpayer's income was the expertise of its managers who were all based in Hong Kong.
61. A variety of tests have been applied by our Courts to determine the source of income derived from the sale of moveable property. In **CIR v Epstein, 1954 (2) SA 55 (T)**, the Transvaal Provincial Division applied the "place where sale contracts are concluded" test to determine the source of income. It found that as the minerals had been sold in Australia the source of income was not located in South Africa. On appeal this decision was reversed¹⁷. In **Overseas Trust Corporation Ltd. vs CIR 1926 AD 444**, it was held in the Cape Provincial Division that the source was South African because by buying the shares the taxpayer had employed its capital in South Africa, the decision to sell had been made in South Africa and instructions to the taxpayer's agent in Germany to effect the sale had been sent from South Africa. The fact that sales had been concluded in Germany was said to be irrelevant to the determination of the source as the taxpayer had neither carried on trade or business in Germany nor had he employed capital there. This decision was upheld on appeal in **ITC 382, 9 SATC 439 (1937)**, where it was held that the income of the taxpayer had its source in the United

¹⁶This case is discussed by D Toh in (1990) 3 Juta's Foreign Tax Review 50.

¹⁷1954 (3) SA 689 (A).

Kingdom. The taxpayer derived income from trading in gold in the United Kingdom. The taxpayer's agent concluded the contracts of purchase and sale in the United Kingdom. Payment also took place in the United Kingdom. The Court found on the facts that the taxpayer's exercise of control from South Africa over the transactions was not sufficient to make South Africa the source. On the basis of these South African decisions it would appear that there might be a conflict of decisions between it and those reached in Hong Kong on the source of income from the sale of moveable property.

Other case law

62. In a recent decision the Privy Council rejected the Commissioner's practice of applying the "operations" test to determine the source of income in Hong Kong.
63. In **CIR vs Hang Seng Bank Ltd. 1990**¹⁸, the taxpayer, during the years 1978/1979, 1979/1980 and 1980/1981, acquired certificates of deposit ("CDs") on the Singapore and London markets through the agency of corresponding banks in Singapore and London. It then sold the CDs usually a few days before the CDs were due to mature. The decision to buy or sell was made as part of the ordinary business of the taxpayer and was carried out by its employees in Hong Kong. They would review the foreign money market information available to them from various sources and would thereafter contact the foreign brokers with instructions to either buy or sell the CDs. The prices at which the instruments were traded would reflect, inter alia, the amount of interest which would become payable on them in due course. Payments and receipts would then be effected through an appropriate account of the taxpayer in New York. The ownership of such CDs was not remitted to Hong Kong but retained in the custody of the off-shore branches of the bank until the instruments were sold.
64. The first submission made by the Commissioner was that the business of the taxpayer was one and indivisible. As it carried on business in Hong Kong and as the transactions in question which caused the profits were directed from Hong Kong, the income was sourced in Hong Kong. The Commissioner accordingly submitted that the profits accruing from the overseas trading could not be looked at in isolation. These profits were components of the profits of the taxpayer's entire business and those profits, as a whole, arose in and were derived from Hong Kong. These submissions were rejected by the Court. It held that:

"Three conditions must be satisfied before a charge to tax can arise under Section 14:

¹⁸(1990) 3 Jutas Foreign Tax Review 106 at page 106.

1. The taxpayer must carry on a trade, profession or business in Hong Kong;
2. The profits to be charged must be "from such trade, profession, or business" which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;
3. The profits must be "profits arising in or derived from Hong Kong".

65. The Court continued in an interesting argument relating to apportionment as follows:

"Thus the structure of the section (section 14) presupposes that the profits of a business carried on in Hong Kong may be accrued from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not To accept the construction which underlies the Commissioner's primary submission would reduce the effect of condition (3) to negligible significance".

66. The Commissioner in his second submission argued that the income was derived from Hong Kong as the relevant investment decisions were taken in Hong Kong and as the funds used by the Bank to invest overseas in the CDs were derived from their Hong Kong depositors. This submission was also rejected by the Court. It held that the source of the profits of individual transactions must be located only by reference to the gross profit accruing from those transactions. It also held that the place where the funds were obtained was not an important factor as also the place where the investment decisions were made.

67. The Court held that it is impossible to lay down exact rules of law for determining the source of income. It proposed the following broad guide line, namely:

"... One looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit would have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and selling at a profit, the profit will have arisen in or

derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected".

68. The Court accordingly found that the source of the taxpayer's activities were located outside Hong Kong. It found that the dominant factors giving rise to the taxpayer's income, that is the buying and selling of CDs was outside Hong Kong. Consequently the source of the profits was also outside Hong Kong. The Court followed the decision in **CIT v B Mehta of Bombay, 1938 ITR 521**, where the place where the investment decisions were made was not relevant in the determination of the source of the profits from dealing in commodity futures contracts.
69. This case is similar to the decision in **Lever Brothers**. It posed the question that "one looks to see what the taxpayer has done to earn the profit in question". This is clearly similar to the quid pro quo test adopted in **Lever Brothers**.
70. In **CIR v HK-TVB International Ltd.**¹⁹ it was held that the royalties received by the taxpayer was from a source in Hong Kong. In this case the taxpayer granted sub-licences to overseas customers for the broadcasting of films outside Hong Kong. The films were produced in Hong Kong but the sub-licencing agreements were concluded outside Hong Kong by the taxpayer's salesmen. The Court found that as the taxpayer did not have a profit-generating operation outside Hong Kong the income from the royalties was from a source in Hong Kong. This case is comparable to the decision in **ITC 1491** (discussed in Chapter 2), where the taxpayer derived franchise fees from the United Kingdom through a franchise developed in South Africa. The Court found that as the taxpayer's activities which was the dominant cause of the income, was located in the United Kingdom the source of the profits was clearly located there. The taxpayer therefor had established a "profit-generating operation" in the United Kingdom which was contrary to the taxpayer's activities in the Hong Kong case.

The concept of a "permanent establishment"

Introduction

71. Tax treaties or Double Tax Agreements are international agreements concluded with the object of eliminating double taxation by the contracting states. International double taxation may loosely be defined as the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical or

¹⁹See D Toh op.cit. at page 52.

overlapping periods. Double taxation mainly occurs when one country taxes the worldwide income of its residents, the other by way of the source of income. There are no statutory provisions, save for certain deeming provisions in our law determining the source of income. It is therefore up to the courts to determine the source of income from the facts of each case. Double tax treaties on the other hand incorporate rules of source. The classification of the nature of income has a very important impact on the determination of its source. The main characteristic of rules of source in these agreements are that they are operational or functional rules, which gives a geographical location to the income. In this manner it identifies the state which will have the right to tax the income or give relief from double taxation. It is possible in certain instances that income which has its source in South Africa will not be taxable here. For example, even if business profits are sourced in South Africa in terms of South African domestic tax laws, according to the rules in the treaty those profits will not arise from a location in South Africa unless they are attributable to a permanent establishment located there.

72. Where doubt arises as to the source of income it may be of assistance to establish whether the income falls within the ambit of a particular treaty. In such an event the source of the income must be determined with reference to that treaty. Whenever the source of income becomes of importance it is necessary to establish in each and every instance the possible application of a treaty. Even where a treaty is not of application a general understanding of treaty provisions may be of assistance in establishing the source of income in general. In addition, an understanding of source locations in tax treaty law may be of assistance in determining the source of income in our law.
73. According to **Passos**²⁰, the rules of source in double tax treaties are not tax imposing provisions or rules. They merely function as an operational means of allocating taxing rights and obligations between contracting states. For the subsequent levying of tax to take place, they must be supplemented by domestic taxing provisions and, in South Africa, by rules or principles relating to source. According to her, the treaty rules determine²¹:-
- 73.1 The rights and limitations of South Africa in taxing income derived by a non-resident, that is, a resident of the other contracting state;
- 73.2 The commitment of South Africa to give relief from double taxation to income derived from a contracting state by a South African resident.

²⁰Passos, Tax Treaty Law, 1986 Juta at page 128.

²¹Op.cit.

74. Double tax treaties mainly, in some cases exclusively, deal with income tax. The rules included in the separate articles dealing with the various items of income establish the following general principles relating to non-South African residents²²:-

74.1 Business profits are sourced in South Africa to the extent that they are attributable to a permanent establishment of the foreign resident located in South Africa;

74.2 Income from immovable property is sourced at the place where the immovable property is situated;

74.3 Dividends are usually sourced in the country in which the company distributing the dividends is a resident. However for purposes of South African law, the place of incorporation is the determining factor. The source of dividends is relevant only insofar as it concerns non-resident's shareholder's tax;

74.4 Interest is generally sourced in the country in which the person paying the interest is a resident. It is interesting to note that this rule does not coincide with the principle established in the **Lever Brother's** case. It should be noted that the debtor's residence is of great importance for the imposition of non-residents tax on interest;

74.5 Royalty income arise in the country in which the property or right is to be used;

74.6 Income from independent personal services is taxed according to the same rule as for business profits. Income attributable to a fixed based is taxed in the country where such fixed base is located;

74.7 Income from dependent personal services is usually sourced at the place where the employment is exercised;

74.8 Income from shipping and aircraft operations will be taxed at the location of the effective management of the enterprise.

Methods to avoid double taxation

75. Two main methods have been developed for the prevention of international double taxation. These are:

75.1 Unilateral measures; and

²²Op.cit. at pages 128 to 130.

- 75.2 The use of treaties.
76. There are four categories of unilateral relief of which two are available in South Africa. These are:²³
- 76.1 Exemptions;
 - 76.2 Deductions or rebates;
 - 76.3 Apportionment;
 - 76.4 Rate.
77. South African unilateral measures comprise provisions in the **Income Tax Act** which either exempt items of foreign source income from South African tax, or grant rebates from South African tax due for foreign taxes paid on the income in question²⁴. Section 10 of the Act contain four exemptions, namely:-
- 77.1 Income of non-resident ship operators are exempt from South African income tax in terms of section 10(1)(cG);
 - 77.2 Copyright assignment proceeds are exempt in terms of section 10(1)(m);
 - 77.3 Remuneration of non-resident government employees rendered outside South Africa are exempt by virtue of section 10(1)(p);
 - 77.4 Interest on foreign bank deposits are exempt in terms of section 10(1)(w).
78. The Act makes provision for the granting of rebates for foreign taxes paid in two instances. Section 6 bis of the Act provides for the granting of a rebate for foreign taxes paid on royalty income which is taxed both in South Africa and in another/other country/ies. This section permits the deduction of foreign taxes from the South African income tax payable by any person in whose taxable income is included an amount received or accrued to him for the use of, or the right of use of, or the grant of permission to use in any other country other than South Africa, a patent, design, trade mark, copyright, model, pattern, plan, formula, process or

²³Danziger (1989) 2 Juta's Foreign Tax Review 39. See also W Steinberg "An introduction to the methods available to avoid double taxation with countries that do not have double taxation agreements with South Africa" 1990 LLM research paper UCT.

²⁴Danziger "International Tax" at page 320.

other property of a similar nature, or a motion picture film or a film or video tape or disc for use in connection with television, or a sound recording or advertising matter used or intended for use in connection with these categories of property. Section 6 quater grants a rebate for foreign taxes paid by South African residents on foreign-source income. The section clearly only applies in those cases where South African source rules, deemed or otherwise, have included the income in question in taxable income. Practise Note 9 sets out the method of calculating these rebates²⁵.

79. There are two types of double tax treaties, namely multilateral treaties and bilateral treaties. Multilateral double tax treaties have been considered at different times and in various contexts. They have however not taken root because of the complexity of applications except in the field of administrative assistance and exchange of information. The European Free Trade Association in 1969 studied the feasibility of establishing a multilateral double tax convention within Europe. The report concluded that though this type of convention was technically feasible, there were more disadvantages than advantages. In particular, a multilateral convention would be more complex, and therefore more difficult to apply and understand, than a bilateral convention. It would also be less flexible requiring frequent amendment and revision. There are nonetheless three significant multilateral double income tax treaties namely, the Andean Pact, the Comecon Convention (now disbanded) and the Nordic Multilateral Treaty.²⁶
80. There are three model bilateral double taxation treaties. These are:-
- 80.1 The OECD Model Convention, whereof almost 200 bilateral treaties have been concluded between OECD member states, is by far the most popular. The latest draft was completed in 1977. The other two model conventions are variants of this model;
- 80.2 The United Nations Model Convention 1980. In 1967 the United Nations adopted a resolution to establish a group of experts on tax treaties between developed and developing countries. The latter had previously complained that the OECD Model Convention favoured the former. Whereas the OECD Model grants the primary right to tax to the state of residence, the UN model gives

²⁵Danziger "International Taxation" at pages 321 to 323. See also the discussion by Danziger in Juta's Foreign Tax Review relating to the pro-rata method of rebates adopted by the Receiver of Revenue as set out in Practise Note 9 following the decision in CIR v Bulman's Estate (1987) 1 SA 659 (A).

²⁶D R Davies, Principles of International Double Taxation Relief, 1985 Sweet & Maxwell at pages 36 to 39.

the primary right to tax to the state of source. It should be noted that the concept of trading through a permanent establishment is retained in the UN model;

80.3 The United States Model income tax treaty, whereof the latest draft was finalized in 1981. This model treaty is not designed to replace or to be an alternative to the OECD Model, but is apparently intended as a means of aligning the OECD Model articles with United States domestic tax laws and policies²⁷.

81. In 1921, the League of Nations, in response to a resolution of the International Financial Conference, appointed a panel of four economists to examine the incidence of double taxation. Their report was released in 1923. It set out four methods for granting double tax relief. These are:

81.1 The country of residence deducts from the tax of its residents all foreign tax paid;

81.2 The country of source exempts non-residents from tax on any income earned within it;

81.3 The tax must be divided between the country of residence and the country of source;

81.4 Certain categories of income would be taxed in the country of residence, others in the country of source. The country of source would however retain the right to tax all income but would grant a rebate against foreign tax paid.

82. It is trite that the fourth method has been generally incorporated in double tax agreements.

The definition of a "permanent establishment"

83. Article 5 of the OECD model states that:

"Permanent Establishment

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

²⁷Op.cit. at page 44.

2. The term "permanent establishment" includes especially:
 - a. a place of management;
 - b. a branch;
 - c. an office;
 - d. a factory;
 - e. a workshop, and
 - f. a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months.
4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
 - (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
 - (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
 - (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
 - (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
 - (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
 - (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an

authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.
7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

84. It is clear from the above definition that the principle of taxation is that business income derived in a country by an enterprise which is not a resident of that country, should be taxed there only if the business which is carried on is of a continuing and lasting kind. In appropriate cases it may be possible to avoid becoming subject to tax in a foreign country by carrying on business activities with and not within such country. The definition of a "permanent establishment" is of great assistance in this regard. The presence of a tax treaty between the countries concerned may often be of particular value in determining precisely the nature of the business activities which may be carried on without thereby setting up a permanent establishment and hence attracting tax. Taxpayers are thus able to plan their activities accordingly. It also becomes possible to resolve the competing claims of the various tax jurisdiction in those cases where the carrying on of business activities and residence occur in different states.

85. According to **Davies**²⁸, the basic structure of the permanent establishment concept has been characterised as involving a three-part test comprising the following elements:
- 85.1 The assets test, which determines which assets, such as a branch, factory, workshop, mine, oil or gas well, etc. being a fixed place of business will constitute a permanent establishment;
 - 85.2 The agency/relationship test which determines when the acts of an agent, partner or subsidiary will constitute a permanent establishment even where the enterprise has no fixed place of business in the country concerned;
 - 85.3 The activities test, which sets out which activities, such as the storage, display, delivery or purchase of goods or collection of information, even if performed through a fixed place of business may not constitute a permanent establishment.
86. The **OECD Commentary** makes the following comments in regard to Article 5. It defines the term "permanent establishment" as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. The definition contains the following elements²⁹:
- 86.1 The existence of a "place of business", ie. a facility such as premises or, in certain instances, machinery or equipment;
 - 86.2 This place of business must be "fixed", ie. it must be established at a distinct place with a certain degree of permanence;
 - 86.3 The carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependant upon the enterprise, such as personnel, conduct the business of the enterprise in the state in which the fixed place is situated.
87. According to the **Commentary**, the word "fixed" means that the enterprise must operate at a distinct place - "there has to be a link

²⁸Op.cit. at page 115.

²⁹OECD Model Commentary 1977 as contained in M Edwardes-Kerr, The International Tax Treaty Service, In-Depth Publishing Ltd at paragraph 2. It is interesting to note that the commentary states in paragraph 3 that the establishment need not have a productive character i.e. contribute to the profits of the enterprise.

between the place of business and a specific geographical point"³⁰. In addition, there has to be a continuity of activity at the place of business for it to constitute a permanent establishment - "operations must be carried out on a regular basis"³¹.

88. It is interesting to note that Article 5(4)(f) exclude from the definition of a "permanent establishment" the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. This sub-paragraph is in support of the view that a fixed place of business may combine any or all of the excluded activities without thereby automatically creating a permanent establishment. This is obviously a common sense view.
89. According to paragraph 20 of the **Commentary** on Article 5(4) it lists a number of business activities which are treated as exceptions to the general definition laid down in Article 5(1) which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. According to paragraph 23 of the **Commentary** it is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. The **Commentary** further states in the same paragraph that a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise will not comprise a preparatory or auxiliary activity.
90. The **Commentary** contains some useful source rule tests. For example, it states in paragraph 24 that if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, and to maintain and repair such machinery, it goes beyond the "delivery" mentioned in article 5(4)(a). It regards such after-sale organisations as performing an essential and significant part of the services of the enterprise vis-a-vis its customers. Such activities are therefore not merely auxiliary in character. They thus qualify as permanent establishments.
91. Article 5(5) provides that an agent who has authority to conclude contracts on behalf of an enterprise, and who habitually exercises that authority, will constitute a permanent establishment of the enterprise.

³⁰Op.cit. at paragraph 5.

³¹Op.cit. at paragraph 7.

Whether an agent is "dependent" or "independent" is both a question of law and fact. Paragraph 36 of the **Commentary** in comment on Article 5(6) dealing with independent agents, states that a person will only have independent status if he is independent of the enterprise both legally and economically, and he acts in the ordinary course of his business when acting on behalf of the enterprise. In order to determine the status of an agent, the degree of control exercised over the agent by the principal and whether the agent has to take any entrepreneurial risk will be of great importance.

Case law on "permanent establishments"

92. In **Transvaal Associated Hide and Skin Merchants v COT Botswana**,³² the Court commented on the concept of a "permanent establishment". **Maisels JA** at page 114 held that:-

"As to whether the appellant had a permanent establishment in Botswana, I think the work "permanent" is used in contra-distinction to a merely temporary or occasional use of premises for purposes of trade or business. So looked at, the fact that since 1954 the appellant occupied a shed at a rental first established by way of a premium on the hides purchased by it, and since 1961, at a rental of R1 200 per annum, establishes, to my mind, that the appellant's occupation of the premises was not temporary or occasional, but was permanent."

93. In **Belgium/France October 22, 1963 Cour de Cassation (1963) La Revue Fiscale (542)**³³, a French parent company established a Belgium sales subsidiary. Although the subsidiary had its own management and conducted its own activities, its freedom of action was very tightly controlled by its parent company. The parent company strictly limited its sales territory, forbade it to sell other products and demanded certain reports on its activities. The Belgium tax authorities claimed that the Belgium subsidiary was so tightly controlled by its parents that it was not independent and should be considered a permanent establishment of the parent. The court however found that the subsidiary was wholly independent, notwithstanding such control, and the French parent did not therefore have a permanent establishment in Belgium.

³²29 SATC 97 (1967).

³³M Edwards-Kerr, Chapter 5 at page 18.

94. In **SIR v Downing**³⁴, the taxpayer, who was a former South African resident, resided in Switzerland. He owned a portfolio of shares in listed South African companies. The portfolio was administered by a South African stock broker on the taxpayer's behalf, and his general financial affairs were handled by a South African firm of financial administrators. The stock broker had full authority to buy and sell shares without reference to the taxpayer, and he exercised this authority regularly. The issue was whether gains made by the taxpayer from dealing in shares, which gains were not taxable in Switzerland, were taxable in South Africa. This depended in turn on whether the taxpayer carried on business in South Africa through a permanent establishment for the purposes of the Double Tax Agreement with Switzerland. The point for decision was whether the terms of the DTA between South Africa and Switzerland applied to constitute the broker a "permanent establishment" of the taxpayer. The Appellate Division upheld the Special Court's finding that the stock-broker's activities in managing the share portfolio in this matter were part of his ordinary functions as a stock broker, notwithstanding the wide discretion and unqualified power of management of the portfolio which he held. It was accordingly found that the stock broker's activities did not result in the taxpayer having a permanent establishment under the dependent agent provisions.
95. In **Thiel v Federal Commissioner of Taxation (1988) 20 ATR 170**, a similar arrangement arose as in **Downing's** case. The question also arose here as to whether profits from a sale of shares held in Australia by a Swiss resident would be relieved from Australian tax in terms of the double tax agreement between Australia and Switzerland³⁵. The Court held that the taxpayer would not automatically be relieved from tax in Australia just because he did not have a permanent establishment there. The Court held that the question as to whether the relevant profits were derived from the carrying on of a business still had to be decided. This test was passed in **Downing's** case. It is interesting to note that the taxpayer, inter alia, relied on the decision in **Downing's** case. As the taxpayer in **Thiel's** case only made one isolated sale the Court came to the conclusion that the taxpayer did not carry on a business in Australia. The income was however taxed for other reasons. In **Downing's** case the taxpayer carried out a number of share transactions over a nine year period. Had the Australian Court been faced with the facts of **Downing's** case it would undoubtedly have come to the conclusion that **Downing** carried on a business in Australia. As such **Downing** would have been found to have had a permanent establishment in Australia. Hence

³⁴1975 (4) SA 518 (A).

³⁵See the discussion by Fernandes (1989) 2 Juta's Foreign Tax Review 60.

Downing would have been taxed as a result³⁶. It should be noted that **Thiel** subsequently appealed which was dismissed.³⁷

96. In **Firestone Tyre and Rubber Company Limited v Llewellyn [1957] 1 All ER 561** an American parent company, Firestone Rubber and Tyre Company, operated on a world-wide basis and had a subsidiary in the United Kingdom which manufactured tyres for the local United Kingdom market and for export. The parent company had a number of distributors for its products. Agreements between the parent company and its distributors set out the terms on which its products would be supplied to them and their obligations as distributors. The United Kingdom subsidiary had a list of the distributors and the distributors had a list of the manufacturers, including the United Kingdom subsidiary. The agreement between the parent company and the subsidiary was that the subsidiary would fill orders obtained by the parent company from overseas distributors. These distributors ordered direct from the UK subsidiary which accepted payment and deducted its own cost and a 5% profit margin and credited the remainder to the parent company. The parent company was then assessed by the United Kingdom tax authorities on its profits from these exports from the United Kingdom to its distributors. The subsidiary argued that when it exported tyres to a distributor this was a sale by it to the parent company and delivery under the parent company's order. The House of Lords however found that the parent company was assessable on the basis that it was exercising a trade in the United Kingdom of selling tyres through its agents to overseas distributors under contracts entered into in the United Kingdom. Although this case was decided before the relevant double tax treaty came into effect it is of useful illustration. If the original plan had been adhered to, and orders had come through the parent, the outcome may have been in favour of the taxpayer. According to **Lehmann and Coleman**³⁸, if these events had occurred in circumstances where either Australia's, United Kingdom or United States treaties had applied, the activities of the subsidiary which occurred, as distinct from what was planned, would have constituted a permanent establishment. The subsidiary acted as a non-independent agent, that concluded contracts on behalf of its parent company. However, if the planned activities had occurred, there may well have been no permanent establishment for the purposes of the US treaty.

³⁶See Arthur (1990) 3 Jutta's Foreign Tax Review 49.

³⁷See Arthur (1991) 4 Jutta's Foreign Tax Review 13.

³⁸(1957) 28 TC 127, quoted in Davies op.cit at page 116.

97. In a United States tax case **Consolidated Premium Iron Ores Limited**³⁹ it was held that a Canadian Company which only had a mailing address in the United States but had no office, telephone listing or bank account there, did not have a permanent establishment in the United States. At page 152 of the judgment it was held that:

"The terms "permanent establishment", normally interpreted, suggests something more substantial than a licence, a letterhead and isolated activities. It implies the existence of an office staffed and capable of carrying on the day-to-day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity. The descriptive word "permanent" in the characterisation "permanent establishment" is vital in analyzing³ the treaty provisions. It is the antithesis of temporary or tentative. It indicates permanence and stability".

The "business article" provision

98. The "business profits" article compliments the permanent establishment concept. An enterprise of one treaty state only becomes liable to tax in the other treaty state if it carries on business in the other state through a permanent establishment in that state. The business profits article determines the way in which the taxable profits of the permanent establishment are to be determined. According to **Danziger**⁴⁰, there are two questions that need to be asked:

98.1 Is there a permanent establishment;

98.2 If so, what, if any, are the profits on which the permanent establishment should be taxed?

99. According to **Danziger**⁴¹, the principle underlying the business profits article is that:

"The profits attributed to the permanent establishment are those which it would have made if, instead of dealing with head office it had been dealing with a separate entity under

³⁹G Lehmann & C Coleman, Taxation Law in Australia 1989 Butterworths at page 884.

⁴⁰Op.cit. at page 349.

⁴¹Op.cit. at page 351.

market-related conditions and at market-related prices. The same rule applies with regard to the permanent establishment's transactions with other permanent establishments of the same enterprise and with related companies in the same group. In determining the profit attributable to the permanent establishment, the revenue authorities refer to the accounts of the permanent establishment. Where the accounts do not accurately reflect the profit of the permanent establishment (for example where transfer pricing in relation to sales of goods by the enterprise to the permanent establishment has occurred) the authorities are empowered to rectify or adjust the accounts."

100. The allocation of profits between the permanent establishment and its parent or holding company may be of considerable assistance in regard to establishing such principles in our own law. As a first measure the tax authorities will rely on the books of accounts maintained by the permanent establishment. Failing that they will apply the arms length principle to establish and allocate the profits due to the parent company and the permanent establishment respectively.
101. Determining an arm length's price is very difficult to apply in practise. The 1979 report of the **OECD Committee of Fiscal Affairs' on Transfer Pricing and Multinational Enterprises** provides the basic model for determining an arm's length price. There are four possible methods. These are⁴²:
 - 101.1 The comparable uncontrolled price method. Uncontrolled sales may include sales between a member of a multi-national enterprise and an unrelated third party. To determine whether the uncontrolled sale is comparable, the following factors must be considered:
 - 101.1.1 Are the markets economically comparable?;
 - 101.1.2 Are the market levels comparable?;
 - 101.1.3 Are the goods comparable?;
 - 101.1.4 Are there other factors which mean the uncontrolled sale is not comparable?
 - 101.2 The resale price method. This method looks at the price charged by a member of a multi-national enterprise when it resells the

⁴²Lehmann & Coleman at page 897.

product it purchased from an associated company. In order to ascertain the arm's length price which it should have paid, its own resale price is the starting point. To ascertain the price it should have paid, its own costs and an appropriate profit margin are deducted to ascertain the price it should have paid to its affiliate..

101.3 The cost plus method. This method is used to ascertain the arm's length price that a supplier should receive for goods sold by it. This method adds to the supplier's cost a reasonable profit margin to arrive at the arm's length price.

101.4 Other or "fourth methods". These methods are also discussed by the **1979 OECD Report**. These methods may allow a departure from the arm's length principle.

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Introduction

1. A foreign undertaking wishing to extend its business activities into South Africa must consider a number of factors before doing so. The assumption will be made that such an undertaking will trade within South Africa and not merely with it. The following issues mainly from a tax point of view have been identified as material factors:
 - 1.1 The choice of business entity;
 - 1.2 The determination of taxable income;
 - 1.3 The impact of double tax agreements;
 - 1.4 The impact of withholding taxes;
 - 1.5 Exchange Control requirements;
 - 1.6 Various trade and business related considerations.

2. Liability for tax is dependant upon the existence of a connecting factor between a taxing jurisdiction on the one hand and a taxpayer or taxable event on the other. In the case of an individual taxpayer, the principal connecting factors are residence, ordinary residence, domicile and citizenship (nationality). In the case of a company, they are management and control, beneficial ownership, place of incorporation and the location of the registered office. The principal connecting factor with regard to a taxable event is the real or deemed source.

3. When a foreign enterprise trades within the country of source as opposed to merely trading with that country, the existence of an applicable double tax agreement becomes important. In the absence of a double tax agreement, the foreign enterprise's investment should, where possible, be routed via a third country that has double tax agreements with both the country of residence of the foreign enterprise and also the country of source. In the absence of such a third country, the principles of taxation applicable in the country of residence of the foreign enterprise and the country of source, must be carefully examined. This chapter will only discuss those cases where there is a double tax agreement between the country of residence of the foreign enterprise and the country of source, being South Africa, and where the activities of the foreign undertaking will qualify as a "permanent establishment".

4. The "permanent establishment" concept determines the tax liability of an enterprise of one contracting state, that is the resident state, if it carries on business in the other contracting state, that is, the state of source. The latter may only tax income attributable to the permanent establishment. Many states regard a very low level of business activity by foreigners as sufficient to establish a connecting factor between that state and the foreign enterprise for purposes of taxation. A permanent establishment requires some degree of physical presence on the part of the enterprise in the state of source.

5. One of the main objectives of a double tax agreement is to resolve the claims of computing tax jurisdictions where an enterprise is resident in one country and carries out business activities in another from which it derives income. Central to this issue is the point at which the activities of a foreign enterprise will become subject to domestic taxation in the country where the profits are earned. In the United Kingdom, according to **Davies**¹ that threshold is described as the point when a foreign enterprise trades within the United Kingdom as opposed to merely trading with the United Kingdom. Similar criteria are used by other countries.
6. According to **Kent** and **Rosenzweig**² four "fundamental techniques" are required for inter-state tax planning. These are:
 - 6.1 The distribution of post-tax profits after, hopefully, minimising the burden of withholding taxes;
 - 6.2 The source allocation of pre-taxed profits being a pre-requisite towards an interplay of the variant tax rates "inter-state";
 - 6.3 Extraction of pre-tax profits by means of various charges for items such as interest, management fees, etc., from the enterprise situated in a high tax country to one with more favourable rates;
 - 6.4 Finally, an attempt to minimize the tax burden on the executives within the enterprise concern, combined with a maximization of the tax benefits by use of an astute inter-relationship of the abovementioned principles, would result in the Utopian inter-state tax plan.
7. The further discussion of these issues in Chapter 4 is premised on the following assumptions:
 - 7.1 The taxpayer is foreign and will carry on business in South Africa either by way of a branch or subsidiary. It may or may not therefore carry on business as a "permanent establishment" in South Africa;
 - 7.2 There is a double tax agreement between the foreign taxpayer's country of residence or management and South Africa;
 - 7.3 The foreign taxpayer may derive income from South Africa by way of business profits, interest, royalties or dividends. Any differences

¹Davies paragraph 10.07 at page 114.

²"Aspects of International Tax Planning", SA Chartered Accountant, Vol. 17, Nos 4 to 9, 1981.

in the tax treatment between the types of income will be dealt with insofar as it may be necessary;

7.4 There may or may not be a danger of double taxation.

The choice of business entity

8. Foreign companies that decide to carry on business in South Africa via a permanent establishment can do so either by way of incorporating a local subsidiary or by registering as an external company in terms of Section 322 of the **Companies Act, No 61 of 1973**. This discussion will not deal with partnerships, joint ventures, trusts and so forth. In the event of the incorporation of an external company, it will carry on business as a branch in South Africa. According to **Passos**³, the tax consequences of the two forms of businesses inter alia are:-

8.1 A branch and its head office is regarded as the same legal entity. As such it is not possible for the head office and the branch to enter into any agreements, such as royalty, loan, service or management agreements. This is so as it is not possible for a legal entity to conclude agreements with itself. The head office is therefore precluded from extracting pre-tax income from South Africa such as royalty payments, interest on loans, management and other service charges. However by virtue of Section 11(b) of the **Income Tax Act**, expenses incurred by the head office that are directly related to the trading operations of the branch in South Africa will be deductible in the hands of the branch. When branch profits are remitted to the head office, these are not subject to any withholding tax as South Africa does not impose a withholding tax on the remittance of foreign branch profits. However, dividends paid by the external company to its foreign shareholders out of the South African branch profits will be subject to the withholding tax on dividends. In such an event the branch should remit its profits to the head office, where the latter should declare the dividend to its shareholders. The dividend must accordingly not be declared from South Africa.

8.2 According to **Passos**⁴ in practise Revenue treats the branch as a separate tax centre. The Revenue authorities will accordingly permit the transfer of stock between the head office and the branch to be made at a reasonable profit and not at cost. The approach is a practical solution to apportion profits and expenses between the head office and the branch. The branch is also

³At 19.

⁴loc.cit.

permitted to depreciate business assets transferred to it. As the transfer of these assets back to the head office (or another branch in another country) will not constitute a sale between the head office and its branch the recoupment provisions contained in the **Income Tax Act** cannot be of application. This may present taxpayers with important tax planning opportunities.

- 8.3 A subsidiary on the other hand constitutes a separate legal entity from that of its holding company. As such the holding company and the local subsidiary can enter into agreements with each other and the former can extract pre-tax income from South Africa. Dividends paid by the subsidiary to the holding company will however be subject to the withholding tax on dividends. Royalties will also be subject to a withholding tax.
9. In addition to the above, the following further considerations will also be of importance:
- 9.1 There is a substantial difference in carrying on business via a local subsidiary or a branch upon disinvestment from South Africa. In the case of the latter it is only possible to effect a sale of business and not also a sale of the corporate entity itself.
 - 9.2. The head office's country's tax system must be considered. Where the head office is liable for tax on world-wide income, the branch results will impact thereon. It may be advisable to conduct a branch operation during the start-up phase of a business when losses are more likely. In such an event the head office obtains an immediate tax benefit. On the other hand the foreign parent is exposed to delictual liability in a foreign jurisdiction.
 - 9.3 Foreign corporations can undertake joint ventures with South Africans locally in one of two ways, namely:
 - 9.3.1 A joint venture strictu sensu, whereby the parties jointly form a company in or out of South Africa. According to **Passos**⁵ the tax principles applicable will resemble those applying to a local subsidiary;
 - 9.3.2 A joint venture by way of partnership. According to **Passos**⁶, the position of the foreign enterprise will be similar to that of a foreign enterprise trading through a branch in South Africa.

⁵Op.cit at page 29.

⁶loc.cit.

10. Section 28 bis of the **Income Tax Act** provides that where a foreign company transfers the business of its local branch to that of a South African company, the Commissioner may make certain concessions as an incentive for the foreign company to do so. The transfer of a branch business to a local subsidiary can therefore take place without changing the tax profile of the business. This is an important provision and has the following consequences:
 - 10.4.1 The branch need not re-value its assets such as stock and investments;
 - 10.4.2 Any assessed loss by the branch can be transferred to the subsidiary. Under suitable circumstances, the head office may set branch losses off its income and such losses may also be transferred to the local subsidiary.
11. Finally, care should be taken in the choice of a business entity insofar as it pertains to article 5(7) of the **OECD Double Taxation Convention on Income and Capital**. It recognises that an overseas subsidiary company is a separate legal entity from its parent, so that it is not automatically regarded as a permanent establishment. If in fact the subsidiary functions as a non-independent agent acting on behalf of its parent, it will constitute a permanent establishment. Thus, while an overseas subsidiary company in a treaty country will usually not be a permanent establishment of the parent company, an overseas branch will always have that status. The provisions of this paragraph may or may not operate in favour of the taxpayer. The **OECD model Commentary** states that a person will only have independent status if he is independent of the enterprise both legally and economically and he acts in the ordinary course of his business when acting on behalf of the enterprise⁷. As a test for determining the status of an agent, the **Commentary** refers to the degree of control exercised over the agent by the enterprise, and whether the agent has to take any entrepreneurial risk. If an agent acts almost exclusively for one enterprise, it may be difficult for him to show that he is independent.

The determination of taxable income

12. It is trite that South Africa will impose normal tax on business profits derived by foreign enterprises when the profits are sourced or are deemed to be sourced in South Africa, the enterprise carries on trade or business in South Africa and such trade or business is carried on through a permanent establishment situated in South Africa. The exact ambit of the foregoing will be determined with reference to the relevant double

⁷1977 Commentary page 67 paragraph 36.

tax agreement. According to **Danziger**⁸ the general provisions of the **Income Tax Act** which determine how taxable income is determined are:-

- 12.1 Section 11(a) which provides that for the purpose of determining the taxable income derived by a person from a trade carried on in South Africa, expenditure and losses actually incurred in South Africa in the production of income are allowed as deductions from income of such persons so derived, provided the expenditure or losses is not of a capital nature;
 - 12.2 Section 11(b) which provides that for the purpose of determining the taxable income derived from a South African source, expenditure and losses actually incurred outside South Africa in the production of such South African income are allowed as a deduction provided it is also not of a capital nature. It is interesting to note that Section 13(a) of the **Income Tax Act, 1991**, with respect to the 1992 and subsequent tax years removed the Commissioner's discretion under Section 11(b);
 - 12.3 Section 23(f) which prohibits the deduction of expenses incurred in respect of any amounts received or accrued which do not constitute "income" as defined in Section 1 of the **Act**;
 - 12.4 Section 23(g) which prohibits the deduction of monies claimed as a deduction from income derived from trade, which are not wholly or exclusively expended for the purposes of trade. This section has now been amended⁹. It now permits an apportionment of expenditure which is incurred partly for purposes of trade and partly for purposes other than trade. Previously it prohibited the apportionment of combined expenditure and losses incurred partly for trade and partly for other purposes. The tax authorities and the Courts have in recent years applied Section 23(g) more stringently. This led to the decision in the recent case of **CIR v Solaglass Finance Co. (Pty). Ltd. 1991 (2) SA 257 (A)**. The amendment now permits the deduction of expenditure which is incurred for a dual purpose.
13. The extent to which business profits are taxable are restricted to the nett business profits attributable to the South African permanent establishment. The treaties do not contain detailed rules defining the

⁸Danziger "International Income Tax at page 193.

⁹Section 20 of the 1992 Income Tax Act (Act No 141 of 1992).

profits attributable to a permanent establishment. According to **Passos**¹⁰ some general directives are adopted by South African Revenue authorities for ascertaining the profits attributable to a permanent establishment. These include:

- 13.1 A basic directive which attributes to the permanent establishment, the profits that the establishment might be expected to derive if it were a distinct and separate enterprise from the holding company, and dealing at arm's length with it;
 - 13.2 A subsidiary method which determines the profits attributable to the permanent establishment on the basis of apportionment of the total profits of the enterprise between the head office and the permanent establishment.
14. There are a number of specific deductions which may be of interest to South African branches of foreign companies. These are:
- 14.1 Expenses and operating costs incurred in South Africa in relation to foreign assets which do not generate South African source income are not deductible. In **ITC 800**¹¹, a South African company was disallowed a deduction claimed under the head of "Postage and Cables" as it appeared to the Court that the amount claimed related to a cable sent by the company to the United States in connection with mineral rights situated in Namibia which were owned by it. Any income which may have been earned as a result of this expenditure would not have its source in South Africa.
 - 14.2 There are a number of conflicting special Court decisions on the deductibility of foreign head office costs in the determination of the South African tax liability of branches of foreign companies for South African tax. In **ITC 36**¹², an English company with a local branch deducted 2.5% of the total administrative expenses incurred by its London head office from its South African income tax liability. The deduction was allowed on the basis that the allocation of a small proportion of the total expenditure of the head office was a reasonable charge against the branch. In **ITC 103**¹³, an English shipping company which had local branches claimed a deduction for the costs incurred by it in the United Kingdom in

¹⁰At page 162.

¹¹20 SATC 226 (1954) quoted by Danziger at page 218.

¹²2 SATC 64 (1925) quoted by Danziger at page 219.

¹³3 SATC 328 (1927) quoted by Danziger at page 220.

purchasing goods for the branches and shipping such goods to them. The Court held that the company was entitled to deduct from the income of a branch, any expenditure incurred in its United Kingdom office which related to the business activity of the branch. The ratio for the decision was that the head office and the branch was a single legal person. In **ITC 329**¹⁴, the Court disallowed a deduction by a United Kingdom insurer with a branch in South Africa, a portion of the head office expenses in the ratio which the insurers South African premium income bore to its total premium income. The Court rejected the insurers' argument that the deduction claimed reflected the cost of the control exercised by the head office over the branch operations. The Court was of the view that it had not been shown that the expenditure claimed had actually been incurred by the branch outside South Africa, and that it was not sufficient to show an arbitrary pro rata allocation without demonstrating that the expenditure in issue had actually been incurred by the entity which claimed it. It should be noted that there had been no actual payment of the costs by the branch, and that the costs had not been incurred by the branch, but by the head office and all its branches taken together.

The impact of double tax agreements

15. Section 108(1) of the **Income Tax Act** empowers the State President to conclude double tax agreements with governments of other countries. Section 108(2) gives such agreements the force of law once promulgated in the Government Gazette. According to **Danziger**¹⁵ Section 108 of the **Income Tax Act** is a specific application of Section 6(3)(e) of the **Republic of South Africa Constitution Act, No. 110 of 1983**. It is trite that double tax agreements cannot impose liability for tax. They merely function to limit the fiscal jurisdictions of the contracting states in respect of certain items of income. These agreements therefore may contain provisions which are contrary to the provisions of the **Income Tax Act**. However according to **Horak**¹⁶ subsequent domestic legislation which is contrary to a provision of a double tax agreement will override the treaty provision. This is so as a result of the principle *lex posterior derogat priori* in terms whereof subsequent legislation overrules a contrary provision enacted earlier.
16. Although a double tax agreement is equivalent to a statute, it nevertheless remains an international treaty, so that it is to be interpreted

¹⁴8 SATC 261 (1935) also quoted by Danziger at page 220.

¹⁵At page 326.

¹⁶At page 180.

according to the rules governing treaties and not only according to the principles of construction applicable to local tax legislation. The **Vienna Convention on the Law of Treaties (1969)** lays down rules for the construction of international treaties. According to **Passos**¹⁷ although South Africa is not a signatory to this Convention, its provisions would carry persuasive authority.

17. The general principle to be applied is set out in article 31(1) of the **Vienna Convention** which states that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". South African Courts take judicial notice of international law. In **South Atlantic Islands Development Corporation Ltd. vs Buchan 1971 (1) SA 234 (C), Diemont J** held as follows¹⁸:

"Although I am surprised that there is no decision in which a South African Court has expressly asserted that international law forms part of our law, I would be even more surprised if there were a decision asserting the contrary. It appears to have been accepted in both the English and the American Courts that international law forms part of their own law. (see **West Rand Central Gold Mining Company Ltd. vs R [1905] 2 K.B. 391** and **Banco Nacional De Cuba vs Sabbatino [1963] U.S. 398**). There are also one or two indications in decisions in our Courts that judicial notice will be taken of international law.

18. It should be noted that international law enjoys no privileged position in South Africa's legal system. International law rules may be overridden by South African legislation. The only international law rules which South African Courts will apply directly are the customary rules of international law¹⁹. As most of the rules of treaty interpretation contained in the **Vienna Convention** are customary rules of international law, it can be argued that the South African courts should apply these rules.
19. The interpretation of a double tax treaty also differs significantly from the interpretation of domestic tax legislation. Article 32 of the **Vienna Convention** permits, as an aide to construction, reference to the travaux préparatoires of a treaty, that is the preparatory work leading to a treaty

¹⁷At page 69.

¹⁸This reference was obtained from Horak at page 182 footnote 28.

¹⁹Horak at page 182.

and the circumstances of its conclusion. This is not allowed in the construction of domestic legislation. This tool of construction was approved and applied by the House of Lords in **Fothergill vs Monarch Airlines [1981] A.C. 251**. It was held that to qualify as travaux préparatoires, any relevant material must be "public and accessible, and clearly and indisputable point to a definite legislative intention". The **OECD Commentaries** can also be referred to as a guide to the interpretation of double tax agreements.

20. The South African Courts have considered the interpretation of a tax treaty on only one occasion, that is, in the case of **Secretary for Inland Revenue vs Downing (1975) SA 518 (A)**. The taxpayer was formerly resident in South Africa. He now resided in Switzerland. As he was not permitted to take all his assets on emigration he had a substantial asset base in South Africa. It consisted mainly of listed shares on the Johannesburg Stock Exchange. This portfolio was managed by a local stock broker who enjoyed full authority to buy and sell shares for and on behalf of the taxpayer. The revenue authorities sought to tax **Downing** on gains made on the purchase and sale of shares in his portfolio on the basis that he carried on business in South Africa via a permanent establishment through the offices of his stock broker.
21. In the course of its judgment the Court acknowledged that the terms of the treaty were based upon the **OECD Model Convention** of 1963. It did not however indicate to what extent it regarded the **OECD Commentary** as binding on South African Courts. The lower Court did, however, base its argument on a passage from the **OECD Report**. This may be regarded as an indication that the Courts will take the **Commentary** into account when a treaty is interpreted²⁰. The approach followed by the Court is in conformity with the rules of construction set out in the **Vienna Convention**. The Court did not however refer to it.
22. In **Transvaal Hide and Skin Merchants (Pty) Ltd. v Collector of Income Tax, Botswana, 29 SATC 97 (1967)**, a South African company relied on the permanent establishment concept to avoid liability for income tax in Botswana. It bought and cured hides in Botswana which were then sold in South Africa. The taxpayer argued that as it was not maintaining a permanent establishment in Botswana it was not liable for Botswana income tax. Article III(1) of the treaty between Botswana and South Africa provided that the activities of a foreign enterprise would be taxed insofar as it was attributable to a permanent establishment in Botswana. The taxpayer clearly maintained a permanent establishment in Botswana and hence a case for apportionment existed. The Court in

²⁰At page 526 of the judgment.

the course of its judgment held the following in regard to the status of the double tax agreement between Botswana and South Africa²¹:

"Mr Gould contended that as the Double Taxation Agreement is still in force, the Income Tax Proclamation must be taken to be amended pro tanto, i.e. to the extent to which it is necessary to give effect to the Agreement. I shall assume this to be so, although I am in some doubt whether agreements of this nature should not be considered merely as inter-governmental arrangements which afford the resident of a state relief as against his own state, and not as affording the non-resident exemption from tax for which he would be liable in terms of the taxation laws of the state of which he is a non-resident".

23. According to **Horak**²² this is not a correct interpretation of a double tax agreement. He submits that it is the very purpose of such agreements to limit double taxation. He also submits that double tax agreements often function to exempt a non-resident of the source state from the liability to pay income tax in the source state.
24. It is clear that double tax treaties help to create an environment of fiscal certainty which encourages trade and investment between countries. The permanent establishment concept employed in double tax treaties define the type of business activity which denotes whether or not an enterprise operating in a foreign country has a taxable presence there. The profits of international shipping and airway enterprises are inherently exposed to international double taxation. Tax treaties are probably the most effective way of eliminating double taxation in this area.
25. South Africa has concluded a number of comprehensive double tax treaties. In addition it has also concluded a number of sea and air-transport agreements. The agreements concluded by South Africa are based on the **OECD model treaty**.

The impact of withholding taxes

Introduction

26. The **Income Tax Act** levies a number of taxes. Firstly it levies an income tax upon all persons who derive income from sources within or

²¹At page 113 to 114 of the judgment.

²²At page 187 to 188.

deemed to be within the Republic. Secondly, in the case of certain categories of income, namely, dividends, royalties and the income derived by ship and aircraft operators, the gross income accruing to the non-resident is taxed at a flat rate. By the use of double tax agreements, the rate of the withholding tax may be reduced. No provision is made for any allowance for expenditure and losses incurred in the production of income in the levying of withholding tax.

27. Withholding taxes are only applied to income accruing or paid to non-residents. These taxes are imposed due to the difficulty which may be experienced in recovering taxes from persons who do not live within a country.
28. The responsibility to pay withholding taxes over to the authorities falls upon any one of a number of withholding agents appointed by the **Income Tax Act**. It should also be noted that withholding taxes mainly fall due upon payment and not upon accrual. This principle is however departed from time to time.

Non-resident shareholder's tax

General

29. Section 41 of the **Income Tax Act** provides for a non-resident shareholder's tax (NRST) at the rate of 15% of the gross amount of any dividend or interim dividend paid to a non-resident. On the other hand dividends received by a resident is exempt from tax in terms of Section 10(1)(k) of the **Income Tax Act**. It should be noted that the source of dividends in South Africa is the location of the share register on which the shares in respect of which the dividends are paid, are registered.
30. NRST is in terms of Section 42 payable in respect of:
 - 30.1 Any interim dividend, the payment whereof has been approved by the directors of any company or by some other person under authority conferred by the memorandum and articles of association of those companies;
 - 30.2 Any dividend which has been declared by any company.

provided that the shareholder to whom the dividend or interim dividend is paid or payable is:

1. A person not ordinarily resident nor carrying on business in the Republic; or
2. A deceased estate of a person not ordinarily resident nor carrying on business in the Republic at the date of his death; or

3. A company which has its place of effective management outside the Republic;
 4. A holder of bearer scrip, irrespective of whether the holder is resident within or outside the Republic.
31. The determination of the persons who are the shareholders is made at the date on which the dividend is declared, unless a different date is fixed as being the date on which the registered shareholders are entitled to dividends.
32. Although Section 42(1) states that NRST is payable in respect of a dividend or interim dividend paid or payable to "the shareholder" who received the dividend or interim dividend, it does not require the shareholder to be the registered shareholder with regard to the share on which the dividend or interim dividend is due. Section 1 of the Act contains a definition of "shareholder". It is defined inter alia as:
- "In relation to any company, shareholder means the registered shareholder in respect of any share. except that where some person other than the registered shareholder is entitled, whether by virtue of any provisions in the memorandum or articles of association of the company or under the terms of any agreement of contract, or otherwise to all or part of the benefit of the rights of participation in the profits or income attaching to the share so registered, such other person shall, to the extent that he is entitled to such benefit also be deemed to be a shareholder".
33. The registered shareholders of a company are usually entitled to participate in its profits or income. Hence dividends are normally paid to the company's shareholders. In the event that some other person is legally entitled to all or a part of the dividends received by a registered shareholder, such other person is also deemed to be a shareholder to the extent of his entitlement. The nominee/beneficial shareholder relationship accordingly falls within the ambit of this definition.

The 1992 amendment to Section 42

34. Dividend payments received by a non-resident beneficial shareholder from the registered shareholder will thus be subject to NRST. It should be noted that Section 42(1)(iii) was amended by Section 27 of the 1992 **Income Tax Act**. Before the amendment it provided that NRST would be payable by "a company which is not a South African company". In an unreported judgment on 10 March 1992, the Transvaal Income Tax Special Court held that Section 42(1)(iii) fell foul of the anti-discrimination

provisions of the South Africa Netherlands double tax agreement²³. The taxpayer was a company incorporated in the Netherlands and where it also had its place of effective management. It held shares in a company incorporated in South Africa. The Netherlands company was liable for NRST in terms of Section 42 on dividend distributions to it by the South African company. It claimed a refund on the basis that article 25 of the treaty prohibited South Africa from imposing a more burdensome tax on the nationals of the Netherlands than on its own nationals. Article 10 of the same agreement permitted the country of source to impose tax on dividend income accruing to residents of the other state. As dividends are exempt from tax in South Africa, the Court found that article 25 prohibited the taxation of dividends accruing to the Netherlands company. The Court found that the sole criterion for the imposition of NRST on the dividend paid to the taxpayer was the fact that it was not a national of South Africa. The Court used an example of two companies, A and B, both resident in the Netherlands each holding shares in a company C carrying on business in South Africa to illustrate how the discrimination manifests itself. If A happened to be a South African company, it would not be subject to NRST on a dividend received from C whereas B would be subject to such tax. As a result Section 42(1)(iii) was amended to remove reference to a South African incorporated company as criterion for the imposition of NRST²⁴.

Exemptions to NRST

35. There are a number of exemptions to NRST. These are set out in Section 42(2). They are:
- 35.1 Dividends paid by co-operatives;
 - 35.2 Dividends paid by public utilities;
 - 35.3 Dividends paid by non-resident ship or aircraft operators;
 - 35.4 Dividends accruing to ecclesiastical, charitable or educational institutions;
 - 35.5 Dividends distributed out of oil-mining income;
 - 35.6 Dividends in the form of an annuity;
 - 35.7 The interest element of a unit trust distribution;
 - 35.8 Dividends accruing to non-resident insurers;

²³This case is fully discussed by Horak in (1992) 5 SA Tax Review at page 63.

²⁴There is an interesting discussion by Horak as to whether the Court properly discussed the issue whether a South African company effectively managed in the Netherlands could be said to be in the same circumstances as a Netherlands company also managed there. He finds that the South African company resident in the Netherlands is in a worse position insofar as the application of the ordinary tax laws in South Africa are concerned.

35.9 Dividends paid to TBVC pension funds or retirement annuity funds.

Apportionment

36. Section 46 of the **Income Tax Act** provides that NRST must be calculated only upon the South African source income of the company declaring the dividend. Hence where the company declaring the dividend derives income from sources partly within South Africa and partly outside South Africa, the NRST payable on the dividend is calculated on an amount which bears to the dividend the same ratio as the sum of the net profits of the company derived from sources within the Republic bears to its total net profits derived from all sources.
37. According to **Meyerowitz**²⁵, it is not clear on what basis the determination is to be made; whether it relates only to the profits of the company's financial year in which the determination is made, or to accumulated profits as well, or to all the profits of the company derived by it at any time up to the time of the determination. **Meyerowitz**²⁶ also submits that neither Section 30, which deals with taxable income where a person carries on business extending beyond the Republic, nor Section 49 which defines "total net profits" for the purpose of undistributed profits tax, is applicable or relevant. He further submits that in view of the fact that there need be no relation between current profits and the dividend and that the section refers to the sum of the profits from sources in the Republic and the total sum of its profits derived from all sources, the last alternative is the correct one.
38. **Meyerowitz** further continues that it is the practice of Inland Revenue to determine the ratio according to the profits of the company as reflected in its accounts for the last financial year and to use this ratio until a fresh ratio is determined, again on the profits reflected in the accounts for the last available financial year prior to the new determination.

The payment of NRST

39. Section 44(1) provides for the payment of NRST by and the recovery of the tax from the person responsible for the payment of the dividend to the non-resident shareholder. Section 44(1) also provides that the tax shall be payable by and recoverable from:

39.1 In the case of dividends distributable by any company to any person whose address appearing in the share register of the

²⁵Paragraph 1607.

²⁶See footnote C to paragraph 1607.

company is outside the Republic or to any holder of bearer scrip, the company by which the dividend is declared; or

- 39.2 In the case of dividends received by any agent in the Republic on behalf of any shareholder referred to in Section 44, the agent so receiving the dividend.
40. The payment of NRST becomes due only within 30 days of either:
- 40.1 The date on which the dividends are payable, if the dividends are payable by the distributing company directly to the shareholder; or
- 40.2 The date of delivery of the dividend payment at the address of the South African agent of the foreign shareholder.
41. According to **Passos**²⁷ the fact that the law places relevance on two different dates (date of declaration of the dividends and the date of payment of the dividends) leads to the situation that if payment of the dividends does not occur, the liability for NRST never becomes effective.

The dividend's article in the OECD Model

42. Most countries impose withholding tax on dividends, some as high as 30%. The rate found in South Africa is therefore relatively low. By the use of double tax agreements, this rate may be reduced to as little as 5%, in cases of distributions to parent companies. The "dividends" article in the **OECD model** permits the residence state to tax the dividend income of its residents derived from sources in the source state, but also permits the source state to tax the dividends by way of a withholding tax at a maximum rate of 15%. Neither the residence or the source state is granted the exclusive right to tax such income. According to **Danziger**²⁸ in order to qualify for the withholding treaty benefit, the dividends must either be beneficially owned by a company which is resident in the residence treaty state, or they must be paid to a resident of the residence state who is subject to tax on those dividends in that state.

²⁷At page 45.

²⁸At page 363.

43. Article 10 of the **OECD model** provides that²⁹:

- "1. Dividends paid by a company which is a resident of a contracting state to a resident of the other contracting state may be taxed in that other state.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that state, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed:
 - (a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
 - (b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other state independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or

²⁹Davies at pages 147 to 148.

fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject to the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State".
44. The "dividends" article generally provides that taxation may be levied on dividends both in the state of source and in the state of residence. The right of taxation by the state of source is however limited by the double tax treaty, usually to 15%, and the state of residence gives double tax relief by means of rebate or exemption³⁰. South African treaties follow the **OECD model** by generally imposing the limit of 15% withholding tax which is reduced to 5% or 10% in the case of direct investment subject to a minimum holding in the paying company. It should be noted that the limitation on taxation by the state of source is only applicable if the recipient is the "beneficial owner" of the dividends. Hence it will not apply if the recipient is an agent or a nominee. The **OECD model** provides a detailed list of items which may be regarded as dividends. The term generally covers any form of distribution from company profits which is derived from the ownership of shares. It does not include income derived from debt-claims such as debentures or loans. Article 10 will not apply where the dividends are derived from a shareholding which is "effectively connected" to a permanent establishment of the recipient which is situated in the country of the paying company's residence. "Effectively connected" dividends will be taxed under the "business profits" article or the "personal services" article as the case may be.

Methods to reduce or avoid NRST

45. There are a number of methods to reduce or avoid the source tax on dividends. These are discussed below. If company X, a resident of country A, wishes to invest in the shares of a company in country B, and country A has no tax treaty with country B, company X may be subject to withholding tax in country B at a rate of 30%. In order to obtain the benefit of a reduced source tax rate, company X could create an

³⁰Davies at 152.

intermediary company in a country that does have a favourable tax treaty with country B. The term "treaty shopping" is used to describe a situation where a taxpayer places itself in a situation whereby it will take advantage of the benefits of a double tax agreement which would otherwise not be available to it. A taxpayer in a typical treaty shopping scheme will interpose a third party between it and the party with whom it will transact. The third party is placed in a jurisdiction that has concluded a favourable double tax agreement with the country in which the taxpayer will invest. The extradition of income from the country of investment is routed via the third party as interest, dividends or royalties. When a company is incorporated in such a country, it will generally qualify as a resident of that country for purposes of tax treaties concluded by that country³¹. Company X would then transfer its shares to this company. This step could reduce the source tax in country B to as low as 5%, provided the intermediary company satisfies the requirements for such a reduced rate to apply, e.g. it holds more than 25% of the shares of the distributing company in country A. The intermediary company will therefore receive dividends. Where the income is subject to a significant tax burden in the intermediary country, the deviation serves no purpose since the total foreign tax paid on the dividend income might even increase as a result of the implementation of this scheme. For such a scheme to be successful, the base country should either exempt such dividend income from its taxation or it should impose tax at a lower rate. The distribution of the profits of the intermediary company to company X should also be either exempt from tax in the base country or the rate of tax should also be low to ensure the success of this scheme³².

46. In the event where there is no double tax agreement between the country of residence of the foreign company and South Africa, a scheme similar to the above may be implemented. Care must be taken in doing so lest any anti-avoidance legislation applies. This will be commented on below.
47. The Netherlands is often used in treaty shopping schemes as it has concluded a large number of treaties and itself employs favourable domestic tax laws. This is particularly the case where the Dutch "participation privilege or exemption" rule apply³³. In terms of this rate a small "spread" is required to be taxed by the Dutch tax authorities. The Dutch withholding tax on dividends imposed at a rate of 25% is consequently reduced to 5%. Under the participation exemption dividends received by a Dutch parent company and capital gains upon

³¹Horak at 16. See article 4(1) of the OECD model convention.

³²This commentary and evaluation is also from Horak at pages 16 to 17.

³³Horak at page 17 and Passos at page 206. Also see (1988) 1 *Juta's Foreign Tax Review* 37 and (1990) 3 *Juta's Foreign Tax Review* 80.

the alienation of the shares of a qualifying participation are exempted from the taxable income of the parent company. The participation exemption was enacted in the **Netherlands Corporation Tax Act 1969** to avoid double taxation, on certain income. Corporate profits are first taxed in the hands of the company and thereafter on the dividends in the hands of the shareholder. In order to inject certainty into its tax regime, the Dutch tax authorities grant rulings in advance in respect of the applicability of the exemption privilege. Many of the Dutch tax treaties provide for a reduction on withholding tax on dividends by the country of source to the residents of the other contracting states. In the case where the parent company is resident in the other state and its 25% or more of the voting power of the company paying the dividends, the withholding tax imposed by the country of source is for example reduced to 5% in the treaties with the United Kingdom³⁴ and the Netherlands³⁵ and 7.5% in the treaty with Germany³⁶.

48. According to **Passos**³⁷ the 5% limitation on the withholding tax on dividends in terms of both the United Kingdom and Dutch treaties is beneficial to both South African companies investing abroad as well as to foreign companies investing in South Africa that use either the Netherlands or the United Kingdom as a base for a group holding company.
49. By the use of a treaty shopping scheme, the Dutch withholding tax on dividends, which as mentioned is imposed at present at a rate of 25%, will be reduced to 5% when the dividends are paid to a South African shareholder. It should be noted that the 15% NRST imposed by South African fiscal authorities will also be reduced to 5% when the recipient of the dividend is a Dutch holding company³⁸.
50. Any treaty shopping scheme such as for example one where South Africa and the Netherlands are used, must involve the use of a second Dutch treaty (or South African treaty) to exempt subsequent dividend distributions by the Dutch/South African conduit from Dutch/South African withholding tax. In the event that such a treaty shopping scheme cannot be applied, the nature of the investment must be changed to either a loan or a royalty licensing agreement as the case may be.

³⁴Article 10(2) of the treaty.

³⁵Article 10(2)(a) of the treaty.

³⁶Article 10(2) of the treaty.

³⁷At page 205.

³⁸Article 10(2) (a) of the treaty.

51. According to **Passos**³⁹, investors using a Dutch group holding company have also taken advantage of the treaty between the Netherlands and the Netherlands Antilles for routing the dividends. This treaty provided an exemption from Dutch withholding tax on dividends, but the dividends would then be subject to corporate tax at a reduced rate of 2.4% to 3% in the Netherlands Antilles. According to Netherlands Antilles domestic tax legislation no withholding tax is imposed on dividends. This construction was known as the "Dutch sandwich"⁴⁰. As a result of this scheme the total foreign tax burden on dividend distributions of a company in the "target" country amounted to approximately 8%. The double tax treaty between the Netherlands and the Netherlands Antilles has, however, been renegotiated and as from January 1986, the Dutch withholding tax was reduced to 7.5% if the Antilles company tax rate remains 3%, or to 5% if the Antilles tax rate is increased to 5.5%. This has now made the "Dutch sandwich" less attractive⁴¹.
52. * NRST may also be reduced by the use of dual resident companies. South Africa levies income on a source basis. The concept of residence is important vis-a-vis some of the provisions of the **Income Tax Act**. The concept is even more important vis-a-vis double tax agreements as it determines the personal scope of such treaties, that is, who may benefit therefrom. It also affects the operation of other articles in the treaty which allocate income according to the residence of the taxpayer, for example, business profits can be taxed only by the state of the taxpayer's residence (save for the profits of a permanent establishment), and reduced withholding tax rates only apply to residents of the other treaty countries. Article 4 of the **OECD model** deals with residence. It provides that the question of whether a person is a resident of a state for tax purposes is to be determined by the domestic laws of that state. By reason of the fact that states apply different residence criteria dual residence problems may arise. For example, a company will be resident in the United Kingdom for tax purposes if it is managed and controlled there⁴². For purposes of South African law a company will be resident in

³⁹At page 206.

⁴⁰Horak at page 17.

⁴¹Passos at page 206.

X ⁴²Prior to 15 March 1988, a company was regarded as being resident in the United Kingdom if it was managed and controlled there. As from 15 March 1988 all companies incorporated in the United Kingdom are treated as residents. However companies incorporated overseas continues to be treated as being resident in the United Kingdom if its central management and control is situated there. It should be noted that residence is a question of fact. According to English case law a company is managed and controlled where the directors

South Africa if it is incorporated here. Accordingly a company incorporated in South Africa and managed and controlled in the United Kingdom will qualify for residence in both states.

53. Most of the double tax agreements provide a set of rules for determining the residence of persons who are resident in both treaty states. According to **Danziger**⁴³, the format of these rules is to determine whether the taxpayer has a permanent home in one of the treaty states and, if so, to designate that state as his residence state. Where he has a permanent home in both states, his centre of vital interests in one of the states is sought. Where it is not possible to determine his centre of vital interests or where he does not have a permanent home available to him in either state, he is regarded as being resident in the state in which he has his habitual abode. Where he has a habitual abode in both states, he is then deemed to be a resident of the treaty state of which he is a national. As a last resort, the issue may be settled by the tax authorities of the treaty states by mutual agreement.
54. Article 4(3) of the **OECD model** provides that a dual resident person (other than a natural person) will be deemed to be a resident in the place of its "effective management". This rule has been adopted in all the double tax treaties concluded by South Africa.
55. If a company incorporated in South Africa is thus managed and controlled in the United Kingdom it will be deemed to be a resident of the United Kingdom for purposes of the tax treaty between South Africa and the United Kingdom. For purposes of South African tax law, the company will remain a South African company⁴⁴. When several South African trading subsidiaries of a United Kingdom group are held by an intermediate South African holding company, that is effectively managed and controlled in the United Kingdom, dividends paid by the South African trading subsidiaries to the South African intermediary holding company are exempt from normal tax⁴⁵. As the intermediary holding company has been incorporated in South Africa, liability for NRST on the dividends does not arise. The dividend distributions by the South African holding company may not be subjected to NRST in accordance with article 9(6) of the tax treaty between South Africa and the United Kingdom, since the

managing the affairs of the company meet. See (1988) 1 Foreign Tax Review 17 and 26.

⁴³At 337.

⁴⁴See the definition of a "South African company" in Section 1 of the Income Tax Act.

⁴⁵See Passos at page 107.

holding company is a resident of the United Kingdom for purposes of the treaty⁴⁶.

56. In order to avoid NRST, an emigrant who will become a non-resident shareholder in due course can form a trust whereof he is the donor. His child and himself must be the beneficiaries. The shares are then sold to the trust on loan account, which may or may not carry interest. The trust is set up in such a way that one of the deeming provisions of Section 7 is applicable to the taxation of the trust. Any dividends deemed to be the income of the donor will be exempt from tax as a result of the provisions of Section 10(l)(k) of the **Income Tax Act**. NRST cannot be levied since the trust is the shareholder and is resident in South Africa. The dividend income can accordingly be remitted tax-free to the beneficiaries.
57. The following issues pertaining to this scheme have been identified:
- 57.1 The liability for NRST;
 - 57.2 The conduit pipe principle as it applies to trusts;
 - 57.3 The nature of a trust;
 - 57.4 The provisions of Section 7(7) of the Income Tax Act;
 - 57.5 The tax consequences of interest-free loans;
 - 57.6 The exchange control consequences of such a trust.

The liability for NRST

58. To be liable for NRST, one must be a shareholder as defined in the **Income Tax Act** and also be a non-resident within the meaning of the Act. A person is non-resident if he neither resides, nor carries on business in the Republic⁴⁷. The beneficiaries in the scheme must accordingly fall into that category. The next issue to be settled is whether they fall within the ambit of the definition of a shareholder.
59. It is clear that Section 1 of the **Income Tax Act** contains a broad definition of "shareholder". Over and above the ordinary meaning of the term, namely the person registered with a company as a shareholder, the definition also contains a deeming provision. The Courts have held that in order to qualify as a "deemed shareholder" under the definition, the person concerned must be entitled, in a sense of having a legally enforceable right, to receive the dividend (or a part thereof) from the registered shareholder. The registered shareholder is in such

⁴⁶Horak at page 191.

⁴⁷It should be noted that the beneficiaries and donor may remain as directors of the company concerned. It has been held that the services of a director does not amount to the "carrying on of a business". See CIR v Kuttel 1992 (3) SA 242 (A).

circumstances a mere conduit for the benefit of the "deemed shareholder"⁴⁸

60. It follows that the trust must be discretionary in nature so as to prohibit any beneficiary from obtaining an entitlement to any trust income. In such an event, the deeming provision of the definition of "shareholder" will not apply. It should be noted that the time at which the trustees exercise their discretion in favour of the beneficiaries must be postponed until after the trust expenses have been deducted.

The conduit pipe principle as it applies to trusts

61. Two appeal court cases, **Armstrong vs CIR 1938 AD 343** and **Rosen's** case held that income passing through a trust retains its identity provided income is distributed to the beneficiaries in the same fiscal year in which it is received. The principle has therefore been established that the trust is merely a conduit pipe through which the income flows. Therefore, if a trust receives a dividend as income and distributes it to a beneficiary during the same fiscal year, it retains its nature as a dividend.
62. Section 25B of the **Income Tax Act** attempts to formalise the common law trust conduit pipe principle. The effect of this provision is that:
- 62.1 Income which is received by or accrues to the Trustee where there is an ascertained beneficiary with a vested right to income is deemed to be the income of the beneficiary, to the extent to which it is derived for his immediate or future benefit (unless the provisions of Section 7 deem the income in the hands of the donor);
- 62.2 Where the beneficiary has a vested right to income resulting from the exercise of a discretion by the Trustee, the income will be deemed to have been "derived" for the benefit of the beneficiary;
- 62.3 Where income is deemed to be that of a beneficiary because of the first sub-paragraph above, any deduction or allowance pertaining thereto shall be allowed in the hands of the beneficiary;
63. Prior to the introduction of Section 25B it was not possible for the beneficiaries to utilise losses generated in the trust. If the trust distributed any of its income, this was income as defined, i.e. before allowing the deduction of any assessed loss, and the beneficiaries were taxed on the income, the trust retaining its loss. Section 25B(3) now

⁴⁸See *Bells Trust vs CIR 1948 (3) SA 480 A at 490* and *SIR vs Rosen 1971 (1) SA 172 (A) at 185-6*.

permits any deduction or loss to take place in the hands of the beneficiary.

The nature of a trust

64. The benefits which a beneficiary may receive from a trust consists of either vested or contingent rights. The difference between vested and contingent rights with respect to trusts is as follows⁴⁹:
- 64.1 In the case of a vested right, the beneficiary is entitled to specific assets or sums of money, even if the trustees have a discretion regarding the method by which it will be applied to the advantage of the beneficiary. This right forms part of the beneficiary's estate and he may dispose of it in his will. In the event of insolvency, the right will form part of his insolvent estate.
- 64.2 The beneficiary has a contingent right when the right will not become a vested right until the occurrence of a specified event which is yet to take place. If the event does not take place, the beneficiary never receives benefits from the trust. A contingent right is a right to the possibility of benefits only.
65. If a trustee has an absolute discretion with respect to the distribution of trust assets or income, e.g. he may distribute such assets or income to any of the beneficiaries as he sees fit, the beneficiaries will merely have contingent rights to the income or assets. There is no accrual of income to the beneficiaries until the trustee exercises his discretion and makes a distribution among the beneficiaries. As soon as the trustee exercises his discretion, the contingent right of a beneficiary becomes a vested right, and he is liable to tax on the income distributed to him⁵⁰.

The Provisions of Section 7(7) of the Income Tax Act

66. Prof. Davis in the September 1986⁵¹ issue of the **Taxpayer** discusses the applications and provisions of Section 7(7)(a) of the **Income Tax Act** to this scheme. This discussion flows from the fact that previously the Receiver of Revenue agreed with the interpretation of the scheme set out above. The Receiver of Revenue had however adopted a different view, by holding that the provisions of Section 7(7)(a) are applicable to such trust income as the donor retained an interest in the trust property. The

⁴⁹See Honoré's South African Law of Trusts, Honoré and Cameron, 4 ed at pages 471 to 473.

⁵⁰See Estate Munro vs CIR 1925 TPD 693, 1 SATC 163.

⁵¹At page 163.

Commissioner also argued that Section 43A applied, namely that where a dividend by virtue of the provisions of Section 7(7) is deemed to have accrued to a person, such person is deemed to be the shareholder in respect of such dividends. Hence the Commissioner adopted the view that NRST could be levied upon the donor.

67. Section 7(7)(a) which was introduced into the **Income Tax Act** in 1983 provides that if by reason of a donation, settlement or other disposition, a person cedes rights to income to a third party for the latter's benefit in such a manner that the donor remains the owner or retains an interest in the income producing property or if the property itself is transferred to the third party in a manner whereby the donor is entitled to regain ownership thereof at a fixed or determinable time, then any income received or which accrues to the third party will be deemed to have been received by or to have accrued to the donor.
68. Prof. Davis was of the view that the applicability of Section 7(7) to the NRST tax saving scheme would depend on the provisions of the trust deed in question. If the trust deed provides a right to the donor to revoke a donee's right to income, Section 7(6) provides that such income will be deemed to be that of the donor so long as he retains the power of revocation. Such a power may be interpreted as providing the donor with a "retained interest" in the property which would bring such income under the provisions of both Section 7(6) and (7).
69. Prof. Davis was of the further view that if Section 7(7) is interpreted as requiring the donor to retain an interest in the property whereby he can benefit from it, then it is not impossible to reconcile the sub-sections; Section 7(6) applies whenever the donor retains a right to curtail a donee's rights to income in circumstances where he does not necessarily have a right to benefit himself (because he can confer such rights on another person), whereas Section 7(7) applies whenever the donor's right of retention can be employed to benefit himself.
70. Hence Prof. Davis advances the argument that a trust deed which empowers the donor to revoke a beneficiary's right and confer it on another but which does not empower him to benefit himself, should not fall within the ambit of Section 7(7). He is of the further view that neither would a trust, which provides that the beneficiary's right to enjoy trust income is to be suspended until the happening of an event (whether fixed or contingent), necessarily fall within the ambit of Section 7(7) as such stipulations in a trust deed do not have to provide the donor with a right to regain or retain a beneficial interest in the donated property. Such trust would in all probability fall within the ambit of Section 7(5).
71. According to Prof. Davis one possibility of a revenue attack upon the scheme in terms of Section 7(7) remains. If it is assumed that the donor

has sold assets to the trust with the purchase price remaining as an outstanding loan, could it not then be argued that:

- 71.1 There has been a disposition to the trust;
- 71.2 That the donor can call up the loan; and
- 71.3 If he does so, he would effectively regain his ownership of the assets initially transferred to the trust; or retain an interest in the property?

72. In **Joss vs SIR 1980 (1)(SA) 674 (T)**, the Court made it clear that property sold to a trust at fair market value would not constitute a disposition for the purposes of Section 7(3) in which the same phrase, donation, settlement or other disposition as contained in Section 7(7) is used. This was also the case in **Ovenstone vs SIR 1980 (2) SA 721 (A)**. Prof. Davis is accordingly of the view that on the basis of the Joss and Ovenstone cases, only the refusal to charge interest on the loan, would constitute a disposition for the purposes of Section 7. It would therefore be difficult for the revenue authorities to argue that a sale of an asset to a trust at fair market value is the kind of disposition whereby the donor remains owner or retains an interest of the kind required for Section 7(7).
73. If the sale to the trust is not at a fair market value, it is possible that Section 7(7) can be employed by revenue. If there is a fear of such an attack, a non-resident donor can donate the outstanding loan to the trust immediately upon emigration thereby ensuring that he has no retained right as required by Section 7(7). Consequently, it is Prof. D Davis' view that it would appear that a trust deed can be drafted to fall within the provisions of either Section 7(5) or Section 7(6) without revenue being able to tax the dividend income on the basis of Section 7(7). Hence it is still possible to employ the NRST tax saving scheme in the event of the trust deed being correctly drafted.

The Tax Consequences of interest-free loans

74. The occurrence of interest-free loans raises the following income tax issues:

- 74.1 The application of Section 7(7) of the Act;

This section contains various requirements which must obviously be satisfied for it to apply. In the absence of an agreement to pay interest between the donor and the trust, the donor will not have a right to income that can be ceded or otherwise made over for purposes of this section. It can therefore not apply.

74.2 Section 103(1) of the Act;

This section is a general anti-avoidance provision which empowers the Commissioner to nullify, for tax purposes, any "abnormal" attempt to avoid, postpone or reduce liability for income tax. The effect and purpose requirements of this section offers taxpayers the best avenues to prove that it is not applicable. It can therefore also not apply.

74.3 The incidence of donations tax;

This part of the enquiry relates to both the donations tax implications of advancing loans repayable on demand and the interest-free nature thereof. Once again in the absence of an agreement to charge interest between the donor and the trust, there can be no donations tax consequences. The trustees must record in writing that the loans are repayable on demand. There can thus also not be any donations tax consequences in regard to the loans per se.

74.4 Estate duty consequences;

The effect of the interest-free loan is to freeze the value of the donor's estate for estate duty purposes. Once again, in the absence of an agreement to charge interest on these loans, no deemed interest can be included for estate duty purposes.

The exchange control consequences of such trusts

75. All requests for the transfer abroad of capital and income from inter vivos trusts must be referred to Exchange Control⁵².

76. The basic approach adopted by Exchange Control is that income distributions due to non-residents or emigrants must be credited to one of the following accounts⁵³:

76.1 The emigrant's blocked account in respect of pre-emigration net income;

76.2 The emigrant's income receiving account in respect of post-emigration income;

76.3 A financial rand account;

⁵²Exchange Control Manual, October 1990, South African Reserve Bank at page N1.

⁵³loc.cit.

76.4 A blocked account in terms of the requirements of Exchange Control Regulation 4(2) or

76.5 A non-resident transferable account.

- 77 Exchange Control distinguishes between own-asset and third-party funded trusts⁵⁴. Trusts funded from own assets get more favourable treatment (i.e. the funds may be transferred through the commercial rand as opposed to the financial rand) than third-party funded trusts. Capital distributions would only be allowed for credit to an emigrant's blocked account, that is, it would not be transferable.
78. When determining the policy to be adopted with respect to a particular trust, the source of financing, i.e. identifying the funder of the trust, is very important.
79. Where a trust is established by an emigrant prior to the date of emigration and funded by the emigrant from his or her own assets and not from financing by a third party, Exchange Control will consider allowing the concomitant income generated subsequent to emigration to be transferred to the emigrant at the commercial rand rate of exchange. This will obviously only be done within the limits imposed in respect of income transfers to emigrants. At present this amounts to R300 000 per year⁵⁵.
80. In a third-party funded trust the rules differ according to whether the beneficiaries are emigrants or non-residents as well as the timing of establishment and the nature of the funding thereof⁵⁶.
81. In the case of emigrants, income will be allowed to be distributed through the financial rand should the funding of the trust have taken place at least five years before the date of emigration. If the funding took place within a period of five years prior to emigration, then all income distributions to such an emigrant will only be allowed to a blocked account in terms of Regulation 4(2).
82. Capital distributions would be dealt with on the following basis⁵⁷:

Where the funder is still alive	To a Regulation 4(2) blocked account
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⁵⁴Op.cit at page N2.

⁵⁵loc.cit.

⁵⁶loc.cit.

⁵⁷loc.cit.

Where the funder has died	To a financial rand account in instances where the emigrant beneficiary had not benefitted from the trust in any way; or
	To an emigrant's blocked account in instances where the emigrant had been receiving income from the trust.

83. In cases where the trust was founded and funded long before the emigration of the beneficiary, the Control will adopt a more lenient attitude than in the case where the trust was established or funded shortly before emigration. In terms of current policy where the trust was established within a period of five years prior to emigration, Regulation 4(2) will be applied to capital and income distributions whereas with trusts established more than five years prior to emigration financial rand income transfers will normally be allowed.
84. In the case of original non-resident's income and capital distributions should be credited to a Regulation 4(2) blocked account during the lifetime of the funder.
85. On the death of the funder the distributions from the trust become a legacy. The following dispensation applies:
86. In the case of an own-asset trust the assets in the trust will devolve on the heirs of the funder and will be transferable through financial rand to any beneficiary regarded for exchange control purposes as a non-resident.
87. In the case of a third-party funded trust where a beneficiary has a vested interest in the trust recognised by Exchange Control, capital distributions made to emigrant beneficiaries will be credited to an emigrant's blocked account and the income that accrues on it can be transferred through normal banking channels but only within any limits that may have been imposed on the transfer of income to emigrants. In instances where Exchange Control does not recognise the beneficiary's vested interest, capital distributions will be credited to a financial rand account.
88. Capital distributions made to original non-residents must be credited to a financial rand account and the income that accrues, can be transferred through normal banking channels.
89. Once Exchange Control have determined that income distributions may be remitted to the non-resident beneficiary, whether at the financial rand

or commercial rand rate of exchange, authority will be granted for the transfer of net current income for the period for which audited financial statements (or those signed by the trustees) are held as well as for a like amount of net current income anticipated for the ensuing twelve month period as and when such income is actually earned. When the following financial year's financial statements are received Exchange Control would authorise the transfer of any income generated in excess of that previously authorised for that particular financial year and sanction the transfer of the ensuing twelve month's anticipated income in an amount equal to that for the current year⁵⁸.

90. It should be noted that as a beneficiary of a trust whereof a taxpayer (natural person) is the funder has certain estate duty disadvantages. Such an arrangement will fall into the provisions of Section 3(3)(d) of the **Estate Duty Act, No. 45 of 1955**. This Section deems property of the deceased to include any property which the deceased was, immediately prior to his death, competent to dispose of for his own benefit or for the benefit of his estate. If a taxpayer is a beneficiary of a trust formed by himself, he may be regarded as being in a position where he could control the assets for his own benefit. However the exchange control benefits, whereby trust income will be remitted via the commercial rand medium as opposed to the financial rand medium may outweigh the estate duty disadvantages.

Non-resident's tax on interest

Prior to the 1988 Income Tax Act

91. Prior to the **1988 Income Tax Act**, non-resident's tax on interest (NRTI) was charged at the flat rate of 10% on the gross interest paid to:
- 91.1 Non-South African companies; and
 - 91.2 Individuals not ordinarily resident in South Africa
- by a debtor resident or carrying on business in South Africa.
92. NRTI was imposed on interest earned from sources inside and outside South Africa. In those cases where the interest was sourced or deemed to be sourced in South Africa, it was subject to normal tax as well. The taxpayer did however receive a credit against normal tax for any NRTI paid.
93. Interest from certain investments, such as from Government stock, were exempt from both NRTI and income tax.

⁵⁸Op.cit at page N4.

Subsequent to the 1988 Income Tax Act up to the 1992 Income Tax Act

- 94 NRTI was abolished in the 1988 Income Tax Act⁵⁹. Henceforth only interest sourced in South Africa was subject to income tax. On 3 February 1992⁶⁰, the Commissioner for Inland Revenue issued a media statement concerning the income tax on interest paid or accrued to non-residents. In this statement, the Commissioner confirmed the general principle, contained in the Income Tax Act, that income tax is levied if interest is received by or accrues to a taxpayer from a South African source. It was further stated that the source principle applies to all taxpayers, including non-residents and, briefly stated, means that the actual source of interest is determined by the place where the credit is made available by the creditor to the debtor. This statement included an example and held that if a non-resident made an investment directly in South Africa, the interest thereon is from a South African source. Where, however, the non-resident made the credit available outside South Africa to the South African debtor and he (the debtor) was obliged, in terms of an agreement, to transfer the funds to South Africa for his account, the source of the interest was, in terms of existing tax law, outside South Africa. The statement continued that there were various exceptions to these general principles of which the following were examples:
- 94.1 Interest payable to non-residents on stock or securities issued by the Government, Transnet, any local authority, Escom or the SABC;
 - 94.2 Some double taxation agreements entered into between South Africa and other countries provide that the South African tax may not exceed an agreed percentage of the interest.
95. Non-residents who therefore derived interest from a South African source had the same obligation as South African residents to render income tax returns and to pay the tax which was owing on assessment.
96. Under the guidelines of the media statement, interest on foreign funds trapped in the net under the Standstill Arrangements would have been taxable as most of these funds were transferred at least once from one

⁵⁹The Income Tax Act previously provided for unilateral relief from double taxation in respect of royalties and interest. The abolition of NRTI was mainly due to the cancellation on the United States/South Africa double tax agreement and the impact of the "Rangel Amendment" in the United States which denied the United States foreign tax credit with respect to certain foreign countries such as South Africa. See (1988) 1 Foreign Tax Review 1, 24 and 27.

⁶⁰Government Gazette No. 13763 dated 3 February 1992.

South African account to another⁶¹. The statement also made it clear that interest on deposits in South African banks by emigrants or foreigners who earned such interest in South Africa, would also be taxable even if they were no longer ordinarily resident in South Africa. As a result, the Financial Rand weakened as many non-residents withdrew their funds from South Africa. On 14 February 1992, the Commissioner for Inland Revenue issued a further media statement concerning the tax liability of non-residents on income derived from South Africa. He once again confirmed the general principles. He did however clarify that certain double taxation agreements entered into between South Africa and other countries limit the rate of tax South Africa may impose on South African sourced interest accruing to residents of the other state. He further stated that interest received by or accrued to any creditor in respect of debts which are covered by the Third Interim Debt Standstill Arrangement are exempt from all taxes. He also stated that deposits made with South African financial institutions by non-residents through the financial rand are not specifically exempted from tax. The taxability of such interest would once again be subject to ordinary source rules.

Subsequent to the 1992 Income Tax Act

97. The Minister of Finance, Mr Derek Keys, in a press statement on 3 June 1992, announced that all interest which accrues to a person who is not ordinarily resident in South Africa or a company which is not managed and controlled in South Africa will be exempt from tax. Section 10 of the **1992 Income Tax Act** subsequently inserted a new Section 10(1)(hA) into the **Income Tax Act**. It provides that there shall be exempt from tax:

"Interest received by or accrued to a person (other than a company) who is ordinarily resident outside the Republic or a company which is managed and controlled outside the Republic; provided that -

- (i) the exemption under this section shall not apply to any natural person who was at any time ordinarily resident in the Republic if such person has during the year of assessment carried on business in the Republic; and
- (ii) For the purpose of this paragraph, the expression "Republic" shall include any

⁶¹See Horak (1989) Juta's Foreign Tax Review 31. This is particularly the case where use is made of the "substitution-of debtors" procedure. This issue was again discussed by C Drew (1992) SA Tax Review 5.

country which has the purposes of applying any regulation made under Section 9 of the Currency and Exchanges Act, 1933 (Act no. 9 of 1933), being included in the Common Monetary Area".

98. The above section contained the words "carrying on business". There are several cases on the issue as to whether non-resident directors of South African companies which are either controlled by the taxpayers or in which the taxpayers hold shares can be said to be carrying on business in South Africa. In **Joel & Joel v CIR**⁶² it was held that directorships were insufficient in itself to show that the taxpayers were carrying on business in South Africa, as the taxpayers could not be said to carry on the business of the companies which they controlled⁶³. This was confirmed in **ITC 1501, 53 SATC 314**, where **Howie J** held that the business carried on by a company is that of the company alone and not that of the director. The fact that the taxpayer's intention became the company's intention was immaterial. It did not mean that the taxpayer was carrying on the business of the company. In **CIR v Kuttel 1992 (3) SA 242 (A)**, the revenue authorities took **ITC 1501** (in part) on appeal insofar as it concerned whether the taxpayer was ordinarily resident in South Africa. Although the taxpayer continued to own assets in South Africa, it found that but for Exchange Control Regulations, he would have taken all of his South African assets to the United States. As he was unable to do so he was compelled to visit South Africa from time to time to manage his local affairs. However these visits became less and less and of shorter duration. It was accordingly held that there was no inconsistency between retaining assets in South Africa and being ordinarily resident in the United States. The approach of **Howie J** as well as the judgment in the Appellate Division is according to the **Taxpayer**⁶⁴ of particular importance in view of the introduction of Section 10(1) (hA) into the **Income Tax Act**. The exemption does not apply to former South African residents who carried on business in South Africa during the year of assessment. As directors according to **ITC 1501** does not carry on the business of the companies concerned, the decision is therefore of particular importance.
99. As a result of the amendment interest earned by non-residents in South Africa is now tax free. This introduces a new dimension in the South

⁶²1922 WLD 29 and also see Overseas trust Corporation Limited vs CIR 1926 AD 444.

⁶³These references were noted in Danziger at page 64.

⁶⁴August 1992 at page 150 and following.

African income tax environment and is clearly aimed at encouraging foreign investment. It may even be possible to promote South Africa as a tax haven in certain limited instances.

The interest article in the OECD Model

100. Article 11 of the **OECD model** allows interest to be taxed in the state of the recipient's residence and also in the state where it is earned, although state of source taxation is limited to a maximum of 10%. It provides that:

- "1. Interest arising in a Contracting State and paid to a resident of the other contracting state may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term "interest" as used in this article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is that state itself, a political subdivision, a local authority or a resident of that State. Where, however,

the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State due regard being had to the other provisions of this Convention."

101. The reduction in withholding tax only applies if the recipient is the beneficial owner and not an intermediary such as an agent or nominee. This restriction is also included in most of the South African double tax treaties and is intended to prevent treaty shopping. The **OECD model Commentary**⁶⁵ states that where interest is taxed in both treaty countries, double taxation may not be fully relieved if the lender has himself borrowed in order to finance a loan. Accordingly if the source country taxes the gross amount of interest but the country of the lender's residence, taxes on the net amount after expenses, the lender may have an excess of the foreign tax credit which cannot be utilized. As a result the lender may suffer double taxation.

102. The term "interest" is widely defined. It is important to note that excluded from the definition of "interest" is any participation in profit which "rests upon a provision of funds that is subject to the hazards of the enterprise's business"⁶⁶. This provision is not included in the South African treaties. They merely provide that the underlying obligation may not carry a right to participate in profits.

⁶⁵OECD model Commentary page 108 paragraph 13.

⁶⁶OECD model Commentary page 109 paragraph 18. See for example article 11(3) of the South Africa/Netherlands treaty. It is interesting to note that article XI(3) of the South Africa/Switzerland treaty provides that the underlying obligation may participate in the profits of the enterprise.

103. As with dividends and royalties, the "interest" article does not apply if the interest is derived from assets "effectively connected" to a permanent establishment or fixed base of the recipient which is situated in the country of source. In this case, the "business profits" or "personal services" articles will apply. Paragraph 5 provides that in general the source of interest is determined by the payer's residence. However, in the case of interest which is connected to a permanent establishment or fixed base, the source of the interest is the place where the permanent establishment or fixed base is situated. Finally it should be noted that paragraph 6 contains an anti-transfer pricing provision. In cases where excessive interest is charged and there is a "special relationship" between the payer and the beneficial owner of the interest, the authorities can have regard to existing market rates to determine the amount of interest that will fall within the relevant double tax agreement.
104. As a result of the amendment to the Income Tax Act the interest articles in South African double tax agreements have been rendered nugatory insofar as it concerns inward investment.

The withholding tax on royalties

General

105. In **Millin vs CIR 1928 AD 207**, the Court held that the source of royalty income was the place where the licensed property was created or developed. Section 9(1)(b) provides that an amount paid for the use in South Africa or the right of use in South Africa on a patent, design, trademark, copyright, model, pattern, plan, etc., is from a South African source. It is clear from the provisions of this section that technical property and know-how for purposes of South African income tax includes intellectual property in its widest sense. This rule applies irrespective of where the property or asset has been produced or made, where the right of use or permission to use has been granted, where payment for the use or right of use is made, and where the person who makes the payment is resident. Section 9(1)(bA) deals with the deemed source of know-how receipts. Paragraph (gA) of the gross income definition contained in Section 1 of the **Income Tax Act** provides that any amount received or accrued from another person for the use of intellectual property must be included in gross income. **Passos**⁶⁷ holds that a distinction should be made between contracts in which the contractor renders some assistance or service in connection with the supply of scientific, technical, industrial or commercial knowledge and those contracts in which the contractor himself is applying or using that knowledge to render a service or produce a work. She submits that payments for the former are covered by the deeming provision of Section

⁶⁷At page 15.

9(1)(b), and that payments for the latter are in essence remuneration for services and subject to the source principles applying to income from services rendered. **Swiegers**⁶⁸ suggests that the South African income tax position of the foreign licensor could be analysed from five points of view. These are the types of receipts to be classified as royalties, the location of the source of the receipts derived from royalties, the decision whether the receipts are income or capital, the collection of income tax from non-residents and the question whether there are any allowable deductions available for deduction against such receipts, where such receipts are from a source within South Africa. From the outset it must be made clear that according to **Swiegers** as a result of paragraph (gA) of the gross income definition all payments relating to intellectual property will be on revenue account.

The provisions of Section 35 of the Income Tax Act

106. Section 35 of the Income Tax Act provides for the withholding of tax from royalty payments made to non-residents. Royalty income which is deemed to be sourced within South Africa is subject to normal tax. Where deemed source royalty income accrues to non-residents or to foreign companies not managed and controlled in South Africa, the tax rate is reduced to 30% of amounts deemed to have accrued to the non-resident. No deductions are allowed from such amounts. Normal tax is then payable at the rate applicable to the recipient. In the case of companies, the rate is 48% at present. This system is commonly known as the withholding tax on royalties. The effective rate of tax is accordingly 14.4% (30% x 48%) in the case of companies and 12.9% (30% x 43%) in the case of persons. The person who is required to make payment of the royalty is personally liable to make the withholding tax payment to the Revenue authorities. The Commissioner may recover the amount from such person in the same way as if he were the taxpayer on whom an assessment has been made⁶⁹.
107. Article 12 of the OECD model deals with royalties. This article gives the exclusive right of taxation to the country of residence. It provides that:
 - "1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.
 2. The term "royalties" as used in this Article means payment of any kind received as a consideration for the use of, or

⁶⁸(1988) 1 Foreign Tax Review 50

⁶⁹Section 35(2)(e).

the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

3. The provision of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other state independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.
 4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."
108. Similar to the articles dealing with dividends and interest, the benefit of the article is restricted to the "beneficial owner" so that an intermediary such as an agent or nominee is excluded. According to **Danziger**⁷⁰ the royalty articles in South Africa's double tax agreements follow three patterns, viz., an article which grants the right to tax the royalty to the recipient's residence state, an article granting the right to tax to the source state and lastly, an article allowing the resident state a limited right to tax the royalty and requiring it to give credit for the source state's tax levied on the royalty. South Africa's double tax agreements with the United Kingdom, the Netherlands, Swaziland, Switzerland and Germany follow the OECD model whereby the taxing right is granted to the residence state.

⁷⁰At page 371.

109. As is the case with the dividend and interest articles, article 12(3) provides that royalties which are "effectively connected" to a permanent establishment or fixed base of the beneficial owner which is situated in the country of source, is excluded from the article and are treated as business profits or income from independent personal services as the case may be. It is therefore possible to reduce the withholding tax on royalties where the recipient is a resident of a contracting state with whom South Africa has concluded a favourable double tax agreement.

What comprises royalty payments

110. The definition of royalties include payments for "know-how" but excludes so-called "show-how" payments for services such as technical assistance or training which are dealt with under the articles covering business profits. "Know-how" is defined by the Association des Bureaux pour la Protection de la Propriété Industrielle as "all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly under the same conditions inasmuch as it is derived from an experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique"⁷¹. The Commentary also states that where there is a "mixed" contract covering both "know-how" and technical assistance then in principle the consideration derived from such a contract should be apportioned between the various parts of the contract to determine the appropriate tax treatment. However, if one part of the contract predominates over the rest, then the entire consideration may be characterised by the major part of the contract⁷².
111. The property, rights and information which are usually included in the treaties and which are capable of generating royalty income are⁷³:
- 111.1 Copyrights of literary, artistic or scientific work;
 - 111.2 Patents;
 - 111.3 Trademarks;
 - 111.4 Designs and models;
 - 111.5 Plans;
 - 111.6 Secret formulae or processes;
 - 111.7 Industrial, commercial or scientific equipment;
 - 111.8 Information concerning industrial, commercial or scientific equipment.

⁷¹OECD Commentary page 117, paragraph 12.

⁷²OECD Commentary page 117, paragraph 12.

⁷³Passos at page 117.

112. According to **Passos**⁷⁴ with a contract for services the emphasis changes from the use of the asset to the performing of services. In such an event the performer applies his know-how, as opposed to supplying that know-how. In the case where the element of services in a contract is merely ancillary and subsidiary to the use of the property or right licensed, the related payments will still be regarded as being royalties. **Passos** further holds that when the main object of the contract is the performance of a service or the provision of assistance, the payment cannot be included in the concept of royalties. According to her it is interesting to note that the concept of royalties includes rentals received from leasing agreements in respect of industrial, commercial or scientific equipment. This may become an important part of the royalty definition to exploit.
113. Article 12(4) provides that as is the case with interest and dividends where there is a special relationship between the payer and the beneficial owner of the royalties, the article shall not apply to any excess over the amount of royalties which would have been paid in the absence of such a relationship.

Avoiding the withholding tax on royalties

114. A tax treaty shopping scheme can reduce South African withholding tax on royalties. The Netherlands may once again be used as such a conduit. The South Africa/netherlands treaty provides that royalties derived by a Dutch resident from South Africa are only taxable in the Netherlands⁷⁵. Parties to a royalty agreement for use in South Africa can therefore interpose a conduit company in the Netherlands and licence the patent to it. The Netherlands company can in turn sub-licence the patent to users in the desired countries and obtain the required treaty benefits. It will however, be subject to Dutch corporate tax (at a rate of 40%)⁷⁶ as royalty income. Subsequent royalty payments to the ultimate beneficiary can be deducted from the company's income. According to **Horak**⁷⁷, the Dutch fiscal authorities merely require a small "spread" (+/- 8 out of 100 units) to be left in the Dutch company subject to the Dutch corporate tax. The success of this scheme is dependant on the fact that the

⁷⁴At page 118.

⁷⁵See Article 12(1) of the agreement.

⁷⁶See the "Netherlands" entry in International Tax Systems and Planning Techniques.

⁷⁷At page 192.

Netherlands imposes no withholding tax on royalty payments to foreigners⁷⁸.

115. Foreign companies that will derive royalty income from South Africa, can reduce the withholding tax on such royalty income by, for example, interposing a Netherlands company between the country of management and control and South Africa. The treaty between the Netherlands and South Africa provides that royalties derived by a Dutch resident from South Africa are only taxable in the Netherlands⁷⁹ subject to the anti-avoidance provisions contained in both double tax agreements and South African domestic tax laws.
116. Certain Dutch companies provide royalty conduit services. Should the services of such companies be utilised, the establishment cost of a Dutch licensing company will not be incurred. This can be an expensive exercise and the use of such a royalty conduit company can lead to substantial savings.

Exchange Control Requirements

General

117. Exchange control regulations were first introduced in South Africa on 9 September 1939 on the eve of the Second World War. These regulations were replaced in 1942. They were issued in terms of the **1942 War Time Regulations Act**. It was only in 1948 that these were replaced by a set of regulations which were issued under the **Currency and Exchanges Act, No. 9 of 1933**. These regulations were amended in 1951 and again on 1 December 1961. The regulations issued in 1961 are still in force.
118. Different exchange control rulings apply to the transactions of residents of the common monetary area (CMA) and non-residents thereof. The CMA comprises of the Republic of South Africa, including the port and

⁷⁸As stated royalties paid to a foreign company will be subject to tax at 14.4%. Where this payment is made to a Netherlands company the withholding tax is reduced to nil. Should the holder of the patent be located in for example the Channel Islands a 5% withholding tax will be imposed on distributions from the Netherlands company to the Channel Islands company. In the event of a favourable ruling only 8% of the royalty income will be taxed in the Netherlands. The effective rate of tax applied to the royalty income is thus 3.64% as opposed to the 15% South African tax imposed where use is not made of the double tax agreement. The calculation used is as follows: $8\% \times 40\% = 3.2\%$ (1) $8\% - 3.2\% = 4.8\%$ $4.8\% \times 5\% = 0.24\%$ (2) . (1) + (2) = 3.64%.

⁷⁹See article 14 of the treaty.

settlement of Walvis Bay, Transkei, Bophuthatswana, Venda, Ciskei, Lesotho, Swaziland and Namibia. These territories form a single exchange control territory and there are almost no trade and exchange restrictions between the members thereof⁸⁰.

119. A South African resident for exchange control purposes is a person (that is, a natural person, body corporate, foundation, trust or partnership) whether of South African or any other nationality who has taken up residence, is domiciled or registered in the Republic of South Africa. A non-resident is a person (that is, a natural person or legal entity) whose normal place of residence, domicile or registration is outside the CMA. An important question arises as to whether there are any grounds on which a Court can interfere in the event that the exchange control refuses an application. There is only one unreported decision dealing with this issue, namely **Royal Holdings Incorporated vs Minister of Finance and South African Reserve Bank**. The decision was handed down in the Transvaal Provincial Division on 10 September 1980. Briefly, a Court can only decide on such an issue in terms of the so-called Rule 53 Review Procedure of the Supreme Court. A decision by the Control can only be reviewed on the basis that the official concerned did not apply his mind to the application. For purposes of administrative law, an official applies his mind when he considers all the facts relating to the issue before him. The question as to whether the decision is reasonable or not, is immaterial. If the official is able to show that all the facts and circumstances pertaining to the application was considered, the review will fail. It is therefore important to present the Control with well motivated applications as aggrieved applicants have little, if no legal remedies.
120. Certain exchange control issues, vis-a-vis, inward investment have been identified. These are:
- 120.1 Inward capital investments;
 - 120.2 Local financial assistance to affected persons and non-residents;
 - 120.3 The debt standstill arrangements;
 - 120.4 Payments for services mainly of a business nature.

Inward Capital Investment

121. In 1985, several international banks decided, for political reasons, not to renew South Africa's short-term trade credit lines. As a result, a debt standstill and consequent moratorium on foreign capital repayments was announced by the South African government on 1 September 1985. A crisis precipitated by these events led to the reimposition of exchange controls and the re-introduction of a dual exchange rate system, namely

⁸⁰Exchange Control Manual 1990 at page D8.

the commercial rand and the financial rand which had been abolished on 7 February 1983. The financial rand is essentially a disinvestment currency created in order to protect South Africa's reserves in a climate of disinvestment. It may only be used for certain approved capital investments. The essential differences between the commercial rand and the financial rand lie firstly in their respective values in relation to the US Dollar and secondly in the effects that transactions designated in their respective currencies have upon the country's gross gold and foreign exchange reserves. The financial rand is always traded at a discount when compared to the commercial rand. This reflects the position that the supply of financial rand (from disinvestment) has usually exceeded the demand (for investment). Commercial rand transactions either increase or reduce reserves in line with the monetary flow. Financial rand transactions on the other hand are transactions concluded between non-residents of South Africa or between a non-resident and a resident and as such have no impact on reserves.

122. The financial rand may be used for acquiring the following inward capital investments⁸¹:

- 122.1 Quoted securities, without the approval of exchange control;
- 122.2 Investments with authorised banks; and with exchange control approval;
- 122.3 Unquoted securities;
- 122.4 Industrial and commercial property; as well as for
- 122.5 The introduction of capital funds by immigrants.

123. The use of financial rand will not be permitted for⁸²:

- 123.1 Investment into a close corporation, trust or partnership;
- 123.2 Investment as loan capital;
- 123.3 Investment in preference shares or in debentures;
- 123.5 Prospecting and exploration costs or feasibility studies;
- 123.6 Purchase of farming property, funding of capital improvement costs or for the purchase of live stock, implements, etc.;
- 123.7 Purchase of residential properties or funding of capital improvement costs;
- 123.8 Investment in a share-dealing company;
- 123.9 Investment in money market instruments;
- 123.10 Investment in time share or share block schemes;
- 123.11 Funding of working capital or any current assets; and
- 123.12 Funding of intangible assets.

⁸¹Op.cit.

⁸²loc.cit.

124. The following conditions are also attached to the use of financial rand in respect of certain types of transactions⁸³:
- 124.1 Commercial and industrial property to be acquired with financial rand may only be registered in the name of a South African registered and incorporated company;
 - 124.2 If the importation of plant, machinery, and equipment is necessary, provided such items are not available or able to be manufactured locally, payment will only be permitted after receipt of the goods in South Africa and only after a valuation certificate has been issued by a valuator acceptable to exchange control;
 - 124.3 In acquiring shares in an existing company, financial rand may only be used to acquire fixed assets excluding intangibles subject to suitable valuation certificates;
 - 124.4 The introduction of further equity through financial rand for the sole purpose of accelerating repayment of permissible loans or for repayment of outstanding trade indebtedness via commercial rand will not be authorised;
 - 124.5 The sale proceeds of assets acquired via the medium of financial rand may not be utilised, for any purpose, without prior exchange control approval;
 - 124.6 The sale proceeds of non-resident owned South African assets are subject to the financial rand procedure;
 - 124.7 Pre-acquisition profits are regarded as capitalised;
 - 124.8 Any existing loan accounts acquired via financial rand are regarded as capital and no interest may be charged thereon;
 - 124.9 The financial rand may not be used to settle the interest charged on financial rand overdrafts;
 - 124.10 If different classes of shares are to be issued, exchange control requires full particulars and reasons;
 - 124.11 The implications of exchange control regulation 3(1)(f) regarding local financial assistance must be born in mind. Where an acquisition leads to an over-borrowed situation, the control will not usually be favourably disposed thereto and a firm indication as to how and over what period such an overborrowed situation

⁸³Op.cit at page R2 to R3.

would be rectified, must be furnished. As such exchange control would not necessarily agree to dividends being transferred to the non-resident investor whilst the over-borrowed position exists.

125. According to the exchange control manual, the basic principles⁸⁴ applied by exchange control in considering what an acceptable capital structure should be in the case of new investment made in the RSA by entities wholly owned by non-residents, are as follows:
- 125.1 The share capital and share premium of the company or other entity should at least be equal to its fixed assets;
 - 125.2 Exchange control will not allow an investment through financial rand to provide for the company's working capital requirements;
 - 125.3 Exchange control will consider requests for the introduction of loan funds via the commercial rand. The gearing ratio which will be allowed, may differ between enterprises, but generally a ration of equity capital to loan capital of 1:3 will be considered favourably;
 - 125.4 In the instances where shares in an existing company are being acquired, the exchange control will only allow the release of financial rand to cover the value of the fixed assets against the submission of a valuation certificate. The acquisition of intangibles such as goodwill and current assets may only be funded by way of commercial rand either through a direct capital introduction or by way of a foreign land. Introduction of a loan requires prior exchange control approval.
126. It should be noted that exchange control will give preference to investments resulting in an increase in productive economic activity, for example⁸⁵:
- 126.1 The expansion of manufacturing capacity;
 - 126.2 The promotion of exports;
 - 126.3 Import replacements;
 - 126.4 Projects in labour surplus areas in the expansion of labour intensive industries;
 - 126.5 The development of strategic industries; and
 - 126.6 The introduction of new or improved technology.

⁸⁴At page R4.

⁸⁵loc.cit and at page R5.

127. It is clear from the above that exchange control will expect all of the funds invested through financial rand to go into fixed assets excluding intangibles.
128. Financial rand introduced into the company must be capitalised into share capital or credited to a share premium account. Where a South African interest exists the manner in which the share premium is contributed and allocated would have to be fully explained if such share premium does not rank *pari passu* to all shareholders. It follows therefore that the financial rand mechanism may not be used when making an investment in a partnership, close corporation or a branch. In general all loan funds must be introduced via commercial rand once exchange control approval has been obtained. Redeemable preference shares and debentures are regarded as loans for exchange control purposes. Finally it should be noted that financial rand may only be released against the issue and non-resident endorsement of the share certificate/s and provided all other exchange control conditions have been complied with.

Local Financial Assistance to affected persons and non-residents

129. Exchange control regulations 3(1)(e) and 3(1)(f) contain a general restriction regarding the granting of local financial assistance to affected persons and non-residents and also security given by non-residents. These regulations provide that:

"Subject to any exemption which may be granted by the Treasury or a person authorised by the Treasury, no person shall, without permission granted by the Treasury or a person authorised by the Treasury and in accordance with such conditions as the Treasury may impose -

(e) grant any financial assistance to any person in the Republic, where as security for such financial assistance, the person granting the financial assistance in turn relies on any security, guarantee, undertaking or financial assistance, directly or indirectly furnished by -

- (i) any person resident outside the Republic; or
- (ii) "an affected person" and

(f) "grant any financial assistance to any person in the Republic, where such person -

- (i) is not resident in the Republic; or
- (ii) is an affected person"

130. Permission for the granting of financial assistance in the above circumstances must accordingly be obtained from exchange control except where authorised dealers have been authorised to do so.
131. In terms of exchange control regulation 1 an "affected person" is a body corporate, foundation, trust or partnership operating in the RSA, or an estate in respect of which:
- "(i) 25% or more of the capital, assets, or earnings thereof may be utilised for payment to, or to the benefit in any manner of, any person who is not resident in the Republic; or
 - (ii) 25%; or (iii) 25% or more of the voting securities, voting power, power of control, capital, assets or earnings thereof, are directly or indirectly vested in, or controlled by, or on behalf of, any person who is not resident in the Republic".
132. It should be noted that financial assistance includes⁸⁶ the lending of currency, the granting of credit, the taking up of securities, the conclusion of an instalment, and/or hire purchase sale or a lease, the financing of sales or stocks, discounting, factoring, the guaranteeing of acceptance credits, the guaranteeing or accepting of any obligation, as suretyship, a buy-back and a lease-back but excludes trade credit, which comprises:
- 132.1 The granting of credit by a seller in respect of any commercial transaction directly involving the passing of ownership of the goods sold from seller to purchaser; and
 - 132.2 The granting of credit solely in respect of the payment for services rendered.
133. According to the exchange control manual⁸⁷, non-resident subsidiaries may borrow locally up to 50% of the total shareholders investment, which is taken to mean the paid up equity capital, preference shares, undistributed earned profits, shareholders loans from abroad and, in certain instances, the hardcore of shareholders trade credit. This total is generally known as the companies "borrowing base" or "effective capital".
134. The effect of local participation in non-resident controlled entities is to make the abovementioned norms more liberal, the greater the local participation i.e. the ability to borrow locally increases. The formula for

⁸⁶Exchange Control Manual at page Q2.

⁸⁷loc.cit.

calculating the "local financial assistance ratio" or permitted percentage of effective capital is

$$50\% + \frac{(\% \text{ South African interest} \times 50\%)}{(\% \text{ Non-resident interest})}$$

135. Thus a 25% local shareholding will increase the maximum allowable local borrowings to 67% of the effective capital; a 50% local interest yields a 100% figure etc.

The debt-standstill arrangements

136. During the early part of 1985 political and economic development in Southern Africa led to an ever increasing reluctance on the part of foreign banks to lend to South Africa. Some foreign banks withdrew their credit lines completely and continued requests by these banks for repayment of loans resulted in an outflow of capital which South Africa could not afford. In addition the ability of local banks to provide offshore facilities became very difficult. Foreign banks who were prepared to lend to South Africans demanded excessively high margins pushing the costs of offshore finance far beyond those of local monies. As a result, South African businessmen repaid foreign loans resulting in an even greater outflow of capital forcing the rand to depreciate in value and putting pressure on local interest rates to move higher. Eventually the South African authorities declared a moratorium on the repayment of the country's international debt on 28 August 1985. The moratorium was subsequently referred to as the "standstill". On 2 September 1985, the currency market was reopened, but the repayment of the country's total foreign commitment was suspended until 31 December 1985. This suspension has been extended to 31 December 1993⁸⁸.
137. The authorities decided that with a number of exceptions, the funds outstanding for repayment would fall into "blocked" or standstill funds. Foreign debt included overdrafts, bankers acceptances, Euro facilities, discounting of bills under usance, documentary letter of credit, discounting of documentary bills of collection and so on. The items excluded from the standstill arrangements were⁸⁹:

137.1 Repayments on the surety of public debt issued for or on behalf of the South African public sector;

⁸⁸The first interim arrangement extended the moratorium until 31 March 1986. This was followed by the second interim arrangement that lasted until 30 June 1990. The third interim arrangement has extended the moratorium until 1993.

⁸⁹Exchange control manual at P1.

- 137.2 Debts to international financial agencies;
 - 137.3 Debt guaranteed by foreign governments or their export credit agencies;
 - 137.4 Foreign debt commitments of the South African Reserve Bank, including gold swops;
 - 137.5 Any new foreign loans taken out after 28 August 1985 that are not intended to replace maturing loans during the standstill period;
 - 137.6 Current interest payable on foreign loans which will remain freely transferable through the medium of the commercial rand;
 - 137.7 Amounts due directly to a foreign supplier or the collecting banker on his behalf in respect of goods and services received on or after 1 January 1985;
 - 137.8 Small claims due by given debtor of the equivalent of USD 50 000 or less.
138. The standstill arrangements contain various alternatives for various interested parties who wish to escape its provisions. These are:
- 138.1 A substitution of creditors procedure⁹⁰;
 - 138.2 A substitution of debtors procedure⁹¹;
 - 138.3 Payment of the loan to the public investment commissioners⁹²;
 - 138.4 The conversion of standstill debt into long-term loans⁹³;
 - 138.5 The conversation of standstill debt into financial rand investments⁹⁴.

⁹⁰Paragraph 6 of the second and third technical memorandums.

⁹¹Paragraph 7 of the same documents.

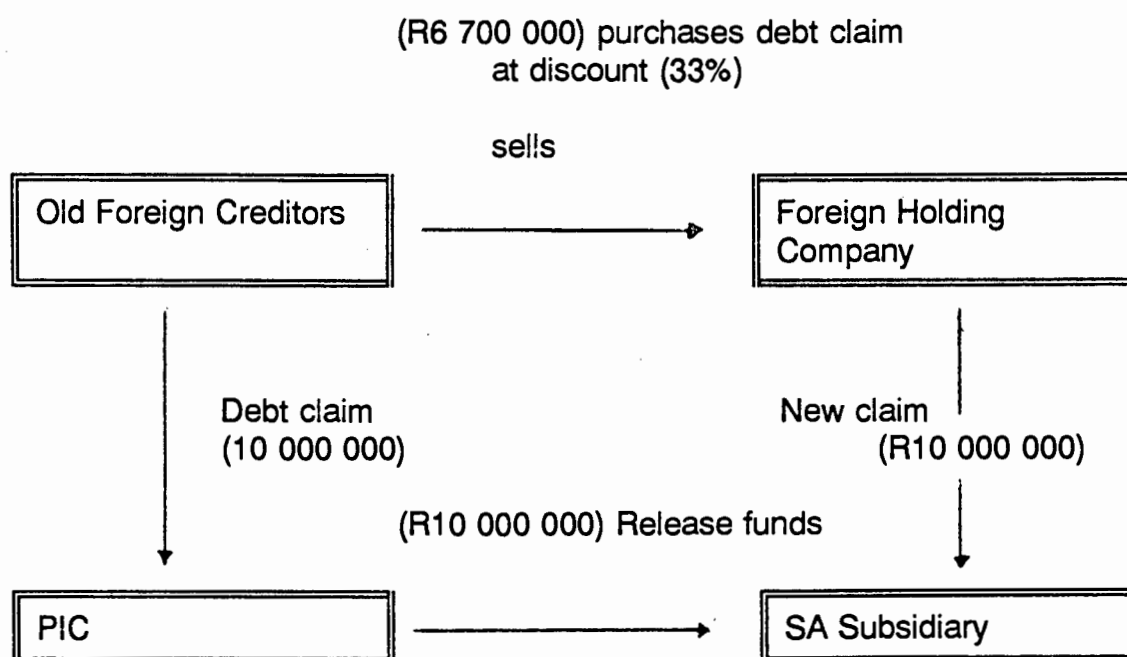
⁹²Paragraph 7(2) of the same documents.

⁹³Paragraph 12 of the same documents.

⁹⁴Paragraph 3.11 of the second memorandum and the Exchange Control Manual at page P4.

139. It should be noted that some USD 23 billion was initially included in the standstill arrangement. It is estimated that some USD 8 billion inter alia remain with the Public Investment Commissioners on deposit. Claims caught in the standstill arrangements are traded by foreign creditors on the international market at a discount to their face value. They trade at a slight premium to the financial rand. As a result, investment opportunities arise in that foreigners who will undertake inward investment into South Africa may wish to buy such a debt claim rather than make use of the financial rand mechanism.

140. The mechanics of such structure is set out below:



141. The above structure envisages the substitution of the foreign US holding company for the original foreign creditor. The holding company acquires the debt at a discount to its face value.

142. The PIC releases the full face value of the debt to the SA subsidiary company (the substituted debtor). Interest is paid by the SA subsidiary company to the US holding company on the full face value of the loan.

143. If the loan is converted to a long term loan (at least 10 years) the claim will no longer be subject to the debt standstill except insofar as downpayments have to be made in accordance with a prescribed schedule over the 10 year period. Interest may be paid semi-annually, but is generally restricted to a maximum of LIBOR⁹⁵ + 1.5%. This will

⁹⁵Assuming LIBOR to be +/- 12.5%.

151. The advantages of an investment via the substitution of debtor procedure as opposed to a Financial Rand investment are:
- 151.1 A net return on investment in this example of approximately 14% together with a capital gain over the period of the loan of approximately 33% of the full face value of the debt in the hands of the holding company;
 - 151.2 The tax efficiency of debt financing i.e. the interest payments are tax deductible, whereas dividends are paid after tax;
 - 151.3 The loan is designated in one of the major currencies and thus any foreign exchange exposure by the lender to depreciation in the value of the South African Rand is eliminated;
 - 151.4 In the past provided the loan is correctly structured, the foreign lender is not liable to normal South African tax on the interest payments received. This is no longer a consideration.
152. According to the exchange control manual⁹⁶ the following must be noted in regard to such substitutions:

152.1 Where the creditor is a parent company

If the non-resident parent company of the new South African debtor is to be the creditor then the exchange control would consider the purpose for which the funds are to be used. If the funds are for working capital, the exchange control would look at a 3:1 shareholder's loan to share capital ratio. Where the funds are to be used for long-term asset purchases, for example plant and machinery, the exchange control may insist on the full capitalization of the funds;

152.2 Where the creditor is a party not related to the debtor

Exchange Control would allow a loan to be taken up for most purposes except as a prepayment for imports or where the nature of the security which is offered could result in the company accelerating or setting off repayments of the loan. That would be construed as contrary to the standstill arrangements. Exchange Control would also view carefully the possibility of a subsequent substitution of creditors which would result in a circumvention of sub-one above.

⁹⁶At page P3.

153. Where there is an arrangement with an existing debtor or a new debtor and a foreign creditor whereby the creditor agrees to make funds available on a long-term basis, then these funds are regarded as falling outside the standstill arrangement and repayments are then made on a basis that ensures that the capital outstanding can be repaid in not less than six equal half yearly instalments commencing after seven and one half years from drawdown, with full and final settlement ten years after drawdown⁹⁷. The following provisions apply:

153.1 Where the creditor is the parent company

The same criteria would apply as in the substitution of debtors.

153.2 Where the creditor is a party not related to the debtor

The same criteria would apply as in the substitution of debtors.

Payments for services mainly of a business nature

Remittance of dividends from the RSA

154. The norm applied by exchange control is that dividends from current income earned from normal trading activities will receive more favourable treatment, that is transferred through the commercial rand and not the financial rand, than those declared from capital gains in accumulated non-current profits⁹⁸.
155. The remittance of dividends from the RSA for a non-resident shareholder of a quoted company will take place as follows⁹⁹:
- 155.1 A dividend declared out of income and from normal trading activities subsequent to 1 January 1984 (as a supplementary measure to the debt standstill) or the date of acquisition of the underlying investment, which ever is the latest, is remittable through the commercial rand;
- 155.2 A dividend declared out of capital gains or out of income earned from normal trading activities prior to 1 January 1984 is only remittable through the medium of the financial rand, provided authority is obtained from exchange control.

⁹⁷Paragraph 12 of the third technical memorandum.

⁹⁸Exchange Control Manual at page 11.

⁹⁹Loc.cit. The provisions relating to an emigrant shareholder is the same, save that it is the later date of 1 January 1984 or the date of emigration.

156. The requirements for non-quoted companies and other business entities are different to those relating to quoted companies. From 1 June 1989, any non-quoted company in the RSA wishing to transfer a dividend to a non-resident and/or an immigrant shareholder is required to produce an auditor's report as well as a representation letter, which must be in the prescribed form, signed by a director or senior official of the paying company, stating that the dividend is payable from income which is typical of the ordinary trading activities of the company and that no portion of the net income after taxation out of which the dividend has been declared, arises from surpluses as a result of the re-valuation of assets or profits accruing from the realisation of any assets other than trading assets, and that the nett remittable income has been earned since 1 January 1984¹⁰⁰.

Royalties and fees arising from the use of copyrights, designs, patents and trademarks

157. Agreements by South African companies to pay royalties, licence and patent fees to non-residents are subject to approval from exchange control. A South African undertaking who will enter into an agreement with a foreign firm involving the payment of royalties must submit to the Department of Trade and Industry and Tourism, three copies of the draft royalty agreement as well as a completed questionnaire. The Department will pass the request onto exchange control with their recommendations, upon which a final decision will be made. Any royalty payment eventually made to the non-resident licensor must be substantiated by an auditor's report confirming the basis of calculation and that it is in terms of the relevant agreement¹⁰¹.
158. It should be noted that royalty payments are usually calculated as a percentage of the manufacturing costs or a percentage of the nett ex-factory selling price, excluding any tax such as VAT. A distinction is made by the Government Department concerned between royalty agreements relating to consumer goods and those for intermediate and capital goods. For consumer goods a royalty of up to 4% of the ex-factory selling price is regarded as acceptable. In the case of intermediate and capital goods, a payment of up to 6% may be considered favourably¹⁰².

Various trade and business related considerations

¹⁰⁰Op.cit at page 12. The requirements are set out in detail in Circular 9/89 of the South African Institute of Chartered Accountants.

¹⁰¹Loc.cit.

¹⁰²Loc.cit.

General

159. Any enterprise that wishes to undertake inward investment into South Africa must have regard to a multitude of trade and business related considerations apart from the income tax and exchange control considerations discussed thusfar. It is important even in a study such as this to be alive to these issues. The following issues have been identified:
- 159.1 The Regional Incentive Development programme;
 - 159.2 Export trade promotion;
 - 159.3 Import and export control;
 - 159.4 Industrial financing;
 - 159.5 Customs and excise;
 - 159.6 Competition and price control;
 - 159.7 The use of land for industrial purposes;
 - 159.8 The use of water;
 - 159.9 The employment of labour;
 - 159.10 Road transport;
 - 159.11 Health regulations, air pollution control and environment conservation;
 - 159.12 Industrial research, measurement, accuracy and standards.

The Regional Incentive Development Programme

160. In terms of the old Regional Incentive Development programme ("RIDP") which came to be known as the decentralisation policy, the Government provided generous incentives to encourage industrialists to locate their operations in designated areas, in or adjacent to black "homelands".
161. The new RIDP¹⁰³ introduced by the Government in 1991 differs from the old in important respects. It emphasises the development of new productive capacity outside South Africa's two main industrial centres (the core Pretoria/Witwatersrand/Vaal (PWW) complex and Durban/Pinetown), rather than subsidising industrialists to move to designated areas.
162. These are also now based on companies' profits rather than their costs, so that those who take advantage of the incentives must be competitive. There are also special incentives for foreign investors.
163. The RIDP offers two incentive schemes. These are:
- 163.1 An establishment grant;
 - 163.2 A profit/output incentive.

¹⁰³Document from the Office of Regional Development and marked Revision 1/July 1991.

The establishment grant

164. In terms of this part of the programme, a 15% interest payment is made on 70% of the total operational assets of the enterprise at the end of the first and second financial year. To qualify for the establishment grant, applicant companies must have an operational equity component of not less than 35%, calculated as a percentage of total assets per its balance sheet.
165. It should be noted that the Cape Peninsula for example qualifies for a 60% incentive payment. Where the total operational assets amount to say R1.5 million, the annual grant will amount to:

$$\begin{aligned} &60\% \times 15\% \times 70\% \times \text{R}1.5 \text{ million} \\ &= \text{R}94\,500 \end{aligned}$$

166. Any payment received as an establishment grant will be tax free. The establishment grant is payable for two years and on the above example will accordingly amount to R189 000 spread over two year in eight quarterly cash payments. Applicants for the relocation of undertakings from abroad will be considered on merit. Approved foreign undertakings qualify for the reimbursement of their relocation costs up to a maximum of R1 million per project in addition to the establishment grant.

The profit/output incentive

167. The profit/output incentive is calculated according to the following profit/output-based formula:

[20% of PBT] x [1 + 200% of ROA] not to exceed the annual establishment grant as calculated above.

PBT = profit before tax excluding incentives, as taken from the annual financial statements prepared for the shareholders and audited in terms of the Companies Act or certified in terms of the Close Corporation Act.

PBIT = PBT (as defined above) plus interest on all borrowings.

ROA = return on assets calculated as follows: PBIT (as defined above) % Total Assets.

168. Total assets = fixed assets, current assets and all other assets at values as reflected in the balance sheet.

NB. All of the above calculations are to follow generally accepted accounting practices excepting for the exclusion of

extraordinary/abnormal items of a non-trading nature in calculating the PBT and PBIT.

169. This incentive is paid for three years. In the event that the undertaking shows profit before tax of R2 million and profits before interest on tax at R2.2 million, the amount of the incentive will be:

$$60\% [20\% \times R2 \text{ million}] \times [1 + 200\% (R2.2 \text{ million} \% R1.5 \text{ million})] \\ = R94 \text{ 399}$$

170. The profit/output incentive is paid annually for a further period of three years. It may however not exceed the establishment grant as calculated at the end of the second financial year, in any particular year during which the profit/output incentive is payable.

Export Trade Promotion

171. In order to promote export trade, the Government offers a wide range of incentives and assistance to exporters. In order to qualify for these incentives, an enterprise must be registered as an exporter with the Department of Trade and Industry.

172. The most important export trade promotions are:

- 172.1 The general export incentive scheme;
- 172.2 The Export Credit Reinsurance Act.

The general export incentive scheme

173. The new incentives for the promotion of exports came into operation on 1 April 1990¹⁰⁴. They comprise the following:

- 173.1 The previous category A incentive (input cost assistance) and category B incentive (added value assistance) expired on 31 March 1990;
- 173.2 The establishment of the general export incentive scheme ("GEIS") with effect from 1 April 1990 under which tax free cash subsidies are paid to exporters and which replaced the category A and B incentives;
- 173.3 The category C incentives (marketing development scheme) are replaced by an export marketing assistance scheme ("EMA") with amended provisions, from 1 April 1990;

¹⁰⁴This information was obtained from a publication by Coopers Theron Du Toit on the subject. It was published in June 1991.

- 173.4 The category D incentives (the exporters or marketing allowance) provided for in Section 11bis. of the **Income Tax Act** remained available until 31 March 1992.
174. The GEIS incentives and the existing category D incentive are not mutually exclusive, so a qualifying exporter may claim both incentives until 31 March 1992.
175. The tax free cash subsidy paid to qualifying exporters under GEIS is calculated according to the following formula:

$$Z = U \times (M \pm E) \times P$$

Where:

- Z = the tax free export subsidy
U = the export sales value of the products exported
M = the manufacturing level factor
E = the exchange rate factor which serves to adjust M for the effects of inflation and for fluctuations in the exchange rate, and
P = the local content factor.

176. The local content factor is calculated as follows:

$$P = (U - I)/U$$

Where:

- U = the export sales value of the product
I = the invoice value of inputs known to be imported.

177. If P is less than 35%, the factor is equal to zero. If P exceeds or equals 75%, the factor is 1. If P exceeds or equals 35% that is less than 75%, the actual percentage must be used in the calculation of Z in the subsidy formula.
178. If a scarcity situation in the local markets results in an input shortage, and exporters must temporarily resort to the import of inputs, claimants should calculate an average actual local content factor for exports during the period of temporary input imports. Particulars of such a calculation must accompany the claim.
179. Schedules 1, 4, 5 and 6 to the Customs Act provide for relief from various customs and excise duties and surcharges to persons or groups

of persons under certain conditions and circumstances. This is part of GEIS.

180. In terms of Note 7(K) a manufacturer who exports at least 15% of the total value of all the goods manufactured by him, calculated according to the ex factory price, may qualify for relief from surcharge on capital goods imported for use by him. Note 7(K) has retrospective effect and qualifying manufacturers who have paid surcharge on imported capital goods may apply for permits for goods imported on or after 10 May 1989 and secure a refund.
181. The following EMA schemes are available:
- 181.1 Primary export marketing research;
 - 181.2 Outward selling trade missions;
 - 181.3 Inward buying trade missions;
 - 181.4 Exhibition assistance schemes.
182. The EMA takes the form of cash grants provided and administered by the Department of Trade and Industry for specific export marketing activities.

Export credit reinsurance

183. In South Africa, export credit insurance is mainly provided by Credit Guarantee Insurance Corporation of Africa Ltd. ("CGIC") which extends cover against both the political and the commercial risks of non-payment.
184. CGIC works in close collaboration with the Government but is privately owned by a number of South Africa's leading banks, financial institutions and insurance companies. CGIC underwrites the commercial risk for its own account and that of its commercial reinsurers, whilst the political risks are fully reinsured with the South African Government in terms of the **Export Credit and Foreign Investments Re-insurance Act, No 78 of 1957.**

Import and export control

185. The Department of Trade and Industry also controls the granting of import and export permits. It should be noted that while import and export control on commodities is being phased out, control on certain products is still applied.

Industrial financing

186. The Industrial Development Corporation is a statutory institution offering an extensive range of financing facilities to assist private entrepreneurs in the establishment and expansion of manufacturing industries in South

Africa. The financing period is normally between three and ten years with very favourable interest rates.

Customs and excise

187. Customs duty is payable on certain imported goods as indicated in the Customs tariff and excise duty on certain locally manufactured products, for example, petroleum and potable alcoholic products and cigarettes. It is important to note that industrialists may apply to the Board of Trade and Industry for a rebate on the customs duty payable on imported raw materials inputs used in the manufacturing process. Registration with the Commissioner for customs and excise as a manufacturer under industrial rebate is also required. There are a number of existing rebate provisions for the importation of raw materials and/or components used for manufacturing purposes.
188. It should also be noted that it is the Government's policy to protect South African industries from foreign competition on a moderate and selective basis using, as primary instrument, a customs tariff. The Board of Trade and Industry considers applications for amendments to the customs tariff. It is therefore essential that any institution that envisages manufacturing or assembling any products in South Africa, or in any other part of the South African Customs Union area, and for that purpose requires protection from foreign competition, or any other amendment to the customs tariff, should apply in advance to the Board of Trade and Industry, in order to establish whether the desired amendment is justifiable in the general economic interest. There are different types of applications for customs tariff protection such as applications for protection against normal foreign competition, applications for protection against dumping and other forms of disruptive competition, application for interim protection in exceptionally urgent cases and applications for advance assurance of protection of proposed new industries.
189. The Director General: Trade and Industry requested the Industrial Development Corporation in February 1992 to investigate and report on the need for and desirability of provisions for the establishment of export processing zones in South Africa. The report recommended that the principle of such zones be approved as an element of industrial development policy. South Africa may accordingly introduce such zones in the near future. This will clearly benefit economic growth in the region.

Competition and price control

190. The Competition Board is a statutory body which was established on 1 January 1980 in terms of the **Maintenance and Promotion of Competition Act, No 96 of 1979**. Its main purpose is to advise the Government in connection with competition policies. The Act makes provision for the maintenance and promotion of competition in the

economy, the prevention of, or control over restrictive practises, and the monitoring of the acquisition of controlling interests in businesses or undertakings, and monopoly situations. Price control is exercised in terms of the **Price Control Act, No 25 of 1964**. In terms of this Act, the price controller, may determine, control or regulate the maximum prices of goods or services at the manufacturing as well as at the retail level. Price control has been almost completely abolished. The only prices which are presently controlled are those relating to the sale of coal, paraffin, petroleum and sugar.

The use of land for industrial purposes

191. In South Africa, land is zoned for different purposes. In almost all the local authorities areas, substantial quantities of land is zoned for industrial purposes. In terms of Section 2 of the **Physical Planning Act, No 88 of 1967**, which is administered by the Provincial Administrations, no town planning scheme or amendment of such scheme making provision for the zoning of land for industrial purposes that was not zoned for such purposes may be approved without the written authorisation of the Administrator concerned. Application for a permit to use land for other purposes, should be made to the Department of Mineral and Energy Affairs (where natural resources are involved), or to the Conservation Concern of the province concerned (where nature areas are involved).

The use of water

192. The following activities are regulated in terms of the **Water Act, No 54 of 1956**:
- 192.1 The construction of a dam or the erection of a pump;
 - 192.2 The right to extract water from a Government water works or from a public stream or from any public source;
 - 192.3 The right to use for industrial purposes any water, including underground water and sea water brought ashore as well as effluent supplied by other parties;
 - 192.4 Water usage and pollution control with regard to mining activities;
 - 192.5 Disposing of effluent produced by an industrial undertaking;
 - 192.6 The erection or enlargement of a water care works or the alteration of any process applied therein.

The employment of labour

193. The Department of Manpower administer several important labour Acts. These are:
- 193.1 The **Labour Relations Act, No 28 of 1956**, the object whereof is to provide for the registration of employers' organisations and

trade unions. It also establishes the negotiating machinery for the settling of disputes;

- 193.2 The **Wage Act, No 5 of 1957**, which provides for the laying down of minimum wages and conditions of service for specific industries or trades which do not fall under the provisions of the Labour Relations Act;
- 193.3 The **Basic Conditions of Employment Act, No 3 of 1983**, which applies to all employers and employees insofar as their conditions of employment are not regulated in terms of industrial council agreements under the **Labour Relations Act** or Wage Determinations under the **Wage Act**;
- 193.4 The **Unemployment Insurance Act, No 30 of 1966**, the object whereof is to ensure contributors against the risk of the loss of earnings arising from unemployment under certain prescribed conditions;
- 193.5 The **Workmen's Compensation Act, No 30 of 1941**, the main purpose whereof is to insure employees against industrial accidents and illnesses from which the death, or temporary or permanent disability of a workman may result;
- 193.6 The **Machinery and Occupational Safety Act, No 6 of 1983**, the main purpose whereof is to regulate an employee's safety and health in the workplace.

Road Transport

194. The **Road Transportation Act, No 74 of 1977** is administered by the Department of Transport. This Act provides that any person who carries on an industry, trade or business and who wishes to convey his own goods, other than exempted goods, by means of his own vehicle beyond an exempted area, should apply for a private road carrier permit.

Health Regulations, air pollution control and environment conservation

195. Industries handling foodstuffs, medicines, pharmaceutical or potentially hazardous or polluting chemicals must liaise with the Department of National Health and Population Development insofar as any legislation may apply to them. In terms of the **Atmosphere Pollution Prevention Act, No 45 of 1965**, no person shall within a controlled area carry on a scheduled process as defined in the Act unless he is the holder of a current registration certificate authorising to carry on such process.

196. The **Environmental Conservation Act, No 100 of 1982** provides that no-one may undertake any activity which may lead to the disturbance of the natural state of vegetation, soil, water or other natural surface within a limited area, that is, a strip land 1 000 metres wide, in the provinces of the Cape of Good Hope and Natal measured landward from the highwater mark of the sea, save under authority of a permit and in accordance with any conditions set out therein.

Industrial research, measurement, accuracy and standards

197. The Council for Scientific and Industrial Research play an important role in the formulation of policy and decisionmaking with regard to manufacturing. The South African Bureau of Standards provides a service to assist businesses to acquire satisfactory measurement capabilities. There is a substantial movement in South Africa for companies to implement the quality assurance programmes. Enterprises may therefore apply to the South African Bureau of Standards to have their measurement systems approved and monitored by the National Calibration Service and monitored to ensure that its capabilities are maintained. One of the main objectives of the Bureau is also to promote the standardisation and product quality in trade and industry. An essential aspect of this effort is the preparation of specifications, codes of practice and standard methods, collectively known as standards.

Anti-avoidance provisions

General

198. International business operations may be exposed to the risk of being subject to double taxation. At the same time such activities may present opportunities for tax avoidance or tax evasion. The following issues have been identified as material in this regard:
- 198.1 Thin capitalisation;
 - 198.2 Transfer pricing;
 - 198.3 Section 103(1) of the **Income Tax Act**;
 - 198.4 Treaty abuse provisions;
 - 198.5 Fraus legis;
 - 198.6 Tax rulings;
 - 198.7 The attorney and client relationship.

Thin capitalisation

199. According to **Danziger**¹⁰⁵ thin capitalisation is the capitalisation of a subsidiary by its foreign holding company by means of debt, the interest on which is deductible by the subsidiary, rather than by equity in respect of which the dividends paid are not deductible by the subsidiary. The term is also used to describe a situation in which the funds borrowed by a company are excessive in relation to the share or equity capital injected by the shareholder; the share capital is then said to be thin compared with the loan capital¹⁰⁶. Thin capitalisation has been a cause of concern for fiscal authorities worldwide. It has also been a subject of a special report by the OECD in 1987.
200. As thin capitalisation permits a company to pay a large proportion of its operating profits as tax deductible interest, instead of dividends, it has been the subject of fiscal counter-measures in many countries. Some developed countries have legislation against it, whilst in other countries, such as in South Africa, reliance is placed on exchange control regulations and the lending requirements of financial institutions.
201. Thin capitalisation is often encountered in an international context when a holding company funds a subsidiary that is located in another country. Funding is usually effected through interest-bearing loans rather than contributions to share capital. Double taxation agreements between countries usually permit one of the parties to the agreement to treat a portion or the whole of a loan to a company as thin capital if the loan funding is excessive in regard to the amount of the loan that could have been obtained by the company in an arm's length situation¹⁰⁷. Article 11 of the OECD model have added the words "for whatever reason" to the excessive interest clause. According to **Davis**¹⁰⁸ the English fiscal authorities have taken the view that this clause may be interpreted to cover the amount of the loan as well as the rate of interest, so as to restrict treaty benefits relating to interest where a United Kingdom resident company has a high debt to equity ratio. In such a case, the interest on the excessive amount of the loan may be subject to the full United Kingdom withholding tax and not the reduced treaty rate.
202. There are no provisions in South African income tax legislation which prohibits thin capitalisation. The exchange control regulations limit the

¹⁰⁵At page 303.

¹⁰⁶Van Dorsten (1988) 1 Juta's Foreign Tax Reviews 77.

¹⁰⁷Van Dorsten (1989) 2 Juta's Foreign Tax Review 14 at 15.

¹⁰⁸At page 156.

amount that non-residents or entities in which non-residents have an interest may borrow locally. In accordance with regulation 3(1)(f) the maximum amount that may be borrowed without Reserve Bank approval by non-residents are limited. The same applies with regard to the "substitution of debtors" procedure in the standstill arrangements¹⁰⁹.

Transfer pricing

203. According to **Danziger**¹¹⁰ transfer pricing may be described as the export of profits to foreign countries through artificial inter-company pricing arrangements, or through excessive interest, royalty, or management charges, or the trading of goods with overseas affiliates below or in excess of their true value. Hence in the South African context, transfer pricing will arise when a South African entity charges artificially low prices to a foreign related entity for goods or services supplied to such foreign entity, or is charged artificially high prices by the related entity for goods or services supplied to the South African entity. In such a manner, the profits liable for South African tax will be reduced. Many countries have adopted specific legislation aimed at preventing transfer pricing. No such legislation has been adopted in South Africa.
204. The **Income Tax Act**¹¹¹ contains no specific provisions prohibiting transfer pricing, apart from Section 31, which empowers the Commissioner to adjust prices of commodities imported into South Africa or exported from South Africa, but only where such adjustment is made in terms of a double taxation agreement. In the absence of legislation to prevent transfer pricing, the same result can be achieved by using the general deduction formula, that is, that only expenditure incurred in the production of income is deductible. Non-arm's length prices will therefore not be taken into account in determining taxable income, as it will not satisfy the requirements of the formula. A related argument is that excessive expenses are not incurred in the production of income. There is a host of cases dealing with this issue in relation to excessive salaries.
205. Article 11 of OECD model covers transfer pricing. It is an important application of the arm's length principle to transactions between related entities. The arm's length principle is applied to dealings between a permanent establishment and its parent enterprise under the "business

¹⁰⁹See paragraph 152 above.

¹¹⁰At page 303.

¹¹¹See Lategan (1991) 4 *Juta's Foreign Tax Review* 54, for a very comprehensive discussion on transfer pricing in the South African context. The author also has regard to anti-transfer pricing provisions contained in the Customs and Excise Act, No 91 of 1964.

profit" article. Article 9 only applies to associated enterprises which are resident of the two treaty states concerned. This article permits the entire accounts of the two enterprises to be adjusted where there is evidence of non-independent dealings between them.

206. In addition to the general deduction formula, Section 103(1) may be applied to instances where a taxpayer has entered into a transfer pricing scheme. This section will apply to a scheme which is entered into, wholly or mainly, to avoid tax. However in practice, the exchange control authorities play a far more active role in combating transfer pricing than the revenue authorities through the use of the exchange control regulations.

Section 103(1) of the Income Tax Act

207. Section 103(1) of the **Income Tax Act** contains a general anti-avoidance provision. The section provides that whenever the Commissioner is satisfied that any:

207.1 Transaction, operation or scheme has been entered into, or carried out;

207.2 Which has the effect of avoiding, reducing or postponing the liability for the payment of any tax imposed by the **Act**; and

207.3 Having regard to the circumstances:

207.3.1 Was entered into by abnormal means or in an abnormal manner, or

207.3.2 Has created rights and obligations not normal in an arm's length transaction; and

207.4 Was entered into solely or mainly for the purpose of avoiding, reducing or postponing any tax.

he shall determine the liability for tax as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as an in the circumstances of the case deems appropriate.

208. All the requirements set out by this section must be fulfilled before the Commissioner may invoke its provisions¹¹². In order to determine whether a transaction is normal, it should at first be established whether

¹¹²See *SIR v Geustyn Forsyth & Joubert* 1971 (3) SA 567 (A) at page 571 to page 572. See also *Hicklin vs SIR* (1980) (1) SA 481 (A) at page 491.

it was concluded at arm's length¹¹³. When considering the normality of the rights or obligations created by the transactions or of the means or manner employed, due regard has to be paid to the surrounding circumstances¹¹⁴. The problem of normality or abnormality is always a question of fact. Whether a scheme is effected by the provisions of this section must be answered by reference to the purpose and effect of the scheme and the circumstances surrounding it at the time it was implemented or carried out. A foreigner that implements a treaty shopping scheme to avoid South African source tax can, for instance, argue that it is normal in international trade to locate the centre of an enterprise's activities in a commercial centre like the Netherlands, the United Kingdom, Switzerland or any number of tax havens.

Treaty abuse provision

209. According to **Passcs**¹¹⁵ the "person" or scope article of the **OECD model** determines the entities covered by a treaty. As a result, the concept of a resident for purposes of the treaty in general limit the application of its benefits to a defined category of persons, who are described as "treaty residents". The mechanism whereby intermediate companies are incorporated to afford treaty benefits to its residents of first countries are described as "treaty shopping" or "treaty abuse". Different measures have been adopted by States to counteract treaty shopping either in the treaties to which they are parties or in their domestic tax legislation. According to **Davies**¹¹⁶ measures adopted by the United Kingdom include, inter alia, the following measures:

209.1 Article 16 of the United Kingdom and United States double tax treaty is an "anti-shopping" provision designed to prevent residents or third parties from obtaining benefits under the treaties relating to dividends, interest and royalties. Where a company is a resident of one of the treaty countries and at least 25% of its capital is owned by individuals who are not residents of that treaty country and are not United States nationals, then in certain circumstances, dividends, interest or royalties received by the holding company will not be entitled to the reduced rate of withholding tax provided for by the treaty;

¹¹³See Geustyn's case at page 573 to page 574.

¹¹⁴See Hicklin's case at page 495.

¹¹⁵At page 263.

¹¹⁶At page 89.

- 209.2 Holding companies are excluded from the benefit of the United Kingdom double tax treaties with Luxembourg and the Netherlands Antilles where such a company is entitled to special tax benefits in Luxembourg or the Netherlands Antilles;
- 209.3 Also excluded from the benefits of the United Kingdom double tax treaties are the Caribbean international business companies which enjoy a very low or null rate of taxation.
210. The **OECD model** contains some provisions which aim to counter tax avoidance schemes involving tax treaties. Article 10 (2) of the **OECD model** provides a reduced withholding tax rate in the source state on condition that the recipient is the beneficial owner of the dividend. The limitation of source tax on interest and royalty payments is also granted on condition that the recipient is the beneficial owner in terms of the relevant article. According to **Horak**¹¹⁷ these provisions imply that limitation of source tax is not available to an intermediary person interposed between the beneficiary and the payer of the income unless the beneficial owner is also a resident of that contracting state. The **OECD model** also contains various "arm's length" requirements. Article 9 of the **OECD model** is an example of such a provision. It is aimed solely at preventing transfer pricing between related or associated enterprises. It provides that where associated companies conclude agreements which provides for unrealistic prices the treaty states may include in the profits of any one of the enterprises, the profit that should have been included if the entities had been dealing at arm's length.

Fraus legis

211. The basic principle of Roman Dutch law is that no-one must act in fraud of the law. The Court in **Dadoo Ltd. and others vs Krugersdorp Municipal Council, 1920 AD 530**, confirmed that the *fraus legis* doctrine applied in South African law. According to **Horak**¹¹⁸ this doctrine as applied by the Courts in South Africa is of limited use to the Revenue authorities in their efforts to counter the "abuse" of tax treaties.

Tax rulings

212. In a recent English decision, **Rex vs IRC, ex parte MFK Underwriting Agents Limited [1990] 1 All ER 91**, the Court held that for a revenue ruling to be binding certain conditions must be met, namely:

¹¹⁷At page 127.

¹¹⁸At page 200.

- 212.1 The taxpayer must make a full disclosure of the transaction in question;
- 212.2 The taxpayer must indicate that he intends using the ruling;
- 212.3 The ruling relied on should be clear, unambiguous and devoid of relevant qualifications.
213. The doctrine of legitimate expectation on which the above decision was founded was recently approved by the Appellate Division in **Administrator Transvaal vs Traub and others 1989 (4) SA 731 (A)**. Accordingly, should a taxpayer obtain a ruling in terms of the conditions outline in the MFK case, he would have a legitimate expectation that revenue would comply with such a ruling. Some taxpayers to obtain certainty and also in the desire not to fall foul of any relevant anti-avoidance legislation may wish to apply for a tax ruling. These cases may accordingly be used as authority to do so. However, Section 3(2) of the **Income Tax Act**, provides that the Receiver of Revenue may withdraw a ruling at any stage. Taxpayers who therefore wish to structure their taxplanning on the basis of a ruling must do so with care¹¹⁹.

The attorney and client relationship

214. Section 74 of the **Income Tax Act** is couched in very wide terms and allows the Commissioner for Inland Revenue to require any person to produce, for examination by the Commissioner, any plans, books, accounts, trade lists, stock lists or documents for the purpose of obtaining full information in respect of any income of any taxpayer. It also allows the Commissioner to search and seize any books, records, accounts or documents for any assessment.
215. There is a special relationship of professional privilege between a lawyer and his client. This privilege protects from disclosure communications between such an advisor and his client which are made in confidence for the purpose of enabling the client to obtain legal advice. Professional privilege only exists with regard to the lawyer and client relationship and does not, for instance, extend to accountants. Section 74 enables the Receiver of Revenue to search and seize documents, even documents found in the possession of an attorney. However, by virtue of professional privilege, Revenue is precluded from using such documents in the Special Income Tax Court. On the other hand, should Revenue seize such documents from the offices of an accountant, they will be entitled to use it in the Special Court. The advantage which attorneys therefore afford clients in the tax field is an important tax planning aid. It is

¹¹⁹See Van Blerk (1989) 2 Juta's Foreign Tax Review 7 and 34. See also February 1990 The Taxpayer 24.

therefore advisable to structure certain transactions through the offices of an attorney to enable the taxpayer to benefit from this relationship and to reduce the tax risk inherent in some transactions¹²⁰.

¹²⁰Van As, February 1991 and March, Accounting SA, 41 and 69 respectively.

CHAPTER 5

OUTWARD PLANNING

- Introduction
- The use of double tax agreements and tax havens
 - Double tax agreements
 - Tax havens
- The basic forms of outward expansion
 - General
 - Finance Companies
 - Captive Insurance Companies
 - Licensing expenses
 - Excursus: countertrade
- The anti-avoidance provisions pertaining to outward investment
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- The exchange control consequences pertaining to outward investment
 - General
 - Direct investment
 - Loans by residents to non-residents
 - Transfer abroad of reinsurance premiums
 - Exports
 - Excursus : Product loans

Introduction:

1. A South African undertaking extending its operations to foreign countries is also faced with the problem of trading with as opposed to trading within another country. In the case where a local undertaking trades with another country, the income generated therefrom will in all probability have a local source. However, in the event that it trades within another country, this may lead to foreign tax liability. The local enterprise must be in a position where it is able to control the extended activities, that is, as to whether it will create a foreign source for its profits in a foreign country or whether it will merely extend its South African business to that foreign company, but still maintain its South African source connection.
2. According to **Passos**¹, in the event that the local enterprise wishes to ensure that it derives South African source income, it can do so in two ways:
 - 2.1 To limit the foreign activities in such a way as not to be trading in a foreign country, or where a treaty applies, not to be trading through a permanent establishment there;
 - 2.2 To link closely the foreign activities with the South African business to give the income arising from those activities, a South African source. This may be achieved, for example, where South African employees travel to the foreign country to obtain contracts and conclude the contracts for the sale of goods in South Africa.
3. Although double taxation may be avoided through unilateral or bilateral provisions, the local undertaking may wish to avoid a foreign tax liability due to the possible adverse cash flow consequences of paying foreign taxes which is only to be recovered later in South Africa, the administrative costs of filing tax returns in a foreign country, and generally moving the source of its income out of the South African tax fold. By doing so, it may not receive as favourable tax allowances and deductions as it would in South Africa.
4. The following issues are identified as being relevant to outward expansion:
 - 4.1 The use of double tax agreements and tax havens;
 - 4.2 The basic forms of outward expansions;
 - 4.3 The anti-avoidance provisions pertaining to outward investment;
 - 4.4 The accounting consequences of outward investment;
 - 4.5 The legal aspects of international tax planning;

¹At page 25.

- 4.6 The exchange control consequences pertaining to outward investment.
5. A South African company planning to expand offshore, will generally do so in the following manner:
 - 5.1 It will open a small office in a foreign country or appoint a suitable agent who will assist it in achieving the necessary export sales targets. The actual sales will be affected by the sales representative of the local South African company. The advantages of having overseas representation in the form of a foreign sales office or agent are to provide a fixed base to store its stock, to display such stock and to circulate brochures to potential customers. In addition it can pass on enquiries which may affect sales.
 - 5.2 As the offshore base becomes more successful, the local undertaking will be faced with a choice whether to register in the foreign country as a branch or to incorporate a foreign subsidiary. In the event that the fixed base in the foreign country continues to be used solely for the purposes of storage, display and promotion and no sales are effected, then no local tax should be levied based on profits derived from export sales. This will be the case for as long as the activities of the local company does not fall within the meaning of a permanent establishment in the foreign jurisdiction.
 - 5.3 Whether the South African company registers its offshore base as a branch or forms a local subsidiary will largely depend on non-tax considerations such as its exposure to foreign liability, foreign company law requirements and the like. In the event that it wishes to restrict the scope of operations of the foreign base, it can implement a service agreement between it and the fixed base which clearly defines the duties required of the foreign base and which at the same time limits the scope of its activities. To further secure the position of the foreign base, the local company should apply for an appropriate foreign tax ruling to confirm the status of its foreign base.
6. The following general planning consideration will be material in outward expansions:
 - 6.1 The first stage of the tax planning process should be to analyse the different items of tax involved in the project and to calculate as far as possible, the likely total tax burden. It may also be necessary to take into account the likely gross return of the project and the non-tax expenditure involved. In addition, other key factors that a local concern must consider are the political and economic stability of the country of investment and the integrity of its Government, the attitude of the country towards foreign investors, other taxes and fees, double tax agreements, exchange control, company laws, transportation and

telecommunication facilities with the outside world and lastly the costs of incorporation.

6.2 The most favourable form of a transaction, operation or relationship from the tax point of view must be selected. Dividends, interest, royalties and capital gains frequently receive different tax treatment both at the domestic and treaty level. It will thus be necessary to take such differences into account in deciding, for example, whether an investment should take the form of a dividend producing share participation or an interest producing loan. In the case of industrial property, it might be necessary to decide whether the right should be sold or exploited by way of a royalty agreement. In addition the tax consequences of operating through a subsidiary, a branch office or an independent agent are frequently quite different as well².

7. The following considerations must also be taken into account:

7.1 The rate of tax imposed on corporate profits in investment countries under examination;

7.2 Whether the dividend distributions and branch profits are subject to withholding taxes and, if so, at what rate;

7.3 Whether any tax credits or deductions are available in the country of residence of a shareholder in respect of taxes paid in the investment countries under examination.

The use of double tax agreements and tax havens

Double tax agreements

8. There are many instances in which a tax treaty should be consulted. According to Bischel and Feinschreiber³, ten of the most important circumstances are:

8.1 Any time there is a transaction or proposed transaction between a local entity and an entity of a country with which the country of the local entity has a treaty;

8.2 Any time there is a transaction between foreign entities with an ultimate

²There is a good discussion of the differences between a branch and a subsidiary by Eskinazi and Kaplan (1989) 2 *Juta's Foreign Tax Review* 3. A point often overlooked is that branch losses is not deductible in South Africa as it would have been incurred outside South Africa.

³Fundamentals of International Taxation at page 281.

- economic effect on a local entity;
- 8.3 When there is choice of structure for a transaction involving a foreign entity;
 - 8.4 When an acquisition, sale, exchange, disposition, relocation, incorporation, merger, or liquidation has taken place involving foreign assets or a foreign entity in which a local entity has an interest;
 - 8.5 When employees are abroad in a country with which the country of the local entity has a treaty;
 - 8.6 When a local entity receives or contemplates receiving income that has a source from a country with which the country of the local entity has a treaty;
 - 8.7 When a local entity pays out or contemplates paying out local source income to a payee in a country with which the country of the local entity has a treaty;
 - 8.8 When a local taxpayer is entitled to a foreign tax credit for foreign taxes paid to a country with which the country of the local entity has a treaty;
 - 8.9 When the Revenue authorities of the country of the local entity or the foreign taxing authorities of a treaty country make an allocation of income, deductions or credits;
 - 8.10 When a foreign country with which the country of the local entity has a tax treaty imposes more burdensome taxes on a local entity than it does on any of its own nationals.
9. As the most dominant connecting factor for South African income tax liability is source, the significance of rules determining the source of income is obvious. The **OECD model** employ several rules of source. It does not however include a separate article on source. According to **Passos**⁴ the main characteristic of rules of source in the treaties is that they are operational or functional rules, which give a geographical location to the income in order to identify the state that will enjoy the right to tax or give relief from double taxation. The rules are based on the existence of an economic connection of an activity or property to a particular country sufficient to justify its right to tax the related income.
10. The specific items of income for which separate taxing rules are adopted usually include:
- 10.1 Income from immoveable property. No limitation is imposed on the right

⁴At page 127.

of the country where the property is located to tax this type of income;

- 10.2 Business profits. The country of source is granted the right to tax business profits only if and to the extent that they are attributable to a local permanent establishment;
 - 10.3 Investment income i.e. dividends, interest and royalty. With the exception of royalties, the country of source agrees to a reduction of its taxes. An exemption is usually granted by a country of source in relation to royalties;
 - 10.4 Earned income, with separate provisions covering independent personal services, dependent personal services, public entertainers, professors and students, director's fees, government services and pensions (including annuities);
 - 10.5 Any type of income not covered by other provisions. The country of residence is usually granted the exclusive right to tax this income;
 - 10.6 Capital gains. The right to tax capital gains on a property of a given kind is in general granted to the state that in terms of the treaty is entitled to tax the income derived from it.
11. South Africa has concluded several comprehensive double tax agreements with inter alia, the United Kingdom, Switzerland, Germany, Israel, the Netherlands and Sweden. The double tax agreements with Canada and the United States were repealed by these countries in 1987. In addition South Africa has also entered into a number of sea and air transport agreements with inter alia, Belgium, France, Greece, Japan, Italy, Norway, Portugal and Spain. } Com

Tax havens

12. According to International Tax Systems⁵ the fundamental requirements for a tax haven are:
 - 12.1 There must be a virtual absence of corporate taxation on income and capital; or if resident companies are subject to a tax on income and capital, then there must be concessions offered entitling certain companies to tax exemption on such income;
 - 12.2 If income is to be received from outside the tax haven, then either no foreign withholding taxes are levied on such income, or if internal tax legislation of the foreign country requires production of tax at source or the imposition of tax on assessable profits, there must be a double tax treaty which reduces such tax to nil or a nominal amount;

⁵At page 7001.

- 12.3 There must be no withholding taxes levied by the tax haven on distributions or other payments to non-residents;
 - 12.4 The tax legislation of the tax haven must not include anti-avoidance provisions clawing back any of the above advantages, particularly where the owner of the tax haven company is non-resident;
 - 12.5 The exchange control legislation must not prohibit the free-flow of funds between group members;
 - 12.6 The tax haven must be politically and economically stable to ensure the permanence of the group's presence in the tax haven and the security of its assets;
 - 12.7 Communication to the tax haven must be adequate and inexpensive if the company is to be partly managed by non-residents;
 - 12.8 If it is to be managed locally, there must be the required labour force available who can effectively manage the company.
13. According to **Langer**⁶, the tax havens of the world may be broadly classified into four separate categories. These are:

13.1 No-tax havens

At least six countries have virtually no taxes at all. These include such traditional no-tax havens as the Bahamas, Bermuda and the Caymans. Also included in this group are Turks and Caicos, New Hebrides and Nauru. None has any income tax or capital gains tax. None is a party to any tax treaty. It is comparatively easy to form a corporation in one of these no-tax havens.

13.2 Countries taxing only local income

Several havens tax income on a territorial basis only, i.e. taxing income from domestic sources but exempting income from foreign sources. Included in this category are Liberia, Panama, Costa Rica and Hong Kong. A corporation based in one of these countries can earn unlimited amounts of foreign source income without paying any local income tax.

13.3 Low-tax havens with treaty benefits

Several low-tax jurisdictions are parties to tax treaties. The Netherlands Antilles, for example, is a party to several favourable income tax treaties. It also has special low rates applicable to several types of

⁶At page 15.

corporate income. The British Virgin Islands also has low tax rates. Jersey, Guernsey and the Isle of Man are each a party to double tax agreements with the United Kingdom.

13.4 Countries offering special privileges

Some countries not generally considered to be tax havens allow special privileges which may prove suitable as tax havens or financial centres for limited purposes. Luxembourg, the Netherlands, Switzerland and Liechtenstein all offer special privileges to qualifying holding companies. Jersey, Guernsey and the Isle of Man in addition to their low tax rates also recognise a special category of corporation generally known as a corporation tax company. Ireland provides tax exemption for manufacturing and processing of exports. Antigua, Barbados and Grenada each recognises international business companies. These companies bear a maximum tax rate of about 2.5% and may even benefit from some tax treaty provisions.

14. Tax havens may be grouped loosely into the following areas:

14.1 The Caribbean area, Bahamas, Bermuda, Cayman Islands, British Virgin Islands, Netherlands Antilles and Panama;

14.2 The Mediterranean area, Gibraltar and Cyprus;

14.3 The European area, Netherlands, Switzerland, Liechtenstein, Andorra, Luxembourg, Campione and Monaco;

14.4 The Channel Islands area, Guernsey, Jersey and the Isle of Man;

14.5 The Pacific area, Hong Kong, Vanuatu and Nauru.

The basic forms of outward expansion

General

15. There are several types of companies that will serve as vehicles for outward expansion. Some jurisdictions are more favourably disposed towards say shipping companies than others and taxplanners must be aware of these differences. The first stage in the tax planning process is to calculate the impact of local taxes. Thereafter the planner must select the appropriate vehicle to conduct the activity, that is, via a company, permanent establishment, branch and so on. Thirdly, the planner must study the tax consequences of the proposed venture in the country within which the activity will be conducted. Finally, the tax planner should, where possible, consider the use of a third country that may result in a reduction in the overall tax burden of the proposed venture. This part of the discussion will briefly consider the various types of companies that are common to most jurisdictions. The

discussion is premised on the assumption that the taxpayer is South African and is engaged in expanding its activities offshore. Due to the danger of exceeding the required length of a paper such as this shipping companies, group holding companies and purchasing companies will not be discussed.

Finance companies

16. A South African taxpayer can use an off-shore finance company to provide finance to its foreign subsidiaries. The following considerations apply to such a finance company:
 - 16.1 The Exchange Control legislation of the country of incorporation;
 - 16.2 Whether this country imposes a withholding tax on interest paid to non-resident lenders;
 - 16.3 The tax consequences of exchange gains and losses in both the country of the lending company and also the country of the borrower;
 - 16.4 Whether either of these countries have adopted "thin capitalisation" legislation.
17. Many countries subject non-residents to a withholding tax on payments of interest from resident companies. Such rates of withholding tax may vary from 5% to 35%, and may depend on whether the loan is secured or unsecured. Where withholding taxes are a major consideration, it is important that the country of incorporation of the finance company is a party to double tax treaties with all countries from which interest payments are received. The withholding tax on interest is normally substantially reduced, if not eliminated, in double tax treaties.
18. The Netherlands is an ideal base for a finance company. The treaty between South Africa and the Netherlands provides for a limitation of the South African source tax on interest to 10%⁷. Interest paid to the finance company incorporated in the Netherlands will not be subject to Dutch tax. The Dutch fiscal authorities also require that a small "spread" be left in the Dutch company subject to Dutch company tax⁸. The Netherlands is also regarded as a favourable location for international finance companies as it has concluded an extensive number of favourable double tax treaties.
19. Luxembourg has recently created rules similar to those of the Netherlands in relation to international finance companies. It should be noted however that

⁷Article 11 (2) of the treaty between South Africa and the Netherlands.

⁸Horak at page 193 and see also Van Blerck (1989) 2 *Juta's Foreign Tax Review* 48.

Luxembourg has a more limited range of tax treaties than the Netherlands. The status of a "Luxembourg finance company" will be granted only if the following criteria are met⁹:

- 19.1 The company must form part of an "international group", with the single purpose of granting loans to group companies and re-financing those loans;
 - 19.2 The ultimate parent company of the group must have an equity capital of at least 7.5 billion Luxembourg francs;
 - 19.3 A major portion of the loans granted by the finance company must be made to non-Luxembourg members of the group.
20. The position with regard to exchange gains and losses is of obvious importance, particularly in the light of the rapid movements in currency markets in recent years. It is important to ensure that losses incurred by the finance company, because funds are borrowed in strong currencies, or funds are lent onwards to group companies in weaker currencies, are tax deductible in the country of its incorporation. According to "International Tax Systems"¹⁰ one of the cardinal rules in international financing operations is to ensure that asset and liabilities are matched, where ever possible, in the same currencies.
21. Foreign exchange gains and losses are taxed or tax deductible in very limited circumstances in South Africa. Section 24B of the **Income Tax Act** provides that foreign exchange gains or losses are either taxed or tax deductible where a foreign debt has been incurred by a South African taxpayer. Foreign exchange gains which are not dealt with under the provisions of Section 24B are dealt with under the provisions of the gross income definition. In the event that the gain is regarded as being of a capital nature it is not taxable¹¹. In the case of foreign exchange losses not falling within the ambit of Section 24B regard must be had to Section 11(a) of the **Income Tax Act**. It has been held that losses of a capital nature are not deductible¹², whereas losses of a revenue nature are deductible¹³. Unfortunately a detailed discussion of this

⁹See Van Blerck op.cit.

¹⁰At page 119.

¹¹See CIR v Brown Brothers Ltd. 1955 (2) SA 165 (T). It was held in SA Marine Corporation Ltd. v CIR 1955 (1) SA 654 (C) that revenue gains are taxable.

¹²See ITC 114, 4 SATC 64 (1928).

¹³See ITC 807, 20 SATC 338 (1955). See Van Blerck (1988) 1 Juta's Foreign Tax Review 43 for a decision tree relating to forex gains and losses. There is also a discussion by Horak (1992) 5 SA Tax Review 23 relating to ITC 1498, 53 SATC 260

subject is beyond the scope of this paper.

22. Exchange losses and gains arising on foreign currency borrowings are either tax deductible or taxable under Dutch tax law. According to **E S Louw**¹⁴ an opportunity for tax savings arises from a recent decision of the Dutch Supreme Court. In terms of this decision a Dutch company can borrow money from a group finance company in a foreign currency (say rands) on terms such as that it can deduct any exchange loss arising for tax purposes whilst having the facility to escape Dutch tax on a currency gain. He illustrates this planning point by way of an example.
23. According to the example, a Dutch company makes a rand loan from its South African parent company, which is convertible into ordinary shares in the Dutch company. The conversion price is pegged by reference to the rand/guilder rate ruling at the time that the loan was made. Should the South African holding company elect not to convert the loan to ordinary shares, it will be repaid in the original currency of the agreement, that is, rand. Should the rand strengthen against the guilder, the South African parent company can elect to have the loan repaid rather than convert it to shares. The repayment of the loan will be tax neutral for the South African parent company as it will not generate any exchange gain or losses since the loan is denominated in rands. The Dutch subsidiary, however, will suffer an exchange loss which will be deductible for Dutch income tax purposes.
24. On the other hand, should the rand weaken against the guilder, the South African parent company may elect to convert the loan to ordinary shares. The conversion will be effected at the original exchange rate and, according to the Supreme Court decision, the conversion using historic exchange rates will not amount to a taxable event in Dutch tax law. In the event of conversion, the loan is in essence denominated in guilders and a conversion of a guilders loan into guilders shares will not result in any exchange gain or loss. In either of these events, no South African income tax consequence will arise.
25. If a group finance company is used to finance a group subsidiary company with an interest-bearing loan, it is important to ensure that the interest paid by the group subsidiary company will be an allowable deduction against its taxable profits. Some countries, such as Germany¹⁵, consider such interest payments on loans from group finance companies as distributions and, in addition to refusing their deduction against taxable profits, impose a withholding tax on such payments as if they are in fact dividends. A greater danger exists that the loan may fall within the "thin capitalisation" legislation of the country of

(1989), which is the latest decision on Section 24B.

¹⁴(1990) 3 Juta's Foreign Tax Review 47.

¹⁵International Tax Systems at page 118.

incorporation of the subsidiary company. In such an event, this country may consider that the loan is in fact capitalising the subsidiary company and may reclassify such a loan as equity capital. Many countries, such as Germany, Australia, the United States and the United Kingdom, have enacted specific legislation or have established guidelines to regulate thin capitalisation. Two general approaches to counter the abuse of thin capitalisation by way of specific statutory requirements were identified in a special report by the OECD¹⁶:

- 25.1 The so-called arm's length principle is flexible, in that the method of capitalising a company is examined in the light of the facts and circumstances of each instance. The guiding principle is that a lender who is prepared to advance a large amount to a company with relatively low equity capital must be regarded as having an interest in the profitability of the company, and consequently his loan must be taken to be an equity investment.
- 25.2 The fixed ratio approach examine the debt:equity ratio of a particular company and, if that ratio exceeds a specified fixed ratio, disallow the interest deduction, even treating interest payments as dividends in some circumstances.
26. According to "International Tax Systems"¹⁷ if the finance company needs to capitalise a subsidiary company with a sum on which interest may be disallowed, it may be beneficial to arrange a "back to back" loan, in which the finance company deposits the sum required with a local bank, and a foreign branch of that bank then lends the money to the group's subsidiary company in which the funds are to be retained. Such an arrangement may of course fall foul of the anti-avoidance legislation of the country of incorporation of the subsidiary company. It should be noted that the Netherlands does not have any "thin capitalisation" legislation.

Captive insurance companies

27. A captive insurance company is an insurance company formed to insure or reinsure the risks of a group of affiliated companies. A large multi-national group of companies may pay a large amount in premiums every year. Should they channel their short-term insurance premiums to a wholly-owned subsidiary of the group, and re-insure most of the risks with major reinsurance companies, substantial savings may ensue. According to **Langer**¹⁸, large

¹⁶"Thin Capitalisation" Issues in International Taxation No 2 OECD (1987) Paris. See Van Dorsten 1989 (2) Juta's Foreign Tax Review 14.

¹⁷At page 119.

¹⁸At page 356.

multinational groups with operations in many countries have traditionally acted as self-insurers for certain risks. In addition, a captive insurance company may also enable the various subsidiaries to obtain insurance against risks not generally covered by commercial insurance companies. The income tax laws in many countries, such as South Africa¹⁹, do not permit a deduction for amounts set aside as self-insurance reserves. A captive insurance company may provide the answer to such a dilemma. Such companies are usually incorporated in a tax haven that imposes no tax or a minimum of tax on premium or reinvestment income generated by the insurance of the world wide risks of the group. A number of tax jurisdictions permit insurance premiums paid to the captive insurance company to be deductible even though they are paid to a subsidiary company²⁰.

28. According to **Ginsberg**²¹ the inducements for companies to form captive insurance companies are:
- 28.1 Lower insurance costs due to the absence of marketing, sales costs and commissions. In addition the premiums reflect the experience of a particular group rather than general market conditions or rates.
 - 28.2 Increased liquidity, as premiums are available for investment by the company paying the premium instead of the premium having to be paid in advance to a commercial insurance company. Traditionally, insurance premiums are paid by the insured in advance, but re-insurance premiums are not paid until the end of the period of coverage. The captive insurance company in the event that it receives the premium in advance, can invest the entire amount of the re-insurance premium for its own account during the interval. Substantial interest earnings may result.
 - 28.3 The ability to get certain coverage is often not available from commercial sources, such as for nuclear risk, super tankers, strikes and so on.
 - 28.4 Superior coverage may be obtained by writing a policy to suit ones own requirements.
29. The report of the Commission of Inquiry into the Flow of Short-Term Insurance Premiums out of the Republic and the Operations of Captive Insurers under the chairmanship of Judge Melamet was published in 1990. The Commission defined a captive insurance company as:

¹⁹In terms of Section 23(e) of the Income Tax Act reserves are not deductible.

²⁰Langer at page 356. This is also the case in South Africa.

²¹At page 41.

"An insurance company that only insures all or part of the risks of its parent".

30. The Commission found that certain parent companies were using captive insurance companies as a fronting mechanism, that is, the so-called "rent-a-captive"²². In this regard the Commission highlighted two ways in which this fronting was effected:
- 30.1 The insurance company received a premium and used the premium to cover all losses of a certain type up to a specified amount as and when they occurred. At the end of the period of insurance any surplus premiums was refunded or carried forward to the following period or, if there was a shortfall, an additional premium was collected immediately or debited to the ensuing year;
 - 30.2 Alternatively, the "rent-a-captive" was used as a front to access directly local and overseas reinsurance markets on behalf of the parent company.
31. In addition the Commission was concerned that captives were being used to make payments of premiums out of pre-tax income, which was then remitted off-shore and either retained there or returned to South Africa in the form of tax free dividends. The Commission found that approximately R200 million and R300 million left South Africa in 1987 and 1988 in the form of such premiums²³. The Commission was also of the view that off-shore captives had been abused by the laundering of monies to evade tax in the following manner:
- 31.1 Premiums paid to captives were claimed as a deduction for tax purposes;
 - 31.2 A portion of the premium was then used for reinsurance, whilst the balance, together with any commission received from the reinsurer (for place in the business) was used to form a fund;
 - 31.3 The fund, which was built up from pre-tax earnings, was then returned to the parent company as a dividend free of tax²⁴.

²²The Commission's Report is discussed by Dieperink (1990) 3 *Juta's Foreign Tax Review* 30 and 64.

²³loc.cit.

²⁴Op.cit at page 31. It should be noted that dividends from sources outside South Africa received by or accrued to a person (other than a company) who is ordinarily resident in South Africa or received/accrued to a South African company is deemed to be from a South African source in terms of para (k) of the gross income definition.

32. As a result of its findings, the Commission made a number of recommendations. These were:
- 32.1 The three regulatory bodies, Exchange Control, the Registrar of Financial Institutions and the Commissioner for Inland Revenue, had not always worked together in appraising the authorisation of "off-shore" captives. It therefore recommended that these bodies be co-ordinated to consider each application for the formation of an "off-shore" captive;
 - 32.2 The immediate task of the abovementioned parties should include an examination of the activities of existing off-shore captives (it should be noted that the Commission identified the existence of some 21 off-shore captives) with a view to:
 - 32.2.1 Recommending to Exchange Control what funds, accumulated off-shore by the captive, should be returned to the parent company in the Republic and in what form these funds should be returned;
 - 32.2.2 Identifying and referring to the Commissioner of Inland Revenue any unjustified claim which had been claimed as a deduction for income tax purposes in prior years;
 - 32.2.3 Identifying and referring to the Registrar all payments of premiums which had been made directly to off-shore captives and establishing whether Section 60(2) or 75 of the **Insurance Act, No 27 of 1943**, had been contravened in any way.
33. In addition to the abovementioned recommendations the Commission also recommended that²⁵:
- 33.1 Any future grant of approval to establish a captive be made subject to the provision that the parent company submit annual returns for consideration by the above parties in a prescribed format;
 - 33.2 Premiums paid to off-shore captives be disallowed as a deduction for tax purposes save and except for that portion of the nett amount actually expended on bona fide reinsurance;
 - 33.3 As regards the so-called "rent-a-captive" facilities offered by certain local insurance companies, the Commission was of the view that Revenue should investigate these operations to determine whether they have contravened the provisions of the **Income Tax Act**.

²⁵Loc.cit. At page 64 Dieperink investigates the measures taken by other countries to legislate against captives.

34. Finally, the Commission recommended that in view of the Republic's current economic situation and the shortage of foreign currency, a limited licence be granted for "on-shore" captives.
35. Bermuda is the most favoured tax haven for the formation of captive insurance companies. Other tax havens used for this purpose are the Cayman Islands, Guernsey, Vanuatu, the Netherlands Antilles, the Bahamas and Gibraltar²⁶.

Licensing companies

36. In **CIR vs Mullin (1928) AD 207**, the Court held that the source of the royalty payments received by the taxpayer was in South Africa. She was an author who resided in South Africa and received royalties from an English publisher in terms of a contract entered into in England. The Court held that as the dominant cause of the income was the exercise by the author of her wits, skill and labour in South Africa and not the contract in England, the source of the royalty payments was accordingly found in South Africa. Section 9(1)(b) deems any income resulting from the use in South Africa of any patent, trademark and so on to be from a South African source. Section 35 of the **Income Tax Act** provides for a withholding tax in respect of royalties paid to non-Republic residents. Section 6 bis provides relief where a patent, design, trademark and so on is used in a country other than the Republic and the resultant income has been taxed in that other country as well as in South Africa. In terms of this section, if the foreign tax is not recoverable the taxpayer may, in determination of his South African tax deduct so much of the foreign tax that does not exceed the South African tax on the amount. Finally, paragraph (g) of the gross income definition includes in gross of income any amount received as a premium for the use of any patent, trademark and so on. Paragraph (gA) of the gross income definition is similar to paragraph (g) and brings into gross income any "know-how" payments, that is, amounts received for the imparting of scientific, technical, industrial or commercial knowledge for use in the Republic.
37. Foreign royalties paid to South African licensors are generally regarded on the strength of Millen's case and also because of paragraph (g) of the Gross Income Definition to be from a source in South Africa. Hence royalty payments received by South African licensors will be taxable here. The only relief available to such licensors is Section 6 bis. According to **Passos**²⁷ because of the provisions of Section 6 bis, the use of an intermediary foreign licensing company as a tool for reducing foreign withholding taxes is limited. She is of the further view that in most instances the total amount of income tax charged on the royalties received by the South African licensor through an intermediary foreign licensing company are increased. This is as a result of the fact that

²⁶Ginsberg at page 42 and page 154.

²⁷At page 55.

any reduced foreign withholding tax is paid by the foreign intermediary licensing company in the country from which the royalties are paid and any taxes paid by that company in its country of incorporation will not be permitted as a rebate against the normal tax payable in South Africa. The disallowance will arise because they do not constitute tax as paid directly by the South African licensor.

38. According to **Passos**²⁸, the outright sale of the property giving rise to the royalty payment to a foreign company may be the only answer for South African licensors. She cautions that care must be taken that the proceeds from such a sale retains its capital nature so that it will not be taxed in South Africa. She advises that many factors must be considered before a decision to sell the property is taken. These factors are:
- 38.1 Whether the South African licensor will use the property in South Africa in its South African business;
 - 38.2 The incorporation of a foreign company to own a property is subject to exchange control approval. Such approval is also required for the payment of royalties by a South African company to a foreign licensor;
 - 38.3 The foreign country of incorporation of the foreign licensor has to be chosen carefully. Patents should not be registered in tax havens as they have not entered into many double tax treaties with high tax countries. As a result there will be no reduction on the withholding taxes imposed in the countries of ultimate use, which will in all likelihood be a high tax country. It is accordingly preferable to incorporate the licensor in a country with a wide treaty network such as the Netherlands or Denmark;
 - 38.4 The type of property may be such that it will always give rise to proceeds of an income nature.
39. Care must be taken in determining the amount to be paid by the new licensor to the South African licensor. Should development costs have been incurred, these will be recouped in South Africa. It is very difficult to find an arm's length price. According to "International Tax Systems"²⁹, the purchase price should take into account the geographic area permitted under the licence, the right to grant sub-licenses, the extent to which there are substitutes in existence and the extent of the costs incurred by the research and development company.
40. The Netherlands is frequently chosen for the incorporation of patent holding companies. The treaty between the Netherlands and South Africa provides

²⁸loc.cit.

²⁹At page 124.

that royalties derived by a Dutch resident from South Africa are only taxable in the Netherlands³⁰. Although the royalty income of the Dutch company will be subject to Dutch tax, subsequent royalty payments to the resident in the third country qualify as deductions³¹. The Dutch tax authorities however require a thin spread, which will be subject to Dutch tax (+/- 8 out of 100 units) to be left in the Dutch company³². Some patent holding companies have been incorporated in the Isle of Man. These companies in turn enter into a sub-licence agreement with an intermediate Dutch licensing company. The Dutch intermediate licensing company in turn sub-licenses any one of a number of users in various countries. Once again, the withholding tax on royalties may be reduced by the extensive network of treaties entered into by the Netherlands in this manner. The Netherlands and Channel Islands double tax agreement provides for a withholding tax of 5% by the Netherlands. This withholding tax will only be imposed on the "spread" reported as taxable income in the Netherlands. Substantial tax savings will accordingly arise³³.

Excursus : Countertrade

General

41. The term "countertrade" includes any foreign trade transaction in which there is an element of reciprocity. For example, South Africa might sell manufactured goods to Zambia in exchange for copper. More specifically, countertrade transactions "are those transactions which have as a base characteristic a linkage, legal or otherwise, between exports and imports of goods or services in addition to, or in place of, financial settlements"³⁴. Countertrade may also take the form of investment, technology transfer, or some other benefit required by the importing company or country.
42. There has been a steady increase in countertrade in the past two decades. This is mainly due to the international debt crisis as many countries, particularly in the developing world, cannot obtain the necessary trade credit or financial assistance that enables them to import goods and technology. In addition countries are able to preserve their valuable foreign exchange. The following basic forms of countertrade occur:³⁵

³⁰See article 12(1) of the South African and Netherlands treaty.

³¹See Spitz "Tax Havens" Netherlands at page 14.

³²Op.cit.

³³Steinberg's paper at page 15.

³⁴Report of the Secretary-General, United Nations, 1984. Noted in Safto's Export Finance Handbook (1990) at page 115.

³⁵Safto's Handbook at page 116.

- 42.1 Barter, in terms whereof goods are exchanged directly for other goods of approximately equal value;
 - 42.2 Compensation, in terms whereof goods are paid for totally or partly in kind. The parties to such an arrangement invoice each other for goods but the amounts are off-set against each other in a mutual compensation or clearing account;
 - 42.3 Counter-purchase, in terms whereof the participating parties sign two separate contracts that specify the goods or services to be exchanged. In this manner one transaction can be effected independently of the other. For example, a South African company is to import R1 million worth of capital equipment from Germany. The company then imposes a countertrade commitment on the German supplier whereby the latter must buy R1 million worth of manufactured goods produced by a subsidiary of the South African company. A common term of such agreements permits the supplier to assign the counter-purchase commitment to a third party;
 - 42.4 Advance purchase, in terms whereof receipts from the sale of countertrade goods from, say, a developing country are deposited in an escrow account. It is managed by a bank until such time as sufficient funds have accrued to pay for the agreed imports whereupon the latter are shipped by the supplier in the developed country to the developing country;
 - 42.5 Buy back, in terms whereof one party agrees to supply technology or equipment that enables the other party to produce goods with which the price of the technology or equipment is repaid.
43. Countertrade require special financial arrangements. These are³⁶:
- 43.1 Escrow accounts, receive the revenue resulting from the sale of the countertrade goods and holds it "in trust" until sufficient funds have accrued to cover the previously agreed proportion of the value of the export goods which are to be supplied. The exporter is accordingly paid from the escrow account;
 - 43.2 Bilateral clearing accounts, are usually established at Government or at central bank level between two countries wishing to develop two-way trade. The account is a mechanism for off-setting the mutual imports and exports between the two countries in order to avoid the actual transfer of foreign currency.
 - 43.3 Evidence accounts, are similar in operation to bilateral clearing accounts

³⁶Op.cit at page 118 to 119.

but are established on a company basis.

The income tax consequences of countertrade

44. Counter purchase is considered to be the classical form of countertrade and is the most frequently used form of countertrade. Consequently, only the income tax consequences pertaining to counter purchases will be analysed. The basic characteristic of countertrade is that there is a reciprocal counter obligation on the part of the other party to the agreement. The question accordingly arises as to whether the parties to the counter purchase have incurred an obligation that is either:
- 44.1 Unconditional and not dependent on the performance of the other; or
 - 44.2 Dependent upon performance of the other and incurred specifically in exchange for such other obligation.
45. As such the question arises as to whether these agreements are for purposes of income tax divisible or indivisible³⁷. According to **Stelzner** the question is whether a party to a countertrade agreement has incurred both an accrual in respect of the goods he exports and expenditure in respect of the goods he undertakes to import at the same time³⁸.
46. According to **Stelzner** a counter purchase consists of three separate documents, each of which is signed by both parties to the counter purchase. These documents are³⁹:
- 46.1 The main agreement, which is generally a standard export agreement is similar to an ordinary cash sale in terms whereof the exporter undertakes to sell certain specified goods at a specified price. The price is determined by reference to the exact nature and extent of the exporter's counter performance obligations. This agreement is an independent contract and there is no reference in it to any counter performances by the seller. It is accordingly unconditional upon the counter performance obligations being met alternatively clearly divisible from it;
 - 46.2 The countertrade agreement is a separate agreement in terms whereof the exporter undertakes to purchase certain goods or products from the

³⁷This question has been analysed in detail by Stelzner in a Technical Research Paper at the University of Cape Town in 1990 titled "Countertrading and the Income Tax Act".

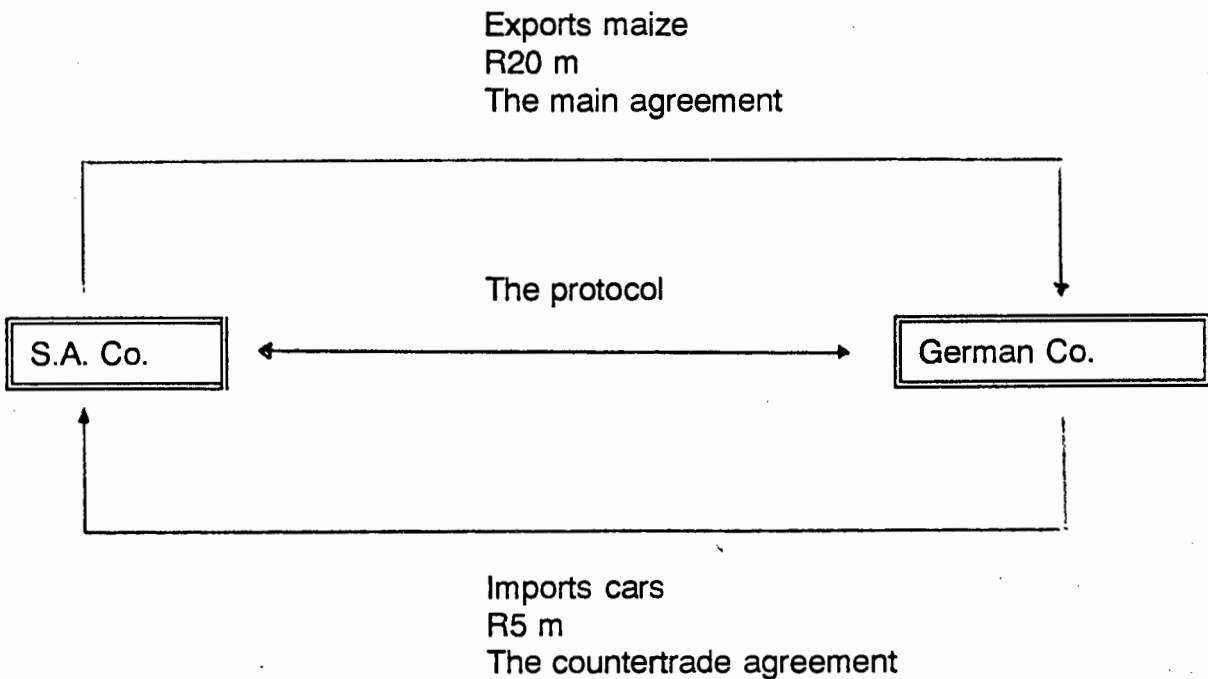
³⁸Op.cit. at page 15.

³⁹Op.cit at page 29.

importer. To recap, the nature and extent of the countertrade performance is usually an undertaking by the exporter to purchase certain goods from the importer at a fixed percentage of the total value of the main agreement. The price of the goods which are purchased by the exporter is rarely specified other than a reference to their market value on world markets;

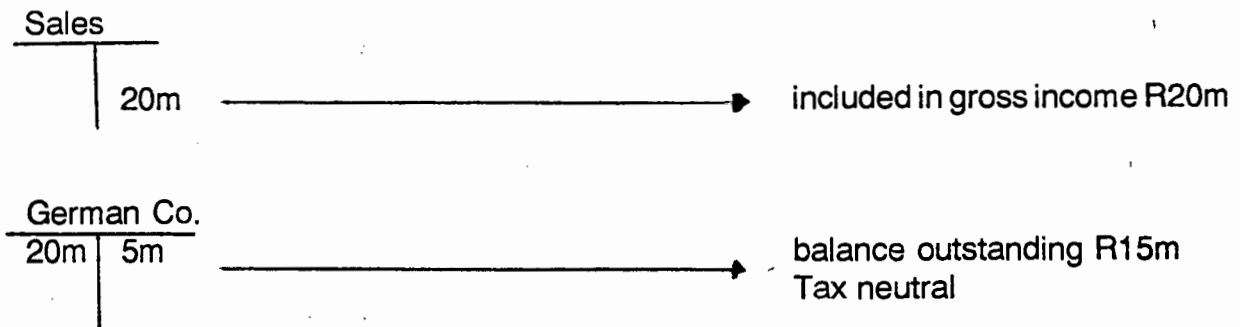
46.3 The protocol, is the third part of the standard countertrade agreement. It ensures that the link between the above two agreements can be proven. This document is usually first signed. In it both parties undertake to conclude the separate purchase agreements simultaneously.

47. The mechanics of such a scheme is set out below:



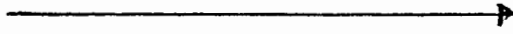
Accounting consequences

Income Tax consequences



Stock

5 m



Section 11(a) deduction for trading stock. Section 22(1) relating to closing stock will however defer the Section 11(a) deduction until the year of sale.

48. The income tax consequences of the above scheme is as follows:

48.1 The South African company will have earned income by way of an accrual for purposes of the gross income definition prior to the execution of a contract, should same occur in the following year of assessment. The main agreement containing the export obligations of the South African company will fall within the ambit of **CIR vs People's Stores (Walvis Bay) (Pty) Ltd. 1990 (2) SA 353 (A)**, in terms whereof **Hefer JA** stated that:

"Income, although expressed as an amount in the definition, need not be an actual amount of money but may be 'every form of property earned by the taxpayer whether corporeal or incorporeal which has a money value including debts and rights of action'."

It was further held that no more is required for an accrual than that the taxpayer has become entitled to an amount. For this reason "any right (of a non-capital nature) acquired by the taxpayer during the year of assessment and to which a money value can be attached, forms part of the "gross income" irrespective of whether it is immediately enforceable or not ...".

48.2 The next question is whether the South African company has incurred an unconditional obligation by virtue of its commitments as set out in the countertrade agreement. Does its obligations to import the cars meet the requirements of Section 11(a) of the **Income Tax Act**. According to **Stelzner**⁴⁰ the key requirement of the general deduction formula which must be satisfied for purposes of countertrade is whether the expenditure has "actually been incurred". He submits that the South African company's obligations as set out in the countertrade agreement constitutes an unconditional obligation as required by **Nasionale Pers Bpk. vs KBI 1986 (3) SA 549 AD** and **Edgars Stores Ltd. vs CIR**

⁴⁰Op.cit. at pages 18 to 23.

1988 (3) SA 87 AD. He is accordingly of the view that the reciprocal obligation upon the South African company in the example above to import the cars is not contingent upon its performance in terms of the main agreement. A factor not considered in the analysis of **Stelzner** is that the effect of Section 22(1) relating to closing stock will render the Section 11(a) deduction in the first year of assessment nugatory. This is so as the effect of Section 22(1) is to defer the Section 11(a) deduction until the year of sale, which will only occur in year two. It is submitted that the Section 11(a) can not be claimed in a vacuum and as such cannot be merely expensed to the income statement. Accordingly there are no means to avoid the application of Section 22(1).

The anti-avoidance provisions pertaining to outward investment

49. The same considerations apply to outward investment as discussed in chapter 4 under the same heading relating to inward investment.

The accounting consequences of outward investment

50. Section 291 of the **Companies Act** provides that group annual financial statements need not deal with a particular subsidiary if the holding company's directors are of the opinion that:
- 50.1 It is impracticable or would be of no real value to the members of the holding company, or would entail expense or delay out of proportion to the value to the members;
 - 50.2 The result would be misleading or harmful to the business of the holding company;
 - 50.3 The business of the holding company and that of the subsidiaries are so different that they cannot be reasonably treated as a single undertaking.
51. Where a subsidiary is not dealt with in group annual financial statements and the interest in such subsidiary is material in relation to the financial position or the results of the holding company, there shall be included in the annual financial statements of the holding company the information required by paragraphs 56 to 58 of the fourth schedule to the **Companies Act**. Disclosure is accordingly still required. Paragraph 16 of Accounting Statement (AC) 110 provides a variety of reasons for excluding subsidiaries from consolidated financial statements, including the inability of the holding company to exercise effective control, or because it would be misleading where the subsidiary operates under severe restrictions, such as a particular political dispensation or exchange control which is expected to continue for the foreseeable future. Foreign subsidiaries may be at issue here.

52. Where foreign subsidiaries are included in consolidated statements the account balances of the foreign subsidiary must first be converted to the currency of the financial statements of the holding company. According to statement AC112, the method of translating the financial statements of foreign operations should be determined by the characteristics of the operations themselves as well as the financial nature of those operations. In this context a foreign subsidiary is regarded as belonging to one of the following two categories, namely:

52.1 The foreign subsidiary represents a foreign entity;

52.2 The foreign subsidiary represents an integrated foreign operation.

The legal aspects of international tax planning

53. International trade transactions are governed either by the national laws of the parties to the contract or by international treaties or conventions adopted by or binding on the countries concerned. There are several international treaties aimed at the global unification and integration of international trade law. These are:

53.1 The Vienna Convention on Contracts for the International Sale of Goods (1980);

53.2 The Geneva Convention on Agency in the International Sale of Goods (1983);

53.3 The Hague Convention on the Law applicable to Contracts for the International Sale of Goods (1986);

53.4 The Ottawa Convention on International Factoring and International Financial Leasing (1988);

53.5 The Convention on International Bills of Exchange and International Promissory Notes (1988).

54. According to **Van Dorsten**⁴¹ an optimal structure would co-ordinate the most advantageous tax and legal consequences as it is clearly not desirable to have a structure which is effective for tax purposes but which contains legal pitfalls for the parties. He suggests that the legal and tax requirements of each country in which business operations are undertaken must be fully examined to minimise not only the liability for tax but also legal formalities, restrictions and risks.

55. The most important question concerning international contracts is which legal system governs the contract. The branch of law which decides what law will

⁴¹(1990) 3 Juta's Foreign Tax Review 86 at page 87.

be applied is known as the conflict of laws or private international law. The applicable law is referred to as the proper law of the contract. It is established by first ascertaining whether a law has been imputed by legislation, if not the law chosen by the parties will apply, if no law has been chosen the courts will impute a proper law based on the evidence placed before it.

56. It is vital to bear in mind that international tax planning cannot be done in isolation and must be implemented with suitable simultaneous legal planning.

The exchange control consequences pertaining to outward investment

General

57. Certain exchange control issues vis-a-vis outward investment have been identified. They are:

- 57.1 Direct investment;
- 57.2 Loans by residents to non-residents;
- 57.3 Transfer abroad of reinsurance premiums;
- 57.4 Exports;
- 57.5 Excursus: product loans.

Direct Investment

58. Exchange Control Regulation 2 stipulates that:

"Except with permission granted by the Treasury, and in accordance with such conditions as the Treasury may impose, no person other than an authorised dealer shall buy or borrow any foreign currency or any gold from, or sell or lend any foreign currency or any gold to any person not being an authorised dealer".

and

"An authorised dealer shall not buy, borrow or receive or sell, lend or deliver any foreign currency or gold except for such purposes or on such conditions as the Treasury may determine".

59. The purpose of exchange control is to prohibit all dealings in foreign exchange except with the permission of and on the conditions approved by the Treasury. Accordingly all acquisitions of assets outside the CMA and all outward transfers of capital and income by residents to destinations outside the CMA require the approval of exchange control. Requests by individuals to make investments abroad are not agreed to. Exchange control will only approve investments

abroad made by companies⁴².

60. Applications fall broadly into two categories, that is, the establishment of subsidiary companies and joint ventures which are self-sufficient and branches and offices generating little or no income. Applications for making direct investments must include information on the following issues:⁴³
 - 60.1 The promotion of exports;
 - 60.2 The disguising of South African ownership or involvement. This is often the case in regard to shipping companies where ships are registered off-shore so as to acquire a flag of convenience;
 - 60.3 The ability to render services better or to better exploit the products, technology, knowledge or ideas of residence;
 - 60.4 The safe-guarding of domestic interests, such as essential imports of goods and technology;
 - 60.5 The names of the shareholders. It should be noted that the control will not allow individual residents to hold shares in their own names and would require such shares so to be registered in the name of a South African registered company.
 - 60.6 The proposed financial structure of the undertaking, that is, issued share capital, loan funds, guarantees to be issued for credit facilities abroad and so on;
 - 60.7 The manner in which capital will be employed;
 - 60.8 An estimate of annual running expenses;
 - 60.9 What funds, if any, it is required to remit from South Africa and whether on a permanent or temporary basis;
 - 60.10 A projection of the financial position of the foreign concern, including cash flows, over the following two or three years.
61. Exchange control insists that all nett income generated by a foreign concern should be repatriated to South Africa. In addition such concerns are required to submit financial statements on these operations to the Control on an annual

⁴²Exchange Control Manual at page O1.

⁴³Loc.cit.

basis⁴⁴.

62. When funds are to be remitted from South Africa on a regular basis to finance an off-shore operation, an annual application must be submitted to exchange control. Such an application must include the following information⁴⁵:

62.1 A report on the operations of the past year;

62.2 An up to date financial statement of the foreign concern.

63. The expansion of a foreign venture by way of an acquisition or the establishment of additional foreign entities will be treated on the same basis as set out in paragraph 62. Such applications must contain the following information:

63.1 The family tree of the off-shore group of entities before and after the restructuring/merges;

63.2 Pro-forma balance sheets of each foreign entity reflecting its financial position before and after the restructuring/merger.⁴⁶

64. The basic principle at present is that all such investments and any working capital may only be made by the financial rand medium. In the case where equipment and machinery is exported from South Africa to a foreign venture, exchange control will permit it to be capitalised at the commercial rand rate of exchange. In those instances where the foreign entity requires a nominal share capital and the establishment costs equate the share capital of the company, the transfer of funds to cover such costs will be permitted at the commercial rand rate of exchange.⁴⁷

Loans by residents to non-residents

65. Loans by residents to non-residents are also subject to exchange control approval. Such approval will normally be granted where the loan is related to an approved foreign investment by the applicant. These transactions take place in commercial rand⁴⁸.

⁴⁴Loc.cit.

⁴⁵Loc.cit.

⁴⁶Loc.cit.

⁴⁷Loc.cit.

⁴⁸Op.cit. at page O3.

Transfer abroad of reinsurance premiums

66. The transfer abroad of reinsurance premiums by the local insurance industry is also subject to exchange control approval as well as approval by the Registrar of insurance. Should such permission be granted, funds in payment thereof may be remitted abroad through the commercial rand rate of exchange subject to the condition that all settlements due from abroad are transferred to South Africa in terms of Exchange Control Regulation 6⁴⁹.

Exports

67. Exchange Control Regulation 6 requires every person resident in South Africa to sell to an authorised dealer within seven days of accrual, all foreign currency to which they may become entitled. It should be noted that this regulation applies not only to the proceeds from exports but also to the proceeds of any assets sold abroad. The Reserve Bank controls the receipt in South Africa of the proceeds of exports or the sale of assets with two forms, namely:
- 67.1 Form 178, which must be used when the export of goods from South Africa will result in the accrual of foreign currency to the exporter;
- 67.2 Form E which is an offer to sell foreign currency to the authorised dealer concerned.
68. Exporters are obliged to sell goods exported within a reasonable time but not later than six months from the date of shipment. They must accordingly receive the full currency proceeds not later than six months from the date of shipment. Within certain prescribed limits authorised dealers may, without reference to exchange control, authorise exporters to grant credit up to a total of twelve months to foreign importers provided they are satisfied that the credit is necessary in a particular trade or that it is needed to protect an existing export market or to capture a new one. Extensions beyond the initial twelve month period must be approved by exchange control⁵⁰.
69. The exchange control authorities have laid down that all exports, except those for which payment has already been received or in respect of which payment will be received within seven days of shipment, must be covered forward within a period not later than seven days after shipment and must remain continuously covered until the proceeds of the exports are received;

Excursus: Product loans

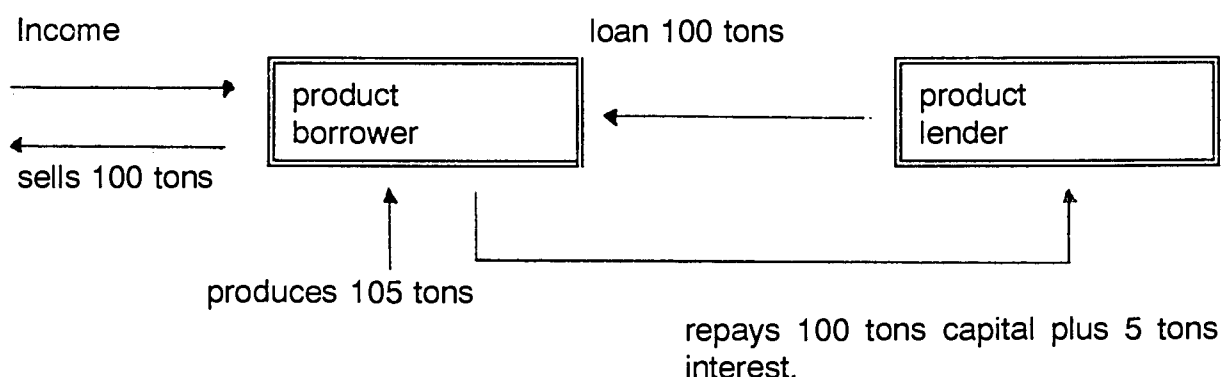
70. Product loans are a variation of countertrade. These loans have also been

⁴⁹Exchange Control Manual at page I 9.

⁵⁰Exchange Control Manual at page K2.

devised as a result of the international debt crisis. The theory behind a product loan is that the owner of a stockpile of a commodity earns no income merely by holding the product in question. On the contrary he may incur a holding cost in the form of storage expenses or the opportunity costs associated with funding the stockpile. The owner might therefore be prepared to lend a specified quantity of the product for a stipulated period to a credit-worthy borrower at a cost to the borrower that is substantially below the comparable rate of interest on money loans. The borrower is normally a producer of the product lent to him and sells the borrowed product in order to raise cash for use as working capital. Between the date that the loan is made and the date of repayment, the borrower produces the product in question and "repays" the product loan with interest, in the form of additional products, to the lender⁵¹.

71. The main benefit of a product loan to the lender is that it generates an income from an otherwise dormant asset. On the other hand, the borrower is able to raise a form of low-cost finance. The mechanics of such a scheme is set out below:⁵²



72. Such loans have certain exchange control consequences. According to **Burger**⁵³ there appears to be no prohibition in the exchange control regulations against the borrowing or lending of commodities other than gold. There is also no prohibition relating to the export of commodities such as iron, ore, wool or sugar which are normally the subject matter of product loans. Regulation 10(1) (a)(i) does however stipulate that "no person shall export from the Republic during any period of twelve months a total quantity of goods which exceeds in value R20 or such greater amount as the Treasury may determine, if no payment for such goods has been or is to be received in the Republic from a

⁵¹See Burger (1990) 19 Businessman's Law 251 for a discussion of these loans.

⁵²Op.cit. at page 253.

⁵³Op.cit. at page 254.

person outside the Republic."

73. **Burger**⁵⁴ argues that the proceeds from the sale of the borrowed commodity, on the date of entering into the loan, constitutes payment from a source outside South Africa. As the transaction constitutes a loan, and also due to the lack of payment for the eventual export from South Africa, exchange control approval will be required for such loan. He also submits that there is a commercial reason why one must view the transaction as a loan and approach the Reserve Bank for approval. The Reserve Bank, in an effort to encourage the raising of new loans, offers successful South African borrowers a subsidy to reduce the cost of new off-shore finance. The amount of the subsidy is at the discretion of the Reserve Bank and is provided to the local borrower through the forward cover mechanism. It would therefore be to the advantage of local borrowers of foreign products to structure their transactions, from an exchange control point of view, as a loan, conveniently denominated in product terms but with a currency equivalent, so that they will benefit from the reduced forward cover exchange rate.
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⁵⁴Loc.cit.

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