

**INCOME TAXATION BY
RESIDENCE AND/OR SOURCE
IN LESOTHO**

By

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PREFACE

"The Income Tax Acts themselves impose a territorial limit; either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there", per Lord Herschell in *Colquhoun v Brooks* (1889) 2 TC 490 at 498

These remarks by Lord Herschell even though directed at the United Kingdom tax system in 1889 seem to capture the situation in the new tax law in Lesotho. A recurring question for any tax system to date is is taxation by either residence and/or source appropriate?

This question inspired my research into the examination of the new Lesotho Income Tax Order No 9 of 1993.

SUMMARY OF CONTENTS

	<i>Page</i>
BACKGROUND	1
1. GENERAL INTRODUCTION	3
1.1 INTRODUCTION	3
1.2 THE SOURCE OR RESIDENCE DEBATE	3
1.3 TAXATION ON THE BASIS OF RESIDENCE	6
1.4. TAXATION ON THE BASIS OF SOURCE	7
1.5 CONCLUSION	8
 PART I - DOMESTIC TAXATION IN LESOTHO	
2 THE CONCEPTS OF RESIDENCE AND SOURCE	9
2.1 THE RATIONALE BEHIND THE CONCEPTS OF RESIDENCE AND SOURCE	9
2.1.1 Introduction	
2.1.2 The rationale behind the concepts	9
2.1.3 The significance of residence and source	10
2.2 CONCEPTUALISING "RESIDENCE" AS THE BASIS OF TAXATION IN LESOTHO	12
2.2.1 The importance of different approaches	12
2.2.2 Which approach for Lesotho?	14
 3. THE TESTS OF RESIDENCE AS ESTABLISHED AND DEVELOPED BY JUDICIAL DECISIONS IN THE UNITED KINGDOM	16
3.1 INTRODUCTION	16
3.2 DEFINITION OF RESIDENCE IN THE UNITED KINGDOM	16
3.3 A DIGEST OF ENGLISH CASES ON RESIDENCE	22

3.3.1	Cases where taxpayers held to be resident in the united kingdom	22
3.3.2	Cases where taxpayers held not to be resident in the United Kingdom	22
3.4	THE UNITED KINGDOM INLAND REVENUE GUIDELINES ON RESIDENCE	33
3.4.1	Rules	34
3.4.2	Examination of these rules	34
3.4.3	Established factors which support residence	37
3.5	DISTINCTION BETWEEN "RESIDENCE", "ORDINARY RESIDENCE" and "DOMICILE"	37
3.5.1	Relevance of the concepts	37
3.5.2	"Residence" and "ordinary residence"	39
3.5.3	Domicile	43
3.6	RESIDENCE OF COMPANIES	44
3.6.1	Place of central management and control	44
3.6.2	Dual residence of a company	45
3.6.3	Can residence of a company change daily?	48
3.6.4	Statutory test of incorporation	49
3.7	RESIDENCE OF PARTNERSHIP	50
3.7.1	Introduction	50
3.7.2	Case law	50
3.8	RESIDENCE OF TRUSTS IN THE UNITED KINGDOM	52
4.	THE CONCEPT OF RESIDENCE IN THE SOUTH AFRICAN TAX LAW	53
4.1	"DEFINITION OF THE CONCEPT"	53
4.2	"RESIDENT" AND "ORDINARILY RESIDENT"	54
4.3	CASE LAW	54
4.4	RESIDENCE OF LEGAL PERSONS	64
4.4.1	Introduction	64
4.4.2	Residence of partnership	64
4.4.3	Residence of companies	65
4.4.4	Residence of a trust	66
4.4.5	Conclusion on residence of legal persons	67

5.	THE APPLICATION OF CONCEPT OF "RESIDENCE" IN LESOTHO	68
5.1	RELEVANCE OF THE CONCEPT	68
5.2	RATIONALE BEHIND DIFFERENTIATION BETWEEN RESIDENT AND NON-RESIDENT TAXPAYERS	68
5.2.1	Sources of income in Lesotho	69
5.2.2.1	Migrant Workers' remittances	70
5.2.2.2	Exemption of farming income from taxation	71
5.2.2	Expatriate taxpayers	72
5.2.3	Non-resident taxpayers	72
5.2.4	Conclusion	73
5.3	RESIDENCE OF INDIVIDUAL TAXPAYERS	74
5.3.1	Normal place of abode	75
5.3.2	Presence of more than 182 days	75
5.3.3	Lesotho Government official posted abroad	75
5.3.4	The common law test of residence ⁵	
5.4	RESIDENCE OF COMPANIES	84
5.5	RESIDENCE OF PARTNERSHIPS	90
5.6	RESIDENCE OF TRUSTS	90
5.7	CONCLUSION	91
6.	SOURCE AS A BASIS FOR TAX LIABILITY IN LESOTHO	92
6.1	INTRODUCTION	92
6.2	MEANING OF "SOURCE"	93
6.3	STATUTORY SOURCE RULES IN LESOTHO: SECTION 103	97
6.4	CONCLUSION	137

PART II - INTERNATIONAL TAXATION IN LESOTHO

7.	INTERNATIONAL DOUBLE TAXATION	138
7.1	INTRODUCTION	138
7.1.1	Double taxation agreements	138
7.1.2	The concept of permanent establishment	139
7.1.3	Effect of taxation treaties to domestic tax law	140

	iv.
7.2	DEFINITION 141
7.2.1	Domestic double taxation 141
7.2.2	Economic Double taxation 142
7.2.3	International (multiple) double taxation 142
7.3	COMMON CAUSES OF DOUBLE TAXATION 143
7.3.1	Common solutions towards eliminating/ mitigating double taxation 146
7.4	DOUBLE TAXATION AGREEMENTS AS MEASURES TO ELIMINATE OR MITIGATE DOUBLE TAXATION 150
7.4.1	The exemption principle 151
7.4.2	The credit method 151
7.4.3	Other measures 151
7.4.4	Conclusion 152
7.5	INTERPRETATION OF FISCAL STATUTES AND DTAs 152
7.5.1	Introduction 152
7.5.2	The Vienna convention on the law of treaties 153
7.5.3	The Renvoi clause in DTAs 155
7.5.4	General principles of interpretation 155
7.5.5	Conclusion 156
8.	TAX TREATY FRAMEWORK FOR LESOTHO 157
8.1	SECTION 112 OF THE LESOTHO INCOME TAX ORDER 157
8.1.1	Introduction 157
8.1.2	The relationship between treaties and the Income Tax Order 157
8.2	AUTHORITY TO ENTER INTO DOUBLE TAXATION AGREEMENTS IN LESOTHO 160
8.3	DOUBLE TAXATION AGREEMENTS THAT LESOTHO IS PARTY TO 164
8.3.1	Introduction 166
8.3.2	Income tax DTAs 164
8.3.3	Double death duties agreement 165
8.4	CONCLUSION 167

9.	ANALYSIS OF DOUBLE TAXATION AGREEMENTS LESOTHO IS PARTY TO	168
9.1	INTRODUCTORY REMARKS	168
9.2	BACKGROUND ON THE DIFFERENT MODEL TAX TREATIES: THE OECD MODEL, THE US MODEL, THE UN MODEL AND THE ANDEAN PACT MODEL	169
9.3	SOME CONTROVERSIAL AREAS IN DTAs BETWEEN DEVELOPED AND DEVELOPING COUNTRIES	175
9.3.1	Introduction	175
9.3.2	Criticism of Inequality	176
9.3.3	Source jurisdiction limited	176
9.3.4	Conclusion	178
9.4	SCOPE OF THE DTAs	179
9.4.1	Title of the treaty	179
9.4.2	Taxes covered	182
9.4.3	Personal scope	183
9.5	THE IMPORTANCE OF THE CONCEPT OF RESIDENCE IN DTAs	184
9.5.1	Introduction	184
9.5.2	Examination of the concept of residence under the OECD Model Convention	186
9.5.3	DTA concept of temporary residence	189
9.6	LESOTHO-UK DTA AND THE CONCEPT OF RESIDENCE	192
9.7	LESOTHO-RSA DTA AND THE CONCEPT OF RESIDENCE	193
9.8	REMARKS ON THE DTA CONCEPT OF RESIDENCE IN LESOTHO	194
10.	PERMANENT ESTABLISHMENT	195
10.1	INTRODUCTION	195
10.2	THE OECD MODEL CONVENTION	196
10.2.1	General rule	196
10.2.2	Inclusions	200
10.2.3	Exclusions	201
10.2.4	Deemed existence provisions	201
10.2.5	Deemed exclusion provisions	203
10.3	LESOTHO-UK DTA	205
10.4	LESOTHO-RSA DTA	206

10.5	DECIDED CASES RELATING TO THE CONCEPT OF PERMANENT ESTABLISHMENT IN SOUTHERN AFRICAN LAW	207
10.6	CONCLUSION	213
11.	INTERNATIONAL TAXATION OF INCOME	214
11.1	INTRODUCTION	214
11.2	INCOME TAXED ON THE BASIS OF RESIDENCE	214
11.3	INCOME TAXED ON THE BASIS OF SOURCE	215
12.	INCOME FROM IMMOVABLE PROPERTY	217
12.1	INTRODUCTION	217
12.2	A COMPARATIVE APPROACH IN THE MODELS	218
12.3	LESOTHO-UK DTA	220
12.4	LESOTHO-RSA DTA	221
12.5	CONCLUSION	222
13.	INTERNATIONAL TAXATION OF BUSINESS PROFITS	223
13.1	DEFINITIONS	223
13.2	TAXATION OF BUSINESS PROFITS	227
13.2.1	Allocation of profits to a permanent resident	228
13.2.2	The "force of attraction" rule	228
13.2.3	The "rule of attribution"	229
13.2.4	The "effectively connected" rule	231
13.3	TAXATION OF BUSINESS PROFITS UNDER THE DIFFERENT MODELS	233
13.3.1	OECD Model Convention	233
13.3.2	The US Model	234
13.3.3	The UN Model	235
13.3.4	The Andean Pact Model	237
13.4	TAXATION OF BUSINESS PROFITS UNDER THE LESOTHO-UK DTA	239

13.5	THE TAXATION OF BUSINESS PROFITS UNDER THE LESOTHO-RSA DTA	240
13.6	WHAT CONSTITUTES "ARM'S LENGTH" DEALING	243
13.7	PURCHASING ACTIVITIES	246
13.8	ACTIVITIES OF FOREIGN INSURANCE COMPANIES IN LESOTHO	249
13.9	IMPLICATIONS OF FOREIGN EXCHANGE LOSSES/GAINS AND THE FINANCIAL RAND MECHANISM ON BUSINESS PROFITS	251
13.10	CONCLUSION	253
14.	TAXATION OF PROFITS FROM OPERATIONS OF INTERNATIONAL TRANSPORT	254
14.1	14.1.1 Introduction	254
	14.1.2 OECD Model	254
	14.1.3 US Model	255
	14.1.4 UN and Andean Pact	256
14.2	LESOTHO-UK DTA	257
14.3	LESOTHO-RSA DTA	259
14.4	CONCLUSION	260
14.5	DECIDED CASES	261
14.6	TAXATION OF PROFITS OF ASSOCIATED ENTERPRISES	262
	14.6.1 Introduction	262
	14.6.2 The OECD Model	263
	14.6.3 The US, UN and Andean Pact Models	264
	14.6.4 The Lesotho-UK DTA	264
	14.6.5 The Lesotho-RSA DTA	265
	14.6.6 Conclusion	267
14.7	DOMESTIC LEGISLATION TO COUNTER TRANSFER PRICING MANIPULATION	267
15.	INTERNATIONAL TAXATION OF INVESTMENT INCOME	272
15.1	GENERAL INTRODUCTORY REMARKS	272
15.2	INTERNATIONAL TAXATION OF DIVIDENDS	274
	15.2.1 Introduction	274
	15.2.2 The OECD Model Convention	275

15.2.3	The US Model	276
15.2.4	The UN Model	276
15.2.5	The Andean Pact Model	277
15.2.6	The Lesotho-UK DTA	278
15.3.7	The Lesotho-RSA DTA	279
15.3	INTERNATIONAL TAXATION OF INTEREST	280
15.3.1	Introduction	289
15.3.2	The OECD Model Convention	281
15.3.3	The US Model	282
15.3.4	The UN Model	283
15.3.5	The Andean Pact Model	283
15.3.6	The Lesotho UK DTA	284
15.3.7	The Lesotho-RSA DTA	285
15.3.8	Conclusion	285
15.4	INTERNATIONAL TAXATION OF ROYALTIES	286
15.4.1	Introduction	286
15.4.2	The OECD Model Convention	286
15.4.3	The US Model	287
15.4.4	The UN Model	287
15.4.5	The Andean Pact Model	288
15.4.6	The Lesotho-UK DTA	288
15.4.7	The Lesotho-RSA DTA	289
15.4.8	Conclusion	291
16	INTERNATIONAL TAXATION OF PERSONAL SERVICE INCOME	292
16.1	INTRODUCTION	292
16.2	TAXATION OF INDEPENDENT PERSONAL SERVICES	293
16.2.1	The OECD Model Convention	293
16.2.2	The UN Model	294
16.2.3	The US Model	294
16.2.4	The Andean Pact Model	294
16.2.5	The Lesotho-UK DTA	295
16.2.6	Lesotho-RSA DTA	295
16.2.7	Conclusion	296
16.3	DEPENDENT PERSONAL SERVICES	297
16.3.1	Introduction	297
16.3.2	The OECD Model	297
16.3.3	The US Model, UN Model	298
16.3.4	The Andean Pact Model	298
16.3.5	The Lesotho-UK DTA	299
16.3.6	The Lesotho-RSA DTA	299
16.3.7	Conclusion	300

16.4	DIRECTORS' FEES	300
16.4.1	The OECD Model Convention	300
16.4.2	The US MODEL	301
16.4.3	The UN Model	301
16.4.4	The Andean Pact Model	301
16.4.5	The Lesotho-UK DTA	302
16.4.6	The Lesotho-RSA DTA	302
16.4.7	Conclusion	302
16.5	CONSULTANCY/TECHNICAL/MANAGEMENT FEES	303
16.5.1	Introduction	303
16.5.2	The OECD, UN, US Model texts	303
16.5.3	The Andean Pact Model	304
16.5.4	The Lesotho-UK DTA	304
16.5.5	The Lesotho-RSA DTA	305
16.5.6	Conclusion	305
16.6	TAXATION OF INCOME OF ENTERTAINERS AND SPORTSMEN (ARTISTES AND ATHLETES)	305
16.6.1	Introduction	305
16.6.2	The OECD Model Convention	306
16.6.3	The UN Model	308
16.6.4	The US Model	308
16.6.5	The Andean Model	308
16.6.6	The Lesotho-UK DTA	309
16.6.7	The Lesotho-RSA DTA	309
16.6.8	Conclusion	310
16.7	INTERNATIONAL TAXATION OF PENSIONS AND ANNUITIES	311
16.7.1	Introduction	311
16.7.2	The US Model	312
16.7.3	The OECD Model Convention	312
16.7.4	The UN Group	314
16.7.5	The Andean Pact Model	314
16.7.6	The Lesotho-UK DTA	315
16.7.7	The Lesotho-RSA DTA	315
16.7.8	Conclusion	316
16.8	INTERNATIONAL TAXATION OF GOVERNMENT SERVICES	316
16.8.1	Introduction	316
16.8.2	The OECD Model, US Model, UN Model and the Andean Pact Model	317
16.8.3	The Lesotho-UK DTA	317
16.8.4	The Lesotho-RSA DTA	318
16.8.5	Conclusion	318
16.9	INTERNATIONAL TAXATION OF PROFESSORS AND TEACHERS	319
16.9.1	Introduction	319
16.9.2	The OECD Model Convention	319

16.9.3	The UN Draft, US Draft, Andean Pact Model	320
16.9.4	The Lesotho-UK DTA	320
16.9.5	The Lesotho-RSA DTA	321
16.9.6	Conclusion	322
16.10	TAXATION OF STUDENTS AND BUSINESS APPRENTICES	323
16.10.1	Introduction	323
16.10.2	The OECD Model, US Model, UN Model	323
16.10.3	Lesotho DTAs with the UK and RSA	323
16.11	TAXATION OF CAPITAL GAINS	324
16.11.1	Introduction	324
16.11.2	The OECD Model	324
16.11.3	The US, UN Models	325
16.11.4	The Andean Pact Model	325
16.11.5	The Lesotho-UK DTA	326
16.11.6	The Lesotho-RSA DTA	326
16.12	OTHER INCOME	327
16.12.1	Introduction	327
16.12.2	The Lesotho DTAs	327
16.12.3	Conclusion	328
17.	CONCLUDING REMARKS ON TAXATION BY SOURCE AND/OR RESIDENCE IN LESOTHO	329
17.1	THE LESOTHO SOURCE RULES	329
17.1.1	Introduction	329
17.1.2	Criticism of the concept of source	330
17.1.3	When is taxation by source justifiable?	331
17.1.4	Conclusion	332
17.2	LESOTHO RESIDENCE RULES	332
17.2.1	Introduction	332
17.2.2	Criticism of taxation by residence	333
17.2.3	When is taxation by residence justified?	334
17.2.4	Conclusion	334
17.3	REMARKS ON TAXATION ON THE BASIS OF SOURCE AND/OR RESIDENCE IN LESOTHO	335
17.4	RECOMMENDATIONS	336

S U M M A R Y

1. INTRODUCTION

The purpose of this brief summary is to highlight the salient features of this dissertation. Major legal authorities as well as secondary sources consulted for this research will also be highlighted in this synopsis.

The focus of this work is the recent Lesotho Income Tax Order No 9 of 1993, which will hereafter be referred to as the new Lesotho Income Tax Order. This law came into operation on April 1 1993.

The *raison d'être* which prompted this research was the fact that the new Lesotho Income Tax Order drastically departed from the repealed Income Tax Act No 7 of 1981. The latter generally embodied all the salient features found in the South African Income Tax Act No 58 of 1962. Notable amongst the main features of the new law, was the departure from the standard source-based definition of "gross income". As a corollary to this, the new Lesotho Income Tax Order introduced extended Lesotho tax jurisdiction from source based to world-wide (residence) based.

Thus the present writer was prompted to undertake a comparative analysis of the new Lesotho tax law vis-a-vis the South African Income Tax law mainly and the United Kingdom Income Tax law generally. The approach in this analysis was through a

comparative and integrated thematic treatment of income taxation on the basis of source and/or residence both at domestic and international level in Lesotho, the objective being to establish to what extent has the new law departed from the 1981 Act and the South African Act.

2. ORGANISATION

There are two major parts to this dissertation. The first part deals with the examination of the twin concepts of source and residence, as the basis of determining tax liability in Lesotho. Here focus is on the domestic level. The second part is devoted to examination of the twin concepts on an international level. Double Tax Agreements Lesotho is party to, namely with South Africa and the United Kingdom, have been used in this analysis including the recently renegotiated texts in both instances. There are concluding remarks with recommendations towards the end.

3. FINDINGS

At domestic level, the new Lesotho Income Tax Order has incorporated and enacted the general principles of determining source of income as well as expanded these through addition of deemed source provisions. Thus substantively, despite reorganisation of the Income Tax law in Lesotho, the role of the concept of source has not altered. The well-developed body of judicial decisions in both the Republic of South Africa and the

United Kingdom on determining source of income remains applicable. Similarly, the enacted provisions on determination of residence of an individual, a company, a trust or partnership in the Lesotho new Income Tax law embody case law as well as rules established in the United Kingdom to determine residence. The impact of South African tax law in this context has been minimal, bearing in mind that residence plays a very limited role as a basis of taxation in South Africa.

At the international level, Lesotho double tax agreements concluded with South Africa and the United Kingdom respectively, have generally followed the widely used Model Convention of the Organisation for Economic Co-operation and Development (OECD). The OECD Model Convention uses the concepts of source and residence to allocate the right to tax between the contracting State parties as a measure to avoid or alleviate double taxation.

A recurring question throughout this dissertation is whether Lesotho is justified to use either source or residence as a basis of determining tax liability. The new Lesotho tax law has attempted to simplify the often complicated task of determining either source of income or residence of a potential taxpayer through enacted general principles. To a certain extent, the problem of uncertainty often levelled against these concepts is ameliorated. However, the problems of the concepts being artificial; technical and thereby resulting in inequitable taxation remains.

The use of source of income as a basis for determining tax liability is not controversial when applied in a wholly domestic area. However, when extended to non-residents, inequitable results emerge. Taxation on the basis of residence is generally free of problems. The tests of determining residence, however, are fluid, depending on the policy being pursued. For instance, if broadening the income tax base as wide as possible is the objective as in the United Kingdom, there is a tendency to visit tax liability to unsuspecting visitors with no meaningful connection with the tax jurisdiction. This apart from being unjustifiable tends to discourage international trade and investment. South Africa on the other hand, focuses more on the taxation on the basis of source of income and as a result does not attach much importance to residence. Thus to encourage foreign investors, a restricted test of residence has been adopted over the years in South Africa.

Lesotho residence rules are similar to the general principles established in the United Kingdom. However, taking into account that Lesotho is a capital importing country and therefore economically inferior when compared to the United Kingdom, it seems unlikely that Lesotho will adopt the United Kingdom approach without considering adverse implications to its fragile economy. Furthermore, the unique geographical situation of Lesotho, being situated in the belly of South Africa, makes it almost impossible to cut the umbilical cord due to their symbiotic relationship. Lesotho has introduced different categories of residents such as expatriate taxpayers (being

overseas technical assistance personnel, taxed at standard rate of tax); other concessions include exemption of migrant workers from tax due to policy considerations.

The adoption of the OECD Model in Lesotho DTAs has been done without due consideration of the peculiar circumstances in the relationship with South Africa and the United Kingdom respectively. Despite that there are other models such as the United Nations Model and the Andean Pact Model which have been modelled from the perspective of developing countries, these were not adequately utilised by Lesotho in the negotiations. The underlying assumptions of the OECD Model are not necessarily applicable to developing countries.

4. CONCLUSION:

Despite the stated departure from source base taxation to the residence (world-wide) basis, the new Lesotho Income Tax Order has in effect crystallised both source and residence as crucial basis of taxation in Lesotho. The result is a broadened income tax base. It remains to be seen, how this wide jurisdiction will be covered effectively bearing in mind manpower constraints in the office of the Commissioner of Income Tax. The implementation of the new tax law will determine the extent of its success particularly through the enacted provisions on source and residence.

BACKGROUND

Under the new Lesotho *Income Tax Order No 9 of 1993*, income tax is imposed on "every individual, trustee, company and non-resident who has chargeable income for the year of assessment" (section 3(1)). Chargeable income, in accordance with the normal methods of calculation, is gross income less allowable deductions.

In its definition of "gross income" as "the sum (total) of employment income; business income; property income and any other income or gain" excluding amounts exempt from income tax under section 17, the new law has departed from the standard source-based definition which had been followed in the repealed *Income Tax Act No 7 of 1981*. The latter generally embodied all the salient features found in the South African *Income Tax Act 58 of 1962*. The source-based definition of "gross income" has proved to be one of the most difficult and litigated provisions of the South African Income Tax Act.

Furthermore the new Lesotho definition of "gross income" makes no specific provision for the exclusion of receipts of a capital nature which was found in the 1981 Act. It would seem that the legislature while pursuing the objective of broadening of the tax base in Lesotho, extended definition of the tax base so wide that it went beyond ordinary concepts. Thus the definitions of employment, business and property income has ignored the distinction between income and capital gains.

The two other important concepts introduced by section 17 are those regarding residence and source. Section 17(2) provides that income of a resident taxpayer includes income from all geographical sources. On the other hand, section 17(3) provides that gross income of a non-resident taxpayer includes only income from a Lesotho source. This means that a taxpayer who is resident in Lesotho is taxable under the Lesotho Income Tax Act, for all his/her gross income from all sources irrespective of whether this is derived from within or outside of Lesotho. For a taxpayer who is not a resident of Lesotho, only income derived from a source in Lesotho is taxable.

Lesotho has since the enactment of the new income tax law also renegotiated Double Taxation Agreements entered into between South Africa and the United Kingdom respectively. Consequently, the analysis of the twin concepts of source and residence as tests for determining tax liability will be extended to the international level.

PART I

DOMESTIC TAXATION IN LESOTHO

CHAPTER I

GENERAL INTRODUCTION

1.1 INTRODUCTION:

The purpose of this dissertation is to examine the twin concepts of source and residence, as the basis of determining liability for income tax in Lesotho. The relevance of these concepts in today's complex global economy and the controversies surrounding their application must be revisited and reviewed from time to time if any taxation system is to meet some of the established basic tenets of a good system of taxation viz. simplicity, certainty, equity and efficiency. These principles espoused by Adam Smith seem to be still relevant in modern tax law.¹

1.2. THE SOURCE OR RESIDENCE DEBATE:

The debate whether to apply the concept of source and/or residence as the basis for liability to income tax is a continuing one all over the world.² Some jurisdictions have opted for a combination of both concepts while others, like the United States of America apply "Citizenship" as an additional

1 Adam Smith, *Wealth of Nations*, 1776, Book V, Chapter II part 2.

2 *Recent Tax Problems*, Ed. Dyson J Faculty of Law University College of London, Stevens & Sons, 1985 at 73, commenting on U.K. situation.

basis of taxation. The concept of residence or world basis taxation as it is often called, seems to be applied in most of the major developed Western countries such as the United Kingdom.³ Australia, like some other Commonwealth Countries such as Canada, applies a combination of residence and source as tests for tax liability.⁴ While South Africa applies as a general principle, source as the basis of taxation there are specific exceptional instances where residence is also a criterion.⁵ The Margo Commission of Inquiry into South African income tax⁶ records receiving a number of representations calling for a change to the general principle of residence or world basis of taxation, while others strongly urged retention of the source principle. This debate for change could be traced back to the Franzsen Commission of Enquiry into Fiscal and Monetary Policy in South Africa, 1969,⁷ and the De Kock Commission in 1984.⁸ The Margo Commission in its recommendation at paragraph 26.21 retained source as the basis and pointed out that it did not consider the change to a full world basis of

3 1987 Report of the Margo Commission of Enquiry into South African Income Tax, 397.

4 Grbich Y, Bradbrook AJ, Pose K, *Revenue Law: Cases and Materials*, Butterworths, Australia, 1990 at 781.

5 See Huxham K and Haupt P, *Notes on South African Income Tax 1993*, H & H Publications, Hedron Tax Consulting & Publishing CC, Cape Town, 1993 p 15.

6 See 1987 Report of the Margo Commission *supra* at p 397-399.

7 *Ibid* citing Commission of Enquiry into Fiscal and Monetary in South Africa, *Taxation in South Africa; Second Report*, Pretoria, Government Printer, November 1970 para 20 (RP 86/1970).

8 De Kock Commission of Enquiry into Fiscal and Monetary Policy in South Africa, *The Monetary System and Monetary Policy in South Africa: Final Report*, Pretoria: Government Printer, May 1985 para 12.44 (RP 70/1984).

taxation to be warranted then. The change to a basis of residence/world basis, it was conceded, would impose considerable administrative burdens on the fisc, especially in relation to companies and trusts operating in foreign jurisdictions. Moreover, it was pointed out, "the experience of foreign jurisdictions has shown that the determination of residence for fiscal purposes can be extremely complex."⁹

The general revision of the Lesotho Income Tax Law has, *inter alia*, been justified as a means of broadening the tax base. This in turn, it is argued, will lead to lower income tax rates with the necessary corollary of greater compliance by taxpayers. The argument continues that the broadening of the income tax base under the new law will guarantee that there is a more equitable distribution of the tax burden among taxpayers than was the case under the old law.

The fallacy of this argument, in the context of the application of the two criteria of source and residence as the basis for determining liability for income tax, is that these are prone to manipulation. Both are fluid concepts which on application in today's economy, elsewhere referred to as the "global village",¹⁰ result in inconsistent, technical and artificial systems of taxation. This affords a rich recipe for tax avoidance and evasion. Furthermore determination of either source or residence can sometimes be very complicated.

9 Margo Commission Report *supra* at p 398.

10 See Grbich et al *supra* at p 780.

1.3. TAXATION ON THE BASIS OF RESIDENCE:

The concept of "residence" particularly has been found to create a certain degree of technicality and artificiality.¹¹ The determination of whether a person is resident or non-resident in a particular tax jurisdiction is often said to be a question of fact and degree and not of law.¹² Residence is often said to be a question of fact with no technical or special meaning. However, the number of cases where individuals have been held to be resident where no (even educated) layman would have thought so, and sometimes vice versa makes one doubtful. As succinctly put by Anthony Sumption, "the very circumstance that each individual case has to be decided upon its facts has led to what seem strikingly illogical and inconsistent decisions and the necessity to extract from these some principles for general application has necessarily created a certain degree of technicality and artificiality."¹³ Furthermore, the application of residence as a criterion becomes problematic especially with artificial entities like corporations, trusts and partnerships which do not fit comfortably into this basis of tax jurisdiction.

It remains to be seen how the Lesotho Income Tax Order resolves complex problems raised above.

11 See Sumption A, *British Tax Review* 1973 "Residence" at 155ff.

12 *Cohen v CIR* 1946 AD 174.

13 Sumption *supra*.

1.4. TAXATION ON THE BASIS OF SOURCE:

On the other hand, taxation by source even though *prima facie* justifiable when applied within a wholly domestic context, becomes problematic when extended to non-residents. It may sometimes be difficult to defend taxation by source with individuals who may have nothing in common with the jurisdiction but a mere passing connection. As remarked by Stephen Edge:

"Any jurisdiction that taxes by sources has to accept that, with the many difficult trust and business structures around the world, there are tremendous practical problems in the way of identifying the source of certain items of income".¹⁴

The ease of international communications today, coupled with widespread international trade and investment, exacerbates the problem. Any taxation system which uses source as a basis for determining tax liability has to deal with the resultant practical problems of identifying the source of certain items of income. Situations of multiplicity of sources abound in these circumstances. Some jurisdictions have resolved the problem with deeming source rules. Modern developments in the field of commerce with international money transfers and international capital markets blur the sources of some income.

14 Recent Tax Problems, Ed. Dyson J Faculty of Laws, University College of London, Stevens & Sons 1985 at p 89

The Multinational Corporations in their quest for investment and profits know no boundaries. It therefore, becomes almost impossible to identify one jurisdiction as having the significant connection with the income derived. Questions of apportionment, sharing "the bite at the tax cherry", promotion of international investments also arise. The appropriate tax liability base to apply in cases of passive, or non-business income such as interest, dividends, especially involving recipients with a temporary connection with the country remains a controversial question.

1.5. CONCLUSION:

This work will focus on the Lesotho Income Tax Order, both at domestic level (Part I) as well as at the international level (Part II), in examining how the concepts of source and residence have been used. The socio-economic factors peculiar to Lesotho will, no doubt, provide the context especially the policy framework within which these concepts are used. However, since Lesotho is in a unique geographical situation, completely surrounded by South Africa, the South African tax system will no doubt play a major influence. This is more so since the repealed Lesotho Income Tax Act of 1981 was based closely upon that of South Africa. The United Kingdom through the historical relationship with both Lesotho and South Africa will continue to have an influence in both legal systems.

CHAPTER 2

THE CONCEPTS OF RESIDENCE AND SOURCE

2.1. THE RATIONALE BEHIND THE CONCEPTS OF RESIDENCE AND SOURCE

2.1.1 INTRODUCTION

The basic taxation rules in Lesotho are clear, that residents pay tax on income from all sources (world wide basis), while non-residents pay tax only on income from Lesotho sources. What constitutes "residence" or "non-residence" will be dealt with fully later. It suffices for now to point out that section 5 sets out the necessary tests. Section 103 comprehensively describes what constitutes Lesotho-source income and this will also be examined closely later. Thus the critical concepts underlying the practical issue of whether in a given case tax is payable in Lesotho or not are to a large extent residence and source.

2.1.2 THE RATIONALE BEHIND THE CONCEPTS

The justification behind these two concepts as the basis for imposing tax in a given jurisdiction was best given in the often cited passage in the case of *Kergeulen Sealing and Whaling Co Ltd v CIR* per Stratford CJ.¹⁵ Taxation by residence

15 1939 AD 487 at 507; 10 SATC 363 at 380, discussed *infra* page 133; see also *Silke on South African Income Tax*, para 5 page 5-2

is often justified on the ground that "a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the good order and government of the country that shelters him".¹⁶ The rationale behind "source" as the basis of tax liability is that it is presumably equitable that "a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth".¹⁷

These principles, as stated earlier, have been cited with approval in several cases¹⁸ and have been adopted without qualification in the 1987 Margo Commission Report.¹⁹ For the present, this justification will be accepted without entering into the debate regarding justification for the imposition of taxes in the first place.

2.1.3 THE SIGNIFICANCE OF RESIDENCE AND SOURCE

The determination of residence and/or source are relevant for a number of issues under the Lesotho tax system. It should be noted that the instances below are not exhaustive but merely illustrative:

- The gross income of a resident taxpayer includes income from all geographical sources under section 17(2). This

16 *Ibid.*

17 *Ibid.*

18 See *Boyd v CIR*, 1951 (3) SA 525 AD; *Kergeulen Sealing supra*

is subject to certain exceptions such as the members of the diplomatic corps based in Lesotho (Section 22(a)) and the exemption of interest from savings accounts (section 27(1));

- The gross income of a non-resident taxpayer includes only Lesotho-source income (section 17(3));
- The rates of income tax chargeable to resident taxpayers (individuals) differ from those chargeable to non-resident taxpayers. The former are charged at a progressive rate ranging from 25% to 40% while the latter are charged at a standard fixed rate of 25%. Expatriate taxpayers even though resident in Lesotho are charged at a concessional rate of 25% (the period of residence is limited to seven years) for this concession to be applicable;
- Lesotho residents are exempted from tax in Lesotho on foreign-sourced employment income in certain circumstances (section 104);
- Residents are entitled to a foreign tax credit against liability to Lesotho income tax for taxes paid in foreign jurisdictions (section 105).

② - International taxation principles revolve around the granting of the exclusive right to tax to either the country of residence of the taxpayer or the country of

country of residence of the taxpayer or the country of source of the income under consideration. The different models judiciously attempt to balance the interests of the contracting States to tax treaties using the concepts of residence and source.

2.2. CONCEPTUALISING "RESIDENCE" AS THE BASIS OF TAXATION IN LESOTHO:

As observed earlier, whether a taxpayer is a resident or non-resident is of vital importance in determining the extent of his/her tax liability in Lesotho. The meaning of residence is to be gleaned from a combination of statutory provisions and the common law general principles as applied and developed under case law. Different statutory provisions apply depending on the type of taxpayer being dealt with in given circumstances, viz an individual, a company, a partnership or a resident fund. Section 5 of the Income Tax Order covers individuals, section 6 covers companies, section 7 focuses on partnership while section 8 deals with resident funds. Since it is trite law that imposition of tax is an annual event, the issue of the taxpayer's residence is to be determined on a yearly basis.²⁰

2.2.1 THE IMPORTANCE OF DIFFERENT APPROACHES

It will be necessary to be careful how one conceptualises "residence" under the Lesotho Income Tax law owing to the changes introduced by the new law. The jurisdictions which bear

20 *Cohen v CIR* 1946 AD 174 at 186 per Schreiner JA.

a heavy influence on Lesotho legislation, namely the United Kingdom and the Republic of South Africa, have divergent approaches on the question of residence. Caution should, therefore, be exercised on which approach Lesotho is to follow lest there be confusion. As seen earlier, there are two bases for imposing tax liability, ie source and residence. The South African tax liability is generally based on the concept of source while tax liability in the United Kingdom is based on the concept of residence.²¹ Apart from this difference on the basic concepts for determining tax liability, there is another divergence on the policy considerations being pursued under these two tax jurisdictions. This has led to different approaches of interpretation of even the same word by the British Courts and the South African Courts. For instance, the South African tax law, amongst others, promotes the policy of encouragement of foreign investment, and towards that end, an exception to the general rule of source has been introduced in favour of non-residents who held government stocks, eg Eskom stock, to popularise them as an investment. As a result, a narrower construction is adopted in South Africa in the interpretation of residence.²²

The British approach in the interpretation of residence has been geared towards extending the ambit of the tax net as wide

21 *Ibid* per Schreiner JA at 182.

22 See the following cases: *Robinson v COT* 1917 TPD 542; also *Cohen v CIR supra* at 188 per Davis AJA; *ITC 1501*, 53 SATC 314 t 322, affirming subnom *CIR v Kuttel* 1992 (3) SA 242 (A).

as possible in an effort to broaden the tax base. Consequently, the Courts favour a wide construction in interpreting the concept.²³ The British approach is that the words must be given their natural and ordinary meaning. Moreover it would seem from the recent decision of *Shah v Barnet London Borough Council* (cited in footnote 23), that the meaning of residence laid down in the *locus classicus* tax cases of *Levene* and *Lysaght* (also cited in footnote 23), is not limited to income tax legislation only. On the other hand in South Africa, the approach seems to be narrow. Thus the concept of residence also acquires different meanings depending on the context and the specific legislation in question. The policy being pursued by the legislature under a particular legislation determines the meaning the Courts will adopt. Consequently, it appears, at least according to Judge Howie in *ITC 1501* (cited in footnote 22), that the meaning of the term in question in the decided case of *Biro v Minister of the Interior*²⁴ dealing with naturalisation would not be helpful in the interpretation of the same term in the income tax case.

2.2.2 WHICH APPROACH FOR LESOTHO?

The question which arises, therefore, is which course will Lesotho adopt? Will it be a wider construction, following the

23 This can be gleaned from various cases: *IRC v Cadwalader* (1904) 5 TC 667, *Reid v RC* 1926 SC 589, 10 TC 673; *Levene v IRC* [1928] All ER 746, 13 TC 486 (HL); *IRC v Lysaght* [1928] All ER 575, 13 TC 511; *Shah v Barnet London Borough Council* [1983] 1 All ER 226

24 1957 (1) SA 234

United Kingdom's interpretation or will it be a narrower construction emulating the South African approach? No doubt, the particular circumstances of Lesotho and the policy considerations underlying the new Income Tax Order will clarify the position. However, this is easier said than done since due to the unique special circumstances of Lesotho and its economy, the objectives being pursued under the new law are mixed. The stated objectives are, *inter alia*, to broaden the income tax base (thereby favouring the wider English construction) while at the same time, cognizant of Lesotho's reliance on the assistance of overseas technical personnel, certain exceptions have been introduced. It is self-evident that a developing country like Lesotho which is classified among the least developed countries must need foreign capital and investment relatively more than its sole neighbour, South Africa. As some put it: when South Africa sneezes, Lesotho coughs. To exacerbate the problem, the Accompanying Memorandum to the Order²⁵ suggests that the intention of the legislature is to follow the tests of residence as established and developed by the United Kingdom judicial decisions.

The application of the concept of residence in both the United Kingdom's and South Africa's tax system will therefore be examined in greater detail to highlight the differences and set the background against which the Lesotho concept of residence will be evaluated.

25 See Income Tax Order 1993, Explanatory Memorandum, printed by the Government Printer, Lesotho, Commentaries to Sections 4, 5, 7 and 8 at pages 23 to 28.

CHAPTER 3

THE TESTS OF RESIDENCE AS ESTABLISHED AND DEVELOPED BY JUDICIAL DECISIONS IN THE UNITED KINGDOM

3.1. INTRODUCTION:

As mentioned in the previous chapter, the intention of the Legislature in Lesotho in enacting the Income Tax Act was that the tests of residence as established and developed by the United Kingdom judicial decisions should be followed. These are examined below.

3.2. DEFINITION OF RESIDENCE IN THE UNITED KINGDOM:

The Tax Acts in the United Kingdom contain no definition of "residence". Whether a person resides for tax purposes is a question of fact to be determined having regard to all the circumstances of each case.

The *Oxford English Dictionary* defines the word "reside" as:

"to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place".

Viscount Cave in *Levene v IRC*²⁶ quoted this definition with approval, remarking that it may be accepted as an accurate indication of the word "reside" (subject to any modifications which may result from the terms of the Income Tax Act and Schedules).

The *Oxford Companion to Law* defines "residence" as:

"the place in which an individual actually lives, or where the management of a corporation is carried on. It is distinct from domicile, but it is a factor relevant for determining of the jurisdiction of a Court, for taxation, voting and elections, and other purposes. The concept is sometimes qualified by 'actual' or 'ordinary' residence".²⁷

As Viscount Cave in *Levene's* case, *supra*, pointed out, there is normally no difficulty in determining where one has his/her settled or usual place of abode, even if that person from time to time leaves it for the purpose of business or pleasure. A case cited in support of this submission is that of a master of a ship who had his home in Glasgow where his wife and family lived. Despite his frequent voyages and physical absence from the United Kingdom during the year of assessment, he was held

26 *Levene v IRC* [1928] All ER (HL) 746 at 749; also quoted with approval by Anthony Sumption, *British Tax Review* 1973, "Residence", at 155.

27 *The Oxford Companion to Law* by David M Walker, Clarendon Press, Oxford 1980 at 1064.

to be a resident in the United Kingdom. This case is clear and not controversial. But the other cases, cited by Viscount Cave in support of his submission, mentioned earlier and characterised as "comparatively simple" leave one wondering if the concept of "reside/residence" is still defined as in the *Oxford English Dictionary* quoted above. These are the cases of *Cooper v Cadwalader*²⁸ and *Loewenstein v De Salis*.²⁹ Viscount Cave made this remark in relation to these two cases:

"Just as a man may have two homes - one in London and the other in the country - so he may have a home abroad and a home in the United Kingdom, and in that case he is held to reside in both places and to be chargeable with tax in this country."³⁰

The two cases mentioned above, involved foreign nationals who the Court decided were resident in the United Kingdom. In *Cooper v Cadwalader*, an American citizen residing and working in New York, had rented a house in Scotland for shooting, and spent two months there annually. He was held resident because he maintained the premises with two servants throughout the year of assessment. Similarly in *Loewenstein v De Salis (Inspector of Taxes)*, a Belgian resident abroad occupied for short periods a shooting box in the United Kingdom belonging to a company he controlled. He was held resident. It would,

28 *Cooper v Cadwalader* (1904) 7 F146, 5 TC 101 (CA).

29 *Loewenstein v De Salis (Inspector of Taxes)* (1926) 161 LT Jo 235, 10 TC 424.

30 *Levene's case, supra*, at 749.

therefore, seem that "residence" or "resident" as used in the Income Tax Acts in the United Kingdom have not only a wide construction but a special and technical meaning.

The absurdity of the finding in the case of *Cooper v Cadwalader* (*supra*) was echoed by Viscount Sumner in the case of *IRC v Lysaght*³¹ in these remarks:

"Who in New York would have said of Mr Cadwalader 'his home is in the Highlands, his home is not here?' After all, many nomads are homeless folk, though they may reside continually here and there within the limits of the United Kingdom. Property, obviously, is no conclusive test. Whether Mr Lysaght resides in his own or in a hired house in Ireland cannot have much to do with it, nor is a person precluded from being resident because he puts up at hotels, and not always the same hotel, and never for long together."

Having remarked about the artificiality of the finding in *Cadwalader's* case, however, it would be noted that Viscount Sumner went on to distinguish this with the example of homeless people residing within the limits of the United Kingdom. He further pointed out that ownership of property is not a conclusive test. However, with due respect, the two scenarios are distinguishable in that *Cadwalader* normally resided in New York where he worked and came to visit Scotland only during his holidays abroad. The nomads referred to above seem to be home-

31 *IRC v Lysaght* 13 TC 511, [1928] All ER 575 at 580

less people in the sense that they wander from place to place "within the limits of the United Kingdom" [the underlining mine]. These would be homeless tramps, who as Anthony Sumption remarked,³² do not usually figure in disputed tax cases. Alternatively they could be what Sumption refers to as "... peripatetic taxpayers - the different kinds of tramps possessed of ample means but preferring to enjoy those means without the responsibility of a home and who move from one place to another not only in the United Kingdom but all over the world. It is this peripatetic taxpayer who has made perhaps the greatest contribution to the case law on residence". Cadwalader did not fit into any of these categories.

The complications with the conceptualisation of the words "residence/resident" under the United Kingdom Income Tax law are becoming clear. The tax net is cast so wide that any person finding himself/herself in the United Kingdom for only a minute or two would be regarded as resident for the year in which that minute was spent.³³ To show the absurdity of this approach, Sumption (*supra*) even submits that an accidental visit in a diverted aeroplane (for weather/technical reasons maybe), could have disastrous consequences for its passengers.³⁴ This it is submitted would be stretching the net too far. The case of *Robson v Dixon* cited by Sumption above, involved a pilot of KLM Airlines whose base was at Schiphol Airport, Amsterdam. He

32 See footnote 25 *supra*.

33 See Sumption, *supra*, at 170.

34 *Robson v Dixon* [1972] 3 All ER 671.

bought a home in England where his wife and children lived. He commuted between his home and Schiphol Airport with his duties always commencing in Amsterdam. On certain occasions the taxpayer landed in and took off from Heathrow to Schiphol and vice versa as part of scheduled flights. He was assessed for United Kingdom Income Tax but claimed exemption on the ground that his employment with KLM Airlines in the relevant years of assessment fell outside the United Kingdom and that any duties performed in the United Kingdom were merely incidental to the performance of the other duties outside the United Kingdom, and that he was not, therefore, a United Kingdom resident for tax purposes even though his home was in the United Kingdom. He was held to be resident and his duties were held not to be performed outside the United Kingdom so as to qualify him for exemption under the Finance Act 1956, section 11 thereof.

In the course of his judgment in *Robson's* case above, Viscount Pennycuik mentioned that a landing in the United Kingdom by reason of some emergency, such as weather conditions or mechanical trouble, might be regarded as incidental to the performance of duties outside the United Kingdom. Following from this a United Kingdom citizen working abroad would in those circumstances not jeopardise his/her position by such landing. Furthermore, Pennycuik remarked that a single landing during the course of the year might be disregarded under the *de minimis* principle. All these remarks were made *obiter* since they had no bearing on *Robson's* case. Be that as it may, the application of the test of residence as a basis of taxation in

the United Kingdom has become so absurd and artificial that a person may face claims for income tax in respect of tax years in which they never set foot in the United Kingdom.³⁵

3.3. A DIGEST OF ENGLISH CASES ON RESIDENCE:

As there is no definition of "residence": or "ordinary residence" in the United Kingdom tax legislation, one may cite a number of cases without discerning the principles which influenced the decision(s). This shows the complexity of determining residence of a taxpayer in certain cases.

3.3.1. IN THE FOLLOWING CASES, THE TAXPAYERS WERE HELD TO BE RESIDENT IN THE UNITED KINGDOM:

*Reid v IRC*³⁶ where the appellant, a British subject, gave up a house in the United Kingdom, selling the furniture and living in hotels in the United Kingdom and abroad owing to health considerations and other factors. She spent three and a half months in the United Kingdom annually, her banking account was in London and her personal effects were stored in London. In delivering his judgment on the stated case whether the Commissioners misdirected themselves as to a matter of law in their finding that she was resident, the Lord President Clyde (as he then was) remarked:

35 See *Reed v Clark* [1985] STC 323

36 *Reid v IRC* 1926 SC 589, 10 TC 673.

"The expression 'resident in the United Kingdom' and the qualification of that expression implied in the word 'ordinarily' to resident are just about as wide and general and difficult to define with positive precision as any that could have been used. The result is to make the question of law become (as it were) so attenuated, and the field occupied by the questions of fact become so enlarged, as to make it difficult to say that a decision arrived at by the Commissioners with respect to a particular state held proved by them, is wrong"³⁷ (the underlining mine).

It was not surprising, therefore, that the finding of the Commissioners was not disturbed despite that in the two years to which the appeal related, the appellant moved about between various places on the continent of Europe for about 8½ months of each year, returning to the United Kingdom for the remaining 3½ months. Lord Sands in his concurring judgment had this to say:

"I do not find it necessary to come to a definite conclusion as to whether, irrespective of the determination of the Commissioners, the Appellant, who started off as a person resident in this country, had, within the period here in question shed altogether the character of a dove which returns to the Ark and became a raven wandering to

37 *Supra* at 678.

and fro upon the earth."³⁸

One could discern a tone of disapproval from Lord Sands' remarks on Miss Reid's way of life, which with due respect was not relevant, the issue being whether during the period in question Miss Reid was "ordinarily resident in the United Kingdom". It seems Lord Sands would not be sure nor differ had the Commissioners decided the other way!

In *Levene v IRC*,³⁹ the appellant had surrendered his lease of premises in the United Kingdom and sold his furniture; he lived in hotels in the United Kingdom and abroad and from 1919 to 1925 and was in the United Kingdom four to five months annually to obtain medical advice, visit relatives, take part in religious observances, attend to his income tax affairs and visit his parents' grave. He was held to have remained resident in the United Kingdom and in the words so often quoted, Lord Sumner stated:

"The evidence as a whole disclosed that Mr Levene continued to go to and fro during the years in question leaving at the beginning of winter and coming back in summer, his home thus remaining as before. He changed his sky but not his home" (the underlining mine to highlight the absurdity).⁴⁰

38 *Reid v IRC* (*supra*) at 681.

39 *Levene v IRC* 13 TC 486 [1928] All ER Rep (HL) 746

40 *Levene v IRC* at 751 and 501

Note should be taken that in both *Reid's* case and *Levene's* case, the individuals concerned were initially British subjects, i.e. British by nationality. It would, therefore, appear that once British one would always be taxable as resident in the United Kingdom notwithstanding any change of one's mode of living. Similarly in *IRC v Lysaght*⁴¹ the appellant had no place of abode in the United Kingdom. He lived and worked in England for most of his life, but on retirement he sold his English house and went to live permanently in Ireland. He was however, retained as an advisory director of a company and he came to England every month to attend the directors' meetings, staying at hotels or with relatives. The decision of the Appeal Commissioners that the appellant was "resident" and "ordinarily resident" in the United Kingdom for the years in question was upheld in the House of Lords. Rowlatt J in delivering his sole judgment in the King's Bench Division said:

"I think one must simply consider him as a gentleman who, ... has his residence in Ireland, and just comes over here. Secondly, one must remember ... that one must not look for an establishment. ... a tramp has a "residence" in this country. ... If a man chooses to live at hotels instead of his own house, or even stay with friends, it really does not affect the question of residence."⁴²

41 *Lysaght v IRC* 13 TC 511 [1928] All ER Rep 575

42 *Lysaght v CIR* [1928] All ER Rep 575; 13 TC 511 at 516

Even though Lysaght was not found to fall in the tramp class (using the expression of Lord President Clyde in *Reid's* case), because he had this obligation every month to attend the directors' meeting for which he was well paid, the Commissioner's decision was upheld. In the Court of Appeal, the judgment of Sargant LJ in *Lysaght's* case distinguished this case from *Levene's* case, *supra*, in that, throughout the whole period the appellant was alleged to have been resident in the United Kingdom, he had kept up a home in Ireland and resided there in the ordinary sense of the word. Sargant LJ went on to point out this about Mr Lysaght:

"His visits to England have been for short periods of a week only in each month, have been for strictly business purposes only, and have not been in the society of his wife. ... There has been no choice of him of England as a desirable abode, and no intention of being present here otherwise than in the course of his duties; and no one could, I think, predicate of the appellant with accuracy that he ever had the intention of making England his home in any ordinary sense of the word."⁴³

Accordingly, the Lord Justice differed from the finding of Rowlatt J and the Special Commissioners and held that the appeal should succeed. He, however, went on to conclude:

"In doing so, I do not think that I am differing from the

Special Commissioners on any question of fact. As I read their decision they have carefully found the facts, and have segregated them from any question of law; and the facts so found I entirely accept. But they have then gone on to decide a question of law on these facts and have 'held' that on the facts found the Appellant resided in the United Kingdom. This is a conclusion of law within the principles of Lord Wrenbury's reasoning in the *Great Western Railway v Bater* [8 TC 231]; and it is solely as to this conclusion of law that I differ from them and from Mr Justice Rowlatt."⁴⁴

These remarks serve to highlight the complications which arise when a stated case is taken on appeal and how Judges, with due respect, vacillate on deciding whether interpretation or a finding of the issue of residence is a question of fact or law. Lord Hanworth MR, in his concurring judgment had this to say on this issue:

"I am satisfied that this Court can review the result which the Commissioners held to follow in law upon the facts found. The meaning of "residence" in the Income Tax Act must be a question of law; and upon the facts found by the Commissioners the Courts must determine whether the subject has brought himself within the terms of the exemption in the Act, rightly construed."⁴⁵

44 *Ibid*, at 521 TC

45 *Ibid*, at 519 TC

Lord Lawrence in delivering his dissenting judgment had to state: "I need hardly say that in view of the judgments which have just been delivered I profoundly distrust my own opinion."⁴⁶ This underscores the uncertainty around this issue, which becomes even more exacerbated when one notes that the House of Lords reversed the judgment of the Court of Appeal, restoring the decision of Rowlatt J in the Kings Bench.

Viscount Sumner in delivering his judgment remarked that a debate on the meaning of a case stated is an unsatisfactory prelude to a debate on the general law applicable. He went on in support of the Commissioner's decision in these words:

"Their experience makes them fully conversant with the wide scope of their functions and with their limits and it is most unlikely that they intended to leave unfound the ultimate fact of residence, which was the substance of the whole case before them."⁴⁷

Lord Sumner's remarks highlighted what an onerous task an appellant has to succeed in a stated case on the question of residence. He then went to consider the main issue before the Court:

46 *Ibid*, at 521

47 *Ibid* at 527 TC. These remarks of Lord Sumner have been cited with approval both in the United Kingdom and in South Africa. See *Shah v Barnet London Borough Council and Other Appeals* [1983] 1 All ER 226 (HL) at 234 and *CIR v Kuttel* 1992 (3) SA 242 at 248

"My Lords, the word 'ordinarily' may be taken first. The Act on the one hand does not say 'usually' or 'most of the time' or 'exclusively' or 'principally', nor does it say on the other hand 'occasionally' or 'exceptionally' or 'now and then', though in various sections it applies to the word 'resident' with a full sense of choice, adverbs like 'temporarily' and 'actually'. I think the converse to 'ordinarily' is 'extraordinarily', and that part of the regular order of a man's life, adopted voluntarily and for settled purposes, is not 'extraordinarily'.⁴⁷

In these words, Lord Sumner laid the distinction between "residence" and "ordinary residence".

Note should be taken that the cases of *Reid*, *Levene* and *Lysaght*, (cited and discussed above) involved persons who were initially British subjects.

3.3.2. IN THE FOLLOWING CASES, THE TAXPAYERS WERE HELD NOT TO BE RESIDENT IN THE UNITED KINGDOM

From the above cases it can be deduced that Inland Revenue never indemnify those once British and resident in the United Kingdom. However, in *IRC v Combe*,⁴⁸ a British subject who came to the United Kingdom on the business of his American employers and lived in hotels was held not to be resident. One would remark as Lord Morison did that Combe "was fortunate in

escaping chargeability to Income Tax."⁴⁹ But again the decision seems to revolve around the reluctance of the learned Judges to disturb the view taken by the Commissioners.

In contrast again, in the cases of *Zorab* and *Brown*, respectively, the Court refused to upset the Commissioners' finding that the respondents were not resident in the United Kingdom; these were foreign nationals. In *IRC v Zorab*,⁵⁰ a retired Indian civil servant with no establishment in the United Kingdom visited the United Kingdom occasionally from Europe staying in hotels and visiting friends. He spent five to six months each year in the United Kingdom and it was held that he was a mere visitor. Judge Rowlatt distinguished *Zorab's* case from *Cadwalader's* case,⁵¹ pointing out that in the latter, "the gentleman had an establishment in Scotland; he had a lease available to him in Scotland going on all year."⁵²

Regarding *Miss Reid's* case,⁵³ Judge Rowlatt had this to say:

"There the Commissioners had found residence and the Court did not disturb it. One cannot help thinking that that was a stronger case than this case. The lady had some connection with this country. Her furniture was stored and her banking account was kept here, and so on. They are small

49 *Ibid*, at 411

50 *IRC v Zorab* [1926] 11 TC 289

51 *Cooper v Cadwalader* 5 TC 101

52 *IRC v Zorab supra* at 292

53 *Reid v CIR*, 10 TC 673

things, but things which, I think, must be taken into consideration. ... This gentleman seems to be a mere traveller. ... He is a native of India, he has retired from his work and he really travels in Europe. All that can be said is that in the course of his habitual travels he spends a considerable period every year in England."⁵⁴

The fact that some three to four years had passed since Mr Zorab was in India and that he had no intention of returning unless for short visits were disregarded. Similarly, in *CIR v Brown*⁵⁵ another retired Indian civil servant who gave up his home in the United Kingdom and stored his furniture and went abroad, occasionally visiting the United Kingdom and staying in hotels was held not resident in the United Kingdom. Evidence showed that for many years Mr Brown had a habit to spend two or three months of the winter abroad but was unable to do so during the First World War. Rowlatt J in a judgment of one paragraph stated:

"I am bound to say that I think this is a stronger case in favour of residence than the last case (being Zorab's case *supra*). After all, he had some furniture and a banking account and he had connections with England, and if the Commissioners had found the other way I should not have disturbed them. It is not unlike *Miss Reid's* case (*supra*),^o but I do not think I can disturb them. After all,

54 *IRC v Zorab supra* at 292

55 *CIR v Brown* [1926] 11 TC 292

it is their duty to decide the facts and not my duty. Opinions may differ about questions of fact and unless I can see that there is some error in law I have no business to interfere, and I do not think I can do so. It is a question of the proper inference of fact and therefore, the appeal must be dismissed with costs."⁵⁶

This judgment says it all. It is almost an impossible task to have the Commissioners' finding on residence disturbed on appeal.

In *Mieseгаes v IRC*⁵⁷ a school boy, a Dutch national, came into the United Kingdom with his father as refugees. His father left the United Kingdom permanently to live in Switzerland but the boy remained at a boarding school in the United Kingdom. For the purpose of exemption from income tax on the interest from certain British Government securities, the boy claimed that he was not ordinarily resident in the United Kingdom during this period. He normally spent his school holidays with his father at his residence in Switzerland. The Commissioners of Inland Revenue had concluded that his sojourn for the greater part of each year while pursuing his studies was enough evidence that he was resident then in the United Kingdom. The case came before Wynn-Parry J in the Chancery Division on appeal and on the analysis of the facts and bearing in mind the limitations of the Court to interfere with conclusions of fact, the appeal

⁵⁶ *Ibid*, at 296

⁵⁷ *Mieseгаes v IRC* 37 TC 493

was dismissed with costs. The Court of Appeal unanimously upheld the decision of the Court *a quo*. Lord Evershed MR, in his concurring judgment stated that:

"These two words 'ordinarily resident' have the meaning which they have 'in the speech of plain men', ..."⁵⁸

As Sumption remarked,⁵⁹ this is not very helpful, since taxpayers, special commissioners, judges and lawyers have for years differed in their view of the meaning of the two words. The discussed cases highlight the problem.

3.4. THE UNITED KINGDOM INLAND REVENUE GUIDELINES ON RESIDENCE

It would seem that owing to lack of definition of the concept of "residence" in the tax cases, the Inland Revenue have evolved a number of rules drawn from the court decisions to determine whether or not a person is resident in the United Kingdom during a particular tax year.⁶⁰ It should be noted, however, that these rules have no legal force and are merely guidelines, nor can they be invoked against the Commissioners in their findings.

58 *Ibid*, TC 405

59 A Sumption, *British Tax Review* 1973 155 at 171

60 *Trolley's Tax Planning* 1986 ed Glyn Saunders et al at 144; Inland Revenue booklet: "Residents and Non-Residents Liability to Tax in the United Kingdom". Inland Revenue 20

3.4.1 These rules are as follows:

- (i) A person will be resident in the United Kingdom for a tax year if he spends 183 or more days in that country during that year. (So-called Six Months Rule.)
- (ii) A person will also be resident in the United Kingdom if he is there for less than 183 days during the tax year but since leaving the United Kingdom has visited that country for periods which amount to an average of three months or more a year. The average is calculated at over a four year period. (Presence of Less than Six Months.)
- (iii) A person will also be treated as resident in the United Kingdom in any tax years in which he visits the United Kingdom, even for a single day, if he has "accommodation available for his use" in that country.⁶¹ (Place of Abode.)

3.4.2 A detailed examination of these rules follows below:

(i) The Six Months Rule:

It would seem that a person cannot escape being resident in the United Kingdom simply because he is also resident elsewhere (Avoidance of Double Taxation Treaties would

61 *Ibid*

normally alleviate the danger of double taxation). Intention seems to be irrelevant. If one spent 183 days or more in the United Kingdom, he is taxable as a resident.

(ii) Presence of Less than Six Months:

(a) Regular Visits

A person who maintains no place of abode in the United Kingdom may nevertheless be held resident there if he pays regular visits to the United Kingdom even though for less than 183 days in each year of assessment, if these visits form part of his habit of life.⁶² It would seem that this rule of regular visits may explain the finding in the cases of *Levene v IRC*⁶³ and *IRC v Lysaght*⁶⁴ respectively.⁶⁵ Persons who come to the United Kingdom for study purposes with a period expected to take more than four years will be regarded by Revenue as resident and ordinarily resident from the date of arrival in the United Kingdom.⁶⁶

(b) Former Residence

Under section 49 of the Income Tax and Corporation

62 Pinson B et al *Pinson on Revenue Law*, 17th ed, Sweet and Maxwell, London 1986 p 183

63 *Levene v IRC* discussed above, see page 24

64 *IRC v Lysaght* discussed above, see page 25

65 Pinson *supra* at 183

66 Inland Revenue booklet 20 in footnote 57 at para 23-24; see also *Miesegees v IRC* page 32

Taxes Act 1970 in the United Kingdom, a British subject or citizen of the Republic of Ireland, whose ordinary residence has been in the United Kingdom, and who leaves the United Kingdom for the purpose of occasional residence abroad, will be treated as actually residing in the United Kingdom during his absence. Here again, cases of *Levene's* nature may have influenced this legislation. There seems to be a presumption that such a person retains his ordinary residence but this may be rebutted by proof of abandonment of the United Kingdom residence. Here again it will be a question of degree in a particular case.⁶⁷

(iii) The Place of Abode in the United Kingdom:

A person who has a home abroad but who also has a place of abode in the United Kingdom will be treated as resident within the year of assessment during which he/she visits the United Kingdom, notwithstanding the shortness of the visit. If his/her visits are in four or more consecutive years, he/she will be treated as ordinarily resident also. Ownership of the place of abode is not necessary. The test is whether accommodation is also available for the taxpayer's use.⁶⁸

67 Pinson *supra* at 184 cites *Reed v Clark* [1985] STC 323

68 *Ibid* at 182; see also cases of *Cooper v Cadwalader* (1904) 5 TC 101 referred to on pages 18-20 and *Loewenstein v De Salis* (1926) 10 TC 424 on page 18

3.4.3 Established factors which support residence:

Sumption lists some factors which have in the past been used to establish whether a person is resident in the United Kingdom.⁶⁹ These are as follows: physical presence in the United Kingdom; nationality; past history as to residence; present habits and mode of life; frequency, regularity and duration of visits; purpose of such visits and conversely the purpose of the absence abroad; family and business ties with the United Kingdom and whether a place of abode is maintained in the United Kingdom or is available for use. It should be noted that some of these factors are common to those broadly categorised as rules in paragraph 3.4.1 above. The point is that the list is not exhaustive, these are merely indicative of factors which have influenced the Courts in earlier cases. One cannot with precision predetermine any case without consideration of its peculiar circumstances. Note should also be taken that these factors have also been listed in the Explanatory Memorandum accompanying the Lesotho Income Tax Order (commentary to section 5).

3.5. **DISTINCTION BETWEEN "RESIDENCE", "ORDINARY RESIDENCE" AND "DOMICILE":**

3.5.1 RELEVANCE OF THE CONCEPTS

In the United Kingdom, the difference between the concepts of

69 Anthony Sumption's article "Residence" 1973 *British Tax Review* 155 at 156

"residence", "ordinary residence" and "domicile" is vital. The importance of the distinction lies in the fact that they attract different tax liabilities. The position is neatly and clearly summarised by *Trolley's Tax Planning* in this paragraph:

"Broadly speaking, a person's country of residence is the place where he lives during a tax year; he is ordinarily resident in the country in which he is normally resident; and he is domiciled in the country where he intends to ultimately return to live out his life. Income tax is based primarily on residence. If a person is resident in the United Kingdom he is normally liable to United Kingdom tax on his worldwide income. If he is not resident in the United Kingdom he is still liable to United Kingdom tax on income arising in the United Kingdom but his non-United Kingdom income is outside the scope of United Kingdom income tax. Capital gains tax depends on both a person's residence and ordinary residence. If a person ceases to be resident in the United Kingdom without also ceasing to be ordinarily resident there, he will remain liable to United Kingdom capital gains tax in respect of gains on his worldwide assets. If he ceases to be both resident and ordinarily resident he is outside the scope of United Kingdom capital gains tax, even (with some exceptions) on United Kingdom assets. Capital transfer tax, in contrast, is based on domicile. If a person is domiciled in the United Kingdom he is liable to United Kingdom capital

transfer tax on his worldwide assets even though he may be both resident and ordinarily resident in another country. If a person is not domiciled here he is liable to capital transfer tax on United Kingdom assets only."⁷⁰

3.5.2 "RESIDENCE" AND "ORDINARY RESIDENCE"

As remarked in paragraph 3.3, the concepts of "residence" and "ordinary residence" are not defined in the United Kingdom Tax Acts. These have been said to have their ordinary dictionary meaning. As stated in *Lysaght v CIR*,⁷¹ they are questions of fact and degree, they have no special or technical meaning. For an individual, "residence" defines the country where he/she lives, while "ordinary residence" has been equated to habitual residence and contrasted to occasional, casual or extraordinary residence. A person may be resident but not ordinarily resident in the United Kingdom in a year of assessment and conversely, he may be ordinarily resident but not resident. This shows that logic is not helpful here. One would have thought that a person who is not resident in the United Kingdom in a tax year will not be ordinarily resident there either. However, it seems that the Department of Inland Revenue takes the view that a person who usually lives in the United Kingdom and goes abroad for a long holiday not setting foot in the United Kingdom for that tax year, will nevertheless still be ordinarily resident in the

70 *Trolley's Tax Planning* 1986, *supra*, at 143

71 *Lysaght v CIR* [1928] 13 TC 511 at 536

United Kingdom that year.⁷² The purchase of a house in the United Kingdom is some indication of "ordinary" residence. According to Inland Revenue's Statement of Practice on the issue, a person who visits the United Kingdom is not usually regarded as having become "ordinarily resident" until he has been in the United Kingdom for at least three years, unless it is clear from the onset that he intends to be there for three years or more (eg acquisition of accommodation).⁷³ In the same vein, a person who leaves the United Kingdom is normally not regarded as ordinarily resident if he has not been resident in the United Kingdom for three consecutive tax years. As for a person who goes abroad for full-time service, if his/her absence from the United Kingdom is for a complete tax year, he/she is normally regarded as not resident and not ordinarily resident in the United Kingdom until the day preceding his return.⁷⁴

As mentioned earlier, the *locus classicus* cases in the United Kingdom on the question of "residence" and/or "ordinary residence", are those of *Levene v IRC*⁷⁵ and *Lysaght v IRC*⁷⁶ discussed in paragraph 3.3 above. These cases even though decided in 1928 seem to be relevant and continue to be used to date as authority on the question of residence for instance in

72 Finance Act 1962, section 20; *Trolley's Tax Planning*, *supra*, at 146

73 SP 3/81. [1981] S.T.I. 200 and 202; *Pinson on Revenue Law*, *supra* at 181

74 *Trolley's Tax Planning*, *supra* 146

75 *Levene v IRC* [1928] All ER Rep 746, 13 TC 486

76 *Lysaght v IRC* [1948] All ER Rep 746, 13 TC 511

*Shah v Barnet London BC*⁷⁷ which has been quoted with approval even in the South African case of *CIR v Kuttel*.⁷⁷

Shah v Barnet London BC above, involved students who had applied for and were refused local authority grants for their education, and the issue was whether the education authorities were correct in their decision that the said students had not been ordinarily resident in the United Kingdom for three years, as required by the 1962 Education Act, and, therefore, were not eligible. Lord Denning in the Court of Appeal⁷⁷ refused to quash the decision pointing out that the students' parents would not have paid income tax in the United Kingdom, from which the grants would have been financed. Moreover, he also noted that since 1962 when Parliament enacted the Education Act, the circumstances had changed. Then there were no restrictions to Commonwealth citizens studying in the United Kingdom but since 1971, through the Immigration Act, students even before being admitted into the United Kingdom have to prove that they can pay their own way.

On the statutory interpretation of the words "ordinarily resident" in the context of the 1962 Education Act, Lord Denning stated that the traditional approach of simply applying the natural and ordinary meaning ought to be followed. The words were said to mean:

77 *R v Barnet London Borough Council ex p Shah* [1982] 1 All ER 698; *Shah v Barnet London BC* [1983] 1 All ER 226 (HL). See also *CIR v Kuttel* 1992 (3) SA 242 AD

"that the person must be habitually and ordinarily resident, apart from temporary or occasional absences of long or short duration."⁷⁸

On that test Lord Denning found that all the students in the case would qualify for the grants. However, as circumstances since 1971 were said to have changed, the traditional method of interpretation was abandoned and a purposive interpretation adopted by filling the gaps which Parliament had left. The result was interpretation of the words "ordinarily resident" in the context of the changes brought about by the Immigration Act. Templeman LJ in his concurring judgment went further. After examining amongst others, the cases of *Levene v IRC*, *IRC v Lysaght* and particularly *Miesegaes v IRC*,⁷⁹ he found the decision not relevant to the Education Act nor to the circumstances of the case, thus denying the relevance of these tax cases.

The House of Lords, as per Lord Scarman in reversing the decision of the Court of Appeal by allowing the appeals, pointed out that:

"the basic error of law in the judgments below was the failure by all the judges, save Lord Denning MR, to

78 *Ibid* at 704 [1982] 1 All ER

79 *Levene v IRC* 13 TC 486 see page 24 above.
Lysaght v RC 13 TC 511, see page 25 above.
Miesegaes v IRC 37 TC 493, see page 32 above.

appreciate the authoritative guidance given by this House in the *Levene* and *Lysaght* cases as to the natural and ordinary meaning of the words "ordinarily resident".⁸⁰

It has therefore been authoritatively clarified by the House of Lords that in seeking the natural and ordinary meaning of the words "ordinarily resident", these were not limited to the Income Tax Acts. Lord Denning's meaning was approved coupled with a further explanation that the adverb "habitually" denotes "residence adopted voluntarily and for settled purposes".

3.5.3 DOMICILE

Domicile is a legal concept to be determined generally by common law rules as developed in the field of private international law (Conflict of Laws). Professor Ellison Kahn submits that no definition of domicile is accurate since properly speaking, none of these are definitions.⁸¹ They are all illustrations seeking to explain something which is obscure. One would, therefore, be wary not to enter into the ramifications of this concept. Domicile has been defined as a person's permanent home.⁸² It has elsewhere been described as the country where one intends to die.⁸³ The common law rule is that a person acquires at birth a domicile of origin, being the

80 *Shah v Barnet London Borough Council and other appeals* [1983] 1 All ER 226 at 238e

81 Ellison Kahn, *South African Law of Domicile of Natural Persons*, the Rustica Press 1972 at p 4

82 *Ibid* at p 5 relying on *Mason v Mason* (1985) 4 EDC 330

83 *Trolley's Tax Planning, supra*, at 153

country of his/her father's permanent home. This remains so until a person acquires a domicile of choice in another country or a domicile of dependence which is acquired *ipso jure* (by dependent persons viz married women, minors and insane people). Domicile is basically a question of intent and the surrounding circumstances. While one may be resident in two or more countries at one time, there is always only one place one is domiciled.

3.6. RESIDENCE OF COMPANIES:

3.6.1 PLACE OF CENTRAL MANAGEMENT AND CONTROL

It should be noted that we have so far been considering "residence" in the context of individuals. The tests for determining whether a company is resident in the United Kingdom seem to be analogous to those applicable to individuals. This is because the company is taken to reside where its central management and control actually resides and these are individuals. The classical case in this context is that of *De Beers Consolidated Mines Ltd v Howe* where the Lord Chancellor Lord Loreburn in his judgment stated:

"In applying the conception of residence to a company, we ought, ... to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. ... An individual

may be of foreign nationality and yet reside in the United Kingdom. So may a company."⁸⁴

The facts in this case were that De Beers Consolidated Mines Ltd was a company registered in South Africa which operated diamond mines there. It also had its head office in that country and the general meetings of its shareholders were held there. Directors' meetings were held both in South Africa and London but the majority of the directors (16) and life governors (3) resided in London (1 life governor and 6 directors resided in the Cape Colony in South Africa). A board met at Kimberley and another in London. However, the most important task of controlling the diamond market (the important business of the company) and the general policy of the company was by the London group. In view of the above considerations, it was held that for income tax purposes, the company was resident in the United Kingdom.

3.6.2 DUAL RESIDENCE OF A COMPANY

From the quotation of the remarks of the Lord Chancellor above in the *De Beers Consolidated Mines* case, and from the observation that an individual may have more than one residence (see *Cooper v Cadwalader* [19904] 5 TC 101 discussed in paragraph

84 *De Beers Consolidated Mines Ltd v Howes* [1906] AC 455, 5 TC 198 at 212; the case has since been applied in several cases eg *Swedish Central Railway Co v Thompson* [1925] AC 495, 9 TC 342; *Unit Construction Co v Bullock* (HL) [1959] 3 All ER 831; see also Australian case of *Koitaki Para Rubber Estates v FCT* (1940) 64 CLR 15 and 241 respectively.

3.3), it seems it may be concluded that a company may also be in the same position. In *Swedish Central Railway Co v Thompson*⁸⁵ the place of control was Sweden, the directors and shareholders held their meetings there and the dividends were paid in Sweden. However, the company was incorporated in the United Kingdom, and had its seal, its registered office and its register of shareholders there. The company's secretary lived in London and the Committee of Directors met there to affix the seal to instruments, to deal with the transfer of shares and sign cheques on the company's London bank account. The company's accounts were drawn up and audited in London. The Commissioners of Inland Revenue found that the company was resident in England. The House of Lords upheld this decision on the ground that a company might have two places of residence and the Swedish Central Railway Co was resident in both Sweden and England. Lord Atkinson in his dissenting judgment approved the test laid down in *De Beer v Howe*, (above) namely that the residence of a trading corporation is where the business is really carried on and that this is "where the central management and control actually abides". However, he pointed out, it would be quite impossible, according to ordinary use of language, to say that "central control and management of a company" can abide in two or more different and separate places.⁸⁶

85 *Swedish Central Railway Co v Thompson* 9 TC 342

86 *Ibid* at 373 ff

In the first place, Lord Atkinson pointed out, it is a false analogy to infer that, because an individual can acquire as many residences as he pleases, so does a fictitious person, a company. He highlighted that the *De Beers* case *supra*, amongst others, decided that the place of registration of a company does not *per se* fix the residence of a company. At best, registration like the birth of an individual, is a fact which must be taken into account in determining the question of residence. Further, the approach laid down in the *De Beers* case is the same for both foreign companies and British companies. If one company is carrying on two entirely separate and independent business enterprises, eg running a tramway company in one place, carrying on the business of patent medicine manufacturers in another and of cotton spinners in the third country, since the enterprises are separate and independent, applying the test laid by Lord Loreburn would fix separate residence of each for income tax purposes. On the question whether a company only carrying on one trade or business could be able to have two or more seats of control of that trade and therefore two or more residences, Lord Atkinson's response was that this was impossible. He remarked:

"There cannot be, ... two systems of central management and control of one entire business situated in two distinct and separated places. Then if it only be a portion or fragment of the real business of the company which need be carried on in each residence, one may ask in vain, as I did during the progress of this case, how

is that fragment to be ascertained? It appears to me to involve a contradiction in terms. What is to be its amount, what proportion of the whole?"⁸⁷

This dissenting judgment of Lord Atkinson in *Swedish Central Railway Company* case, illustrates clearly how wide the net is cast under the United Kingdom income tax law in pursuit of a policy of extending the ambit of its taxpayers. Consequently, this is yet another case analogous to the situation which faced Cadwalader.⁸⁸ The test of residence when applied to foreigners, be they individuals or corporations become highly technical and artificial. The harsh effects of this wide tax net may, however, be ameliorated by remitting as little income to the United Kingdom as possible by these passing foreigners.

3.6.3 CAN RESIDENCE OF A COMPANY CHANGE DAILY?

In the case of *Egyptian Delta Land and Investment Co v Todd*⁸⁹ the company was registered in London but carried on its business in Egypt. Its affairs were controlled and managed there (the directors and secretary general all resident in Cairo). However, to meet the requirements of the United Kingdom Companies Act, the company appointed a London secretary. The company having been assessed for income tax in the United Kingdom, the House of Lords unanimously held that incorporation

87 *Ibid* at 380

88 See *Cooper v Cadwalader* discussed in para 3.3

89 *The Egyptian Delta Land and Investment Co Ltd v Todd* [1928] 14 TC 119

and the consequential arrangements necessary to comply with the United Kingdom law did not alone render a company resident in the United Kingdom. The company had altered its Articles of Association so as to remove the control and management to Cairo. It, therefore, becomes possible that a company may change residence from day to day. The company's accounting period normally influences such decisions. It is unlawful for a company to cease to be resident in the United Kingdom without the consent of the Treasury.⁹⁰ The cases dealt with above cover operational control, which is vested in the directors to the general exclusion of shareholders. However, if in practice some other body exercises control and management, the *de facto* situation will determine the question of residence.

3.6.4 STATUTORY TEST OF INCORPORATION

Apart from the *De Beers* test for company residence, there is now a second test which became applicable after 15 March 1993 in the United Kingdom.⁹¹ The effect of this statutory test is to add incorporation as a test of residence. In other words, a company incorporated in the United Kingdom from 15 March 1988, is resident there for tax purposes. Such a company will not also be regarded as being resident where its central management and control exists. It should be noted that the old case law test in *De Beers* case, remains important especially

90 Section 482 (1)(a) of the Taxes Act 1970

91 See J Tiley, *UK Tax Guide 1989-90*, Butterworths eighth ed at para 32.14 discussing FA 1988, Section 66(1)

where the company is incorporated abroad and where the company was in the United Kingdom before 15 March 1988.

3.7 RESIDENCE OF PARTNERSHIP:

3.7.1 INTRODUCTION

Partnership is defined as "the relationship which subsists between persons carrying on a business in common with a view of profit".⁹² Partnership is in the form of an agreement which might be written. The existence of a partnership is a question of fact though it has legal consequences. The basic question is whether the persons involved are "carrying on a business with a view of profit" in the United Kingdom.

3.7.2 CASE LAW

In *Colquhoun v Brooks*⁹³ a partnership carried on its business in Melbourne, Australia and the issue was whether a partner resident in the United Kingdom but engaged in a trade carried on entirely abroad was liable to income tax in respect of all the profits of that trade, or only in respect of so much of those profits as may be brought to the United Kingdom either in money or kind. It was held that the partnership was a foreign or colonial possession chargeable under the 5th Case

92 United Kingdom Partnership Act 1890, section 1

93 *Colquhoun v Brooks* (1889) 2 TC 490 (HL)

of Schedule D, and that therefore, the United Kingdom resident partner was liable only in respect of that portion of the profits accruing to him as was remitted to the United Kingdom. The terms of Schedule D imposed tax upon the annual profits or gains arising or accruing to any person residing in the United Kingdom from any trade, whether carried on in the United Kingdom or elsewhere. In the course of his judgment, Lord Herschel made these pertinent remarks:

"The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom and the person whose income is to be taxed must be resident there."⁹⁴

These remarks of Lord Herschel succinctly define the parameters of taxation to income in the United Kingdom and the position has not changed to date. It can thus be noted that although residence is said to be the major test in determining liability to income tax in the United Kingdom, the concept of source also does play a role in the basic framework of taxation.

The partnership residence rules in the United Kingdom seem to rely on the place of management of the partnership, which is analogous to the position of a company.⁹⁵ It should be noted

94 *Ibid* p 499

95 *Recent Tax Problems*, J Dyson (ed) Current Legal Problems, Faculty of Laws, University College, London, Stevens and Sons 1985 p 77

however, that in *Brooks* case above, Brooks did not take any active part in the conduct of the business, he was taxed on income remitted to him as his share of profits. Normally the liability of partners to tax is joint liability and not several liability of each.⁹⁶ A joint return of the partnership income is normally made by the "precedent partner", who is first named in the partnership agreement and who is usually the partner resident in the United Kingdom. The ordinary rules applying to individuals would be applied in computing the income. Moreover, there is allocation of the income to each partner for tax purposes and this is by reference to the sharing formula of profits in the year of assessment.

3.8 RESIDENCE OF TRUSTS IN THE UNITED KINGDOM:

Trust income is generally assessed regarding the source from which the income arises in the United Kingdom. The person charged with tax is neither the trustee nor the beneficiary as such, but the person in actual receipt and control of the income sought to be taxed.⁹⁷ Residence of that person will therefore be determined accordingly.

96 See *Income Tax Commissioners for the City of London v Gibb* 24 TC 221 (HL)

97 *Williams v Singer* 7 TC 387 (HL) at 411

CHAPTER 4

THE CONCEPT OF RESIDENCE IN THE SOUTH AFRICAN TAX LAW

4.1 "DEFINITION OF THE CONCEPT":

The South African Income Tax Act 58 of 1962 has no definition of the word "residence" though the terms "resident" and "ordinarily resident" are used in its provisions. The closest definition of "resident of the Republic" is found under section 9A dealing with investment income of foreign investment companies. Subsection 1 thereof defines "resident of the Republic" as:

"a person (other than a company) who is ordinarily resident in the Republic or a domestic company and includes a person, wherever he is resident, who acts in a fiduciary capacity in respect of any direct or indirect interest of any beneficiary in any foreign investment company if such beneficiary is a resident of the Republic".

The use of "resident" and "ordinarily resident" in the same provision has been said to infer that the two have different meanings.⁹⁸ Furthermore, the two expressions have been used in

98 See *CIR v Kuttel* 1992 (3) SA 242 (AD) at 247 per Goldstone JA.

other provisions of the Act which appear distinguishable. It therefore becomes imperative to highlight the differences in these two expressions.

4.2 "RESIDENT" AND "ORDINARILY RESIDENT":

There is little case law on the meaning of residence in South African tax law. This is not surprising since the concept of residence plays a very limited part in determining tax liability in South Africa as compared to the concept of source of income. The leading cases are those of *Cohen v CIR*⁹⁹ and *CIR v Kuttel*,⁹⁴ which are the decisions of the Appellate Division, the highest judicial authority. Both decisions support the point that the expressions under discussion ought to be given their natural and ordinary meaning. This is also supported by *Meyerowitz and Spiro*¹⁰⁰ where it is contended that the term "ordinarily resident" does not bear a special or technical meaning. However, it is submitted that the fact that these terms when used in the South African income tax context bear different meaning and therefore lead to different results from those found under the British income tax legislation is *prima facie* evidence of the special and technical meaning of these terms. The present writer, therefore, has difficulty in appreciating this "ordinary meaning" of these concepts about

99 *Cohen v CIR* 1946 AD 174, 13 SATC 362, discussed at page 56

100 *Meyerowitz and Spiro on Income Tax in South Africa*, para B 575-2

which all these learned authorities are in unison, since they are at pains to stress the difference in the policies pursued under the tax legislation in South Africa and in the United Kingdom (incidentally, the approach in the United Kingdom in interpreting these concepts is also said to be natural, ordinary not special nor technical).¹⁰¹

It is therefore submitted that the terms "resident" and "ordinarily resident" have to be used with caution bearing in mind the differences of approach between the United Kingdom and South Africa. As observed elsewhere this is due to the fact that tax liability under the United Kingdom Tax Acts is based on residence, whereas in South Africa it is based on source of income.¹⁰² Therefore, the policy in interpreting these terms under English legislation is to extend the ambit of the tax net and thus extending the meaning of "resident" and "ordinarily resident", while the South African tax policy is to encourage foreign investment with exceptions to the general rule of source of income. (See *Lysaght's*, *Levene's* cases for the United Kingdom approach and *Cohen's* and *Kuttel's* cases, *infra*, for the South African approach.) The South African Courts so far, have refused to address the issue whether a taxpayer can reside in more than one country for tax purposes.

101 See *Lysaght v CIR*, also *Levene v IRC*, *supra*, at paragraph 3.5.2

102 The point acknowledged in *Cohen's* case and *Kuttel's* case *infra*

4.3. CASE LAW

The facts in *Cohen's* case were that a taxpayer domiciled in South Africa was posted to the United States by his employer in June 1940. He was accompanied by his family and established a home in a New York flat. Prior to his departure he had leased a flat in South Africa for a period of five years. This flat contained the taxpayer's furniture and was sublet fully furnished. The taxpayer and his family were absent from South Africa for the whole year ended 30 June 1942 and yet the Commissioner for Inland Revenue felt that the taxpayer was ordinarily resident in South Africa for the relevant year and therefore, taxable on the dividends received during that year. The taxpayer contested this ruling. The Appellate Division upholding this ruling held that the taxpayer was ordinarily resident in South Africa even though he was not physically present there during the whole year of assessment in question. The taxpayer therefore was liable to supertax on dividends received.

Schreiner JA delivering his judgment in *Cohen's* case defined "ordinary residence" as "the country to which (one) would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home."¹⁰³ The term "resident" was not defined in so many words except that it is relatively

103 *Cohen v CIR, supra* at 185

casual or occasional in contrast to "ordinarily resident" which is more fixed or settled residence. The latter, it was pointed out, might not be the country of domicile, for it might be one's domicile of origin and one might not have formed the fixed and settled intention to the exclusion of other countries as domicile of choice. So it can be noted that even in the South African context, these concepts are rather fluid. Schreiner JA in an *obiter* stated that it was unnecessary to express any opinion whether or not a man may be ordinarily resident in more than one country. It was, however, clear that the learned judge harboured a negative opinion in view of the above definition.

*Kuttel's*¹⁰⁴ is the most recent decision from the Appellate Division on residence. The formulation of Schreiner JA in *Cohen's* case regarding the term "ordinarily resident" and quoted above was adopted as a place where one has his usual or principal residence - his real home.¹⁰⁵ "Ordinarily resident" was held to be different and narrower than just "resident". It was recognised and reiterated that the policy of the legislature under the Income Tax Act in providing exemptions from taxation, to encourage investors from outside South Africa to invest would be frustrated if the term "ordinarily resident" was given an extended meaning (as in the United Kingdom). It, therefore, becomes clear that the natural, ordinary dictionary meaning of these terms is not enough. They have to be tackled

104. *CIR v Kuttel*, *supra* footnote 98

105. *Ibid* at 249

taking into account the differences in the policies pursued under different tax jurisdictions as well as the context of the provisions where they appear.

The facts in *Kuttel's* case were that the taxpayer left South Africa in 1983 to take up residence in the United States. He applied for permanent residence there and soon after arriving there rented a house, established church membership, opened banking accounts, acquired an office, bought a car and registered with Social Security. The taxpayer was motivated by positive prospects of successfully conducting his fishing business operations in the United States. He realised most of his assets in South Africa leaving what he could not take with him due the South African Exchange Control Regulations on maximum transmissible income. His children remained in Cape Town to complete their schooling and after which they joined their parents in the United States. The taxpayer made periodic visits to South Africa during the tax years in question; these were occasioned by continuing liquidation of his assets, his interest in boat-building projects and round-the-world races, attending his brother's funeral, and general review of his investments in South Africa in the event of the depreciation of the rand. During these visits the taxpayer normally lived in the house owned by the company in which he and his wife were the sole shareholders. The house was not let and was, therefore, available to the taxpayer any time he wanted to live in it. The fall in the value of the rand caused a diminution of the taxpayer's estate and he took the reasonable steps of

protecting his capital by effecting substantial renovations and extensions to the house. The duration of his visits to South Africa was on average becoming less towards the end of the period in question (1983-1986). The Commissioner for Inland Revenue assessed the taxpayer to income tax on interest and dividends earned by him during the years 1984, 1985 and 1986. The taxpayer successfully appealed (see ITC 1501, 53 SATC 314) and the Commissioner for Inland Revenue took the appeal up to the Appellate Division, the issue being whether the taxpayer was exempted from tax on interest and dividends received by or accrued to him as "a person (other than a company) not ordinarily resident nor carrying on business in the Republic".

Goldstone JA in delivering the majority decision of the Appellate Division, found that in applying the test of "ordinarily resident" as formulated by Schreiner JA in *Cohen's* case, (viz where was the taxpayer's usual or principal residence, his real home?) there was no doubt that at the relevant times the taxpayer was not ordinarily resident in South Africa. The learned judge pointed out that the taxpayer had decided to emigrate to the United States and, but for the provisions of the Exchange Control Regulations, he would have realised all his assets and taken the proceeds from South Africa to the United States. By reinvesting his capital in Eskom stock, the taxpayer was simply making the most advantageous arrangements in the circumstances. The fact that the taxpayer's children upon completion of their schooling in Cape Town permanently joined their parents in the United States strengthened the

taxpayer's argument that his usual or principal residence or home was now in the United States. It was found that the taxpayer's visits were not normally associated with "home coming/return" but were rather business trips relating to companies and the building of the yacht which began prior to the decision to emigrate to the United States. The fact that over the period in question, these visits had become less frequent and of shorter duration also added weight in favour of the taxpayer's contention. Even the keeping of a house in South Africa was found to be in no way inconsistent with his usual or principal residence or home having been in the United States. He was applauded to have sound financial reasons for retaining an interest in immovable property; furthermore he required a place to live when he visited Cape Town. In other words, the fact that he retained a residence in Cape Town was "quite consistent with his ordinary residence being in the United States".¹⁰⁶ These were reasons for holding in favour of the taxpayer and dismissing the appeal.

These remarks by Judge Goldstone clearly show the extent the South African tax courts are flexible in pursuit of the stated policy of encouragement of foreign investment. There is no doubt that on similar facts to those in *Kuttel's* case, the taxpayer, if the setting had been in the United Kingdom tax jurisdiction, would have been found liable. It should be noted that Justice Goldstone in *Kuttel's* case, following on the suggestion by Schreiner JA in *Cohen's* case, also found it

106 *CIR v Kuttel, supra*, at 249

unnecessary to decide whether a person may or may not be held to be ordinarily resident in more than one country at the same time.¹⁰⁷ This is regretful since the question, therefore, remains unanswered in the South African context. *Meyerowitz and Spiro* submit that:

"On the adopted formulation of ordinary residence, a person can only have one real home, but if it cannot be determined as between South Africa and one or more other countries in which he has his real home then, because of the onus resting upon the taxpayer, he would not be able to claim the exemption. If, however, a person's mode of life is such that it cannot be said that he has a real home anywhere he will be able to discharge the onus of establishing that he is not ordinarily resident in the Republic."¹⁰⁸

As said earlier, the issue remains academic since the Appellate Division declined to decide on it. Judge Howie in ITC 1501, however, had no qualms about entering these turbulent untested waters. The learned judge in delivering the judgment of the Cape Special Court said:

"In my opinion, the law-giver could, in all the circumstances, never have intended 'ordinarily resident' in the Act, to bear the meaning accorded those words in the

107 *CIR v Kuttel, supra*, at 248

108 *Meyerowitz and Spiro, supra*, at para 575-2

English cases mentioned above [*Levene v IRC* and *IRC v Lysaght*]. On the contrary, it intended that expression to have the meaning suggested by Schreiner JA in *Cohen's* case. It follows that a taxpayer is not 'ordinarily resident' in more than one country at a time. I hold that view mindful of the reservation expressed by E.B. Broomberg *Tax Strategy* 2 ed at 131, that the idea of 'the "most fixed or settled residence", the place to which the taxpayer would 'naturally return', is, from the point of view of tax avoidance planning, imprecise as a definition"¹⁰⁹ (the underlining mine).

The term "residence" was considered in the case of *Robinson v COT*,¹¹⁰ where a taxpayer born in South Africa, who had carried on business and investments there prior to his emigration to England, was held to be resident in South Africa. The taxpayer and his family moved to England in 1889 and lived there. However due to his investment interests in South Africa he made periodic visits at irregular intervals, sometimes accompanied by his family. The taxpayer bought a house in Wynberg in 1891. A house bought in England was later sold and the family moved into a leased house. Owing to the disturbances in South Africa in 1915 the taxpayer came to South Africa to oversee his financial interests. He was accompanied by his daughter, with whom he lived in Muizenberg until the end of 1916. Since the Wynberg house had not been sold (having been put up for sale and vacant

109 ITC 1501, 53 SATC 314

110 *Robinson v COT* 1917 TPD 542, 32 SATC 41

from 1907), the taxpayer moved to live there with his daughter. When assessed for tax on the interest received on large holdings in Cape government stock, the taxpayer claimed exemption from liability in terms of the then Income Tax Act 28 of 1914 section 5(f) thereof, which exempted from liability tax holders not residing in the Union. The court rejected the taxpayer's contention that his expressed intention of returning to his real and permanent home in England entitled him to an exemption since he was not resident in the Union.

The court found that despite this expressed intention the taxpayer's prolonged stay in South Africa went beyond the possible limits of a casual visit and that this constituted residence. It was pointed out that on the circumstances of the case, physical presence of the taxpayer for a period of two and a half years coupled with maintenance of a home in South Africa were strong indicators of residence. Mason J in the course of his judgment put the word "residence" in the context it appeared as well as the object pursued:

"The general principle of our income tax is that source of income and not the mere residence of the inhabitant should determine liability, but this special exception is introduced in favour of non-residents who hold government stocks, clearly to popularise them as investments. But where a person has been living all this time in the country and has had the benefit of its government for himself, his property and business, there

seems no a priori reason for exempting him from taxation."¹¹¹

It is submitted that the taxpayer might have been exempted if the wording of the statute then was "ordinarily resident" instead of merely "residing".

4.4. RESIDENCE OF LEGAL PERSONS:

4.4.1. INTRODUCTION

Residence of legal persons, like constitution of such entities, is very fictitious and artificial. It has therefore been suggested that in applying the conception of residence of a company, one ought to proceed on analogy of individual persons.¹¹²

4.4.2. RESIDENCE OF PARTNERSHIP

A partnership is not a juristic person separate from the individuals who constitute it. Therefore, a partnership is not taxed in its own name. Each partner is taxed on his/her share of the partnership income whether it is withdrawn or not. The residence of the individual partner and taxation of partnership

111 Ibid SATC at p 45

112 See remarks of Lord Loveburn in *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* 1906 AC 455, 5 TC 198 at 212-13

income is often expressed as being jointly and severally.

4.4.3. RESIDENCE OF COMPANIES

The South African Law follows the United Kingdom approach in that a company is held to reside at a place where its central management and control actually resides.¹¹³ There is a distinction made between a domestic company and an external company. The former is defined as a South African company or a company managed and controlled in the Republic while an "external company" is any company other than a domestic company. Ascertaining where a company is managed and controlled is a question of fact after considering all the information in a relevant case.

Thus a place of registration or incorporation of a company may not necessarily point conclusively to a place of management or control. Like in the United Kingdom, a company may be held to reside where it is not registered or incorporated.¹¹⁴ Silke submits that the South African legislature recognised this principle, by defining a domestic company as a South African company or a company managed or controlled in South Africa.¹¹⁵ The place where the directors of a company meet and exercise

113 See *Silke on South African Income Tax Law* para 14.45 p 14-33 where he cites the case of *De Beers Mines Ltd v Howe supra*

114 See *De Beers Consolidated Mines case supra*, ITC 1054 (1964) 26 SATC 260 and *Estate Kootcher v CIR* 1941 AD 256, 11 SATC 198

115 *Silke, ibid*

their control, ie effective management of a company, is where the company resides.¹¹⁶

The problems associated with residence of a company have been addressed under the United Kingdom residence in paragraph 3.6 above.

4.4.4. RESIDENCE OF A TRUST

Meyerowitz¹¹⁷ submits that there is no provision in the South African Income Tax Act which deals with ordinary residence of a trust. The learned writer suggests that the situation would seem to be similar to that prevailing in the United Kingdom, viz a trust is ordinarily resident where its management and control resides. Thus the position is analogous to that of a company's residence.

Silke submits that estates or trusts are resident where the executors, administrators or trustees are resident.¹¹⁸ The cases of *Nathan's Estate v CIR* as well as *CIR v Jagger & Co (Pty) Ltd* are cited.¹¹⁹ Each case is to be considered on its merits but Silke further submits that the place where the

116 See *Union Corporation Ltd & Others v CIR* [1953] AC 482, 34 TC 207.

117 See Meyerowitz and Spiro, [1953] AC 482, 34 TC 207

118 See *Silke on South African Income Tax* para 14.73 p 14-30-1

119 See *Nathan's Estate v CIR* 1948 (3) SA 866 (N), 15 SATC 328; *CIR v Jagger & Co (Pty) Ltd* 1945 CPD 331; 13 SATC 430

assets of the estate/trusts are managed or controlled may well be crucial¹²⁰

Clegg¹²¹ also cites *Nathan's* case for residence of trusts which supports the principle of residence as central management and control.

4.4.5. CONCLUSION ON RESIDENCE OF LEGAL PERSONS

The determination of residence of trusts, companies as well as partnerships is elusive since it is a matter of fact in each case. In the context of trusts and companies, even though these entities are legally separate, residence is determined by ascertaining residence of the individuals effectively managing or controlling the entities. The place of incorporation or registration is merely a factor to be considered amongst others. No doubt this uncertainty leaves room for manipulation of the concept of residence.

120 See Silke *ibid*

121 See Clegg DMJ, "Ordinary Residence of Trusts", *The Taxpayer* Vol 43 1994 p 139 and the editors' response thereto, which is that the case of *Nathan* does not derogate from the submission that residence of a trust is analogous to that of the company, ie control and management residence. See also 1994 *Taxpayer* 87

CHAPTER 5

THE APPLICATION OF CONCEPT OF "RESIDENCE" IN LESOTHO

5.1. RELEVANCE OF THE CONCEPT:

The key provisions incorporating "residence" as the basis for determining tax liability in Lesotho are section 17(2) and (3). These state that gross income of a resident taxpayer includes income from all geographical sources whereas gross income of a non-resident taxpayer includes only Lesotho-source income.

5.2. RATIONALE BEHIND DIFFERENTIATION BETWEEN RESIDENT AND NON-RESIDENT TAXPAYERS:

The Explanatory Memorandum to the Lesotho Income Tax Order states that the broadening of the income tax base is amongst others, the rationale for extending Lesotho's tax jurisdiction to cover foreign-source income of its residents. This way it is argued, there will be a more equitable distribution of the tax burden among taxpayers. It will be recalled that a constricted tax base was amongst others, one of the criticisms levelled at the now repealed 1981 Income Tax Act. This inevitably led to high income tax rates and a heavy burden on the few taxpayers.¹²²

122 See Selialia F.L. "Personal Income Tax in Lesotho: its Impact on the Economy", Central Bank of Lesotho, Staff Occasional Paper No 7, Maseru, August 1992

5.2.1. SOURCES OF INCOME IN LESOTHO

The main sources of income in Lesotho households are subsistence farming, cash crops and livestock, business income, cash wages and salaries, migrant workers' remittances and what are referred to as "other sources of income".¹²³ The migrant workers' remittances seem to be the main source accounting for 36.6% of the total number of households. This is followed by subsistence farming with 24.3%, while cash wages and salaries account for an overall 16.3% (note should be taken that the latter represents the main source of income in urban areas). Migrant workers' remittances apart from being the main source of income countrywide, are the main source for rural households particularly. The table below clearly shows this. (Note should however be taken of declining figures due to retrenchment of migrant workers.)

NUMBER OF HOUSEHOLDS BY MAIN SOURCE OF INCOME
(Per Cent)

<u>Source of Income</u>	<u>Maseru urban</u>	<u>Other urban</u>	<u>Rural</u>	<u>Lesotho</u>
Subsistence Farming	2.7	0.4	27.9	24.3
Cash crop and livestock	1.6	1.2	11.5	10.1
Business income	9.7	13.6	1.9	3.2
Cash wages and salaries	64.0	42.6	10.0	16.3
Migrant Workers' remittances	14.7	27.4	39.3	36.6
Other sources of income	7.3	14.8	9.4	9.5
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: Bureau of Statistics, Household Budget Survey 1986/87

5.2.1.1 MIGRANT WORKERS' REMITTANCES

Owing to administrative constraints and mainly on policy considerations, remittances of the Basotho migrant workers have been exempted from taxation under the new Income Tax law. Section 104 of the Income Tax Order provides that employment income of residents earned in a foreign country is exempted from income tax if that income is chargeable to tax in the foreign country. This means that foreign-sourced employment income of residents is exempt from income tax on the condition that it is chargeable to tax in that foreign country of employment. If it is not chargeable to tax, it means that Lesotho does have jurisdiction over such income. The Commentary of the Accompanying Memorandum to section 104 states that income which is not taxed in the foreign-source country due to the fact that it falls below the tax margin will be regarded as being notionally charged in the foreign-source country. An example cited in this context is the remittances of some Lesotho migrant workers in South Africa (underlining mine). The provisions of section 104, therefore, reserve the right of Lesotho to assert tax liability on foreign-sourced employment income accruing to its residents. The circumstances under which this liability will be asserted or not asserted have not been clearly stated; possibly this is to allow the Commissioner of Income Tax to exercise his discretion. However, it is submitted that too much latitude has been allowed. Apart from the mine-workers stated in the Commentary to section 104, there are other Lesotho citizens working in South African industries.

The policy considerations in this context would be viewed as the general cost of the migrant labour system to the social fabric in Lesotho. The abhorrence of the migrant labour system, its social ills such as broken families, the squalid conditions under which some men live in hostels and poor retirement packages are some factors which one may speculate could have influenced this policy. Notwithstanding these policy considerations which support the exemption of foreign remittances of migrant workers, it is doubtful whether the office of the Commissioner of Income Tax would have the administrative capacity to collect taxes from foreign sourced employment income. As seen from the figures quoted above, showing the heavy reliance on migrant workers' remittances, Lesotho's main export is its human resources. With appropriate training, the personnel in the Department of Income Tax could be strengthened to improve the income tax collection machinery in Lesotho.

5.2.1.2 EXEMPTION OF FARMING INCOME FROM TAXATION

According to section 29 of the Income Tax Order, income derived by a resident individual from farming carried on in Lesotho is exempt from income tax. The definition of farming covers both pastoral and agricultural, i.e. crop farming and livestock farming. It would seem, according to the Commentary on this provision that farming operations carried on by a company and farming operations carried on outside Lesotho are excluded from the exemption. Bearing in mind that the combination of subsistence farming, cash crops and livestock accounts for about 34%

of the service of household income in Lesotho, the remaining taxable types of income would be those from business income, wages and salaries, and other sources of income. These constitute about 29% of the source of household income in Lesotho. One, therefore, cannot help wondering how effective is the stated objective of broadening the income tax base in Lesotho. The prospects become much worse when one considers that there is a standard concessional rate of tax which has been extended to "expatriate taxpayers".

5.2.2 EXPATRIATE TAXPAYERS

This is yet another category of resident individuals who in recognition of Lesotho's reliance on the assistance of overseas technical personnel are levied tax at the flat rate of 25% on income derived from Lesotho. The maximum period of residence which an expatriate may qualify under this concession is seven years. Thus an expatriate who resides in Lesotho for more than seven years will be treated as a permanent resident and the normal progressive tax rates will apply.

5.2.3 NON-RESIDENT TAXPAYERS

Non-resident taxpayers (whether individuals or companies) are charged at the standard rate of tax, presently 25% (section 12 of the Income Tax Order). Note should, however, be taken that this does not apply to trustees since their liability for tax depends on whether there is chargeable trust income. It will

be recalled that according to section 17(3), chargeable income of non-resident taxpayer includes only Lesotho-source income. The only valid reason for extending the concessional rate of tax to non-residents would seem to be promotion of foreign investment.

5.2.4. CONCLUSION:

In conclusion, therefore, it would seem that the Lesotho Tax Order does not only differentiate between resident and non-resident taxpayers, but goes further. Residents are further categorised into migrant workers, farmers, expatriate taxpayers and permanent residents. All these categories are treated differently for income tax purposes. Permanent residents are taxed on their world-wide income. However, employment income earned outside of Lesotho is exempted from the tax net if it has already been chargeable in the foreign country where it was earned. In the case of the migrant labourers working in South Africa, it would seem that there is a presumption that even if they were not chargeable to income tax there, their income would remain exempt in view of the hardships imposed by the migrant labour system. Farming income derived inside Lesotho by residents is also exempted from taxation. On the other hand, expatriate taxpayers who are serving in Lesotho under technical assistance agreements, while falling under the category of residents, are nevertheless charged at a concessional standard rate of 25%. This is to encourage such service. However, if an expatriate under the scheme resides for more than seven years

the concessional rate ceases to apply. An ordinary non-resident taxpayer is also charged a concessional rate of 25% on income derived from Lesotho. This is also to encourage such foreign investors (as individuals or companies) to bring capital to Lesotho. The importance of differentiating between the various categories of taxpayers can not, therefore, be overemphasised. It determines the extent of tax liability, if any.

It would also seem that owing to the unique position of Lesotho as an enclave within an economic giant, the Republic of South Africa, Lesotho's economy is fraught with contradictions. For instance the tradition of exporting its able-bodied men to the South African mines, while at the same time relying heavily on overseas technical assistance in the form of "experts". As one of the least developed countries, Lesotho also places high importance on the ability to attract foreign capital to enhance creation of manufacturing industries and the necessary jobs for its citizens. Even though not stated in so many words, it is evident the ability of subsistence farmers to pay income tax is a factor which influenced their exemption. These are some factors underlying the different categories of residents and non-residents in the Income Tax Order and their different tax liability.

5.3. RESIDENCE OF INDIVIDUAL TAXPAYERS:

Section 5(1) provides circumstances under which an individual will be deemed a resident of Lesotho for income tax purposes. These provide four tests of residence as alternatives, applied progressively.

5.3.1 NORMAL PLACE OF ABODE

An individual who has a normal place of abode in Lesotho and is present in Lesotho for part of the year of assessment is a resident. There is no minimum period of presence stated under this test.

5.3.2 PRESENCE OF MORE THAN 182 DAYS

An individual who is present in Lesotho for a period of more than 182 days in any consecutive period of twelve months is a resident. Note should be taken that the period is measured by presence of more than 182 days in any consecutive period of twelve months without necessarily confining this to a year of assessment.

5.3.3 LESOTHO GOVERNMENT OFFICIAL POSTED ABROAD

An individual posted abroad by the Lesotho Government during the year of assessment is a resident. It would seem that presence of the individual in any part of the year of assessment is not a requirement under this test.

5.3.4 THE COMMON LAW TEST OF RESIDENCE

Section 5(1)(d) states that an individual is a resident individual for the entire year of assessment if that individual is otherwise a resident of Lesotho. The Commentary to this

section points out that reference to a person who is "otherwise a resident of Lesotho" means a person who is a resident of Lesotho under the general principles established by United Kingdom decisions.

It should be noted that tests 5.3.1, 5.3.2 and 5.3.3 are specific while test 5.3.4 is very general. Thus it would be prudent given a specific case to examine an individual's status by reference to the more specific tests and then proceed to the more general one. It should also be noted that these tests (except for 5.3.3), correspond to the United Kingdom's Inland Revenue's Guidelines on residence which have been discussed above.¹²⁴

The United Kingdom rules are, however, guidelines whereas these tests in Lesotho have been enacted as statutory binding provisions. Note should also be taken that these tests are, therefore, exhaustive as contrasted to mere illustrative guidelines.

In this respect, the Lesotho Income Tax Order, section 5(1) is quite similar to the provisions of the Australian Income Tax Assessment Act, 1936, section 6(1) thereof. Under this Act the tests of residence of individuals are as follows:

1. the individual is a resident of Australia according to ordinary concepts (the common law rule);

124 See paragraph 3.4

2. the individual is domiciled in Australia unless the Commissioner is satisfied that the person's permanent place of abode is outside Australia (the domicile rule);
3. the individual has been in Australia for more than one-half of the year of income (i.e. in excess of 183 days) unless he/she can satisfy the Commissioner that his/her usual place of abode is outside Australia and that he/she does not intend to take up residence in Australia (the half year rule); or
4. the individual is a member of a Commonwealth superannuation fund or is a spouse/child of such an individual.¹²⁵

It would seem that the Lesotho Income Tax Order has abandoned the distinction between varying degrees of residence such as "ordinary residence". The main categories of residents are expatriate taxpayers and permanent residents. The determining factor here is the seven year limit beyond which a resident expatriate taxpayer graduates to the status of permanent resident and therefore loses the concessional tax rates. The distinction between residents and permanent residents has no relevance in regard to Lesotho citizens.

The determination of residence for tax purposes, is an annual

125 Y Grbich, A J Bradbrook, K Pose, *"Revenue Law Cases and Materials"*, Butterworths 1990 at p 788

event, followed in each year of assessment. Each of the tests applied is discussed below.

(i) Normal place of abode test:

This test covers the situation characterised as having "accommodation available for use" coupled with presence in Lesotho for part of the year of assessment. Since there is no stated minimum period, it is arguable that even a single day's visit will suffice. However, after examination of the divergence of approaches to this matter under British and South African courts as well as the differing policies pursued, it is submitted that Lesotho will have to chart a middle course. The United Kingdom approach as seen in *Cadwalader's case*¹²⁶ will not augur well for a developing country like Lesotho trying to attract foreigners to visit Lesotho as tourists or preferably as potential investors. At the same time, the South African approach as exemplified in the recent decision of the Appellate Division in *Kuttel's case*¹²⁷ seems to open the flood gates for enterprising taxpayers.

It is submitted that circumstances such as in *Kuttel's case* would warrant the piercing of the corporate veil. The fact that the house was owned by a company in which the taxpayer and his wife were sole shareholders, obviates this. Another point which the Appellate Court avoided from addressing is the fact that the taxpayer through his enterprising activities may be taken

126 *Cooper v Cadwalader* 5 TC 101, discussed in paragraph 3.2

127 *CIR v Kuttel, supra*, discussed in paragraph 4.3

to be resident for tax purposes in more than one country at a time. This reluctance on the part of the South African Courts to address this issue can be traced back to 1946, in the leading case of *Cohen v CIR*.¹²⁸ There, Schreiner JA having defined "ordinary residence" as the more settled residence where one would return from his wanderings, expressed reservations on the question whether one may ordinary reside in more than one country. He found it unnecessary in that case to decide the issue. He had, however, earlier said:

"that a man may have more than one residence for the purposes of income tax statutes has long been established, if it was ever in doubt. Whether he can be "ordinarily resident" in more than one country at the same time seems to be less clear. It may depend on the provisions of the particular statute which is being interpreted".¹²⁹

Broomberg¹³⁰ prefers the English approach and criticises the South African approach:

"The idea of the most fixed or settled residence, the place to which the taxpayer would return, is imprecise as a definition and a (tax) planner, searching for guidelines might well refer to the two well-known English

128 *Cohen v CIR*, 1946 AD 174 discussed, *supra*, paragraph 4.2

129 *Ibid* at 183

130 Broomberg E B, *Tax Strategy* 2nd edition, Butterworths 1983

decisions on residence, because these cases have been frequently cited in our courts. They are: *CIR v Lysaght* (1928) AC 234 and *Levene v CIR* (1928) AC 217.¹³¹

In conclusion, it is submitted that the Lesotho Commissioner of Income Tax as well as the courts in deciding on the question of "normal place of abode" will be best advised to steer the middle course between the United Kingdom and the South African approaches. The main determining factors are the underlying objectives which the Income Tax Order has been designed to promote in the economy of Lesotho.

(ii) Presence of more than 182 days test:

This test is referred to as the "six-month rule" in the United Kingdom while in Australia it is the "half year rule". The approach is generally the same: one would be taken to be resident for tax purposes if present in a country for more than six months, unless certain circumstances exist which preclude this conclusion. In Australia, a person in those circumstances will have to satisfy the Commissioner that there is a usual place of abode outside Australia and that he/she does not intend to take up residence in Australia. In the United Kingdom, it is not sufficient to escape tax liability by simply stating that one is resident elsewhere. Intention is irrelevant; once one spent the 183 days or more in the United

131 *Ibid* at p 131

Kingdom, one is taxable.¹³² The Lesotho Income Tax Order half year rule according to the commentary to section 5(1)(b) will be satisfied by either a single period of presence or an accumulated period within the period of twelve months. The twelve month period within which the 183 days will be measured does not refer to the year of assessment, i.e. it may be within two overlapping years of assessment. There is no reference to the question of whether an individual has another place outside Lesotho which he regards as his place of abode or real home under this test. It is submitted, therefore, that one may normally reside in South Africa but if a seven month period is spent in Lesotho, that person would satisfy this test (the implications of the Double Tax Convention between Lesotho and South Africa will for now be ignored). This obviates the possibility of being resident for tax purposes in Lesotho and another country. This is becoming normal in today's mobility. Foreign tax credit will remedy any discrepancies.

(iii) The Lesotho Government official posted abroad:

This is the simplest test of residence since the determining factor is the status of an individual as an officer of the Lesotho Government posted overseas. Invariably, this would be a Lesotho citizen posted in a diplomatic mission or some official capacity. The Lesotho Government would pay the remuneration as well as foreign service allowance for such an

132 See section 51 of the Income and Corporations Taxes Act 1970

official. Since under the Vienna Convention for Diplomatic Relations, 1962, and the Vienna Convention for Consular Relations, 1963, officials of the sending state are treated as diplomats in the receiving state, enjoying amongst other privileges and immunities, exemption from local taxes, it will only be equitable for Lesotho as the sending state to assert tax jurisdiction over income so earned. After all, one is not a diplomat in one's country; Moreover the source of the funds would be in Lesotho.

(iv) The common law test of residence:

This is the widest test of all the aforementioned criteria for determining residence. It is a residual provision which, when all the other tests have been applied and failed, one may nonetheless be found as resident of Lesotho on the basis of common law principles. It is, therefore, possible that an individual may be a resident according to the common law principles without meeting the other tests, e.g. the half year rule. A case of an intending migrant who wishes to settle with his family in Lesotho is an example here. Such a person will qualify as resident upon the date of arrival. The general principles of residence as established by the United Kingdom's decisions such as *Lysaght v IRC* (1928) 13 TC 511; *Levene v IRC* (1928) 13 TC 486 are cases in point.

In the light of the earlier discussion of the application of the concept of residence in the United Kingdom including the

digest of British cases on residence, it will be appreciated that this test is very wide. The question of residence is that of fact after consideration of a number of factors to reach a conclusion. The decided cases offer factors which in the past have influenced the Courts in their findings, none of these are conclusive. They are at best guidelines or persuasive considerations. The problems arising from the application of the concept of residence in the United Kingdom in regard to common law principles will no doubt arise in Lesotho. It is, however, hoped that the Commissioner and the Courts will be influenced by the policy considerations applicable in Lesotho.

The factors to be taken into account have been set out in discussing the United Kingdom practice, and will not be repeated here. Lesotho's unique socio-economic conditions as well as its culture will no doubt contribute to expansion of the list. Suffice it to point out that in each case, the individual's lifestyle, family and business ties, property ownership, nationality and general history will all constitute important factors to be taken into account. The United Kingdom common law rules on residence are somewhat of an enigma which may make one who has never set foot in the United Kingdom through a tax year a tax resident. Lesotho will have to be wary of the highlighted pitfalls especially in relation to temporary residents.

5.4. RESIDENCE OF COMPANIES:

Section 6(1) provides three tests of residence for companies.

These are as follows:

- i) the place of incorporation/formation; or
- ii) the place of management and control; or
- iii) the place of majority of operations.

It will be noted that these tests are alternatives. This approach will give many companies the status of residence unlike under the United Kingdom approach where the decisive factor was the place where control management and control actually resides.¹³³ This includes:

- a company incorporated in Lesotho, with its operations conducted there as well as its management and control;
- a company incorporated in Lesotho, but managed and controlled outside Lesotho;
- a company incorporated in Lesotho but managed and controlled outside as well as its operations conducted outside Lesotho;

133 See however a discussion on the second test in the United Kingdom on the place of incorporation introduced by FA 1988, section 66(1), at page 49

- a company incorporated outside Lesotho, but managed and controlled in Lesotho with its operations outside Lesotho;
- a company incorporated outside Lesotho, with no management and control in Lesotho but with the major operations carried on in Lesotho.

The first test includes incorporated and unincorporated associations. Note should be taken of the words "incorporated and formed" under the laws of Lesotho. This provision tallies with the definition of a "company" under section 3(1) which is very broad. It reads: A company -

"means a body corporate or unincorporated, whether created or recognised under the law in force in Lesotho or elsewhere, but does not include a partnership or trust" [section 3(1)].

It should be noted that the above definition of a company will cover both resident and non-resident companies. By including corporate and unincorporated associations registered or formed under the laws of Lesotho it would seem that this covers a company incorporated under the Lesotho Companies Act No 25 of 1967 as well as other associations created by law. This would include registered trade unions, societies, clubs, political parties, co-operatives and stokvels. The list is not exhaustive. This is a broad sweeping provision. Note should,

however, be taken that in terms of section 25 of the Order, income of certain organisations which are religious/charitable, amateur sporting associations or trade unions or similar bodies are exempted from taxation. The main factor here would be lack of profit-making as the major motive behind establishment of such an association. Some burial societies have mushroomed all over Lesotho and it is submitted these may fall under the exempted organisations unless the Commissioner decides otherwise.

The second test of management and control of a company adopts the United Kingdom's test of corporate residence. Mere presence of management and control in Lesotho will suffice under this test though in practice it will be accompanied by other acts of carrying on business or major operations (of the third test).

It is generally considered that a company is managed and controlled where the majority of its directors hold their meetings.¹³⁴ [Control may also be exercised by shareholders.] The case of *De Beers Consolidated Mines Ltd v Howe*, *supra*,¹³⁵ provides an example where applying the Lesotho tests above, dual (or even triple!) residence might be ascribed to the company. The De Beers Consolidated Mines Ltd was incorporated in South Africa with its registered head office in Kimberley. The company carried on its mining operations in South Africa

134 See *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455

135 5 TC 198 discussed *supra* at paragraph 6.1

and the diamonds were sold in London. A board met at Kimberley and another in London. However, the most important task of controlling the diamond market fell on the London based board. Thus it was held that the company resided in the United Kingdom.

In the leading Australian case of *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation*,¹³⁶ the taxpayer was a company which was incorporated in New South Wales, but had its office registered as a foreign company in Papua. It owned and operated rubber plantations in Papua, which were managed by an officer of the company there acting under a power of attorney which authorised him to manage and conduct the company's business in Papua. The officer was assisted by an executive staff consisting of an assistant manager and a bookkeeper in Papua. The company's rubber was normally consigned to the company in Sydney and sold in Australia as packed in Papua, without further processing. The sale was conducted by a Sydney firm of selling agents which handed the sales accounts to the company's manager in Sydney. The directors of the company who exercised supervisory functions over the operations in Papua, resided in Sydney and always met there. The majority of shareholders resided in Australia and all general meetings were held in Sydney. The issue was that the Commissioner of Taxation assessed the company on profits derived from the sale of rubber. The taxpayer did not disclaim residence in New South

136 *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) AITR 167; 64 CLR 241

Wales, but also claimed it was resident of Papua. It was held that the company was not a resident of Papua within the meaning of the Australian Income Tax Assessment Act. While conceding that the company may be resident in more than one country (relying on the decision of *Swedish Central Railway Co Ltd v Thompson* (1925) AC 495 discussed *supra* in paragraph 6.2), the Court pointed out that the operations carried out in Papua were by the manager under a power of attorney. This in effect meant that the operations of the attorney were of course operations of the company. The staff in Papua were merely servants of the company and their responsibilities did not extend to the control of the general or corporate affairs of the company, which were all centred in Sydney.

It is submitted that on facts similar to those above, if the tests provided under the Lesotho Income Tax Order were applied, the company would be found to have the status of dual residency. This is because the residence of central management and control will not be given an overriding consideration above all the other tests. It would only be fair that a proportionate tax be levied in the circumstances similar to the *De Beers Consolidated Mines Ltd* case and *Koitaki Para Rubber Estates Ltd* case discussed above, taking into account that, but for the operations e.g. of diamond mining in South Africa and the rubber plantations in Papua, there would be no product to sell. After all, these were resources taken out of South Africa and Papua respectively. Other jurisdictions "bite at the tax cherry" must be taken into account.

It should be noted that under section 6(2), a branch in Lesotho of a non-resident company is treated as a separate person and a resident company. As such it will be taxable on its worldwide income. A "branch" under section 3(1) is defined as a place where a person carries on business and includes acting through an agent in conducting such business, a place where substantial equipment/machinery are installed and a place where a person is engaged in a construction, assembly or installation project.

It thus seems that the Lesotho Income Tax Order in its provisions for determining residency of a company has a sweeping effect. The corporate tax base has been broadened so wide that it is almost inconceivable how any corporate or unincorporated body will escape the tax net. This is due to the wide definition of the expression "company". The residence tests are also very wide in that they apply the place of incorporation or the place of management and control or the place where the majority of the company's operations occur as determining factors. Cases of dual residency will no doubt abound in these circumstances. Lesotho foreign tax credit rules under section 105 are subject to many qualifications and limitations. It will, therefore, be cold comfort to a taxpayer to be told that in the absence of a Double Taxation Treaty, the adverse effects will be ameliorated by the foreign tax credit provisions. This does not augur well for a country promoting foreign investment.

5.5. RESIDENCE OF PARTNERSHIPS:

Since a partnership *per se* is not liable to tax, but rather it is each individual partner who is taxable, a partnership is resident in Lesotho if at any time during the year of assessment it has a resident of Lesotho as a partner (section 7). Note should be taken that there is no minimum period of presence required. In this case only one day's presence may suffice for a partner to be deemed resident in terms of the residency rules for individuals (under section 5).

5.6. RESIDENCE OF TRUSTS:

Trusts like partnerships, are not liable to tax *per se*. Trusts are taxable provided there is taxable income. Generally tax liability is on the trustee in his fiduciary capacity but if vesting has occurred, i.e. the beneficiary has become entitled to the trust income, the beneficiary will be taxable. The residence of a trust would, therefore, be determined in relation to the management and control of the fund (trustees) and its beneficiaries.

Section 8 of the Lesotho Income Tax Order provides that a superannuation fund is a resident fund if:

- (a) it is organised in Lesotho and operated for the principal purpose of providing superannuation benefits to resident

individuals; and

(b) it has its management and control in Lesotho.

It should be noted that the two requirements are not alternatives, they must, therefore, both be satisfied to qualify a fund for residency. Organisation of a superannuation fund in Lesotho means execution and registration of the trust deed in Lesotho. For a fund to qualify for being operated under section 8, its main objective must be to provide superannuation benefits to the individuals who are residents in terms of section 5. Local management and control of the fund will be determined as for companies, i.e. focusing on where major management decisions are made.

5.7. CONCLUSION:

The Lesotho Income Tax Order has incorporated the general principles found in the United Kingdom as rules for residence. However due to the peculiar economic position of Lesotho, new classes of residents such as the expatriate taxpayer (made up of foreign technical assistance personnel) have been designed. Due to the peculiar economic position of Lesotho and reliance on migrant worker remittances, these have also been exempted from taxation in Lesotho. The residence rules for companies, partnerships or trusts in Lesotho are similar as in South Africa and the United Kingdom.



CHAPTER 6

SOURCE AS A BASIS FOR TAX LIABILITY IN LESOTHO

6.1. INTRODUCTION:

It should be recalled that gross income of a resident taxpayer includes "income from all geographical sources" while that of a non-resident taxpayer includes only "Lesotho-sourced income" (section 17(2) and (3)). Having devoted the earlier parts to the question of residence, it will be worth examining what constitutes Lesotho-sourced income. The relevance of this exercise is particularly significant for the taxation of non-residents.

Section 103 of the Lesotho Income Tax Order provides statutory source rules which are exhaustive. In other words "any income which is not Lesotho-source income is foreign-source income" [see section 103(2)]. Determination of what constitutes foreign-source income is not only relevant *vis-a-vis* non-residents, but also for residents. This is due to the unilateral tax relief provisions under section 105. In the absence of the Double Taxation Treaty existing between Lesotho and a foreign country, Lesotho will credit its residents accordingly, for foreign tax paid in a foreign country, presumably from foreign-source income.

Under the 1981 Lesotho Income Tax Act, source was determined according to the general principles which have been developed by the courts of the Republic of South Africa and the United Kingdom. However, it is not always easy to determine source according to these rules which at best are guidelines. Thus de Villiers JA in *Rhodesia Metals Ltd (in liquidation) v COT* stated (in a dissenting judgment):

"Source means not a legal concept but something which the practical man would regard as a real source of income. ... The ascertaining of the actual source is a practical hard matter of fact."¹³⁷

This passage provides the test and guidance on the meaning of "source".

6.2. MEANING OF "SOURCE":

The Lesotho Income Tax Order has no definition of "source". Guidance is from case law. It has been laid down authoritatively that the question of source of income is a "hard practical matter of fact" which a practical man would ascertain. The leading authority is the case of *CIR v Lever*

¹³⁷ *Rhodesia Metals Ltd (in liquidation) v COT* 1938 AD 282 at 300, 9 SATC 363, being a quotation from a judgment of Isaacs, J, in an Australian case, *Nathan v FCT* 25 CLR 183

*Bros and Unilever Ltd*¹³⁸ where Watermeyer CJ, as he then was, analysed the word "source" as it appeared in the South African Income Tax Act 31 of 1941. The learned Chief Justice pointed out that the word has several possible meanings but he chose to dwell on two meanings. These were use of "source" figuratively, where in relation to receipt of money it meant "the originating cause" of the receipt of money or as "the quarter from which" the money is received. The inference in the two possible meanings were according to Watermeyer CJ, derived from a series of decisions both local and foreign, which dealt with the meaning of the word "source". He went on to point out 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

138 See *CIR v Lever Bros and Unilever Ltd* 1946 AD 441, at 449-50; 14 SATC 1 at 13, and also *Rhodesia Metals Ltd (in liquidation) v COT* 1940 AD 432, 11 SATC 244 where the often quoted judgment of Isaacs J above, in an Australian case *Nathan v FCT* 25 CLR 183 was approved

else. Often the work is a combination of these."¹³⁹

The learned Chief Justice went on to highlight the possibilities of multiplicity of sources occurring in different countries and the lack of any guiding decision then on the use of apportionment.

The Lesotho Income Tax Order does not make provision for apportionment where there are multiple sources for one income. The provision on foreign tax credit may arguably be some form of apportionment of income but this would be stretching the concept too far. The fact which remains is that even though, as stated above, "source" of income is supposed to be a practical matter, the issue of ascertaining it remains problematic. This is due to the concept's susceptibility to manipulation. The process of identifying a source of income differs depending on the nature of income in question. It, therefore, becomes a tedious task to formulate any guidelines or general principles.

In the Australian case of *Esquire Nominees Ltd (Trustee of Manolas Trust) v ICT*,¹⁴⁰ where the issue was the source of dividend income, Stephen J made pertinent remarks regarding the meaning of source and these are as follows:

139 *CIR v Lever Bros and Unilever Ltd* 1946 AD at 450

140 *Esquire Nominees Ltd (Trustee of Manola Trust) v FCT*, Full High Court of Australia, (1973) 4 ATR 75 at 87

"The word 'source' has a quite variable meaning, depending upon the context in which it appears. A river's source may refer to the locality from which come the waters which go on to make up its stream or to its origin in melting snows or monsoonal rainfall; the first is a purely locational concept, the second is concerned rather with the character of its origin. In the present case it is clear that it is in a locational sense that 'source' is used.

Again as in problems of causation, the answer to any question as to 'source' or 'origin' must depend upon whether a proximate or a remote, or perhaps ultimate, source or origin is enquired after."

It becomes clear, therefore, that apart from the problem of different meanings of "source", the type of income at issue and the degree of causation are important factors to be borne in mind in conceptualising "source". The originating cause test and the location test will be used in this analysis. Where there are a number of sources the task becomes complicated. When a multiplicity of sources arise the main (real, dominant or substantial) source is decisive.

The statutory source rules under the Lesotho Income Tax law will be outlined and examined *vis-a-vis* the established general principles. The South African Income Tax Act has over the years enacted deemed-source provisions. These will also be

incorporated in the evaluation. Harris¹⁴¹ classifies sources of income in two types: the "source type", which focuses on the type of activity from which the income is earned such as employment, business, property or capital gains, and "geographical source" which focuses on the geographical territory within which the income is earned. This classification will be referred to in this thesis.

6.3. STATUTORY SOURCE RULES IN LESOTHO: SECTION 103:

Section 103 of the Lesotho Income Tax Act provides comprehensive source rules which, as submitted above, are exhaustive. The provisions of the above-mentioned section are subdivided into paragraphs (a) to (m). Some source rules are re-enactment of generally accepted principles while some are a "legal fiction".

- (a) **Income derived from any activity which occurs Lesotho is Lesotho-source income (underlining mine) [section 103(1)].**

This is the general rule which focuses on the geographical territory of Lesotho. Justification for source as a basis for tax liability is that a country which produces wealth by virtue of its natural resources or the activities of its inhabitants

141 Harris E.C., *Canadian Income Taxation*, Butterworths 1979 p 109

is entitled to a share of that wealth.¹⁴² This rule, therefore, draws on any activity occurring in Lesotho as its rationale. Under this rule fall many activities such as employment income, business income or any services rendered. It would therefore seem that unless the situation has been specifically covered under the subsequent paragraphs, subsection 1(a) in its generality may be invoked. The focus here is on the location or geographical territory of Lesotho. The South African so-called "activities test" as applied in the case of *CIR v Epstein* 1954 (3) SA 689 (A) (to be discussed later under subparagraph (e)), falls under this rule. It is therefore a normal source rule/test.

- (b) **Income derived from services performed under a contract entered into with the Lesotho Government is Lesotho-source income [section 103(1)(b)].**

It should be noted that under this provision it is immaterial where the contract for services was entered into, as long as it is entered into with the Lesotho Government the requirement would be satisfied. Presumably, the services rendered would be performed in Lesotho, though one can imagine situations of contract of services entered into abroad with the Lesotho missions abroad.

142 See *Kerguelen Sealing and Whaling Co Ltd v CIR* 1939 AD 487 at 507; 10 SATC 363, discussed at page 133 *infra*

The employment service of Lesotho diplomatic staff abroad would fall under this category, though in any event the test of residence of individuals under section 5 will also cover the situation adequately. The services of the foreign contractors of the Lesotho Highlands Water Scheme may fall under this category. It may be a variety of services involved.

The *prima facie* test of source for payment for services rendered is the place where these services were rendered.¹⁴³ The types of services will vary e.g. employment, contract, sale of goods etc. Thus in *Millin v CIR*,¹³⁴ Solomon CJ held that it was the exercise of Mrs Millin's wits and labour that produced the royalties in issue and that these were employed in the Republic of South Africa in both writing the book and dealing with her London publishers. It mattered not, on the analogy of *Overseas Trust Corporation Ltd v CIR*¹⁴⁴ case, that the contract granting the publishers the right to publish Mrs Millin's book was entered into in England. The test applied here was that of the "originating cause", the *quid pro quo*. Without Mrs Millin's employment of her wits to write the book, there would have been no contract of publication. Therefore, the Appellate Division held that South Africa was the source of the royalty income received from her novel. Similarly, in

143 See ITC 77 (1927) 3 SATC 72; *Millin v CIR* 1928 AD 207, 3 SATC 170; *CIR v Lever Bros* 1946 AD 441, 14 SATC 1; *CIR v Epstein* 1954 (3) SA 689 19 SATC 221; *COT v Shein* 1958 (3) SA 14 (FC), 22 SATC 12

144 *Overseas Trust Corporation Ltd v CIR* 1926 AD 444, 2 SATC 71

Whitfield v CIR,¹⁴⁵ the taxpayer, ordinarily resident in South Africa and employed by a South African company as footwear salesman, was held to have earned commissions for services rendered outside South Africa. His absence which involved a substantial period of regular visits in neighbouring territories was held to be a fixed and permanent *modus operandi* not temporary absence.

The Lesotho-source income rule in paragraph (b) above, by focusing simply on the services rendered for the Government of Lesotho under a contractual arrangement irrespective of where the contract was entered into and the place where those services were rendered, departs from some of the general principles of source as enunciated in case law. In *CIR v Lever Bros and Another* 1946 AD, the issue was the source of income of a South African company which superseded the original purchaser and had to provide certain services which included provision of credit in England. No activity under the contract took place in South Africa, if all took place abroad. The Appellate Division held that the source of the income earned was certainly not South Africa, but where the services were rendered. Similarly in *COT v Shein* 1958 FC, the taxpayer was engaged to manage a store in Botswana. He normally resided at the store but some years later, he arranged for someone to manage the store for him (storekeeper) while he went to live

145 1993 (2) SA 236 ECD where section 9(1)(d)*bis* which deems source to be from the Republic of South Africa was held not applicable on commission earned outside the Republic of South Africa

in Bulawayo. He made private arrangements for paying the storekeeper out of his remuneration and spent the first four days of each month in Botswana supervising the store. He performed for a few hours some work, in each month, in Bulawayo. The Rhodesian Commissioner of Tax sought to assess the taxpayer for tax on a certain portion of the earnings derived from the store in Botswana. It was held that the source of income accruing to the taxpayer was Botswana and the appeal of the Commissioner of Tax was, therefore, dismissed. The Court pointed out that the services rendered were mainly in Botswana, delegation of duties to the storekeeper did not change the nature of the arrangement. The work performed in Bulawayo was casual and incidental in nature. It was so trivial that, since he was not even paid separately for these extraneous duties, it would be artificial to propose apportionment in the circumstances.

The Lesotho-source income rule in paragraph (b) above is similar to the South African deemed source rule under section 9(1)(e) of the South African Income Tax Act. The rule provides that any services rendered by work or labour on behalf of the South African Government, including any provincial administration or local authority or the South African Tourist Corporation or the Council for the Scientific and Industrial Research are deemed to be from a source in the Republic, notwithstanding that such services are rendered outside the Republic. The services rendered have to be in accordance with a contract of employment entered into with the body concerned. Note should

of course be taken that the Lesotho rule does not have the many qualifications reflected under the South African deeming provision. Definition of the "Lesotho Government" under section 3(1) includes:

"a statutory corporation and any other body in which the Government or a statutory corporation has a controlling interest."

It is submitted that the Lesotho provision covers not only the services rendered to the Government and its agencies but also bodies in which the Government or the parastatal corporations have a controlling interest. Note should also be taken that the deemed-source provision by nature deems income to be from a source which on normal source rules would not qualify.

(c) Income derived by a resident of Lesotho from services performed as a driver of a vehicle, or an officer or member of the crew of any vehicle or aircraft, where the services are performed both in and out of Lesotho is Lesotho-source income [section 103(1)(c)].

This provision is similar to the South African deeming provision under section 9(1)(f) which provides that amounts received by or accrued to a person by virtue of services rendered, work or labour done by a person ordinarily resident in South Africa, as officer or member of the crew of any ship or aircraft owned by a domestic company or a person ordinarily

resident in South Africa, shall be deemed to be from the South African source, notwithstanding that such services are rendered outside South Africa nor that payment is made elsewhere. The Lesotho provision does not make reference to the ownership of the vehicle or aircraft nor does it refer to the question of payments for the services rendered. This is because a Lesotho citizen is taxed on a world-wide basis and that provision would, therefore, be rendered nugatory. It will be presumed that income arising under this rule will be dealt with in conjunction with foreign employment of residents.

- (d) **Income derived from immovable property located in Lesotho, including gains from the disposal of an interest in such immovable property and from the disposal of shares in a company the property of which consists directly or indirectly principally of interests in immovable property located in Lesotho is Lesotho-sourced income [section 103(1)(d)].**

Note should be taken that emphasis here is on income from immovable property located in Lesotho. A limited capital gains tax has been introduced under the new Lesotho Income Tax Order. This provision covers rental income from leasing of immovable property as well as sale proceeds from immovable property. The leading case here is that of *Rhodesia Metals Ltd (Liquidator) v COT*.¹⁴⁶ An English company located and registered in

146 *Rhodesia Metals Ltd (Liquidator) v COT* 1938 AD 282, 9 SATC and 1940 AD 432, 11 SATC 244

England, had the sole business of mining claims in Rhodesia. The mining claims were sold to another English company and the issue before the Court was the source of the income derived from the sale. The Appellate Division's judgment which was upheld by the Privy Council, was that the source of the income received was Rhodesia, where the immovable property was situated. Issue was made of the fact that in effect, no capital had been employed in Rhodesia and that the taxpayer was resident in London where the contracts were also concluded. Notwithstanding, the Court found that the immovable property in Rhodesia was the basic, substantial or dominant source.

In the Rhodesian case of *COT v British United Shoe Machinery (SA) Pty Ltd*¹⁴⁷ the South African company dealing with machinery used in the manufacture of shoes had its machines leased to a trader in Rhodesia. The Court held that, since it was the machine which gave rise to rental income, the source of rental income was where the machines were located and utilised, i.e. Rhodesia. It would seem that if rental income is derived from leasing of immovable property, the location of that immovable property will be the source of income. According to Meyerowitz¹⁴⁸ the place where the contract of letting is entered into and the place where the leased article is used is not conclusive when dealing with movable property. However, in the case of immovable property, the source will invariably be

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

148 Meyerowitz and Spiro on Income Tax at page 62 para 210

the place where it is situated. The usage of the property is the dominant cause for rental income. Thus the Lesotho source rule in paragraph (d) is an enacted normal source rule relating to source of income of immovable property. This is Harris' "geographical source" test.

The other leg of the provisions of paragraph (d) refers to "disposal of shares in a company the property of which consists directly or indirectly principally of interests in immovable property located in Lesotho". The above-mentioned case of *Rhodesia Metals Ltd (in liquidation) v COT* is also relevant in this context since it involved disposal of mining claims.

Property income under section 20 of the Income Tax Act has been defined to exclude capital gains from the disposal of personal assets; for instance, disposal of private residence will not be property income. It includes income derived from the following listed sources: dividends, interest, natural resource payments, rent, royalties and gains on the disposal of investment assets. Specifically excluded are business or employment income.

- (e) **Income derived by a resident of Lesotho from the disposal of movable property, other than business income, derived from a business conducted outside of Lesotho, is Lesotho-source income.**

"Disposal" is a broadly defined term under section 3(1). It

will include any change of ownership (sale, gift etc) irrespective of loss or gain with the exclusion of business income from business conducted outside Lesotho. Note should be taken that under the new Lesotho Income Tax law, there is no distinction between income and capital gains in the context of business i.e. revenue and capital. Every asset in a business regardless of whether it is revenue or capital in nature, is a business asset. The general source rule for business is that the source is where the business is carried on or where the capital is employed, whichever is the dominant.¹⁴⁹ "Business" under section 3(1) is defined quite broadly, it includes a trade, profession, or vocation, and an isolated transaction with a business character. It would, therefore, seem that the analogy of the tree and the fruit will not be of much relevance for Lesotho business income as contrasted to the prevailing South African position. Furthermore it would seem that the tricky distinction between "carrying on business" and "a profit-making scheme" as characteristics of trading in the revenue and capital debate in South African tax law,¹⁵⁰ is not of much relevance. According to the definition of "business" in the Lesotho tax law, it would not matter that it was a single adventure in trade.

149 See *Overseas Trust Corporation Ltd v CIR* 1926 AD 444, 2 SATC 71; *CIR v Black* 1957 (3) SA 536 (AD), 21 SATC 226; *CIR v Epstein* 1954 (3) SA 689 (AD) 19 SATC 221

150 See e.g. *CIR v Pick 'n Pay Employee Share Purchase Trust* 1922 (4) SA 39 (AD), 54 SATC 271

Factors which in the past have been taken to constitute a business/trade in the decided cases are as follows: intention of the taxpayer to have profit as the main motive for the activity in question, scale of activities, continuity of the activity, commercial character of the transaction, system and organisation. No single factor is decisive and even though profit-making and repetitiveness are the hall marks of a business, an isolated transaction will not negate the character of the activity in question. Thus, in an English case of *Edwards v Bairstow*,¹⁵¹ the House of Lords held that the sale of a spinning plant even though an adventurous isolated transaction by two gentlemen with no special skill, constituted carrying on a trade.

Disposal of movable property includes any change of ownership. There is an Australian case¹⁵² which suggests that the term may be given an extended meaning to include a compulsory acquisition. Other questions which arise would be whether an exchange of property or a trade-in arrangement would also constitute disposal of movable property. It is submitted that they would since in the two instances, ownership changes and this is for a return, a *quid pro quo*. Even an outright donation is included.

151 *Edwards v Bairstow* [1955] 3 All ER 48 (HL)

152 See *Steinberg v Federal Commissioner of Taxation* (1975) 5 ATR 565

The case of *CIR v Pick 'n Pay Employee Share Purchase Trust*,¹⁵³ is a typical example of how thin the line can be in the distinction between income and capital gains in the business context. The facts were that the Pick 'n Pay Group established a trust for its employees incentive scheme whereby shares were sold to the employees at the market price with the purchase price remaining outstanding. The employees could forfeit shares if services were terminated within five years or at any time due to dishonest or fraudulent conduct. The share price was payable in five years. Profit arose in the years of assessment from the forfeiture of shares and there were losses as well. The issue, therefore, was the nature of the transaction - was it a share dealing profit-making scheme? The Appellate Division in the majority judgment held that the trust was not sharedealing, therefore there was no scheme of profit-making. The profits made were purely fortuitous in that they were incidental to the main purpose of the scheme, which was to provide an incentive to its employees. The proceeds were, therefore, of a capital nature and not income/revenue. A dissenting judgment (2:3) held that the shares were floating and not fixed capital and that the proceeds were therefore of a revenue nature, not capital. Notwithstanding the primary purpose of the scheme as incentive to its employees, the dissenting judgment went on to hold that the trust nevertheless contemplated profits arising from the trading in shares. It should be noted that the majority decision was based on the test of the "scheme of profit making" to the exclusion of all

153 See citation at footnote 141 *supra*

other factors.

The determination of source of income becomes complicated in the cases of multiplicity of sources. These are instances of cross-border transactions where other jurisdictions are potential sources of income. Note should be taken that "business income derived from a business conducted outside Lesotho" under paragraph (e) has been excluded. It is submitted that notwithstanding this exclusions, a determination will still have to be made as to whether a particular "business income is derived from a business conducted outside" Lesotho. The complexity of this exercise will be illustrated by the following cases:

In *CIR v Epstein*¹⁵⁴ a South African resident entered into a partnership agreement with an Argentinean company for purchase of asbestos in South Africa, shipping it and selling it in Argentina. The profits were shared equally and the issue was the source of the profit of the South African partner. It was held that since the profits arose from the taxpayer's activities in South Africa, not as a result of sale of the asbestos in Argentina, the source of his half share was South African.

In the case of *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax, Botswana*,¹⁵⁵ a South African company

154 *CIR v Epstein* 1954 (3) SA 689 (AD), 19 SATC 221

155 *Transvaal Associated Hide and Skin Merchants v COT, Botswana* 1967 30 SATC 97

traded with raw hides acquiring them from an abattoir in Lobatse, Botswana for resale in South Africa. The Court held that even though the business transactions extended between Botswana and South Africa, the process of salting and preparing the hides in Botswana was the dominant cause of the accrual of income and the source was therefore Botswana. The curing of the hides was found more dominant than the selling of the wet salted hides. Without this crucial process of curing, there would have been no hides to sell.

Note should be taken that since then, South Africa has introduced section 9(1)(a) which departs from the normal source rules. This section deems proceeds from a contract concluded in South Africa, for the sale of movable goods, to be from a South African source irrespective of where the goods are to be delivered.

Another relevant case is that of *Overseas Trust Corporation Ltd v CIR*¹⁵⁶ which involved a South African company which sold shares in Germany. It was held that the company earned the profits from the employment of its capital in South Africa in acquiring the shares and the source was, therefore, South African. In contrast, in *CIR v Black*,¹⁵⁷ a stockbroker based in Johannesburg bought and sold some shares in London and the issue was the source of profits accrued from the sale. The Court held that South Africa was not the source as the

156 *Overseas Trust Corporation Ltd v CIR* 1926 AD 444

157 *CIR v Black* 1957 (3) SA 536 (AD), 21 SATC 226

stockbroker employed his capital in London and realised his profits there. The Johannesburg share-dealing business was regarded as distinct from the London sharedealing which was in fact found to be secondary.

It should, therefore, be noted that under paragraph (e), the Lesotho-source rule has enacted the general principle of source income arising from disposal of movable property. However as seen from *Epstein's case supra*, *Transvaal Associated Hide and Skin case supra*, *Overseas Trust Ltd case supra*, and *Black's case also supra*, there is always the potential problems of multiplicity of sources. What constitutes the main, dominant cause of income and the associated issue of apportionment often arise. No doubt the conclusion of double tax treaties where relevant would alleviate the problems of double taxation as unjustified taxation, particularly between Lesotho and South Africa.

(f) Income derived from the disposal of a membership interest in a resident company is Lesotho-source income.

Section 3(1) defines the term "disposal" in a rather broad manner. Disposal of an asset does not only cover change of ownership under the general principles but is extended. It means:

- (a) the sale, exchange, redemption or distinction of the asset; or

- (b) the transfer of the asset as a gift; or
- (c) the destruction, loss, or extinction of the asset, including the disposal of a part of an asset but does not include the passing of an asset to the personal representative of the deceased taxpayer or a beneficiary.

It therefore means that "disposal" in this context will not be limited to cases of gains only, even losses would be covered.

The term "membership of interest", in relation to a company has been defined to include a share.¹⁵⁸ Note should be taken of the significance of "include" i.e. denoting it covers any equity interest in a company. Disposal of membership interest in a resident company will, therefore, include a normal sale of shares (one's shareholding), a cancellation or redemption of a share or debenture and a variation of share rights. Note should be taken that "residence" is a factor only in so far as a company in question is concerned. The taxpayer could be a resident or non-resident shareholder.

It would also seem that liquidation, whether formal (by winding up under the Lesotho Companies Act)¹⁵⁹ or informal, as when shareholders of a company appropriate its assets to themselves, distributions received will also be treated as a disposal by

158 Section 3(1) definition of the term "membership interest".

159 The Lesotho Companies Act No 25 of 1967

the members of their membership interest in the company. It should be noted that the definition of "dividend", in the Income Tax Order,¹⁶⁰ even though broad to include any distribution by a company to a member of the company by virtue of membership, it specifically excludes liquidation distribution. The tax treatment of a liquidator's distribution is beyond the scope of this dissertation. It would seem that by the use of "the destruction, loss or extinction of the asset" to also denote disposal, a disposal occurs even where no one acquires the right/interest in a resident company.

It will be recalled that the three alternative tests for residence of a company are incorporation; management and control; or having the majority of operations undertaken in Lesotho. Taxation by source in this context may give rise to anomalies, for instance where a company has been deemed resident by virtue of mere incorporation in Lesotho while most of its major operations are in Namibia. One of the questions which may prove difficult to answer, therefore, would be the justification or taxation in Lesotho in such circumstances.

- (g) **Income derived from the rental of movable property used in Lesotho is Lesotho-source income.**

The most cited case in regard to source of rental income from movable property is that of *COT v British United Shoe Machinery*

160 See definition of dividend under Section 3(1) of the Lesotho Income Tax Order

(Pty) Ltd.¹⁶¹ This Rhodesian case involved a South African company which leased machinery for shoe manufacture to a trader in Rhodesia. There were no branch offices in Rhodesia and the letting contract was for a long duration. The Court held that it was the machinery which gave rise to rental income and that the source of such income was where the machinery was located, i.e. Rhodesia. Note should be taken that the taxpayer in this case carried on business as a dealer in footwear manufacturing machinery either by selling or leasing. Leasing accounted for about 59% of the taxpayer's business activities.

According to Meyerowitz,¹⁶² the above-mentioned case of *British United Shoe Machinery (Pty) Ltd*, does not provide the general rule for source of income derived from rental of movable property. Silke¹⁶³ is of the same opinion. It would seem that as a general rule, source of rental income of movable property is determined by examining whether the use of the property or the business activities of the lessor is the dominant, originating source of the income. Thus neither the place where the article leased was used nor the place where the leasing contract was entered into would be conclusive, as to the source of the rental income in question. It would seem that, in leasing smaller articles such as motor cars for limited short periods, the business of the lessor would be the

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

162 Meyerowitz and Spiro on *Income Tax* (supra) at p 62, para 210

163 Silke on *South African Income Tax*, Memorial edition 1994 Service 6 Vol 1 para 5.12, p 5-19 to 5-21

source of the rental income, i.e. the business would be the dominant originating cause.

Another relevant case in this context is that of ITC 1087¹⁶⁴ where a company resident in Sweden manufactured machines for making containers and also derived considerable income from rentals for the use of the machines in Rhodesia. The Court basing its decision on the case of *British United Shoe Machinery (Pty) Ltd* above, held that the source of the rentals was Rhodesia, where the movable property was used.

The Lesotho-source rule in paragraph (g) above, has enacted the ratio found in the above-mentioned Rhodesian cases of *British United Shoe Machinery (Pty) Ltd* and ITC 1087. The determining factor is the "use" of the rented movable property in Lesotho. This rule has restricted the general rule of source income of rented movable property since one can envisage cases whereby, even though an article is rented in Lesotho or anywhere else for that matter, its use could be anywhere. It is submitted that all other factors such as where the contract of leasing was entered into, its duration, the place where the article was used and the taxpayer's business operations in general, should have been included in determining the source of rental income of movables. A more equitable source of the income could then be deduced.

- (h) **Income derived from the sale or licence of industrial or intellectual property used in Lesotho is Lesotho-source income.**

This situation will arise in the utilisation of industrial or intellectual property in Lesotho. The term "royalty" has been broadly defined in the Order. It means a payment for:

- "(a) the use of, or the right to use, a copyright, patent, design or model, plan, secret formula or process, trademark, or other like property or right; or
- (b) the use of, or the right to use, industrial, commercial, or scientific equipment; or
- (c) the supply of know-how; or
- (d) the use of, or right to use, a cinematographic film, video tape, sound recording, and any other like medium; or
- (e) the supply of assistance ancillary to the matters referred to in paragraphs (a) to (d); or
- (f) a total or partial forbearance with respect to a matter referred to in paragraphs (a) to (e)."¹⁶⁵

In *Millin v CIR*¹⁶⁶ the issue was the source of payments received by Mrs Millin from the sale of her book through her publishers in England. The book was written by Mrs Millin in South Africa but the right to publish it was given by her in a contract entered into in England with her publishers in return for which she received royalties. It was held that her wits, labour and intellect in writing the book and dealing with her publishers were exercised in South Africa and that these were the source of her income not the contract.

The Lesotho-source rule for payments arising in whole or part from industrial or intellectual property focus on the geographical location of the "use" of the rights. It will therefore be immaterial where the contract of use of the intellectual property was entered into nor where the discovery was made i.e. the activities which culminated in the intellectual property. The rule covers outright sales as well as leasing arrangements (licence) of these rights.

Note should be taken of the South African deeming source rule for royalties under section 9(1)(b). This rule deems any income arising from the use, or right of use, or the grant of permission to use in the Republic of South Africa, any patent, trade mark, copyright, or any model, pattern, plan, formula or process, motion picture, film, video tape, disc, advertising matter, irrespective of where it has been produced, to be from

166 See *Millin v CIR*, *supra* footnote 134, 1928 AD 207; 35 SATC 170

a South African source. The similarities between the Lesotho-source rule under paragraph (h) above and the South African deeming source rule under section 9(1)(b)¹⁶⁷ should also be noted. They both focus on "use" in the respective territories. The South African rule has, however, excluded residents of any neighbouring country, any external company as well as persons not ordinarily resident in the Republic. The Lesotho-source rule has no such exclusions and it will be therefore immaterial whether the "user" is resident or not.

- (i) **Interest where the debt is secured by immovable property located in Lesotho, where the borrower is a resident of Lesotho, or where the borrowing relates to a business carried on in Lesotho is Lesotho-source income.**

"Interest" has been broadly defined under the Lesotho Income Tax Order. The definition does not only cover the ordinary meaning which is "an amount paid or accrued under a debt obligation which is not a return of capital", but also includes "any discount, premium, swap payment, or similar payment".¹⁶⁸ The expanded definition keeps up to date with the trends in international lending and borrowing transactions. Use of documents, premiums and swap payments are but features of interest payments in international finance transactions today.

167 See Section 9(1)(b) of the South African Income Tax Act

168 See section 3(1) of the Lesotho Income Tax Order.

The Lesotho-source rule on interest income relates to three broad situations: (i) a debt secured by immovable property in Lesotho; (ii) where the debtor is a resident of Lesotho; or (iii) where the debt incurred is related to a business carried on in Lesotho. "Interest" in these instances may be in the form of a loan interest/investment interest, mortgage interest or *mora* interest, the latter being interest charged for delay in making payment(s) timeously and as such incidental to the main obligation.

The question of source of interest income epitomises the fruit/tree analogy. The leading case in this context is that of *CIR v Lever Bros and Unilever Ltd, supra*,¹⁶⁹ where all the authorities were reviewed. Watermeyer CJ in whose majority judgment Davies AJA concurred (with Schreiner JA dissenting), held that notwithstanding that the debtor in respect of the loan by the taxpayer resided in South Africa, the interest was not received from a source within South Africa and did not, therefore, form part of the taxpayer's gross income. In his reasoning, the learned Chief Justice, as he then was, made pertinent remarks regarding the source of interest income:

- that "provision of credit is the originating cause or source of the interest received by the lender", rather than the debt *per se*;

169 See *CIR v Lever Bros and Unilever* cited in footnote 138 above *ff*, facts discussed *infra*

- the source of income in business operations is where the trade or business is habitually carried on, i.e. the place the capital is employed to earn income;
- the mere fact that a debtor resides in a given country does not make that country the source of interest paid. A proper enquiry on the real source of interest paid has to be conducted and this relates to ascertaining the originating cause and thereafter its locality.

Turning to the facts of *Lever Bros and Unilever Ltd*, Watermeyer CJ found that a company registered in South Africa entered into an agreement abroad the effect of which was that it undertook an obligation of an overseas company to pay to the taxpayer, another overseas company, interest upon a large sum of money which was the unpaid portion of the purchase price of a large holding of shares in companies registered and carrying on business abroad, the shares remaining pledged to the taxpayer. No business was carried on in South Africa, no contract was entered into in South Africa, no capital was employed in South Africa and no services were rendered in South Africa except possibly the flotation of the South African company. Further, it was found that as a precondition for the involvement of the South African company in the transaction, the Treasury had stipulated that no payment of capital or interest would be made from assets/any funds in South Africa and that this condition was observed. In dismissing the appeal of the Commissioner seeking to tax the interest payable by the South African

company over the debt it had taken over, Watermeyer CJ pointed out that despite some difficulty of differentiating the reasoning of the practical man from that of the theoretical lawyer, one thing certain was that no practical man could ever come to the conclusion that the money came from a source in South Africa. The interest was, in fact, paid from funds received by the South African company from the United States as dividends on shares held there.

Davis AJA in similar fashion expressed the view that even though the practical man may have some difficulty in deciding "whether the source was located in England, where *inter alia*, the contracts were made, where the trustee was situated, where credit was given and where all payments had to be made, or whether it was in America where the assets were situated, and where those assets earned the money out of which the interest was paid. But the one place he would not choose would be South Africa."¹⁷⁰

Schreiner JA in his dissenting judgment pointed out that "if one accepts that the locality of a debt as depending on the place where it is recoverable, the general rule, which is not peculiar to any particular system of law, is that actor

170 *CIR v Lever Bros and Unilever Ltd*, 1946 AD 441 at 464-465. Reference to the "practical man" being application of the often quoted passage from a judgment of Isaacs J in an Australian case of *Nathan v FCT* 25 CLR 183 (see footnote 123 above). The passage has been referred to in approval by De Villiers JA and Lord Atkin in the Privy Council in the *Rhodesian Metals* case (1938 AD 282; 1940 AD 432)

sequitur forum rei"¹⁷¹ (i.e. the plaintiff follows the defendant's court/residence in instituting proceedings) and consequently, the South African company could be sued to recover the capital and interest. The residence of the debtor, therefore, was according to the learned Judge, the natural situation of the debt and the source of the interest of the debt. The fact that the securities in the trust agreement were lodged in London was found immaterial. Where the debtor obtained the funds to pay the interest on his debt and the mode of transfer of the funds to the creditor were in the learned Judge's opinion irrelevant to the issue. The hypothetical practical businessman would be surprised if he were to be informed that "a source of interest on a long-term loan was the contract, made possibly decades ago, and not the loan debt itself."¹⁷²

The different bases on which the learned Judges arrived at their respective decisions show how flexible the concept of "source" can be.

Apart from loan/investment interest which was the issue in the *Lever Bros and Unilever Ltd* case, interest is often charged for the debtor's delay in making timeous payments. This was the case in *COT v William Dunn & Co Ltd*¹⁷³ which purchases were made by an agent in London on behalf of a principal in South

171 *Ibid* at p. 462

172 *Ibid* at p. 463

173 *COT v William Dunn and Co Ltd* 1918 AD 607

Africa where the goods were then despatched. Commission was payable to the agent, who also charged interest on the money advanced for the purchases. The Commissioner sought to tax the agent on the interest as recovered from a source in South Africa. It was held that since the agent company in making purchases and shipping the goods used its capital in its business in England, the interest was not received from a source within the Republic. Note should be taken that in this case the mere fact that the debtor (purchaser) was in South Africa did not affect the decision. The place where the taxpayer employed his capital to earn interest was the decisive factor. Meyerowitz¹⁷⁴ submits that interest *in mora* as was in this case, is incidental in nature as contrasted to the commission which was the main profit in the transaction.

Other relevant cases are the Special Court's decisions in *ITC 958*¹⁷⁵ and *ITC 1021*.¹⁷⁶ In *ITC 958*, T, a South African resident deriving income from employment in South Africa, made a loan of £4,500 in a contract concluded in South Africa to one N, a resident of South West Africa. On instructions of N, £2,500 of the amount was made payable to a creditor in South Africa while the balance of £2,000 was remitted to N in Windhoek. A mortgage bond for £4,500 was registered in Windhoek in favour of the South African taxpayer. Having been assessed on the amount of interest received, the South African taxpayer

174 *Meyerowitz and Spiro on Income Tax* para B 196

175 *ITC 958* (1960) 24 SATC 640

176 *ITC 1021* (1963) 25 SATC 416

contested this. The court held that interest was from the source within the Republic. The reasoning was that the loan contract and the payment of the money to the borrower were made in South Africa and therefore the source of interest was South Africa. The court also made reference to the place of payment of interest being South Africa but, according to Meyerowitz,¹⁷⁷ relying on the judgment of Watermeyer CJ in *Lever Bros* case (*supra*), no significance has to be attached to the place where the interest is payable. Silke¹⁷⁸ submits that on the principle established in the *Lever Bros* case, the taxpayer ought to have succeeded in his appeal at least in regard to the interest payable, on the balance made available in South West Africa, i.e. £2,000. To this extent, it is submitted that the decision did not follow the principle in the *Lever Bros* case. Note should be taken that the Court did not make an apportionment but viewed the loan contract that gave rise to the obligation to pay interest as a composite single transaction.

Another case *ITC 1021*, involved a taxpayer who under a contract entered into in South Africa succeeded a retiring participant in a mortgage bond over property in South West Africa (then) and the issue was the source of the interest received. It was held that the source of the interest received was South West Africa, since, notwithstanding that the contract by which the

177 *Meyerowitz and Spiro on Income Tax* para B 206

178 *Silke on South African Income Tax* vol 1 para 5.10 pages 5-15 to 5-17

taxpayer succeeded the retiring participant was entered into in South Africa, the original arrangement in providing the mortgagor with credit was in South West Africa. It was common cause that the source of the interest in the case of the original participants in the mortgage bond was South West Africa. The Commissioner, however, contended that it was the taxpayer's activities in South Africa which resulted in his being substituted as participant in the bond. The originating cause of interest was held to have not been affected by the acquisition of the new participant, it was the provision of the credit, as laid down in the case of *Lever Bros and Unilever*, in South West Africa.

South Africa has deeming source provisions in respect of interest received from building societies and banks in South Africa as well as interest from a neighbouring country accruing to a resident/domestic company but excluding cases of business carried on through a permanent establishment in the neighbouring country.¹⁷⁹ Neighbouring country refers to Namibia, Botswana, Lesotho, Swaziland and any territory which was formerly part of South Africa i.e. former TBVC. Note should also be taken that a "domestic company" is according to the South African Income Tax Act, one which is registered or managed and controlled in South Africa. The "permanent establishment" normally features under the double tax agreement and refers to "a place of management, a branch or office, a

179 See Sections 9(2), 9(3), 9(4) and 9(5) of the South African Income Tax Act

factory, a workshop, a mine, a quarry, a building site, or a construction or assembly project".¹⁸⁰

It should be noted that the Lesotho-source income rule regarding interest does not only encompass the general principles as enunciated in the cases of *Lever Bros and Unilever*, *COT v William Dunn and Co*, and the ITC decisions above, but has gone further to incorporate provisions similar to the South African deeming provisions above. The residence of the debtor/borrower *per se* was rejected in the *Lever Bros and Unilever* case but this is a factor in the Lesotho-source rule on interest. The provision of credit as the main dominant factor in the determination of the source of interest received may in these circumstances be eclipsed by the stated factors under subparagraph (i).

(j) A dividend, management fee, or director's fee paid by a resident company is Lesotho-source income.

The term "dividend" is broadly defined under section 3(1) of the Lesotho Income Tax Order. It means "a distribution by a company to a member of the company as member, other than a liquidation distribution". This broad definition has apparently been designed to catch payments which have in the past been made to avoid attracting tax.

180 See Huxham and Haupt, *Notes on South African Income Tax* 1993 at p 24

The general source-rule of dividend income is that it is derived from shares and therefore is located where the share register of the company is.¹⁸¹ This principle was supplemented by the case of *Lamb*¹⁸² which decided that the location of shares which are registered other than in the principal register will depend upon the particular statutory provisions which give rise to their recognition. Thus, where a branch register is deemed to be part of the principal register, shares in the branch register will be deemed to be located in the principal register as well. Note should however, be taken that in South Africa since dividends are no longer incorporated as part of taxable gross income, their source is no longer an issue of importance. Furthermore, non-resident shareholders' tax (NRST) which is essentially tax on dividends paid to non-residents, will be scrapped with regard to dividends declared on or after the beginning of October 1995.¹⁸³

Under the new Lesotho Income Tax Order, dividends paid to resident members are exempted from tax. The key factor is that the dividend be payable to a non-resident. Even though there is no tax payable by individuals on dividend income as stated above, dividends paid to non-residents attract withholding tax (with the exception of manufacturing income). Furthermore there is advance corporation tax which is imposed on dividends paid by a resident company including where dividends have been

181 See *Boyd v CIR* 1951 (3) SA 525 (AD); 17 SATC 366

182 *Lamb v CIR* 1955 (1) SA 270 (AD); 20 SATC 1

183 See the South African Minister of Finance's Budget Speech for 1995/96 on NRST abolition.

"deemed" to have been paid.

In view of the broad definition of "dividend" and the anti-tax avoidance provisions regarding disguised dividend and dividend stripping, a wide range of transactions which involve distribution of payments to a member/associate of a company are deemed dividends. These include interest free loan, excessive payment for services rendered or for property between the company and its members. The rationale for these deeming provisions is that a tax avoidance scheme was becoming prevalent in Lesotho whereby payments such as management fees were used to export profits free of tax from the subsidiary foreign registered companies investing in Lesotho. The director's fee is basically payment for services rendered and since these are for a resident company, it is only fair to assume that these were rendered in Lesotho, hence the source of income is Lesotho. The *ITC 235*¹⁸⁴ and *ITC 250*¹⁸⁵ cases draw a distinction between director's fees and the salary, which support deeming the director's fees to be from a source where the company resides.

- (k) **A pension or annuity payment by the Lesotho Government or resident or for services rendered or employment exercised in Lesotho is Lesotho-sourced income.**

184 *ITC 235, 6 SATC 263*

185 *ITC 250, 7 SATC 46*

In the first instance, the pension or annuity has to be paid by the Lesotho Government or a resident of Lesotho in order to qualify under this paragraph. Note should be taken that where the Government is involved it is immaterial in this context, where the payment was made or where the services were rendered. In the second alternative ground, for the pension or annuity to qualify as Lesotho-source income, the services or employment has to be rendered or exercised in Lesotho. Again it is immaterial where the payment was made and even where the service contract was entered into. There is no definition of the concepts in the Order and ordinary usage is adopted.

The leading case in South Africa in this context is that of *Boyd v CIR*,¹⁸⁶ in which Centlivres CJ stated *obiter* that:

"If a resident of the Union whose sole source of income is South West Africa pays in terms of a contract made in the Union an annuity to another person ... the source of that other person's income is the Union. It might be said that the ultimate source of the annuity is in South West Africa but, I do not think that on a proper interpretation of the word 'source' in the definition of "gross income" one is required to go back to the remote cause.¹⁸⁷ It is difficult to find any distinction in principle between my hypothetical annuity and the dividend in the present case. In both cases, before the

186 *Boyd v CIR* 1951 (3) SA 525 (AD), 17 SATC 366

187 *Cf Lovell and Christmas Ltd v COT* 1908 AC 46 at p 52

amount is paid, the debtor is a *persona* resident in the Union, the debtors are separate *personae* distinct from the *personae* who are the creditors and the *fons et origo* of the debt is a formal act performed in the Union."¹⁸⁸

The decision of *Boyd v CIR* (*supra*), has been applied on annuities to mean that the originating cause of the payment is the *fons et origio*, i.e. the origin of the formal act which gave rise to the annuity. This is often either the contract (contractual annuity) or a will (testamentary annuity). The other two requirements drawn from *Boyd's* case are that the debtor is a person resident within South Africa and that the creditor and the debtor are two separate persons. These principles have been applied with varying degrees in the Special Court cases of *ITC 826*,¹⁸⁹ and the Rhodesian *ITC 1069*.¹⁹⁰

The South African deeming sections 9(1)(g)(i) and (ii) cover pension and annuity payments for Government services, and non-Government services respectively. The treatment of the annuity or pension payments in the two categories differ and for Government services, such pension/annuity may in certain circumstances be exempt from tax.

188 *Boyd v CIR, supra* at 534

189 *ITC 826* (1956) 21 SATC 189

190 *ITC 1069* (19) 27 SATC 145, taken on appeal to the Appellate Division as *COT v R* 1966 (2) SA 342 (RAD). See also the 1972 *Tax Reporter* 279

Note should be taken that for the Lesotho-source rule under paragraph (k) above, whether the pension or annuity payment is made by the Lesotho Government (including parastatals) or by a resident of Lesotho, there is no discrimination to the tax treatment, unlike the prevailing practice in South Africa. As observed earlier, it is immaterial where the payment is made nor where the formal act originating the right to the payment was entered into. The Lesotho-source rule is in this case much broader than its South African counterpart.

- (1) **A natural resource payment for a natural resource taken from Lesotho is Lesotho-source income.**

The term "natural resource payment" has been broadly defined in the Lesotho Income Tax Order. It means:

"a payment for minerals or a living or non-living resource of the land, or a payment calculated in whole or in part by reference to the quantity or value of minerals or living or non-living resource taken from the land." ¹⁹¹

The Explanatory Memorandum to the Order points out that this definition would include concepts such as royalty for taking of natural resources. Examples such as removal of minerals or timber are cited. One would recall the furore which surrounded the question of imposing tax on some contractors who were

191 See Section 3(1) of the Lesotho Income Tax Order, 1993.

building roads and laying infrastructure for the Lesotho Highlands Water Project. The proposed tax/levy was for utilisation of quarry stones and the argument was that this amounted to alienation of a national asset without any compensation to the nation (to whom the land in Lesotho is vested). This provision will cover the exploitation or exploration activities under the Lesotho Mining Rights Act 1967. The definition according to the Explanatory Memorandum to the Order, is not intended to cover payments for crops or livestock.

South Africa has a deeming source provision under section 9(1)(fA) regarding amounts received or accrued for services rendered in respect of prospecting or mining activities beneath or above the Continental Shelf and under the Minerals Act 50 of 1991 or the Mining Rights Act No 20 of 1967 or under any sub-lease or lease arrangement within the territory. These are deemed to be from a source within the Republic notwithstanding where the payment for such services is made nor where the work is done.

It is submitted that under the Lesotho sub-paragraph (1), it would seem that it will also be immaterial where the services were rendered nor payment made, so long as it is for a natural resource taken from Lesotho such payment is deemed to be Lesotho-source income. A smuggled diamond sold in London emanating from Lesotho will, therefore, be covered under these provisions.

- (m) **Income derived by a resident of Lesotho in carrying on a business as owner or charterer of a vehicle, vessel or aircraft is Lesotho-source income.**

The general rule of source of business income is that it is located where the business is carried on or where the capital is employed, whichever is the dominant source.¹⁹² An old case of *Kerguelen Sealing and Whaling Co Ltd v CIR*¹⁹³ comes to mind in regard to shipping business. The facts were that a company registered in South Africa (then referred to as the "Union") had its head office in Cape Town where it was registered together with its shipping operations. These operations involved whaling operations outside the territorial waters of South Africa, in fact in the Antarctic Ocean. The operations were conducted with a floating factory called "Tafelberg" and a fleet of whale catchers. The catchers shot the whales and towed them to the floating factory where the oil was extracted. The oil was then carried by the "Tafelberg" to Cape Town whence it proceeded to deliver the oil to the purchasers at ports outside South Africa.

The important issues arising from the stated case were whether the Special Court was correct in holding that the income derived from the whaling operations in the Antarctic Ocean in

192 See the *Rhodesia Metals Ltd v CIR* (*supra*) already discussed at page 103 ff

193 *Kerguelen Sealing and Whaling Co Ltd v CIR* 1939 AD 487, 10 SATC 363, cited earlier on subparagraph (a) on the activities test of source of income and in the introduction at page 9

the given years of assessment was derived from a source within the Union and that the income was deemed to have been derived from a source within the Union, by virtue of a contract made within the Union. The Cape Provincial Division having answered the first question in the affirmative and the second in the negative. The case was taken up on appeal before the Appellate, the appellant company appealing on the first question while the Commissioner appealed on the second question.

The Appellate Division, with Stratford CJ delivering the judgment, answered the first question in the negative, i.e. income derived from the operations of a ship, even assuming it to be a Union ship, outside the territorial waters of the Union, was not derived from a source within the Union. The second question was, however, answered in the affirmative i.e. the contracts signed in Cape Town and the interchange of copies by post between Cape Town and London, on the established principles of contract as decided in the case of *Cape Explosives Works Ltd v SA Oil and Fat Industries Ltd*,¹⁹⁴ led to the conclusion that the contracts were concluded in Cape Town and therefore, under the deeming source provisions the income was derived from a source within the Union.

Stratford CJ in his judgment¹⁹⁵ made important remarks regarding the distinction between actual source and artificial

194 *Cape Explosives Works Ltd v SA Oil and Fat Industries* (1921) CPD 244

195 *Op.cit.*, see pages 507 to 508

source of income derived from shipping operations. The learned Chief Justice examined the general assertion that "a ship is part of the territory whose flag she bears" while on the high seas. While accepting this proposition, the learned Judge pointed out that this had to be applied in the particular Act of Parliament (Income Tax Act) in order to ascertain the intention of the legislature. He examined the principle of equity in both systems of applying residence or source as the basis of tax liability and the rationale underlying the respective systems. He also pointed out that whichever system a country adopts, one assumes that there is an effective means of enforcing the tax jurisdiction set out. Using the two principles of equity and effectiveness in regard to the issue, the learned Judge remarked that:

"In my opinion the word source is used to convey the idea ... that if the natural resources of the Union of South Africa or the activities of its inhabitants produce the wealth, that wealth must be taxed, and this view accords with the notion of the equity of the tax. Then again the notion of "taxing at the source" is also clearly implied, and involves the supposition that the Government will be able to collect tax, that is that the Union Government has control of the source. This is the idea of effectiveness - that is the ability to collect tax. We cannot suppose the legislature intended to issue a *brutum fulmen* as it would do if the ship were registered in Cape Town and the owner resided abroad. The effective power to

collect the tax at its source is, ... clearly assumed in the Act ... and one sees how ridiculous that idea becomes when the source is the ship in the Antarctic."¹⁹⁶

The learned Judge went on to hold that "when the legislature used the words 'source' within the Union in the Income Tax Act it meant a source within the actual, the fixed geographical limits of the Union.

It was on this reasoning that Stratford CJ (with three others concurring) held that the income derived from the whaling operations in the Antarctic Ocean was derived from a source outside the Union. (Note should, however, be taken that the taxpayer was found liable to tax on the other question of a contract made within the Union.)

The position in South Africa has since changed with the enactment of the deeming provision under section 9(1)(c) which deems income derived by shipowners or aircraft owners to be from a source within the Republic irrespective of where the operations of the business are carried on.

It should be noted that under the Lesotho-source rule, paragraph (m), the requirements are that the owner carrying on the business must be a resident in order to deem the income to be Lesotho-source income. This is in accordance with the principle that Lesotho citizens are taxed on a world-wide basis. The

effectiveness of the exactions leaves much to be desired taking into account the present staffing situation of the office of Commissioner of Income Tax. Note should be taken that it is immaterial where the business is carried on nor where a contract under which the income will be derived is entered into. One can not help observing the artificiality of the rule. This is a feature common to all the deemed-source rules in that once there is a departure from the natural source according to the practical reasonable man's test, the notion of equity in these circumstances is not that important. The Lesotho rule has been extended to vehicles apart from vessels or aircraft.

6.4. CONCLUSION ON THE LESOTHO SOURCE RULES:

The Lesotho statutory source rules are comprehensive and exhaustive. The rules under the Income Tax Order have embodied the general principles of determination of source of income. Furthermore, the Lesotho source rules have incorporated substantively most of the South African deeming-source provisions.

Deeming-source provisions are by definition a legal fiction. In other words, the legislature deems income to be from a source which on application of general principles will not qualify. Thus in these artificial circumstances, the principle of equity is often ignored in pursuit of some other stated objective such as broadening the tax base.

PART II

INTERNATIONAL TAXATION IN LESOTHO

CHAPTER 7

INTERNATIONAL DOUBLE TAXATION

7.1. INTRODUCTION:

The controversy surrounding the merits of both source and residence as principles of taxation does not only occur at the domestic level but in the international arena as well. There are basically two schools of thought, those who support the residence principle and those who support the source principle. However, as a tax treaty is by nature a negotiated and mutually agreed solution, some compromises are bound to arise. Dual application of the two is common.

7.1.1. DOUBLE TAXATION AGREEMENTS

The generally accepted objectives of double taxation agreements (for brevity to be referred to as "DTAs" hereafter), are to avoid double taxation, prevent tax evasion and to facilitate international trade and investment.¹ The extent to which these objectives are achieved and prioritised will vary from country to country depending on the legal, economic and political conditions and aspirations being pursued. These traditional objectives of DTAs pose no problem. In that context the

1 See Atchabahian Adolfo, "Some Aspects of International Double Taxation between Developed and Developing Countries", *Bulletin for International Fiscal Documentation* Vol XXV no 12, 1971 p 451 at 454; See also Danzinger E, *International Income Tax: The S A Perspective* Butterworths 1991 327

objectives are complementary. There is reciprocity and neutrality. However, DTAs between developed and developing countries exacerbate the controversy around source and residence as factors determining tax liability.²

As observed earlier, the developed countries generally favour taxation on the basis of residence while the developing countries generally favour the principle of taxation on the basis of source. The result of these two approaches is a conflict which is apparent in the different tax treaty models.³ ✓

7.1.2. THE CONCEPT OF PERMANENT ESTABLISHMENT

The concept of permanent establishment is central in DTAs as a means of avoiding double taxation and this will be discussed further in Chapter 10 in more detail. Suffice it to point out

2 See Atchabalian *loc cit*; Atchabalian A, *The Andean Subregion and its approach to Avoidance or Alleviation of International Double Taxation*, Bulletin for International Fiscal Documentation Vol XXVIII August no 8, 1974 308 at 315ff; also Gendre Francois *The Treatment of Investment Income under the Andean Pact Model Convention*, Bulletin for International Fiscal Documentation Vol XXIX February no 2, 1975 59ff; Hausman J *Andean Pact: Capital Exporting Nations*, Bulletin vol XXIX *op cit* p 99; see also Irish Charles, "International DTA and the Income Taxation by Source" vol 23 *International Comparative Law Quarterly* 1974 292

3 Reference here is to the OECD Model Convention; the Andean Pact Model Convention, adopted by the Commission of the Cartagena Agreement in November 1971 (Decision No 40) and operating in Latin America; the United Nations Model Convention and the United States Model Convention. Note should, however, be taken that most taxation systems in practice end up with a dual system of taxation by residence and source with either or both applicable in certain instances.

that this concept is one of the most controversial terms found in DTAs. The genesis of this controversy hinges around the source/residence debate. In other words, the determination of the concept of permanent establishment applies the notions of source and residence and thereby results in either a narrow or broader definition. The approach of developed countries to the concept of permanent establishment is prejudicial to developing countries which complain that it is narrow, restrictive and marginalises the source country particularly in the all-important area of taxation of business profits of multinational enterprises.⁴

7.1.3. EFFECT OF TAXATION TREATIES TO DOMESTIC TAX LAW

Domestic source rules must always be read subject to the operation of any applicable double tax agreement since under certain circumstances the latter may supersede the former. This is perhaps better expressed, "domestic tax rules are extensively modified by double tax treaties".⁵ Consequently, one cannot purport to examine the role of the concepts of source and residence in Lesotho taxation without considering their impacts on the DTAs Lesotho is party to.

4 See Atchabahian, Irish, Gendre above.

5 The point on domestic source rules made by Passos, *Tax Treaty Law*, p 127 while the general one is made by Grbich, Bradbrook & Pose on *Australian Revenue Law, Cases and Materials*, Butterworths 1990 p 781

7.2. DEFINITION:

The phrase "double taxation" has been defined in ITC 1364 (1980) 45 SATC 23 at 25, to mean taxation of the same income over again or twice in the hands of the same person. According to Spitz, there are different types of double taxation but he focuses on three types: domestic double taxation, economic double taxation and international double taxation.⁶ These are considered below.

7.2.1. DOMESTIC DOUBLE TAXATION

Domestic double taxation refers to a situation where one tax jurisdiction levies tax twice on the same subject matter and taxpayer. The occurrence of this type of double taxation is unusual since most tax systems are designed to prevent it. It is now trite fact that income tax is an annual event. Thus the Lesotho Income Tax Act provides for cash-basis and accrual-basis in accounting for income and deductions of a taxpayer.⁷ It should be noted that in this context double taxation applies only to the same tax. Imposition of different types of taxes such as value added tax, estate duty etc will thus be excluded from this definition.

6 See Anschütz U, Harmonization of Direct Taxes in European Economic Community, 13 *Harvard International Law Journal* 1972 at p 12; see also Spitz B K, *International Tax Planning*, Butterworths, London 1972 at 12; same reproduced substantively by the same writer at (1988) 1 *Juta's Foreign Tax Review*, p 69;

7 At Sections 51 and 52 respectively.

7.2.2. ECONOMIC DOUBLE TAXATION

Economic double taxation is generally defined in terms of a case where the same profits are subjected to tax at more than one level. The classical example invariably given is the situation where corporate profits are taxed first in the hands of a company and, secondly, upon distribution, in the hands of the shareholders.⁸ The undesirability of this trend is obvious. Furthermore the use of the term "economic double taxation" has been criticised by Spitz, as this is not, strictly speaking, a case of double taxation. Notwithstanding its practical effect, Spitz prefers to maintain the legal fiction that since the taxpayers in the given example, are different legal *personae*, i.e. the company and the shareholder, this is not double taxation. Furthermore, he points out, even the quality of income in the hands of a company and upon distribution in the hands of shareholders is different hence one can not speak of the same income being taxed twice. The present writer's opinion is that the learned writer is splitting hairs, economic double taxation is a reality, not a figment of someone's imagination. ✓

7.2.3. INTERNATIONAL (MULTIPLE) DOUBLE TAXATION

International (multiple) double taxation is the common usage of the term "double taxation" and is usually designed to refer to a situation of levying of comparable taxes by two or more

8 See note 8 above and also J S Schwarz (1988) 4 *Juta's Foreign Tax Review* p 67.

countries on the same taxpayer with respect to the same subject matter and for the identical period of time.⁹ Passos uses the term "international juridical double taxation" and highlights that it is this form of double taxation that double tax treaties are designed to address. Note should, however, be taken that in some instances, treaty provisions under a "Mutual Agreement Procedure" clause may allow resolution of double taxation cases not provided for in the treaty e.g. international economic double taxation.¹⁰

Focus in this dissertation will be on international double taxation and the term "double taxation" will be used to denote such unless the context indicates otherwise.

7.3. COMMON CAUSES OF DOUBLE TAXATION:

One of the most commonest causes of double taxation is the combination of residence taxation and source taxation.¹¹ This can manifest itself in various ways, for instance:

- When a taxpayer is a resident of a country which imposes tax on residence basis, i.e. world wide, and that taxpayer derives income from another country which imposes tax on the basis of source;

9 See Anschütz *loc cit*; also Passos A, *Tax Treaty Law*, 1st ed, Juta Tax Library 1986 p 77; Butterworth's *Australian Tax Handbook* 1994 p 1070 para [40 010].

10 Passos *op cit* p 245.

11 Spitz *op cit* p 26.

- Sometimes more than one jurisdiction may regard the taxpayer as resident, and thus taxable in the respective jurisdictions (dual/multiple residence);
- Even in the case of source based taxation income may, through differing source rules and deemed-source provisions be subject to claim by various tax jurisdictions. Spitz gives an example of income derived from a contract concluded in one state but performance of which is provided in another;
- Conflict of definitions between different tax systems may cause double taxation or at worst tax avoidance.¹²

It should be noted from the foregoing that the concepts of residence and source are not mutually exclusive. Furthermore, even in situations where one or other of these concepts is used as the common criterion for taxation by all the various jurisdictions involved, mutual exclusivity cannot be guaranteed. This is due to the differing meanings attached to them.^x Thus, in the United Kingdom the place of effective management and control of a company will be a decisive factor in deciding whether the said company is resident for tax purposes, but in Sweden the place of incorporation will be the criterion for determining residence of a company and therefore where it is

12 See Hadari Y - "Tax Treaties and their Role in the Financial Planning of the Multinational Enterprise" *American Journal of Comparative Law*, vol 20, 1972, 111 at 117

taxable. This provides an ideal setting for overlapping tax jurisdictions.

The fact that different tax systems classify their taxes in various ways is another cause for double taxation. According to Hadari¹³ two main principles by which countries assert their power to tax revolve on the status of the taxpayer otherwise known as the "personal link system" on one hand, and the source of income, usually referred to as the "territorial system" which focuses on the geographical area from which the income originates.

Personal link systems focus on personal factors such as residence, citizenship, domicile or nationality. They tend to be global or unitary, i.e. the country asserts its jurisdiction on a worldwide basis once it has identified its taxpayer.

As a result the personal-link tax system has a very broad concept of what constitutes income and under its wide ranging web every kind of conceivable income is taxed. This is the system followed by many highly industrialised countries (obviously with sophisticated back-up administration systems for implementation). In this category are countries like the United States, the United Kingdom, Germany and Australia, to name but a few. These are the countries which Lesotho has emulated under the revised Income Tax Act.

13 Op.cit at p 115 ff.

Contrasted to personal-link tax systems are the territorial systems, which are characterised as being schedular with distinctions drawn between various kinds of income for which different rules and rates are applicable. From the jurisdictional point of view of this system, only domestic source income is taxed. It therefore becomes very important whether the system has classified the different types of income as local or foreign sourced and therefore whether taxable or non-taxable. This system is common in capital-importing countries such as the Latin American countries, and this is the system prevailing in South Africa.

From the aforementioned factors it can be noted that underlying the problem of overlapping tax jurisdiction is the conflict of different tax systems with both residence and source asserting jurisdiction on the same income or on the same taxpayer; conflict of definitions of even the same concept can occur, hence transactions involving two personal link jurisdictions or two territorial systems are not entirely spared from the problems of double taxation. It would thus seem that double taxation is an inevitable result of increased world trade and international economic relations as a whole.

7.3.1. COMMON SOLUTIONS TOWARDS ELIMINATING/MITIGATING DOUBLE TAXATION

There are some legal mechanisms which have been formulated to eliminate or mitigate the effects of double taxation so as to

provide a favourable environment for international trade and investment. These are either unilateral or bilateral/ (multilateral).

(i) Jurisdictional limits:

The fact that a country chooses to base its taxation system on residence and/or source in determining liability to tax is in itself a measure of setting territorial limits and mitigating overlapping tax jurisdictions. Thus the way domestic tax laws are naturally formulated is directed towards mitigating double taxation. However some overlapping usually occurs especially where off-shore sourced income and non-residents are concerned. The choice of a tax system is a unilateral Sovereign act. It is essentially a question of national policy and interest.

(ii) Unilateral tax relief measures:

Most tax systems have a general provision which grants unilateral tax relief to cope with the problem of double taxation. This could be in the form of a rebate allowed in respect of foreign income taxes paid. The majority of developed countries usually provide for such unilateral relief measures,¹⁴ Commonly by granting full or limited tax credit the general

14 See Hadari *supra* n. at p 113; see also Irish ICLQ 1974 p 313; see also Passos, *Tax Treaty Law*, chapter 33 where she discusses South African methods for elimination of international double taxation at p 231 ff; see also Atchabahian A - Some Aspects of International Double Taxation between Developed and Developing Countries, *Bulletin for International Fiscal Documentation* vol xxv, December/No 12 1971 p 451

effect of which is that credit is given for tax paid abroad, but this does not grant full exemption from the local jurisdiction. The home country simply treats taxes paid abroad as if they have been paid to it, thus offsetting its income tax claim against the taxpayer. It should be noted that the above situation assumes a residence basis taxation which will become overridden by domestic unilateral tax relief measures for off-shore sourced income. The credit is normally not automatic and does not exceed the amount of tax due at home.

Section 105 of the Lesotho Income Tax Order provides that a resident taxpayer is entitled to a foreign tax credit against liability to Lesotho income tax in respect of foreign income tax (including foreign withholding tax) borne on foreign-source income. It will be noted that in the case of a resident taxpayer, foreign-source income is normally liable to tax in Lesotho according to the domestic law.¹⁵ However, a compromise is struck to foster international trade and investment. The foreign tax credit may not exceed the Lesotho income tax on the foreign-source income and a formula is provided for calculating the average rate of Lesotho income tax.¹⁶ Similarly no credit will be allowed for foreign taxes paid for income which is exempted from Lesotho income tax.

15 See Section 17(2) of the Lesotho Income Tax Order, 1993.

16 See Section 105(2) and (3) of the Lesotho Income Tax Order.

Another unilateral tax relief measure for ameliorating the effects of double taxation in Lesotho is exemption of foreign employment income of residents from Lesotho income tax.¹⁷ However, the exemption is applicable only where tax has been levied in the foreign country; if tax is not levied, it is usually because it fell below the tax-free threshold in the foreign source country.

It has, however, been argued that problems of international taxation are better solved by using¹⁸ double taxation agreements than unilateral promulgation in domestic laws.¹⁹ According to Hadari, experience has shown that tax treaties although not eliminating totally the hazards of double taxation, represent a satisfactory accommodation of conflicting tax claims. He cites unilateral arrangements in transactions involving two personal-link jurisdictions to show this deficiency as follows.

Two global systems such as those prevailing in the United Kingdom and the United States readily reflect the deficiencies of the unilateral measures.²⁰ Thus a subsidiary company may be regarded as resident in the United Kingdom under English tax law if its business is in fact managed and controlled by an

17 See Section 104 *ibid*.

18 See Hadari *supra* at p 113.

19 See Hadari *ibid*.

20 See *De Beers Consolidated Mines v Howe* (1906) 5 TC 198 at 217 per Lord Loreburn; see also *The American Thread Co v Joyce* (1913) 6 TC 163 and *Swedish Railway Co v Thompson* (1925) AC 495 at 445 for UK authority that a company may be resident in more than one country at the same time.

English parent corporation and at the same time regarded as a United States company under United States domestic tax law if incorporated in the United States. This arises because under the United Kingdom law, residence of a company for tax purposes is at its chief place of business, its central management and control and the place of incorporation being only factors but not conclusive in the enquiry. In contrast, under the United States law a domestic company is so designated by its place of incorporation which is the sole criterion. The upshot is that a dual resident could be liable to tax in both countries. It is in this context, therefore, that DTAs are felt to be the most effective measures to counteract double taxation.

Thus despite the unilateral tax relief provisions in the Lesotho Income Tax Order to counteract international double taxation, Lesotho has decided to enter into DTAs.

7.4. DOUBLE TAXATION AGREEMENTS AS MEASURES TO ELIMINATE OR MITIGATE DOUBLE TAXATION:

There are two leading principles which are followed in elimination of double taxation in DTAs. These are the principle of exemption and the principle of credit.²¹ There may also be a deduction method for foreign taxes paid on income also

21 See the 1963 and 1977 OECD Model Income Tax Treaties and Commentaries 2nd ed compiled and partially edited by Kees van Raad, Kluwer' see Commentary to Articles 23A and 23B regarding methods for eliminating double taxation.

subject to tax in the country of residence.²² The exemption and credit methods are often used as alternatives in treaties.

7.4.1. THE EXEMPTION PRINCIPLE

The exemption principle precludes income from taxation in the other contracting state to avoid double taxation, e.g. "shall be taxable only ...". There may be "full exemption" or "exemption with progression".

7.4.2. THE CREDIT METHOD

The credit method works more or less along the principle of deduction from the tax due. There may be "full credit" where the total amount of tax paid in the other state is deducted or "ordinary credit/limited credit" where credit granted is limited to the granting state limits.²³

7.4.3. OTHER MEASURES

The other measures adopted to alleviate international double taxation and encourage foreign investment especially in developing countries are but variations of either the credit method or the exemption method. These include measures such as tax sparring, tax deferral, tax reduction and investment

22 See also Passos *Tax Treaty Law* at p 233.

23 See Commentaries to OECD Articles *supra*; see also Passos at p 233.

credit. Some of these mechanisms are capable of either being implemented unilaterally or incorporated in a tax treaty to maximise their benefit.²⁴

7.4.4. CONCLUSION:

The concepts of source and residence continue to feature in DTAs as the basis upon which to allocate jurisdictional limits of the States parties to a DTA. Problems are encountered in DTAs, when countries employ different bases of taxation, ie a source basis and a residence basis.

7.5. INTERPRETATION OF FISCAL STATUTES AND DTAs:

7.5.1. INTRODUCTION

The general rule of interpretation of fiscal legislation is that where there is no ambiguity, the ordinary meaning must be given to the provisions. Where there is doubt, and there is more than one reasonable consideration, the construction which is favourable to the taxpayer is to be adopted (the *contra fiscum* rule).²⁵

24 See Atchabahian A, *Some Aspects of International Double Taxation between Developed and Developing Countries*, vol xxv, *Bulletin* p 451 ff.

25 See *Silke on South African Income Tax* para 25.3 p 25-6-1 quoting Lord Cairns in *Partington v The Attorney General* 21 LT 370 at 375; quoted with approval in *CIR v Delfos* 1933 AD 242, 6 SATC 92 at 101-2; also *Glen Anil Development Corporation v SIR* 1975 (4) SA 715 (A) at 727, 37 SATC 319 at 344 where the *contra fiscum* rule was approved

DTAs are part of public international law. Interpretation of treaties is governed by the Vienna Convention of the Law of Treaties, 1969.²⁶

Treaty interpretation is one of the most complicated areas of the law of treaties. This is due to the wide ranging impact of treaties. The scope of application of provisions of a treaty are to a large extent determined by its interpretation. Distinction has to be made between the rights and obligations of the State parties and the rights which individual taxpayers enjoy resulting from the treaty.

7.5.2. THE VIENNA CONVENTION ON THE LAW OF TREATIES

The Vienna Convention is the codification of principles of customary international law principles on interpretation. As such, some elements are similar to the general rules of interpretation of fiscal statutes. According to Article 31, which provides the general rule of interpretation, 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.²⁷

26 See Passos at p 68 where she discussed the Vienna Convention; see also *Blackstone's International Law Documents* ed. Malcolm D Evans, Blackstones Press 1991 p 147-165. Note should also be taken that there is also the Vienna Convention on the Law of treaties between States and International Organisations and between International Organisations, 1986, but this is not applicable in this context

27 See Article 31(1) of the Vienna Convention on the Law of Treaties

The context of the treaty in this context includes its preamble, annexes and any agreement made by the parties in connection with the conclusion of the treaty.²⁸ Other factors to be taken into account include subsequent agreement or practice of the parties in the application of the treaty as well as any relevant rules of international law.²⁹ A special meaning will be given to a term if it was the parties' intention.

According to Article 32 of the Vienna Convention on the Law of Treaties, supplementary means of interpretation, including preparatory work and circumstances of the conclusion of the treaty may be resorted to where there is ambiguity, obscurity, absurdity or unreasonableness.

Furthermore, where a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless there is provision on which particular text is to prevail. The meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.³⁰

The Vienna Convention embodies elements of the formalistic and the teleological method of interpretation.³¹

28 Article 31(2) *ibid*

29 Article 31(3) *ibid*

30 See Article 33 *ibid*

31 See Horak JDD, *The Use and Abuse of DTAs*, thesis LLM Stellenbosch (1987) para 3.2.2.2

7.5.3. THE RENVOI CLAUSE IN DTAs

Article 3(2) of the OECD Model³² provides that a term not defined in the treaty shall have the meaning which it has under the domestic tax laws of the State applying the agreement, unless the context requires otherwise. This is a *renvoi* clause.

The *renvoi* clause is a special feature of DTAs and generally tries to reconcile the national tax laws of the contracting States. This is to ensure certainty.

The renegotiated DTAs between Lesotho and the United Kingdom and South Africa respectively contain a *renvoi* clause essentially similar to the OECD Model text. The scope and effect of a *renvoi* clause in a tax treaty will be determined in accordance with the Vienna Convention on the Law of Treaties.

7.5.4. GENERAL PRINCIPLES OF INTERPRETATION

There are general principles of interpretation of treaties some of which are incorporated in the Vienna Convention. These include the principle of *bona fides*, the principle of effectiveness, principles of natural justice such as the *audi alteram partem* rule, and other established legal rules of interpretation such as the *expressio unius est exclusio alterius*, *ejusdem generis* and the *noscitur asociis*.

32 See the discussion of Article 3(2) of the OECD Model Convention by Van Raad, 1963 and 1977 *OECD Model Income Tax Treaties and Commentaries* 2nd ed, Kluwer

The *contra fiscum* rule mentioned under the introduction in 7.5.1 above, has been approved in income tax, estate duty and transfer duty legislation.³³ The *contra fiscum* rule is an established Roman-Dutch law principle [*non male judicat qui in dubio contra fiscum judicat*]. The present writer will not go into the debate whether the fiscal statutes should be interpreted in the same manner as other statutes.

7.5.5. CONCLUSION

The scope of the DTA regarding the rights and obligations of the contracting States as well as the rights of the individual taxpayer under a treaty are determined by its interpretation. Where the provisions are clear the ordinary meaning of the terms is to be adopted taking into account the object and purpose of a DTA. Issues such as the meaning of the concept "double taxation" therefore arise. Where there is ambiguity other factors such as the *contra fiscum* rule, preparatory work and special circumstances of the treaty will be resorted to. The domestic tax law may also be relevant in determining the scope and effect of a treaty provision. Thus one can not over-emphasise the importance of the rules of tax treaty interpretation.³⁴

33 See *SBI v Raunbenheimer* 1969 (4) SA 314 (AD); also Lewis R Dison, "The *Contra fiscum* Rule in Theory and Practice", 1976 *SALJ* 159 at 163

34 See the criticism of the *Glen-Anil* approach in D M Davis "Tax Avoidance - the British Example" in *De Rebus* 347 at 347; see also Dison *ibid*

CHAPTER 8

TAX TREATY FRAMEWORK FOR LESOTHO

8.1. SECTION 112 OF THE LESOTHO INCOME TAX ORDER:

8.1.1. INTRODUCTION

According to Section 112(1), in the event of inconsistency between the provisions of the Income Tax Order and the terms of any international agreement Lesotho is party to, the terms of the agreement will prevail over the provisions of the Order. The only exemption in this regard would be the provisions of Part XI on anti-avoidance measures. Note should be taken that the term "international agreement" is not particularly limited to Double Taxation Agreements but encompasses other treaties Lesotho is party to, i.e. agreements with other states and/or international organisations on various subject matters.

8.1.2. THE RELATIONSHIP BETWEEN TREATIES AND THE INCOME TAX ORDER

The effect of section 112(1) above is to depart from the normal practice regarding the relationship between international law and domestic law. Perhaps it is worth digressing for the moment into Public International Law. There are essentially two traditional theories which have revolved on the relationship between international law and domestic law. These are on one

hand the theory known as dualism (or sometimes pluralism) which stresses that international law and municipal law are two distinct systems of law which operate at different levels, and on the other hand the monist approach, whose proponents contend that international law and municipal law are an integral part of the same system. In between these two extremes are compromises, for instance the so-called "Fitzmaurice Compromise" coined by Sir Gerald Fitzmaurice in the mid-fifties.³⁵

It is beyond the scope of this dissertation to enlarge upon the jurisprudential debate on the relationship between international law and municipal law but it suffices to highlight the relationship between Double Tax Treaties (which are part of the international law system) and the domestic tax law. In the event of a conflict between a tax treaty and domestic tax law, most monists would contend that the tax treaty provisions must prevail. Even though emphasis is on the unity of the entire legal order, predominance is given to international law which is the so-called basic norm of the legal order, also the ultimate reason for validity of the national legal orders.³⁶ Consequently international law is regarded as being superior to municipal law (a will of nations versus a will of one state, as it were).

35 See Sen B, *A Diplomat's Handbook of International Law and Practice*, 3rd ed, UNITAR, Martinus Nijhoff Publishers 1988; Shaw M N, *International Law*, 3rd ed Grotius Publications, Cambridge, 1991 at p 102 ff and Wallace R. M M *International Law*, London, Sweetwell and Maxwell 198.

36 See Shaw M N *op cit* 103, where he discusses the Kelson's hierarchical system.

The dualist approach in the event of a conflict would be to view these as two distinct systems of law operating at different levels, viz the international level and the local level. The two are viewed as mutually exclusive and for international law to apply at the domestic level, it has to be expressly incorporated in the municipal law of that particular state. The process is usually referred to as "incorporation" or "transformation". The United Kingdom and most Commonwealth States, including Lesotho and South Africa, follow the dualist approach.³⁷ Conclusion of a treaty is viewed as an executive act and not a legislative act. For the treaty provisions to be enforceable as domestic law, it has to be included in the legislation.

In practical terms, and in the context of the Lesotho taxation system, the dualist approach would mean that for each tax treaty concluded, the same has to be "incorporated" under the Income Tax Order in order to extend the (protection) provisions of that treaty to the persons in Lesotho. This means that the treaty has to pass before Parliament in order to bring the municipal law (Act/Order) into conformity with the treaty. It should be noted that in the United Kingdom the power to make or ratify treaties lies with the Queen (as head of State),

37 This rule was confirmed by the Appellate Division in *Pan American Airways Incorporated v S A Fire and Accident Insurance Co* 1965 (3) SA 150 in the case of South Africa.

acting on the advice of her Ministers.³⁸ Similarly in Lesotho, this royal prerogative lies with His Majesty the King with advice of the Cabinet. Ratification of a treaty means that the State is now bound by international law to implement the provisions of the treaty. However, only "incorporation"/"transformation" of a treaty will enable the local Courts to enforce that treaty as part of the municipal law.³⁹

The effect of Section 112 provisions, therefore, eliminates the need for the process of incorporation/transformation for "international agreements". These agreements supersede the provisions of the Income Tax Order. The international agreements including tax treaties are incorporated *ipso facto* into municipal law as and when they are concluded. It will, therefore, be very misleading to form an opinion on the tax implications of most international (commercial) transactions in isolation without treaties, due to the overriding effect of treaties in Lesotho.

8.2. AUTHORITY TO ENTER INTO DOUBLE TAX AGREEMENTS IN LESOTHO:

There seems to be no provision under the new Income Tax Order, 1993 specifically authorising negotiation and conclusion of the

38 See Akehurst Michael, *A Modern Introduction to International Law*, 2nd ed, 3rd impression, London, George Allen & Unwin Ltd 1975, at p 63 where the practice is discussed.

39 Akehurst *op cit* at 152 ff.

DTAs. This omission, regarding the importance of DTA's is quite glaring. This is more so since the repealed Income Tax Act No 7 of 1981 under Sections 105 and 106 thereof made detailed provision for conclusion of taxation agreements.⁴⁰ Authority to conclude DTAs ought to have been provided for expressly rather than by implication.

40 Sections 105 and 106 of the 1981 repealed law read as follows:

Double taxation agreements:

105. (1) The Minister may on behalf of the Government enter into an agreement with the government of another country with a view to the prevention, mitigation or discontinuance of the levying of tax under this Act and the income tax laws of that other country in respect of the same income or to the rendering of reciprocal assistance in the administration of and the collection of tax under this Act and such income tax laws.

(2) An agreement entered into under subsection (1) shall be laid before the National Assembly as soon as may be after the agreement is entered into and shall not take effect until it is approved by resolution of the Assembly but, upon approval, it shall come into operation from the date specified in the agreement.

(3) The Minister may at any time amend an agreement entered into under subsection (1), and an agreement so amended shall be laid before the Assembly as soon as may be after its amendment and if approved by resolution of the Assembly the agreement shall -

(a) operate in its amended form; or

(b) cease to operate,

as the case may be, from the date specified in the amended agreement.

(4) An agreement or amended agreement made under this section shall be published in the Gazette at the same time as the resolution of the Assembly approving it.

Special taxation agreements.

106. (1) An agreement entered into before or after the commencement of this Act between the Government and another party for the purpose of taxing mining operations shall be valid notwithstanding any provision in the agreement providing for the taxation of income on a basis different to that of this Act or any other law, and any such provision shall have the same force and effect as if it had been incorporated in this Act.

(2) Subsection (1) shall also apply to any agreement between Government and a company engaging wholly or substantially in the purchase and sale of precious stones as defined in the Precious Stones Order 1970.

Note should be taken that Section 105 of the repealed Income Tax Act, 1981, was almost substantively similar to Section 108 of the South African Income Tax Act 58 of 1962.⁴¹ The reference to the Minister in the Lesotho Income Tax Law is to the Minister of Finance, who under the 1981 Act was empowered to enter into tax agreements. In South Africa, this power rests with the State President who upon conclusion of such an agreement must make notification by proclamation in the *Government Gazette* and must also table the same in the House of Assembly. Revocation or amendment of an existing agreement must follow the same procedure. The Lesotho 1981 Income Tax Law similarly laid procedural requirements regarding publication of a concluded, amended or revoked tax agreement. The text has to be laid before the National Assembly for approval and once approved by resolution, had to be published in the *Gazette*.

The importance of provisions authorising the negotiation and conclusion of DTAs cannot be overemphasised. These should set out clearly who is the sole authority for negotiating DTAs and what are the parameters within which such authority is to be exercised. The repealed law, for instance, authorised the Minister of Finance to conclude DTAs "with a view to the prevention, mitigation or discontinuance of the levy of tax ... in respect of the same income or to the rendering of reciprocal assistance in the administration of and the collection of

41 See De Koker, Urquhart, *Income Tax in South Africa* vol 1, Butterworths p 30; also Silk A S, Divaris C, Stein M L, *Silke on South African Income Tax*, 11 ed Juta & Co 1989, chapter 24, para 24.1, pgs 1397-1400.

tax ...".⁴² It has been submitted that "rendering of reciprocal assistance" would give the local courts jurisdiction to entertain proceedings for the recovery of taxes imposed by a foreign state.⁴³ But since the practice is generally frowned upon, with the exception of tax treaties concluded with the USA, an express provision not a mere conclusion by implication would be necessary to enable such a wide interpretation of the provisions. It should also be noted that the South African provision in contrast to the repealed Lesotho provision expressly covers donations tax and by implication has the effect of combining relief from double taxation of estate duty and donations tax.⁴⁴

The publication of the DTAs concluded does not only afford government transparency in its exercise of public service but is also educational for potential beneficiaries of DTAs.

42 The repealed Lesotho Income Tax Act, 1981 at Section 105(1).

43 See Silke above at para 24.1 p 24-2 to 24-3 referring to the use of similar wording in the South African Tax Act. However note will be taken that except with the DTA South Africa has entered with the USA where this has been explicitly provided for, practice has not rendered this provision to be interpreted so widely. This is due to the sensitive nature of extraterritorial legal jurisdiction.

44 See Silke at para 24.1 p 24.1 citing the *Explanatory Memorandum on the Income Tax Bill 1978*, WPS - '78 at 11. Note should however also be taken that there is an old 1944 Double Death Duties Agreement between Lesotho and South Africa. See Meyerowitz, *The Law and Practice of Administration of Estates and Estate Duty*, 6th ed, The Taxpayer, Cape Town, loose-leaf replacement 1 Feb 1992, p A-152

8.3. DOUBLE TAX AGREEMENTS THAT LESOTHO IS PARTY TO:

8.3.1. INTRODUCTION

The transitional provisions at Section 214(3) provide as follows:

"A taxation agreement made under Section 105 and 106 of the Income Tax Act 1981 or its predecessor continues to have effect under this Order."⁴⁵

8.3.2. INCOME TAX DTAs

In effect there are strictly speaking two existing DTAs falling under this category. These are namely, *The Arrangement of 25 November 1949 (as amended on 3 July 1968) between the Government of the Kingdom of Lesotho and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes*,⁴⁶ in the first instance and the *Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income imposed in Basutoland and in the Union of South Africa, between the Government of Great Britain and Northern Ireland (on behalf of Lesotho then a British Protectorate) and the Government of the*

⁴⁵ See Section 214(3) of the Lesotho Income Tax Order, 1993

⁴⁶ For text thereof see the United Nations Treaty Series, 1969 at p 182, registered by the UK as No. 9783

Union of South Africa signed in Cape Town on 18 June 1959 (Proclamation No 260 of 1959).⁴⁷ Both of these agreements are obviously old and have been renegotiated. These are taxation agreements in *stricto sensu* directed at income tax.

8.3.3. DOUBLE DEATH DUTIES AGREEMENT

It should, however, also be highlighted in the discussion of double tax agreements that Lesotho is party to, that there is an old 1944 *Double Death Duties Agreement between Lesotho and South Africa*.⁴⁸ The term "death duties" is elsewhere referred to as "death taxes" and these cover all taxes imposed on the estate of a deceased person. Thus in some jurisdictions these taxes take the form of "transfer taxes"/"transfer duties", "franchise taxes" or "estate taxes" which are levied when the property of the deceased is transferred to his heirs and beneficiaries.⁴⁹

The Double Death Duties Agreement between Lesotho and South Africa was entered into under the provisions of the *Lesotho Administration of Estates Proclamation No 34 of 1946* and the

47 Meyerowitz D, Spiro E, Meyerowitz and Spiro on *Income Tax* Section D p 40ff, Silke et al, *Silke South African Income Tax* p 1559ff.

48 See Note 36 above and the text of this Agreement can be found in Meyerowitz, D, *The Law and Practice of Administration of Estates and Estate Duty*, 6th ed, *The Taxpayer*, loose-leaf Replacement 1 of February 1992 p A-152.

49 See Goodman Wolfe D, *International Double Taxation of Estates and Inheritances*, Butterworths, 1978 at p 1; See also the OECD Draft Double Taxation Convention on Estates and Inheritances 1966 generally on the subject.

now repealed South African Death Duties Act 29 of 1929, but was preserved by Section 31(2) of the current *Estate Duty Act 45 of 1955, as amended*. Note should also be taken that the Agreement was initially entered into as a tripartite one with South Africa on one hand and Botswana, Lesotho and Swaziland (then all protectorates under the United Kingdom colonial rule) on the other hand. The other states that were parties to the agreement have since opted out and the agreement therefore remains in force only in respect of Lesotho.⁵⁰ How effective this agreement is in practice will have to be examined in an in-depth manner elsewhere; this aspect is beyond the scope of this dissertation. Suffice it to point out that on the part of South Africa, the Margo Commission amongst others,⁵¹ recommended the abolition of estate duty and donations tax to be replaced by a capital transfer tax. The Government's reaction through the Budget Speech in 1985 by the Minister of Finance and the White Paper to the Margo Commission Report showed in principle, willingness to undertake this reform. However, to date there has been no change in the practice in the South African Master's offices on the Administration of Estates Act.

50 See Meyerowitz, *The Law and Practice of Administration of Estates and Estate Duty*, at pg 31.2 and A-152.

51 See the Report of the Commission of Inquiry into the Tax Structure of South Africa, 1987, RP 34/1987 at para 20.67-68 p 322.

8.4. CONCLUSION:

For reasons aforesaid, analysis of the double taxation agreements that Lesotho is party to will focus on the income tax agreements, viz the DTAs with South Africa and the United Kingdom respectively. The Double Death Duties Agreement between Lesotho and South Africa will, nevertheless, be mentioned where it is highly pertinent; otherwise it must be borne in mind throughout the discussion of taxes generally.

In the event of inconsistency between the provisions of the Income Tax Order and the terms of any treaty, the treaty provisions will prevail over the tax law.

There seems to be an omission in the Income Tax Order authorising negotiation and conclusion of DTAs. This has to be rectified bearing in mind the importance of DTAs and their effect on the Lesotho tax system.

CHAPTER 9

ANALYSIS OF DOUBLE TAXATION AGREEMENTS LESOTHO IS PARTY TO

9.1. INTRODUCTORY REMARKS:

This analysis will be undertaken against the background of the draft model conventions of the Organisation for Economic Co-operation and Development (OECD) of 1963 and 1977 for the avoidance of double taxation.⁵² The OECD models have been chosen as the basis in this analysis due to their wide acceptance and usage internationally amongst both OECD member states and non-member states, e.g. South Africa.⁵³ Furthermore, the fact that apart from South Africa, the only other country with which Lesotho has presently concluded a double taxation agreement is the United Kingdom, a member of the OECD and an entrenched user of OECD model texts,⁵⁴ supports the method adopted here.

52 Note has been taken that there is yet another revised latest 1992 OECD Model Convention but the present writer was not able to lay hands on this. See the *Australian Tax Handbook*, 1994, Butterworths at para 40020 page 1070 which refers the reader to the Butterworths' *Australian Tax Practice International Agreements* loose-leaf service at [21001]; see also Jacques Sasseville, *The New OECD Model Tax Convention* (1993) 6 *S A Tax Review* 119.

53 See Passos, *Tax Treaty Law* at p 75 where she submits that although not a member of OECD, South Africa in its bilateral treaties has used the OECD drafts; see also Horak JDD, *S A Tax Treaties - Principles of Negotiation* (1991) 4 *Juta's Foreign Tax Review* 48 ff,

54 See De Koker, Urquhart, *Income Tax in South Africa*, vol 1, Butterworths, service issue no 8 amended to 31 August 1993 at para 30.2.1 where the writers use the United Kingdom agreement with South Africa as a model of analysing the operation of DTAs that South Africa is party to, due to the former's conformity to the model convention of the OECD referred to earlier.

However, where relevant, the other model texts, such as the Latin American Andean Pact Model, the United Nations Model and the United States Model will be used in this comparative analysis.⁵⁵ This integrated approach is chosen to compensate for some shortcomings in the OECD model text which is seen as a text for the developed countries and does not therefore, cater for the peculiar needs and circumstances of the developing countries⁵⁶ such as Lesotho.

9.2. BACKGROUND ON THE DIFFERENT MODEL TAX TREATIES: THE OECD MODEL, THE US MODEL, THE UN MODEL AND THE ANDEAN PACT MODEL:

To facilitate understanding of the different models of DTAs which will be used in this analysis, some information on their backgrounds is given below. The comparative presentation of the texts has been well documented and revised by Van Raad,⁵⁷ except for the Andean Pact Model.

The OECD Model:

The genesis of the OECD Model texts can be traced from 1948 when the Organisation for European Economic Co-operation (OEEC).

55 See Kees van Raad (ed) *Model Income Tax Treaties - A Comparative Presentation of the texts of the Model Double Taxation Convention on Income and Capital of the OECD (1963 and 1977), the United Nations (1980) and the United States (1981) 2nd ed 1990*, Kluwer Law and Taxation Publishers, the Netherlands.

56 See Horak J D D, *loc cit*

57 See note 47 above (Kees van Raad uses the OECD Model of 1977 as reference to facilitate comparison between the texts).

was created as a vehicle for encouraging economic growth in Europe after World War II, removal of barriers to international trade, free movement of capital and elimination of double taxation in international economic relations. The OEEC was later reorganised as the Organisation for Economic Co-operation and Development (OECD) which was representative of all the developed western nations, not only those in Europe.⁵⁸

The Committee on Fiscal Affairs of the OECD which comprised of experts from the member states drew up the 1963 and later the 1977 model conventions on tax treaties. Member states are expected to negotiate bilateral conventions based on the model with reservations where deemed necessary. There are official commentaries to aid in the interpretation of the OECD Model texts.⁵⁹ These have been slightly revised by the 1992 OECD Model Convention.

The major criticism against the OECD Models is that they were drafted by developed countries and therefore do not cater for the peculiar needs of developing countries. Furthermore, there

58 OECD members are: Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Ireland, Italy, Iceland, Japan, Luxembourg, Norway, New Zealand, the Netherlands, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States of America. Note should be taken that even though the organisation was established to oversee the administration of the Marshall Aid Plan for the recovery of Europe after the Second World War, its focus has over the years broadened to include participation of non-European countries such as Canada, Japan, the USA and Australia (see Passos above at p 73 ff).

59 See Kees van Raad (ed.) 1963 and 1977 *OECD Model Income Tax Treaties and Commentaries*, 2nd ed 1990 Kluwer.

is a presumption of some sophistication of the tax administrators who implement the model. Moreover, the model is perceived as favouring taxation on the basis of residence and requires considerable tax concessions from the source countries. The practical effect of DTAs between developed and developing countries has been characterised as taking substantial amounts from the poor countries to the rich countries.⁶⁰

The UN Model:

This is the product of the United Nations Group of experts from developed and developing countries.⁶¹ The group was established in 1967 and given the task of formulating guidelines for tax treaties between developed and developing countries.⁶² The United Nations Model Double Taxation Convention between Developed and Developing Countries was concluded in December 1979. The main thrust of this work is its emphasis on taxation by source, which is a departure from the OECD Model.⁶³ This has arisen mainly through the expansion of the concept of "permanent establishment" and the source jurisdiction.⁶⁴ The

60 See Irish C R, *International Double Taxation Agreements and Income Taxation at Source* I.C.L.Q., vol 23 1974 p 293

61 See Horak, at footnote 45; see also Surrey Stanley S, *United Nations Group of Experts and the Guidelines between Developed and Developing Countries*, Harvard International Law Journal vol 19 p 1-220, which provides the background to the UN Model draft; see also Danzinger E, *International Income Tax, A Perspective*, Butterworths, 1991 p 331.

62 ECOSOC Resolution 1273, 43 U.N. ESCOR, Supp (NO 1) 5, UN Document E/442 (1967).

63 See Horak and Surrey respectively, *supra*.

64 See Horak *op cit* p 50; Surrey *op cit* p 10

major criticism against the UN Model is that it adopted the OECD Model as a basis of its work and that this led to very few changes. The *status quo* was maintained.⁶⁵ It is submitted that the UN Model is a compromise document.

The US Model:

The current 1981 US Model Income Tax Treaty is an updated version of the 1977 US Model except for procedural rules. The US Model is a slight variation of the OECD Model. The most important changes concern allowing the United States to tax her citizens even if residing in a tax treaty member state (i.e. a state having a tax treaty with the U.S.). The US Model's version of the concept of source is "origin" and the basic approach is to thrash out the claims for tax between the country of residence and the country of origin.⁶⁶

Briefly the purpose of US tax treaties seem to remain as removal of tax irritants in international transactions. At the same time, the thrust of these treaties as in the OECD Model, appears to be limitation of the taxing power of the country of source, where an investment by US corporations is likely to be made. This is achieved through the imposition of percentage

65 See Costa R.V., Remarks on the 20th Inter-American Center of Tax Administrators Conference 1977, International Bureau of Fiscal Documentation, vol xxxii 1978 12.

66 See USA: Treasury Model Income Tax Treaty of 18 May 1976 as amended, *Bulletin for International Fiscal Documentation*, 1977 vol 31 at 313 ff; see also Beale RJE, *The Law relating to Double Taxation Agreements between South Africa and Zimbabwe*, LLM UNISA 1981 at 4.3 citing Lazerow "OECD Draft Influence on US Income Tax Treaties".

limits for withholding tax on dividends/interest and other passive income items to be remitted, and the US business becomes taxable in the other country only if there is a "permanent establishment" and vice versa. Reciprocity is achieved in this model if the parties are both developed countries with investment moving in both directions. Developing countries attract lower tax revenues,⁶⁷ a criticism shared with the OECD Model text.

The Andean Pact Model:

The Andean Pact Model has been characterised as the culminating point in the controversy on the respective merits of the source and the residence principles in the international taxation of income.⁶⁸ This model was adopted by the Economic Commission for Latin America in 1971 and provides a text of a convention among the member countries and another model text is for prevention of double taxation between a member country and a country outside the region. The two texts are basically the same, and therefore no particular distinction will be drawn in this context.⁶⁹

67 See Hellawell Robert, *United States Income Taxation and Less Developed Countries: A Critical Appraisal*, vol 66 Columbia Law Review 1393 at 1419.

68 See Gendre Francois, *The Treatment of Investment income under the Andean Pact Model Convention*, *Bulletin for International Fiscal Documentation* vol xxix, February no 2 1975 59 at 59.

69 Per Decision 40 of November 16, 1971 and is usually referred to as the Cartagena Agreement; see Gendre above; also Atchabahian A, "The Andean Subregion and its approach to Avoidance of Alleviation of International Double Taxation, *Bulletin* vol xxv viii 1974 308

The Andean Pact Model is the reflection of the classical position of Latin American Countries which dates back from the Montevideo Declaration on the validity of the principle of source. According to this approach, there is no restriction on the taxing power of the country of source. The point of departure is that the basic criterion for determining the taxing authority for levying income tax is that of source. Consequently, the OECD Model Convention with its preference for the residence principle is rejected by the Andean Countries. The concept of permanent establishment is also ignored in the Andean Pact Model. Emphasis is laid on the principle of source for income and parallel to this is the principle of economic location of property. There are, however, some exceptions to the exclusivity of the source principle as a basis of taxation in the Andean Pact Model. These relate to the taxation of profits of international transportation enterprises, where the country of residence of the enterprise is given preference.⁷⁰

The main criticism levelled against the Andean Pact Model is the extent of its pragmatism as an effective model tax treaty.⁷¹ To some critics it is nothing more than a strong declaration of the countries in that sub-region. In contrast to some of the objectives of the DTAs, such as international promotion of investments, the Andean Pact Model focused on its

70 See Atchabahian; Gendre *supra*.

71 See Gendre Francois *loc cit*; see also Hausman J S, "The Andean Pact Model Convention as viewed by the Capital Exporting Nations", *Bulletin for International Fiscal Documentation*, vol xxix 1975 p 99 at 101 ff.

subregion without due regard to the equally strong position of the developed countries. No doubt on practical application of the Model some further concessions will have to be made particularly when there is a developed country in the negotiations. In its present form the Model is not viewed as encouraging foreign investments in the subregion.

9.3. SOME CONTROVERSIAL AREAS IN DTAs BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

9.3.1. INTRODUCTION:

The most controversial areas of the international tax agreements in the context of income tax seem to arise when one of the contracting parties is a developing country. In other words, the most important problems in DTAs arise when the contracting parties have unequal economic development and consequently the parties are perceived to bargain at relatively weaker and stronger positions respectively.⁷² The reasons for this are that concepts of reciprocity, neutrality and permanent establishment seem to favour the developed countries at the

72 See Atchabahian A, "Some aspects of International Double Taxation between Developed and Developing Countries", vol xxv, *Bulletin for International Fiscal Documentation* No 12, 1971, p 451 ff; See also Hadari Isaac, "Tax Treaties and their Role in the Financial Planning of Multinational Enterprises", *American Journal of Comparative Law*, vol 20 1972, 111; Hellowell, "US Income Taxation and Less Developed Countries: a Critical Appraisal", (1966) 66 *Columbia Law Review* 1393 at 1419; Irish, CR, "International Double Tax Agreements and Income Taxation at Source", *International and Comparative Law Quarterly* vol 23 1974 292 ff.

expense of developing countries. The principles of source and residence permeate through this discussion.

9.3.2. CRITICISM OF INEQUALITY:

The general criticism levelled against the majority of the DTAs is that this crucial element of inequality between the parties is ignored, hence the assumptions in the principles of reciprocity and neutrality. Emphasis on the country of residence as having dominant or in some instances exclusive right to levy tax works well and is mutually desirable between two developed countries in a DTA. The same approach where one of the parties is a developing country leaves the latter with lower revenues and concomitantly expand the revenues of the more developed partner. This is because investments in this context flow in one direction, from the developed country to the developing country. The developing country as the source country merely remits profits, dividends, interest, royalties, management and consultancy fees etc to the developed country as the residence of the foreign investor. Under these circumstances, the concept of reciprocity which underlies DTAs becomes a fallacy or diminished.

9.3.3. SOURCE JURISDICTION LIMITED

Recognition of the jurisdiction of the country of source where given, is limited, eg the percentages on withholding payments

at source. Due to the predilection for the country of residence the concept of "permanent establishment" has also been conceptualised so as to limit the operation of the source of income principle. The concept of permanent establishment under the OECD Model has a narrow restrictive approach. This results in a constricted tax base for the developing country and fiscal sacrifices with the concomitant depletion of the balance of payments.⁷³

It is in this context that developing countries under the auspices of the UN Group proposed the UN Model with emphasis in DTAs on income taxation at source in DTAs. The UN Model text also contained a broader concept of permanent establishment which for example recognised Consultancy Services connected with a project if carried out within in a period of less than six months duration. The OECD Model text requirement of the fixed place of business being operative for the minimum period of twelve months disqualified the majority of construction works in developing countries which often ran short of the minimum 12 month period requirement. At the other extreme end is the Andean Pact Model which ignored the concept of permanent establishment.

73 See Atchabahian *op cit* at 458 in his criticism of the OECD Model 1963 conceptualisation of the permanent establishment. Reference here is to the 1967 United Nations Group of Experts on Tax Treaties between Developed and Developing Countries established under the Economic and Social Council and duly adopted.

9.3.4. CONCLUSION

From the abovementioned issues, it seems that the concepts of residence, source and permanent establishment are the critical^x factors in the DTA provisions. This is because these concepts are central to the practical question concerning in which of the countries that a re parties to the agreement the tax is payable. The analysis of underlying assumptions in the formulation of these concepts in DTAs is therefore vital. This is more so when the contracting parties to a DTA are at unequal level of development. It is assumed that in entering into international tax agreements, the contracting parties are prompted as far as possible, by national economic and social aspirations.

For Lesotho, therefore, in assessing the DTA's provisions the critical issues would include:

- Being a debtor nation, how does she strike a balance between the objectives of securing capital through foreign investment and promoting international trade with a fair tax system?
- Bearing in mind the international competition for capital and having, in South Africa, a relatively highly-industrialised neighbour, how does Lesotho ensure that foreign investors bear their fair share of the infrastructure costs that Lesotho incurs in delivering the necessary services conducive to profitable undertakings?

- Bearing in mind the almost entrenched tradition of the majority of Lesotho's able-bodied men of being employed in the South African mines as migrant workers (historically Lesotho's largest foreign income earners) which income tax policy does Lesotho adopt in this context?

This list of questions to be examined is merely illustrative.

9.4. GENERAL SCOPE OF THE DTAS:

9.4.1. TITLE OF THE TREATY

Reference to the scope of the DTA refers to both the fiscal aspects and the personal aspects. The title of the treaty itself is a good starting point for analysis of the scope of the DTA. It is from the title of the 1963 and 1977 texts of the OECD Model that it is noted the model is aimed at "*avoidance of double taxation with respect to taxes on income and capital*". This is the title suggested in the text of the 1977 Model convention.

The first DTA that Lesotho entered into with the UK⁷⁴ focused according to its title, on "*... Avoidance of double taxation*"

74 The Arrangement of 25 November 1949 (as amended on 3 July 1968) between the Government of the Kingdom of Lesotho and the Government of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the prevention of Fiscal Evasion with respect to Taxes.

and the prevention of fiscal evasion with respect to taxes". One notes the difference from the OECD title as quoted above and therefore wonders if there is any significance in the different wording. Questions which are likely to arise would be whether the words "prevention of fiscal evasion" are wider than "avoidance of double taxation" or vice versa. Or is usage of the two together simply tautologous and verbose, for which lawyer's drafting is often criticised? Note should also be taken that the OECD Model text refers to both "income and capital" taxes while the Lesotho-UK earlier text simply refers to "taxes". Answers to these questions have largely been pre-empted by the new OECD Model.

The new OECD Model Tax Convention has proposed a revised heading which has been characterised as neutral.⁷⁵ The new suggested title reads "Convention between (State A) and (State B) with respect to taxes on Income and on Capital".⁷⁶ This is reported to have been selected for in recognition of the fact that the OECD Model Tax Convention does not deal only with avoidance of double taxation or prevention of fiscal evasion but also with non-discrimination, which is an independent issue. However, States that are parties are advised to exercise their freedom of choice in the title and could therefore use "*the avoidance of double taxation*" or "*the prevention of fiscal evasion*" as they deem fit.

75 See Sasseville Jacques, *The New OECD Model Tax Convention (an edited version)* (1993) 6 SA Tax Review 119.

76 Sasseville *ibid.*

The Lesotho-RSA DTA is similar in its title to the Lesotho-UK DTA. This is not surprising since in actual fact the UK participated in both tax agreements, albeit in different capacities. In the first instance, the 1949 Lesotho-UK Arrangement could be equated to the UK negotiating and signing the treaty by herself since Lesotho was then under British protection.⁷⁷ The Lesotho-RSA DTA on the other hand, was in fact entered into between the UK in her representative capacity (on behalf of the then Basutoland Protectorate) and RSA.⁷⁸

The renegotiated DTAs with both the UK and RSA respectively, retain the earlier texts' title wording, ie - "*The Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*".⁷⁹ The Lesotho-UK DTA, however, goes further to add "capital gains" in its title and this is to conform with the domestic income tax laws in the United Kingdom. Since Lesotho in its domestic law has introduced capital gains tax, even though in a limited form,⁸⁰ it may seem that "capital gains" could have been added to the title of the Lesotho-RSA DTA. The difficulty with this suggestion is that there is no capital gains tax in South Africa. It

77 Note should however be taken that the 1949 Arrangement between the then Basutoland and the UK was subsequently amended after Lesotho's independence in 1968. This act implies the act of succession to the earlier Arrangement and it will not be too helpful to overemphasise this point.

78 See Silke, *South African Income Tax*, 11th ed, para 24.16 p 24-46. However, again in this case Lesotho succeeded to the Agreement following independence.

79 See Annex I and II respectively.

80 See Section 20 of the Lesotho Income Tax Order.

therefore, remains prudent to define the taxes covered in terms of "Lesotho tax" and "South African tax" respectively.⁸¹

9.4.2. TAXES COVERED

The scope of the DTA on taxes covered naturally correspond to the taxes imposed under the domestic laws of the contracting parties. This helps to ensure identification of taxes covered as well as the implementing authorities. The OECD Model text and the commentaries thereto show that the list of taxes is not exhaustive but purely declaratory so that there is room for additional taxes which may be imposed in the future.⁸²

The 1949 Lesotho-UK text covered normal tax, super tax and "any other taxes of a substantially similar character". The 1994 renegotiated and unsigned text in the case of Lesotho simply covers income tax, while in the case of the UK it covers the income tax, corporate tax and capital gains tax. The text has gone further to exclude expressly an amount which represents a penalty or interest imposed under the law of either party, which does not qualify as a tax.⁸³ It would seem that in the context of computing the rate of tax or granting credits for foreign tax, it would be important to know clearly which

81 See Article 2 of the Lesotho-RSA renegotiated DTA, Annex II.

82 See Van Raad Commentary to Article 2 of the OECD Model text 1977.

83 See Article 2(2) of the draft Convention between Lesotho and the UK for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and Capital Gains (dated 19.01.94), Annex I.

amounts can be included and which amounts can not.

The 1959 Lesotho-SA DTA was similar to the earlier Lesotho-UK DTA in covering normal tax, super tax and any other taxes of a substantially similar character" imposed by the respective parties.⁸⁴ The renegotiated version of the Lesotho-RSA DTA covers income tax as under the Lesotho Income Tax Order 1993 and, for South Africa, normal tax, the non-resident shareholders' tax (NRST) and the secondary tax on companies. However, the 1995/96 budget speech following upon the Katz Commission⁸⁵ recommendation has announced the lifting of the NRST from October 1, 1995. The move is seen as being merely temporary to alleviate the current high taxation levels in South Africa.

9.4.3. PERSONAL SCOPE

The modern DTAs are generally applicable to persons who are residents or in some cases citizens of one or both contracting states.⁸⁶

84 See Article 1 of the Agreement between the Governments of South Africa and the UK for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income imposed in the Union of South Africa and in Basutoland, Proclamation No 260 of 1959. See text in Silke on *S A Income Tax* 11th ed p 1559

85 The Katz Interim Report of the Commission of Inquiry into certain aspects of tax structure of South Africa, 1994

86 See Commentary to Article 1 of the OECD Model Convention. Particular attention is therefore drawn to the fact that the OECD Model Convention contain no special provision relating to partnership. Parties are advised to examine the problems of partnerships in their negotiations and resolve as deem fit.

Similarly all the old Lesotho DTAs and the renegotiated DTAs are limited to apply to persons who are residents of Lesotho, the UK or South Africa respectively. The term "person" has been defined under both renegotiated DTAs with the UK and South Africa respectively, to include "an individual, a company and any other body of persons ... treated as an entity for tax purposes."⁸⁷ The DTA with the UK expressly excludes a partnership.⁸⁸

It is submitted that since members of a partnership are generally taxed as individuals, their residence and whether they are covered by the personal scope of the DTAs will be treated on the individual basis. The fiction of treating a partnership as a tax entity is not maintained in Lesotho, South Africa and the UK.⁸⁹

9.5. THE IMPORTANCE OF THE CONCEPT OF RESIDENCE IN DTAs

9.5.1. INTRODUCTION

The importance of the concept of residence in international tax agreements is that it provides one of the crucial deciding factors in determining the personal scope of the agreement. In

87 See renegotiated DTA with South Africa, Article 3(1)(i) at Annex II, renegotiated DTA with UK, Article 3(1)(e) at Annex I.

88 DTA with UK Annex I *loc cit*.

89 See Passos *loc cit* at 32 for RSA, also Lesotho Income Tax Order Sections 75-79

other words, residence remains a vital factor in establishing the jurisdictional limit of the DTA. Through residence, relevant person(s) to be covered as beneficiaries or objects of the provisions of the DTA are identifiable.

However, it will be recalled from the earlier discussion of the concept of residence in Chapter how fluid and illusory it could be. The concept of residence is prone to manipulation especially when applied to artificial entities like companies, trusts and partnerships which are often formed with pro-active knowledge on tax implications. The rules on temporary residence have the tendency to visit tax liability on foreigners having the slightest contact with the taxing jurisdiction. Moreover, the inevitable questions of fairness, justification etc arise with the danger of double taxation looming heavily in the circumstances.

The importance of the concept of residence is that it not only determines the personal scope of the application of the provisions of a DTA but also can be a vital solution in "tie-breaker" cases where there is double taxation due to dual residence or dual overlapping of taxation by residence and taxation by source. This is through special treaty definitions of "residence" with the so-called "tie breaker" rules designed to thrash out claims of dual residency in the territories of the two contracting parties.

The crucial role of the concept of "residence" in the DTAs

cannot, therefore, be over-emphasised. It is a determining factor as to whether a taxpayer falls under the scope of the DTA provisions. As a result it has become a standard provision in DTAs, with the exception of the USA-RSA treaty which does not focus on residence,⁹⁰ but rather on citizenship.

The OECD Model convention has incorporated detailed rules regarding determination of residence. There are, however, no such detailed rules with regard to the determination of source of income.⁹¹ At best, the concept of source is applicable as the converse position of the expressly stated application of residence. For instance, the right to tax business profits of a permanent establishment situated in the country is given expressly to the country of residence.⁹² Conversely, the country of source taxes business profits originating from it if there is no permanent establishment.

9.5.2. EXAMINATION OF THE CONCEPT OF RESIDENCE UNDER THE OECD MODEL CONVENTION;

Article 4 of the OECD Model Convention is generally intended to apply to persons (natural or judicial), who are residents

90 See *Passos Tax Treaty Law* at p 89 where the writer examines the concept of treaty resident by a comparative analysis of the South African tax treaties with the OECD Model provision on treaty resident.

91 See *Passos supra*, at 127 where the observation is in regard to South African tax treaties (modelled after the OECD text). Note should however be taken that source is used in the operative paragraph.

92 See Article 1 OECD Model Tax Convention.

of one or both of the contracting parties to the DTA.⁹³ The text simply provides that the term "resident of a Contracting State" refers to persons liable to tax by reason of "domicile, residence, place of management or any other criterion of a similar nature". In this way, the Convention has avoided the controversies surrounding the concept of residence in domestic law(s) of the contracting parties. However, the choice of residence as a basis by which the potential contracting parties will assert their tax jurisdiction clearly highlights the assumption underlying the OECD Model draft. The criteria for treaty residence include the aforementioned personal attachment factors without regard to the liability of the taxpayer nor the source/origin of income to be taxed. Provision has been made to exclude from the term "resident of a Contracting State", persons liable to tax only in respect of income from sources in the Contracting States.⁹⁴ Also according to the OECD Model Commentary to Article 4, the provision was added in 1977 to cater for persons like diplomats or other government service personnel. It is, however, submitted that this provision is redundant insofar as it relates to foreign diplomats and consular staff serving in the other country, since the Vienna Conventions adequately exempt such personnel from taxation in

93 See the *Australian Income Tax Practice - International Agreements* vol 1 A-M, Butterworths, as updated to Service 18, March 1993, commentary to Article 4 of the OECD Model Convention para 21 105.

94 See Article 4(1) of the OECD Model Convention, 1977 draft.

the receiving state.⁹⁵

It should, however, be noted that this concept of treaty residence seems to leave out persons who are taxed on the basis of other factors apart from residence. The obvious case would be a state which levies tax solely on the basis of source, eg South Africa. In such a situation circumstances arise where, despite some personal attachments, there is no tax liability because of the foreign-source nature of the income in question. The OECD Model does not use a wider term like "taxpayers" of the Contracting States in its personal scope. As a result there may be exclusion of other taxpayers who do not fit into the personal attachment definition of "resident" in terms of the model draft. In this context one may name taxpayers who are subject only to the Non-Resident Shareholders' Tax or the Non-Resident Tax on Interest in South Africa.⁹⁶

Consequently, the invariable use of residence as a general basis for taxation under the OECD Model text in Article 4 poses potential peculiar problems for (developing) countries whose tax systems are based on the concept of source.

95 See Article 37 of the 1961 Vienna Convention on Diplomatic Relations and Article 49 of the 1963 Vienna Convention on Consular Relations respectively. The overwhelming majority of the UN member States including Lesotho, South Africa and the UK are parties to both Conventions.

96 See Passos, *Tax Treaty Law* at p 93. The NRTI was levied in terms of Sections 64A to 64F of the South African Income Tax Act, 1962, but has since been abolished since 15 March 1988; the NRST is levied in terms of Section 42 in the form of tax withheld at source and will be abolished from October 1, 1995. Non-residents may still be liable to normal tax if the "source" of the interest in the relevant loan eg SA/UK - source is located where funds were made available - (1988) 1 *Juta Foreign Tax Review* 59 at 61, (1988) 2 *Juta Foreign Tax Review* at 27 on withholding taxes generally.

9.5.3. DTA CONCEPT OF TEMPORARY RESIDENCE

The OECD rules for dual residence:

The major bulk of the OECD residence provision under Article 4 is devoted to the so-called "tie-breaker" rules which are applicable in cases of dual residence. Dual residence in this context is limited to residence in both Contracting States and does not concern itself with residence in a third country. The approach is in five stages, applied in descending order and as alternatives.

The OECD Model Convention rules for resolving cases of dual residence between the contracting parties do not refer to the domestic residence laws of the parties. The rules give preference to one contracting party over the other. The issue is - what are the underlying assumptions in this allocation? It must also be appreciated that the rules have justifiably dealt with the individual and judicial persons separately.

The Individual:

For an individual, the following tests determine which contracting party is entitled to levy taxes:

- (i) The existence of a permanent home available in one Contracting State.

- (ii) If there are permanent homes in both countries, then preference is given to a State with which the personal and economic relations of a person are closer (often referred to as the "centre of vital interests").
- (iii) Where there is no permanent home in both States or where the centre of vital interests can not be found, preference is given to the Contracting State where the person has an habitual abode;
- (iv) Where there is an habitual abode in both States or in neither, then preference is given to the Contracting State of which the individual is a national;
- (v) Where the individual is a national of both or neither contracting parties, then the issue is to be resolved through mutual agreement between the competent authorities.

It should be noted that no element of time has been built into any of these tests and therefore it would remain a question of fact and degree in each case.

Other bodies of persons:

Article 4(3) of the OECD Model Convention makes provision for

dual residence of companies and other bodies of persons regardless of whether they are or are not legal persons. The preference in this context is to the State in which the "place of effective management" is situated. According to the commentary to the provision, it seems that the formulation was particularly drafted with taxation of income from shipping, inland waterways, transport and air transport in mind.⁹⁷

Note should be taken that not much emphasis is placed on formal registration, and that countries like Canada and the United States reserved their right to use the test of place of incorporation/organisation in the case of a company.⁹⁸

There has not been much expansion to the interpretation of the words "effective management". The term has, however, been equated to the UK concept of where the company's business is managed and controlled.⁹⁹ In other words, emphasis would be on the overall policy control of the company. However, New Zealand has been recorded as reserving her position on the use of the term "effective management" in referring to the day-to-day management of the company irrespective of where the overriding control is exercised.¹⁰⁰

97 See Commentary to Article 4(3) of the OECD Model Convention, Butterworths Australian Tax Practice International Agreement loose-leaf Service 18 at para 21 123.

98 Ibid.

99 See the UK approach in *De Beers Consolidated Mines Ltd v Howe* (1906) AC 455 discussed in Part I para 6.1

100 See Commentasry to Article 4(3) of the OECD Model Convention.

9.6. THE LESOTHO-UK DTA AND THE CONCEPT OF RESIDENCE

As observed in the discussion of the concept of treaty residence, the 1949 Lesotho-UK Arrangement on Avoidance of Double Taxation, the respective countries' domestic laws determined who was resident in Lesotho or in the UK. Regarding the residence of a company or any body corporate, these were treated as resident in either of the two contracting parties if their business was managed and controlled there. There were no "tie-breaker rules" for dual residence in the old arrangement.¹⁰¹

The renegotiated DTA has substantially been drafted along in lines of the OECD draft.¹⁰² However, the new text omits the OECD proviso which was added in 1977 to Article 4(1). This relates to the exclusion from the term "resident", persons liable to tax only in respect of income from sources in that State or capital situated therein (which among others, has been interpreted to exclude diplomats and consular offices posted in the other Contracting State) by Passos. Her submission is that the literal interpretation of this proviso may mean that a person will not qualify as a resident under the DTA if that country does not tax income from a foreign source, i.e. only

101 See Wheatcroft G S A, *British Tax Encyclopedia*, vol 5, parts 9 to 11: Double Taxation, Release No 87 up to date to October 10, 1983 at page 9503-9510 which reproduces the Lesotho-UK Double Taxation Relief Order 1949 and the 1968 Amendment of the Arrangement.

102 See Annexure II for the renegotiated text as initialled 19/10/94, Article 4 thereof.

limited to taxation from local sourced income. The present writer's submission, however, is that diplomats are not such a good example since they are exempted from local taxation by international conventions on diplomatic relations anyway.

The "tie-breaker" rules adopted for dual residence of individuals and other persons have been those of the OECD Model text.

9.7. THE LESOTHO-RSA DTA AND THE CONCEPT OF RESIDENCE:

The 1959 DTA between Lesotho and South Africa is substantially similar to the old Lesotho-UK Arrangement discussed above. The comments made on the latter, therefore, apply in *pari passu*. Briefly this means that the term "resident" has been used to refer to any person who is ordinarily resident, either in Lesotho or RSA for the purposes of the domestic tax laws in the respective States. A resident company, similarly, refers to a company whose business is managed and controlled in either of the two countries. There was no provision for "tie-breaker" rules regarding dual residence.¹⁰³

Under the renegotiated Lesotho-RSA DTA, the provision on residence has substantially adopted the OECD Model text.¹⁰⁴

103 See Article II(f) of the Lesotho and SA per Proclamation No 260, 1959 reproduced at *Silke on South African Income Tax*, 11th ed at A 81ff.

104 See Annexure II, Article 4 thereof.

The revised text has, however, slightly departed from the OECD Model in its omission of the concept of "domicile" in Article 4(1) among the personal factors by which a person would be referred to as "resident of Lesotho". Thus the concept in this context has as far as possible been related to the domestic laws. Similarly in regard to the term "resident of South Africa", the domestic tax laws in regard to individuals being "ordinarily resident" and "the place of effective management in South Africa" as being the crucial factors have been incorporated.¹⁰⁵

The 1977 OECD rider excepting persons liable to tax only in respect of income from local source and capital situated therein has been omitted for reasons aforesaid in the context of the UK text.

The "tie-breaker" rules of the Lesotho-RSA DTA for dual residence of individuals and other persons including companies reflect the OECD Model draft.

9.8. REMARKS ON THE DTA CONCEPT OF RESIDENCE IN LESOTHO:

The Lesotho DTAs have adopted the OECD Model concept of residence except for minor disparities. The concept of residence in both DTAs with South African and the United Kingdom respectively are similar. It would seem that the fact that South Africa and the United Kingdom approaches differ in some respects did not have any impact here.

105 See Article 4(1)(a) and (b) above.

CHAPTER 10

PERMANENT ESTABLISHMENT

10.1. INTRODUCTION:

The concept of permanent establishment is one of the most controversial elements of tax treaties. It is generally defined as a fixed place of business through which an enterprise conducts its activities in another State. The existence of a permanent establishment becomes especially crucial when, apart from being used as a measure to alleviate double taxation, the concept is used to allocate the right to tax business income between the contracting parties. Given the importance of business profits within the system of income taxation, it, is therefore, vital which of the contracting parties will have the right to levy tax on those profits. The situation becomes aggravated by the nature of operations of modern enterprises which are often networks dispersed internationally, which causes difficulty in establishing from where the profits originate. The solution to this is again underscored by the source/residence concepts.

The debate surrounding the concept of permanent establishment revolves around whether to tax business profits on the basis of source or residence. The OECD Model's conception of the permanent establishment is criticised for being restrictive and thereby extending preference to the country of residence (generally a developed country) in the taxation of business

profits. The UN Model has attempted to broaden situations considered as permanent establishment and has geared towards extending the scope of the country of source (usually developing countries) in the taxation of business profits. At the other extreme, is the classical position of the Latin American countries, which have done away with the concept of permanent establishment. The principle of source is incorporated in the Latin American approach as the exclusive criterion for asserting jurisdiction over income generated within a territory.

10.2. THE OECD MODEL CONVENTION:

The concept of "permanent establishment" is one of the terms which the OECD Model Convention has defined in great detail. The term has been widely defined with a general definition, inclusions, exclusions and deeming provisions. No doubt this is potentially a pitfall for the unwary and as one writer aptly puts it: "The drafting is elegant and coherent enough to warrant a careful reading".¹⁰⁶

10.2.1. THE GENERAL RULE

According to the OECD Model Convention, the concept of permanent establishment generally refers to "a fixed place of business through which the business of an enterprise is wholly or

106 See Grbish Y, Bradbook AJ, Pose K, *Revenue Law Cases and Materials*, Butterworths 1990 p 835.

partly carried on".¹⁰⁷ In other words there has to be a place of business which must be fixed or have some sense of permanency. Another important element is that there must be persons often referred to as dependent agents whose activities focus on conducting business including conclusion of contracts on behalf of the permanent establishment.¹⁰⁸ The element of profitability of the enterprise is not stated but it is submitted that it is implied.¹⁰⁹ This does not exclude the incurring of losses as being another risk in conducting business.

The effect of the concept of permanent establishment in the OECD Model Convention is that the source country is given the right to levy tax on business profits only if attributable to the permanent establishment situated therein. Put in other words, an enterprise of another State is not liable to tax in the other State unless it carries on business in that other State through a permanent establishment situated therein.¹¹⁰ This general rule seems clear and neutral. Nevertheless, in relation to DTAs between a developed country and a developing country, the effect of this provision is to load the odds against the developing partner. This is because the normal

107 See Article 5(1) of the OECD Model Convention.

108 See OECD Commentaries on Article 5(1).

109 Note, however, that Van Raad on his OECD Commentary on Article 5(1) argues that mention should have been made that the establishment must have a productive character so that it contributes profits to the enterprise.

110 See Hellawel Robert, *US Income Taxation and Less Developed Countries: A Critical Appraisal*, *Columbia Law Review*, vol 66 1966 p 1393 at 1419; also Atchabahian A, *Some aspects of International Double Taxation between Developed and Developing Countries* vol XXV, *Bulletin for International Fiscal Documentation* 1971 p 451 at 457.

trend is for the developed country to be the country of residence of the enterprise which carries on business in the developing country. Through the constricted narrow approach to what constitutes the permanent establishment, the taxing power of the country of source from which the profits are derived (developing country) is limited. Conversely, as the taxing power of the country in which the revenue is generated is constricted, the revenue of the country from which the investment comes expands. This traditional tax treaty approach would work mutually between two developed countries, when investments are moving in both directions (reciprocity). However, between parties of unequal level of development, the concept of permanent establishment is one of the factors which results in loss of revenue to the developing country, with no compensation for infrastructure costs and has an adverse effect on balance of payments.¹¹¹

The problem noted above becomes exacerbated by modern innovations in communications, such as facsimiles, mobile telephones and computers. With such high mobility in modern international communications there is no longer absolute necessity or justification for maintaining a permanent establishment (in the form of employees) for doing business in another country. Only brief visits are deemed necessary to conclude deals with huge amounts of money being exchanged between the parties. This is a rich recipe for tax evasion.

111 See Irish C, *International DTAs and Income Tax at Source*, 1974 I.C.L.Q. 292 at 293 ff.

This scenario, therefore, makes it imperative to broaden the concept of permanent establishment or perhaps even formulate other grounds for levying of tax at the country of source.¹¹²

It should, however, be noted that the OECD Member States do not approve of the broadening of the term permanent establishment.¹¹³ It is felt that this move would extend the tax base of the host countries unreasonably.

Similarly, the six months minimum period for qualifying a construction project as permanent establishment is found unacceptable. Nevertheless, it is common cause that the shorter period is gaining acceptance in recently concluded tax treaties.¹¹⁴ The US Model required a construction project to last more than 24 months to constitute a permanent establishment. It is needless to point out how unpopular this extreme period was.¹¹⁵

112 It should be noted that the Latin American countries have, for various reasons including those mentioned above, done away with the concept of permanent establishment. The Andean Model is exclusively based on the principle of source of income. See Atchabahian A, "The Andean Subregion and its Approach to Avoidance or Alleviation of International Double Taxation, Vol xxviii *Bulletin for International Fiscal Documentation* 1974 309 at 314

113 See Schwarz, J S, "Tax and International Flows" (1991) 4 *Juta's Foreign Tax Review* 28, where the writer reports on the 1990 Symposium organised by the OECD in association with IMF for both developed and developing countries.

114 Ibid, see also Passos, *Tax Treaty Law* p 145 and Danzinger E, *International Income Tax: RSA Perspective*, Butterworths, p 343, regarding the RSA-Israel DTA which adopted the six months test; Zimbabwe-Norway 1990 DTA *Income Tax Reporter*, vol 31, 1992 59 at 80.

115 See USA Treasury Model Income Tax Treaty of 18 May 1976 as amended, *Bulletin for International Fiscal Documentation*, vol xxxi 1977 p 313 at 315.

The 1981 US Model tax treaty has aligned itself with the OECD Model in setting 12 months as the minimum period for a construction project to qualify as a permanent establishment.¹¹⁶

With these comments in mind, consideration will now turn to the detailed inclusions and exclusions of the OECD Model Convention on the concept of permanent establishment.

10.2.2. INCLUSIONS

The list is said to be merely illustrative but not exhaustive.¹¹⁷ Each example has to be considered against the general definition under paragraph 10.2.1 above. The list specifically mentions that the term "permanent establishment" includes a place of management, a branch, an office, a factory, a workshop and a mine/oil or gas well, a quarry or any other place of extraction of natural resources.¹¹⁸ A building site or construction or installation project will constitute a permanent establishment if it lasts for a period of more than twelve months. This is the only instance in the Convention where the concept is defined in terms of time.¹¹⁹

116 See Kees van Raad - *Comparative Presentation of the tests of the OECD (1963 and 1977) Model Conventions, the UN (1980) and the US (1981) 1990 Kluwer Publications.*

117 See Van Raad Commentary on OECD Model Convention Article 5(2).

118 See Article 5(2) OECD Model Convention.

119 See Article 5(3) OECD Model Convention. Note, however, that the UN Model draft has shortened the period to six months duration and thereby broadened the concept.

As discussed above in the introduction, the shorter six months period is becoming popular even though this does not augur well for the OECD Member States generally.¹²⁰

10.2.3. EXCLUSIONS

There is a detailed provision which states these activities that shall not be deemed to constitute a permanent establishment. The general characteristic which is common in all the instances is that activities of a purely preparatory or auxiliary nature are excluded from the concept of permanent establishment. These exclusions include storage, display, delivery of goods, processing of goods, collection of information and advertising if such activities have a purely preparatory or auxiliary character. The effect of the test as to whether an activity is of a preparatory or auxiliary nature is to restrict the general definition of the concept of permanent establishment.¹²¹

10.2.4. DEEMED EXISTENCE PROVISIONS

Notwithstanding that there is no fixed place of business in terms of the general definition, the inclusions and exclusions at paragraphs 10.2.2 and 10.2.3 above, a permanent establishment is deemed to exist where business is carried on through

120 See Schwarz *loc cit.*

121 See Article 5(4) of the OECD Model Convention.

a resident agent in the other State.¹²² This is the so-called dependent agent and the distinction between dependent and independent agents in this context is crucial.

Dependent agents are often equated to employees. The salient features of dependent agents are that these persons (natural or juristic) must have authority to habitually conclude contracts in the name of the enterprise. Isolated incidents do not qualify and the contracts must relate to the operations of the enterprise. A recent Australian case illustrates how this works in practice.¹²³ The facts were that New Zealand resident taxpayers were carrying on a business of buying and selling shares in Australia which was conducted through a dealer employed by an Australian firm of stockbrokers. The issue was whether the dealer qualified as a permanent establishment of the New Zealand taxpayers. The facts disclosed that the dealer habitually exercised his authority as an attorney and agent of the New Zealand taxpayers to conclude contracts on their behalf. The New Zealand taxpayers were, therefore, held to carry on business in Australia, through a permanent establishment and thus to be taxable there. The taxpayers had sought protection under the Australian/New Zealand DTA and argued that their share trading business in Australia was carried on through a broker, general commission agent or other

122 See Van Raad, Commentaries on OECD Model Convention, Article 5(5).

123 See AAT Case 8775 (1993) 26 ATR 1056 discussed in the *Australian Tax Handbook* 1994, Butterworths, para 40 070 pg 1074

agent of independent status (see the next section at 10.2.5). It was, however, found that the dealer was merely an employee of a broker and not a broker himself. The dealer was not a general commission agent since he was not working for clients generally; he worked for the stockbroking firm and there was close consultation with the New Zealand taxpayers.

From the above case, it is clear that the New Zealand taxpayers could have escaped Australian tax liability if they had carried on their sharedealing business through an independent broker who traded in shares as part of his ordinary business and who served the public at large, i.e. if the business had not been confined to that of the New Zealand taxpayers/residents alone. This is due to the deeming exclusion provisions found in the Australian/New Zealand DTA which is modelled after the OECD Model Convention regarding the concept of permanent establishment.¹²⁴ Activities of persons may with proactive knowledge be planned to fall or not to fall within the DTA scope.

10.2.5. DEEMED EXCLUSION PROVISIONS

Business carried on in another State through a broker, general commission agent or any other agent of an independent status is deemed not to constitute a permanent establishment, provided the said agent is acting in the ordinary course of his/her

124 The OECD Model Convention Article 5(6) is the equivalent of the Australian/New Zealand DTA Article 4(7).

business.¹²⁵

The crucial question here is the extent of the agent's obligations vis-a-vis the enterprise. Relevant factors include the risks assumed by the agent, the extent of supervision and control involved between the agent and the enterprise etc.¹²⁶

A typical controversial case cited in this context relates to taxation of insurance companies. In terms of the definition of the concept of permanent establishment, an insurance company in one State may be taxed in the other State, if it carries on the insurance business in the other State through a fixed place of business (a branch or office) or through dependent agents. However, as observed by the OECD commentaries on this provision, agencies of foreign insurance companies may by design, not meet these requirements of permanent establishment. The practical effect is that these insurance companies may be carrying on a large volume of business in a State without paying any taxes on profits arising therefrom.¹²⁷ The

125 See the OECD Model Convention at Article 5(6) and commentaries thereon.

126 See the OECD Model Convention at Article 5(6) and commentaries thereon.

127 To highlight this possibility, it is reported that various DTAs concluded by OECD member States often include a clause to the effect that insurance companies are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there. The desirability of inclusion of a provision similar to this will be determined by the exigencies and legal situation prevalent in the contracting States involved. It is, therefore, left to the discretion of the parties to a DTA to choose what is suitable in their situation. See OECD Model *ibid*.

relevance of this issue for Lesotho is discussed at page 249.

The existence of a subsidiary company does not constitute that into a permanent establishment of the parent company for taxation purposes. This is due to the fact that the two are legally independent entities with separate existence. The essence of a permanent establishment is that it is merely an extension of an enterprise in the other contracting State and not an independent legal entity.¹²⁸ This general principle is, however, not conclusive. Certain treaties depart from this and the acts between the subsidiary and the parent company will have to be closely examined.

10.3. THE LESOTHO-UK DTA:

The Lesotho-UK Arrangement of 1949 is essentially similar to the OECD Model text in its conception of the permanent establishment. The Arrangement has a brief definition of the concept of permanent establishment:

"a branch, management or other fixed place of business, but does not include an agency unless the agent has and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has stock of merchandise from which he regularly fills orders on its behalf ..." (See paragraph 2(j) of the treaty.)

128 See Passos *Tax Treaty Law* at p 157.

The definition also goes on to exclude business conducted through a *bona fide* broker or general commission agent from the concept of permanent establishment. Similarly, a fixed place of business used exclusively for the purchase of goods and merchandise has been excluded. Likewise a subsidiary company resident in another territory does not constitute a permanent establishment.¹²⁹

The renegotiated tax treaty between Lesotho and the UK is to a large extent an adoption of the OECD Model Convention draft on the concept of permanent establishment. The only major deviation is in regard to the adoption of the period of more than six months as a prerequisite for a building site, construction or installation to qualify as a permanent establishment.¹³⁰ It will be recalled that the six month period in this regard is modelled after the UN Model Convention. Construction, building site or installation works are in principle works of a specific duration.

10.4. THE LESOTHO-RSA DTA:

The provision on permanent establishment in the old tax treaty between Lesotho and RSA is essentially similar to the OECD

129 See the Arrangement between Lesotho and the UK for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes and income in its definition of the concept of permanent establishment, *The British Tax Encyclopedia*, Vol 5, Wheatcroft CSA (ed) at p 9504

130 See Article 5(3) of the renegotiated Lesotho-UK DTA at Annex I

Model draft. The renegotiated draft has introduced some slight deviations but these are not changes in substance but rather expansion in the drafting.¹³¹

The renegotiated Lesotho-RSA DTA has adopted the minimum period of six months for a building site, construction or installation to qualify as a permanent establishment. Moreover, an "assembly project" has also been added as a new activity qualifying as a permanent establishment in this category.¹³² It is submitted that this does not add anything new substantially since an assembly project is essentially similar to installation or construction project. There is some degree of permanency and the activities are not auxiliary or preparatory.¹³³

10.5. **DECIDED CASES RELATING TO THE CONCEPT OF PERMANENT ESTABLISHMENT IN SOUTHERN AFRICAN LAW**

There are very few decided cases on double tax agreements generally, and this situation prevails with the concept of permanent establishment.

The often quoted case in this context is that of *Transvaal Associated Hide and Skin Merchants (Pty) Ltd v Collector of*

131 See Article 5 of the new Lesotho-RSA DTA at Annex

132 It should be noted that the adoption of the 6 months period is becoming the norm in the latest DTAs. For example the same period was adopted in the Zimbabwe DTA with Norway 1990, see *Income Tax Reporter* Vol 31 1992 59 at 80.

133 See Passos, *Tax Treaty Law* 144. Note should however be taken that this category of PE is defined in terms of time because of its temporary nature.

*Income Tax, Botswana.*¹³⁴ The taxpayer in this case was a company incorporated, managed and controlled in South Africa which carried on the business of buying and selling hides and skins. The hides which were "green" i.e. fresh from slaughtered animals were purchased from an abattoir in Lobatse, Botswana. But the sales and payments were made in South Africa by the company. There was, however, a shed adjoining the abattoir and occupied by the company which "cured" the green hides, graded and stored them ready for dispatch. The issue was the source of income from these sales.

The Double Taxation Agreement between the Government of the UK and South Africa¹³⁵ was argued to be applicable to Botswana as the then Bechuanaland Protectorate. Assuming that to be so, even though the learned Judge Maisels expressed some doubt, it was held that the company carried on business in Botswana through a permanent establishment. It was found that the activities of the company went beyond the mere purchase and storage of goods in a warehouse. This was because of the crucial process of curing of the hides at Lobatse which was found to be dominant over the selling of the hides. The source of income was therefore held to be Botswana.

134 Case of the Court of Appeal Botswana, May 1967, reported in 29 SATC 97; 1967 (3) SA 504.

135 The Double Taxation Agreement between the Government of Great Britain and Northern Ireland and the Government of the Union of South Africa, as notified in the High Commissioner's Notice No 70 of 1959; see the report of the case and the remarks of Maisels JA 1967 (3) SA 504; 29 SATC 97 at 109.

Considering the question whether the company had a permanent establishment in Botswana, Judge Maisels pointed out that:

"the word 'permanent' is used in contradistinction to a merely temporary or occasional use of premises for purposes of trade or business."¹³⁶

From the facts of the case, the occupation of the premises by the company was since 1954. Permanency in those circumstances was obvious.

Another case of *SIR v Downing*,¹³⁷ involved the DTA between South Africa and Switzerland¹³⁸ and the issue was whether the taxpayer, resident in Switzerland, carried on business in South Africa through a permanent establishment in terms of the DTA. From the facts it appeared that upon emigrating to Switzerland the taxpayer left some assets in South Africa which were managed by a local firm. These included shares which was managed by a broker who was authorised to make as much profit as possible. The broker could make whatever changes in the portfolio that he deemed fit. However, the broker frequently informed the taxpayer as well as the managing firm about any changes in the portfolio. The court found that the broker was merely acting as agent in the ordinary course of his business. Therefore there was no permanent establishment in the RSA and

136 Ibid at 115.

137 1975 (4) SA 518 (A), 37 SATC 249.

138 Proclamation R240 of 1967.

therefore no tax payable.

The concept of permanent establishment as used in the OECD Model Convention envisaged that a distinction be made between dependent and independent agents. The latter conducts his own business on his own premises and generally operates independently of his principal while the former acts habitually on behalf of a non-resident principal.¹³⁹

Downing's case is often compared and contrasted with the Australian case of *Thiel vs Federal Commissioner of Taxation*.¹⁴⁰ In the latter case, the taxpayer also resident in Switzerland, engaged in buying and selling shares in Australia after his business in Switzerland ran into difficulties. The Commissioner sought to tax profits from the sharedealing in Australia. The taxpayer objected, invoking Article 7(1) of the DTA between Australia and Switzerland. This is the standard OECD Model Convention provision which states that profits of an enterprise of one contracting State are taxable in the other State only if they accrue from business conducted through a

139 See *The Taxpayer* 1975 210 at 217 on its commentary on the decision in *SIR v Downing*. Note should also be taken that the court in this case sought the OECD Model Convention to guide it in interpreting the relevant DTA.

140 (1988) 88 ATC 4094, and 90 ATC 4717, discussed by Arthur PRN, "DTAs Implications of, *Thiel*" (1990) 3 *Juta's Foreign Tax Review* 48 and at (1991) 4 *Juta's Foreign Tax Review*, 13.

permanent establishment.¹⁴¹ The Full High Court¹⁴² overruled the decision of the full Federal Court holding that the provisions of Article 7 regarding taxation of business profits were applicable to the taxpayer under the treaty. The taxpayer's activities in acquiring and selling share units were found to be adventurous but in the nature of the shared dealing trade and therefore constituted an "enterprise of one of the contracting States". Accordingly, the taxpayer was not subject to Australian tax.

The Federal Court decision of Franklyn J, which was overturned had focused on the question of whether the taxpayer's activities could be characterised as "an enterprise" within the meaning of Article 7. The learned Judge found that the taxpayer's shared dealing activities were an isolated venture with no continuity or repetition. Furthermore, the funds which the taxpayer utilised in this shared dealing came from an interest-free loan from his parents, not from a bank in contrast to his usual business activities.¹⁴³ Despite the fact that it was clear that there was a motive to make profit, Franklyn J held that the activities of Thiel did not qualify

141 Note should be taken that this article is similar to most DTAs which follow the OECD Model Convention and was also the same in the SA-Switzerland DTA invoked in *Downing's* case *supra*. Furthermore, the court in *Thiel's* case extensively referred to the 1977 OECD Model Convention and commentaries thereon.

142 Reported at (1990) 21 ATR 531 or (1990) 90 ATC 4717.

143 Note, however, that due to the taxpayer's financial difficulties in carrying on his business of importing and selling earth moving machinery, perhaps approaching his parents for an interest-free loan was also a sound business move (securing capital the cheapest way).

as business profits and were therefore not covered by the DTA provision. They were thus taxable in Australia.

In comparing *Downing's* case with *Thiel's* case, Arthur¹⁴⁴ notes that both involved taxation of non-resident Swiss investors, carrying on business in South Africa and Australia respectively. However in contrast, while *Downing's* case focused on the meaning of "permanent establishment", *Thiel's* case centred on the meaning of "enterprise". The two decisions, it is submitted, complement each other. Before business profits of a non-resident investor are taxed where there is a DTA applicable, it must be ascertained whether they were proceeds through a permanent establishment. Furthermore, the word "enterprise" can qualify an isolated incident as business profits provided it is in the nature of that trade.¹⁴⁵ Arthur¹⁴⁶ criticised Franklyn J's judgment in the light of the often quoted remarks of Jessel MR in *Smith v Anderson*¹⁴⁷ which states that "anything which occupies the time and attention and labour of a man for the purpose of profit is business". The

144 Arthur *loc cit*, see *supra*

145 It should however be noted that the South African Appellate Division has not pronounced that profits arising out of a single transaction can be taken as business profits within the DTA provisions. However it is hoped that *Thiel's* case will be persuasive authority in support of this opinion more so when its decision extensively invoked the OECD Model Convention and commentaries thereon. As observed earlier, Passos, *Tax Treaty Law*, p 75, is also of the view that although RSA is not an OECD Member State, by adopting the OECD Model text in her treaties, there is a presumption that the commentaries thereon should at least have a persuasive effect in the interpretation of treaties.

146 Arthur *loc cit*.

147 (1880) 15 Ch D 247 at 258.

CHAPTER 11**INTERNATIONAL TAXATION OF INCOME****11.1. INTRODUCTION:**

The tax treaties have adopted rules which distinguish between different categories of income for which there is different tax treatment. Income classification covers income from immovable property, business profits, shipping, international transportation and passive income items (dividends, interests). There is also differentiation between income earned through dependent and independent personal services, directors' fees, artistes and athletes, pensions, government service and students. In the different classes of income either source or residence is applied as the basis for determining taxation and, in some instances, both tests are applicable. It should be noted, however that source rules in tax treaties are often used* to assign geographical location to income or property.¹⁴⁸

11.2. INCOME TAXED ON THE BASIS OF RESIDENCE:

The following types of income are generally taxed on the basis of residence of the recipient. Deviations arise in certain circumstances:

148 See Passos *op.cit.* at 127.

- **Profits of an enterprise carried on in another country** are taxable in the country of residence of the enterprise provided that business is carried on through a permanent establishment in the country of source.
- **Profits derived from the operation of ships or international transportation (land or air)** are taxable in the country of residence of the operator.
- **Remuneration derived from personal services** is taxable in the country of residence provided that the employee was not present in the other country (of source) for a period not exceeding aggregate 183 days in the fiscal year.
- **Income derived from professional services or independent services** is taxable in the country of residence except if there is a fixed base regularly available in the other country.
- **Pensions and annuities** are taxable in the country of residence of the recipient.
- **Public service employees** are taxed in the country of residence, ie by the paying Government.
- **Remuneration of teachers/professors provided presence is for less than two years in the other country** is taxed in the country of residence.

- **Payments made for maintenance/education of students** are taxable in the country of residence.

11.3. INCOME TAXED ON THE BASIS OF SOURCE:

Some classes of income are taxed on the basis of source of income. A corresponding credit is often extended to the country of residence if required. These include:

- **Income from real/immovable property** - This includes payments for exploitation of natural resources, mines, quarries, royalties, or any income accessory to immovable property. The income is generally taxed at the place it is generated.
- **Business income derived through a PE in another country.**
- **Public entertainers/sportsmen** income is taxed where the performance is done.
- **Employment coupled with presence for more than 183 days.**
- **Directors and similar appointments** are taxed at the place of residence of the company.

CHAPTER 12

INCOME FROM IMMOVABLE PROPERTY

12.1. INTRODUCTION:

The general rule is that income from immovable property is taxed where the property is located. This means that source is the determining factor for tax liability.

12.2. A COMPARATIVE APPROACH IN THE TAX TREATY MODELS:

According to the OECD Model Convention, income derived from immovable property is taxed in the State in which the property is situated.¹⁴⁹ It would seem that residence of the recipient of the income is irrelevant in this context. The deciding factor is the location of the income producing immovable property. Source in this case takes precedence over residence. According to the commentary on the article, this is due to the close economic connection between the source of income and the State of source. "Immovable property" has been defined by listing items generally associated with the term and those not considered as such.¹⁵⁰ The law of the State in which the

149 See Article 6 of the OECD Model Convention.

150 See commentary to Article 6 of the OECD Model Convention. Note should be taken that this Article covers a situation where income sought to be taxed, has been derived by a resident of a contracting State from immovable property situated in the other contracting State. Income derived from immovable property in a contracting State will be treated according to the domestic law of that State. The same will presumably apply to income from property situated in a third state.

property is situated is crucial.

Items considered to fall under income from immovable property include payment received for assets or right of use of property accessory to immovable property. Thus livestock and equipment used in agriculture and forestry, usufruct of immovable property, right to exploit mineral deposits and other natural resources fall into this group; leasing of immovable property also falls within this category. Specifically excluded from immovable property are ships, boats and aircraft. The list attempted to include property generally treated as immovable in most legal systems. However, some countries expressed reservations to the provisions of the Article. It is submitted that reservations expressed were not necessary, bearing in mind that in any event, the OECD Model draft specifically stated that the meaning of the term "immovable property" shall be according to the domestic law of the State in which the property is situated.¹⁵¹ A similar approach is taken by the UN and Andean Models.

151 Ibid. Note should also be taken on reservations on the Article expressed by Finland and France respectively. Finland reserved the right to levy tax on shareholders in Finnish companies income from direct use, letting or any kind of exploitation or enjoyment of immovable property situated in Finland. France's reservation was retention of the application of taxation of income from shares or rights in immovable property situated in France. Note should also be taken that according to the OECD commentary to this Article, indebtedness secured by immovable property falls under the provisions regarding taxation of interest, hence it has not been included. However the South African DTAs with the Netherlands and Swaziland include debt claims of every kind, secured by mortgage but excluding bonds or debentures under income from immovable property. See Danzinger, *International Income Tax* at p 348.

There is no discrepancy here. The UN, US and Andean Models retained substantively similar provisions as the OECD Model Convention regarding treatment of income from immovable property. The primary right of the source country to impose tax is not in dispute. The US Model uses the term "real property" and grants primary but not sole right to tax income from immovable property to the country where it is situated.

This provision of the OECD Model Convention reflects the general rule in most tax legal systems. That is, source of income from immovable property is the place where the property is located. The assumption would be that the income would be taxed where it originates. However, as discussed earlier,¹⁵² some countries levy tax on world-wide income of their residents. Lesotho and the UK are examples in this context, while South Africa levies tax only on income sourced from within or deemed to be from a source within that territory.

The situation in the UK is that capital gains tax is levied on persons who are resident or ordinarily resident there irrespective of where the source of that income is.¹⁵³ In other words, capital gains tax in this context can be levied even for immovable property located outside the UK provided that it is remitted there by the resident.

152 See Part I, Chapter 1.

153 *Butterworth UK Tax Guide* 1989-90 p 925 ff; see also *Simon's Taxes*, Volume F Double Tax Relief, (Revised 3rd ed) Fl.1226 p 167.

It is not precisely clear from either the OECD Model or the UN Model whether income from immovable property, should be taxed on a gross or net basis. It has been commented that in keeping with other instances of taxation at source, taxation of income from immovable property should be geared towards profits not gross income.¹⁵⁴ It is submitted that these details ought to be left to the discretion of the contracting parties.

12.3. LESOTHO-UK DTA:

The 1949 DTA between Lesotho and the UK made no specific provision for taxation of income from immovable property. Perhaps in this case income from immovable property would fall under business profit articles as it is often treated. The term "royalty" used in the DTA specifically excluded any amount paid in respect of the operation of a mine or quarry or of other extraction of natural resources.¹⁵⁵ The renegotiated DTA explicitly recognises the right to tax income derived from immovable property in the country in which the property is situated.¹⁵⁶ The OECD Model Convention text has been incorporated as discussed above in 12.2.

154 See Proposed Draft Double Taxation Convention for use between developed and Developing Countries with Explanatory Commentary, *Harvard International Law Journal*, vol 19 p 67. at p 133.

155 See Article 7(2) of the Lesotho-UK DTA Arrangement of 25 November 1949, *Simons Taxes*, vol F DTAs, Revised 3rd ed p 2791.

156 See Article 6 of the revised Lesotho-UK DTA, Annex I.

There is, however, a further provision on capital gains which states that these may be taxed in accordance with the provisions of the domestic law of each respective State party.¹⁵⁷ This applies in this context to profits from the sale of immovable property.

12.4. LESOTHO-RSA DTA:

The 1959 DTA does not have a definition of immovable property nor does it list the categories of items qualifying under the term.¹⁵⁸ However, the term "industrial or commercial profits" is defined to include mining, farming and agency profits but excludes income in the form of royalties, rents, dividends, interests etc.¹⁵⁹ The treaty further provides that income of whatever nature derived from real property in the territory of one of the treaty States by a resident of the other State shall be exempt from tax in the residence State.¹⁶⁰ In other words, the State of source where the real property is situated levies the tax. Similarly, any royalty or other amount paid for regarding operation of a mine or quarry or any other extraction of natural resources in the territory of one of the State parties by a resident of the other State shall also be exempted from taxation in the residence State.¹⁶¹

157 Op cit at Article 14.

158 See The Lesotho-RSA DTA, 1959 at Silke, *The South African Income Tax*, 11th ed, Juta Article VII(1).

159 *Ibid.*

160 Lesotho-RSA DTA, 1959, *op.cit*, p 1562.

161 Lesotho-RSA DTA, 1959, *ibid.*

It should be noted that this provision covers "income of whatever nature" derived from real property and as such is very wide. Specifically excluded would be royalties, rents, dividends and interest which are subject to another provision.¹⁶²

The renegotiated Lesotho-RSA DTA¹⁶³ has merely incorporated the OECD Model Convention and the remarks made earlier apply here *in pari passu*.

12.5. CONCLUSION:

The international taxation of income from immovable property does not present problems. All the Models examined, ie the OECD, the US, UN and Andean Pact Models, agree on the right of the State where the property is situated to taxation. This approach favours the country of source and there is agreement that this is fair enough. The Lesotho DTAs adopt a similar approach.

162 See Lesotho-RSA DTA, 1959, *op.cit* p 1561, on Article VI which provides for taxation of these items at the State of source/use. See also Danzinger *International Income Tax*, *op.cit*, p 348-349.

163 See Annex II *infra*.

CHAPTER 13

INTERNATIONAL TAXATION OF BUSINESS PROFITS

13.1. DEFINITIONS:

Neither the term "business" nor "profit" is defined by the OECD Model Convention. The commentaries where the term "profits" has been used point out that it has been found unnecessary to define the term. Nevertheless, the term when used in the OECD Model Convention has a broad meaning including all income emanating from carrying on an enterprise.¹⁶⁴ Another term often used interchangeably with "business profits" is that of "industrial and commercial profits".¹⁶⁵ The scope of the term "business profits" is left to be determined by the contracting parties.

The word "business" has, however, been considered by the Courts and in the often quoted remarks of Jessel MR:

"anything which occupies the time and attention and labour of man for the purpose of profit is business."¹⁶⁶

164 See commentary to Article 7(7).

165 Note should however be taken that the term "industrial and commercial profits" was used in the older DTAs while the current term generally used is "business profits". See Lesotho-UK DTA 1949, Lesotho-RSA DTA 1959 and contrast these with the renegotiated DTAs respectively. Silke, *SA Income Tax* 10th ed para 24.2 p 24-8 to 24-10 remarks that "industrial or commercial profits" is a term of international tax language with no counterpart in the SA law.

166 See *Smith v Anderson* 15 Ch D at 258.

The OECD Model Convention in its commentaries advises on a special definition of the term "profits" especially where there are changes in the special articles on dividends, interest and royalties.¹⁶⁷ The term "enterprise" has not been defined either, save to state that whether or not an activity is performed by an enterprise it is to be determined by the domestic laws of the parties to a DTA.¹⁶⁸ The Andean Pact Model defines the word "enterprise" to mean an organisation constituted by one or more persons that undertakes a profit making activity.¹⁶⁹

The US Model defines "business profits" as "income derived from any trade or business whether carried on by an individual, company or any other person, or group of persons, including the rental of tangible personal (movable) property, and the rental or licensing of cinematograph films or tapes used for radio or television broadcasting".¹⁷⁰ The UN Model, similar to the OECD Model, avoided the question of defining "business profits" except for tying them to the concept of permanent establishment.

167 See commentary to Article 7(7).

168 See OECD Model Convention Article 3 and commentaries thereon.

169 See Atchabahian, *The Andean Subregion and US Approach to Avoidance, or Alleviation of International Double Taxation*, *Bulletin for International Fiscal Documentation*, vol xxviii 308 at 326.

170 See Article 7(7) of the US Model Convention; See also Surrey S, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, *Harvard International Law Journal*, vol 19 1978 p 1 at p 12.

The Lesotho-UK 1949 Arrangement defined the term "industrial or commercial profits" by stating what the term did not include. The exclusions were income in the form of rents, royalties (other than rents or royalties in respect of motion picture films), interest, dividends, management charges and remuneration for labour or personal services.¹⁷¹

The Lesotho-RSA 1959 DTA defined the term "industrial or commercial profits" to include mining, farming and agency profits but did not include items similarly excluded in the Lesotho-UK DTA discussed in the preceding paragraph.¹⁷² The inclusion and exclusion of certain items of income under "business profits" has according to Passos, given rise to confusion. An example cited in this context, is that of classification of mining income which has been classified as business income in some treaties while it has been classified as income from immovable property in others.¹⁷³

Note should be taken that all items on the list of income excluded from the "business profits" are generally treated separately in the tax treaties. Passos points out the fallacy of the view that the classification of business profits includes all income that is not specifically dealt with separately in a treaty. Such a view, she submits is refuted by

171 See the Lesotho-UK 1949 DTA, Article 2 thereof at *Simon's Taxes* Vol F, Revised Third ed. at p 22792.

172 See the Lesotho-RSA 1959 DTA, Article II thereof, Silke, *South African Income Tax*, 10th ed. at p 1559.

173 See Passos *op cit*, p 111 where treaties of South Africa with Canada and Sweden respectively are cited.

the furnishing of a residual provision generally found in DTAs providing for "other income" not specifically dealt with.¹⁷⁴

The renegotiated Lesotho DTAs with the UK and RSA respectively, no longer use the term "industrial or commercial profits". Instead the modern term used is that of "business profits" which, however, as in the OECD Model Convention, has not been defined. The Lesotho Income Tax Order defines "business" to include a trade, profession, or vocation and an isolated transaction with a business character.¹⁷⁵ Moreover since the distinction between income and capital gains has been removed in the business context in Lesotho, all gains of a business are included in its taxable gross income.¹⁷⁶

The South African Income Tax Act uses the term "carrying on of a business" or "trade".¹⁷⁷ These have been considered in case

174 *Ibid.*

175 See Section 3(1) of the Lesotho Income Tax Order, 1993. According to the Explanatory Memorandum to the Order in the commentary to the definition of the term "business", business is defined widely to incorporate established judicial decisions in the UK and South Africa. The established factors are: profit motivation, sale of activity, repetition and continuity of activity, commercial character, and organisation. None of the factors is decisive.

176 See Section 19(2) of the Lesotho Income Tax Order.

177 See the South African Income Tax Act, 1962, Section 1 definition of "trade", "company business": Section 10(1)(hA) or Section 42 etc and cases such as *Kuttel's case* (discussed *supra*) 1992 (3) SA 242 (A), and its Special Court decision of ITC 1501 53 SATC 314; ITC 1529 54 SATC 252. "Business" is discussed in *AA Mutual Insurance Association Ltd v Biddulph* 1976 (1) SA 725 (A) where it was decided that even a single isolated activity enterprise or pursuit may constitute a business; See also *Comet Electrical Wholesalers (Pty) Ltd v SATC Cabling & Wiring (Pty) Ltd* 1977 (4) SA 254 (W).

law. The Act does not define "carrying on of business" but the term "trade" is widely defined to include every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent or any copyright or any other property of similar nature.

In the context of international taxation, the term "carrying on a business" has been considered in the Southern African case of *SIR v Downing*¹⁷⁸ and the Australian case of *Thiel v Federal Commissioner of Taxation*.¹⁷⁹ These have been discussed at paragraph 10.5.

13.2. TAXATION OF BUSINESS PROFITS:

Taxation of business profits as discussed in chapter 12, revolves on the question of permanent establishment. The concept of permanent establishment determines which country will levy taxes in the vast majority of international business transactions. The general rule as embodied in the OECD Model Convention is that an enterprise of a State party shall not be taxed in the other State unless it carries on business through a permanent establishment.¹⁸⁰ Where there is no permanent

178 1975 (4) SA 518 (A), 37 SATC 249, discussed at 12.5.

179 (1988) 88 ATC 4094 and 90 ATC 4717, discussed at 12.5.

180 See Article 7(1) of the OECD Model Convention, which is a corollary and continuation of Article 5 on the definition of the concept of permanent establishment.

establishment, taxation will be in the country of residence of the enterprise. Where a permanent establishment is found to exist, several questions arise. In the first instance, it has to be ascertained what proportion of the profits is attributable to the permanent establishment.¹⁸¹ This raises a further question regarding the criteria to be applied in the allocation of profits to a permanent establishment.

13.2.1. ALLOCATION OF PROFITS TO A PERMANENT ESTABLISHMENT

There are competing views on the allocation of profits to a permanent establishment. There is the so-called "force of attraction" principle generally favoured by developing countries and the so-called "rule of attribution". Certain items of income such as dividends, interest and royalties are allocated by some revenue sharing "effectively connected" rule.¹⁸²

13.2.2. THE "FORCE OF ATTRACTION" RULE

This rule is to the effect that if an enterprise of one country carries on business in another country through a permanent enterprise, the entire profits of that enterprise from within the other country are taxable by that country whether or not the profits are attributable to the permanent establishment.

181 See Article 7(2) of the OECD Model Convention.

182 See Articles 10, 11 and 12 of the OECD Model Convention respectively, which will be dealt with *infra*.

Excluded from the application of this rule are passive income items (dividends, interest and royalties) which are dealt with separately.¹⁸³ Most of the developed countries are reported to have abandoned the "force of attraction" rule in recent tax treaties due to the fact that it taxes income which is felt is unrelated to the permanent establishment.¹⁸⁴ In other words, separate sources of profit of an enterprise must be ascertained. Developing countries point out that this places a burden on their simple tax administrations. *

13.2.3. THE "RULE OF ATTRIBUTION"

This rule is to the effect that profits attributable to the permanent establishment are exclusively taxed in the country of source i.e. where the permanent establishment is located.¹⁸⁵ There are no detailed rules for ascertaining the profits attributable to a permanent establishment.¹⁸⁶

Nevertheless, the general rule is that the profits must be those emanating from the permanent establishment as if it were a distinct and separate enterprise engaged in similar

183 See Commentaries on Article 7 of the UN Draft, *Harvard International Law Journal* vol 19 *op.cit*, p 115

184 See the Australian Tax Handbook, Butterworths 1994, *op cit*, para 40090 p 1075 which cites the Australian-US DTA of 1983. The renegotiated DTA substituted the force of attraction with the rule of attribution in regard to business profits.

185 See Article 7 of the OECD Model Convention.

186 These sentiments are echoed by Passos, *Tax Treaty Law*, *op cit*, at p 162; also McDaniel P, *Source Rules in US Tax Treaties*, International Bureau of Fiscal Documentation, 1980 vol xxxiv, p 559 at 560

activities but wholly independently from the foreign (parent) enterprise. The latter is often characterised as dealing "at arm's length".¹⁸⁷ Separate books of accounts are maintained so that profits and expenses of the permanent establishment are ascertainable. This is often referred to as the direct method of determining business income attributable to a permanent establishment.¹⁸⁸

There is another, indirect method of determining profits attributable to a permanent establishment. This is through apportionment of the profits of the enterprise between the permanent establishment and the head office. However, this applies only where it is customary to apportion profits.¹⁸⁹ Thus the tax authorities must be familiar with the apportionment method.

The Andean Pact rule dealing with the attribution of business income is not very clear.¹⁹⁰ Since the concept of permanent establishment has not been included, the taxation of business

187 See Article 7(2) of the OECD Model Convention; see discussion on what constitutes "arm's length" dealing at para 13.6 *infra*.

188 See Passos *ibid*. See Article 7(2) *supra*.

189 See Passos *ibid*. Also See Article 7(4) of the OECD Model Convention. See also Danzinger, *International Income Tax: The South African Perspective* at p 353.

190 See Hausman J, The Andean Pact Model Convention as viewed by the capital exporting nations, *Bulletin for International Fiscal Documentation*, vol xxix 1975 p 99 at 103

profits occurs where these have been generated.¹⁹¹ This general rule is not helpful where enterprise generate income in several states. For instance, there may be a multiplicity of sources.

13.2.4. THE "EFFECTIVELY CONNECTED" RULE

The OECD Model Convention deals with investment income (dividend, royalty, interest, rent) "effectively connected" with a permanent establishment in the same way as business profits attributable to a permanent establishment. This means that dividend, royalty, interest or rental income "effectively connected" to a permanent establishment is taxable in the country of source i.e. where the permanent establishment is located.¹⁹² There is no definition of the term "effectively connected" and the OECD Commentaries also do not offer one. Passos¹⁹³ submits that the term designates an economic link between the investment income and a permanent establishment. She further submits that the OECD Model uses the terms "effectively connected" and "attributable" interchangeably except that the former applies to investment income while the

191 See Article 7 of the Andean Pact Model, see also Piedrabuena Enrique, *The Model Convention to avoid Double Income Taxation in the Andean Pact*, *Bulletin for International Fiscal Documentation* 51 at 53.

192 See Articles 10(4), 11(4), 12(3) and 16(3) of the OECD Model Convention. Note should, however, be taken that this is not the general treaty treatment of investment income. The general rule including definitions of what falls within categories of dividends, interests or royalties or rents income shall be dealt with in detail *infra*.

193 Passos, *Tax Treaty Law*, *op cit*, 175 ff.

latter applies to profits. Furthermore, the term "effectively connected" is used to designate a relationship between the investment income and an asset belonging to the permanent establishment. These seem to be a factual and legal use of the term but without relevant case law the discussion is like splitting hairs.

Under the Andean Pact Model Convention, even though there is no requirement for the concept of permanent establishment, there are some coincidences even though these may be misleading. For instance, dividends are taxed only by the country of residence of the enterprise paying them.¹⁹⁴ Difficulties arise, however, when the abovementioned rule is applied strictly regarding the exact geographical origin of the dividends themselves. Interest income under the Andean Model is taxed where the capital loan is effectively used.¹⁹⁵ The source of the capital loan itself is disregarded. Problems of application of the source principle on interest income occur not only in the context of the Andean Pact Model but even in the OECD and UN Models. These will be dealt with in more detail *infra* (see page 280 ff). The position of royalties is similar to the problems of application of tax on interest. The Andean

194 See Article 10 of the Andean Pact Model Convention, see also Gendre F, *The Treatment of Investment Income under the Andean Pact Model Convention*, *Bulletin for International Fiscal Documentation*, vol xxix, 1975 59 at 61; also Costa Romal Valdes, *The Andean Pact Model Convention, the Andean View*, *Bulletin for International Fiscal Documentation*, *op cit* p 91 at 92.

195 See Gendre F, *op cit*, p 61; Costa *ibid*; See also Article 10 (1) of the Andean Pact Model.

Pact Model provides that royalties (Confined to payment for use of patents, trade marks, non-patented technical knowledge, or other similar tangible property) are taxable where the intangible properties are used.¹⁹⁶ As with interest, discrepancies arise regarding whether the tax at source is levied on gross or net amount of royalties, and from reconciliation of the concept of place of use and the place from which payments are made. Taxation of investment income will be dealt with in more detail later (see page 272 ff). The purpose of this discussion on the Andean Model treatment of investment income was to highlight how the "effectively connected" rule has been used even without the requirement of a permanent establishment.

13.3. TAXATION OF BUSINESS PROFITS UNDER THE DIFFERENT MODELS:

13.3.1. OECD MODEL CONVENTION

The general rule of taxation of business profits under the OECD Model Convention revolves around the concept of permanent establishment. This means that profits of an enterprise of a State party will only be taxable in the other State if it carries on business in the latter State through a permanent establishment. Only profits attributable to a permanent estab-

196 See Article 9 of the Andean Pact Model Convention; See also Gendre *op cit* p 62, Costa *op cit* p 95.

lishment are taxable. The test used to ascertain these is often referred to as the "dealing at arm's length" rule. This means that only those profits which a permanent establishment might be expected to make if it were a separate and distinct entity engaged in similar activities but dealing independently of the (parent) enterprise are taxable. Expenditure incurred for a permanent establishment, including normal executive and administrative expenses is deducted notwithstanding where expended. This no doubt leaves room for manipulation of the expenditure of a permanent establishment towards reduction of the taxable profits. Mere purchasing activities of goods does not qualify as profits of a permanent establishment. Apportionment of profits of an enterprise is allowed where it is customary to do so in the States party to the Agreement. Profits are determined annually through established auditing methods. Income items attributable to a permanent establishment but dealt with in other separate provisions of the treaty are not to be affected by the above provisions (e.g. dividends, interest, royalties).¹⁹⁷

13.3.2. THE US MODEL

The US Model uses the requirement of permanent establishment to the same extent as the OECD Model in the taxation of business profits. The US Model, however, adds research and development expenses and interest to the list of expenses which

¹⁹⁷ See Article 7 of the OECD Model Convention and commentaries thereto.

can be allocated to a permanent establishment.¹⁹⁸

13.3.3. THE UN MODEL

The most notable deviation of the UN Model from the OECD Model in regard to the taxation of business profits relates to the extension of the concept of permanent establishment. This was the attempt to broaden the concept. As discussed in Chapter 12, the OECD Model 12 month requirement period for construction project to qualify as a permanent establishment has been shortened to a 6 month period. Furthermore, whenever an agent conducts all its activities on behalf of an enterprise, this qualifies as a permanent establishment. Similarly, profits resulting from purchase of goods or merchandise may be treated as resulting from a permanent establishment, this is subject to agreement of the parties to the bilateral negotiations.¹⁹⁹

The UN Model has retained the "force of attraction principle in regard to taxation of business profits."²⁰⁰ This means that where a permanent establishment through which a foreign

198 See Article 7(3) USA Treasury Model Income Tax Treaty, *Bulletin for International Fiscal Documentation* vol xxxi 1977 313 at 315.

199 See Article 5, paragraphs 3, 4(a) and (b) and 6 of the UN draft. See also the International Chamber of Commerce, Comments on the UN Model Tax Convention between Developed and Developing Countries, *Bulletin for International Bureau of Fiscal Documentation* vol xxxv 1981 p 309 at 310; See also Surrey S, UN Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries, *Harvard International Law Journal*, vol 19 1978 p 1 at 13ff.

200 See Article 7(1) of the UN Draft and Surrey's commentaries thereto, *op cit*, p 115.

enterprise is carrying on business in another country has been found to exist, all profits of that enterprise derived from the country where the permanent establishment is situated are taxable there regardless of whether or not the profits emanate from the permanent establishment. However, the "force of attraction" principle has been limited and therefore does not apply to investment income (dividends, interests and royalties) which are dealt with separately in the treaty. The concept of "force of attraction" is extended to include in the taxable profits of an enterprise with a permanent establishment, profits of sale of goods or merchandise similar to those sold through that permanent establishment.²⁰¹ This includes sales performed elsewhere and not connected to the permanent establishment at all. The arm's length standard is similar to that of the OECD Model. The deduction of head office expenses incurred on behalf of the permanent establishment is limited to actual costs incurred. There is no deduction allowed for payments of interest, royalties, fees by way of commissions for specific management fees to the head office by a permanent establishment. Banking enterprises are an exception to this rule.²⁰²

As in the OECD treatment of business profits, apportionment of total profits of the enterprise is allowed where such practice is customary. Under the UN draft provision for determining profits attributable to the permanent establishment is to be

201 See Article 7(1)(b) of the UN Draft.

202 See Article 7(3) of the UN Draft and commentaries thereon.

consistent year by year. This is similar to the OECD Model approach. Profits of items of income dealt with separately are not to be affected by the general provisions for business profits.²⁰³

13.3.4. THE ANDEAN PACT MODEL

Although the OECD, US and UN Models remain committed to the requirement of permanent establishment to justify taxation of business profits, by the country of source, Latin American countries are also firmly committed to resist this. Consequently, the Andean Pact Model advocates exclusive taxation at source, particularly of business profits (with the exception of profits of international transportation business). The requirement for the concept of permanent establishment is at best omitted or ignored. Business profits are taxable only in the country where the activities are undertaken and where the activities are exercised in more than one country, each one of the countries then taxes income generated in its territory.²⁰⁴ Activities are listed by way of example or assumptions of business activities and these are similar to those listed by developed countries under the OECD Model and

203 See Articles 7(4) to (7) of the UN Draft and commentaries thereon.

204 See Article 7 of the Andean Pact Model Convention; See also Atchabahian A, The Andean Subregion and its approach to Avoidance or Alleviation of International Double Taxation, *Bulletin for International Fiscal Documentation*, vol xxviii 1974 308 at p 326 ff; Costa R.V., Criteria for the Allocation of the Power of Taxation among Different Jurisdictions.... *Bulletin for International Fiscal Documentation*, vol xxxii 12 at p 16 ff.

others, as constituting a permanent establishment. Investment income (dividends, interests and royalties) similar to the OECD Model and others, is treated under separate provisions. It is submitted that even though the Andean Pact Model does not use the concept of "PE" the rules regarding business contact amount to the same.

The major criticism levelled against the taxation of business profits under the Andean Pact Model is the exclusive application of the source principle.²⁰⁵ Gendre²⁰⁶ points out that the exclusive right to tax by the country of source under the Model is merely a "strong declaration rather than a practical rule for settling international double taxation". He suggests that perhaps use of the term "priority" right to tax by the source country will be more acceptable especially taking into account that a tax treaty is not a one-sided document of declaration but rather a culmination of a tedious process of negotiation with mutual concessions at the end of the day. Similarly, Hausman²⁰⁷ views the Andean Pact Model as ill-advised taking into account that the requirement of the concept of permanent establishment is not necessarily inconsistent with the taxation of business profits at source. He concedes, however, that the question of whether the requirements of

205 See Gendre Francois, The Treatment of Investment Income under the Andean Pact Model Convention. *Bulletin of International Fiscal Documentation* vol xxix 1975 p 59 ff; See also Hausman JS, The Andean Pact Model Convention as viewed by the Capital Exporting Nations, *Bulletin op cit* p 99 at

206 Gendre *ibid*.

207 Hausman, *op cit*, p 103.

"permanent establishment" as defined in the OECD Model is suitable for transactions between capital exporting and capital importing countries is a matter open for debate.

The major difference between the Andean Pact Model and the OECD Model centres around the requirement of permanent establishment as a prerequisite to enable the source country to tax business profits. The Andean Pact Model insists on the primary exclusive right of the source country to taxation of business profits while the OECD Model imposes certain limitation in exercising that right of taxation. Nevertheless, a common element in both models is that there must be some connecting factor to enable the country to exercise taxation of business profits. The factor could be called a permanent establishment according to the OECD Model or it could be some business activities culminating in a profitable business contract in the Andean Pact Model. The difference therefore centres around the different conceptions on the source of profits of an enterprise.

13.4. TAXATION OF BUSINESS PROFITS UNDER THE LESOTHO-UK DTA

The old and the renegotiated Lesotho-UK DTA essentially follow the OECD Model Convention on taxation of business profits.²⁰⁸ A remarkable feature is the omission of the provision regarding

208 See Article 3 of the Lesotho-UK 1949 Arrangement and Article 7 of the renegotiated Lesotho-UK DTA, Annex

determination of profits of a permanent establishment on the basis of apportionment of the total profits of the enterprise if it has been a customary practice.²⁰⁹ The implication here is that the contracting parties found this provision redundant and the question which arises is why? The Lesotho Income Tax Order does not make any provision for apportionment of income. At best there is a foreign tax credit or exemption for foreign sourced income of residents. There seems to be no such provision in the UK Income Tax Acts. Any form of apportionment available is done internally. An example is apportionment for deduction where a private residence is used for personal purpose and business purpose (as a study). The reason may, therefore, be that apportionment is not a custom hence its exclusion. Another notable omission is the provision for determination of profits of a permanent establishment to be the same method year after year.²¹⁰ Perhaps this provision was found unwarranted.

13.5. TAXATION OF BUSINESS PROFITS UNDER THE LESOTHO-RSA DTA:

Both the 1959 treaty and the renegotiated one essentially follows the OECD Model Convention on taxation of business

209 Reference is to the omission of Article 7(4) of the OECD Model.

210 Reference is to the omission of Article 7(6) of the OECD Model.

profits.²¹¹ Practical implications of this provision may nevertheless be illustrated through relevant decided cases where available.

The definition of income included in business profits is generally similar to that in the OECD Model Convention but the 1959 Lesotho-RSA DTA had an interesting provision to the effect that where there is inadequate information to determine profits attributed to a permanent establishment, then the authorities of the States party to the DTA may exercise a discretion or make an estimate. This provision has, however, been omitted in the revised draft. Determination of profits attributable to a permanent establishment on the basis of apportionment according to the prevailing custom is included in the revised draft even though Lesotho's legislation does not clearly provide for apportionment.²¹²

South Africa on the other hand, has a long history of

211 See Article III of the Lesotho-RSA 1959 DTA, Article 7 of the renegotiated Lesotho-RSA, Annex

212 In the *Transvaal Associated Hide and Skin Merchants v COT, Botswana*, 29 SATC 97, a 1967 Botswana Court of Appeal case discussed *supra*, apportionment was rejected on the grounds that the taxpayer failed to claim it in its notice of objection to the assessment in question and furthermore, the Botswana income tax legislation made no provision for apportionment. See Danzinger E, *International Income Tax*, op cit 108.

apportionment of income according to source.²¹³ The Income Tax Act, however, makes no provision for apportionment.²¹⁴ Where granted by the Courts apportionment is usually claimed by the taxpayer and the onus is therefore on the taxpayer to show that apportionment is justified.

Most of the cases where it has been granted relate to the rendering of dependent services by employees working in more than one country.²¹⁵ However, Danzinger submits that claims for independent services should not be viewed as inevitably unsuccessful when compared with those for dependent services.²¹⁶ Each case will depend on its merits and facts.

Apportionment has been denied where it was felt that the income derived from one country is so insignificant in relation to the

213 The claim for apportionment of royalty income was raised unsuccessfully in *Millin v CIR* 1928 AD 207, 3 SATC 170 at 175, where Australian decisions which have adopted the principle were cited with approval, viz. *COT for New South Wales v Meeks* 19 CLR 568, *Mount Morgan Gold Mining Co v Com of Income Tax, Queensland* 33 CLR 76; *CIR v Lever Bros and Ano* 1946 AD 441, 14 SATC 1 at 10, Watermeyer CJ gave a qualified approval of the principle; *CIR v Epstein* 1954 (3) SA 689 (A), 19 SATC 221 at 234 considered apportionment of income in an international partnership of a South African resident and Argentinians; Apportionment has been granted in *SIR v Kirsch* 1978 (3) SA 93 (T); *CIR v Nell* 1961 (3) SA 774 (A) and some Special Court cases.

214 See Danzinger E, *International Income Tax: The South African Perspective*, op cit p 107 ff.

215 See Special Court cases of ITC 97 3 SATC 245 (1927), ITC 396 10 SATC 87 (1937), ITC 837 21 SATC 413 (1957), ITC 1088 24 SATC 202 (1966) and *SIR v Kirsch*, supra.

216 Danzinger, op cit, p 110 where the Special Court case of ITC 938 is discussed. This involved a claim for apportionment of commissioned income earned from sale of immovable property situated outside South Africa.

income derived from another country.²¹⁷ Thus apportionment will not be granted under the *de minimis* rule for income characterised as "trivial and incidental" or for duties viewed as "incidental and subsidiary".

It should, however, be noted that taxation of income from rendering independent personal services as well as dependent personal services has been specifically provided for under the Lesotho-RSA DTA.²¹⁸ Consequently, these classes of income will have to be taxed according to the specific provisions not as business profits.

13.6. WHAT CONSTITUTES "ARM'S LENGTH" DEALING

As stated in 13.2.3, in determining business profits attributable to a permanent establishment, the rule is that these will be profits which might be expected to accrue to a permanent establishment if it were a distinct and separate entity engaged in similar business but wholly independent of the enterprise.²¹⁹ This has been characterised as the "arm's

217 See *COT v Stein* 1958 3 SA 14 (FC), 22 SATC 12, 1958 Taxpayer 129 where the taxpayer was employed in a dependent service to manage a store in Bechuanaland. The taxpayer performed some minor duties in Bulawayo where he resided. The Court found the latter duties to be entirely "subsidiary and incidental" to the real work of conducting business in Bechuanaland.

218 See Articles 14 and 15 of the renegotiated Lesotho-RSA DTA, Annex II, which will be discussed more in detail *infra*.

219 See Article 7(2) of the Lesotho-RSA renegotiated DTA which is similar to the OECD Model Article 7(2).

length" dealing rule. The question that arises is what constitutes an "arm's length" deal?

A decided case in point here is that of *Anglo American Corporation of SA Ltd v COT*.²²⁰ This involved foreign exchange loss of the Zimbabwe branch of the South African enterprise, the issue being whether the loss on inter-office accounts that was suffered due to devaluation of the rand qualified as a deduction in the hands of the Zimbabwean branch. The facts disclosed that the South African enterprise collected in South Africa money in rands that was owed to its Zimbabwean subsidiary company. The amounts so collected remained in the South African company's books as a credit to the Zimbabwean office account until a "set-off" by amounts collected by the Zimbabwean company on behalf of South African subsidiary companies. Beadle CJ held that the manner in which the appellant company chose, as a single persona to record transactions in the books of accounts kept in South Africa and Zimbabwe did not affect the overall tax position. The Court refused to accept that for tax purposes the head office and the branch were separate enterprises according to the DTA between South Africa and Zimbabwe.²²¹

220 1975 (1) SA 973 (RAD), 37 SATC 48. Case also discussed by Clegg DJM, *Tax Law through the cases*, 1991 Juta p 198-202; See also Danzinger E, *International Income Tax: The South African Perspective*, Butterworths 1991 at 350.

221 See Article III(2) of the Double Taxation Agreement between South Africa and Zimbabwe (referred to as Southern Rhodesia then) Proclamation No 214 1965; See Silke, *South African Income Tax* 10th ed. p 1496-1502.

The relevant clause required that to be regarded as an "independent enterprise", the business had to be "engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment".²²² MacDonald JP in rejecting the claim pointed out "it is inconceivable that independent enterprises entering into an agreement for the mutual discharge of each other's debts in their respective countries would agree that the risk of devaluation would fall on the "independent enterprise" making the payment to the creditor and not upon the "independent enterprise at whose request the debt is discharged."²²³ From these facts it was concluded that the business was conducted by a single taxpayer not different *personae*.

However, it should be noted that under the Lesotho Income Tax Order, a branch in Lesotho of a non-resident company is treated as a separate person which is a resident company.²²⁴ A "branch" is defined as any place where a person carries on business. This means that on facts similar to those in *Anglo American Corporation of SA Ltd* case above, not much significance will be attached to the "arm's length" deals, since the branch as a resident company will be taxable on its

222 *Ibid.*

223. See 37 SATC 45 at 53. Note that despite the variation with the recent DTAs which uses the words as if "it were a distinct and separate enterprise ... dealing wholly independently with the enterprise of which it is a PE", the meaning remains the same.

224 See Section 6(2) of the Lesotho Income Tax Order, 1993.

world-wide income.²²⁵

13.7. PURCHASING ACTIVITIES:

The OECD Model Convention provides that no profits shall be attributable to a permanent establishment by virtue of mere purchase of goods or merchandise by that permanent establishment.²²⁶ This provision has been incorporated in both the renegotiated DTAs between Lesotho, UK and South Africa respectively.²²⁷ However, as observed at paragraph 13.3.3, the UN Model has included a discretionary provision for either inclusion or exclusion of purchasing activities as constituting a permanent establishment.²²⁸

The lack of consensus even among the developing countries concerning the issue whether purchasing activities constitute a permanent establishment has influenced some writers to recommend that the subject requires more study and analysis.²²⁹

225 See Section 3 of the Lesotho Income Tax Order. It must however be conceded that the discussion remains academic since the provisions of the DTAs and the Income Tax Order have not been tested.

226 See Articles 5(4) and 7(5) of the OECD Model Convention

227 See Article 7(5) Lesotho-RSA; Article 7(5) Lesotho-UK.

228 See Article 7(5) of the UN Model.

229 See Survey, *op cit* Vol 19 1978 HILR p 21.

The Andean Pact Model in a way admits the complexities of determining the source of income of commercial sales, particularly cross-border activities. For instance, where a seller is a manufacturing enterprise in one contracting state and the buyer is an enterprise of the other contracting state, there is no doubt that both enterprises are generating profits. However, the question as to the source of income is not easily answered. Consequently, the Andean Pact Model handled the issue with unprecedented caution. It is not deemed that mere essence of purchasing activities constitutes a permanent establishment but rather, that the possibility is admitted.²³⁰

According to Passos there is an implicit general rule that income from the sale of goods bought by an enterprise is deemed to have its source entirely in the country of sale. There is, therefore, no portion of the income which can be attributed to be derived from the country of purchase.²³¹ However some compromises have to be struck in view of the fact that developing countries as exporters of raw materials consider the source rule for sale of manufactured goods as favouring the industrialised countries. The argument is that the raw materials rise in value once exported to the developed countries. Therefore, the developed countries should grant the

230 See Piedrabuena E, *Andean Pact Model* op cit p 55. Note however that Piedrabuena considers that since mere purchasing of product can not generate local income the Andean Pact Model should have started from the opposite angle as does the OECD Model.

231 See Passos *Tax Treaty Law* op cit p 168; See also Danzinger E, *International Income Tax* op cit p 353.

developing countries some right to levy taxes on part of profits derived from sale of those raw materials. Furthermore, it is argued, this is exacerbated by the general trend that once the raw materials have been used in manufacture, some of the products are exported back to the countries that produced them at a higher price.²³² The argument here is for upholding the general principle that source of income is in the country where the goods are sold. However, a proposal for some compromise or exception in regard to the export of raw materials from developing countries to the industrialised countries is made. This is part of the never ending debate about the new international economic order (NIEO). The trading pattern between developing countries and developed countries is that of exporters of (cheap) raw materials which are ultimately imported back as finished (expensive) goods. The issue of taxation of income from purchasing activities due to its complexity requires more study and analysis.

232 See Atchabahian A, *Some Aspects of International Double Taxation between Developed and Developing Countries*, vol xxv, *Bulletin for International Fiscal Documentation* 1971 p 451 at 456; See also Irish C R, *International Double Taxation Agreements and Income Taxation at source ICLQ* vol 23 1974 p 292 at 305 where he argues that in view of the volume of sales of finished goods in developing countries and that this in turn means creation of employment opportunities in the developed countries, all income attributable to such sales (whether interest, dividends or business profits) ought to be taxed principally or exclusively at source.

13.8. ACTIVITIES OF FOREIGN INSURANCE COMPANIES IN LESOTHO

As noted at paragraph 10.2.5 under the discussion of permanent establishment,²³³ an insurance company in one State may be taxed in the other State if it carries on the insurance business in the other State through a fixed place of business which could be a branch or office or through dependent agents. To counteract evasion of taxation by insurance companies which may by design carry on business in another State without formal identifiable "fixed place of business" a deeming clause has been suggested. This would deem an insurance company to have a permanent establishment in another State if it collects premiums in the other State through an agent or insurer on risks situated in that other State through such agent. The option to include a clause to this effect is left to the parties depending on the factual and legal situation prevailing in the territories involved.²³⁴

According to the report of the Commissioner of Insurance in Lesotho, in the capacity of overall supervisor of the insurance industry, volumes of business, estimated at 10 million Rands, are siphoned outside Lesotho by unregistered insurance companies and brokers conducting business in Lesotho illegally. The legal requirements for the insurance industry carrying on

233 See Article 5(6) of the OECD Model Convention and commentaries thereto.

234 See Central Bank of Lesotho Annual Report for 1991, March 1992 Maseru at p 49-50.

business in Lesotho²³⁵ include registration as an insurer and complying with the regulations which include holding the prescribed amount of working capital depending on the type of insurance business, investing in Lesotho in assets as prescribed, keeping proper records and co-operating with the Commissioner of Insurance in its supervisory role. The establishment of an office in Lesotho will therefore constitute a permanent establishment. It is recommended that, to catch agents of outside companies, particularly those from South African Companies, a deeming provision should be introduced in the Lesotho DTAs. The renegotiated DTA between Lesotho and South Africa also be revisited with respect to this issue. However, as identified in the Central Bank of Lesotho report discussed above, dissemination of information regarding operation of the insurance industry, negative economic implications of the activities of unregistered operators etc have to be highlighted to the public.²³⁶ Note should, however, be taken that Basotho cross into South Africa to contract with the insurance companies providing competitive packages. The solution of criminalising the transaction as in Swaziland is not recommended.

235 See generally the Lesotho Insurance Act No 18 of 1976 (as amended) and the Insurance Regulations 1985; the Income Tax (Superannuation and Life Assurance) Regulations, 1994.

236 It is, however, submitted that if the unregistered insurance actors could be persuaded to carry on legitimate business in Lesotho, this will in turn create a healthy competition and thereby result in an improved service in the industry. The potential for a broadened income tax base can not, in those circumstances, be overemphasised.

**13.9. IMPLICATIONS OF FOREIGN EXCHANGE LOSSES/GAINS AND
THE FINANCIAL RAND MECHANISM ON BUSINESS PROFITS:**

Lesotho and South Africa are parties to the Southern Africa Common Monetary Area.²³⁷ This means that the South African Rand is the main currency in the area even though domestic units, such as "Maloti" or "Malangeni" are legal tender, in Lesotho and Swaziland respectively. These are pegged to the rand. Apart from the usual foreign currency fluctuations when business is carried on across international borders, the Common Monetary Area had an added problem of the double exchange mechanism (the dual exchange rate system).²³⁸ Internal transactions utilised the commercial rand while foreign investors (non-residents wishing to transfer investment proceeds from rands into foreign currency) operated through the financial rand mechanism. The discount between the financial rand/commercial rand mechanism often caused disparities in trade.²³⁹

The recommendation, therefore, was for inclusion in the DTAs of the effect of the financial rand/commercial rand mechanism

237 The parties to the Multilateral (Rand) Monetary Area Agreement of 5 December 1974 (as amended 1986) are Lesotho, Namibia, South Africa and Swaziland (Namibia became a member of her own right upon independence).

238 The financial rand mechanism was recently abolished with effect from 13 March 1995, the discussion therefore is academic

239 See Horak JDD, *S A Tax Treaties - Principles of Negotiation* (1991) 4 *Juta's Foreign Tax Review* 48 at 49, where he discusses for instance transfer of dividend income to non-resident shareholders.

as well as tax treatment of exchange gains and losses.²⁴⁰ There is no more need for the former recommendation. It will be noted that South Africa has established domestic rules in regard to the source of profits/losses arising from the conversion of the South African rands into foreign currency.²⁴¹ The source of profits/losses which results from the carrying on of business in South Africa is South African and vice versa. Lesotho treats foreign currency gains and losses as interest income and expense respectively.²⁴² The tax implications of these provisions will be best incorporated in the DTAs towards creation of a stable predictable mechanism for foreign investors.

Some jurisdictions have considered the manner in which foreign currency fluctuations ought to be taken into account in calculating foreign tax credit and this may also offer some guidance for DTA provisions.²⁴³ In-depth discussions of these issues are beyond the scope of this dissertation.

The discussion on the impact of the financial Rand mechanism

240 Horak *loc cit*.

241 See Danzinger E, *International Income Tax*, *op cit* p 187-189 where he discusses Section 24 of the South African Income Tax Act and the decided cases of ITC 941 24 SATC 440 (1960) and *South African Marine Corp v CIR* 1955 (1) SA 654 (C)

242 See Section 58 of the Lesotho Income Tax Order, 1993, and Commentaries thereto.

243 See Wilkie SJ, *The Canada-United Kingdom Income Tax Convention*, Article 21 thereof, *Bulletin for International Bureau of Fiscal Documentation*, vol 43 1989 p 63 at 67 where he cites decisions of *The Queen v The Bank of Nova Scotia* (1981) CTC 161; 81 DTC 5155 (FCA) and *Canadian Imperial Bank of Commerce v The Queen* 81 DTC 5199 (FCA).

on business profits has been overtaken by the recent abolition of the finrand with effect from 13 March 1995. With the unitary rand now in place, the issue of the impact of foreign currency fluctuations however still remains to be resolved.²⁴⁴

13.10. CONCLUSION:

The international taxation of business profits under the OECD Model is tied to the concept of permanent establishment. This means that business profits are taxed in the country of residence of an enterprise unless there is a permanent establishment in the country of source to which the profits are attributable. Lesotho DTAs with South Africa and the United Kingdom respectively have followed the OECD Model text. Peculiar business relations such as the insurance industry and the rand foreign exchange mechanism ought to have been specifically provided for in the DTA between Lesotho and South Africa. The concept of permanent establishment in the OECD Model Convention has a predilection towards the country of residence of enterprises. The latter has a more advantageous position to taxation of business profits than the country of source where the profits are generated.

244 See *Business Day*, Monday March 13, 1995 reporting on the abolition of the financial rand and the statement of the Minister of Finance, South Africa on the issue, pages 1, 5 and 12.

CHAPTER 14

TAXATION OF PROFITS FROM OPERATIONS OF INTERNATIONAL TRANSPORT

14.1.1. INTRODUCTION

According to the general approach, profits from the operation of ships or aircraft are taxable at the place where the effective management of the enterprise is situated. This traditional role has been interpreted to mean that taxation of international transportation is at the place of residence of the enterprise. Road transportation may also be included here.

14.1.2 THE OECD MODEL

The scope of the OECD provision²⁴⁵ covers shipping, inland waterways transport and air transport. Land transportation is not included. It also covers profits arising from activities closely connected with such business. These include sale of passenger tickets, operation of a bus service connecting a town with its airport or port, advertising, inland transportation of goods for storage at a depot or delivery. Keeping a hotel for transit passengers is included provided that such service has been included in the price of the passage ticket. The emphasis here is that it must not cover keeping of a hotel as

245 See Article 8 of the OECD Model Convention and the commentaries thereto which, amongst others, point out that in certain circumstances, a place of effective management may not be situated at the State in which an enterprise operating ships or aircraft is a resident. Therefore States wishing to confer exclusive taxing right on the State of residence may draft this clearly so.

a separate business. The lease of containers in inland transport is also included.²⁴⁶

The term "international traffic" is defined to cover domestic traffic as well as international transportation of people over more than one State.²⁴⁷ Thus it will also extend to traffic between third States. Profits derived from operation of boats engaged in inland waterways transport is taxable in the place of effective management of the enterprise which if it is aboard a ship, or boat, shall be deemed to be in the home harbour of the ship or boat.

14.1.3. THE US MODEL

The US Model Convention provides that profits of an enterprise engaged in international traffic of ships or aircraft are taxable only at their place of residence.²⁴⁸ The effect here is allocation of taxing authority on the residence country only. Thus it is basically the same as the OECD Model Convention although the draft is slightly different. According to Danzinger, sometimes the article is drafted through an exemption format. That is to state that a resident of a contracting party operating in international traffic of ships or aircraft is exempted from taxation in the territory of the other

246 *Ibid*; see also Passos *Tax Treaty Law op cit* at 113-114.

247 See Article 3 subparagraph (d) of the OECD Model Convention and commentaries thereto; See also Danzinger E, *International Income Tax: The SA Perspective op cit* at 359

248 See Article 8 of the US Model Convention.

contracting party.²⁴⁹ In practice the end result is the same.

14.1.4. THE UN AND THE ANDEAN PACT MODELS

One of the areas where the developing countries have expressed reservations is in regard to the taxation of profits of maritime transportation.²⁵⁰ Their argument is that, taking into account the reliance of developing countries on international trade, that is on the transportation of cargo between developed and developing countries, taxation of business profits therefrom should not be exclusively taxable at the place of residence of the shipping companies. Most developed countries have resident companies who conduct the bulk of shipping business in the developing countries' waterways. As a result, the traditional approach of exclusive jurisdiction in the residence (effective management) country is felt to put developing countries at a disadvantage. This is part of the ongoing debate under the UN Convention of the sea.

The UN Model has alternative approaches to the issue of taxation of profits from international shipping operations.²⁵¹

249 See Danzinger *op cit* p 358; See also Surrey *op cit* at p 19 who reports that the US was considering moving to the direction of source jurisdiction approach at footnote 40.

250 See Atchabahian, Andean Subregion and the approach to avoiding alleviation of international double taxation, *Bulletin*, vol xxviii 1974 308 at 329-30; See also the ICC Comments on the UN Model Tax Convention, *Bulletin*, vol xxxv 1981 309 at 310; See also Surrey, *UN Group of Experts, op cit* at p 20 and Horak JDD, *SA Tax Treaties Principles of Negotiation op cit* at 50.

251 See Atchabahian, *ibid*; Surrey, *ibid*.

In the first instance the jurisdiction to tax is allocated solely to the country of effective management (residence) which is equivalent to the OECD Model provision. In the alternative, the primary right to tax profits is at the source but these means countries in which shipping activities are more than casual. Apportionment of profits is also envisaged and some countries do invoke it in practice.²⁵²

One area where there is consensus is in regard to taxation of profits of transportation by air. This is due to the fact that while many developing countries do not have shipping companies, they usually have airlines (owned by governments). As a result in this context the exclusive taxation of air transport in the country of effective management (residence) presents no problems. Thus the OECD Model, US Model, UN Model and the Andean Pact Model Conventions are on this point in one accord.²⁵³

14.2. THE LESOTHO-UK DTA:

According to the 1949 Arrangement between Lesotho and the UK, profits of a resident of one of the contracting parties derived from operating ships or aircraft shall be exempt from tax in the other territory.²⁵⁴ As observed earlier by Danzinger,²⁵⁵

252 See Beale RJE, *The Law Relating to DTAs between South Africa and Zimbabwe*, 1982 LLM UNISA p 108 where he cites India and Ghana as countries who frequently compromise by apportioning profits in this context.

253 See Atchabahian *ibid*, Surrey *ibid*.

254 See Article 5 of the Lesotho-UK Arrangement of 25 November 1949.

255 Danzinger *op cit* 358.

this is substantially similar to the OECD Model of exclusive taxation at the place of effective management (residence). The revised DTA clearly confers exclusive right to taxation of profits derived by a resident to the State of residence.²⁵⁶ This draft has expanded the definition of profits from the operation of ships or international traffic to include income from the rental, on a bare boat basis of ships or aircraft which rental is specifically excluded according to the commentary to the OECD Model text.²⁵⁷ The inclusion of profits from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise simply includes formally and expands some of the OECD Model Convention commentaries on the now commonly used inland transport of "containerisation".

Given the well articulated position of developing countries in regard to transportation, especially of goods, one wonders whether Lesotho during the renegotiation of this clause attempted to highlight her position. Lesotho as an enclave within South Africa is in a unique position as a landlocked country. All her goods have to be "containerised" to and from the ports of entry in South Africa. Perhaps it may be conceded that the chances of enterprises resident in the UK operating in international transportation in Lesotho are minimal due to

256 See Article 8 of the renegotiated Lesotho-UK DTA, Annex I.

257 See Article 8(2)(a) of the renegotiated DTA *ibid*.

the geographical position of the two. Such a possibility can not however be excluded, after all enterprises in the quest for profits know no boundaries. However, this fact in itself was a leverage Lesotho could have used to persuade the UK to make a concession towards apportionment of taxation of profits derived from these operations. These comments are to be even more pertinent when extended to the DTA with South Africa.

14.3. THE LESOTHO-RSA DTA:

The 1959 Lesotho-RSA DTA provided that profits derived by the Government or a resident of one of the territories from operating transport services shall be exempt from tax in the other territory.²⁵⁸ This effectively reserves the taxing right to the residence State as in the OECD Model Convention. The renegotiated draft essentially follows the OECD Model with emphasis on the taxation at the place of effective management of the enterprise.²⁵⁹ The comment regarding the feasibility of apportionment of profits, bearing in mind the reliance of Lesotho on the South African transport operators for inland "containerised" goods, is even more applicable here than in connection with the Lesotho-UK DTA.

258 See Article V of the 1959 DTA between Lesotho and RSA.

259 See Article 8 of the renegotiated Lesotho-RSA DTA Annex II; See also Passos *Tax Treaty Law*, op cit 189ff-191.

There is an existing forum among the members of the Customs Union²⁶⁰ whose objective is to facilitate and maintain effective road transportation arrangements, and in particular, to achieve equitable shares in road transportation between their countries.²⁶¹ In this context the need to develop healthy transport industries amongst these States who rely on South Africa, has been acknowledged by the contracting parties. The three main objectives are to regulate cross-border road transport, to achieve ultimately an equal distribution of traffic and implement an equitable infrastructure cost recovery system. It is therefore recommended that Lesotho, in renegotiating a DTA with South Africa, should build on the existing agreements towards a proportional share in taxing cross-border transport profits.

14.4. CONCLUSION:

The traditional rule of allocating the sole taxing right of profits derived from international transport operations presents problems especially in the area of shipping and inland transportation through "containerisation". There seems to be no problem with regard to transportation between States which

260 See the South African Customs Union Agreement of 1969 as amended between Botswana, Lesotho, Namibia, South Africa and Swaziland, especially Article 15 thereof on cross-border transport.

261 See the Memorandum of Understanding on Road Transportation in the Customs Area Pursuant to the Customs Union Agreement, 1990.

both have enterprises of this nature. However, in DTAs between developed and developing countries some form of compromise has to be struck for apportionment between the parties, on the right to levy taxes on profits from international transport operations.²⁶² Lesotho in her DTAs ought to have negotiated some compromise especially with South Africa.

14.5. DECIDED CASES:

In *South African Marine Corporation Ltd v CIR*²⁶³ a South African ship owner operated in the United States through an agent by chartering ships and collecting freights. The issue before the Court was the source of income earned through this venture. The Court held that in accordance with Section 9(1)(c) of the South African Income Tax Act, even though the shipping operations were carried on in the US, the income was from a South African source. Section 9(1)(c) deems income derived from any business carried on by a person ordinarily resident in South Africa as owner or charterer of any ship or aircraft to be from a South African source. Disposal of any commodity acquired in connection with such operations is also deemed to be from a South African source.²⁶⁴ Foreign exchange profits

262 See Pepper H W T, *Transportation Taxes, Bulletin for International Fiscal Documentation* vol xxix, 1975 274 at p 312; See also Atchabahian, *ibid*; Beale *ibid*; and Surrey *ibid*.

263 1955 (1) SA 654 also discussed by Danzinger *op cit* p 189.

264 See Section 9(1)(c) of the South African Income Tax Act, 1962; See also Huxham and Haupt, *Notes on South African Income Tax 1993*, p 22.

derived from transmission of funds from such an operation also fall under Section 9(1)(c).

It may be worth noting that before the introduction of Section 9(1)(c) into the South African Act, the Special Court²⁶⁵ held that income derived from shipping and carriage of cargo from the United States to Europe by a company resident and incorporated in South Africa was not from a South African source. The rationale was that the conclusion of the carriage contract and ship chartering took place outside South Africa.

14.6. TAXATION OF PROFITS OF ASSOCIATED ENTERPRISES:

14.6.1. INTRODUCTION

This covers the taxation of profits of parent and subsidiary companies and companies under common control. Essentially, the problem of allocation of profits between internationally related companies is thus addressed. The general rule is that both income and expenses of these entities have to satisfy the criteria of "arm's length" dealing. If not, some adjustment to market prices is made. Covered under this area are debatable

265 See ITC 81 3 SATC 136 (1927) discussed by Danzinger *op cit* p 189 footnote 14. Another highlighted case is that of *Rhodesia Railways and others v COT* 1925 AD 438 especially the *obiter* remarks of Russel J regarding the source of income of a UK company operating a railway line running through Zimbabwe and Botswana but operated by South African Railways on behalf of the UK company under a contract concluded in South Africa.

issues like tax havens, thin capitalisation, transfer pricing and dividend stripping.²⁶⁶ Due to the complexities involved in these issues, no indepth discussion will be undertaken here.

14.6.2. THE OECD MODEL CONVENTION

The OECD Model Convention provides that an adjustment will be made where an enterprise of a contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other State. This includes participation of the same persons in the management of both enterprises.²⁶⁷ The type of business relationship covered is typically that of parent company and its subsidiaries, or of sister corporations and there must be some form of distortion of profits. As observed earlier under business profits, attribution of profits to a permanent establishment is also to be on arm's length basis.²⁶⁸ Other provisions requiring arm's length dealings relate to interest and royalties between related entities.²⁶⁹

266 See Passos *op cit* p 181-187; Danzinger *op cit* p 360-61.

267 See Article 9 of the OECD Model Convention and commentaries thereto; See also Sasseville J, the New OECD Model Taxation Tax Convention (1993) 6 SA Tax Review 119 at 120 where amongst others it is highlighted that the revised model commentary on Article 9 para 3 refers to the 1979 Report on Transfer Pricing and Multinational Enterprises" which includes approach guidelines for application of the arm's length principle.

268 See para 13.6 above.

269 See paragraph 15.3 and paragraph 15.4 *infra*, See also Surrey *op cit* p 121

14.6.3. THE US, UN AND ANDEAN PACT MODELS

The US Model Convention basically incorporates the OECD Model text.²⁷⁰ Similarly, the UN Model²⁷¹ and the Andean Pact Model²⁷² retain the same principle. In addition, the UN Guidelines include a detailed consideration of the different approaches to the allocation of income and expenses including possible arrangements which can be made between the competent authorities of the treaty States.²⁷³ As observed by Atchabahian,²⁷⁴ in order to cope adequately with problems arising in the international allocation of income and expenses, including transfer pricing and related distortions, the effectiveness of exchange of information between tax administrations can not be over-emphasised. The effectiveness of such a mechanism becomes crucial especially to developing countries who often have no access to such information since the residence of most transnational corporation's parent company is located in the developed countries.

14.6.4. LESOTHO-UK DTA

The 1949 DTA between Lesotho and the UK contains a provision

270 See Article 9 of the US Treasury Model.

271 See Article 9 of the UN Draft; See also Surrey *op cit* p 10-11.

272 See Article 7 of the Andean Pact Model.

273 See also Surrey, *ibid*, also p 157-158.

274 See Atchabahian A, Tax Aspects of the Activities of Transnational Corporations and International Double Taxation, *Bulletin for International Fiscal Documentation* vol xxxi p 147 at 150

requiring enterprises engaged in trade or business in the other territory through a permanent establishment to attribute to the permanent establishment only those profits that would be generated by an independent enterprise engaged in similar activities but dealing at arm's length basis. The provision on related enterprises is to the effect that the taxing authorities may ignore the "independent states" and tax the true profits as they arise in each country.²⁷⁵

The renegotiated draft basically reproduces the OECD Model draft as discussed above.²⁷⁶ Therefore the comments made thereunder are equally applicable here.

14.6.5. LESOTHO-RSA DTA

The 1959 Lesotho-RSA DTA also incorporated the requirement of arm's length standard for dealings between related entities.²⁷⁷ The exceptional provisions of this DTA relate to two additional special provisions.²⁷⁸ Firstly, the source of income derived by the associated enterprises is deemed to be in the State of residence of the enterprise provided that the domestic tax law of the State has such a source rule. Secondly, the revenue authorities are empowered to determine the

275 See Articles 3 and 4 respectively of the 1949 Lesotho-UK DTA.

276 See Article 9 of the Lesotho-UK renegotiated DTA, Annex

277 See Article III(2) and Article IV of the Lesotho-RSA, 1959

278 See Article IV(2) and (3) of the 1959 Lesotho-RSA DTA,; See also Danzinger *op cit* p 361-362 where he comments about these special provisions.

proportion of the profits which might accrue to an enterprise on the arm's length basis by exercising their discretion or making an estimate if inadequate information is supplied. The proviso here again is that the domestic law must enable exercise of such powers. The importance of these provisions can not be overemphasised in view of the fact that implementation of the "arm's length" dealing gives rise to economic double taxation if a corresponding adjustment is not effected by the other contracting state.²⁷⁹ It is submitted that this mechanism in the old Lesotho-RSA DTA meant that once the article on related enterprises was applied, there would be a deemed source of the profits so derived and there would therefore be no economic double taxation in the other State.

It could perhaps be highlighted that South Africa has a legislative provision which enables the Commissioner for Income Tax to apply the principle of arm's length basis in the determination of taxable income for persons buying or selling commodities. This is recognition of the powers of the Commissioner usually conferred under the DTAs without the corresponding domestic provision.²⁸⁰ The criticism levelled against this provision, however, is that it is very narrow. Its coverage is

279 See *Passos Tax Treaty Law*, *op cit* p 182. Note should also be taken that according to *Passos*, none of the South African treaties she analysed incorporated the "semi-automatic" adjustment mechanism, i.e. once an adjustment has been made by one State on the profits of a related enterprise, the other State takes cognizance of this and makes an appropriate adjustment to that amount to avoid economic double taxation.

280 See Section 31 of the South African Income Tax Act, 1962.

limited to purchases or sales of commodities and therefore, does not cover provision of services, licensing of intangible property, such as patents, know-how, trade marks or copyrights; the granting of loans and the use of property.²⁸¹ Furthermore there seem to be no guidelines in regard to the ascertainment of the "arm's length" standard incorporated under the provision.

14.6.6. CONCLUSION

The renegotiated DTA between Lesotho and South Africa in its associated enterprises clause incorporates the OECD Model draft.²⁸² The special provisions of the 1959 DTA discussed above have been omitted. However, there is also a provision for correlative adjustment to avoid economic double taxation.²⁸³

14.7. DOMESTIC LEGISLATION TO COUNTER TRANSFER PRICING MANIPULATION:

The Lesotho Income Tax Order contains provisions which give broad powers to the Commissioner to distribute, apportion or allocate income, deductions or credits between associated taxpayers as an anti-avoidance measure.²⁸⁴ These powers are

281 See Passos *op cit* p 184-195; See also Theunis Lategan, Transfer Pricing in S A (1991) 4 *Juta's Foreign Tax Review* 54.

282 See Article 9 of the renegotiated Lesotho-RSA DTA, Annex II

283 See Article 9(2) *ibid*.

284 See Section 113 and 114 of the Lesotho Income Tax Order, 1993.

not limited to any particular form of income and include income arising from the transfer of intangible property between associates. The Commissioner is furthermore given powers to recharacterise the source and nature of any income as loss to counteract transfer pricing manipulation of these rules. The Lesotho legislation is therefore much broader than its South African counterpart.

The South African legislation in its anti-avoidance provision²⁸⁵ gives the Commissioner discretionary powers to adjust and determine tax liability where a transaction, operation or scheme is geared toward avoiding, postponing, or reducing liability for tax. Amongst the requirements in this provision is that of normality, i.e. that the parties created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, scheme or operation of the nature in question or that it is an arm's length dealing. Apart from the provision regarding application of the arm's length test to the purchase or sale of commodities,²⁸⁶ in the determination of taxable income related enterprises there is no specific provision in the South African tax legislation directed to counteract transfer pricing

285 Section 103 of the South African Income Tax Act, 1962.

286. Section 31 of the South African Income Tax Act discussed above at Chapte3 15.

schemes.²⁸⁷ Even though the general anti-tax avoidance provision may be applied in transfer pricing cases, it has been criticised for not being comprehensive enough to combat the problem. This is due to the extent that transfer pricing manipulation has permeated the business transactions of most foreign multinationals.

The South African anti-avoidance provision also includes a deeming provision incorporating the arm's length test. This provides that if a South African taxpayer carrying on business in South Africa disposes of shares held in a South African company to a non-South African person (including company) such a transaction would be deemed not at arm's length and therefore abnormal. This then lays the onus on the taxpayer to prove to the satisfaction of the Commissioner, that the parties are independent persons dealing at arm's length.²⁸⁸

Note should be taken, however, that by the usefulness of the arm's length test in South Africa has been marginalised by the absence of Revenue guidelines about its application. There are generally known approaches such as the re-sale-minus (sales for

287 See Lategan T, *Transfer Pricing in South Africa*, (1991), 4 *Juta's Foreign Tax Review* 54ff; See also van Blerck MC, *The Margo Report - International Implications* (1988) 1 *Foreign Tax Review* 5 at p 7 where the implications of the Margo Commission report are summarised in the context of international tax law. The 1979 "Transfer Pricing and Multinational Enterprises" Report referred to in the new OECD Model Convention with approval is another important reference to those wishing to examine the subject in detail (see *Sasseville supra*).

288 See Section 103(3) of the South African Income Tax Act, 1962.

companies), cost plus (service for companies) and the commonly applied "any other method".²⁸⁹ However, these are all theories; what actually happens in practice is not very clear. The subjective nature of the arm's length test i.e. a matter of opinion, despite the fact that his decision is subject to objection and appeal does not allay fears.²⁹⁰ In any event, even parties not dealing at arm's length can still enter into normal *bona fide* business transactions.²⁹¹ The Margo Commission Report recommended immediate action towards transfer pricing issues and the White Paper to the report accepted the recommendation.²⁹² For some time there was nothing on the table, though some sources reported that the Tax Advisory Committee of the Minister of Finance was seized with the issue since 1991.²⁹³

The recent Katz Commission Report has recommended that measures to counter tax avoidance through transfer pricing should be introduced such as those in the United Kingdom, which relied strongly on OECD guidelines.²⁹⁴ The approach in this context

289 See Murray Roger, *International Tax Planning - Modern Strategy*, (1991) 6 *S A Tax Review* 81 at p 90.

290 See Passos *Tax Treaty Law* p 183; See also Section 103(1) and (4).

291 See Trevor Emslie "Dealing at arm's length" (1988) 3 *Tax Planning* 127; See also decided cases of *CIR v Kings* 1947 (2) SA 196 (A) esp 216; *Hicklin v SIR* 1980 (1) SA 481 (AD) and a detailed analysis thereof by Theo van Wyk; Section 103 (1) *Hicklin v SIR* in *De Rebus* 1990 p 32 and ITC 1542 and ITC 1546 at SATC vol 54 1992 pages 417 and 477.

292 The Margo Commission Report at

293 See Lategan *op cit* p 54 at p 59.

294 See *The Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*, 1994 para 14.6.27 page 232

is urged to be in the form of anti-transfer pricing legislation but which relies on arm's length concepts to dictate acceptable pricing practices.

CHAPTER 15

INTERNATIONAL TAXATION OF INVESTMENT INCOME

15.1. GENERAL INTRODUCTORY REMARKS:

International taxation of investment income has been characterised as the area where conflict between the two objectives of promotion of investment flow and increasing tax revenues in international taxation is pronounced.²⁹⁵ Here again the debate revolves around the merits of source or residence as the basis of taxation of investment income. The competing claims to the right to taxing investment income are between the residence country of the investor (usually a developed country) and the source country where the investment generated income (usually a developing country). The term investment income as generally used will in this context include dividends, interest and royalties.²⁹⁶

The tax implications of investment income will be treated under separate sections since conventionally each class of income is

295 See Gendre F, The Treatment of Investment Income under the Andean Pact Model Convention, *Bulletin for International Fiscal Documentation*, vol xxix 1975 p 59 at 63.

296 See Gendre *supra*; Costa R V, The Treatment of Investment Income under the Andean Pact Model Convention - The Andean View, *Bulletin op cit* p 91; See also Atchabahian A, The Andean Subregion and its approach to avoidance or alleviation of International Double Taxation, *Bulletin* vol xxviii 1974 308; Passos Tax Treaty Law p 197 where reference is also to rentals from immovable property. The latter has been included under paragraph on taxation income from immovable property

dealt with under separate provisions. It is, therefore, more practical to treat them as such. Moreover, these classes of income, even though referred to together as investment income, exhibit distinct characteristics. Consequently, the importance of maintaining the integrity of each type of income can not be over-emphasised.²⁹⁷

The general approach taken by the OECD Model Convention on the taxation of dividends, interests and royalties is that a fixed rate of maximum withholding tax a source country may impose is set, and the balance is to be taxed by the residence country of the beneficiary. The US Model approach is essentially similar to the above OECD Model approach. In contrast, the UN Model refrained from setting percentage limits on withholding tax on these classes of income. It has been left to the discretion of the parties to negotiate the preferred limits. The extreme position of the Andean Pact Model provides for exclusive taxation of dividends, interests and royalties in the source country.

According to the International Chamber of Commerce, the fact that the UN Model Convention has set no limits on the withholding rate of tax on dividends as well as on interest and royalties respectively, is considered to be a major failure of the model. It is feared that this lacuna leaves room for more disputes on negotiation of DTAs. Therefore, it is argued that there may be fewer concluded treaties or at worst (for

297 See Atchabahian *ibid* p 322.

developed countries), there will be excessive claims on the rate of withholding tax at source.²⁹⁸

It is submitted that the UN Model Convention on this aspect offers the necessary flexibility to negotiating countries. This way, the parties can set limits for withholding tax taking into account peculiarities in their tax systems,²⁹⁹ including recovery of infrastructure costs incurred in the production of such income.

15.2. INTERNATIONAL TAXATION OF DIVIDENDS:

15.2.1. INTRODUCTION

There are competing claims to taxation of dividends. These are between the country of source and the country of residence of the beneficiary. The middle course is through withholding a certain limit as withholding tax at source while the balance is taxed at the country of residence. This way there is no exclusive right to tax.

298 See the International Chamber of Commerce, Comments on the UN Model Tax Convention between developed and Developing Countries, *Bulletin*, vol xxxv 1981 309 at 311.

299 See Horak JDD, S A Tax Treaties, Principles of Negotiation, (1991) 4 *Juta's Foreign Tax Review* 48 at 51 where RSA is urged to adopt the UN Model draft in negotiating with developed countries

15.2.2. OECD MODEL CONVENTION

Under the OECD Model the term "dividends" is defined to refer to the distribution of profits to the shareholders by different kinds of companies. These companies include companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies. Debt claims are specifically excluded from the term. The general rule is that neither the country of residence of the beneficiary nor the country of source of the dividends has an exclusive right to taxation of dividends. Consequently, the OECD Model gives the source country the right to withhold tax on dividends at a maximum rate of 15 per cent, while the residence country of the beneficiary may levy tax on the remitted portion. There is a limit of 5 per cent on tax on dividends which may be withheld at source if the beneficial owner is a company holding at least 25 per cent of the capital of the company paying the dividends.³⁰⁰ Furthermore it will be recalled that dividends paid in respect of an entity constituting a permanent establishment, will not be taxed as dividends but rather as profits of the permanent establishment in the source State.³⁰¹ The major impact of the OECD provision is the withholding limits of 15% on portfolio investment dividends and 5% on

300 See Article 10 of the OECD Model Tax Convention and Commentaries thereon which concedes that due to the differences of laws of OECD member countries, it is impossible to define the term fully and exhaustively; See *Passos op cit* p 204ff; *Danzinger op cit* 344ff.

301 See Article 7(7) of the OECD Model Tax Convention and Commentaries thereto.

direct investments. The concept of economic double taxation has not been addressed due to the uncertainty around it. Other States do not accept the validity of the concept.

15.2.3. THE US MODEL

The US Model substantially incorporates provisions similar to those of the OECD Model Convention in regard to international taxation of dividends. However, there is a slight variance, where the beneficiary or shareholder is another company, not an individual. While the OECD Model requires 25 per cent holding before the 5 per cent limit on withholding rate applies, the US Model requires only a 10 per cent holding by the shareholding company.³⁰² The latter coincides with the UN Model guideline on the percentage of share ownership which constitutes direct investment by both an individual and a corporation.³⁰³

15.2.4. THE UN MODEL

The UN Model in taxation of dividends allows both the country of source and the country of residence the right to tax dividends. There is a distinction between direct investment and portfolio investment in this respect.³⁰⁴ Provisions of the

302 See Article 10(2)(a) of the US Model Convention, *Bulletin* vol xxxi 1977 p 313 at 316

303 See Surrey S S, *UN Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, in *loc cit* at p 36

304 Surrey *ibid*, UN Model Convention Article 10

OECD Model are essentially retained except that there is no prescribed percentage limit on withholding tax on dividends, which have been left to the discretion of the parties to the negotiation.³⁰⁵ Note should however be taken that the developing countries favour increases in the withholding rates. It is emphasised that withholding tax imposed by the source country has to reflect reimbursement for expenses incurred in the production of dividend income. The UN Model in its guidelines on direct and portfolio investment provides that a 10% share of ownership constitutes a direct investment for both corporations and individuals.³⁰⁶ There is some controversy here since in some countries an individual is capable of portfolio investment only.

15.2.5. THE ANDEAN PACT MODEL

According to the Andean Pact Model, dividends are taxable only by the country in which the distributing enterprise resides. This is a result of application of the doctrine of exclusive

305 Surrey *op cit* p 39-40; Horak J D D, *S A Tax Treaties - Principles of Negotiation* (1991) 4 *Juta's Foreign Tax Review* 48 at p 50.

306 See Commentary to Article 10 of the UN Model, *Harvard International Law Journal* vol 19 1978 at 124. The 10 per cent lower limit for share ownership is said to be designed to align with the limits often set for share ownership by foreigners in some developing countries (usually 50 per cent). In that context, a 10 per cent share ownership will be considered substantial.

taxation in the source country.³⁰⁷

15.2.6. THE LESOTHO-UK DTA

The 1949 DTA between Lesotho and the UK exempted taxation of dividends paid by a company resident in one territory to a resident of the other territory. In other words the dividend income was taxable in the country of residence of the recipient shareholder.³⁰⁸ If the recipient of a dividend was a company owning 10% or more of shares there was no tax payable since the income would have been taxed as profits.³⁰⁹

The revised DTA essentially follows the OECD Model draft.³¹⁰ However taxation of dividends at the source, i.e. in the State where the company paying dividends is resident, is limited not to exceed 10 per cent of the gross amount of dividends.³¹¹ This is even lower than the OECD Model Convention limit of 15%. Unlike the OECD Model and the UN Model, which set minimum requirements of at least 25% or 10% shareholding respectively, the revised DTA exempts from taxation dividends received by a resident of another contracting party, if the company pays the

307 See Article II of the Andean Pact Model; See also Atchabahian A, *The Andean Subregion and its approach to Avoidance or Alleviation of International Double Taxation*, *Bulletin*, vol xxviii 1974 308 at 332; Gendre F, *Treatment of Investment Income under the Andean Pact Model Convention*, *op cit* p 60

308 See Article 6 of the 1949 Lesotho-UK DTA.

309 See Article 6(3) *ibid*.

310 See Article 10(1) of the revised Lesotho-UK DTA, Annex II

311 See Article 10(2) *op cit*.

dividend through a permanent establishment carrying on business therein or through a fixed base relating to performance of independent personal services therein. In other words, dividends regarded as effectively connected to a permanent establishment or a fixed base will not be taxable under this provision but rather under the business profits provision or on independent personal services.³¹²

15.2.7. LESOTHO-RSA DTA

The 1959 DTA between Lesotho and RSA had no special provision regarding taxation of dividends accruing from one territory and payable in another. This was dealt with under the provision regarding taxation of industrial or commercial profits. The revised draft³¹³ essentially incorporates the provision of the OECD Model Convention in regard to taxation of dividends. The maximum percentage of withholding tax on dividends payable to a non-resident recipient (referred to as beneficial owner) is, like the OECD rate, set at 15 per cent. There are no set percentages on shareholding by non-residents. The 15% maximum tax withholding rate is applicable notwithstanding the shareholding percentage. The competent authorities are to agree on the modalities of applying the limitations. The provisions on taxation of dividends do not affect the taxation of profits out of which dividends are paid.

312 See Article 10(4) *op cit*.

313 See the DTA between Lesotho and RSA, 1959; See Article 10 thereof.

The South African tax system will be lifting the payment of Non-Resident Shareholders' Tax from October 1, 1995.³¹⁴ This is reported to be a temporary measure. This will be in respect of a foreign investor with a minimum of 25% control of a company.

15.3. INTERNATIONAL TAXATION OF INTEREST:

15.3.1. INTRODUCTION

As remarked by one writer, Giddy, the major problem met when dealing with interest is that it is "all things to all men".³¹⁵ The term interest as generally used, means a return on savings to an individual or even a corporate investor. However, to a banker it means profits from banking and the problem is usually aggravated where interest is taken as part of profits. Similarly, to a trader or manufacturer who sells on extended credit terms, interest is also profits derived from the sales.

314 See the *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*, 1994, whose recommendation on abolition of the NRST was approved through the 1995/96 Budget Speech of the Minister of Finance

315 See Giddy R, Some International Problems relating to the Taxation of Interest, *Bulletin*, vol xxxii 1978 p 489.

There are three competing approaches³¹⁶ in regard to international taxation of interest. Firstly, that it is taxable in the country of residence of the debtor; or secondly, that it is taxable in the country of residence of the creditor; or thirdly, that it is taxable in the country where the source of interest income is situated. The three approaches are not mutually exclusive and some overlapping may occur in some instances.³¹⁷ This gives a background to the associated problems of ascertaining who has the right to tax interest in the light of modern developments in international finance.

15.3.2. THE OECD MODEL CONVENTION

The primary right to tax interest is that of the country of residence of the recipient. Interest is defined widely to include debt claims of every kind according to the OECD Model. Similar to dividends, interest attracts withholding tax at source, when it is paid. The right to tax interest at the country of source is limited to 10%. This poses no problem where a resident is involved. Where a non-resident is involved,

316 There may be differences in the formulation of these approaches but basically the aim is to highlight the competing claims in regard to the taxation of interest income between the lender's and the borrower's countries. At the same time, cognizance is to be taken of the activities which in fact enabled the borrower to discharge his/her obligations under the loan agreement. See for instance the South African case of *CIR v Lever Bros and Unilever* 1946 14 SATC 1 which decided that source of interest was the place where credit for the loan was made available (with Schreiner dissenting).

317 See Harvey McGregor discussion on the UK/US DTA, *British Tax Review* No 6, 1977, p 331

however, there is a potential of the taxpayer being taxed twice on the same interest. Thus unlike dividends, interest is susceptible to economic double taxation.³¹⁸

Implicit in the OECD Model approach of taxation of interest at source is the fact that the source country may forgo taxation of interest for non-residents. In the United Kingdom, withholding tax is applicable to annual interest rather than short term interest. This has been cited as an illustration that the rules regarding taxation of non-business income such as interest, have been developed in an historical context which may no longer be applicable in today's economy.³¹⁹ The argument being that in the past, a debtor was given tax relief for interest paid through the right to withhold tax from interest payments. Relief in this form, the argument continues, was only given in relation to annual interest payments and, therefore, short interest payments were paid free of withholding tax. Another question which arises in this context is the extent to which withholding taxes should apply to interest paid on international debt. The OECD Model Convention does not offer solutions to these problems.

15.3.3. THE US MODEL

The US Model essentially retains the OECD Model draft including

318 See Article 11 of the OECD Model Convention

319 See Jacqueline Dyson (ed) *Recent Tax Problems*, article *Taxation by Source or by Residence* by Stephen Edge at p 81

the 10% limit on withholding tax at source on interest. Otherwise the primary right to tax interest payments is granted to the State in which the recipient resides.

15.3.4. THE UN MODEL

As observed in the introductory remarks under paragraph 15.1, the UN Model refrained from setting percentage limits on withholding tax on interest income. Unlike the OECD Model and US Model Conventions, the UN Model approach is that the country of source should have the primary right to tax interest income. However, recognition is also given to the country providing the capital, hence the combination of taxation by source and taxation by residence.³²⁰

15.3.5. THE ANDEAN PACT MODEL

The Andean Pact Model provides that interest shall be taxable only to the State where the loan had been used.³²¹ This is consistent with the principle of source in that the right to tax interest is that of the State where the loan was used irrespective of the nationality of the recipient of the interest payment. There is a presumption that the loan is used in the country where it is paid. This is subject to rebuttal.

320 See Horak, *SA Tax Treaties - Principles of Negotiation* (1991) 4, *Juta's Foreign Tax Review* 48 at 50.

321 See Atchabahian A, "Andean Subregion and International Double Taxation", *Bulletin* Vol XXVIII No 8 1974 308 at 330, discussing Article 10 thereof

15.3.6. THE LESOTHO UK DTA

The 1949 Arrangement does not have a specific provision for taxation of interest. The renegotiated text essentially incorporates the OECD Model draft³²² except for minor departures. For instance, the definition of "interest" although similar to the OECD Model definition,³²³ has not specifically excluded penalty charges for late payment. This omission may be interpreted to imply that penalty charges are included in the description of interest as income from debt-claims of every kind under the Lesotho-UK DTA.

The provisions of the Lesotho-UK DTA goes beyond the OECD Model text. There is a provision which excludes operation of domestic legislation of either State parties where such law treats interest paid to a resident company as a distribution or dividend by the company paying such interest. There are some exemptions from taxation of interest, for instance if it is paid to the Government or local authority of a contracting State.

There is a specific provision which exempts from tax in Lesotho, interest paid to a resident of the United Kingdom, where such interest is paid in respect of a loan made, guaranteed or insured by the United Kingdom Export Credits Guarantee Department.³²⁴ This is the case of the so-called tax

322 See Article 11 of Lesotho-UK renegotiated DTA dated 19-01-94, Annex I

323 See Article 11(3) of the OECD Model Convention

324 See Article 11(11) of the Lesotho-UK renegotiated DTA *ibid*

spared loan, where as a practice, certain developing countries exempt foreign banks which lend money for certain approved purposes from local withholding taxes.

15.3.7. THE LESOTHO-RSA DTA

The 1959 DTA has no specific provision dealing with taxation of interest. The renegotiated draft incorporates the OECD Model text.³²⁵ Comments made on paragraph 15.3.2 will, therefore, also be applicable in this context.

Whether the choice of the OECD Model text in this context was advisable is a debatable issue. Horak in examining the appropriate approach for South Africa in future treaties, remarks that in negotiations with countries lesser developed than South Africa, it should adopt the role of a developed country.³²⁶ Thus in this context it would seem that Horak will approve the use of the OECD Model. The same writer, however, applauds the UN Model draft for lack of prescribed percentage limits on withholding taxes in respect of, amongst other, interest. The present writer suspects that the parties followed the OECD Model without adequate examination of the implications.

15.3.8. CONCLUSION

Lesotho's renegotiated DTAs have adopted the OECD Model approach to taxation of interest income. This means that there

325 See Article 11 of the Lesotho-RSA renegotiated DTA, Annex II

326 See Horak JDD, *op cit* at 51

is a limit of 10% withholding tax at the country of source, while the residue is taxable in the country of residence of the recipient of interest. Note should be taken that where interest is paid to a resident individual, such interest is excluded from gross income and thus the withholding tax is a final tax.³²⁷

15.4. INTERNATIONAL TAXATION OF ROYALTIES:

15.4.1. INTRODUCTION

Taxation of royalties has similarly combined both taxation by source and residence. There is generally certain limitations on the country of source. The debate here must be put in the context of the desire to promote international exchange of patents and technical know-how.

15.4.2. THE OECD MODEL CONVENTION

The OECD Model in the taxation of royalties emphasises the exclusive right of the country of residence of the licensor to collect tax. Royalties like interest, under the OECD Model Convention are taxable in the State of residence of the beneficial owner. Such royalties may only be taxed at country of source if the recipient is the beneficial owner of the royalties and the withholding tax is not to exceed 10 per cent

327 See Holmes KJ, Lesotho - Investment Incentives and Tax Reform, (1993) 6 S A Tax Review

of the gross amount of the royalties.

The term "royalties" has been defined to mean payments received as consideration for the use of, the right of use to use any copyright of literary, artistic or scientific work, any patent, trade mark, design/model, computer programme, plan, secret formula etc. According to the New OECD Model Tax Convention report, payments relating to software could qualify as royalties.³²⁸

15.4.3. THE US MODEL

The US Model essentially incorporates the same elements as in the OECD Model Convention. However, while the OECD Model Convention in its definition of royalties includes rental of cinematographic films, tapes or discs for radio or television broadcasting, these have been specifically excluded in the US Model. They are included as industrial/commercial profits.³²⁹

15.4.4. THE UN MODEL

The UN Model text is similar to the OECD Model text except that the country of the user is entitled to levy withholding tax in an amount the parties agree upon. The UN Model recognises the right of both source and residence countries to tax and

328 See Jacques Sasseville, *The New OECD Model Tax Convention Report*, (1993) 6 *S A Tax Review* 119 at 124

329 See Beale RJ - *The Law Relating to DTAs between South Africa and Zimbabwe* LLM UNISA 1981 at p 61

therefore leaves the limitation to be discussed between the State parties.³³⁰

15.4.5. THE ANDEAN PACT MODEL

The emphasis here is on the exclusive right of taxation on royalties on the country of source. This means that only the State in which the utilisation of the patent or trade mark takes place has the right to tax such income. Thus the country which uses the trade mark or patented invention which gave rise to the payment of royalties should exclusively tax the recipient regardless of nationality or residence.³³¹

15.4.6. THE LESOTHO-UK DTA

The 1949 Arrangement provides for taxation of an amount which represents a fair and reasonable consideration for the rights for which the royalty is paid in the country of residence of the recipient. This is on condition that there was no trade or business in the other State party through a permanent establishment.³³² The definition of the term "royalty" refers to "any royalty or other amount paid as consideration for the use of, or for the privilege of using, any copyright, patent, design, secret formula or process, trade mark, or other like

330 See Article 12 of the UN Model Convention; Van Raad *Comparison of OECD, UN and US Model Texts*

331 See Article 9 of the Andean Pact Model; Atchabahian, *Andean subregion and International Double Taxation, Bulletin Vol XXVIII*, 1974 308 at 330

332 See Article 7(1) of the Lesotho-UK 1949 DTA

property, but does not include royalty or other amount paid in respect of the operation of a mine or quarry or of other extraction of natural resources".³³³

The renegotiated DTA between Lesotho and the UK has incorporated provisions similar to the OECD Model, therefore, the observations made in paragraph 15.4.2 are applicable here. There is no express exclusion for royalty paid in respect of the operation or mine or quarry of natural resources as reflected in the 1949 DTA. This is an oversight Lesotho can not afford as will be shown below.

15.4.7. THE LESOTHO-RSA DTA

The 1959 tax treaty between Lesotho and South Africa³³⁴ covers royalty or rent or any consideration for use of any patent, design, trade mark, copyright, secret process/formula. The right of taxation where such income is paid to the resident of one State arising by virtue of use in another State, is granted to the State of residence of the recipient. Any royalty or amount paid in respect of operation of a mine or quarry of any extraction of natural resources within the territory of one State to a resident of the other shall be exempt from tax in the State of residence of the recipient.³³⁵ It seems that where natural resources exploitation are concerned, source rather than residence is the basis of taxation in that event.

333 See Article 7(2) *ibid*

334 See Article VI of the 1959 Lesotho-RSA DTA

335 See Article VII(2) *ibid*

The renegotiated DTA³³⁶ has incorporated essential elements of the OECD Model text, viz the country of residence of the recipient is granted the right to tax royalties arising from the other State. However, there is withholding tax to the maximum of 10 per cent in the country of source if the recipient is the beneficial owner of the royalties.

The present writer finds it remarkable that the renegotiated DTA did not include a specific provision dealing with taxation of royalties paid in respect of operations of mine or quarry, extraction of natural resources from the territory of another State party. This is particularly so since these were expressly provided for in the 1959 DTA as shown above.

The construction of infrastructure, tunnels and dams for the Lesotho Highlands Water Project involves major operations of quarry extraction of stone in Lesotho. In the past, there has been disagreements between the two countries to the scheme regarding the levying of royalties charges for the quarry extraction of stone used for the Highlands Water Project. The express provision on this issue could have clarified cases of this nature.

Nevertheless, the renegotiated DTA, in a provision not found in the OECD Model text provides that royalties arising in a contracting State shall be deemed to arise in the State whose

336 See Article 12 of the renegotiated Lesotho-RSA DTA, Annex II

resident paid for such royalties. In other words, source of the royalties is ignored but the decisive factor is residence of who paid for the royalties. Where, however, the person paying the royalties has a permanent establishment or a fixed base with which the right or property in respect of the royalties paid are effectively connected, then such royalties will be deemed to arise in the State in which the permanent establishment or fixed base is situated.³³⁷

15.4.8. CONCLUSION

Lesotho DTAs with the United Kingdom and South Africa respectively adopted the OECD Model text in the taxation of royalties. No peculiar circumstances particularly between Lesotho and South Africa were incorporated in the OECD Model formula. The Lesotho Highlands Water Project will continue to stimulate discussions of taxation of royalties especially when the water deliveries also begin. There will be certain royalty payments for the delivery of water from Lesotho to South Africa. Tax implications in this context ought to have been taken into account in the DTA between Lesotho and South Africa. The issue of royalty payments on quarry mining should have been dealt with to avoid ambiguity. It will however be recalled that according to the Lesotho domestic source rules, any exploration of quarries is Lesotho income.

337 See Article 12(6) of the renegotiated Lesotho-RSA DTA, Annex II

CHAPTER 16**INTERNATIONAL TAXATION OF PERSONAL SERVICE INCOME****16.1. INTRODUCTION:**

Personal service income is a broad topic which covers individuals who perform personal services in the other country. These include independent professional services, dependent personal services, Government services, directors' fees, pensions and annuities, artistes and athletes, professors and teachers as well as students. There are competing claims to the right of taxation of income from these various services. The developing countries generally argue that the country where the services are rendered should have the sole right of taxation.³³⁸ The developed countries give the country of residence the exclusive right to taxation of personal service income. Exceptions arise where there is a fixed base within the country of source as well as residence in the country of source for a period of more than 183 days.³³⁹ Government services and directors' fees are often treated as special cases.

338 See Atchabahian, "The Andean Sub-region and its approach to Avoidance or Alleviation of International Double Taxation" 28 *Bulletin for International Fiscal Documentation* 1974 No 8, 309 at 333 to 334; see also the UN Model

339 See Passos, *Tax Treaty* at 215 commenting on the OECD Model approach

16.2. TAXATION OF INDEPENDENT PERSONAL SERVICES:

16.2.1. THE OECD MODEL CONVENTION

Independent personal services cover professional services. The term "professional services" is broadly interpreted to include typical liberal professions such as architect, lawyer, physician etc. The list is by no means exhaustive. The general rule is that income derived by a resident of a contracting State in respect of professional services or similar activities of independent nature are only taxed in the country of residence unless there was a fixed base regularly available in the other contracting State for performing such services.³⁴⁰

Thus independent personal services are taxed similarly with business profits, except that while the concept of a permanent establishment is required for commercial and industrial activities, the term "fixed base" has been used for professional services.³⁴¹ Therefore, independent services are taxed in the country of source only if the individual has a "fixed base" there. The developing countries object to the concept of a fixed base in that it narrows the source jurisdiction. The so-called "professor/teacher" clause is in some DTAs integrated in the independent personal service clause.³⁴²

340 See Van Raad Kees, *OECD Model Income Tax Treaties and Commentaries to Article 14*

341 *Ibid*; see also Passos at 217

342 See Passos at 122

16.2.2. THE UN MODEL

The UN Model like the OECD Model grants the right to tax income from professional services to the country where the services are rendered if the person rendering the services has a fixed base in the country where the services are rendered. Furthermore, the UN Model in keeping with the concerns of developing countries grants the right of taxation to the country where the services were rendered if the stay in that country exceeded an aggregate of 183 days in a fiscal year.³⁴³

16.2.3. THE US MODEL

The US Model applies the 183 day rule above which applies to individuals for all personal services.³⁴⁴

16.2.4. THE ANDEAN PACT MODEL

Similarly under the Andean Pact Model, income from professional services is taxable only in the territory where the services are rendered. Payments for technical assistance services are given specific attention under the Latin American doctrine and the Andean Pact Model. These are taxable in the place where the services are rendered or alternatively, in the place where the activity that will be the subject of remuneration is developed (the topic is usually discussed together with that of

343 See Van Raad *Comparison of OECD, UN and US Model Texts*

344 *Ibid*

royalties).³⁴⁵

16.2.5. THE LESOTHO-UK DTA

The 1949 Lesotho-UK tax treaty provides that remuneration for personal (including professional) services performed in one of the State parties shall be deemed to be income from sources within that territory. In other words such income will be taxable where the services were rendered. The same provision provides that services performed in ships or aircraft by a resident of one of the contracting States shall be deemed to be performed in the country of residence of such an individual.³⁴⁶

The renegotiated DTA between Lesotho and the United Kingdom³⁴⁷ has incorporated the provisions similar to the OECD Model text. Therefore, the comments made on paragraph 16.2.1 above will also be applicable here.

16.2.6. LESOTHO-RSA DTA

There is no provision in the 1959 Lesotho-RSA DTA dealing specifically with taxation of professional services income of a resident of one of the contracting parties for performance

345 See *Ramon v Costa*, 20th CIAT Conference 1977, *International Bureau of Fiscal Documentation* 1978 Vol XXXII, 12 at 21

346 See Article 10(3) of the Lesotho-UK 1949 DTA

347 See Article 15 of the renegotiated Lesotho-UK DTA, Annex I

of services rendered in another contracting State. However, this type of income will fall under taxation of industrial or commercial profits of an enterprise. This is because the term "industrial or commercial profits" has been broadly defined to include remuneration from personal services.³⁴⁸

This means that income for professional services rendered by a resident of one contracting party in another State will be taxable in the country of residence unless there was a permanent establishment to which such income is attributable. Perhaps a proper term in this context would be a "fixed base", but the 1959 DTA does not use such a term.

The renegotiated DTA between Lesotho and South Africa essentially incorporates the provisions of the OECD text. Therefore, the comments made on paragraph 16.2.1 are also applicable in this context.³⁴⁹

16.2.7. CONCLUSION

Lesotho tax treaties followed the OECD Model in the taxation of professional services. These are taxable in the country of residence of an individual unless there is a fixed base in the other country.

348 See Article III of the 1959 Lesotho-RSA DTA

349 See Article 14 of the Lesotho-RSA renegotiated text, Annex II

16.3. DEPENDENT PERSONAL SERVICES:

16.3.1. INTRODUCTION

This relates to income/remuneration derived by a resident of a contracting State through employment in another contracting State. The general trend is to tax employment income where the services are rendered. There are very few differences among the DTA models.

18.3.2.. THE OECD MODEL

Employment income under the OECD Model is taxable in the country where the employment is exercised. The country of residence shall only tax such income if the recipient is present in the other country for a period not exceeding an aggregate of 183 days within a 12-month period; remuneration is paid by an employer who is not a resident of the other State; and remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State. There is an exception concerning income derived from operations aboard a ship/aircraft operated in international traffic. This may be taxed in the country where the enterprise operating the ship or aircraft is resident, ie its place of effective management.³⁵⁰ Further exceptions relate to pensions/annuities, government service remuneration and directors' fees.

350 See Van Raad, *Commentary on Article 15 of the OECD Model Convention*

These have been dealt with separately below at paragraphs 16.4, 16.7 and 16.8.

The new OECD Model Tax Convention³⁵¹ has amended the commentary on Article 15 relating to the 183-day rule. This was a result of a report on "taxation issues relating to international hiring-out of labour". The concern is that the 183-day rule is manipulated through hiring of foreign employees through non-resident intermediaries. The amendment has the effect of redefining the meaning of the term "employer". Thus intermediaries who bear no risk of the work nor have authority over their "employees" are disqualified.

16.3.3. THE US MODEL, UN MODEL

There is substantially no departure by the US Model and the UN Model from the approach followed by the OECD in taxation of income from personal services.

16.3.4. THE ANDEAN PACT MODEL

All personal services, whether professional services or dependent services, if provided in one country and the income is paid in another country, should be taxed where the services were rendered. Two special situations which do not detract from the basic principle relate to the exercise of official functions, eg foreign service officials which are traditionally

351 See Sasseville J, "The New OECD Model Tax Convention", (1993) 6 SA Tax Review 119 at 122

taxed in their own country; and the crews of ships, aircraft and buses undertaking international traffic, which are taxable in the country where the employer resides.³⁵²

16.3.5. THE LESOTHO-UK DTA

Under the 1949 tax treaty a resident of one country party is exempted from taxation on remuneration from personal services including professional services performed in the other State provided presence in the latter State was for a period not exceeding an aggregate of 183 days in a year; and the services were performed on behalf of a person resident in the former State and remuneration is taxable there.³⁵³

It should be noted that these provisions essentially incorporate the elements of the OECD Model. The renegotiated DTA is verbatim the OECD Model text,³⁵⁴ so comments made on paragraph 16.2 above apply *pari passu* here.

16.3.6. THE LESOTHO-RSA DTA

The 1959 DTA between Lesotho and South Africa does not have a provision specifically dealing with taxation of income derived

352 See Article 13 of the Andean Pact Model discussed by Atchabahian, "The Andean Sub-region and its approach to Avoidance and Alleviation of International Double Taxation"; 28 1974 *Bulletin*, 308 at 333 to 334

353 See Article 9(1) and (2) of the 1949 Lesotho-UK Arrangement

354 See Article 16 of the renegotiated Lesotho-UK DTA, Annex I

through dependent personal services. The definition of the term "industrial or commercial profits" includes remuneration for personal services. These are taxable in the country of residence unless they were rendered through a permanent establishment and attributable to such permanent establishment in another country.

The renegotiated DTA has embodied all the elements in the OECD Model clause, the comments made under paragraph 16.3.2 above, therefore, apply *pari passu* in this context.³⁵⁵

16.3.7. CONCLUSION

The Lesotho DTAs have followed the OECD Model Convention in the taxation of income from dependent personal services. Such income is taxable where the services were rendered (with the exception of income from directors' fees, pensions/annuities, government service and services rendered aboard ships, aircraft or any international road traffic.

16.4. DIRECTORS' FEES:

16.4.1. THE OECD MODEL CONVENTION

The OECD Model provides that the directors' fees are taxed in

355 See Article 15 of the Lesotho-RSA renegotiated DTA, Annex I. Decided cases such as ITC 1170 and that of *Whitfield v CIR* 1993 (2) SA 236 ECD illustrates the South African test of what constitutes temporary absence. Section 9(1)(d)*bis* of the South African Income Tax Act may also shed further light in this context.

the country of residence of the company. This is a departure from the general approach that taxation of employment income is where the services are rendered.³⁵⁶

16.4.2. THE US MODEL has no specific Article on directors' fees.

16.4.3. THE UN MODEL

According to the UN Model,³⁵⁷ the directors' fees including salaries, wages and other similar remuneration derived by a resident of a contracting State in his capacity as official in a top level managerial position of a company resident in the other contracting State may be taxed in the latter State. Substantially, this is essentially similar to the OECD Model provision. However, the UN text has expanded on the income included in this category. Furthermore, the heading of the UN text does not only refer to the "directors' fees" but also "remuneration of top level managerial officials". Thus the UN draft is much wider in scope. Recent DTAs seem to favour the UN Model text in this context.³⁵⁸

16.4.4. THE ANDEAN PACT MODEL has no specific Article on directors' fees.

356 See Article 16 of the OECD Model Convention

357 See Article 16 of the UN Model Convention

358 See Article 17 of the Zimbabwe-Norway DTA discussed in (1992) 31 *Income Tax Reporter*, p 65

16.4.5. THE LESOTHO-UK DTA

The 1949 DTA has no specific provision dealing with directors' fees. The renegotiated text embodies the OECD Model text, ie the directors' fees are taxable in the contracting State where the company is resident.³⁵⁹

16.4.6. THE LESOTHO-RSA DTA

There is no specific provision for directors' fees in the 1959 tax treaty. Such income will fall under industrial/commercial profits.³⁶⁰

The renegotiated DTA is similar to the OECD Model text.³⁶¹ The comments made under paragraph 16.4.1 apply *mutatis mutandis* here.

16.4.7. CONCLUSION

The Lesotho tax treaties have adopted the OECD Model text in the taxation of directors' fees. These are taxable in the country of residence/management. This approach is in keeping with the approach of the developing countries that strive towards taxation at source.

359 See Article 17 of Lesotho-UK renegotiated DTA

360 See the discussion on taxation of industrial/commercial profits under para 13.1 above at page 225

361 See Article 16 of the Lesotho-RSA renegotiated DTA, Annex II

16.5. CONSULTANCY/TECHNICAL/MANAGEMENT FEES:**16.5.1. INTRODUCTION**

This is a new specific category of personal services income. Consultancy, technical or management fees are a serious issue for developing countries who insist that they must be taxed in the country of source. In other words, these must be taxed in the country whose residents purchased the services.³⁶² The argument in support of this submission is that consultancy fees often involve large sums and the services are often performed partly in the country of residence of the seller of the services and partly in the source/buyer country. If the traditional approach is followed, the source country will not constitute a permanent establishment unless there is a building/site/office used for a period of at least six months within a year. Thus it is felt that management fees have been used as a crude method of transferring profit from developing countries to developed countries and as such are a target for transfer pricing.

16.5.2. THE OECD, UN, US MODEL TEXTS

There is no similar text in the OECD, UN or US Model texts.

362 See Surrey SS, "United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries", Vol 19 *Harvard International Law Journal* p 1 at 220

16.5.3. THE ANDEAN PACT MODEL

The Andean Pact Model discusses technical assistance business enterprises in the same context as professional services. Due to the magnitude of technical assistance services, including those provided by firms, this type of income is taxable only by the territory in which the services were rendered according to the Andean Pact Model.³⁶³

16.5.4. THE LESOTHO-UK DTA

As remarked earlier, this is a new emerging specific category income. In the renegotiated DTA, the provision is entitled "Management and Technical Fees".³⁶⁴

16.5.5. THE LESOTHO-RSA DTA

The renegotiated tax treaty between Lesotho and South Africa refers to technical fees which are defined as "payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature".

³⁶³ See Article 14 of the Andean Pact Model

³⁶⁴ See Article 13 of the Lesotho-UK renegotiated DTA; the Zimbabwe-Norway DTA also has this specific category of income

16.5.6. CONCLUSION

The effect of the technical/management fees clause referred to above is that technical fees arising in a contracting State and paid to a resident of the other contracting State may be taxed in that other first-mentioned State. This tax so charged is, however, not to exceed 10 per cent of the gross amount of technical fees. Where a resident of one contracting State carries on business in the other contracting State in which technical fees arise through a permanent establishment or fixed base situated therein, these will be treated as effectively connected business profits or as independent personal services as the case may be.

16.6. TAXATION OF INCOME OF ENTERTAINERS AND SPORTSMEN (ARTISTES AND ATHLETES):

16.6.1. INTRODUCTION

The general rule seems to be that the country of source, i.e. where the activities were exercised, has the right to tax income derived by artistes and athletes. The old treaties use the terms "artistes and athletes", while the new treaties use the terms "entertainers and sportsmen" which is felt to be much broader. Even though there is no doubt that income covered under this provision is derived from personal activities as such, it is classified as either activities performed in a

dependent capacity or as an independent activity in others.³⁶⁵ This old approach afforded easy tax avoidance by entertainers since there would be no permanent establishment/fixed base.³⁶⁶ Other treaties deal separately with the taxation of income of artistes and athletes with separate rules neither classified as dependent nor as independent personal services. In some treaties, this type of income falls under the catch-all provision of "other income".

16.6.2. THE OECD MODEL CONVENTION

Under the OECD Model text, taxation of income of artistes and athletes derived from the territory of another State party is exclusively taxable in the country of residence unless there is a fixed base in the first-mentioned State.³⁶⁷ The provision is intended not to impede cultural exchanges of performances abroad and does not apply to entertaining of athletes employed by Government.³⁶⁸

The term "athlete" is not defined while the concept of "entertainer" is given context by use of examples such as theatre, motion picture, radio, television, artistes and musicians. It would seem that managers, coaches, directors,

365 See Passos *op cit* p 122

366 See Eskinazi R.N., "The International Taxation of Non-Resident Artistes and Athletes", (1991) 4, *Juta's Foreign Tax Review* 26 at 27

367 See Article 27 of the OECD Model Convention

368 See Van Raad, 1963 and 1977 *oecd model Income Tax and Commentaries to Article 17*

choreographers and technicians would not fall within the scope of this article.³⁶⁹

The latest amendment to the OECD Model Convention through the commentary to Article 17 excludes income earned by an impresario from his activities as such from the scope of this article.³⁷⁰ The commentary on this Article confirms that it applies to members of teams or orchestras, or artistes or sportsmen employed by their own company, who are paid a salary rather than being paid for particular performances. Furthermore, it is clarified that the OECD Model on Article 17 covers three main situations: the management company which receives income for the appearance of artistes or sportsmen not constituted as a legal entity; the team, troupe or orchestra constituted as a legal entity and receives income from performances; tax avoidance schemes where the income is not paid to the artiste or sportsman taxpayer but to another person, a so-called "star company"/"loan out" company. The company which employs the taxpayer contracts with a promoter in the other country to provide services of the taxpayer for a fee. As the company would not have a permanent establishment in that other country, it would not pay tax there on its income.

369 See R N Eskinazi, "The International Taxation of Non-resident Artistes and Athletes", (1991) 4 *Juta's Foreign Tax Review*, 26 at 27

370 See Jacques Sasseville, (1993) 6 *S A Tax Review* 119 at 121

16.6.3. THE UN MODEL

The UN Model approach does not differ from the OECD due to the common emphasis on source taxation in this provision.³⁷¹

16.6.4. THE US MODEL

The US Model text³⁷² is flexible in that it allows artistes and athletes to fall under provisions dealing with either independent or dependent personal services unless their income exceeds a certain amount in the year of assessment (\$20 000).

16.6.5. THE ANDEAN MODEL

The Andean Model does not differ much from the UN Model approach since they all emphasise the principle of source for taxation of this type of income. However, the Andean Model has a strict application of the principle of source to income under this provision in that the domicile, residence or nationality of the performers as well as the period of time spent in the country where the performance takes place is ignored.³⁷³ Income under this provision is taxed where the activities take place.³⁷⁴

371 See Article 17 of the UN Draft in Surrey, *op cit* at 91

372 See Department of the Treasury at 86

373 See Article 16 of the Andean Pact Model

374 See Atchabahian, "The Andean Subregion and its approach to Avoidance or Alleviation of International Double Taxation", Vol XXVIII 1974 308 at 334

16.6.6. THE LESOTHO-UK DTA

The 1949 tax treaty between Lesotho and the UK expressly excluded profits/remuneration of public entertainers such as stage, motion picture or radio artistes, musicians and athletes from the provision, income from personal (including professional) services.³⁷⁵ Since there is a residual provision granting double taxation relief on "any income" in any of the jurisdictions of the contracting States, there is a cogent argument that taxation of income of athletes and entertainers will fall under this provision.³⁷⁶ There is, however, another argument which is even more stronger, that this type of income is just not covered under the DTA since it has been expressly excluded under paragraph (3) of the tax treaty.

The renegotiated tax treaty has incorporated provisions similar to the OECD text on taxation of income of artistes and athletes.³⁷⁷ Therefore, the comments made on paragraph 18.6.2 are equally applicable in this context.

16.6.7. THE LESOTHO-RSA DTA

The 1959 tax treaty between Lesotho and South Africa has no provision dealing with taxation of artistes and athletes. It is unlikely that this type of income could qualify as

375 See Article 9(3) of the 1949/1969 Lesotho-UK DTA

376 See paragraph 14(4) of the 1949/1969 Lesotho-UK DTA

377 See Article 18 of the renegotiated Lesotho-UK DTA, Annex I

"industrial or commercial" profits due to the absence of a permanent establishment in the other territory under the 1959 DTA. This is also due to the inherent nature of these performances especially where such are undertaken with proactive knowledge of the tax implications.

The renegotiated DTA has adopted the latest terminology of the New OECD Model viz. "entertainers and sportsmen".³⁷⁸ The comments on paragraph 16.6.2 in this context are applicable here as well.

16.6.8. CONCLUSION

International taxation of income of entertainers and sportsmen was in the old treaties dealt with as independent or dependent personal services. This meant that such income was taxable exclusively in the country of residence of the performers unless there was a fixed base regularly available for performance of such services in country of source (where such services are rendered). Alternatively, if regarded as dependent personal services, income derived therefrom would be taxable in the country where the services were rendered unless presence there was of a short duration, not exceeding 183 days in the fiscal year; the employer who paid the remuneration was not resident in the country in which the services were rendered and that such remuneration was not borne by a permanent establishment

378 See Article 17 of the renegotiated Lesotho-RSA DTA, see also Sasseville J on "The New OECD Model" at (1993) 6 S A Tax Review 119 at 121

or a fixed base. It was easy to avoid payment of tax by foreign performers in these circumstances.

The new trend is for a separate specific article which imposes tax on a non-resident entertainer/sportsman performing in the foreign source country, where the services were rendered. As predicted by some writers,³⁷⁹ there is a flood of international entertainers and sportsmen who are coming to perform in South Africa since the April 27, 1994 elections. There are spill-over effects of these performers to neighbouring countries like Lesotho. The renegotiated Lesotho DTAs therefore seem to be abreast with the developments in the international taxation of entertainers and sportsmen.

16.7. INTERNATIONAL TAXATION OF PENSIONS AND ANNUITIES

16.7.1. INTRODUCTION

This category of income relates to private or non-governmental pensions. Private pension/annuities paid in respect of past employment are generally taxable only in the country of residence of the recipient. This is the approach of the developed countries as reflected in the OECD approach and the US Model. The developing countries to the contrary, insist that the country of source of payment of pensions should have the first right to tax this income. This approach is reflected in the UN Model and the Andean Pact Model.

379 See Eskinazi *op cit* 26

16.7.2. THE US MODEL

The US Model text covers pensions, annuities as well as social security payments and other public pensions, alimony and child support. The approach is essentially that the country of residence of the recipient has the right to tax the income.³⁸⁰

16.7.3. THE OECD MODEL CONVENTION

The OECD Model as observed earlier, restricts taxation of private pensions to the country of residence. Similar payments such as the widows' and orphans' pensions are covered. This approach is justified on the grounds of administrative convenience.³⁸¹

The OECD Member countries' practice seems to be diversified in regard to government pensions. Some States argue that the State of source has the right to tax while others argue that the country of residence has the right to tax.³⁸²

The recent amendments to the OECD Model³⁸³ include a suggested provision on "tax treatment of employees' contributions to foreign pension schemes". As the title of this amendment suggests, it is designed for employees working abroad to get

380 See Van Raad, *Commentary to Article 18 and Comparison between OECD, US and UN Model*

381 See Aoki T, "Double Tax Conventions of Japan", 24 *Bulletin for International Fiscal Documentation* 1970 No 12, 548

382 See Van Raad *ibid*

383 See Sasseville J, *op cit* at 123-124

tax relief for pension contributions made to their pension scheme in the home country. The concern was that employees assigned abroad normally do not get relief under both the host country and the home country for contributions paid in the home country. The requirements for both the employee and the contributions to meet for the provision to apply are:

- the employee must have been contributing to the pension scheme and not resident in the host State immediately before his employment in the host State;
- contributions must be made to a pension scheme established in and "recognised for tax purposes" in the home State.

If these conditions are met, contributions made by an employee rendering services in one contracting (host) State to a qualifying pension scheme in the home State will qualify for a deduction for tax purposes in the same conditions and limitations as contributions to a pension scheme of the host State.

This suggested provision on tax treatment of employee contributions to foreign pension schemes has not been included in Article 18 but rather left in the commentary thereto. This was due to reservations expressed by a large number of member countries who had difficulty with either its wording or underlying principles.³⁸⁴

It is submitted that this option has a lot to comment for to countries which wish to deal with the issue.

16.7.4. THE UN GROUP

The flow of taxation of pensions to countries of residence insulates residents from taxation in the country of source of that income. For most developing countries, pension payments are made by enterprises resident in their countries to former employees and therefore this is not essentially different from salaries/wages.³⁸⁵ Therefore, pensions including specifically social security payments under the UN Model text, paid by a contracting State to residents of the other contracting State are taxable in the first-mentioned country, i.e. in the country of source.³⁸⁶ This is an alternative approach since the UN Model also contains a provision similar to the OECD Model.

16.7.5. THE ANDEAN PACT MODEL

According to the Andean Model, pensions and annuities are taxable only by the country of source. The source is considered to be situated in the country in which the contract of employment which originated the income was signed. In the absence of a contract, source of pension and annuities is

385 See Article 18 of the OECD Model Convention

386 See Van Raad *Commentaries on Article 18 regarding the UN Model Text*

regarded as the country from which payment is made.³⁸⁷

It should be noted that this Article reiterates the principle of source. It does not cover cases of pensions or retirement resulting from social security systems.

16.7.6. THE LESOTHO-UK DTA

The 1949 DTA³⁸⁸ between Lesotho and the United Kingdom as well as the renegotiated text,³⁸⁹ are essentially similar to the OECD Model draft discussed above at paragraph 7.2. This means that private pensions/annuities are taxed in the country of residence of the recipient not in the country of source.

16.7.7. LESOTHO-RSA DTA

The 1959 DTA³⁹⁰ as well as the renegotiated DTA³⁹¹ between Lesotho and South Africa essentially follows the OECD Model approach.

387 See Article 15 of the Andean Pact Model, Atchabahian, "The Andean Subregion and its approach to Avoidance or Alleviation of International Double Taxation", Vol XXVIII 1974 308 at 334

388 See paragraph 10(1) and (2) of the 1949/1969 Lesotho-UK DTA

389 See Article 19(1) and (2) of the renegotiated DTA between Lesotho and the UK, Annex I

390 See Article VIII (2) of the 1959 Lesotho-RSA DTA

391 See Article 18 of the renegotiated DTA between Lesotho and RSA, Annex II

16.7.8. CONCLUSION

The Lesotho DTAs with the United Kingdom and South Africa respectively followed the OECD approach in the international taxation of pensions/annuities. This means that residence as a basis of tax has been granted priority in this context. This approach is challenged by the developing countries as reflected under the Andean Pact Model.

16.8. INTERNATIONAL TAXATION OF GOVERNMENTAL SERVICES

16.8.1. INTRODUCTION:

This provision covers both taxation of remuneration and pensions for services rendered under government service. The general approach is that the exclusive right of taxation of income received in the discharge of public service is granted to the paying State. This practice conforms with the rules and practice of international diplomacy and mutual respect between sovereign states.³⁹² Note should, however, be taken that the receiving/host State is entitled to tax remuneration of certain categories of personnel of foreign diplomatic and consular missions. These usually are permanent residents or nationals of that State. Furthermore, the provision in principle does not

392 See the 1963 Vienna Convention on Consular Relations as well as the 1964 Vienna Convention on Diplomatic Relations which the majority of States are parties to including Lesotho, South Africa and the United Kingdom

apply to remuneration or pension paid in respect of trade or business for the State. Similarly, even diplomatic agents are not covered by diplomatic privileges and immunities once they enter the business arena in the host State. For this reason, this is generally frowned upon.

16.8.2. THE OECD MODEL, US MODEL, UN MODEL AND THE ANDEAN PACT MODEL

All these models recognise the exception that income from the exercise of official functions in another State, are only subject to tax in their own country. Source in this context is the overriding factor in determining tax liability.³⁹³

16.8.3. LESOTHO-UK DTA

Remuneration, including pensions paid by the Government of one of the contracting parties to an individual for services rendered in the discharge of governmental duties is exempt from taxation in the other State if the individual is resident in that other territory solely for the purpose of rendering those services.³⁹⁴ This is in terms of the 1949 DTA between Lesotho and the United Kingdom.

393 See Article 19 of the OECD Model Convention and Van Raad "Commentaries thereto on the Comparative Analysis with US and UN Models"; see also Article 15 of the Andean Pact Model

394 See paragraph 8(1) of the 1949/1969 DTA between Lesotho and the UK

The renegotiated DTA³⁹⁵ in the first instance incorporates the same elements as in the old DTA but goes further to elaborate and exclude nationals of the host State as well as individuals who did not become residents of that State solely for the purpose of rendering the services. Pension paid as a result of government service is taxable only in the paying State provided the individual is a resident and national of that State.

Where services rendered to a contracting State or its political subdivision or local authority was in connection with a business carried on by that State, remuneration and pension payable therefrom shall be governed by the provisions regarding dependent personal services, directors' fees and private pensions as the case may be.³⁹⁶

16.8.4. THE LESOTHO-RSA DTA

The 1959 as well as the renegotiated DTA between Lesotho and South Africa is essentially similar to the Lesotho-UK DTA discussed on the above paragraph.

16.8.5. CONCLUSION

Income from rendering of government service whether as remuneration or pension is only taxable in the country of

395 See Article 20 of the renegotiated Lesotho-UK DTA, Annex I

396 See Article 20 of the renegotiated Lesotho-UK DTA, Annex I

source. The rationale here must be that since funds of governments are taxpayers' money, it will not be fair for another jurisdiction to tax this money. Where the individual concerned is not a national nor ordinarily resident in the paying State, the exemption is lifted. Similarly, where business profits are involved, even if it is with a government, the exemption does not apply. Lesotho DTAs follow an established international practice in this context.

16.9. INTERNATIONAL TAXATION OF PROFESSORS AND TEACHERS:

16.9.1. INTRODUCTION

The old DTAs had no specific provision dealing with taxation of income of professors and teachers. This could by implication fall under the category of dependent or independent personal services. The latest DTAs exempt professors/teachers from taxation in the country of the contracting party for services rendered there provided that the duration of residence is less than two years and the professor/teacher is subject to tax in his country of residence.

16.9.2. THE OECD MODEL CONVENTION

The OECD Model does not have a provision dealing specifically with taxation of income of professors. These are by implication from the commentary on taxation of independent personal

services, covered there.³⁹⁷ The term "professional clause" includes the so-called "professor/teacher" clause submerged there.

16.9.3. THE UN DRAFT, US DRAFT, ANDEAN PACT MODEL

Neither the UN Model, the US Model nor the Andean Model contain a separate provision dealing with taxation of teachers/professors. This could be covered by provisions dealing with independent or dependent personal services depending on the context.

16.9.4. THE LESOTHO-UK DTA

The 1949/1969 DTA between Lesotho and the UK does not have a specific provision dealing with income of professors. This could be dealt with under the provision on taxation of remuneration of personal (including professional) services.³⁹⁸ The renegotiated DTA³⁹⁹ does not have a specific provision either for this category of income. The term "professional services" has followed the OECD Model and includes "educational or teaching activities". Thus "professor/teacher" clause will be subsumed under professional services category.

397 See Passos, *Tax Treaty Law* at 226; see also Commentary to Article 14(2) of the OECD Model Convention

398 See paragraph 9(1) and (2) of the 1949/1969 Lesotho-UK DTA discussed in paragraph 18.2.5 above

399 See Article 15 on independent personal services discussed at paragraph 18.2.5 above

16.9.5. THE LESOTHO-RSA DTA

The 1959 DTA as well as the renegotiated DTA between Lesotho and South Africa has followed the approach of the OECD discussed on the above paragraph 16.9.4 *vis-a-vis* the Lesotho-UK DTA. This means that the income is taxable where the individual is resident unless he has a fixed base regularly available in the other State and only so much as is attributable to that fixed base will be taxable.

The question arises as to whether the "professor/teacher" clause where relevant, only applies to teaching but not to research work. Passos reports of certain treaties which extend the exemption to cover remuneration for carrying out of advanced study on research.⁴⁰⁰

The South African Special Court case of a visiting German professor,⁴⁰¹ considered a "professor/teacher clause" in the DTA between South Africa and Germany decided that "a period of temporary residence not exceeding two years" meant an unbroken period of residence looking at the contract that governs the period of employment. The fact that the taxpayer had taken vacation in some instances was held not to constitute breaks in his temporary residence since his salary was paid regardless of a vacation or not. Thus the appellant was found not to fall

400 See Passos, *Tax Treaty Law* at 226 where she discusses Article 17 of the DTA between RSA and Germany

401 See Income Tax Case No 1473 (1989) 52 SATC 128

within the DTA provisions since he was temporarily resident in South Africa for longer than two years.

This German case raises a further question regarding treatment of a professor/teacher who remains in the source country for more than two years. The implication from the Special Court decision is that the professor did not qualify for the exemption under the DTA. This has been submitted by Danzinger to mean that the professor would have to pay tax for three years, one year in (South Africa) the source country and refund for two years in his country of residence (Germany).⁴⁰² In other words, the professor refunded the exemption from tax in South Africa for the two year period, beyond that he became liable to tax at source, ie the one year.

14.9.6. CONCLUSION

The Lesotho DTAs have no special provision for the so-called "professor/teacher clause". This is surprising taking into account the number of expatriate professors who teach in Lesotho's institutions of higher learning. For nationals of the United Kingdom and South Africa falling into this category, they will be treated in terms of provisions for personal services at paragraphs 16.2.5 and 16.2.6 above. In practice, in Lesotho, the foreign personnel is governed by the technical assistance agreement concluded with the respective Governments.

402 See Danzinger LLM dissertation p 138

It is, however, recommended that tax implications arising in such arrangements ought to have been included in the DTAs for clarity.

16.10. TAXATION OF STUDENTS AND BUSINESS APPRENTICES:

16.10.1. INTRODUCTION

The general approach is that income of students from a contracting State is exempted from tax in the other contracting State where they receive their education/training. The requirements for the provision to apply are that the student must be resident in the other State solely for education or training on a full time basis and that payments must be from outside sources. Any remuneration earned in the host State is not covered by this provision.

16.10.2. THE OECD MODEL, US MODEL, UN MODEL

All these Model drafts are substantively reflected in paragraph 16.10.1 above.

16.10.3. LESOTHO DTAs WITH THE UK AND RSA

The Lesotho DTAs incorporate the OECD Model text reflected in paragraph 16.10.1 above. Source of income seems to be the

determining factor. This also applies to the renegotiated DTAs.⁴⁰³

The earlier, 1949, DTA between Lesotho and South Africa has the provision similar to the terms of paragraph 16.10.1 above. However, for practical training, the period is not to exceed the aggregate of 183 days in a year of assessment in the other State and the remuneration exempt from tax is not to exceed £250.⁴⁰⁴ One is doubtful if there is any more relevance for the set amount.

16.11. TAXATION OF CAPITAL GAINS:

16.11.1. INTRODUCTION

The provision for taxation of capital gains is not common in most treaties. This is due to the lack of uniformity in the taxation or non-taxation of capital gains in domestic laws.

16.11.2. THE OECD MODEL

The OECD Model provides for treatment of capital gains in immovable property to be treated as taxation of immovable

403 See Article 21 of the DTA with the UK, Annex I and Article 20 of the DTA with South Africa, Annex I

404 See Article IX (1) and (2) of Lesotho-SA DTA 1959

property. Capital gains by movable property forming part of a business of a permanent establishment of an enterprise of a contracting State in the other contracting State or fixed base in regard to independent personal services may be taxable in the other State where the permanent establishment/fixed base is. Capital gains by ships and aircraft operating in international traffic is taxable only in the country in which the place of effective management of the enterprise is situated.⁴⁰⁵

16.11.3. THE US, UN MODELS

These essentially follow the OECD Model approach.

16.11.4. THE ANDEAN PACT MODEL

The Andean Pact Model provides that capital gains are taxable only by the State in whose territory the goods were situated at the time of the sale. This rule adheres to the principle of source.⁴⁰⁶

Exceptions to this general rule are capital gains from the transfers of the following: ships, airplanes, buses and other

405 See Article 22 of the OECD Model and Commentaries thereto

406 See Article 12 of the Andean Pact Model; also Atchabahian 10 C of Bulletin Vol XXVIII 1974 at 333

transportation vehicles. Capital gains from these are taxable only by the country in which they were registered at the time of the transfer; bonds, stock and similar securities are taxable only by the country in which they were issued. Each exception to the general rule does not retract from the reaffirmation of the principle of source as closely as possible.

16.11.5. THE LESOTHO-UK DTA

The renegotiated treaty between Lesotho and the United Kingdom has a provision which simply states that each contracting State may tax capital gains in accordance with the provisions of its domestic law.⁴⁰⁷

This is fair enough considering the disparities between the laws of these States in taxation of capital gains. The 1949 DTA had no provision for capital gains.

16.11.6. THE LESOTHO-RSA DTA

There is no provision in regard to taxation of capital gains in both the 1959 and the renegotiated DTA between Lesotho and South Africa.

407 See Article 14 of the renegotiated Lesotho-UK DTA

16.12. OTHER INCOME:

16.12.1. INTRODUCTION

This is the so-called "catch-all provision" found in the OECD Model.⁴⁰⁸ The effect is that any income, wherever arising, which has not been expressly covered by other provisions is taxable in the country of residence. This means that the exclusive right to tax is that of the State of residence notwithstanding the source of such income (ie including income from other third States). This is in line with the predilection of the OECD Model towards residence as a basis of taxation in most cases. Other models do not have this provision.

16.12.2. THE LESOTHO DTAs

The OECD Model provision has been included in both of the renegotiated Lesotho DTAs with the United Kingdom⁴⁰⁹ and South Africa.⁴¹⁰ There are, however, certain exceptions: where there is a permanent establishment involved or a fixed base as the case might be, income arising therefrom will be treated in terms of the provisions of business profits or independent personal service respectively. For the DTA with the United Kingdom, where such income is from immovable property, it will

408 See Article 21 of the OECD Model Convention

409 See Article 22 of the Lesotho-UK renegotiated DTA

410 See Article 21 of the Lesotho-RSA renegotiated DTA

be treated in terms of the treaty provisions on immovable property.⁴¹¹

16.12.3. CONCLUSION

The provision on "other income" underscores the importance of classifying income under DTAs. The country of residence has an advantage here. It is given preference to tax any income which has not been classified under the DTAs notwithstanding source of such income. †

411 See Passos, *Tax Treaty Law* at 229

CHAPTER 17**CONCLUDING REMARKS ON TAXATION BY SOURCE AND/OR
RESIDENCE IN LESOTHO****17.1. THE LESOTHO SOURCE RULES:****17.1.1 INTRODUCTION**

The enacted Lesotho source rules under the Income Tax Order have departed from the determination of source purely on general principles.⁴¹² The Lesotho source rules have incorporated the general principles of source as well as the deemed-source rules found in the South African tax legislation. As discussed earlier,⁴¹³ the deemed source provisions are by definition a legal fiction. These are instances which would ordinarily not qualify as source of income under general principles. Thus, apart from the attendant problems associated with the different meanings attached to the concept of "source", the type of income and the degree of causation as well as principles of equity are considerations to be incorporated in appraising any source rules.

Having concluded that the Lesotho-source rules under Section 103 are exhaustive,⁴¹⁴ another question which arises is

412 See Section 103(1) of the Lesotho Income Tax Order, 1993

413 See para 6.3 page 97ff *supra*

414 See para 6.4 page 137ff *supra*, discussing section 103(2)

whether these rules for the determination of source of every type of income are acceptable. It is submitted that the Lesotho-source rules, by means of the expansion of the general principles through the enacted deemed source provision have to a greater extent been successful in encompassing all kinds of income. The Margo Commission while recommending the retention of taxation on the source basis in South Africa, advised that where obvious lacunae in the system become apparent, the deemed source provisions be expanded to remedy the situation.⁴¹⁵ Lesotho taxation law did not only change to a full world basis of taxation but also expanded the source rules. Lesotho DTAs followed the OECD Model without analysis of the objectives designed to be achieved by that model.

17.1.2 CRITICISM OF THE CONCEPT OF SOURCE

The difficulty of defining how significant or substantial the connection with a jurisdiction has to be is one of the major problems encountered in the taxation on the basis of source. The expansion of the source rules through deemed source provisions to remedy the above-mentioned problem, faces criticism in that principles of equity in these circumstances are ignored, while pursuing policy considerations such as broadening the tax base. These comments are equally applicable to Lesotho-source rules.

Another criticism levelled at taxation on the basis of source.

415 See para 26.21 of the Margo Commission Report, op.cit 399

is that, when extended to non-residents particularly, the result becomes technical and artificial. There is often a potential of attaching tax liability on someone with a mere passing connection with the source jurisdiction. Focusing on gross income under source jurisdiction may also mean taxation without relief for underlying costs in generating that income. Cases of multiplicity of sources provide a conundrum particularly in the taxation of multinational enterprises.

17.1.3 WHEN IS TAXATION BY SOURCE JUSTIFIABLE?

Taxation by source within a wholly domestic context is justifiable. When it comes to taxation of business income, taxation on the basis of source seems also fair, provided it takes into account underlying costs or expenditure incurred in the production of income. Questions of profits attributable to the permanent establishment or the fixed base, have led the OECD Model Convention to judiciously combine taxation on the basis of source and on the basis of residence. This is a formula designed to share the tax jurisdiction. Criticism levelled at the OECD Model for its predilection on taxation on the basis of residence shows how impossible it is to formulate an acceptable solution from all quarters.

Taxation of non-business profits on the basis of source is controversial. This covers international taxation of interest, royalties and dividends, which are "pure income" which do not form part of business profits. The problems which arise particularly on international financial transactions in this

context shows how inequitable taxation by source, eg of interest of income can be, where no relief is given for underlying costs. Thus the extent to which withholding taxes (closest to taxation by source as can be) should apply eg to interest paid on international debt issues, remains a thorny issue.

17.1.4 CONCLUSION

The Lesotho enacted source rules have succeeded in enacting the general principles of determination of source of income while at the same time expanded these rules through enacting deeming-source provisions where it was felt a lacunae existed. It would seem that policy considerations such as the broadening of the tax base were paramount in designing comprehensive source rules designed to protect the tax base particularly over non-residents. The 1981 repealed Income Tax Act which determined source according to the general principles as developed by Court decisions in South Africa and the United Kingdom were found inadequate due to their reliance on formal acts. However, it would seem that while Lesotho protected her source base as a capital importing country, canons of taxation such as equity were sacrificed.

17.2 LESOTHO RESIDENCE RULES:

17.2.1 INTRODUCTION

Taxation by residence is relatively uncontroversial. However, problems arise when dealing with temporary residents and

artificial entities such as corporations, trusts and partnerships. These do not conform to ordinary conception of residence as it applies to natural persons, hence the criticism of being artificial and technical. Problems of dual residence as well as rules on ordinary residence remain something of an enigma. These problems, however, do not detract from the submission that taxation by residence is relatively easy to justify particularly on non-business profits.

As observed in dealing with the Lesotho source rules, it would seem also important to point out in this context that due to policy considerations, Lesotho asserts her tax jurisdiction on a world-wide basis. At the same time, due to further issues of a policy nature as well as those of technical and administrative nature, Lesotho residents working in the South African mines are exempted from taxation in Lesotho. This exemption is confined to employment income. Furthermore, due to reliance on overseas technical assistance staff, Lesotho has yet another category of residents termed "expatriate taxpayers" who are taxed at the concessionary standard rate presently set at 25%.

17.2.2 CRITICISM OF TAXATION BY RESIDENCE

The major criticism levelled at systems of taxation on the basis of residence is that the rules for determining residence produce artificial results. It would also seem that the concept of residence depending on policy considerations being pursued, would yield different results on similar facts. This accounts

for the different conception of "residence" as applied under the South African and United Kingdom tax systems. Thus the concept of residence without clearly articulated rules would result in running foul to one of the canons of taxation, viz. certainty. The concept of "ordinary residence" has been characterised as not being ordinary at all particularly when extended to artificial entities. Despite the court decisions on the concept of residence, uncertainty and technicality abound in its application. Furthermore, while it is one thing to assert world-wide jurisdiction, it is another to effectively carry this out. These are issues Lesotho needs to reflect on.

17.2.3 WHEN IS TAXATION BY RESIDENCE JUSTIFIED?

Taxation on the basis of residence is easier to justify, a resident for his privileges and protection ought to contribute to the cost of the government. How effectively the government discharges these responsibilities including economical spending of the collected taxes is another matter. The major challenge in this context therefore would seem to be clear articulation of the rules of residence as contemplated by the Legislature. The Lesotho Income Tax Act has clearly been wary of this through the provisions on residence rules for individuals, companies, partnerships and superannuation funds.

17.2.4 CONCLUSION

The Lesotho residence rules are generally, reasonably free from

problems except for minor difficulties which inevitably arise in the determination of the residence status of a taxpayer. It would seem that the detailed provisions under the Order have, together with the Explanatory Memorandum thereto, pre-empted most of the problems in this context.

17.3 REMARKS ON TAXATION ON THE BASIS OF SOURCE AND/OR RESIDENCE IN LESOTHO

The Lesotho Income Tax Order is a dual system of taxation by residence and source. The new tax law has attempted solomonic wisdom of judiciously attempting to comprehensively cover both taxation of residence and source. The general principles of source and their tendency to focus on formal acts have been expanded through enactment of deeming-source provision. The attendant problems associated with the determination of residence of a taxpayer have been resolved through a rather detailed provision of residence rules for the various categories of taxpayers. Thus it would seem that the Lesotho Income Tax Order has succeeded in remedying common problems associated with either taxation on the basis of residence or source.

Tax systems like everything in nature are, however, never perfect. There is always room for improvement, lest complacency sets in.

17.4 RECOMMENDATIONS

Apart from national policy considerations, any tax system should always be evaluated on the basis of the canons of taxation set out in 1776 by Adam Smith viz equity, certainty, convenience and effectiveness.⁴¹⁶ This task faces the Lesotho tax system. Some problems such as issues of identifying sources of income are inevitable and cannot be avoided where taxation by source applies. The same applies with the concept of residence.

The Lesotho tax treaties, however, suffer from adopting the OECD Model Convention provisions willy-nilly, without highlighting crucial circumstances already examined by other Model Conventions. The procedural requirements including the parameters in negotiating DTAs may also be revisited drawing from the 1981 Act. The concepts of residence, source and permanent establishment ought to have been examined more by Lesotho from a perspective of a developing capital importing country when renegotiating DTAs with South Africa and the United Kingdom. The fact that South Africa is a source based tax system and that the United Kingdom is a residence based tax system seem to have had no impact on the terms of DTAs with these countries. The standard OECD Model Convention was adopted invariably. This does not augur well in the light of progressive ideas from other model conventions.

416 See Margo Commission Report pages 50-52; see also *The Taxpayer* 1994 Vol 43 No 3 at p 41, editorial comment on the South African tax system

The Lesotho/RSA renegotiated DTA has not utilised the existing treaties in the subregion. Reference here is to the Customs Union Agreement which though being renegotiated, has no doubt laid the foundation for economic integration in the region. The bulk of imports and exports to and from Lesotho which are transported by land from South African ports ought to have been clearly built into the DTA. Lesotho could strengthen an argument for apportionment of taxation of income derived through "containerised" cross-border road transport with progress made in the Memorandum of Understanding on Road Transportation 1990, between Customs Union members. Otherwise, South Africa as the place of effective management (residence) of these transport enterprises is entitled to the tax on profits made. The taxation of business income in the insurance industry needs to be revisited particularly vis-a-vis- the DTA renegotiated with South Africa. A deeming provision could be introduced so that the requirement of permanent establishment is satisfied.

The new Lesotho Income Tax Order is a progressive piece of legislation whose effectiveness will be tested by the extent of implementation. The manpower development of the staff of the office of the Commissioner of Income Tax will therefore remain a challenge. Otherwise the Lesotho Income Tax Order will remain a "paper tiger" law gathering dust on some shelves!

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Agreement between the Government of the Kingdom of Lesotho and the Government of the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal evasion with respect to taxes on income and capital gains (renegotiated unsigned) Annex I.

**CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED KINGDOM OF
GREAT BRITAIN AND NORTHERN IRELAND AND THE GOVERNMENT OF THE
KINGDOM OF LESOTHO FOR THE AVOIDANCE OF DOUBLE TAXATION AND
THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON
INCOME AND CAPITAL GAINS**

Initialled on behalf of the
Government of the United
Kingdom of Great Britain
and Northern Ireland:

Initialled on behalf of the
Government of the
Kingdom of Lesotho:

The Government of the United Kingdom of Great Britain and Northern Ireland and
the Government of the Kingdom of Lesotho;

Desiring to conclude a Convention for the avoidance of double taxation and the
prevention of fiscal evasion with respect to taxes on income and capital gains;

Have agreed as follows:

ARTICLE 1

Personal scope

This Convention shall apply to persons who are residents of one or both of the Contracting States.

ARTICLE 2

Taxes covered

(1) The taxes which are the subject of this Convention are:

(a) in the case of the United Kingdom:

- (i) the income tax;
- (ii) the corporation tax; and
- (iii) the capital gains tax.

(hereinafter referred to as "United Kingdom tax");

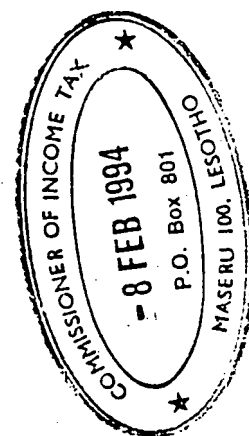
(b) in the case of Lesotho:

the income tax

(hereinafter referred to as "Lesotho tax").

(2) Notwithstanding the provisions of paragraph (1) of this Article, the terms "United Kingdom tax" and "Lesotho tax" do not include any amount which represents a penalty or interest imposed under the law of either Contracting State relating to the taxes to which this Convention applies.

(3) This Convention shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of this Convention in addition to, or in place of, the taxes of that Contracting State referred to in paragraph (1) of this Article. The competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective taxation laws.



ARTICLE 3

General definitions

- (1) For the purposes of this Convention, unless the context otherwise requires:
- (a) the term "United Kingdom" means Great Britain and Northern Ireland, including any area outside the territorial sea of the United Kingdom which in accordance with international law has been or may hereafter be designated, under the laws of the United Kingdom concerning the Continental Shelf, as an area within which the rights of the United Kingdom with respect to the sea bed and sub-soil and their natural resources may be exercised;
 - (b) the term "Lesotho" means the sovereign kingdom of Lesotho comprising all the areas that immediately before 4 October 1966 were comprised in the former colony of Basutoland together with such other areas that may, in accordance with international law, be declared by an Act of the Lesotho Parliament to form part of Lesotho;
 - (c) the term "national" means:
 - (i) in relation to the United Kingdom, any British citizen, or any British subject not possessing the citizenship of any other Commonwealth country or territory, provided he has the right of abode in the United Kingdom; and any legal person, partnership, association or other entity deriving its status as such from the law in force in the United Kingdom;
 - (ii) in relation to Lesotho, any citizen of Lesotho, or any individual treated as a permanent resident under the law of Lesotho; and any legal person, partnership, association or other entity deriving its status as such from the law in force in Lesotho;

- (d) the terms "a Contracting State" and "the other Contracting State" mean the United Kingdom or Lesotho, as the context requires;
 - (e) the term "person" comprises an individual, a company and any other body of persons, but does not include a partnership;
 - (f) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;
 - (g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
 - (h) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
 - (i) the term "competent authority" means, in the case of the United Kingdom, the Commissioners of Inland Revenue or their authorised representative, and, in the case of Lesotho, the Commissioner of Income Tax or the authorised representative of the Commissioner for Income Tax.
- (2) As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

ARTICLE 4

Residence

(1) For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.

(2) Where by reason of the provisions of paragraph (1) of this Article an individual is a resident of both Contracting States, then his status shall be determined in accordance with the following rules:

- (a) he shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests);
- (b) if the Contracting State in which he has his centre of vital interests cannot be determined, or if he has no permanent home available to him in either Contracting State, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;
- (c) if he has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national;
- (d) if he is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

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

ARTICLE 5

Permanent establishment

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

(2) The term "permanent establishment" includes especially:

- (a) a place of management;
- (b) a branch;
- (c) an office;
- (d) a factory;
- (e) a workshop;
- (f) an installation or structure for the exploration of natural resources;
- (g) 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 six 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 sub-paragraphs (a) to (e) of this paragraph, 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) of this Article, where a person - other than an agent of an independent status to whom paragraph (6) of this Article applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts on behalf 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 a person are limited to those mentioned in paragraph (4) of this Article 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.

ARTICLE 6

Income from immovable property

(1) Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

(2) The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.

(3) The provisions of paragraph (1) of this Article shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

(4) The provisions of paragraphs (1) and (3) of this Article shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

ARTICLE 7

Business profits

(1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3) of this Article, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses incurred for the purposes of the enterprise as a whole, whether in the Contracting State in which the permanent establishment is situated or elsewhere.

(4) No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

(5) Where profits include items of income or capital gains which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

ARTICLE 8

Shipping and air transport

(1) Profits derived by a resident of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

(2) For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include:

- (a) income from the rental on a bareboat basis of ships or aircraft; and
- (b) profits from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise;

where such rental or such use, maintenance or rental, as the case may be, is incidental to the operation of ships or aircraft in international traffic.

(3) Where profits within paragraphs (1) or (2) of this Article are derived by a resident of a Contracting State from participation in a pool, a joint business or an international operating agency, the profits attributable to that resident shall be taxable only in the Contracting State of which he is a resident.

ARTICLE 9

Associated enterprises

- (1) Where:
- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or
 - (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State;

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, may be included by a Contracting State in the profits of that enterprise and taxed accordingly.

(2) Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

ARTICLE 10

Dividends

(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 subject to tax in respect of the dividends in that other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the dividends.

(3) The term "dividends" as used in this Article means income from shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation laws of the State of which the company making the distribution is a resident and also includes any other item (other than interest relieved from tax under the provisions of Article 11 of this Convention) which, under the laws of the Contracting State of which the company paying the dividend is a resident, is treated as a dividend or distribution of a company.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the recipient 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 fixed base. In such case the provisions of Article 7 or Article 15 of this Convention, 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 the company's undistributed profits to a tax on undistributed profits,

even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that other State.

ARTICLE 11

Interest

(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 subject to tax in respect of the interest in the other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

(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. The term "interest" shall not include any item which is treated as a distribution under the provisions of Article 10 of this Convention.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the recipient 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 15 of this Convention, 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 paid exceeds, for whatever reason, 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 of interest. 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.

(7) Any provision in the laws of either Contracting State relating only to interest paid to a non-resident company shall not operate so as to require such interest paid to a company which is a resident of the other Contracting State to be treated as a distribution or dividend by the company paying such interest. The preceding sentence shall not apply to interest paid to a company which is a resident of one of the Contracting States in which more than 50 per cent of the voting power is controlled, directly or indirectly, by a person or persons who are residents of the other Contracting State.

(8) The relief from tax provided for in paragraph (2) of this Article shall not apply if the beneficial owner of the interest:

- (a) is exempt from tax on such income in the Contracting State of which he is a resident; and
- (b) sells or makes a contract to sell the holding from which such interest is derived within three months of the date such beneficial owner acquired such holding.

(9) The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment.

(10) Notwithstanding the provisions of paragraph (2) of this Article, interest arising in a Contracting State shall be exempt from tax in that State if it is paid to the Government of the other Contracting State or a local authority thereof or any agency or instrumentality of that Government or local authority.

(11) . Notwithstanding the provisions of Article 7 of this Convention and of paragraph (2) of this Article, interest arising in Lesotho which is paid to a resident of the United Kingdom shall be exempt from tax in Lesotho if it is paid in respect of a loan made, guaranteed or insured, or any other debt-claim or credit guaranteed or insured by the United Kingdom Export Credits Guarantee Department.

ARTICLE 12

Royalties

(1) Royalties 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 royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is subject to tax in respect of the royalties in that other Contracting State the tax so charged shall not exceed 10 per cent of the gross amount of the royalties.

(3) The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films, and films or tapes for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information (know how) concerning industrial, commercial or scientific experience.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the recipient 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 15 of this Convention, as the case may be, shall apply.

(5) Royalties shall be deemed to arise in a Contracting State where the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base in connection with which the obligation to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

(6) Where, by reason of a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid exceeds, for whatever reason, the amount which would have been agreed upon by the payer and the recipient 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.

(7) The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the royalties are paid to take advantage of this Article by means of that creation or assignment.

ARTICLE 13

Management and technical fees

(1) Technical fees 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 technical fees may also be taxed in the Contracting State in which they arise and according to the law of that State, but if the recipient is subject to tax in respect of the technical fees in that other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the technical fees.

(3) The term "technical fees" as used in this Article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the recipient of the technical fees, being a resident of a Contracting State, carries on business in the other Contracting State in which the technical fees arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the technical fees are effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 15 of this Convention, as the case may be, shall apply.

(5) If a resident of a Contracting State, who receives technical fees which arise in the other Contracting State and who is subject to tax in respect thereof in the first-mentioned Contracting State, so elects for any year of assessment, financial year or year of income, the tax chargeable in respect of those technical fees in the Contracting State in which they arise shall be calculated as if he had a permanent establishment or a fixed base in the last-mentioned Contracting State and as if those technical fees were taxable in accordance with Article 7 or Article 15 of this Convention, as the case may be, as profits attributable to that permanent establishment or fixed base.

(6) Technical fees shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority or a resident of that State. Where, however, the person paying the technical fees, 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 obligation to pay the technical fees was incurred, and such technical fees are borne by that permanent establishment or fixed base, then such technical fees shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

(7) Where, by reason of a special relationship between the payer and the recipient or between both of them and some other person, the amount of the technical fees paid exceeds, for whatever reason, the amount which would have been agreed upon by the payer and the recipient 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.

(8) The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the technical fees are paid to take advantage of this Article by means of that creation or assignment.

ARTICLE 14

Capital Gains

Each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

ARTICLE 15

Independent personal services

(1) Subject to the provisions of Article 13 of this Convention, income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other State but only so much of it as is attributable to that fixed base.

(2) The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

ARTICLE 16

Dependent personal services

(1) Subject to the provisions of Articles 17, 19, 20 and 21 of this Convention, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

(2) Notwithstanding the provisions of paragraph (1) of this Article, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

- (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days within any period of twelve months; and
- (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
- (c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

(3) Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic may be taxed in the Contracting State of which the enterprise operating the ship or aircraft is a resident.

ARTICLE 17

Directors' fees

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

ARTICLE 18

Artistes and athletes

(1) Notwithstanding the provisions of Article 15 and Article 16 of this Convention, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

(2) Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 15 and 16 of this Convention, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.

[(3) Notwithstanding the provisions of paragraphs (1) and (2) of this Article, income derived from activities as defined in paragraph (1) performed under a cultural agreement or arrangement between the Contracting States shall be exempt from tax in the Contracting State in which those activities are exercised.]



ARTICLE 19

Pensions and annuities

(1) Subject to the provisions of paragraph (2) of Article 20 of this Convention, pensions and other similar remuneration paid in consideration of past employment to a resident of a Contracting State and any annuity paid to such a resident shall be taxable only in that State.

(2) The term "annuity" means a stated sum payable periodically at stated times during life or during a specified or ascertainable period of time under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

ARTICLE 20

Government service

- (1) (a) Remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
 - (b) Notwithstanding the provisions of sub-paragraph (a) of this paragraph, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:
 - (i) is a national of that State; or
 - (ii) did not become a resident of that State solely for the purpose of rendering the services.
 - (2) (a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
 - (b) Notwithstanding the provisions of sub-paragraph (a) of this paragraph, such pension shall be taxable only in the other Contracting State if the individual is a resident of and a national of that State.
- (3) The provisions of Articles 16, 17 and 19 of this Convention shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

ARTICLE 21

Students

Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that first-mentioned State, provided that such payments arise from sources outside that State.

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ARTICLE 22

Other income

(1) Items of income of a resident of a Contracting State, wherever arising, which are not dealt with in the foregoing Articles of this Convention, other than income paid out of trusts or the estates of deceased persons in the course of administration, shall be taxable only in that State.

(2) The provisions of paragraph (1) of this Article shall not apply to income, other than income from immovable property as defined in paragraph (2) of Article 6 of this Convention, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right of property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 15 of this Convention, as the case may be, shall apply.

ARTICLE 23

Elimination of double taxation

(1) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof):

- (a) Lesotho tax payable under the laws of Lesotho and in accordance with this Convention, whether directly or by deduction, on profits or income from sources within Lesotho (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the Lesotho tax is computed;
- (b) in the case of a dividend paid by a company which is a resident of Lesotho to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividend, the credit shall take into account (in addition to any Lesotho tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the Lesotho tax payable by the company in respect of the profits out of which such dividend is paid.

(2) In the case of Lesotho, subject to the provisions of the law of Lesotho from time to time in force which relate to the allowance of credit against Lesotho tax of tax paid in a country outside Lesotho (which shall not affect the general principle of this Article), United Kingdom tax paid under the law of the United Kingdom and in accordance with this Convention whether directly or by deduction, in respect of income derived by a person who is a resident of Lesotho from sources in the United Kingdom shall be allowed as a credit against Lesotho tax payable in respect of that income.

(3) For the purposes of paragraphs (1) and (2) of this Article, profits and income owned by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources in that other Contracting State.

(4) For the purpose of paragraph (1) of this Article, the term "Lesotho tax payable" shall be deemed to include any amount which would have been payable as Lesotho tax for any year but for an exemption or reduction of tax granted for that year on any part thereof under any of the following provisions of Lesotho law:

- (a) Paragraph 1 of the Third Schedule to the Income Tax Order 1993 so far as this was in force on, and has not been modified since, the date of signature of this Convention, or has been modified only in minor respects so as not to affect its general character; or
- (b) any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.

Provided that relief from United Kingdom tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than ten years after the exemption from, or reduction of, Lesotho tax was first granted in respect of that source.

ARTICLE 24

Limitation of relief

Where under any provision of this Convention any income is relieved from tax in a Contracting State and, under the law in force in the other Contracting State a person, in respect of that income, is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income as is taxed in the other Contracting State.

(1) Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

(2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. []

(3) Except where the provisions of paragraph (1) of Article 9, paragraph (6) of Article 11, paragraph (6) of Article 12, or paragraph (7) of Article 13 of this Convention apply, and subject to the provisions of paragraph (7) of Article 11, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

(4) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

(5) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances, reliefs and reductions for tax purposes which are granted to individuals so resident.

(6) The provisions of this Article shall apply to the taxes which are the subject of this Convention.

ARTICLE 26

Mutual agreement procedure

(1) Where a resident of a Contracting State considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident.

(2) The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention.

(3) The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

(4) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

ARTICLE 27

Exchange of information

(1) The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention, in particular, to prevent fraud and to facilitate the administration of statutory provisions against legal avoidance. Any information received by a Contracting State shall be treated as secret and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

(2) In no case shall the provisions of paragraph (1) of this Article be construed so as to impose on the competent authority of either Contracting State the obligation:

- (a) to carry out administrative measures at variance with the laws and administrative practice prevailing in either Contracting State;
- (b) to supply information which is not obtainable under the laws or in the normal course of the administration of either Contracting State;
- (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

ARTICLE 28

Members of diplomatic or permanent missions and consular posts

(1) Nothing in this Convention shall affect any fiscal privileges accorded to members of diplomatic or permanent missions or consular posts under the general rules of international law or under the provisions of special agreements.

(2) Notwithstanding the provisions of paragraph (1) of Article 4 of this Convention, an individual who is a member of a diplomatic or permanent mission or consular post of a Contracting State or of any third State which is situated in the other Contracting State or who is an official of an international organisation, and any member of the family of such an individual, shall not be deemed to be a resident of the other State if he is subject to tax on income or capital gains in that other State only if he derives income or capital gains from sources therein.

ARTICLE 29

Entry into force

(1) Each of the Contracting States shall notify to the other the completion of the procedures required by its law for the bringing into force of this Convention. This Convention shall enter into force on the date of the later of these notifications and shall thereupon have effect:

(a) in the United Kingdom:

- (i) in respect of income tax and capital gains tax, for any year of assessment beginning on or after 6 April in the calendar year next following that in which the Convention enters into force;
- (ii) in respect of corporation tax, for any financial year beginning on or after 1 April in the calendar year next following that in which the Convention enters into force.

(b) in Lesotho:

for any year of assessment beginning on or after 1 April in the calendar year next following that in which the Convention enters into force.

(2) Subject to the provisions of paragraph (3) of this Article, the Arrangement of 25 November 1949 (as amended on 3 July 1968) between Her Majesty's Government and the Government of Lesotho (hereinafter referred to as "the Arrangement") shall terminate and cease to be effective from the date on which this Convention has effect in respect of the taxes to which this Convention applies in accordance with the provisions of paragraph (1) of this Article.

(3) Where any provision of the Arrangement would have afforded any greater relief from tax than is due under this Convention, any such provision as aforesaid shall continue to have effect:

(a) in the United Kingdom, for any year of assessment, or financial year, or chargeable period, and

(b) in Lesotho, for any year of assessment

beginning, in either case, before the entry into force of this Convention.

ARTICLE 30

Termination

This Convention shall remain in force until terminated by one of the Contracting States. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year [beginning after the expiry of five years from the date of entry into force of the Convention.] [after the year < >] In such event, the Convention shall cease to have effect:

(a) in the United Kingdom:

- (i) in respect of income tax and capital gains tax, for any year of assessment beginning on or after 6 April in the calendar year next following that in which the notice is given;
- (ii) in respect of corporation tax, for any financial year beginning on or after 1 April in the calendar year next following that in which the notice is given;

[(b) in Lesotho:

for any year of assessment beginning on or after 1 April in the calendar year next following that in which the notice is given.]

In witness whereof the undersigned, duly authorised thereto by their respective Governments, have signed this Convention.

Done in duplicate at this
..... day of 19..[.].

For the Government of
the United Kingdom of
Great Britain and
Northern Ireland:

For the Government of the
Kingdom of Lesotho:

ANNEX II

AGREEMENT

BETWEEN THE GOVERNMENT OF THE KINGDOM OF LESOTHO AND

THE GOVERNMENT OF THE REPUBLIC OF SOUTH AFRICA

FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE

PREVENTION OF FISCAL EVASION WITH RESPECT TO

TAXES ON INCOME

Preamble

The Government of the Kingdom of Lesotho and the Government of the Republic of South Africa desiring to promote and strengthen the economic relations between the two countries,

Have agreed as follows:

Article 1.

Personal Scope.

This Agreement shall apply to persons who are residents of one or both of the Contracting States.

Article 2

Taxes Covered

1. This Agreement shall apply to taxes on income imposed on behalf of a Contracting State or its political subdivisions, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income all taxes imposed on total income or on elements of income.
3. The existing taxes to which the Agreement shall apply are in particular:
 - (a) in Lesotho, the taxes imposed under the Income Tax Order, 1993 (Order No 9 of 1993), as at the date of signature of this Agreement;

(hereinafter referred to as "Lesotho tax"); and

(b) in South Africa:

- (i) the normal tax;
- (ii) the non-resident shareholders' tax; and
- (iii) the secondary tax on companies;

(hereinafter referred to as "South African tax").

4. This Agreement shall also apply to any other taxes of a substantially similar character which are imposed after the date of signature of the Agreement in addition to, or in place of, the existing taxes.
5. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws, and if it seems desirable to amend any Article of this Agreement without affecting the general principles thereof, the necessary amendments may be made by mutual consent by means of an Exchange of Notes.

Article 3

General Definitions

1. In this Agreement, unless the context otherwise requires:

- (a) the term "Lesotho" means the sovereign kingdom of Lesotho comprising all the areas that immediately before 4 October 1966 were comprised in the former colony of Basutoland together with such other areas that may, in accordance with international law, be declared by an Act of the Lesotho Parliament to form part of Lesotho; and
- (b) the term "South Africa" means the Republic of South Africa and, when used in a geographical sense, includes the territorial sea thereof as well as any area outside the territorial sea, including the continental shelf, which has been or may hereafter be designated, under the laws of South Africa and in accordance with international law, as an area within which South Africa may exercise sovereign rights or jurisdiction;

- (c) the terms "a Contracting State" and "the other Contracting State" mean Lesotho or South Africa as the context requires;
- (d) the term "company" means any body corporate or any entity which is treated as a company or body corporate for tax purposes;
- (e) the term "competent authority" means:
 - (i) in Lesotho, the Commissioner of Income Tax or his authorised representative; and
 - (ii) in South Africa, the Commissioner for Inland Revenue or his authorised representative;
- (f) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(g) the term "international traffic" means any transport by ship, aircraft or road transport vehicle operated by an enterprise which has its place of effective management in a Contracting State, except when the ship, aircraft or road transport vehicle is operated solely between places in the other Contracting State;

(h) the term "nationals" means all individuals having the citizenship of a Contracting State and all legal persons, partnerships, associations and other entities deriving their status as such from the laws in force in a Contracting State; and

(i) the term "person" includes an individual, a company and any other body of persons which is treated as an entity for tax purposes.

2. In the application of the provisions of this Agreement by a Contracting State, any term not otherwise defined herein shall, unless the context otherwise requires, have the meaning which it has under the laws of that State concerning the taxes which are the subject of this Agreement.

Article 4

Resident

1. For the purposes of this Agreement:

- (a) the term "resident of Lesotho" means any person who, under the laws of Lesotho, is liable to tax therein by reason of his residence, place of management or any other criterion of a similar nature; and
- (b) the term "resident of South Africa" means any individual who is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa.

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

- (a) he shall be deemed to be a resident of the State in which he has a permanent home available to him. If he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

- (b) if the State in which he has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
 - (c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
 - (d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

Article 5

Permanent Establishment

1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on.
2. The term "permanent establishment" includes especially:
 - (a) a place of management;
 - (b) a branch;
 - (c) an office;
 - (d) a factory;
 - (e) a workshop;
 - (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and
 - (g) a building site, or a construction, installation or assembly project which exists for a period of more than six months.

3. 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 for collecting information, for the enterprise;
- (e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise; and

(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.

4. An enterprise of a Contracting State, notwithstanding that it has no fixed place of business in the other Contracting State, shall be deemed to have a permanent establishment in that other State if it carries on supervisory activities therein in connection with a construction, installation or assembly project which is being undertaken in that other State for a period of more than six months.

5. A person acting in a Contracting State on behalf of an enterprise of the other Contracting State (other than an agent of an independent status to whom paragraph 6 applies) notwithstanding that he has no fixed place of business in the first-mentioned State shall be deemed to be a permanent establishment in that State if -

(a) he has, and habitually exercises, a general authority in the first-mentioned State to conclude contracts in the name of the enterprise; or

(b) he maintains in the first-mentioned State a stock of goods or merchandise belonging to the enterprise from which he regularly fills orders on behalf of the enterprise; or

(c) he regularly secures orders in the first-mentioned State wholly or almost wholly for the enterprise.

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 as a permanent establishment of the other.

Article 6

Income from Immovable Property

1. Income derived by a resident of a Contracting State from immovable property, including income from agriculture or forestry, is taxable in the Contracting State in which such property is situated.
2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats and aircraft shall not be regarded as immovable property.
3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 7.

Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the Contracting State in which the permanent establishment is situated or elsewhere.
4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary. The method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
7. Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 8

Shipping, Air and Road Transport

1. Profits from the operation or rental of ships, aircraft or road transport vehicles in international traffic and the rental of containers and related equipment which is incidental to the operation of ships, aircraft or road transport vehicles in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. If the place of effective management of a shipping enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
3. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9.

Associated Enterprises.

1. Where:

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Agreement and the competent authorities of the Contracting States shall if necessary consult each other.

Article 10

Dividends

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 to the beneficial owner shall not exceed 15 per cent of the gross amount of the dividends.

The competent authorities of the Contracting States shall settle the mode of application of this limitation by mutual agreement.

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 or other rights participating in profits (not being debt claims), 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 Contracting 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 fixed base. In such a 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, no tax may be imposed on the beneficial owner in that other State on the dividends paid by the company except in so far as such dividends are paid to a resident of that other State or in so far 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 the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11.

Interest

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 settle the mode of application of this limitation by mutual agreement.
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 purposes 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 a 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 a 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 Agreement.

Article 12

Royalties

1. Royalties 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 royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed 10 per cent of the gross amount of the royalties.
3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films and films, tapes or discs for radio or television broadcasting), any patent, trade mark, design or model, computer programme, plan, secret formula or process, or for the use of, or the right to use, information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 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 a case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. 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 paid, 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 a 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 Agreement.

6. Royalties 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 royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base with which the right or property in respect of which the royalties are paid is effectively connected, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Article 13

Technical Fees

1. Technical fees 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 technical fees may also be taxed in the Contracting State in which they arise and according to the law of that State, but if the beneficial owner is subject to tax in respect of the technical fees in the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the technical fees.
3. The term "technical fees" as used in this Article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any services of a technical, managerial or consultancy nature.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the technical fees, being a resident of a Contracting State, carries on business in the other Contracting State in which the technical fees arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the technical fees are 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. If a resident of a Contracting State, who receives technical fees which arise in the other Contracting State and who is subject to tax in respect thereof in the first-mentioned State, so elects for any year of assessment, the tax chargeable in respect of those technical fees in the State in which they arise shall be calculated as if he had a permanent establishment or a fixed base in the last-mentioned State and as if those technical fees were taxable in accordance with Article 7 or Article 14, as the case may be, as profits attributable to that permanent establishment or fixed base.

6. Technical fees shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority or a resident of that State. Where, however, the person paying the technical fees, 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 obligation to pay the technical fees was incurred, and such technical fees are borne by that permanent establishment or fixed base, then such technical fees shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

7. 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 technical fees paid exceeds, for whatever reason, 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 Agreement.

Article 14

Independent Personal Services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character may be taxed in the other Contracting State only to the extent that the services were rendered in that other State, unless he has a fixed base regularly available to him in that other State for the purpose of performing his activities. If he has such a fixed base, the income which is attributable to that fixed base may be taxed in that other State.
2. The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants or other professional persons.

Article 15

Dependent Personal Services

1. Subject to the provisions of Articles 16, 18, and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.
2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
 - (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 182 days in any period of twelve months; and
 - (b) the remuneration is paid by or on behalf of an employer who is not a resident of the other State; and
 - (c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment exercised aboard a ship, aircraft or road transport vehicle operated in international traffic may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16,

Directors' Fees.

Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17.

Entertainers and Sportsmen

1. Notwithstanding the provisions of Articles 14 and 15, income derived by entertainers such as theatre, motion picture, radio or television artistes, and musicians, or by sportsmen, from their personal activities as such, may be taxed in the Contracting State in which these activities are exercised.
2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised.

Article 18.

Pensions and Annuities.

1. Any pension (other than a pension of the kind referred to in paragraph 2 of Article 19) and any annuity, derived from sources within a Contracting State by an individual who is a resident of the other Contracting State and is subject to tax on the whole or portion thereof in the other State, shall be exempt from tax in the first-mentioned State to the extent that it is subject to tax in the other State.
2. The term "annuity" as used in this Article means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

Article .19.

Government Service

1. Remuneration (other than pensions) paid by, or out of funds created by, one of the Contracting States, a political subdivision or a local authority thereof to any individual for services rendered to that State, subdivision or authority in the discharge of governmental functions shall be exempt from tax in the other Contracting State if the individual is not ordinarily resident in that other State or is ordinarily resident in that other State solely for the purpose of rendering those services.
2. Any pension paid by, or out of funds created by, a Contracting State, a political subdivision or a local authority thereof to any individual for services rendered to that State, subdivision or authority in the discharge of governmental functions shall be exempt from tax in the other Contracting State in so far as the remuneration for those services was exempt from tax in that other State under paragraph 1 of this Article or would have been so exempt if this Agreement had been in force when the remuneration was paid.

3. The provisions of this Article shall not apply to payments in respect of services rendered in connection with any trade or business carried on by either of the Contracting States, a political subdivision or a local authority thereof.

Article 20

Students and Business Apprentices

A student or business apprentice who is present in a Contracting State solely for the purpose of his education or training and who is, or immediately before being so present was, a resident of the other Contracting State, shall be exempt from tax in the first-mentioned State on payments received from outside that first-mentioned State for the purposes of his maintenance, education or training.

Article 21

Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Agreement in respect of which he is subject to tax in that State, shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and a right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

Article 22

Elimination of Double Taxation

Double taxation shall be eliminated as follows:

1. In Lesotho, subject to the provisions of the law of Lesotho, from time to time in force, which relates to the allowance of credit against Lesotho tax of tax paid in a country outside Lesotho (which shall not affect the general principle of this Article), South African tax paid under the law of South Africa and in accordance with this Agreement, whether directly or by deduction, in respect of income derived by a person who is a resident of Lesotho from sources in South Africa shall be allowed as a credit against Lesotho tax payable in respect of that income.
2. In South Africa, taxes paid by South African residents in respect of income taxable in Lesotho, in accordance with the provisions of this Agreement, shall be deducted from the taxes due according to the South African fiscal law. Such deduction shall not, however, exceed that part of the income tax, as computed before the deduction is given, which is attributable to the income which may be taxed in Lesotho.

3. As regards the application of the provisions of paragraph 2, it is understood that the amount of tax which is attributable to such income which has been subjected to tax in Lesotho shall be:

- (a) where the tax on such income is computed by applying a proportional rate, the amount of the net income concerned multiplied by the rate which actually applies to that income; and
- (b) where the tax on such income is computed by applying a progressive scale, an amount which bears to the net income concerned the same ratio as the total tax actually payable bears to the total net income which is subject to tax in accordance with South African fiscal law.

Article 23

Non-discrimination

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

3. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected.
4. Nothing in this Article shall be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
5. In this Article the term "taxation" means taxes which are the subject of this Agreement.
6. It is understood that the taxation in Lesotho of the branch profits of a company which is a resident of South Africa is not regarded as being discriminatory for the purposes of this Article.

Article 24

Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with this Agreement, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 23, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of this Agreement.
2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Agreement. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement. They may also consult together for the elimination of double taxation in cases not provided for in this Agreement.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement contemplated in any of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a commission consisting of representatives of the competent authorities of the Contracting States.

Article 25

Exchange of Information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic laws of the Contracting States concerning taxes covered by this Agreement in so far as the taxation thereunder is not contrary to this Agreement. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic law of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

- 2 The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.
3. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:
 - (a) to carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;
 - (b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
 - (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

Article 26,

Diplomatic Agents and Consular Officers,

Nothing in this Agreement shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

Article 27

Entry into Force

1. Each of the Contracting Parties shall notify to the other the completion of the procedures required by its law for the bringing into force of this Agreement. The Agreement shall enter into force on the date of the later of these notifications.
2. The provisions of this Agreement shall apply:
 - (a) with regard to taxes withheld at source, in respect of amounts paid or credited on or after the thirtieth day following the date upon which this Agreement enters into force; and
 - (b) with regard to other taxes, in respect of years of assessment beginning on or after the date upon which this Agreement enters into force.
3. The Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income imposed in the Union of South Africa and in Basutoland, between the Government of the Union of South Africa and the Government of Great Britain and Northern Ireland signed in Cape Town on 18 June 1959, shall be terminated with effect from the commencement of any year of assessment or period to which the provisions of this Agreement apply.

Article 28

Termination

1. This Agreement shall remain in force indefinitely but either of the Contracting States may terminate the Agreement through the diplomatic channel, by giving to the other Contracting State written notice of termination not later than 30 June of any calendar year starting five years after the year in which the Agreement entered into force.
2. In such event the Agreement shall cease to have effect:
 - (a) with regard to taxes withheld at source, in respect of amounts paid or credited after the end of the calendar year in which such notice is given; and
 - (b) with regard to other taxes, in respect of taxable years beginning after the end of the calendar year in which such notice is given.

IN WITNESS WHEREOF the undersigned, being duly authorised thereto, have signed this Agreement.

DONE at in duplicate, this day of of the year One Thousand Nine Hundred and Ninety

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FOR THE GOVERNMENT OF
THE KINGDOM OF LESOTHO

.....
FOR THE GOVERNMENT OF THE
REPUBLIC OF SOUTH AFRICA