

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

An analysis of the methods used in the South African domestic legislation and in double taxation treaties entered into by South Africa for the elimination of international double taxation

**TRACY GUTUZA**

Thesis presented for the Degree of

**DOCTOR OF PHILOSOPHY**

In the Department of Commercial Law

**UNIVERSITY OF CAPE TOWN**

May 2013

Supervisor: Professor Richard Jooste (UCT)

Co supervisor: Mr. Wally Horak.

**DECLARATION**

I declare that the thesis for the degree of Doctor of Philosophy at the University of Cape Town, hereby submitted, has not been previously submitted for a degree at this or any other university, that it is my own work in design and execution, and that all the materials contained herein have been duly acknowledged.

---

Tracy Gutuza

---

May 2013

University of Cape Town

## **ACKNOWLEDGEMENTS**

I want to acknowledge so many for the help, guidance and especially support during this process:

- my colleagues and friends at the University of Cape Town for their constant support and encouragement,
- my supervisors, Professor Richard Jooste and Mr Wally Horak, for their kind comments and guidance, and
- the National Research Fund for their financial support.

But, it is especially to my family that I wish to extend the greatest thank-you. This thesis would not have been possible were it not for the continuous support and practical baby-sitting services provided by my parents, Helen and Jeff Swartbooi. A very special thank-you goes to my most amazing husband, Brian, who gave me time when I needed it and to my children, Christopher and Sarah, who were willing to sacrifice weekend outings so ‘mummy could work on her PhD’.

Thank-you

**ABSTRACT**

The restructuring of the South African Income Tax system since democracy was used as a case study to analyse the methods used to eliminate international double taxation through the lens of the tax policy principles of equity and neutrality. The theoretical framework used to analyse these methods, when the South African tax system changed from source to residence, was that of considering the equitable basis on which a tax base is chosen; the compatibility of the method of relief with the chosen policy principles of equity and neutrality; and the comparison of inward and outward flows by both residents and non-residents.

The above approach was applied in analysing three identifiable periods, namely the period prior to democracy in South Africa, the period between the years 1994 and 2000, and post 2000. The analysis found that the policy principles of equity and neutrality were not consistently applied to the choice of methods used to relieve international double taxation. Consistent application was undermined by amendments to the Income Tax Act and by the use of anti tax-avoidance provisions to prevent loss to the South African fiscus as a result of an increase in tax planning which resulted from the broadening of the South African tax base. The findings also indicate that although the methods of relief in the Income Tax Act and in double taxation agreements entered into by South Africa reflect the credit system as the default method, the application and quantification of the relief differs.

This thesis adds to the body of literature exploring the policy principles of equity and neutrality, as applied in the context of methods relieving international double taxation and in the context of a recently opened and developing economy.

The results of the research provide a theoretical basis for future restructuring of the South African income tax system as well as the tax systems of other developing countries, particularly in Africa. They also provide a theoretical basis for considering the policy approach to the taxation of cross border income flows and for choosing the method of relief for international double taxation.

This thesis proposes that equity and neutrality should be the over-arching policy principles when considering the methods applied to eliminate double taxation.

University of Cape Town

## Table of Contents

Declaration .....	i
Acknowledgements .....	ii
Abstract .....	iii
Abbreviations, definitions and acronyms .....	xiv
List of tables .....	xv
1 Chapter One .....	1
Introduction .....	1
1.1 Background .....	1
1.1.1 Approaches to equity and neutrality .....	3
1.1.2 Methods used to relieve or eliminate international double taxation... 9	9
1.1.3 The restructuring of the South African tax system..... 11	11
1.2 The research question..... 12	12
1.3 The structure of the thesis .....	15
2 Chapter Two.....	17
South Africa’s jurisdictional link and double-taxation relief regime prior to democracy in 1994: domestic legislation .....	17
2.1 Introduction .....	17
2.2 Prior to democracy: policy principles .....	22
2.3 Equity .....	24

2.3.1	Benefit principle .....	28
2.3.2	Ability-to-pay equity .....	29
2.3.3	Inter-nation equity .....	34
2.3.4	Pre-democracy equity in South Africa .....	35
2.4	Neutrality.....	36
2.4.1	Pre-democracy neutrality .....	45
2.5	Source and residence as jurisdictional links.....	46
2.5.1	Source or territorial?.....	49
2.5.2	Distinction between source and threshold requirement .....	53
2.6	Comparison of categories.....	55
2.7	Outward South African resident trade and investment: local South African resident trade and investment.....	56
2.7.1	Residence.....	56
2.7.2	Exemption method of relief.....	57
2.7.3	Legal form: Branch versus subsidiary .....	59
2.7.4	Dividend income .....	60
2.7.5	Interest and royalty income .....	74
2.7.6	Controlled foreign companies .....	78

2.8	Outward South African resident trade and investment: host country trade and investment .....	83
2.9	Inward non-resident trade and investment: local South African resident trade and investment .....	85
2.9.1	General .....	85
2.9.2	Interest income .....	88
2.9.3	Dividend income .....	89
2.10	Summation .....	90
3	Chapter Three .....	92
	Evolution of South Africa's Cross Border Rules: transition period (1994 to 2000).....	92
3.1	Introduction .....	92
3.2	Transition period policy objectives .....	93
3.3	Transition period: implementation of objectives .....	99
3.4	Methods of relief .....	102
3.4.1	The exemption method to relieve international double taxation ....	102
3.4.2	Credit method to relieve international double taxation .....	104
3.4.3	Deduction .....	107
3.4.4	Source country exemption and tax sparing .....	108
3.4.5	Methods of relief applied in South Africa.....	110

3.5	Outward South African residents' trade and investment: local South African resident trade and investment.....	112
3.5.1	Overview .....	112
3.5.2	Business income in general .....	121
3.5.3	Interest and royalty income .....	122
3.5.4	Effect of the definition of residence .....	125
3.5.5	Legal form: Branch versus subsidiary .....	127
3.5.6	Controlled foreign companies .....	131
3.5.7	Dividend income .....	134
3.5.8	Traditional business and e-commerce .....	141
3.5.9	Equity and neutrality between local and outward trade and investment by South African residents .....	142
3.6	Outward South African resident trade and investment: host country resident trade and investment .....	143
3.7	Inward non-South African resident trade and investment: local South African resident trade and investment.....	146
3.7.1	Business income .....	147
3.7.2	Interest and royalty income .....	147
3.7.3	Dividend income .....	149

3.8	Summation .....	149
4	Chapter Four .....	151
	Millennium period and the change to residence .....	151
4.1	Introduction .....	151
4.2	Millennium period policy objectives .....	155
4.3	Change in the millennium policy objectives? .....	162
4.4	Outward South African resident trade and investment: local South African resident trade and investment.....	164
4.4.1	Meaning and interpretation of residence .....	164
4.4.2	Business income .....	181
4.4.3	Interest and royalty income .....	196
4.4.4	Dividend income .....	197
4.4.5	The tax credit.....	211
4.4.6	The deduction method of relief .....	227
4.4.7	Transfer pricing .....	230
4.5	Outward South African resident trade and investment: host country trade and investment .....	231
4.5.1	Controlled foreign companies and branches .....	233

4.6	Inward non-resident trade and investment: local South African resident trade and investment .....	234
4.6.1	Headquarter company regime.....	235
4.6.2	Business income .....	240
4.6.3	Dividend income .....	240
4.6.4	Interest and royalty income .....	241
4.7	Summation .....	243
5	Chapter Five .....	245
	South African treaty relief.....	245
5.1	Introduction .....	245
5.2	Background .....	246
5.3	Treaty relief in South Africa .....	251
5.4	Pre-democracy period .....	253
5.5	The transition period .....	255
5.6	Millennium change.....	257
5.7	Interaction between unilateral and double taxation agreements relief .....	258
5.8	Outward South African resident trade and investment: local South African resident trade and investment.....	259
5.8.1	Definition of ‘residence’ .....	259

5.8.2	Taxes covered.....	266
5.8.3	Categories of income difference.....	268
5.8.4	Business income .....	269
5.8.5	Interest, royalty income and dividend income .....	277
5.8.6	Approach to controlled foreign companies .....	280
5.9	Outward South African resident trade and investment: host country trade and investment.....	284
5.9.1	Business income .....	284
5.9.2	Interest and royalty income.....	284
5.9.3	Dividend income .....	285
5.10	Inward non-South African resident trade and investment: local South African resident trade and investment.....	286
5.10.1	Business income .....	286
5.10.2	Interest and royalty income.....	287
5.10.3	Dividend income.....	288
5.11	Comparison with other countries .....	289
5.12	Summation .....	291
6	Chapter Six.....	293

Jurisdictional links and methods of relief in other jurisdictions .....	293
6.1 Introduction .....	293
6.2 The method of relief of the other contracting state in double taxation agreements entered into by South Africa .....	294
6.3 Jurisdictional link and methods of relief in domestic tax law.....	296
6.4 African countries.....	297
6.5 India and Australia .....	302
6.6 South American countries .....	302
6.7 North American countries .....	304
6.8 United Kingdom.....	305
6.9 Summation .....	305
7 Chapter Seven .....	306
Findings, conclusion and recommendations .....	306
7.1 Introduction .....	306
7.2 What policy approach to equity and neutrality is reflected in the Income Tax Act? 310	
7.3 How do the methods of relief chosen by South Africa compare with the methods of other countries? .....	318
7.4 Is the method of relief found in the Income Tax Act consistent with the method of relief found in double taxation agreements?.....	319

7.5	Does the method of relief take into account equity and neutrality?.....	320
7.6	Recommendations .....	322
	List of Appendices .....	324
	Bibliography.....	339

University of Cape Town

**Abbreviations, definitions and acronyms**

<i>The Constitution</i>	Constitution of the Republic of South Africa, Act No. 108 of 1996.
<i>CFCs</i>	Controlled Foreign Companies
<i>The Income Tax Act</i>	The Income Tax, Act No. 58 of 1962, as amended from time to time
<i>OECD</i>	Organisation for Economic Co-operation and Development
<i>OECD MTC</i>	OECD Model Tax Convention
<i>STC</i>	Secondary Tax on Companies
<i>South Africa</i>	Republic of South Africa
<i>UN MTC</i>	United Nations Model Tax Convention between Developed and Developing Countries

**List of tables**

Table 1: South African incorporated company compared to place of effective management in South Africa.

Table 2: A comparison of dividend and active income of a South African resident company, a foreign branch of a South African resident company and a South African controlled foreign company

## 1 Chapter One

### Introduction

#### 1.1 Background

In the end somebody's views will have to decide whose interests are more important; and these views must become part of the law of the land, a new distinction of rank which the coercive apparatus of government imposes upon the people.<sup>1</sup>

The opening up of the South African economy after the first democratic elections in 1994 and the reform of the South African tax system meant that the government policy approach to cross border trade and investment had to be reconsidered. The reform and restructure of the South African income tax system is reflected, first, through the extension of the income tax base for residents from income with its source, both actual and deemed, in South Africa to include all income with its source located outside South Africa through the taxation of the worldwide income of South African residents. The latter tax is known as the residence basis of taxation. The second aspect of the reform and restructure related to the default method of relief chosen to eliminate international double taxation that resulted from the above extension of the tax base. The default method of relief changed from exempting income with its source located outside South Africa (the exemption arising as a result of the source basis of taxation) to providing a foreign tax credit ("tax credit") for international double taxation where tax was imposed both in South Africa as well as in the source country of the income.

---

<sup>1</sup> John Cassidy *How Markets Fail: The Logic of Economic Calamities* (2009) London: Penguin Books Ltd 45 quoting from Friedrich Hayek's *The Road to Serfdom* (1944).

It is submitted that such an important change to the tax system, namely the change to tax being imposed on the worldwide income of those defined as a 'resident of a country' from those whose source of income was located in South Africa, should reflect the policy goals of the government. Furthermore, the method of relief chosen to eliminate or relieve international double taxation should also depend on the policy goals of the government.

The policy goals of government should, in turn, depend on whose interests have been determined to be more important and who is to receive comparable treatment. Once it is decided whose interests are more important and who is to receive comparable treatment, the decision has to be reflected in the laws of the land and, in this case, the tax laws applicable to cross border trade and investment.

To ensure that the tax laws follow the government policy approach to cross border trade and investment, the principles of equity and neutrality must be considered. However, it is trite that equity and neutrality should be considered in the design of a country's tax laws and structure.<sup>2</sup> The fiscal policy approach to equity is included in Adam Smith's maxims of an ideal tax system and provides that:

---

<sup>2</sup> See Klaus Vogel *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD and UN Model Tax Conventions for the Avoidance of Double Taxation on Income and on Capital, with particular reference to German Treaty Practice* 3ed (1997) Hague: Kluwer Law International at 13–14; Richard Musgrave & Peggy Musgrave *Public Finance in Theory and Practice* 5ed (1989) New York: McGraw-Hill; Paul Van den Noord & Christopher Heady *Surveillance of Tax Policies: A Synthesis of Findings in Economic Surveys* OECD (2001) Economics Department Working Papers No. 303.2001 OECD at 16. Available at <http://oecd.org/eco/eco>, last accessed 4 July 2003. See also TS Emslie, DM Davis, SJ Hutton, L Olivier *Income Tax Cases and Materials* 3ed (2001) Cape Town: The Taxpayer at 1–14; R C Williams *Income Tax in South Africa: Law and Practice* 4ed (2006) Durban: Lexis Nexis Butterworths at 3–4; The Commission of Enquiry into Certain Aspects of the Tax Structure of South Africa, GG 15924, Regulation Gazette 5378 of 1994. Available at <http://www.treasury.gov.za/publications/other/katz/default.asp>, last accessed 13 November 2012. The 1994 Commission of Enquiry is commonly referred to as the 'Katz Commission'. The Fifth Interim

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state ...<sup>3</sup>

It is submitted that the principles of equity and neutrality should be applied equally to determine the local and cross border application of the tax system. It is therefore imperative that in the structuring of a country's cross border tax system, the role and application of equity and neutrality principles are acknowledged. The choice between a source basis of taxation and a residence basis of taxation on the one hand, and the method used to relieve international double taxation, on the other, involves this consideration of equity and neutrality in the cross border application of the tax system.

#### ***1.1.1 Approaches to equity and neutrality***

Equity is said to form the very base of any tax policy,<sup>4</sup> and yet, as will be seen below, there is no single universally accepted application of 'equity'<sup>5</sup> in cross border trade and investment.

---

Report of the Katz Commission titled 'Basing the South African Income Tax System on the Source or Residence Principles – Options and Recommendations.' (hereinafter referred to as the 'Katz Commission 5th Interim Report'). Available at <http://www.treasury.gov.za/publications/other/katz/5.pdf>, last accessed on 13 November 2012. At para 3.1.2.1 it states that 'Neutrality is a sound tax principle, but in the international context also has a particular competitive dimension which is important to South Africa.'

<sup>3</sup> Adam Smith *The Wealth of Nations* (Edited by Edwin Cannon: New York: Bantam Dell 2005) 1776 at 1043.

<sup>4</sup> Peter Harris *Corporate Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* (1996) Amsterdam: IBFD Publications at 10 where he states that 'Equity is considered the cornerstone of taxation' and indicates that if equity were not considered in the design of tax structure, a state would be able to take what it needed without having a formal tax system.

The one principle of equity that is ‘universally accepted as one of the more significant criteria of a “good tax”’ and ‘is relied upon in discussions of the tax base, the tax unit, the reporting period and more’ is horizontal equity.<sup>6</sup> Similarly, vertical equity is often also taken into account as a criterion of a good tax system.<sup>7</sup> However, it is the underlying bases of these versions of equity, namely the ‘benefit principle of equity’ and the ‘ability-to-pay principle of equity’ and their application in relation to cross border trade and investment, which have no universally accepted application, as will be seen from the discussion below.

The application of horizontal and vertical equity in a domestic economy is achieved through those in similarly situated positions being treated equally and those who are not in similar positions, not being treated equally.<sup>8</sup> The imposition of progressive tax rates, dependent on the amount of taxable income, is a clear example of the application of horizontal and vertical equity in a domestic economy. The principles, namely the benefit and the ability-to-pay principles, upon which horizontal and vertical equity are based, can be applied in the domestic economy without contradiction, as all persons who earn income within that economy derive

---

<sup>5</sup> Klaus Vogel ‘Worldwide vs source taxation of income – a review and re-evaluation of arguments (Part III)’ (1988) 11 *Intertax* 393 at 393 where it is stated that ‘[t]he attempt to formulate a definition of equity which is operational in the way in which definitions in exact science are, would be futile. What “equity” means cannot be defined .... it can only be explained, paraphrased’. See also Musgrave et al (note 2) at 218, where it is stated ‘that there is agreement on equity but no agreement on how the fair share or equity is defined’.

<sup>6</sup> David Elkins ‘Horizontal Equity as a Principle of Tax Theory’ (2006) 24 *Yale Law and Policy Review* 43 at 43. See also Commission of Enquiry into the Tax Structure of the Republic of South Africa, RP 34/1987 at para 4.43 p 50. The Commission is commonly known as the ‘Margo Commission’ and will be referred to as the Margo Commission; Vogel *Intertax* Part III (note 5) at 393–394; Musgrave et al (note 2) at 218–223; Williams (note 2) at 3.

<sup>7</sup> *Ibid.*

<sup>8</sup> Van den Noord et al (note 2) at 17. See also Nancy Kaufman ‘Fairness and the Taxation of International Income’ (1998) 29 *Law and Policy in International Business* 145.

benefits from the infrastructure of that country. Consequently, all such persons should contribute in proportion to the aggregate amount of their income.

The difficulties with the application of these principles of equity for income received by or accrued to persons as a result of cross border trade and investment are that the benefit principle may be applicable in one country, through the income being derived from or originating from the use of a country's infrastructure, while the same income may be received by or accrued to a taxpayer in another country. The combination of the income being derived in one country, and received in another, means that the benefit principle and the ability-to-pay principle are separated. The country in which the income originated and the country in which it was received would have to decide on the applicable version of equity as their policy. In other words, a decision has to be made whether the application of horizontal and vertical equity in cross border income has to take into account the specific country conditions giving rise to or to which the income was connected, which would indicate a policy choice of the benefit principle of equity. Alternatively, the country would have to decide whether to take into account only the amount of income received by its residents, irrespective of where the income was derived, which would indicate a policy choice of ability-to-pay equity. The chosen policy would be implemented first, by the basis on which tax is imposed – by being imposed on all 'residents' (as defined) or at the place where the income originated – and, secondly, by the method used to relieve or eliminate international double taxation.

The benefit principle of equity would be the chosen policy of government where the intention of the government is to achieve equity between those persons whose income is derived from, or originated in, a country as a result of the services

rendered and support given by the country (through government and other relevant stakeholders) to those persons. The taxes paid would be linked to the benefit received through the use of the country's infrastructure and resources, with the tax being viewed as a payment for the services rendered. By contrast, the ability-to-pay approach to equity would be the chosen policy approach where the intention is to achieve equity among the residents of a given territory where such residents earn, generate, receive or accrue the same pre-tax nominal income in a given period of assessment, irrespective of where such income is earned, generated, received or accrued. The application of the equity principle therefore requires a comparison of taxpayers, both in relation to the factors which give rise to their income and the amount of income received by or accrued to the taxpayer.<sup>9</sup>

Whereas the approach to equity compares taxpayers, albeit on different grounds depending on the approach taken, the principle of neutrality seeks to ensure that an assumed efficient market is not distorted by taxation or that a decision to invest, save or spend is not distorted by tax.<sup>10</sup> The role of the neutrality principle as found in the economic concept of 'efficiency'<sup>11</sup> is to ensure that taxes interfere with a taxpayer's decisions as little as possible, with the assumption that a taxpayer's

---

<sup>9</sup> Vogel *Intertax* Part III (note 5) at 396.

<sup>10</sup> Margo Commission (note 6) at para 4.4.2 p 50; Wolfgang Schon 'International Tax Coordination for a Second-Best World (Part I)' (2009) 1(1) *World Tax Journal* 67 at 78; Musgrave et al (note 2) at 216 and 569; Williams (note 2) at 4.

<sup>11</sup> Vogel (note 2) at 14 where he states that 'Economists relate the term "efficiency" to the internal allocation of factors of production, especially of capital. The allocation will be regarded as having become optimal if the use made of the factors of production results in the best possible productivity in the sense of so-called "pareto optimum"'; Musgrave et al (note 2) at 569.

decisions would ‘lead to the most efficient allocation in the society’,<sup>12</sup> where the market in which such traders or investors operate is an efficient market. In a domestic economy, where all traders and investors face the same economic profile and the same tax burden, the imposition of a tax on all the residents would not, generally, interfere with neutrality. However, where income is derived from or originated in one country and received by a person in another country, whether or not tax would be a factor affecting the decision to trade or invest would depend on, *inter alia*:

- the economic benefits received by a trader or investor;
- whether both countries would impose the same tax on that income;
- which country would decide not to impose tax or to impose lower tax;
- and
- the method used by the countries to either eliminate or relieve international double taxation.

This means that the design and structure of the tax system should strive to ensure neutrality in such decisions.

In cross border trade and investment, the added dimension of different countries with different economic profiles could already affect the neutrality of the location of trade and investment. Therefore, the tax system should not have an even

---

<sup>12</sup> Doron Herman *Taxing Portfolio Income Global Financial Markets* (2002) Amsterdam: IBFD at para 1.1.1. See also Margo Commission (note 6) at para 4.43 p 50; Katz Commission 5th Interim Report (note 2) at para 3.1.2.2 where it is stated that ‘An important criterion for an ideal tax system is that it should not influence business behaviour.’

further impact on such neutrality in the case of cross border trade and investment. The approach to neutrality should also seek to ensure some form of neutrality between the decisions to trade and invest in a particular country.

Two main policy approaches to neutrality in cross border trade and investment have been identified.<sup>13</sup> The first approach, which places emphasis on the neutrality between the locations where income is generated, is commonly referred to as ‘capital import neutrality’.<sup>14</sup> From the perspective of the country of residence, this approach seeks to ensure that its residents are tax neutral in the foreign host country of trade and investment, in relation to other traders and investors in that host country. The reason for this choice of neutrality is that its residents would be competitive in that host country as the residents would pay the same percentage or rate of tax as other investors and traders in that host country, and not pay any extra tax to their country of residence. From the perspective of the source country, this approach seeks to ensure that taxpayers who generate income within its territory are tax neutral because they are subject to the same taxes.

The second approach to neutrality places emphasis on the neutrality of the residents of a country and seeks to ensure that the residents of countries are tax

---

<sup>13</sup> The third approach to neutrality, namely capital ownership neutrality, is acknowledged but will not be considered in this thesis as it is beyond the scope of the thesis. The distinction between the approaches of capital import and capital export neutrality is attributed to Richard Musgrave. See Klaus Vogel ‘Worldwide vs source taxation of income – a review and re-evaluation of arguments (Part II)’ (1988) 10 *Intertax* 310 at 317.

<sup>14</sup> Vogel (note 2) at 14; Michael S. Knoll *International Competitiveness, Tax Incentives, and a New Argument for Tax Sparing: Preventing Double Taxation by Crediting Implicit Taxes* (2008) University of Pennsylvania Law School, Institute for Law and Economics (2008) Research Paper No. 08–21 at 2. Available at <http://ssrn.com/abstract=1259927>, last accessed 09 September 2008; Katz Commission 5th Interim Report (note 2) at para 3.1.2.2.; Lynette Olivier & Michael Honiball *International Tax: A South African Perspective* 5ed (2011) Cape Town: Siberink CC at 4.

neutral in relation to trading and investment in the country of residence or in a foreign host country. This approach is commonly referred to as 'capital export neutrality'.<sup>15</sup>

Therefore, where a country's residents trade and invest in foreign jurisdictions and such a country also allows foreigners to invest and trade within its borders, that country's international tax policy has to reflect who is to be treated equitably and what or who is to be neutral. This international tax policy approach to equity and neutrality is reflected in, *inter alia*, the method used to either eliminate or relieve international double taxation as legislated in the domestic income tax legislation and in double taxation agreements entered into by a country for the relief of international double taxation. An analysis of the methods used to relieve international double taxation therefore has to be based on the policy principles of equity and neutrality.

### ***1.1.2 Methods used to relieve or eliminate international double taxation***

There are three basic methods which a country may choose to relieve or eliminate international double taxation.<sup>16</sup> The three methods are the exemption method of relief, the credit method of relief and the deduction method of relief. The exemption method of relief seeks to exempt all foreign sourced income of residents and tax is imposed on the income of taxpayers where the source of income is located in a given territory.<sup>17</sup> This exemption method of relief can take the form of either combining a

---

<sup>15</sup> Vogel (note 2) at 14; Katz Commission 5th Interim Report (note 2) at para 3.1.2.2.; Olivier et al 2011 (note 14) at 4.

<sup>16</sup> Olivier et al 2011 (note 14) at 6.

<sup>17</sup> See Olivier et al 2011 (note 14) at 443; Vogel (note 2) at 16.

worldwide basis of taxation with the exemption of foreign sourced income or imposing tax on a purely source basis of taxation.<sup>18</sup> The exemption method can be implemented in two ways – either by the full exemption method which exempts all the foreign sourced income or by way of exemption by progression which, although exempting the foreign sourced income, takes the income into account to determine the tax rate to be applied to a taxpayer.<sup>19</sup> The credit method of relief provides relief for double taxation by crediting the foreign taxes against the tax paid in the country of residence.<sup>20</sup> The credit methods can be implemented in two ways – either by allowing the resident taxpayer to credit the full amount of the foreign tax against his residence country tax, referred to as the full tax credit, or by way of a limited tax credit which limits the tax credit to the amount of tax that would have been paid in the country of residence.<sup>21</sup> The third method of relief is the deduction method, which allows the foreign taxes paid to be treated as an allowable expense.<sup>22</sup> As in the case of the other two methods of relief, the deduction can be implemented by allowing the

---

<sup>18</sup> It could be said that the two forms cannot be equated because the former includes the foreign sourced income in the tax base whereas the latter does not. It is submitted that while the difference with respect to the tax base does exist, the end result of the two forms is largely identical. See also Vogel (note 2) at 16 where he states that '[t]he most extensive – and most effective – exemption of foreign income is, of course, represented by the territoriality principle ...'.

<sup>19</sup> Olivier et al 2011 (note 14) at 443–444, International Bureau of Fiscal documentation *International Tax Glossary* (2012) (hereinafter referred to as 'IBFD Glossary'). Available at [ibfd.org](http://ibfd.org), last accessed 5 November 2012. The exemption generally takes one of two forms, that is, a complete exclusion of the income or capital from the tax base; Vogel (note 2) at 16 and 1126, *OECD Model Tax Convention on Income and on Capital: Condensed Version* (2010) Paris: OECD (hereinafter referred to as the OECD MTC 2010) at 309.

<sup>20</sup> Olivier et al 2011 (note 14) at 6; Vogel (note 2) at 16 and 1126; OECD MTC 2010 (note 19) at 309.  
<sup>21</sup> Also referred to as the ordinary or normal credit. See OECD MTC 2010 (note 19) at 309; Olivier et al 2011 (note 14) at 6, 443 and 449–455.

<sup>22</sup> Olivier et al 2011 (note 14) at 6, 443, 456–458; James Hines 'Should Countries Try to Tax Foreign Income? 2009 (5) The James Hausman Tax Law and Policy Workshop: Law and Economics Workshop, WS 2006–2006 at 5. Available at [http://taxprof.typepad.com/taxprof\\_blog/files/Hines.pdf](http://taxprof.typepad.com/taxprof_blog/files/Hines.pdf), last accessed 16 November 2006.

full amount of the foreign tax to be deducted or limiting the deduction up to the amount of the domestic tax paid.

The differences between the approaches to equity and neutrality will be discussed in Chapter Two. Suffice it to state at this point that the benefit principle of equity and capital import neutrality is implemented by taxing only income which has its source in a given territory or by combining a residence basis of taxation with exempting the foreign sourced income of residents. By contrast, the ability-to-pay principle of equity and capital export neutrality is implemented by taxing the worldwide income of residents and providing a tax credit in the event that such residents also have to pay tax in the foreign country of investment or trade.

### ***1.1.3 The restructuring of the South African tax system***

Given that these approaches to equity and neutrality affect cross border trade and investment, it would be expected that, with the opening of the South African economy after the first democratic elections in 1994, and the restructuring of the South African tax system, the government policy approach to equity and neutrality in relation to cross border trade and investment would be reflected in, *inter alia*, the restructured income tax system. The restructuring provides an ideal case study for analysing the methods used to relieve international double taxation, particularly in relation to the policy objectives of equity and neutrality.

The restructuring of the taxation of cross border income was (and still is) implemented by a series of amendments made to the Income Tax Act.<sup>23</sup> The first

---

<sup>23</sup> Income Tax Act, No. 58 of 1962.

significant amendments to the source basis of taxation were implemented in 1997. However, the most ground-breaking amendment was implemented in 2001 by the full change in the jurisdictional basis on which tax was levied in South Africa.<sup>24</sup> This changed the tax base from taxpayers whose source of income was located in South Africa, to include those taxpayers who were tax resident in South Africa and whose income had its source located anywhere in the world. The change in jurisdictional link also changed the legislated methods used to relieve international double taxation and affected the application of double taxation agreements entered into by South Africa.

## **1.2 The research question**

On the assertion made earlier, that the restructuring of the South African tax system with respect to cross border trade and investment provides an ideal case study for analysing the methods used to eliminate or relieve international double taxation, particularly in relation to the policy objectives of equity and neutrality, this thesis analyses the methods of relief for international double taxation used by South Africa as reflected in the combination of the choice of the method(s) of relief and the choice of jurisdictional link for the taxation of its residents. The analysis considers and covers three distinct and identifiable periods, namely the period prior to democracy (pre-1994), the transition period (between 1994 and 2000) and the millennium period (post-2000 up until 1 April 2012).<sup>25</sup>

---

<sup>24</sup> The residence basis of taxation was implemented from years of assessment commencing on or after 1 January 2001 when the Revenue Laws Amendment Act No. 59 of 2000 came into effect.

<sup>25</sup> The amendments to the Income Tax Act is discussed up to and including the Taxation Laws Amendment Act No.24 of 2011.

The results of analysing the three periods should solve the questions which this thesis seeks to answer, namely whether the chosen method(s) to relieve international double taxation, as reflected in the choice of jurisdictional link and the specific relief methods, have taken into account equity and neutrality and, if so, which policy approach to equity and neutrality is reflected in the Income Tax Act and in double-taxation agreements. The approach taken is considered against the background of South Africa as a developing country and is compared to choices made by other countries. The analysis also considers the interaction between relief for international double taxation provided in the Income Tax Act and in double-taxation agreements entered into by South Africa with other countries, and whether the respective provisions do and should reflect the same principles.

It is submitted that the answer to the research question will play an important role for future restructuring of the South African tax system and that of other developing countries, particularly in Africa, in considering the reflection of the policy approach to cross border trade and investment in the income tax legislation through the method of relief chosen for the relief of international double taxation. It will also illustrate the inextricable link between the method of relief for international double taxation and the choice of either source or residence as the tax base. In doing so, it will provide a process that a country should follow when considering the change in its basis of taxation and the resultant changes to its methods to relieve international double taxation.

It is further submitted that any tax restructuring process which impacts on cross border trade and investment and a possible change in the tax base, should have an over-arching equity and neutrality approach which is aligned to the government's

cross border trade and investment policy. This alignment should not only support the government policy but it should also reduce the complexity and uncertainty of the income tax legislation that results from continuous revisions and amendments to the income tax legislation in respect of cross border trade and investment, as illustrated in the assessment of the tax restructuring process that has been undertaken by South Africa. Furthermore, the lack of certainty of a tax system is affected by the absence of an over-arching policy with respect to equity and neutrality and this uncertainty may affect trade and investment. This over-arching approach to equity and neutrality is generally reflected in the method chosen to relieve international double taxation.

It is further submitted that the choice of jurisdictional link and methods used to relieve international double taxation must be made by applying the principles of equity and neutrality by means of three comparators: namely, a comparison of the local trade and investment by residents of a country with the outward trade and investment of those residents; a comparison of outward trade and investment by residents of a country with the trade and investment of the host country traders and investors in that host country; and a comparison of inward trade and investment by both residents and non-residents in South Africa.

Given the inextricable link between source and residence on the one hand, and the method chosen to relieve international double taxation on the other, the comparison must take into account whether source or residence is the chosen basic principle for the tax system for cross border trade and investment by residents as well as the effect that the chosen method of relief for international double taxation has on the parties involved. A comparison of these relationships using the criteria of the choice of source and residence as jurisdictional link on the one hand, and the choice

of method used to relieve international double taxation on the other, facilitates the development of a consistent tax policy approach which aligns with a country's policy approach to cross border trade and investment. In addition, any inconsistencies in the income tax legislation with respect to the government policy approach to international trade and investment can be identified and either remedied or justified.

In summary, the analysis of the choice of tax system and the analysis of the methods used by South Africa to relieve international double taxation of its residents should indicate whether the principles of equity and neutrality, the two main principles which should underlie a tax system, have been applied by the government in the context of the cross border trade and investment activities of its residents.

### **1.3 The structure of the thesis**

Chapters Two, Three and Four track and analyse the effect that the chosen method of relief for international double taxation has on the policy principles of equity and neutrality when comparing inward and outward trade and investment by residents and non-residents in terms of the three comparators referred to earlier. The analysis takes into account the changes made to South Africa's tax base by its change from source to source-plus<sup>26</sup> and then to residence, together with the effect of these changes on the unilateral methods of relief provided for international double taxation in the Income Tax Act. Chapter Five does the same analysis for international double taxation relief provided in double-taxation agreements entered into by South Africa with other countries and, furthermore, considers the interaction between the methods

---

<sup>26</sup> 'Source-plus' is being used to refer to the expanded source- plus, rather than to indicate that were no deeming source provisions prior to 1998.

of relief for international double taxation provided in the Income Tax Act and in the double-taxation agreements.

Throughout this excursus of the changes in the South African tax structure, lessons are drawn from and comparisons are made with other foreign jurisdictions and Chapter Six provides a brief excursus of the choices made by other countries.

Based on the analysis and comparisons, Chapter Seven summarises the findings on the approach taken to relieve international double taxation through the lens of equity and neutrality. In addition, a conclusion is made on whether the method(s) of relief for international double taxation chosen by South Africa reflected a uniform approach to equity and neutrality with regard to the three categories compared. Then, a recommendation is made on an approach to relieve international double taxation which would reflect a consistent approach to equity and neutrality both in the Income Tax Act as domestic legislation and in double-taxation agreements.

## **2 Chapter Two**

### **South Africa's jurisdictional link and double-taxation relief regime prior to democracy in 1994: domestic legislation**

#### **2.1 Introduction**

The structure and design of the South African tax system for cross border trade and investment, as reflected in the choice of jurisdictional link and method used to relieve international double taxation, can be traced to South Africa's colonial past, its history of oppression and the transition to democracy in the 1990s.<sup>27</sup> Within recent history, three distinct periods reflecting changes to the structure, design and policies for cross border activities can be identified, namely the pre-democracy period (prior to 1994), the transition period (between 1994 and 2000), and the millennium period (post-2000).

While the pre-democracy period reflected an almost pure exemption system through the use of source as the jurisdictional link,<sup>28</sup> the transition period reflected a hybrid-exemption system through a combination of actual and deeming source provisions, where the latter included certain non-South African sourced income of

---

<sup>27</sup> See David Meyerowitz *Meyerowitz on Income Tax 2007–2008*. (2008) Cape Town: The Taxpayer at para 2.1–2.27. David Clegg & Rob Stretch *Income Tax in South Africa* (2010) Durban: Lexis Nexis (electronic version updated at 2011) at para 1.3. When the Union of South Africa was established in 1910, the British practice of using source as the jurisdictional link in its colonies meant that source became the main jurisdictional link of the Union. The Income Tax Act No. 28 of 1914 defined 'income' as 'any gains or profits ... from any source within the Union' and 'taxable income' as income received by 'any person wheresoever residing, from any source whatsoever in the Union'. The source principle was preserved in subsequent tax legislation such as the Income Tax Consolidation Act No. 41 of 1917, the Income Tax Act No. 40 of 1925 and the Income Tax Act No. 31 of 1941. In terms of these statutes, 'gross income' meant 'the total amount ... received ... from any source within the Union or deemed to be within the Union'.

<sup>28</sup> The concept of source being used here is in the context of income arising or originating within a specified territory as opposed to a source of income in the form of the fruit/ tree analogy.

South African residents in the tax base.<sup>29</sup> The third period, termed the millennium period, brought about a worldwide basis of taxation, where tax was imposed on the income of those classified as South African residents irrespective of the location of the source of that income.<sup>30</sup> These changes to the tax system, particularly during the last two periods, are reflective of South Africa's re-integration into the world economy.<sup>31</sup> As part of fiscal policy, it therefore should also be reflective of South Africa's policy approach towards cross border trade and investment.

South Africa's policy towards trade and investment would, *inter alia*, be reflected in the Income Tax Act by choosing either source or residence as the jurisdictional basis on which to impose tax and by choosing the method used to relieve international double taxation.<sup>32</sup> The choice of the method used to relieve international double taxation can be seen as the government's response to the fiscal policy spillover which is a consequence of the income taxation of cross border trade and investment. Fiscal policy spillover results when the domestic fiscal policies of

---

<sup>29</sup> Section 9C was introduced into the Income Tax Act by the Income Tax Act No. 28 of 1997. Section 9C deemed certain foreign-sourced investment income which was received by or accrued to a South African resident to be from a South African source. The details of s 9C will be discussed in para 3.3 of Chapter Three and para 4.4 of Chapter Four of this thesis.

<sup>30</sup> The residence basis of taxation was implemented with effect from years of assessment commencing on or after 1 January 2001 when s 2 of the Revenue Laws Amendment Act No. 59 of 2000 came into effect. The aforesaid provision introduced the residence basis of taxation into the Income Tax Act by amending the definition of 'gross income'.

<sup>31</sup> In an address to the Royal Institute of International Affairs by Lindiwe Hendricks, the South African Deputy Minister of Trade and Industry at the time, titled 'South Africa's Economic Re-Integration into the World Post-1994', published 09 June 2004, the pre-1994 economy was described as '... an economy that was in absolute ruin ... in recession ... (with) high unemployment'. It further described the South African industry as 'highly protected, subsidized, inefficient and uncompetitive' and 'that South Africa's integration into the global economy was a necessary imperative if there was any hope of achieving growth and development'. Available at <http://www.info.gov.za/speeches/2004/04062511151001.htm>, last accessed 13 November 2012.

<sup>32</sup> The interaction between the policy approach towards trade and investment on the one hand and the choice of jurisdictional link and method of relief on the other, is discussed in paras 2.2–2.5 of Chapter Two of this thesis.

one country spill over into another<sup>33</sup> and is commonly referred to as ‘international juridical double taxation’. Juridical double taxation is particular to cross border activities where tax is imposed on the same income and the same person in more than one country.<sup>34</sup> It is defined as ‘the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods’.<sup>35</sup> Olivier et al states that:

[i]n a juridical/legal sense it refers to the same income being taxed in the hands of the same taxpayer in two different countries. This may arise *inter alia* where a country taxes its residents on their worldwide income and the other country where the income is generated also taxes non-residents on income derived from a source within its jurisdiction.<sup>36</sup>

A further consequence of fiscal policy spillover is international economic double taxation. One definition of economic double taxation is the same income being subject to tax in the hands of more than one person.<sup>37</sup> Some texts indicate that the same income must also be subject to tax within the same period.<sup>38</sup> Within a national domestic economy, this type of double taxation presents itself where, for example, the profits of a business are subject to tax both in the hands of the company and the shareholder. This occurs where the dividend income is included in the profits

---

<sup>33</sup> Philip Black, Estian Calitz & Estiaan Calitz *Public Economics for South African Students* 2ed (2003) Cape Town: Oxford University Press at 151.

<sup>34</sup> OECD MTC 2010 (note 19) at 7.

<sup>35</sup> OECD MTC 2010 (note 19) at 7. See also the definition of juridical double taxation in Olivier et al 2011 (note 14) at 442, Lynette Olivier & Michael Honiball *International Tax: A South African Perspective* 3ed (2005) Cape Town: Siberink CC at 3, where ‘international double taxation’ is described as ‘the same income being taxed in the hands of the same taxpayer in two different countries.’ In Lynette Olivier, Emile Brincker and Michael Honiball *International Tax: A South African perspective* (2003) Cape Town: Siberink CC at 25, it is stated that ‘... international double taxation is defined as the imposition of comparable income taxes by two or more sovereign countries on the same item of income (including capital gains) of the same taxable person for the same taxable period.’ See also Vogel (note 2) at 9–10.

<sup>36</sup> Olivier et al 2011 (note 14) at 6.

<sup>37</sup> *Ibid.*

<sup>38</sup> Vogel (note 2) at 10 where it states that ‘... the term ‘economic double taxation’ is used to describe the situation that arises when the same economic transaction, item of income or capital is taxed in two or more States during the same period, but in the hands of different taxpayers...’.

of the business.<sup>39</sup> According to Vogel, this example of economic double taxation is not true economic double taxation as it arises from the classical system of company taxation.<sup>40</sup> Economic double taxation in a national context is usually relieved in the national domestic economy through methods such as exemption or some form of credit for the shareholder investor.<sup>41</sup> With cross border activities, economic double taxation can occur where two countries both impose tax on the same income but on different persons resident in the respective countries. As stated by Olivier, it ‘is the imposition of comparable taxes by at least two tax jurisdictions on different taxpayers in respect of the same income’.<sup>42</sup> An example is the application of controlled foreign-company rules where two countries impose tax on interest income, with one imposing tax on the legal owner of the capital and the other on the person in control of the capital asset.<sup>43</sup> Olivier et al states that:

[i]n an economic context, double taxation may arise in that the same income is taxed in the hands of two different taxpayers. The classic example of economic double taxation is where corporate profits are first taxed at a company level where they are realized and are then also taxed at shareholder level when they are distributed.<sup>44</sup>

---

<sup>39</sup> OECD MTC 2010 (note 19) at 196 states that ‘Some countries laws seek to avoid or mitigate economic double taxation *i.e.* the simultaneous taxation of the company’s profits at the level of the company and of the dividends at the level of the shareholder’.

Olivier et al 2011 (note 14) at 6. Harris (note 4) at 60; Editor ‘Taxing dividends: an unfair discrimination’ (1960) 9 *The Taxpayer* 61 at 61 where the problem of economic double taxation that results from taxing both dividend income and the profits of the company were raised.

<sup>40</sup> Vogel (note 2) at 10.

<sup>41</sup> Richard J. Vann ‘General Report’ in *Cahiers De Troit International: Trends in company shareholder taxation: single or double taxation?* vol 88a (2003) at 28. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010; OECD MTC 2010 (note 19) at 196–201. Olivier et al 2011 (note 14) at 76.

<sup>42</sup> Olivier et al 2011 (note 14) at 442.

<sup>43</sup> Olivier et al 2011 (note 14) at 6.

<sup>44</sup> Olivier et al 2011 (note 14) at 6; See also B. K Spitz ‘Double Taxation’ (1988) 1 *Juta’s Foreign Tax Review* 69 where it is stated that ‘The problem of economic double taxation is most acute when distributions are made from a company in one country to shareholders in another country in which the relief measures do not dovetail in a satisfactory manner’.....

The design and structure of the income tax legislation would have to provide for these spillover tax consequences and also for additional consequences which result from cross border trade and investment, such as, *inter alia*, tax competition, transfer pricing, thin capitalisation and the use of conduit companies to implement international tax avoidance schemes. The design and structure of income tax legislation therefore has to provide a strategy to deal with each of the above spillover tax consequences. At the same time this would reflect the government's policy towards cross border trade and investment.

Based on the assertion made earlier that a government's policy approach to cross border trade and investment is legislated through its choice of source or residence as well as the method used to relieve international double taxation, it follows that prior to making legislative changes to the jurisdictional link, to the method of relief to be used or to any international anti tax-avoidance measures (such as the use of conduit companies, transfer pricing and thin capitalisation), the policy approach to cross border trade and investment must first be clarified. Furthermore, it is submitted that the policy approach together with the principles of equity and neutrality, as the principles which underlie the design and structure of the tax system, should be reflected in the changes made to income tax legislation. With the changes made to the Income Tax Act during the transition and millennium periods, ostensibly to implement the government's policy approach to international trade and investment, the implementation of the changes to the tax system and the method to relieve international double taxation should have reflected the South African government's approach to equity and neutrality. This would be on the assumption that these two principles underlie all these changes. In order to understand the impact

and significance of the changes made to the methods used to relieve international double taxation in the millennium period, this chapter considers the effect that the choice of method of relief had on equity and neutrality during the period prior to democracy. In other words, in order to understand the present, we have to look at the past.

Given that the tracking of the changes to the methods of relief commences in this chapter, the chapter also provides a theoretical framework of the equity and neutrality principles within the context of the methods used to relieve double taxation and the concomitant choice of jurisdictional link. Although the principles underlying equity and neutrality in the choice of method of relief are theoretical, any policy approach, particularly one that involves change, has to have a theoretical basis in order to anticipate and appreciate the potential direct and indirect consequences of proposed changes. In addition, various commissions that have been appointed to undertake studies of the South African tax structure have recognised these principles of equity and neutrality as underlying the South African tax structure.<sup>45</sup> Therefore, the expectation is that these principles would continue to underlie and inform any changes made to the structure of the Income Tax Act.

## **2.2 Prior to democracy: policy principles**

In describing the South African economy prior to democracy, Van der Berg states that ‘protectionism’ was first ‘an activist policy and later became a defence against

---

<sup>45</sup> The Margo Commission (note 6); The Katz Commission (note 2).

growing international isolation'.<sup>46</sup> It is in this context as a closed economy that income tax continued to be imposed only on income which had its source located within the territorial boundaries of South Africa.<sup>47</sup> The combination of source and a strict exchange control regime controlling the flows of income out of South Africa meant that the tax policy concerns with outward cross border trade and investment were somewhat limited. Other factors, such as the political ideology at the time, the exchange control regulations, and South Africa's colonial history, played a bigger role in determining source as the jurisdictional link.<sup>48</sup> Despite the importance and role of the aforesaid factors, the choice of source does, indirectly, indicate the South African choice of the method to relieve international double taxation and thus reflects the country's policy approach to equity and neutrality at that time. Therefore, it is apposite to analyse the method, provided indirectly in the Income Tax Act, to relieve international double taxation using the principles of equity and neutrality during this source period, and provide the theoretical principles, which underlie equity and neutrality, in relation to the choice of method of relief and jurisdictional link. The analysis accordingly commences with an analysis of the principles of

---

<sup>46</sup> Servaas van der Berg, Ronelle Burger & Megan Louw 'Post-Apartheid South Africa: Poverty and distribution trends in the era of globalisation.' (2007) Research Paper No. 2007/57 UNU/Wider 1 at 1. Available at [http://www.wider.unu.edu/publications/working-papers/research-papers/2007/en\\_GB/rp2007-57](http://www.wider.unu.edu/publications/working-papers/research-papers/2007/en_GB/rp2007-57), last accessed on 24 August 2011. See also address by the Deputy Minister of Trade and Industry (note 31) where the pre-1994 economy was described as '... an economy that was in absolute ruin ... in recession ... (with) high unemployment' and South African industry was described as 'highly protected, subsidized, inefficient and uncompetitive'.

<sup>47</sup> See address by Trevor Manuel, the South African Minister of Finance at the time, at the Annual Conference of the International Bar Association on Thursday 24 October 2002, title 'The South African Tax Reform Experience since 1994' at 6. Available at [http://www.treasury.gov.za/comm\\_media/speeches/2002/20022102501.pdf](http://www.treasury.gov.za/comm_media/speeches/2002/20022102501.pdf), last accessed 13 November 2012.

<sup>48</sup> See Margo Commission (note 6) at para 3.9 p 38; para 26.9–26.15 p 397–8; Katz Commission 5th Interim Report' (note 2) at para 2.13–2.1.4.

equity and neutrality in the context of the choice of the jurisdictional link in cross border trade and investment.

### 2.3 Equity

The relationship between equity and the choice of jurisdictional link is illustrated by the following comment of Stratford CJ:

There is one further remark to make on the equitable principles generally found to underlie liability for tax. In some countries residence (or domicile) is made the test for liability, for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is “source of income”, again presumably, the equity of the levy rests on the assumption 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, wherever that recipient of it may live.<sup>49</sup>

With regard to source, Stratford CJ stated:

In my opinion the word source is used to convey the idea I have mentioned, viz., 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 equity of the tax.<sup>50</sup>

The benefit principle of equity described by Stratford CJ is one of the competing equitable bases on which a state may impose tax.<sup>51</sup> This approach to the equitable basis considers the payment of taxes ‘as a consideration for benefits provided to the individual through state activities’.<sup>52</sup> It should be noted that this does

---

<sup>49</sup> *Kerguelen Sealing and Whaling Company Ltd v Commissioner for Inland Revenue* 1939 AD 487 at 507. See also Olivier et al 2011 (note 14) at 19.

<sup>50</sup> *Ibid* at 508.

<sup>51</sup> Vogel *Intertax* Part III (note 5) at 394 where he states that ‘[a] discussion of equity must first consider the relationship existing between the taxpayer and the state that levies the taxes’.

<sup>52</sup> Vogel *Intertax* Part III (note 5) at 394. See also Kaufman (note 8) at 152; Klaus Vogel ‘The Justification for Taxation: A Forgotten Question’ (1988) 33 *American Journal of Jurisprudence* 19 at 26–28; Olivier et al 2011 (note 14) at 11.

not mean that the payment of taxes is the price paid for state services to a specific individual. It means that tax is the price paid for the totality of state services to all taxpayers collectively.<sup>53</sup> By contrast, the competing sacrifice theory views the payment of taxes as a ‘sacrifice owed to the state due to the higher moral value of the community over individual aims’<sup>54</sup> and this theory is used as support for the worldwide taxation of the citizens of a given country.<sup>55</sup> There is a third approach to the equitable basis on which a state may impose tax and it deals with the redistributive aspects of tax policy.<sup>56</sup> This third approach is mentioned for the sake of completeness but is not relevant for the purposes of this thesis as it deals with the redistribution of taxes whereas this thesis is concerned with the imposition of taxes.

In addition to the equitable basis upon which the state may impose tax, the equitable relationship between similarly situated taxpayers must also be considered. This equitable relationship, termed ‘tax equity’, is achieved where these similarly situated persons face the same tax burden.<sup>57</sup> In cross border trade and investment this equitable relationship can either be between a taxpayer and his country compatriots or between the taxpayer and his competitors in the host country of trade and

---

<sup>53</sup> Vogel *Intertax* Part III (note 5) at 395; Herman (note 12) at para 2.4.2.

<sup>54</sup> Vogel *Intertax* Part III (note 5) at 394; See also Vogel (note 52) at 28–31.

<sup>55</sup> Vogel *Intertax* Part III (note 5) at 395. See also discussion in Elkins (note 6) at 56–59 where the sacrifice theory is discussed.

<sup>56</sup> Vogel *Intertax* Part III (note 5) at 397–398.

<sup>57</sup> For a discussion on ‘similarly situated’ taxpayers, see Musgrave et al (note 2) at 218–223; Elkins (note 6) at 44. See also Joachim Lang and Joachim Englisch ‘A European Legal Tax Order Based on Ability to Pay’ in Andrea Amatucci (ed) *International Law* (2006) The Netherlands: Kluwer Law International at 255 where it states that ‘Tax equity thus calls for equal taxation of taxpayers in objectively similar situations and different taxation of taxpayers in objectively different circumstances’.

investment.<sup>58</sup> The choice of the two comparators required to be equitable is indicative of the two approaches to inter-individual equity where there is cross border income, namely the benefit principle of equity and ability-to-pay equity.<sup>59</sup> It is submitted that the design of a tax system should take into account or at least consider the equity aspects of all of the above comparator relationships, ensuring that they reflect government policy on cross border trade and investment.<sup>60</sup>

A further layer to add to the choice of equitable relationships is the distinction between substantive and formal equality<sup>61</sup> which plays an important role when comparing cross border income. Whereas formal equality between taxpayers looks purely at the amount of income received by or accrued to a taxpayer, substantive equality would consider, *inter alia*:

- whether income received in the state of investment is repatriated to the state of residence, for example, where the foreign income is reinvested in the enterprise in the source state or where it is difficult to withdraw it;

---

<sup>58</sup> Vogel *Intertax* Part III (note 5) at 395. The former basis is the basis of equality on which, according to Vogel, Peggy Musgrave bases her analysis of equity and neutrality.

<sup>59</sup> Harris (note 4) at 10–17. See also Angel Schindel & Adolfo Atchabahian ‘General Report’ in *Cahiers De Troit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/ IFA at 31–32. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

<sup>60</sup> Vogel *Intertax* Part III (note 5) at 394 where it is states that for both inter-individual equity and inter-nation equity there is more than one approach. These approaches can be divided into ‘legitimation, equality and integrity of the tax system, and to redistribution’.

<sup>61</sup> Cheadle, H., Davis, D. & Haysom, N. (eds). *South African Constitutional Law: The Bill of Rights*: (2004) Durban: Lexis Nexis (electronic version) at para 4.3 describes formal equality as being an ‘abstract prescription of equal treatment for all persons regardless of actual circumstances’ and states that it ‘ignores the real social and economic differences between individuals and groups’. It judges individuals and groups ‘by standards that appear to be neutral but which ... embody the interests and experiences of socially privileged groups’ and its application ‘often exacerbates the inequality of socially or economically disadvantaged groups’.

- the degree of risk under which the foreign income has been generated;
- unremitted income;
- the pre-tax business environment; and
- the role and support provided by the government and infrastructure in a particular country.<sup>62</sup>

Although there are different views on the approach to substantive equality, the common link between the forms and approaches to equity is the principle of tax equality, which requires the tax burden to be ‘just and appropriate in determining the similarities and differences relevant for the distribution of the tax burden’.<sup>63</sup> Another way of stating this is that the tax system must reflect ‘non-discriminatory treatment of taxpayers in similar circumstances (horizontal equity)’.<sup>64</sup> The difficulty in practice when comparing taxpayers in a cross border environment is the identification of the ‘similarities’ and ‘differences’ that would enable equality to be achieved between taxpayers. The two approaches to inter-individual equity illustrate these difficulties and the contradictions in determining ‘equity’.

---

<sup>62</sup> Vogel *Intertax* Part III (note 5) at 396.

<sup>63</sup> Lang & Englisch in Amatucci (note 57) at 256.

<sup>64</sup> Bruce Bolnick *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*. Technical Report submitted to USAID/RCSA. USAID/RCSA, SADC Tax Subcommittee, SADC Trade, Industry, Finance and Investment by Nathan-MSI Group. (2004). Available at [http://pdf.usaid.gov/pdf\\_docs/PNACY929.pdf](http://pdf.usaid.gov/pdf_docs/PNACY929.pdf), last accessed 14 November 2012. See also Elkins (note 6).

### 2.3.1 *Benefit principle*

A state that seeks to ensure an equitable relationship between persons who have some kind of economic presence or activity in that state does so on the basis of a direct link between the taxpayer's generation of income and the services (and support) provided by the government of that state.<sup>65</sup> In this approach, it is the link between the government's services and support which gives rise to the generation of income of the taxpayer and for which the taxpayer is paying. Such a state is following the benefit principle approach to equity, implemented by taxing only income generated in that state by using source as its jurisdictional link and using the exemption method of relief for the foreign sourced income of the residents.<sup>66</sup> South Africa's use of source prior to democracy could therefore be said to reflect a policy based on the benefit principle of equity.

If all states followed this approach, a non-resident whose source of income is located in a given country would only be taxed in that country, and the respective resident country should exempt that income from tax. In an ideal world there would be substantive equality between those having a presence in the given territory as these taxpayers would receive the same support, from the government of that territory, in generating that income and would also face the same economic

---

<sup>65</sup> See James Repetti 'Democracy and Opportunity: A new paradigm in equity' (2008) 61 *Vanderbilt Law Review* 1129 at 1135–6." Olivier et al 2011 (note 14) at 11.

<sup>66</sup> Schon (note 10) at 75 where he stated that 'the benefit principle is meant to justify income taxation with respect to the support granted by a country to the generation of income in its territory'. See also Michael Graetz *Foundations of International Income Taxation* (2003) New York: Foundation Press at 5–6 where he refers to the work of Peggy Musgrave and Nancy Kaufman where these issues are analysed.

circumstances and risks. This was largely the approach of South Africa prior to democracy as illustrated in *Kerguelen*.<sup>67</sup>

The use of the benefit principle of equity has been criticised on a number of grounds<sup>68</sup> and, in the view of many commentators, discredited.<sup>69</sup> These criticisms include the argument that the link between the benefit principle and the source principle has in practice been broken.<sup>70</sup> If the link is broken, then the achievement of substantive equality by the use of source is undermined. Even in circumstances where the link is not broken, critics refer to the difficulties in quantifying and apportioning the benefit among inhabitants (taxpayers) and linking the benefit to the tax paid.<sup>71</sup> A further problem with the benefit principle is that it assumes that all persons who generate income within a specific country have the same benefits and support from the government.<sup>72</sup>

### 2.3.2 *Ability-to-pay equity*

In contrast to the benefit principle, a state might want to follow the ability-to-pay principle of equity which is said to bring an element of fairness, as it is based on the taxation of the total amount of income received by a taxpayer. In other words, those

---

<sup>67</sup> *Kerguelen* (note 49).

<sup>68</sup> Repetti (note 65) at 1136–8 where he states that the benefit theory has been criticised on the grounds that it suggests little about tax systems design in general on the grounds that it does not indicate the level of taxation; it does not indicate the appropriate level of government expenditure or redistribution. In other words it does not address distributive justice; it conflicts with a government policy that provides welfare to indigents, and it does not provide guidance in respect of the tax rates or identify the appropriate tax base. See also Schon (note 10) at 75–76 for criticisms of the benefit principle.

<sup>69</sup> Kaufman (note 8) at 153; see also Herman (note 12) at para 2.4.2.

<sup>70</sup> Kaufman (note 8) at 183–184.

<sup>71</sup> Schon (note 10) at 76; Repetti (note 65) at 1136.

<sup>72</sup> Musgrave et al (note 2) at 218.

whose pre-tax earnings are the same are treated in the same manner.<sup>73</sup> The implementation of this approach to equity is done by including in the income of residents, all income earned by a resident of a country, irrespective of whether the source of that income is located in or outside the territorial boundaries of that country, and granting a tax credit in the country of residence in the event of international double taxation.

Using ability-to-pay for cross border income without taking into account whether the income earned in a foreign country is actually received, deferred, or unremitted, or the degree of risk under which the income in that foreign country was generated, does detract from substantive equality, resulting in formal equality being applied. In other words, it will result in inequity between those who are supported by the country to generate their income and those who are not, that is, no substantive equality. The substantive aspect of ability-to-pay is discussed further in Chapter Three in relation to s 9, Right to Equality, in the South African Constitution.<sup>74</sup>

Like the benefit principle, the ability-to-pay principle has also been criticised on the grounds that it also does not indicate the appropriate rate structure and furthermore does not recommend or identify the appropriate tax base.<sup>75</sup> In addition, ability-to-pay is said to allocate income to a certain person and does not tax economic activity or the tools used to perform the activity.<sup>76</sup> The allocation of tax to a person may mean that the economic relationship between the individual and the

---

<sup>73</sup> See Repetti (note 65) at 1139; Hines (note 22) at 27.

<sup>74</sup> Constitution of the Republic of South Africa Act No. 108 of 1996.

<sup>75</sup> Repetti (note 65) at 1139–1140.

<sup>76</sup> Schon (note 10) at 73–74.

State is broken and that taxation is then dependent on political, rather than economic allegiance. The use of political allegiance as a basis for tax jurisdiction has been criticised on the grounds that ‘political allegiance does not produce income, nor does it establish or preserve capital’.<sup>77</sup> Schon, with Vogel agreeing, further questioned whether ability-to-pay has a place within the international sphere as, according to him, this form of equity is ‘rooted in domestic law’.<sup>78</sup>

Another criticism of ability-to-pay as practised is that it is not as respectful of the sovereignty of states as is the benefit principle. The International Fiscal Association 38<sup>th</sup> Congress in 1984 in Buenos Aires adopted a resolution stating that:

... a system of territorial taxation or of exemption of foreign income is preferable (viz. to worldwide taxation) because it is more respectful of the sovereignty of States in tax matters, eliminates distortions or competition in the country where the investment is made, and therefore, does not impede the free flow of investment.<sup>79</sup>

The adoption of this resolution would require that all countries impose tax on the basis of the source of the income being located within their respective territory and would therefore require internationally recognised source rules.

A comparison of the two approaches in an open economy involved in cross border trade and investment indicates that the application of the benefit principle results in an unfair tax burden on taxpayers who are resident within a country and whose source of income is located within that country – that is, as compared to their

---

<sup>77</sup> Eric Kemmeren ‘Source of income in globalising economies: Overview of the issues and a plea for an origin-based approach’ (2006) 60 (11) *Bulletin for International Taxation* 430 at 431.

<sup>78</sup> Schon (note 10) at 72; Klaus Vogel ‘Which Method Should the European Community Adopt for the Avoidance of Double Taxation’ (2002) 56(1) *Bulletin for International Taxation* 4 at 7. See also Kaufman (note 8).

<sup>79</sup> As quoted in Vogel (note 2) at 15.

fellow resident taxpayers whose source of income is located in another country,<sup>80</sup> particularly where countries apply different tax rates. A comparison of two taxpayers, A and B, both with pre-tax incomes of 100 and both being inhabitants (residents) of country X, illustrates this alleged unfairness. Taxpayer A earns his income domestically in country X and his income is taxed at 35% in country X. Taxpayer B earns his income in country Y, a jurisdiction that does not tax this category of income at all. There are no other taxes in either of these countries. Both A and B are assumed to have equivalent, if not identical business operations, both benefit from services of the country in which they operate but only A, whose income has a domestic source, contributes to the provision of home country (country X) services. In the absence of both of them being taxed in a similar way, such as for example through worldwide taxation, it appears that B has an unfair advantage over A.

However, the impression may differ when factors such as the degree of risk, the pre-tax business environment, and the infrastructure of a country – all of which may differ from country to country – are taken into account.<sup>81</sup>

Given that both principles of equity have been criticised and have shortcomings, how does a country choose one or try to reconcile the two approaches to tax equality? The existence of the choice between the two principles is not new. In putting together a framework for international taxation, the 1923 Report to the

---

<sup>80</sup> Hines (note 22) at 25.

<sup>81</sup> See Hines (note 22) at 28; Vogel *Intertax* Part II (note 13) at 317; Vogel *Intertax* Part III (note 5) at 396.

League of Nations on International Double Taxation<sup>82</sup> considered the application of the two alternative equity principles in relation to source and residence as the jurisdictional links. The report viewed exclusive source taxation as ‘illegitimate’ because in their view it was not based on the taxpayer’s full ability-to-pay and ‘as such it was a sign of administrative cowardice and frailty’.<sup>83</sup> Their report further argued that ‘as less developed countries became more industrialised the principle of ability-to-pay at the place of residence would become more widely understood and appreciated’.<sup>84</sup>

The use of residency by most countries to impose tax on the worldwide income of the residents of a country may be evidence that the ability-to-pay approach to equity is the approach chosen by most countries.<sup>85</sup> This usage is not without criticism. One of the criticisms of the use of residency to achieve ability-to-pay equity is the suggestion that the same equity principle can be achieved if countries taxed only income which arose in their respective territories.<sup>86</sup> This means using the location of the source of income as the tax base and where the source of income is

---

<sup>82</sup> Economic experts were commissioned by the League of Nations to study international double taxation and their report was published in 1923. See also Schindel et al (note 59) at 32.

<sup>83</sup> As quoted in Schindel et al (note 59) at 32.

<sup>84</sup> As quoted in Schindel et al (note 59) at 32. See also Arthur Cockfield *Purism and Contextualism with International Tax Law Analysis: How Traditional Analysis Fails Developing Countries*. Queen's University Faculty of Law, Legal Studies Research Paper Series, working paper No.0703 at 6–9 where reference is made to the ‘Report on Double Taxation submitted to the Financial Committee of the League of Nations’. Available at <http://ssrn.com/abstract=989770>, last accessed 14 November 2012.

<sup>85</sup> For a discussion, see Schon (note 10); Lang & Englisch in Amatucci (note 57), Kaufman (note 8); Musgrave et al (note 2); John G. Head & Richard Krever (eds) *Tax Reform in the 21st Century: A Volume in Memory of Richard Musgrave* (2009) The Netherlands: Kluwer Law International.

<sup>86</sup> Nancy H. Kaufman ‘Equity Considerations in International Taxation’ (2001) 26 *Brooklyn Journal of International Law* 1465 at 1468. See also Lang & Englisch in Amatucci (note 57) at 275 where it states that ‘One might also take the stand that if the global income is split up and taxed in several jurisdictions, each of them puts the taxpayer in a *proportionally* comparable situation to a resident who has only domestic income’.

not located in a country, that income would be exempt from tax in that country. As tax would be imposed on the portion of the taxpayer's income which had its source located in a particular territory, the taxpayer's entire ability-to-pay would be subject to tax, albeit in different countries. A problem arises where each country applies different tax rates, as this affects the comparison of taxpayers as inhabitants of a given country and thus distorts ability-to-pay equity. One way of overcoming this problem and achieving ability-to-pay equity using source-only taxation is to require all countries or countries whose inhabitant's trade or do business with each other, to have the same tax rates. Another way, suggested by George Von Schanz, is to reduce the rate of tax on foreign source income accompanied by a reduced rate of tax levied by the host country on domestic source income earned by foreigners<sup>87</sup> – the result being a quid pro quo. The problem of the equity relationship between residents who earn the same amount of income still remains.

A further factor that affects ability-to-pay equity is whether a country imposes tax on a remittance or accrual basis, where accrual is taken to mean when a taxpayer is entitled to the income and not when the income is due and payable.<sup>88</sup>

### **2.3.3 *Inter-nation equity***

In addition to tax being imposed by the state on an equitable basis, and equity between taxpayers being considered, a third notion of equity must also be considered

---

<sup>87</sup> Vogel *Intertax* Part III (note 5) at 395, Klaus Vogel 'Worldwide vs. source taxation of income – a review and re-evaluation of arguments (Part I)' (1988) 8–9 *Intertax* 216 at 219.

<sup>88</sup> See *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (AD) where the court held that 'accrued' should be interpreted as 'entitled to' and not as 'due and payable'.

in cross border trade and investment, namely inter-nation equity.<sup>89</sup> Inter-nation equity, which is concerned with the distribution of tax revenue among various countries, requires co-operation by all countries with respect to the method of allocating taxing rights. The type of co-operation that is required can potentially be achieved through mutual co-operation by using double taxation agreements or an international tax body. Although beyond the scope of this thesis, as inter-nation equity would not be achieved through the design and structure of one country's tax system, this form of equity will be mentioned where applicable.

#### **2.3.4 Pre-democracy equity in South Africa**

Although source was retained as the basis on which income was imposed until the mid-1990s, concern with the appropriateness of ability-to-pay equity was raised by earlier commissions of enquiry that studied the South African tax system. In 1970 the Franszen Commission stated that the adoption of the residence basis of taxation by South Africa's major trading partners, with the concomitant enhancement of equity in the form of ability-to-pay, meant that the source basis of taxation used by South Africa was not reconcilable with South Africa's economic interests'.<sup>90</sup> The Franszen Commission further stated that there was a deviation from the source basis of

---

<sup>89</sup> The distinction between inter-individual equity and inter-nation equity is attributed to Peggy Musgrave. See Vogel (note 2) at 14. For a discussion on inter-nation equity see Musgrave et al (note 2) at 568; Peggy Musgrave 'Sovereignty, Entitlement, and Co-operation in International Taxation' (2001) 26 *Brooklyn Journal of International Law* 1335 at 1344–1146; Vogel *Intertax* Part III (note 5) at 398; Kaufman (note 8) at 188–201.

<sup>90</sup> Margo Commission (note 6) at para 26.12 p 398; Editor, 'Source of Income' (1971) 20 *The Taxpayer* 71 at 71.

taxation, as implemented in South Africa at the time, in some cases,<sup>91</sup> and therefore, it is submitted, in these cases the benefit principle of equity did not apply. The government at the time accepted the recommendation of the Franszen Commission to change to a residence basis of taxation but never implemented the recommendation.<sup>92</sup>

## 2.4 Neutrality

According to Schon, the vagueness of the ability-to-pay and benefit principles of equity seems to give rise to a pure efficiency analysis.<sup>93</sup> One can also add to this the debate concerning the form of equity to be applied. Efficiency, in this analysis of the policy principle, requires the decision to invest, to trade or do business not to be affected by tax considerations on the assumption that the market determines the most efficient allocation of these decisions.<sup>94</sup> An efficient tax system is:

one that minimises the loss of economic welfare and growth due to tax induced distortions in the incentives that guide private decisions on investment, production and technology, consumption, saving, work effort, financing and the legality of activities.<sup>95</sup>

In other words, as a general principle, the tax system must be neutral and not affect business or investment decisions as this interference will undermine the efficiency of the market.<sup>96</sup> It is said that efficiency is particularly ‘important in poor

---

<sup>91</sup> The Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa’ RP 86/1970, commonly known as the Franszen Commission, at para 20, p 6. See also Margo Commission (note 6) at para 26.9 p 397 where reference is made to para 20 of ‘The recommendation was made in its second report, ‘Taxation in South Africa’ chapter.’

<sup>92</sup> Margo Commission (note 6) at para 26.10 p 397. See also Lynette Olivier ‘Residence-based taxation’ 2001 *TSAR* 20 at 21–22. Katz Commission 5th Interim Report (note 2) at para 2.1.2.

<sup>93</sup> Schon (note 10) at 78.

<sup>94</sup> Vogel (note 2) at 14; Vogel *Intertax* Part II (note 13) at 310; Schon (note 10) at 78.

<sup>95</sup> Bolnick (note 64). See also Harris (note 4) at 7–8 ; Musgrave et al (note 2) at 569; Head et al (note 85); Vogel (note 2) at 14 ; Elkins (note 6) at 49; Vogel *Intertax* Part II (note 13) at 310.

<sup>96</sup> For the purposes of this analysis, the concept ‘efficiency’ is not referring to ‘administrative efficiency’. Administrative efficiency looks at the collection and procedural aspects of the tax system. See Vogel (note 2) at 14; Vogel *Intertax* Part II (note 13) at 310.

countries that can least afford economic losses due to avoidable resource misallocation'.<sup>97</sup> In addition, taxpayers should not be able to avoid paying taxes simply by changing their behaviour.<sup>98</sup> However, it is also clear that in reality, a tax system is unlikely ever to be completely neutral. This non-neutrality might arise as a result of a clash between the two policy objectives of equity and efficiency. It might also appear where tax policy is used to achieve economic objectives of growth and development through the use of tax incentives in order to influence investment, savings, the location of businesses, and the location of production or consumption. An illustration of the clash between the policy objectives of equity and efficiency is the use of a poll tax, which, even though viewed as being the most efficient form of tax, is clearly the most inequitable form of tax. An example of the use of the tax system to influence certain activity is the use of tax incentives to stimulate research in and development of intellectual property.<sup>99</sup> It therefore has to be acknowledged that the tax system will never be completely neutral but the general policy objective should be seen as trying to be as neutral as possible, with the exceptions to the neutrality principle being clearly articulated.

As with equity, the overall policy approach to neutrality depends on the relationships being compared and which one is chosen to be neutral. The ambiguity of having to choose between types of neutrality has been noted by Vogel who stated that the choice between types of neutrality infers that there is in fact no neutrality.<sup>100</sup>

---

<sup>97</sup> Bolnick (note 64) at 1–3.

<sup>98</sup> See Elkins (note 6) at 49 where the relation between economic efficiency and elasticity is discussed.

<sup>99</sup> For example, s 11B, s 11D and s 11(gA) of the Income Tax Act provide allowances for certain types of expenditure relating to research and development.

<sup>100</sup> Vogel *Intertax* Part II (note 13) at 313; see also Schindel et al (note 59) at 36; Vogel (note 78) at 5.

The two important approaches to neutrality consider neutrality between, on the one hand, persons who trade and invest in a given state, and on the other, between the residents of the given state. Where the chosen policy is neutrality between persons doing business in or investing in the same state (or territory), it is implemented by either imposing a tax on income where the source is located within that state, resulting in the income with a source located outside of that state being exempt in the hands of the residents, or by combining a residence basis of taxation with an exemption of income where the source is located outside the state of residence of the taxpayer.<sup>101</sup> This form of neutrality is referred to as capital import neutrality.

By contrast, the chosen policy may seek to have neutrality between the trade and investment activities undertaken by its residents, irrespective of whether those trade or investment activities are undertaken inside or outside a country's territorial jurisdiction. This form of neutrality emphasises the neutrality of the worldwide activities of taxpayers and seeks to ensure that all residents are subject to the same tax burden, irrespective of where the trade and investment activity takes place.<sup>102</sup> This form of neutrality, referred to as capital export neutrality, is implemented through imposing tax on residents of a country, irrespective of where the source of their income is located, combined with no tax being imposed by the country where

---

<sup>101</sup> On the assumption that losses and deductions in the source state are treated the same in both 'source-only' and 'residence plus- exemption', and are not taken into account in the residence state. See Vogel *Intertax* Part II (note 13) at 311. See also Schindel et al (note 59) at 35; Fadi Shaheen 'International Tax Neutrality: Reconsideration' (2007) 27 *Virginia Tax Review* 203 at 205; Reuven Avi-Yonah, 'Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113(7) *Harvard Law Review* 1573 at 1605. Katz Commission 5th Interim Report' (note 2) at para 3.1.2.2.

<sup>102</sup> See Krister Andersson 'An Economist's View on Source versus Residence Taxation. The Lisbon Objectives and Taxation in the European Union' (2006) 60 (10) *Bulletin for International Taxation* 395 at 395; Arthur J. Cockfield 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles' (2006) 56 (12) *Bulletin for International Taxation* 606 at 606; Shaheen (note 101) at 205; Avi-Yonah (note 101) at 1605.

the source of income is located.<sup>103</sup> It can also be implemented by imposing tax on the residents of a country irrespective of where their source of income is located combined with the country of residence providing a tax credit for the tax paid in the country where the source of the income was located.<sup>104</sup> A third way of implementing capital export neutrality is by all countries imposing tax only on income which has its source located within its territory combined with the same definition given to source and the same tax rates.<sup>105</sup>

In considering neutrality, during the period prior to democracy, the Margo Commission stated that:

Neutrality requires that people should not be influenced by the tax system to choose one course of action rather than another solely or predominantly because their tax position is better under one of the options. A neutral tax system is one which minimises as far as possible the impact of the tax structure on economic behaviour, including business organisation, work effort and saving.<sup>106</sup>

This statement does not reflect a chosen policy of neutrality but is a statement reflective of neutrality in general. Given that source was the jurisdictional link, the South African government policy with respect to cross border trade and investment was most likely to be reflective of capital import neutrality.

The application of source, its concomitant exemption method of relief, and capital import neutrality have been criticised on a number of grounds. One such criticism states that the concept of capital import neutrality is 'deeply rooted in the

---

<sup>103</sup> Schindel et al (note 59) at 35.

<sup>104</sup> Knoll (note 14) at 3; Vogel *Intertax* Part II (note 13) at 311; See also Hines (note 22) at 4; Katz Commission 5th Interim Report' (note 2) at para 3.1.2.2.

<sup>105</sup> Shaheen (note 101) at 205.

<sup>106</sup> Margo Commission (note 6) at para 4.4.2 p 50.

idea of a traditional unity of the state, territory and market, which has evaporated'.<sup>107</sup> Another criticism is the conflict between the use of source and capital import neutrality, on the one hand, and equity in the form of ability-to-pay, on the other. The conflict with ability-to-pay-equity arises because residents would not be subject to tax on their worldwide income and foreign income would not be taken into account in determining their tax liability. Musgrave also considered the source basis of taxation as interfering with inter-nation equity.<sup>108</sup>

Another concern raised with the use of capital import neutrality is more practical and relates to the differing tax rates, benefits and burdens of countries.<sup>109</sup> A taxpayer will, all other things being equal, choose to invest or undertake activity in a country where tax rates are lower rather than in a country with high tax rates if he knows that such income is to be exempt in his country of residence. A taxpayer is therefore unlikely to be neutral with respect to the country in which he chooses to invest but will probably invest in a country with lower tax rates. The result is, assuming an efficient market, an inefficient allocation of economic resources. Lastly, capital import neutrality is criticised on the basis that it 'presupposes a specific competitive situation between a domestic and foreign taxpayer'.<sup>110</sup> The example given by Schon, of a multinational company establishing a production site or a research and development centre in a given country 'in order to be located in a region where it can cater to the rest of the world and fend off competitors'<sup>111</sup> and not to

---

<sup>107</sup> Schon (note 10) at 81.

<sup>108</sup> Musgrave et al (note 2) at 568; See also Vogel *Intertax* Part II (note 13) at 313.

<sup>109</sup> Vogel *Intertax* Part II (note 13) at 312–314; Vogel *Intertax* Part III (note 5) at 398.

<sup>110</sup> Schon (note 10) at 81.

<sup>111</sup> *Ibid.*

primarily produce goods for customers in that location, illustrates that the competitive situation does not necessarily exist.<sup>112</sup>

On the other hand, the proponents of capital import neutrality argue that it provides parity in relation to third parties in a given country as they will be able to compete on equal grounds. In this way, it is argued that capital import neutrality would increase worldwide efficiency as competition in foreign countries would be on equal terms. Vogel however refers to the study of Horst which indicates that capital import neutrality would only result in world efficiency if it were assumed that the demand for capital were fixed and the supply thereof were varied.<sup>113</sup> Another advantage put forward by the proponents of the source-basis of taxation and capital import neutrality is that the use of source as the tax base reduces the risk of double taxation and, accordingly, the resultant complex and insufficient rules against double taxation are not required.<sup>114</sup>

Those in favour of capital export neutrality argue that it promotes national and international welfare because the taxpayer faces the same tax burden regardless of the location of his activity or investment.<sup>115</sup> They also argue that efficiency, defined as being the most productive allocation and use of the factors of production, is obtained internationally by means of worldwide taxation by the state of residence with the state of residence granting a credit for the tax imposed by the state of source.

---

<sup>112</sup> Ibid.

<sup>113</sup> Vogel *Intertax* Part II (note 13) at 312.

<sup>114</sup> Avi-Yonah (note 101) at 1606; Cockfield, Arthur J. *Examining Policy Options for the Taxation of Outbound Direct Investment* (September 1, 2008). Advisory Panel on Canada's System of International Taxation Research Report, September 2008. Available at SSRN: <http://ssrn.com/abstract=1456485>, last accessed 14 November 2012.

<sup>115</sup> Vogel (note 78) at 5; Cockfield (note 114) at para 2.3.3–2.3.4.

In addition, the harmful effect of double taxation is mitigated by the reduction of the tax burden in the state of residence.<sup>116</sup>

A criticism of capital export neutrality, similar to the criticism of capital import neutrality, is the effect of the differing tax rates on the use of the tax credit as the method of relief. If a full tax credit is provided with the differing tax rates, the application of capital export neutrality could result in the erosion of a country's tax base. A full tax credit applies when the resident state provides a credit for the full amount of direct tax paid in the source state.<sup>117</sup> Therefore, in order to prevent the erosion and subsidisation of the other country's tax revenue, most countries limit the credit. The limitation would normally be the amount of tax that would have been paid in the residence country, had the income arisen in the residence country. It limits the credit to that part of its own tax that is attributable to the income taxable in the source state. A resident would however not be neutral with respect to the location of the investment or undertaking if such a resident is allowed a limited tax credit as described above and the tax rate in the host country in which the source of the income is located, is higher than the tax rate in his country of residence. The tax liability of such a resident would be higher than that of his or her fellow residents. There would therefore be differential treatment between the given resident and other residents who face 'similar circumstances' in the country of residence. Of course, there would be neutrality with other residents who undertook the same foreign investments but as this is not the comparator for capital export neutrality, it does not assist in achieving neutrality.

---

<sup>116</sup> Vogel (note 2) at 1131.

<sup>117</sup> Vogel (note 2) at 1127; OECD MTC 2010 (note 19) at 309.

According to Vogel, the implementation of capital export neutrality through the use of the limited tax credit results in discrimination against direct investment<sup>118</sup> in low tax states, particularly developing countries, and results in ‘fiscal imperialism’.<sup>119</sup> The original intention of tax credit by the United States of America, as discussed in the United States Congress, was to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation.<sup>120</sup> The goal of the tax credit was to achieve equity for both the taxpayer and the state of source.<sup>121</sup> However the implementation of the limited tax credit potentially places the resident taxpayer operating in a foreign country at a competitive disadvantage.

Therefore,

... [t]he exemption method is based on the concept that the State in which items of income arise or in which items of capital are situated has a better right of taxation, and that the exempting State, therefore has to ‘give way’. In contrast, all that the credit method is designed to do is to mitigate an

---

<sup>118</sup> Direct investment is said to be investment through actual entrepreneurial activity and the establishment of an actual enterprise. It has four dimensions, namely, the transfer of capital, the control of investment, a source of funds for foreign operations and a balance of payments flow. It involves the transfer of capital from a source or home country to a host country with control of the management policy and decisions retained by the source or host country, and it is more than just a transient activity. The return to the investor is normally in the form of business profits but where direct investment takes the form of a company owning shares in another company for business reasons such as control of the company, the return will be in the form of dividend income. The return can also be in the form of interest and royalty income where the business requires a loan or where investment is made in the form of intellectual property. See Sadiq Kerrie ‘Unitary taxation – a case for global formulary apportionment’ (2001) 55 (7) *Bulletin for International Taxation* 275. See also Vogel *Intertax* Part II (note 13) at 310 where reference is made to the establishment of a complex of entrepreneurial activities in another country. See also Katz Commission 5th Interim Report (note 2) at para 3.1.1.2 which states that ‘[d]irect investment which related to active business is dictated more by real commercial factors and is therefore less mobile’ and at para 3.1.1.4 where it states that ‘... direct investment (referring to active income) ...’.

<sup>119</sup> Vogel (note 78) at 5. See also Schindel et al (note 59) at 36.

<sup>120</sup> Vogel (note 78) at 5 citing Graetz and O’Hear ‘The original intent of U.S. International Taxation’ 46 *Duke Law Journal* 1021 (1997) who in turn was citing Magill/Schaab ‘American Taxation of income earned abroad’ 13 *Tax Law Review* 115 (1958) at 118.

<sup>121</sup> *Ibid* at 6.

excessive burden considered unfair or economically harmful by reducing it to the level of taxation of the State giving credit.<sup>122</sup>

Another practical problem with the implementation of capital export neutrality is that there is often different treatment of foreign sourced income which is repatriated back to the residence country relative to foreign sourced income which is not repatriated.<sup>123</sup> In some countries, provision is made for the deferral of tax until the foreign sourced income is actually repatriated.<sup>124</sup>

A further concern with capital export neutrality is that, irrespective of their tax rates, countries have different benefits and burdens associated with those tax rates. Thus, although the tax paid by all residents of the country may be same, the benefit and support received in the countries from the tax may be different. If the tax rates are different, this may reflect the different benefits of the tax system and thus, although the resident taxpayers may be neutral with respect to the tax paid, they may not be neutral with respect to the benefits received. Consequently, although individuals and companies resident within the territory of the country may have similar pre-tax incomes, due to the different tax rates, structures, benefits and burdens in different countries, they are not necessarily in similar circumstances and facing the same tax burden when comparing domestic and foreign income. This is recognised by Vogel when he states that the reference base for neutrality is not the absence of taxes but the situation that would be achieved if there were no state

---

<sup>122</sup> Vogel *ibid.*

<sup>122</sup> Vogel, (note 2) at 1131.

<sup>123</sup> Hines (note 22) at 4 to 5; Cockfield (note 84) at 4.

<sup>124</sup> For example, according to Hines (note 22) at 4, the USA provides a deferral for non-repatriated foreign income. See also Angel Q. Yoingco, 'The Study Group on Asian Tax Administration and Research' (2004) 10 (4) *Asia-Pacific Tax Bulletin* 187 at 188 where it is stated that for Malaysia, Singapore and Thailand, income from abroad is taxable only if it is inwardly remitted.

influence, through benefits and burdens in a country.<sup>125</sup> These differences also illustrate the application of substantive as opposed to formal equality.

The discussion on neutrality indicates that capital import neutrality and capital export neutrality may be difficult to achieve and that the implementation of either of them is problematic. Given that a choice has to be made – how is this choice to be exercised? Vogel is of the opinion that if there is to be a basic distinction between these types of neutrality, preference should be given to capital import neutrality as it makes provision for individuals and companies in a similar situation (same territory facing the same concerns) to be treated similarly.<sup>126</sup>

#### **2.4.1 Pre-democracy neutrality**

On the face of it, the imposition of tax only when the source of income was located in South Africa was indicative of capital import neutrality for South African residents. This should have had the effect of making South African offshore investments competitive. This statement presupposes the existence of offshore investments. Given exchange control restrictions and the possibility that South Africa's inhabitants might not have had large amounts of offshore investments, neutrality might not have played a major role as a policy objective. As a capital-importing country, the neutrality principle applicable to be considered relates to inward investments and making South Africa an attractive investment location for both resident and non-resident investors. But this is not under the control of the South African authorities.

---

<sup>125</sup> Vogel *Intertax* Part II (note 13) at 314.

<sup>126</sup> *Ibid* at 313.

## 2.5 Source and residence as jurisdictional links

In considering the methods used to relieve international double taxation in the light of the two policy principles of equity and neutrality, it is clear that ability-to-pay equity and capital export neutrality are implemented by combining the imposition of tax on all who qualify as residents of a given country, irrespective of the location of the source of their income, with a tax credit as the chosen method to relieve international double taxation.<sup>127</sup> By contrast, the benefit principle of equity and capital import neutrality is implemented by imposing tax only on income which has its source located in a country. This results in the exemption of income which does not have its source located in that given country.<sup>128</sup>

In practice, most countries impose tax on both the worldwide income of their residents and on non-residents where the source of non-residents' income is located within that country.<sup>129</sup> Thus a hybrid basis of both source and residence is generally used, which in itself compromises the application of a particular form of equity and neutrality.

Where tax is imposed on income by both the resident and source country, the country of residence usually provides relief for such double taxation. As indicated in the discussions on equity and neutrality, the type of relief provided depends on the

---

<sup>127</sup> See Vogel (note 2) at 14; Graetz (note 66); Harris (note 4) at 319 where he states that 'The foreign tax credit supports capital export neutrality. It is suggested that a worldwide efficient allocation of resources is achieved if residents pay the same amount of tax no matter where they invest'.

<sup>128</sup> See Cockfield (note 114) at 7–8; Vogel (note 2) at 14, Harris (note 4) at 319 where he states that 'Exemption of foreign source income by residence countries supports capital import neutrality. It is suggested that a worldwide efficient allocation of resources is achieved when all enterprises operating in a particular country are taxed with respect income derived from that country at the same rate irrespective of their residence'. See also Kaufman (note 8).

<sup>129</sup> Vogel *Intertax* Part I (note 87) at 217; Cockfield (note 114) at 4–5.

policy relating to cross border trade and investment.<sup>130</sup> For example, whether or not the exemption, credit method or deduction method is used to grant relief from double taxation could depend on the policy of the particular country to encourage or discourage foreign investment by its resident taxpayers. If a country's policy is to encourage outward investment of residents and to ensure that its residents are able to compete on the same basis as others in that foreign territory, then the exemption method is used as a method of relief. This is seen as encouragement for the expansion of the residents' businesses and should be the case for capital exporting countries. However, if the intention is to encourage local investment by residents and discourage overseas expansion, residence coupled with the credit method is the most appropriate. This would only apply in the event that the tax rates, structure and benefits differ between countries and, in particular, if the tax rate in the country of residence is higher than that of the country of source. Two further factors which may affect the policy is whether income, in general, is taxed on a receipt or accrual basis and whether foreign sourced income is taxed when it is actually received in or remitted to the country of residence.

Despite academic arguments with respect to the preferred choice of jurisdictional link and method of relief, the residence basis of taxation, coupled with

---

<sup>130</sup> See Cockfield (note 84) at 12–13 where reference is made to the lack of agreement on the guiding principles with respect to efficiency and that the choice between capital import and capital export neutrality leads to different and opposing policy proposals. See also Vogel (note 2) at 1131 and 1132.

a credit is most used, reflecting a policy choice of ability-to-pay and capital export neutrality for the residents of a country.<sup>131</sup>

The following reasons, some of which are policy based while others are more pragmatic, are given by Ring as the basis for using residence as a jurisdictional link:

(1) It best reflects ability-to-pay because the taxing state can readily base its taxation on the entirety of the taxpayer's income and have an accurate sense of the taxpayer's fiscal picture. (2) Income 'belongs' to people not places (source). (3) People are less mobile than activities. (4) The source approach would put tremendous pressure on the definition of source.<sup>132</sup>

By contrast, the reasons for preferring source are:

(1) The source country provides the infrastructure permitting the creation of the income; (the Benefits principle). (2) The source country may be aware of the income's existence and hence better able to capture the tax. (3) The source country *can* tax it.<sup>133</sup>

The importance and role of the meaning and interpretation of both residence and source should not be underestimated as they play a role in determining the tax base of a particular country.<sup>134</sup> They also affect the taxpayer to whom relief applies, meaning who gets the relief, as well as the relevant form of relief. If different countries have different definitions and interpretations of source and residence, neutrality and equity are compromised when attempting to consider neutrality in

---

<sup>131</sup> See Cockfield (note 114); Olivier et al 2011 (note 14) at 20 states that 'Residence as a basis of taxation is usually adopted by developed and net capital importing countries'. See also Vogel *Intertax* Part 1 (note 87) at 216 where he states that 'It has been taken for granted much too long that income taxes should be based on residence (or on citizenship ...) and, in addition, on source' and at 217, 'Most countries certainly, tax resident individuals and corporations with respect to their worldwide income and some even tax the worldwide income of citizens as well'; Vogel (note 2) at 14 where he states that 'The predominant view is that the best possible efficiency in allocation is obtainable by worldwide taxation in the state of residence and credit being allowed there for tax imposed by the state of source'.

<sup>132</sup> Diane Ring 'International Tax Relations: Theory and Implications' (2007) 60 *Tax Law Review* 83 at 117. See also Schindel et al (note 59) at 31.

<sup>133</sup> Ibid. See also Schindel *ibid*.

<sup>134</sup> See Vogel *Intertax* Part I (note 87).

relation to residents and non-residents. The only certainty then is the neutrality with respect to residents of one country. Thus, not only do the tax rates, benefits and the relevant support play a role with respect to whether there is actual equity and neutrality but the specific country's interpretation of source and residence also play a role. Furthermore, the interpretations given to source and residence affect the need to provide relief for international double taxation and, in particular, when and in what circumstances relief would be required.

Given the apparent international acceptance of residence as the most appropriate jurisdictional link, with source only applying in certain circumstances, it is appropriate to consider what is meant by residence and source both in the international and South African context. Residence only really gained importance in South Africa during the transition period. The interpretation and meaning of residence are discussed in Chapters Three and Four. The interpretation and application of source in the pre-democracy period affected the exemption of income where the source of such income was not located in South Africa and thus affected the apparent applicable policies of the benefit principle of equity and capital import neutrality.

### ***2.5.1 Source or territorial?***

One of the criticisms of source is that its meaning and interpretation differ between countries.<sup>135</sup> As indicated by Vogel, source is not a uniform concept and it has different meanings,<sup>136</sup> with countries having both actual and deemed source rules.<sup>137</sup>

---

<sup>135</sup> Vogel *Intertax* Part I (note 87) at 217; 223–229.

<sup>136</sup> Vogel *Intertax* Part I (note 87) at 223.

The result of having these different meanings is that the use of source as a method to achieve equity and efficiency is undermined. It is submitted that that may mean that residence is a better choice as there is uniform international interpretation of residence.<sup>138</sup> As is seen later, this claim in respect of the meaning of residence is not necessarily correct.

According to Vogel, whether the source basis of taxation enhances or inhibits economic efficiency, and whether or not it is more equitable than worldwide taxation, can be answered only if agreement is reached on the meaning of source.<sup>139</sup> The problem with source as used by many countries is that it is based on a deemed or artificial version of source and not on source as being the originating cause of the income. For example, in certain jurisdictions the source of income is the place where the contract is entered into, where the sale is effected or where the sale takes place.<sup>140</sup> All of these are artificial as they do not look to the 'originating cause' nor locate the origin of the income.<sup>141</sup> The use of this artificial notion of source detracts from source being the proxy for the benefit principle of equity and capital import

---

<sup>137</sup> For different source rules, see Vogel *Intertax* Part I (note 87) at 226–228, Hugh Ault and Brian J. Arnold *Comparative Income Taxation: A Structural Analysis* 3ed (2010) The Netherlands : Kluwer Law International at 495–521, Schindel et al (note 59) at 73–78.

<sup>138</sup> This statement is made in relation to one of the disadvantages of source as stated by Ring (note 132), namely that a 'source approach would put tremendous pressure on the definition of source' which implies that the definition of residence is more uniformly applied.

<sup>139</sup> Vogel *Intertax* Part I (note 87) at 223.

<sup>140</sup> Vogel *Intertax* Part I (note 87) at 226–227.

<sup>141</sup> See Kemmeren (note 77). Kemmeren's interpretation of source is linked to the principle of origin. According to him source is linked to the utilisation of the income and the place where the factors of production are used. Thus the source of income for income tax is located by finding the origin of the income, and the source of income for capital taxes is located by finding the economic location of the capital. The difference between source and origin is that in source the causal relationship between the production of income and the territory is of minor importance whereas for origin, it has predominant importance. The principle of origin is related to taxation based on economic allegiance which looks at the direct benefit principle of equity and the production of wealth. See also Schindel et al (note 59) at 84–87.

neutrality and potentially breaks the link between source and the exemption method used to relieve international double taxation. A uniform approach to source which would reflect the benefit principle of equity and ensure capital import neutrality if used by all countries, has been proposed by Kemmeren.<sup>142</sup> Kemmeren's concept of source looks to the location of the origin of the income.<sup>143</sup> Vogel's concept of source is the connection between the state and the production of the income.<sup>144</sup> Similarly, the Musgraves' definition of source is the place of income-generating activity.<sup>145</sup> The aforesaid discussion shows that for the application of the source principle to secure neutrality, the meaning of source in South Africa must be consistent with its meaning in other countries.

Both Kemmeren and Vogel's concepts of source appear to be reflected in the South African judicial interpretation of source. Up until 2012, the meaning and location of the source of income in South African domestic law was not defined in the Income Tax Act and, except for a few deeming source provisions, had largely been determined by the courts.<sup>146</sup> The most important and influential case dealing with source is *CIR v Lever Bros*,<sup>147</sup> a pre-democracy case which sets out the basic principles relating to 'originating cause' in determining the source of income. The court held that the location of the source of income is determined by firstly ascertaining the originating cause of that income and then locating the originating

---

<sup>142</sup> Kemmeren (note 77).

<sup>143</sup> Kemmeren (note 77) at 431.

<sup>144</sup> Vogel *Intertax* Part I (note 87) at 223.

<sup>145</sup> Vogel *Intertax* Part I (note 87) at 223; Musgrave et al (note 2) at 568.

<sup>146</sup> With effect from years of assessment commencing on 1 January 2012, s 9 of the Income Tax Act introduced specific provisions for the source of, *inter alia*, interest, royalty and dividend income. This amendment to s 9 was introduced by the Taxation Laws Amendment Act No. 24 of 2011.

<sup>147</sup> *CIR v Lever Bros* 1946 AD 441; 14 SATC 1.

cause.<sup>148</sup> It further stated that the source of income is not the ‘quarter whence it comes’.<sup>149</sup> The application of the *Lever Bros* ratio has meant that the source of income for business income is located at its originating cause, being the activities undertaken by the taxpayer to produce the relevant income.<sup>150</sup> Except for dividend income and income from immovable property, the activities test applies to other forms of passive income<sup>151</sup> as well. For interest income, the Supreme Court of Appeal in *First National Bank*<sup>152</sup> placed emphasis on the activities of First National Bank, the taxpayer and, in particular, what it termed the ‘factual matrix’ in order to determine the originating cause and its location. With respect to dividend income, the courts have applied property rules,<sup>153</sup> and for royalty income, the courts have looked at the place where the taxpayer applied his or her mind.<sup>154</sup> As indicated earlier, the source rules for, *inter alia*, dividend income, interest income and royalty income have, with effect from years of assessment commencing on 1 January 2012, largely been legislated. The amended s 9 of the Income Tax Act effectively codifies the location of the source of the aforesaid categories of income.<sup>155</sup>

---

<sup>148</sup> *Lever Bros* ibid at 8.

<sup>149</sup> Ibid.

<sup>150</sup> See also *Commissioner for Inland Revenue v Epstein* 1954 (3) SA 689 (A); 19 SATC 221.

<sup>151</sup> Schindel et al (note 59) at 52 where it is stated that passive income ‘does not necessarily require a defined presence by the investor, either direct or portfolio investment, in the source country’. Passive income would also include royalties and interest income, which does not involve direct or portfolio investment.

<sup>152</sup> *First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Service* 64 SATC 245.

<sup>153</sup> *Boyd v Commissioner for Inland Revenue* 1951 (3) SA 525 (A).

<sup>154</sup> *Millin v Commissioner for Inland Revenue* 1928 AD 207, 3 SATC 170.

<sup>155</sup> The s 9 source provisions are discussed in paragraph 4.4.1 of Chapter Four on p 184–186 of this thesis.

### ***2.5.2 Distinction between source and threshold requirement***

Another consideration in the discussion of source is the distinction, if any, between the concepts of threshold requirement and source insofar as source is concerned with ‘what gives rise to the income’, whereas a threshold provides an ‘in’ and then looks to what gives rise to the income.<sup>156</sup> Thresholds, which are often used to justify source country taxation, include having a fixed place of business, or a certain level of physical presence, or deriving a certain level of income from, or having a certain level of business activity in the country. Once the threshold requirement is met, the next step to consider is the income that the host country is entitled to tax, in other words, what income should be attributed to the host or source country. The possibilities include any income generated by the relevant business activities, any related income, and any income derived from the country, whether or not related to the relevant business activities. One example of a threshold requirement is that of the ‘permanent establishment’ concept found in Article 5 of the OECD and UN MTCs.<sup>157</sup> The country where the permanent establishment is situated is entitled to tax income attributable to the profits from that permanent establishment and to determine the method used to attribute such profits.<sup>158</sup> Another example of a threshold requirement is found in controlled foreign company provisions, for example, s 9D of the Income Tax Act which limits the taxation of a participant in a controlled foreign

---

<sup>156</sup> See Brian Arnold, ‘Threshold requirements for Taxing Business profits under Tax Treaties’ (2003) 57 (10) *Bulletin for International Taxation* 476.

<sup>157</sup> OECD MTC 2010 (note 19); United Nations Model Tax Convention between Developed and Developing Countries New York: United Nations (2001). Available at <http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf>, last accessed 21 November 2012; United Nations Model Tax Convention between Developed and Developing Countries New York: United Nations (2011) Available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf), last accessed 21 November 2012. (Hereinafter jointly referred to as the ‘UN MTC’)

<sup>158</sup> Article 7 of the OECD MTC 2010 (note 19); Article 7 of the UN MTC (note 157).

company in South Africa where such controlled foreign company has a 'foreign business establishment' in its country of residence.<sup>159</sup>

According to the 1980 International Fiscal Association congress, the source rules applicable to business and interest income, are dependent on, *inter alia*, whether a country's approach is based on a common law or continental approach.<sup>160</sup> The central or continental European approach is based on the 19<sup>th</sup> century German and Austrian approach which allocated business profit through the use of the permanent establishment concept, and was followed by other continental European countries.<sup>161</sup> The income attributable to the permanent establishment was determined by treating the permanent establishment as if it were an independent enterprise. Given the continental approach which is different from the common law approach applied by the South African courts, and also taking into account the various South African deeming source provisions, it is evident that the South African source rules differ from those of other countries. The result is that, although on the face of it South Africa's policy goal may have been capital import neutrality for its residents, due to the different source rules applied in South Africa and in the host country, South African residents could either have had the advantage of not being taxed at all (double non-taxation) or have been at a disadvantage and suffered from double taxation resulting from conflicting source definitions, with no double taxation relief. The application of the South African source rules did not automatically result in the

---

<sup>159</sup> See s 9D(7).

<sup>160</sup> As stated in Vogel *Intertax* Part I (note 87) at 226.

<sup>161</sup> *Ibid* at 226 and 229.

exemption of income earned offshore. Therefore it did not always achieve the objective of capital import neutrality for its residents.

## **2.6 Comparison of categories**

The above discussion on equity and neutrality indicates that if one were to ignore the exchange control and closed economy approach of pre-democracy South Africa, the policy approach reflected in the pre-democracy period with respect to equity and neutrality is the benefit principle and capital import neutrality respectively. However, the exemption method of relief for double taxation was not always applied because of the particular interpretation of the concept of source and the application of the deemed source rules, which implies that the approach was not always consistent to achieve the objectives. In order to complete the analysis of the particular approach to equity and neutrality, the following categories of income, including the different legal forms are compared:

- outward trade and investment by South African residents (where the source of the income of the South African resident was not located in South Africa) with local trade and investment by South African residents (where the source of the income of the South African resident was located in South Africa);
- outward trade and investment by South African residents (where the source of the income of the South African resident was not located in South Africa but located in a host country) with non-South African resident investors and traders in the host country; and

- inward trade and investment of non-South African residents (where the source of the income of a non-South African resident was located in South Africa) with local trade and investment by South African residents (where the South African residents' source of income was located in South Africa).

## **2.7 Outward South African resident trade and investment: local South African resident trade and investment**

### **2.7.1 Residence**

Because residence in the context of worldwide taxation was not defined in the Income Tax Act prior to democracy, it is somewhat contrived to draw a comparison between South African residents whose source of income was located in South Africa and those whose source was located outside South Africa. The provisions which deemed the source of certain categories of income to be located in South Africa, used the concepts of 'ordinary resident' for natural persons and 'domestic companies' for other persons.<sup>162</sup> If a broad interpretation is given to residence (to include all natural and artificial entities which have an economic link to South Africa), then a difference between those residents whose source of income was located in South Africa and those whose income was not, emerges. A superficial difference arises as a result of the different tax rates which were imposed on the income. For example, the tax imposed and paid by residents whose source of income

---

<sup>162</sup> The relevant sections prior to the amendments by the Income Tax Act No.28 of 1997 were s 9(2) and s 9(3). Section 9(2), deemed interest accrued to any person ordinarily resident or accrued to a domestic company in respect of a loan to, deposit in any Building Society, Mutual Building Society or similar institution wheresoever incorporated, formed or established to be from a South African source while s 9(3), as it read at the time, deemed interest received by or accrued to a person ordinarily resident or accrued to a domestic company in respect of a loan, deposit in any banking institution to be from a South African source. Section 9(2)(c) deemed the income from ships and aircraft to be from a South African source if carried on by South African residents or domestic companies.

was not located in South Africa could have been less or more than the tax imposed and paid by those residents whose source of income was located in South Africa. The tax imposed and paid was higher where the South African tax rates were lower than the host country rates and it was less where the South African rates were higher. This differential gave rise to tax planning opportunities for taxpayers, particularly with the use of progressive tax rates for individual taxpayers. Of course, if all the countries with which South Africa was trading, or in which South African residents had investments, had applied a source basis of taxation with a similar tax rate and a similar definition of source, then the problem with respect to different forms of equity and neutrality applying to South African residents would not have arisen (that is, capital import neutrality and the benefit principle would have applied to all) and tax planning through the use of source would not have arisen.

Given that source was not the chosen jurisdictional link of South Africa's trading partners and that tax rates and the definition of source were certainly different, the system could not have achieved its objectives. On the contrary, the system allowed the scenario where the income was neither regarded as sourced in South Africa nor in the host country, which made it attractive for residents to transfer income offshore, especially passive income. Such practices may have flourished if South Africa did not have a closed economy with strict exchange control at the time. Therefore, after democracy and the gradual lifting of exchange controls, the need for anti tax-avoidance measures became evident.

### **2.7.2 Exemption method of relief**

Under a pure source basis of taxation, the exemption method of relief for international double taxation is a consequence of using source as a jurisdictional link.

This also means that the form of the exemption method would be automatic, that is, the full exemption method as opposed to the exemption by progression would apply. The use of the full exemption did not alleviate the potential inequity between those who earned income from a source located in South Africa and those whose source of income was not located in South Africa.

Instead of applying the full exemption of relief for the income of residents whose source of income is not located within its jurisdiction, certain countries implement capital import neutrality through the use of ‘exemption with progression’. Exemption with progression applies when the foreign sourced income of a resident is not taxed in the resident state but is taken into account to determine the tax rate to be applied to the resident’s income.<sup>163</sup> This method of exemption was never used in South Africa – if it had, it would perhaps have relieved the perceived inequity of not taxing the foreign sourced income of South African residents.

With respect to neutrality, the use of source should have meant that South African outward trade and investments were competitive in the host country of

---

<sup>163</sup> Vogel (note 2) at 28. See also Ault et al (note 137) at 467 where it is stated that ‘One approach (exemption with progression) is to calculate the tax liability that would have resulted if the income had been included and then apply the resulting rate of tax to the included income’. Olivier et al 2011 (note 14) at 444; IBFD Glossary (note 19) where it states that ‘The exemption generally takes one of two forms, i.e. a complete exclusion of the income or capital from the tax base, or recognition of the income or capital solely for determining the taxation of the remaining income or capital. The latter method, often referred to as “exemption with progression”, is generally effected by way of a proportional reduction of tax on total income or capital to reflect the exempt income or capital, i.e. in the ratio that exempt income or capital bears to total income or capital. In cases of progressive tax rates the effect is to exempt the income or capital in question at the average rate of tax on total income or capital. Where the remaining income is negative, the effect of exemption with progression can be a reduction of losses that would otherwise have been available, e.g. for carry-forward. In practice although countries often exempt positive foreign income, foreign losses are in many cases deductible. Variations on this theme may include exemption “at the top”, whereby the exempt income is treated as being the top slice of taxable income so that the relief is given at the marginal rate, or exemption “at the bottom”, whereby the exempt income is treated as being the first slice of taxable income so that relief is given at the lowest progressive rate.’

investment and, further, that for South African outward investment, neutrality in the form of capital import neutrality applied in the host country. Given the closed economy, this aspect of choosing source was not a consideration as this was not direct policy.

### **2.7.3 Legal form: Branch versus subsidiary**

In considering the impact of the source basis of taxation on foreign investment and trade, the legal form of outward trade and investment should be taken into account. A distinction can be drawn between trade and investment done through a branch of the South African resident as opposed to through a foreign subsidiary of that South African resident. Whereas the legal form through which the trade and investment is conducted may differ, the economic substance may be the same. As South Africa follows the legal form with respect to group company arrangements, the difference in the legal form results in a different category of income being paid and tax being imposed on that different form of income.

Under a pure source basis of taxation, where the legal form of outward trade and investment was the establishment of a foreign branch of a South African resident trader and investor, the profits of that foreign branch were exempt from tax in South Africa provided that the source of income of the branch was not located in South Africa. Similarly losses suffered by the foreign branch were not taken into account in determining the company's taxable income. The fact that the company itself was tax resident in South Africa made no difference for the taxation of the business profits of that branch. By contrast, the profits of a South African resident company which were derived from a South African source through a local division which operated in a separate location from the head office were taxed on the full amount of that income.

When comparing the income of the latter South African resident business with the source of all its income located in South Africa with that of the South African resident company with a portion of its income originating from a source located outside South Africa, it shows that there is no equity on the basis of ability-to-pay for these two South African residents. On the other hand, the foreign branches of such residents were able to compete on the same basis as its host country counterparts, resulting in capital import neutrality in that host country. Likewise, tax was also not imposed on the business income of the foreign subsidiary of a South African resident company or a foreign company with South African shareholders if the source of that business income was not located in South Africa. As the non-South African sourced business profits of both a foreign subsidiary and a foreign branch was not taxed in South Africa under a pure source basis of taxation, the legal form of outward trade and investment was neutral with respect to business profits income insofar as the legal form did not affect the tax liability in South Africa.

#### **2.7.4 Dividend income**

The tax treatment of dividend income, in the context of the location of the source of dividend income, developed largely as a result of the *ratio* in *Boyd v CIR*.<sup>164</sup> The decision in *Boyd* brought certainty to the question as to whether the source of dividend income was located at the same place as the source of the company's profits or at the location of the share register. The court held that the latter location was the source of dividend income.<sup>165</sup> As a result of the decision in *Boyd*, tax was imposed on the full dividend derived from a company registered in South Africa, irrespective

---

<sup>164</sup> *Boyd* (note 153).

<sup>165</sup> *Ibid* at 533.

of the source of its business profits. The court gave two grounds for the source of dividend income being located in South Africa. The first ground was that the share is property which is evidenced by the share register. It is the share as property that gives rise to dividend income<sup>166</sup> and, as in the case of property, the location of the source of dividend income has to be located where the property is located, namely at the share register.

The second ground given by the court was the source of the payment of the dividend being viewed as a debt owed by a company situated in South Africa.<sup>167</sup> The court rejected the place of business of the company as the origin of the dividend income.<sup>168</sup> The result was that where a South African registered company had the source of its business income located outside South Africa, the business income of the company was exempt from tax in South Africa but the dividend was taxed in South Africa, as the source of the dividend income was located in South Africa. The result of this judgement also meant that where a South African resident company (resident through incorporation) located its share register out of South Africa, the dividend income was exempt from tax in South Africa, irrespective of whether or not the source of the business profits was taxed in South Africa.

In 1955, to prevent the use of tax-avoidance schemes by South African residents' outward investment, where neither the source of dividend nor business income was located in South Africa, a 'supertax' was imposed on dividend income received by an individual ordinarily resident in South Africa, irrespective of whether

---

<sup>166</sup> Ibid at 533.

<sup>167</sup> Ibid at 534.

<sup>168</sup> Ibid at 533.

the source of the dividend income was located in or out of South Africa.<sup>169</sup> This taxation of income which had its source located outside South Africa was a departure from the source principle. It also differed from the other provisions which deemed the source of certain income to be located in South Africa. This is because the other source deeming provisions in the Income Tax Act provided ‘a definite link between the Union and the source of the income whereas the foreign source dividend deeming provision did not do so’.<sup>170</sup> As stated in the *Taxpayer* at the time, the taxation of foreign sourced dividend income placed the taxpayer who invested in shares at a disadvantage in comparison to other types of investment income, in particular to other types of foreign sourced investment income.<sup>171</sup>

Because this deeming source provision applied only to shareholders who were natural persons, this tax was only imposed on natural persons who received or were entitled to foreign sourced dividend income. By contrast, the foreign sourced dividend income of companies was exempt. It could be said that a different form of equity and neutrality for dividend income was applied to natural person and corporate persons and it could potentially have affected the choice of business form for outward investments of South African residents.

The treatment of foreign sourced dividend income differed from other categories of income both in terms of the method of relief being provided for such

---

<sup>169</sup> By Act No. 43 of 1955. See Editor, ‘Taxing Dividends from Non-Union Sources’ (1955) 4 *The Taxpayer* 141 at 141; Editor, ‘Plugging the holes’ (1955) 4 *The Taxpayer* 61 at 63.

<sup>170</sup> Editor, Taxing Dividends from Non-Union Sources (note 169) at 141; Editor, ‘Taxation of Foreign Dividends’ (1961) 10 *The Taxpayer* 81 at 81.

<sup>171</sup> Editor, Plugging the holes (note 169) at 63; Editor ‘Taxation of Foreign Dividends: Credit in respect of Foreign Taxes payable’ (1955) 4 *The Taxpayer* 151 at 151.

income and in terms of the legal form of the person receiving or being entitled to such income. This differential treatment of dividend income resulted in a different policy approach to equity and neutrality for dividend income as compared to other forms of foreign sourced income.

The policy approach to foreign sourced dividend income, as a result of a somewhat limited version of residence – by the use of ‘ordinarily resident’ as the test for the residence in terms of the deeming provision – applying to foreign sourced dividend income, was determined by the method of relief provided in the event of international double taxation. The South African resident shareholder was potentially subject to both juridical and economic international double taxation. Juridical international double taxation arose when tax was imposed on the dividend income in the hands of the South African resident in South Africa and in the country of residence of the distributing company. Economic international double taxation arose where the profits from which the dividend was declared was taxed in the hands of the declaring company and the dividend was taxed separately in the hands of the shareholder.

The Income Tax Act provided two forms of relief for these foreign dividend recipient taxpayers. A limited tax credit was provided to individuals upon whom tax was imposed both in South Africa and in the resident country of the company distributing the dividends.<sup>172</sup> However, no relief was provided for economic double

---

<sup>172</sup> A credit was given for any foreign tax paid or payable on dividends from sources outside the Union included in the taxpayer’s income where the dividend was subject to supertax in terms of the proviso to s 7(g)*bis* of the Income Tax Act as authorised by s 29(1)(c) of the Income Tax Act. See also Editor (note 171) at 151.

taxation of the taxpayer, that is, no relief was granted for the underlying corporate tax imposed on the company which declared the dividend. Certain categories of foreign sourced dividend income were exempt from tax, which assisted taxpayers who became or ceased to be 'ordinarily resident' in South Africa. This exemption included the estates of persons who at death were not ordinarily resident in the Union as well as dividends received by persons who acquired the shares before they became ordinarily resident in the Union or out of funds they possessed before becoming ordinarily resident. Dividends declared by Namibian (formerly South West African) companies which satisfied certain requirements were also exempt from tax in the hands of the South African shareholder who was 'ordinarily resident' in South Africa.

The result was a residence basis of taxation for the foreign sourced dividend income of natural persons resident in South African with relief generally being a tax credit. As indicated earlier, this form of limited residence basis differentiated between South African taxpayers on the basis that the limitation of residence applied only to individuals 'ordinarily resident' in South Africa and only to a certain category of income. A further differentiation resulted from the provision not distinguishing between dividend income received from foreign direct investment or portfolio investment,<sup>173</sup> except perhaps for the assumption that foreign direct

---

<sup>173</sup> Portfolio investment is made purely for the purpose of investing money without the establishment of an enterprise or without entrepreneurial investment. It usually entails investing in passive investment instruments such as shares or bonds (loans) with passive income in the form of dividends and interest respectively. The return can also be in the form of royalty income. See Vogel *Intertax* Part II (note 13) at 315. In other words, it is in the form of either granting a loan or acquiring a share of equity capital in an enterprise in the foreign country without the involvement of the investor in the entrepreneurial activity and without obtaining control over the investment. See also Olivier et al 2011 (note 14) at 558.

investment was in the form of a South African resident parent company with a foreign incorporated subsidiary as opposed to an individual owning shares and controlling the company. Furthermore, the residence basis of taxation of foreign sourced dividend income was criticised on the basis that it was not introduced on the grounds of principle but as a means of combating tax avoidance.<sup>174</sup> It was stated that as ‘long as the basis of our tax system is source and not residence no good reason exists either in equity or expediency for such discrimination’.<sup>175</sup> In order to keep the source basis of taxation, it was suggested that a provision be inserted which would exclude the foreign sourced dividend income from ‘supertax’ where the company paying the dividend income did not ‘earn their profits from Union sources’,<sup>176</sup> thus going back to the pre-*Boyd* judgment.<sup>177</sup>

The need to combat tax avoidance as a result of the judgment in *Boyd* meant that a limited residence basis of taxation was introduced which in turn required the introduction of a method to relieve international double taxation. The choice of a limited foreign credit as the method of relief meant that the benefit principle of equity, the principle which for all purposes was the chosen equity principle applicable in South Africa at the time, no longer applied to taxpayers who received foreign sourced dividend income. Instead it could be argued that ability-to-pay equity applied to these taxpayers, which would indicate a diversion from the norm in South Africa at that time. The choice of the limited tax credit also affected the neutrality considerations as South African individual taxpayers were no longer neutral between

---

<sup>174</sup> Editor, ‘Taxation of Foreign Dividends’ (1956) 5 *The Taxpayer* 25.

<sup>175</sup> *Ibid* at 26.

<sup>176</sup> Editor, Plugging the holes (note 169) at 63.

<sup>177</sup> *Boyd* (note 153).

receiving dividend income which had its source located in South Africa and dividend income which had its source located outside South Africa.

Supertax was abolished in 1960 and with it the relevant tax credit was repealed.<sup>178</sup> However, foreign sourced dividend income was still included in the specific deeming provision of 'gross income' and was subject to normal tax. Although the Income Tax Act provided for the exemption of dividend income, these exemptions were primarily intended to eliminate economic double taxation where both the distributing company and the shareholder potentially would pay tax in South African on the distributed dividend income.<sup>179</sup> In other words, the exemptions were limited largely to South African companies who distributed dividends to their South African shareholders. The Income Tax Act did not make specific provision to relieve South African resident shareholders who received or were entitled to foreign sourced dividend income from either juridical or economic double taxation.<sup>180</sup>

In 1962 a consolidated Income Tax Act was introduced which is still the current Income Tax Act, Act No.58 of 1962. Paragraph (*k*) of the definition of 'gross income' in the 1962 Income Tax Act, read with the income exemptions, retained the element of residence for foreign sourced dividend income through the use of

---

<sup>178</sup> Editor 'Tax credits on foreign dividends' (1965) 14 *The Taxpayer* 18.

<sup>179</sup> Section 10(1)(*k*) of the Income Tax Act provided the relevant exemptions.

<sup>180</sup> Editor (note 170) at 82.

deeming source provisions.<sup>181</sup> Following the structure of the earlier ‘supertax’ deeming provisions, the 1962 Income Tax Act provisions deemed the foreign sourced dividend income, received by or accruing to individuals ordinarily resident in South Africa, to have been received by and accrued to such person from a South African source. Thus, for persons other than companies and for foreign sourced dividend income, tax was imposed on the basis of residency where residency was defined as ‘ordinarily resident’. Foreign sourced dividend income received by or accrued to companies was exempt from tax in South Africa whereas if received by individuals it was taxed. One could construe this as being an indication of the difference between direct foreign investment by South African companies, which was exempt, and portfolio investment by individuals, which was taxed. This meant that if a South African parent company had a foreign subsidiary, the dividend income it received from that foreign subsidiary was not included in its taxable income.

---

<sup>181</sup> In terms of the paragraph (k) of the definition of ‘gross incomes’ in s 1 of the Income Tax Act, foreign dividends are specifically included in ‘gross income’. The relevant wording of paragraph (k) at the time read as follows: ‘any amount received or accrued by way of dividend, including ... for the purposes of this paragraph all dividends from sources outside the Republic received by or accrued to any person (other than a company) who is ordinarily resident in the Republic shall be deemed to have been received by or to have accrued to such person from a source within the Republic’. Where dividend income did fall into ‘gross income’, s 10(1)(k) of the Income Tax Act exempted certain categories of dividend income. In particular, dividend income was exempt if it was received by or accrued to, *inter alia*:

- companies, except where the dividends (other than those distributed out of profit of a capital nature) was distributed by a fixed property company (as defined),
- persons (other than companies), not ordinarily resident nor carrying on business in South Africa or persons (other than companies) who were ordinarily resident, where the dividend was received from companies not registered in South Africa, where the dividend was distributed out of the profits of the company which were previously assessed in South West Africa either under taxable income or income subject to super tax and foreign -sourced dividends where the non company shareholder acquired the shares prior to becoming ordinarily resident in South Africa or acquired the shares with funds derived from trade carried on outside South Africa.

The South African resident company shareholder was therefore relieved from both juridical and economic double taxation. By contrast, the South African resident natural person shareholder did not receive such relief. The legal form of the foreign trader or investor therefore was not neutral and its equity could also be challenged. The different tax treatment of an individual shareholder relative to a company shareholder was most likely based on the view that tax should not be imposed on companies as companies are simply conduits and that the tax should be borne by the individual receiving the dividend income. This does presuppose that if tax is imposed on a company, as an anti tax-avoidance measure, relief will be provided for the shareholder at the time when the income is distributed in the form of a dividend. In a cross border situation, where the distributing company and the recipient shareholder are located in different countries, this creates a problem with respect to which country should be able to impose tax on that distributed income and which country should provide relief for economic double taxation.

Economic double taxation results from the company/shareholder distinction. There are those who question this distinction and whether the distribution of dividends from company profits is a separate source of income independent of the company income.<sup>182</sup> Taken even further, it is argued that a company should not be treated as a separate taxpayer because the profits of companies are eventually taxed in the hands of individuals such as shareholders, directors and employees. The

---

<sup>182</sup> Harris (note 4) at 48–50. See the earlier discussion in para 2.1 of Chapter Two where reference is made to the Vogel's assertion that this is not true economic double taxation. Despite this view of Vogel and its recognition by the author, it will be assumed that the classical system of taxation applies which results in a form of economic double taxation. See also the discussion in Harris (note 4) at 130–134; Olivier et al 2011 (note 14) at 76.

counter argument for the taxation of companies is based on the need to prevent companies from accumulating income by not distributing dividends and that companies, as legal persons, also use the infrastructure and support of the country in which they are established or operate. Vogel is of the view that the company/shareholder distinction is not true economic double taxation because it arises from the particular method of taxing.<sup>183</sup>

The relief for economic double taxation is usually accommodated in the domestic economy through the practice of the classical and imputation systems of dividend taxation. In terms of the Income Tax Act, where a South African resident, irrespective of whether it is a natural or artificial person, invested in South African shares, the dividend return is exempt from tax in the hands of the South African resident shareholder.<sup>184</sup> In cross border trade and investment the problem of economic double taxation is most acute when dividends are paid to shareholders in one country – by a company resident in or doing business in another country – and no relief is given in the shareholder resident country for the tax paid on the company profits in its resident country. In other words, no relief is given for the underlying business profits in the hands of the shareholder through providing relief for the underlying tax or providing an indirect tax credit. Where a company is resident in one country and its shareholders are resident in another country, in most cases the dividend income received by the shareholders will have been subject to tax in the

---

<sup>183</sup> See Vogel (note 2) at 10; Margo Commission (note 6) at para 10.23–10.28 p 188. The classical system of taxing dividends is based on the legal view of companies and shareholders as separate legal entities. In contrast to the classical system, the imputation or integration system recognises the economic view of dividends as arising from the activities of the company and grants the shareholder a credit for tax paid by the company on its income.

<sup>184</sup> In terms of s 10(1)(k) of the Income Tax Act.

hands of the company through its inclusion in the taxable income of the company. Whether or not this company taxation will be taken into account in the taxation of the shareholder is dependent on whether the shareholder's country of residence provides relief for this underlying tax through an indirect or underlying tax credit.

Where dividend income, distributed by a company resident or doing business in one country to a shareholder resident in another country, is exempt from tax in the country of residence of the shareholder, the use of the exemption method of relief prevents both juridical and economic double taxation. If, however, a tax credit is granted to the shareholder in its country of residence for juridical double taxation of foreign sourced dividend income, it does not necessarily result in relief from underlying taxation on the company's profits. Therefore, during the period prior to democracy, where the Income Tax Act did not exempt the foreign sourced dividend income received by South African resident shareholders, and provided a tax credit, such shareholders did not get any relief for economic double taxation.

A further concern with dividend taxation is that it might not distinguish between dividends received from direct investment done through a subsidiary of a group and portfolio investment done by an individual. The legal form distinguished between the company and shareholder even in a group of companies arrangement, while the economic perspective viewed a group as one economic unit with the individual companies being segments of the unit. Apart from the corporate rules found in ss 41—47 of the Income Tax Act, the legal view still holds sway in the South African context as companies in a group are still treated as different persons for the purpose of taxation. This is a result of the clear distinction in South African law between the company and shareholder as separate legal entities. However,

exemptions in domestic law can provide relief for economic double taxation. This notion of group company taxation where dividends are in effect received in a chain from direct investment made outside South Africa must be viewed in the light of the availability or not of underlying tax relief.

Relief for economic double taxation in the form of the underlying credit should be considered where, for example, a parent company resident in one country establishes a subsidiary in another country and the source of the income of the subsidiary is located in the country of its establishment. Relief for taxes paid on the subsidiary's business profits could also be provided by the parent company's country of residence by grossing up the dividends received from the subsidiary to include the profits of the subsidiary.<sup>185</sup>

Another way in which relief can be provided to the parent company is through the provision of a participation exemption where the resident parent company has a substantial shareholding in the foreign subsidiary. This participation exemption is intended to deal with the distinction between direct and portfolio investment when dealing with groups of companies. It relieves economic double taxation in the hands of the parent company when the parent receives the dividend distributed by its subsidiary. The dividend income is exempt from tax in the parent company's country of residence on the grounds that the country where the direct investment is made is entitled to the income arising from that direct investment. It is

---

<sup>185</sup> Olivier et al 2003 (note 35) at 435.

therefore linked to the country having the right to tax as well as to the benefit principle of equity and capital import neutrality.

Given the possible types of relief for economic and juridical double taxation, the relief provided to the South African resident shareholder under the old source basis of taxation was limited. The South African resident individual shareholder's only potential relief for tax paid in another country on dividend income arising from foreign direct investment, except for foreign direct investment made to certain neighbouring countries in terms of s 9A,<sup>186</sup> was by means of treating the foreign tax as an expense. The expense had to meet the requirements of the general deductions provision found in s 11(a) and (b) of the Income Tax Act, read with s 23(g) to qualify for a deduction. In terms of s 11(a), the expenditure must have been incurred in South Africa while s 11(b) provided for the deduction of expenditure incurred outside South Africa. As the payment of a foreign tax was an expense incurred, the first requirement to qualify for the deduction method of relief would have been met. However, the other requirements of s 11(a) and (b) would have had to be met, together with that of s 23(g). These provisions, read together, required that the expense was 'incurred in the production of income', 'for the purpose of trade' and was not of a capital nature. Given the extensive case law surrounding the application of these principles, a deduction would not always have been available, especially where the investment which gave rise to the foreign tax was portfolio investment because the foreign tax may not necessarily have been incurred for the purpose of trade, a requirement for ss 11(a) and 23(g).

---

<sup>186</sup> Botswana, Lesotho, Swaziland and the homelands of Transkei, Bophuthatswana, Venda and the Ciskei.

A further problem related to the connection between the income produced and tax, as the expense incurred. The tax needed to be a concomitant result or expense of the income produced<sup>187</sup> where 'income' is defined as 'gross income less exemptions' in terms of s 1 of the Income Tax Act. This means that the 'income' must have been included in 'gross income' and must not have been exempted from tax in South Africa. In the unlikely event that the foreign tax met the requirements of sections 11(a) and 23(g), the deduction only provided limited relief in comparison to the credit method of relief. The relief was limited because the deduction reduced the income upon which the tax was then imposed whereas the credit method reduced the tax paid by offsetting the foreign tax against the domestic tax.

From a neutrality perspective, the deduction method of relief may result in national neutrality, but it does not result in international efficiency. It results in national neutrality because, within the context of the particular country, all taxpayers will pay the 'same amount of tax whether they derive an amount of foreign income net of foreign tax or the same amount of domestic income gross of domestic income.'<sup>188</sup> The extra tax paid in the foreign country would mean that the taxpayer is not neutral internationally.

The above analysis seems to indicate that although the South African income tax system was based on the principle of source, through tax only being imposed on income which had its source located in South Africa, the tax treatment of foreign

---

<sup>187</sup> See Peter Dachs 'Foreign Taxes Levied' (2006) 20 *Tax Planning* 138. See also Olivier, Lynette & Honiball, Michael *International Tax: A South African Perspective* 4ed (2008) Cape Town: Siberink CC.at 327 and Olivier et al 2011 (note 14) at 458.

<sup>188</sup> Harris (note 4) at 320.

sourced dividend income was complicated by a number of factors. These factors included the implications of case law such as *Boyd's case*,<sup>189</sup> the interpretation of what constituted foreign dividends, the deeming provisions which deemed the source of certain residents foreign-source dividend income to be located in South Africa, and the differing methods of relief provided for international double taxation of foreign sourced dividend income. These different methods of relief changed over time with a tax credit being provided earlier in the pre-democracy period, the exemption method of relief applying in certain circumstances, and the deduction method of relief potentially being the default method of relief in the later periods of pre-democracy. The introduction of the limited residence basis for dividend income and the differing methods used to relieve or not relieve both juridical and economic double taxation give the impression that the equity and neutrality consequences of the choice of the method of relief was not a major consideration.

#### **2.7.5 Interest and royalty income**

Unlike the case for dividend income, the source rules still largely applied to interest and royalty income. In general, whether or not income tax would have been imposed in South Africa on interest and royalty income was dependent on whether the source of that interest and royalty income was located in South Africa. If the source was not located in South Africa, such income would have been exempt from tax in South Africa. The one exception applicable to interest income was the deeming source rules which deemed the interest from a bank or financial institution to be from a South

---

<sup>189</sup> *Boyd* (note 153).

African source if received by or accrued to a person ordinarily resident in South Africa or to a domestic company.<sup>190</sup>

The source basis of taxation and exemption of the foreign sourced interest and royalty income also applied to such income received from both a foreign subsidiary and branch of a South African resident company. No distinction was made between interest and royalty income received as a result of outward direct or portfolio investment.

The basis for not imposing tax on foreign sourced interest income is that the country in which the capital is used produces the interest income (wealth) as a result of the productive use in that country, as would be the case where a branch earns interest income.<sup>191</sup> Although the activities rule would apply to direct investment where there would be some activity in the host country, it would not necessarily apply to portfolio investment.<sup>192</sup> The activity giving rise to portfolio investment in the host country is often limited and on the basis of legitimacy, it may be more appropriate for the country which supported the owner of the capital in creating that capital wealth, namely the country of residence to have the right to tax the interest income. This would be in line with the benefit principle of equity and as

---

<sup>190</sup> Section 9(2) as it read at the time, deemed interest to be from a South African source if accrued to any person ordinarily resident in South Africa or accrued to a domestic company in respect of a loan to, deposit in any Building Society, Mutual Building Society or similar institution wheresoever incorporated, formed established. See also s 9(3) and s 9(4) as it read at the time. Sections 9(2), (3) and (4) were deleted by Income Tax Act No. 28 of 1997.

<sup>191</sup> *Boyd* (note 153).

<sup>191</sup> *Lever Bros* (note 147); *First National Bank* (note 152).

<sup>192</sup> The activity being referred to is the involvement of the lender in the entrepreneurial activity of the investment and the control it has over the investment. See the definition of 'direct' and 'portfolio' investment in notes (118) and (173) above respectively.

competitiveness is not an issue, capital import neutrality would not be the appropriate form of neutrality.

By 1990, s 9(4) deemed certain interest payments made<sup>193</sup> to a South African resident or to a 'domestic company'<sup>194</sup> to be from a South African source where the interest accrued from a source within a neighbouring country.<sup>195</sup> The s 9(4) provision did not apply where the interest was effectively connected with a business carried on by the person or company through a permanent establishment in the neighbouring country. With this deeming provision, the foreign sourced portfolio interest income was included in the South African resident's income. The treatment of foreign sourced income therefore differed depending on the country of investment and whether the interest arose from direct or portfolio investment. The reason for this differential treatment was not based on equity or neutrality but was more likely concerned with tax avoidance, exchange control, and perhaps the political situation at the time. The exchange control regulations which governed the amount of income which a South African resident could lawfully invest in a foreign country did not apply to these neighbouring countries.<sup>196</sup>

The South African resident company was able to get relief in the form of the limited credit provided by s 6*quat*. The use of the limited credit as the method of

---

<sup>193</sup> In respect of any loan, advance, deposit, interest bearing security, or debt claim.

<sup>194</sup> A domestic company was defined as a company which is registered or managed and controlled in South Africa in terms of s 9(4) as it read at the time.

<sup>195</sup> Section 9(4). Similarly, s 9(5) deems the following to be from a South African source – a gain made in respect of any banker's acceptance or similar instrument upon maturity or disposal thereof, if such banker's acceptance or instrument was issued in South Africa or in any neighbouring country and the gain was made by a South African resident or domestic company. The neighbouring countries were defined in s 1 as being SWA, Botswana, Lesotho, Swaziland and any other country which was formerly part of the South Africa (Transkei, Bophuthatswana, Venda and Ciskei).

<sup>196</sup> Katz Commission 5th Interim Report (note 2) at para 6.2.1.2.

relief meant that depending on the tax rates of the neighbouring countries, the South African resident paid more tax than if a loan was advanced to a South African resident. In addition, the equity and neutrality principles not only differed with respect to those defined as South African residents but also with respect to the countries in which such income arose.

The application of the source rules with respect to royalty income as determined by the courts, in particular in *Millins* case,<sup>197</sup> meant that the source of the royalty income was located at the place where the person applied his or her mind in creating the intellectual property which gave rise to the royalty income. The place at which the intellectual property was used was not necessarily its source under the South African source rules as developed by the courts. This meant that a South African resident could locate the source of royalty income in a foreign country both by applying his mind and creating the intellectual property in that foreign country and also by using the intellectual property in that foreign country. Therefore, s 9(1), a deeming source provision was inserted as an anti tax-avoidance measure in the Income Tax Act at the time of its enactment in 1962. In terms of the provision, royalties were deemed to be from a South African source if received by or accrued to, from the use, the right of use, or grant of permission to use, intellectual property in South Africa.<sup>198</sup> The source rules related to the use of the relevant intellectual property and were more in keeping with the understanding of source as the

---

<sup>197</sup> *Millin* (note 154).

<sup>198</sup> Section 9(1) as it read at the time.

originating cause of the income, namely that activity or asset which gives rise to the income.<sup>199</sup>

Given that the use of intellectual property in South Africa was subject to a deeming source provision, it made sense to remove royalty income from the South African tax base in situations where the actual use of the intellectual property was in another country. Where the source rules of another country provided that the source of royalty income was located at the place where such intellectual property was used, the possibility of double taxation arose. In the event of such juridical double taxation, s 6bis was inserted in the Income Tax Act<sup>200</sup> to provide relief in the form of a limited tax credit for income arising from the use of a patent, design, trade mark, copyright, model, pattern, plan, formula or process, or any property of a similar nature, or any film, video, tape or disc in a country other than South Africa, and the royalty income was taxed in that country as well as in South Africa.

The attempt to limit the potential double taxation resulting from the deeming source provisions and perhaps to ensure neutrality between the taxation of intellectual property, whether used in South Africa or elsewhere through the use of the deeming source provisions, was undermined by the limitation of the tax credit because neutrality was affected by the tax rates in the host country.

### **2.7.6 *Controlled foreign companies***

One of the concerns with the use of a subsidiary in a source based system is that taxpayers can potentially locate both their residence and the source of their income in

---

<sup>199</sup> Section 6bis.

<sup>200</sup> Section 6bis was inserted by the Income Tax Act No. 88 of 1965.

a low tax foreign jurisdiction, especially where source is linked to a formalistic requirement such as the location of the share register as in the case of dividend income. The cases of *Cohen*<sup>201</sup> and *Kuttel*<sup>202</sup> also illustrate how it is possible to locate residence outside South Africa using relatively formalistic criteria through the use of the 'ordinarily resident' concept. Countries which use a residence basis of taxation would usually use controlled foreign company rules to tax their residents on income earned by, or in companies controlled by, their residents. Countries which use source as the basis of taxation would have to bring the source of that income into their territories through a deeming source provision in combination with residence, for example to deem the dividend income to be sourced in a country based on the residence of the shareholder. This latter method thus constitutes a combination of residence basis of taxation with a source basis of taxation. Such a method was introduced in the Income Tax Act in 1987 as s 9A,<sup>203</sup> probably as result of the Margo Commission's recommendations.<sup>204</sup> Although the effect of using these types of controlled foreign company provisions does not result in juridical double taxation, it does result in economic double taxation. Given that these provisions sought to treat the deemed residence and source income on the same basis as actual residence and source, the jurisdictional link and the method of relief should therefore have reflected the same equity and neutrality policy principles as for non-controlled foreign company source and residents. With South Africa having exempted foreign sourced

---

<sup>201</sup> *Cohen v CIR* 1946 AD 174, 13 SATC 362.

<sup>202</sup> *CIR v Kuttel* 1992 (3) SA 242, 54 SATC 298.

<sup>203</sup> Section 9A(2) provided that 'Where any resident of the Republic is or was a shareholder in a foreign investment company which has during any financial year of the company derived any untaxed profit, such untaxed profit shall, to the extent determined under subsection (3), be deemed to have accrued to the resident from a source within the Republic on the last day of that financial year'.

<sup>204</sup> Margo Commission (note 6) at para 26.21 p 399.

income and having used the various deeming source provisions, as discussed earlier, it had to treat the controlled foreign company income in a manner ensuring that it followed the same policy principles with respect to relief given. One of the distinguishing features of the South African source basis of taxation is that it did not take into account whether the foreign sourced income was taxed in the host country or not – it simply exempted all foreign sourced income, ensuring that the benefit principle and capital import neutrality applied to South African outward investment.

Section 9A included in the ‘gross income’ of residents certain types of foreign sourced investment income received by or accrued to South African residents from certain countries. The effect of s 9A was to deem the untaxed profit of a foreign investment company<sup>205</sup> to be from a South African source if it was received from a company resident in a neighbouring country<sup>206</sup> and if this company was controlled, directly or indirectly by a resident or residents of South Africa. A third requirement was that the profits of this company be derived wholly or mainly by way of investment income. A fourth requirement was that the relevant investment income be subject to normal tax in South Africa if received by or accrued to such company from a source within South Africa and was not subject to tax in the neighbouring country in a manner which is materially similar to normal tax in South Africa.

As a controlled foreign company provision, s 9A was quite limited as it was confined to South Africa’s neighbouring countries. Cognisance was taken of the

---

<sup>205</sup> A foreign investment company was defined in s 9A(1) as a company incorporated, registered or managed or controlled in the countries of Botswana, Lesotho, Swaziland and any country the territory of which formerly formed part of the Republic.

<sup>206</sup> The company from which the investment income was received was either incorporated, registered or managed or controlled in the neighbouring country.

potential economic double taxation that could result and s 9A accordingly provided relief where the income was subject to tax in the neighbouring country. However the method of relief differed depending on the tax structure of the neighbouring country – the income would be exempt from tax in South Africa if it were subject to a materially similar tax in the source country. Alternatively, a credit was available where the non-resident company had paid non-resident shareholders' tax in South Africa and paid a tax that was not materially similar in the source country.<sup>207</sup> The fact that different methods of relief were available clearly indicates that the main purpose of s 9A was as an anti tax-avoidance measure – as long as tax was paid somewhere it did not matter if it was not paid in South Africa.

With respect to equity and neutrality, s 9A created a problem. The applicable principle of equity and neutrality was dependent on the tax structure of the relevant neighbouring country, and was not necessarily in line with the general principle applicable in South Africa. The basic equity principle at play within South Africa at the time appeared to be the benefit principle but this principle was not applicable with respect to the treatment of this controlled foreign company income. Whether or not neutrality in the form of capital export neutrality or capital import neutrality existed depended on the levels of taxation in the other country. Neutrality was clearly not a consideration nor was the development of the neighbouring states, even those that were formerly part of South Africa (that is, the so-called homelands); this illustrated the apartheid policy aspect, even of the tax regime. As s 9A applied only to certain types of foreign sourced investments from the neighbouring countries of

---

<sup>207</sup> Section 9A of the Income Tax Act.

South Africa, the type of investment and its location played a role in determining the type of relief available. For investments falling outside the sphere of s 9A, relief would be in the form of an exemption or a deduction, the former relief being implicit in the source basis of taxation and the latter in terms of the general deduction formula.

The current version of s 6*quat*, inserted at the same time as s 9A, was the unilateral double taxation relieving provision for both juridical and economic double taxation experienced by South African residents.<sup>208</sup> The section provided for a limited tax credit for taxes paid on the foreign sourced income of South African residents where the foreign sourced income was included in the resident's taxable income. A South African resident was defined as a person (other than a company) who is ordinarily resident in South Africa, or a domestic company. The relief in the form of a credit was in line with the Margo Commission's recommendation of a method of relief.<sup>209</sup> The application of the s 6*quat* credit relief potentially meant that where the tax rates of neighbouring countries were higher than South Africa's, a South African resident taxpayer would pay less tax if it invested elsewhere in the world. In the latter case, the non-South African sourced income would be exempt while in the former, a limited tax credit would provide relief. Other than a tax avoidance concern, it is difficult to reconcile the policy behind the different tax

---

<sup>208</sup> Section 6*quat* was first inserted into the Income Tax Act as "Rebate in respect of diamond profit tax (South West Africa)" by the Income Tax Act No. 89 of 1969. It was repealed in 1983 by the Income Tax No. 94 of 1983. It was re-introduced into the Income Tax Act in 1987 by the Income Tax Act No. 85 of 1987 to deal with 'Rebate in respect of foreign taxes on income'.

<sup>209</sup> Margo Commission (note 6) at para 26.23 p 399.

treatments.<sup>210</sup> In addition, to further aggravate the plight of the South African resident taxpayer investing in neighbouring countries, the applicable version of *s 6quat* at the time did not make provision for carrying forward the excess tax where the full foreign tax burden was not relieved in the relevant year of assessment.

Excluding *s 9A*, the taxation of foreign sourced dividend income and certain types of interest income, a comparison of South African residents' local trade and investment with their outward trade and investment, assuming no exchange control, could be said to have reflected a policy approach that leaned towards the benefit principle of equity, both in relation to the basis on which the government was levying taxes and also in relation to similarly situated taxpayers. The comparison further indicates that taxpayers would potentially not have been neutral between local and outward trading and investing

## **2.8 Outward South African resident trade and investment: host country trade and investment**

Although there was no equity on the basis of formal ability-to-pay when comparing South African residents whose source of income was located in South Africa and those whose source was located outside South Africa, South African residents who invested and traded offshore would have been on the same footing with respect to tax liability as others in the host country of investment or business. In other words, the tax liability of South African residents would not have affected the competitiveness of their businesses. In this respect South Africa's tax policy did not spill over into the host country and South Africa's residents in that host country largely faced the same

---

<sup>210</sup> Policies issues referred to include the philosophy and economic policy behind the credit and exemption methods.

economic circumstances as other investors in that country. A possible exception to this would have been where South African residents were competing in that host country with other non-residents who were taxed on a residence basis in their home country, particularly where their country of residence had a higher tax rate than the host country. The above comparisons show that there would only have been neutrality between South African residents as defined and residents of the host country if the host country imposed tax on the same basis and at the same rates on their own residents as on non-residents.

A different form of equity and neutrality applied only to foreign sourced dividend income received by South African natural persons ordinarily resident in South Africa, the s 9A neighbouring country provisions and the s 9 royalties and interest deeming provisions. However, as it is probable that this income was more likely to be portfolio investment with the benefit principle in the country of the debtor (the host country) not being as relevant, taxation in South Africa on this basis would not have undermined these principles.<sup>211</sup> The relevance of the benefit principle of equity to portfolio investment in the country of the debtor (host country) is limited because of the limited role played by the infrastructure and government of the country of source in the derivation of passive income such as dividend or interest income.<sup>212</sup> For example, it can be said that dividend income is derived from the capital provided by the shareholder through the benefits provided by the

---

<sup>211</sup> See the discussion in paras 2.7.4 and 2.7.5 of Chapter Two & para 3.5.1 of Chapter Three of this thesis for a discussion on equity and portfolio investment.

<sup>212</sup> Vogel *Intertax* Part II (note 13) at 316 where he states that '[t]he portfolio investor does not benefit to any substantial extent from public goods supplied by the country of the debtor. The only public good from which he might benefit are the political and economic security provided for his investment'.

shareholder's country of residence, and not from the benefits provided by the country where the distributing company is located.<sup>213</sup>

## **2.9 Inward non-resident trade and investment: local South African resident trade and investment**

### **2.9.1 General**

A comparison of inward trade and investment by non-residents and residents further illustrates the complexity in trying to achieve some standard objective level of equity and neutrality in relation to the methods of relief used to relieve international double taxation. The complexity results from equity and neutrality between these two groups of investors being dependent on, *inter alia*, the jurisdictional link of the respective countries, the methods of relief for double taxation applied by the respective countries, the tax rates in the non-resident's country of residence and whether the Income Tax Act exempt any income of the non-resident. Except for the last-mentioned factor, equity and neutrality will be affected by the tax policies of the non-resident's country of residence, resulting in a spillover of other countries' tax policies and structures into South Africa.

In addition to the ambiguity concerning the spill- (or non-spill-) over of the inward investor's country of residence's policies into South Africa, the spill may be affected by the South African source and residence rules. The South African source rules will affect relief for the inward investor where the relief in the country of residence of the inward investor is dependent on the source of the income being in

---

<sup>213</sup> Vogel *Intertax* Part III (note 5) at 399 where he states that '[t]o justify residence state taxation of such income, it has been emphasized that the capital invested to produce the income in the foreign company was produced originally in the state of residence'.

South Africa. This would be the case where the country of residence of the inward investor exempts any income which has its source in South Africa or gives a tax credit on condition that the source of income is not located in the inward investor's country of residence. Similarly, the South African residence rules will affect relief where relief in South Africa is dependent on the taxpayer being a non-resident. In order for there to be equity and neutrality between those investing or doing business in South Africa, irrespective of whether those persons are resident or non-resident, the interpretation and rules relating to source and residence need to be consistent.

The benefit principle of equity and capital import neutrality is undermined where the source and residence rules are not consistent and their application yields different results.<sup>214</sup> Given that source and residence concepts differ in different countries, and in particular the concepts applied in South Africa and in other countries differ, it is unlikely that equity could be achieved between investors in South Africa, irrespective of their residence, even if a pure source basis of taxation applied in South Africa and a full exemption method of relief is applied by the country of residence of the inward investor.

During the period prior to democracy, where the country of residence used a residence basis of taxation and allowed a limited tax credit for double tax relief, such residents would not necessarily have been competitive in South Africa as their competitiveness and neutrality would have been dependent on the South African tax rate being equal to or lower than that in the country of residence. The end result is

---

<sup>214</sup> See Vogel *Intertax* Part I (note 87) at 223.

that South African residents may have been at an advantage and this may have affected the form of foreign investment into South Africa.

In addition to the lack of equity between South African residents and non-residents receiving South African sourced income, there was also the potential of a clash between the equity policies of South Africa and that of the country of residence of inward investors which needed to be managed. This clash was the result of the country of residence of the inward investor being based on the ability-to-pay principles while the South African policy was based on the benefit principle. Thus, the comparison between South African residents and non-residents whose source of income was located in South Africa shows that equity in the form of the benefit principle and neutrality in the form of capital import neutrality did not ensue due to the combination of the credit and resident basis of taxation which applied in the country of residence of the inward investor. This combination created uncertainty as to whether the inward investor was at an advantage or disadvantage to South African residents and also whether this structure encouraged inward investment into South Africa as the form of equity and neutrality was dependent on the policy of the country of residence of the inward investor. If the country of residence also only taxed income which had its source in that country of residence or exempted foreign sourced income of its residents, then the benefit principle of equity and neutrality in the form of capital import neutrality applied. The same form of equity and efficiency would have existed between South Africa and that country and there would have been no spillover of differing tax policies. This is also important for South Africa in its positioning as a developing country.

### **2.9.2 Interest income**

During the period prior to democracy, one exemption was interest income received by non-residents from a South African source.<sup>215</sup> As foreign capital was needed by both the South African government and South African businesses, the exemption of interest income received by a non-resident from a South African source made policy sense. It relieved pressure on South African interest rates as a result of the tax burden of the non-resident being passed onto the South African debtor. However, the exemption of non-resident interest income resulted in a differential treatment between South African residents and non-residents. It raised the question whether it was appropriate to treat non-residents better than residents. In addition it raised equity issues between residents who would be taxed on interest income and non-residents who would not be taxed.

Another factor that merits consideration is the form of the non-resident investment into South Africa and how its taxation would have compared with the taxation of South African residents. Where the non-resident parent company operated in South Africa through a South African incorporated subsidiary, financed the South African subsidiary by way of a loan and allowed the subsidiary to use its intellectual property, the subsidiary company had to pay the parent company interest and royalty income. The parent company then received income in the form of interest and royalty income. The parent company's interest and royalty income could have been taxed in South Africa on the basis of source, actual and deemed. The interest income would have been exempted as it would have been received by a non-resident. Similarly, if

---

<sup>215</sup> Section 10(1)(h) of the Income Tax Act.

the parent company earned interest or royalty income through a South African branch and the source was located in South Africa, such income would also have been taxed in South Africa, and the exemption for interest income would have applied. The form of the trade and investment into South Africa therefore did not make a difference as the deciding factor was the location of the source of interest and royalty income. The only question would then be whether the interest payment would have fallen into the exemption provision as discussed above.

### ***2.9.3 Dividend income***

By 1990, dividend income was exempt if it was received by or accrued to a company, or to a person not ordinarily resident nor carrying on business in South Africa or to any person resident in South Africa if the shares were held in a non-South African company and that person acquired such shares prior to becoming resident or from outside South Africa.<sup>216</sup>

Based on the source rules developed by the courts, the source of the dividend income paid by a South African subsidiary of a non-resident parent was located in South Africa and its treatment was therefore the same as for any South African company. However, a withholding tax was imposed on dividend income paid by a South African company to shareholders who were neither resident nor carrying on

---

<sup>216</sup> Section 10(1)(k) as it read at the time.

business in South Africa.<sup>217</sup> This tax was referred to as the non-resident shareholders tax (NRST) and was levied at a rate of 15% on the dividends.<sup>218</sup>

The comparison of inward and outward investment in the form of share capital indicates different treatment of residents relative to non-residents, where the former's dividend income was exempt and the latter was subject to the non-resident shareholder tax.

## 2.10 Summation

This chapter has outlined a theoretical framework for equity and neutrality when a tax system is being designed. It has also applied the theoretical framework to analyse the impact of the application of the source basis of taxation and the exemption method of relief in the pre-democracy period in South Africa. Given that pre-democracy South Africa was largely a closed economy with stringent exchange controls, the use of source as a jurisdictional link may not have been a true reflection of a chosen equity and neutrality policy with respect to cross border trade and investment. It is submitted that the use of source and the exemption method was largely practical and not necessarily as a result of a policy approach to equity and neutrality.

This chapter has also indicated that policy must be clear with respect to the categories and persons being compared so that a particular equity and neutrality

---

<sup>217</sup> Section 41–47 of the Income Tax Act as it was at the time. The sections were inserted in the original version of the Income Tax Act No. 58 of 1962, amended over time and deleted by the Income Tax Act No. 21 of 1995.

<sup>218</sup> See Marius Van Blerck 'Company–Shareholder Taxation in South Africa: Single or Double Taxation?' (2003) 57 (12) *Bulleting for International Taxation* 567 at 567.

approach can be implemented. Thus, ability-to-pay equity and capital export neutrality is policy that reflects a comparison of the residents of a country and is implemented by a combination of worldwide taxation of residents and a tax credit for juridical double taxation. This combination also has to provide for or at least consider relief for economic double taxation of dividend income.

The analysis in this chapter indicates that up until 1998, source-basis of taxation was the main basis for levying taxes in South Africa, with certain types of income being deemed to be from a South African source. The main unilateral relief provided for South African residents was the full exemption method by implication as well as the credit or exemption methods as specifically indicated for the deemed source provisions. The reasons for the jurisdictional links, it appears, were mainly that of tax being viewed as payment for the protection offered by the state and, consequently, the benefit principle of equity held sway. There did not appear to be a formal system of considering the principles of neutrality and, as a result, the methods of relief provided were not consistent and were mainly concerned with anti tax-avoidance as opposed to neutrality and equity as policy concerns. The ostensible inconsistency must however be considered against the background of the closed apartheid economy with exchange controls – where foreign sourced income by South African residents was not a major concern – and the introduction of a democracy, the opening of the economy, relaxation of exchange controls and the necessary change in policy. From 1998 onwards a new trend emerged in relation to the taxation of foreign sourced income, as the result of the move towards a residence basis of taxation for all types of income.

### 3 Chapter Three

#### Evolution of South Africa's Cross Border Rules: transition period (1994 to 2000)

##### 3.1 Introduction

The South African political and economic landscape changed in the early 1990s with the dismantling of the apartheid system, the enactment of a Constitution<sup>219</sup> containing a Bill of Rights,<sup>220</sup> and the opening of the South African economy. The first democratic elections held in 1994 resulted in a change of government and, accordingly, a change in economic policy objectives. In particular, the policy objectives had to take into account, amongst others, redistributing income to redress inequalities which existed under the apartheid regime,<sup>221</sup> encouraging exports of South African products and services, and increasing foreign investment into South Africa. These policy objectives had to be implemented and supported by, *inter alia*, amendments to the income tax legislation. In turn, the legislation had to be consistent with the rights contained in the Bill of Rights in the 1996 Constitution.<sup>222</sup>

Evidence of the change in policy objectives and the requirement to be consistent with the Constitution is found in the number of times the Income Tax Act was amended between 1994 and 2000,<sup>223</sup> with many of the amendments changing the tax structure. It is during this period that the redesign and restructuring of the income

---

<sup>219</sup> Constitution of the Republic of South Africa, Act No.108 of 1996.

<sup>220</sup> Chapter Two of the Constitution.

<sup>221</sup> See Address by the then Minister of Finance (note 47) at 2–3.

<sup>222</sup> *Ibid.*

<sup>223</sup> The Income Tax Act was amended nine times from 1994 to 2000 by the following amending Acts: Income Tax Act No. 21 of 1994, Income Tax Act No. 21 of 1995, Income Tax Act No. 36 of 1996, Revenue Laws Amendment Act No. 46 of 1996, Income Tax Act No. 28 of 1997, Taxation Laws Amendment Act No. 30 of 1998, Taxation laws Amendment Act No. 32 of 1999, Revenue Laws Amendment Act 53 of 1999 and the Taxation Laws Amendment Act No. 30 of 2000.

tax system commenced. This chapter analyses the changes made during the transition period to the jurisdictional links to tax and the methods used to relieve, or eliminate, international double taxation. This is done against the background of equity and neutrality to determine whether the underlying principles of equity and neutrality were maintained for cross border trade and investment. The first part of this chapter provides an overview of the transition period policy objectives and the manner in which these objectives were implemented. The second part analyses and compares inward and outward trade and investment against the criteria of equity and efficiency.

### **3.2 Transition period policy objectives**

The response of the newly elected government to the tax implications of the change in policy was the establishment in 1994 of a government commission of enquiry,<sup>224</sup> commonly known as the 'Katz Commission'. The Commission's brief was to undertake a review of South African tax policy and it included the question of whether source should be retained as the main jurisdictional link.<sup>225</sup> In its report, the Commission recommended the retention of the source basis of taxation coupled with deeming source provisions, where the latter extended the source basis of taxation to include certain non-South African sourced income.<sup>226</sup> The recommendations of the Katz Commission, therefore, envisaged a combination of source and residence for the taxation of South African residents, as opposed to an almost exclusive source basis.<sup>227</sup> The deeming source provisions were applied particularly to income classified as passive income where the source of this income was not located in

---

<sup>224</sup> Katz Commission (note 2).

<sup>225</sup> Ibid.

<sup>226</sup> Katz Commission 5th Interim Report (note 2) at para 3.2, and ch 9.

<sup>227</sup> Ibid.

South Africa.<sup>228</sup> The result envisaged was a residence basis of taxation for this passive income by means of including it in the taxable income of those determined to be resident, irrespective of where the source of this passive income was located, and a source basis of taxation for income classified as active income. With respect to those classified as ‘residents’ and those as non-residents, the Katz Commission indicated that a combination of the two jurisdictional links was the norm internationally and that no one country sensibly applied any tax system exclusively.<sup>229</sup> Therefore, the source basis for non-residents was retained.

In considering the retention of the source basis of taxation for active income<sup>230</sup> the Katz Commission acknowledged the problems associated with the use of source as the basis of taxation<sup>231</sup> and, in particular, acknowledged the concern that retention of the source basis of taxation would result in the South African tax base and cross border structure not being aligned to its trading partners.<sup>232</sup> This concern with the non-alignment had also been raised by the earlier Margo Commission<sup>233</sup> and had become more pertinent in 1994 as a result of the end of apartheid and the opening of the South African economy.

Despite the concerns, the Katz Commission did not recommend an immediate and complete change from the source basis of taxation to the residence basis of taxation. The Commission took the view that a source basis of taxation, combined

---

<sup>228</sup> Katz Commission 5th Interim Report (note 2) at ch 6 and the ‘Executive summary’.

<sup>229</sup> Ibid at para 1.3.1.

<sup>230</sup> See Schindel et al (note 59) at 52 where it is stated that ‘[a]ctive income results from a defined business activity in the source country.’

<sup>231</sup> Katz Commission 5th Interim Report (note 2) at chpt 5, p 24

<sup>232</sup> Ibid at para 5.2.

<sup>233</sup> Margo Commission (note 6) at para 26.3–26.21 p 397–399.

with a provision which deemed that income which had its actual source located outside South Africa was from a South African source, would not result in a significant difference in the amount of tax collected when compared with a residence or worldwide basis of taxation combined with an exemption method of relief for active income, which had its source located outside South Africa.<sup>234</sup> In the view of the Katz Commission, the only difference was that the latter residence basis, combined with the exemption method, required extra administration and had higher collection costs.<sup>235</sup> It is interesting that the Katz Commission's recommendations envisaged a residence basis of taxation combined with the exemption method of relief for active income which had its source located outside South Africa, unlike the practice introduced from 2003 which provides relief for international double taxation of foreign sourced income received by or accrued to South African residents by means of a tax credit for virtually all forms of income.

The effect of the recommendation of the deeming source provisions meant that international double taxation, which was not a major concern for South African residents under the source basis of taxation (except perhaps for foreign sourced dividend income, investments into the neighbouring countries and certain deeming provisions),<sup>236</sup> would become a reality because of the possibility of tax potentially being imposed on the South African resident taxpayer both in South Africa and in the actual source country. In discussing the method of relief from international double taxation, the Katz Commission stated that a:

---

<sup>234</sup> Katz Commission 5th Interim Report (note 2) at para 3.1.1.3; 3.1.1.4.

<sup>235</sup> Ibid at para 3.1.6.1.

<sup>236</sup> Section 9 as it read at the time.

jurisdiction that follows the residence principle has only one practical solution at its disposal if it wishes to adhere to the neutrality canon in its income tax system. It must grant tax relief, either unilaterally or through the negotiation of bilateral double tax agreements.<sup>237</sup>

It is not clear which form of relief the Katz Commission is referring to and accordingly, which form of neutrality – capital import neutrality or capital export neutrality. The only discussion in the Katz Commission’s report that refers to capital import and capital export neutrality relates to the objectives of neutrality in respect of South African ‘businesses competing offshore and offshore businesses competing within’ South Africa, and that the tax should be ‘neutral in the jurisdiction of direct investment’.<sup>238</sup> According to the Katz Commission, the source basis of taxation is more likely to achieve this stated objective.<sup>239</sup>

The Katz Commission’s statement on neutrality indicated a preference for a neutrality policy in the form of capital import neutrality for direct investment where individuals and companies within a particular territory face the same tax burden, irrespective of the residence of the taxpayer. It would be implemented by having a source basis of taxation (or an exemption method of relief for international double taxation under a residence basis of taxation) for South African businesses competing in a foreign host country where the source of the South African business is located in that foreign host country. Furthermore, it would have a source basis of taxation for non-resident business undertakings in South Africa where the source of the non-resident business is located in South Africa. While it is possible for South Africa to implement the former through the use of the source basis of taxation in the South

---

<sup>237</sup> Katz Commission 5th Interim Report (note 2) at para 6.4.1.1.

<sup>238</sup> Ibid at para 3.1.2.9.

<sup>239</sup> Ibid at para 3.1.2.11.

African fiscal legislation, the implementation of the latter could only be implemented in South Africa through the use of double taxation agreements as it would depend on the fiscal legislation of the country of residence of the South African inward non-resident investor.

From a policy perspective, the retention of the source basis of taxation for only active income, with its concomitant exemption of active income where the source of the income was not located in South Africa, envisaged that South African outward business trade and investment would retain its competitiveness in the country of trade and investment, with neutrality in the form of capital import neutrality applying to active income. The benefit principle of equity would be applicable to active income of both residents and non-residents where the source of that active income is located in South Africa.

In contrast to active income, the Katz Commission recommended the use of the tax credit for relieving international double taxation of passive income with the assertion that this method of relief was 'sound'.<sup>240</sup> In recommending the tax credit as the method of relief, the Katz Commission stated that the tax credit was already included in the South African income tax system (through *s 6quat*) and stated its belief that this was an entirely appropriate method of relief.<sup>241</sup> From a policy perspective, the combination of the tax credit as the method of relief for international double taxation, combined with the use of source-plus – a form of residence based taxation for the worldwide passive income of South African residents – meant that

---

<sup>240</sup> Ibid at para 9.27.

<sup>241</sup> Ibid at para 6.4.1.2.

equity in the form of ability-to-pay and capital export neutrality applied to passive income.

The combination of source and residence, and of exemption and credit, meant that a different form of equity and neutrality could apply to different forms of income, particularly where South African tax rates differed from those in the host country of trade and investment. The Katz Commission did not, or so it appears from the report, discuss the policy implications of the type of relief to be provided – that is, exemption, credit or deduction – in the event of double taxation of the foreign sourced income of South African residents. In addition, it appears as if the Katz Commission did not consider the jurisdictional link and the methods of relief for international double taxation as part of the policy implementation tools of the overall economic policy of government. Instead, it seems as if these issues were reported on separately from the overall policy with respect to trade and investment.

The link between the Katz Commission recommendations and economic policy, on the basis of the recommendations, can be stated to be premised primarily on the broadening of the South African tax base by the inclusion of non-South African sourced income of South African residents to ensure equity on the basis of ability-to-pay; although, this is not directly stated. It is premised further on retaining the competitiveness of South African active businesses abroad by exempting this income from tax in South Africa.

The need to change the equity consideration for South African residents from the benefit principle to the ability-to-pay principle, together with the need to ensure South Africa's competitiveness internationally, has an inherent conflict. Ability-to-

pay equity requires a residence basis of taxation combined with a limited tax credit for international double taxation, whereas international competitiveness requires the exemption of foreign sourced income. The objective was therefore to find a way to implement both these seemingly conflicting objectives and the use of source-plus, as recommended by the Katz Commission, appears to have found a way to implement these objectives, despite not having fully discussed the principles of equity and neutrality nor the role of the jurisdictional link and methods of relief as the tools to implement the policy of government.

### **3.3 Transition period: implementation of objectives**

The 1997 National Budget Speech of the then South African Government Minister of Finance endorsed the recommendations of the Katz Commission.<sup>242</sup> The statement by the Minister of Finance that South African individuals and corporations would ‘in future be allowed the freedom to transact internationally, as envisaged in the macro-economic strategy’ provides an indication of the government policy towards international fiscal policy.<sup>243</sup> The Minister furthermore stated an objective to reach a point of equality of treatment between residents and non-residents in relation to inflows and outflows of capital.<sup>244</sup> This objective was to be achieved, ostensibly, by extending the deeming source provisions to include in the tax base the worldwide passive income of South African residents in the form of interest, royalties, annuities and rentals. The statement, however, did not indicate how this ‘equality of treatment’

---

<sup>242</sup> The endorsement is found in various aspects of the National Budget Speech delivered by Trevor A. Manual, Minister of Finance, Republic of South Africa on 12 March 1997. Available at <http://www.info.gov.za/speeches/1997/000223318p2003.htm>, last accessed 15 November 2012.

<sup>243</sup> Ibid.

<sup>244</sup> Ibid.

was to be effected by the methods of relief to be applied in the event of international double taxation. It is submitted that this is not a form of equality unless the methods of relief for international double taxation for both residents and non-residents in relation to the inward and outward flow of their trade and investment are the same or similar.

The endorsement of the Katz Commission recommendations by the government was further supported by implementation of the Katz Commission recommendations in the Income Tax Act in 1997.<sup>245</sup> On introducing the change from source to source-plus, the then Minister of Finance, Trevor Manuel, stated that the objective of the change was to move to an:

environment in which South Africans could make ordinary transactions abroad frequently, while the constraints which remained on large movements of capital would increasingly give way to procedural and prudential supervision.<sup>246</sup>

This statement indicates that the introduction of tax on the worldwide passive income of South African residents was influenced by the expected relaxation of the exchange control provisions with the source-plus basis of taxation acting as a buffer to protect the South African tax base.<sup>247</sup>

The Minister of Finance further stated that:

Our vision is informed by the fact that our tax regime must enhance our competitiveness internationally and that it must be structurally cohesive

---

<sup>245</sup> By the introduction of s 9C which deemed certain income to be from a South African source. Section 9C was inserted by the Income Tax Act, No. 28 of 1997 and was in effect from 1 July 1997.

<sup>246</sup> National budget speech of 12 March 1997 (note 242).

<sup>247</sup> See also the South African National Treasury Explanatory Memorandum accompanying the Income Tax Act No. 28 of 1997, 'Explanatory Memorandum on the Income Tax Bill, 1997' at 3. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 15 November 2012.

which means that, amongst other things, we have to broaden our tax base and eliminate damaging tax arbitrage opportunities.<sup>248</sup>

Accordingly, by way of the recommendations of the Katz Commission and perhaps for slightly different reasons, source was extended by the insertion of s 9C into the Income Tax Act.<sup>249</sup> Section 9C deemed the source of certain non-South African sourced income received by or accrued to South African residents to be located in South Africa. This accordingly changed the basis of taxation on which tax was levied in South Africa from the source basis of taxation to a source-plus basis of taxation.<sup>250</sup> Other changes also introduced in 1997 and implemented in 1998 were the introduction of s 9D,<sup>251</sup> the controlled foreign company rules, and amendments to s 9A<sup>252</sup> and s 6quat<sup>253</sup> (the foreign tax credit).

Even though the methods of relief have been mentioned earlier in relation to the choice of source and residence as the basis on which income from cross border trade and investment is taxed, and in relation to the policy principles of equity and neutrality, it is apposite at this point in the thesis, given that it is an analysis of the methods used to relieve international double taxation, to consider the consequences

---

<sup>248</sup> 1997 Budget Speech (note 242).

<sup>249</sup> By the Income Tax Act No. 28 of 1997.

<sup>250</sup> Section 9C deemed certain investment income, in the form of certain types of annuities, interest income, rental income and royalties, which was received by or accrued to a resident or a person other than a resident, arising from activities carried on by him through a permanent establishment situated in South Africa, to be from a source within South Africa. A resident was defined as any natural person who is ordinarily resident in South Africa, and any person other than a natural person which has its place of effective management in South Africa.

<sup>251</sup> By the Income Tax Act No. 28 of 1997.

<sup>252</sup> Ibid.

<sup>253</sup> Ibid.

that result from choosing a particular method of relief for juridical international double taxation.<sup>254</sup>

### **3.4 Methods of relief**

As indicated in Chapter One, the three main methods used to relieve international double taxation are the exemption method of relief, the credit method of relief and the deduction method of relief and as further indicated, the different methods of implementation affect the policy principles of equity and neutrality. The implementation may also affect the cross border trade and investment policy of a country. A further consideration in relation to the methods of relief for international double taxation is its relation to the concept of ‘tax sparing’. This relation will be expanded on after the three methods and their effect on cross border trade and investment have been discussed because it has a particular role in the cross border activities between developing and developed countries.

#### ***3.4.1 The exemption method to relieve international double taxation***

The exemption method, as stated by Vogel, ‘is based on the concept that the State in which the items of income arise or in which items of capital are situated has a better right of taxation, and that the exempting State, therefore has to “give way”’.<sup>255</sup> In other words, it is based on the right of the source state to tax income which arises within its territory based on the benefit principle of equity. The country of residence therefore has to exempt that income from tax. By exempting the income from tax, the country of residence allows businesses or enterprises in the state of source to be

---

<sup>254</sup> Vogel (note 2) at 1131, where it is stated that the philosophy underlying the two methods of relief found in the OECD MTC differs considerably.

<sup>255</sup> Vogel (note 2) at 1131.

competitive because such a business will not be exposed to a higher tax burden than a competitor in the source state, which may well occur in the case where a limited tax credit relief is applied and the tax rate in the residence state is higher than in the source state. This is supported by Ault who states that:

(b)eyond its role as a mechanism for relieving potential double taxation, from a policy point of view, an exemption method is consistent with a policy of capital import or competitive neutrality. It ensures that the income from foreign activities will not be subjected to a higher rate of tax than the rate faced by local competitors. It also ensures that foreign tax holidays or preferences are not “washed” out by additional residence country tax. These effects have a factor in the decision of some countries to utilize the exemption technique.<sup>256</sup>

The further advantage of the exemption method of relief, as indicated by the quote from Ault above, is that where the country of source gives a tax incentive to attract non-resident investors, which result in no or limited tax paid in the country of source, the exemption method of relief retains the incentive for the non-resident investor, whereas the credit method of relief would neutralise the incentive.

Besides the policy reasons for using the exemption method of relief, it has been said that the exemption method, as compared to the credit method, is simpler to implement.<sup>257</sup>

Another reason for using the exemption system as indicated by Ault is that:

some countries have adopted exemption systems in recent times to achieve ‘conduit’ tax treatment – that is, where an entity is resident in a country but the owners of the entity are resident elsewhere – and the income earned by the entity is sourced outside its country of residence. The claim of the residence country of the entity to tax the income, given the tax at source and

---

<sup>256</sup> Ault et al (note 137) at 448.

<sup>257</sup> Ault et al (note 137) at 448 where he states that: ‘Another aspect of the exemption technique that is often stressed is its relative simplicity’; Vogel (note 2) at 1131.

the tax by the country in which the owners are resident, is not considered to be strong and the tax is given up through the use of the exemption system. Given this rationale, the exemption is usually limited to legal entities (typically limited to corporations).<sup>258</sup>

This latter reason for the exemption method appears to have been the basis for the introduction of the headquarter company regime by South Africa in 2000<sup>259</sup> which was subsequently repealed in 2003<sup>260</sup> and reintroduced in 2010.<sup>261</sup> This regime will be discussed in Chapter Four.

As mentioned in Chapter One, the exemption method of relief can be applied either by using a full exemption or using ‘exemption with progression’.

### ***3.4.2 Credit method to relieve international double taxation***

In contrast to the philosophy which underlies the exemption method, Vogel states that ‘all that the credit method is designed to do is to mitigate an excessive burden considered unfair or economically harmful by reducing it to the level of taxation of the State giving credit’.<sup>262</sup> As indicated in Chapter One, a country adopting the credit method to relieve international double taxation will give its resident taxpayers relief for the tax paid in the country of source through crediting the foreign tax against the tax to the paid in the country of residence. The credit method can be implemented either by way of a full tax credit or a limited credit. The full tax credit allows the resident taxpayer to credit the full amount of the foreign tax against his resident country tax. Where the amount of tax paid in the country of source is greater than the

---

<sup>258</sup> Ault et al (note 137) at 448.

<sup>259</sup> By the Revenue Laws Amendment Act No. 59 of 2000.

<sup>260</sup> By the Revenue Laws Amendment Act No. 45 of 2003.

<sup>261</sup> By the Taxation Laws Amendment Act No. 7 of 2010.

<sup>262</sup> Vogel (note 2) at 1131.

amount of tax paid in the country of residence, it may mean that the country of residence has to 'reimburse' the taxpayer for the excess tax paid. The payment of the excess tax means that the country of residence is subsidising the taxes of the country of source. This problem is usually solved by the use of the limited tax credit, as indicated in Chapter One, which limits the tax credit to the amount of tax that would have been paid in the country of residence.<sup>263</sup>

The following quote by Ault succinctly explains the implication of the tax credit:

Beyond resolving the perceived inequity of subjecting the same taxpayer to conflicting tax claims on the same income, from an economic point of view, the foreign tax credit system is generally viewed as consistent with an overall policy of capital export neutrality – that is, from the perspective of the residence country investor, the credit system tends to ensure that the choice between domestic or foreign investment will not be influenced by tax considerations. In practical operation, the credits systems here considered fall far short of this result, in particular where the tax rate in the foreign jurisdiction is higher than the domestic rate. In addition, in practice, the interaction of the various provisions dealing with international income often makes it difficult to determine if a particular rule does or does not further capital export neutrality. Nonetheless, especially in the context of portfolio investment, capital export neutrality has historically been an important factor in the decision to adopt or maintain a credit system.<sup>264</sup>

The disadvantages of the credit system are said to include, *inter alia*:

- the complexity of its administration,

---

<sup>263</sup> Also referred to as the ordinary or normal credit. See OECD MTC 2010 (note 19) at 309.

<sup>264</sup> Ault et al (note 137) at 447; See also Vogel (note 2) at 1132.

- the fact that the use of the limited tax credit means that a country's tax rates must be aligned to that of its trading partners to ensure comparative treatment of both inward and outward investors;
- the requirements that need to be met before a tax credit is granted, as seen in Chapter Five; and
- whether the tax credit would apply to group company taxation and whether it would also provide relief for economic double taxation.

According to Olivier et al, most countries, including South Africa,

have adopted the credit method as a general approach on the basis that the exemption method is applied in certain circumstances where foreign sourced income is thought to have been taxed in similar circumstances at comparable rates. The exemption method is then used as an alternative to the credit method as it is simple to administer. The argument for using the exemption method is that the overall tax liability of the resident is similar to the position as if the credit method had been applied.<sup>265</sup>

Despite the apparent choice that a country has between the two methods of relief, and

[w]hatever their relative advantages and disadvantages, in practice, no country uses a 'pure' exemption or 'pure' credit approach ... The relative 'mix' between exemption and credit varies substantially, however.<sup>266</sup>

---

<sup>265</sup> Olivier, Lynette ; Brincker, Emile & Honiball, Michael *International Tax: A South African Perspective* 2ed (2004) Cape Town: Siberink CC at 265. See also Oliver et al 2011 (note 14) at 443. See also Victor Thuronyi *Comparative Tax Law* (2003) The Hague: Kluwer Law International at 288 where he states that 'Moreover, the foreign tax credit mechanism is almost universally used as a unilateral means to grant relief from double taxation (in combination with the exemption method in many cases)'. Also at 292 where he states that: 'Virtually all countries with worldwide taxation grant unilateral double tax relief through a foreign tax credit'. See also Oliver et al 2011 (note 14) at 443.

<sup>266</sup> Ault et al (note 137) at 448.

### 3.4.3 Deduction

As indicated in Chapter One, in addition to the exemption and credit methods, some countries also use the deduction method of relief in terms of which the foreign tax is seen as an expense of the business. Relief in this form is granted by taxing the net income after deduction of foreign tax.<sup>267</sup> This is only partial relief and does not fully remove the burden of double taxation as the tax is effectively treated as an expense in computing taxable income.<sup>268</sup> Usually relief by credit is more beneficial to the taxpayer than relief by deduction.<sup>269</sup>

According to Olivier et al, the deduction method has fallen into disfavour as, '... the total net tax bill of a taxpayer would result in a higher combined tax rate compared to any of the other methods'.<sup>270</sup> The use of the deduction method does not result in either form of equity or neutrality. Although this method may be justified from the viewpoint of national self-interest' through the extra tax collected, 'it does not achieve equal treatment of residents and is not neutral in terms of the allocation of resources between countries'.<sup>271</sup> It is also not considered as a method of relief in either the OECD or UN MTCs and is said to favour domestic investment as opposed to foreign investment.<sup>272</sup>

---

<sup>267</sup> Olivier et al 2011 (note 14) at 443; Hines (note 22) at 5.

<sup>268</sup> Alastair Munro, *Tolley's Double Taxation Relief* 6ed (2003) London: Lexis Nexis at 17; Hines (note 22) at 5.

<sup>269</sup> Olivier et al 2011 (note 14) at 443.

<sup>270</sup> Olivier et al 2004 (note 265) at 265; Olivier et al 2011 (note 14) at 6.

<sup>271</sup> See Olivier et al 2004 (note 265) at 265; Oliver et al 2011 (note 14) at 443.

<sup>272</sup> Olivier et al 2004 (note 265) at 265.

### 3.4.4 *Source country exemption and tax sparing*

The above discussion centres on the residence country of the taxpayer providing relief for international double taxation. There are occasions when the country in which the source is located gives tax incentives to non-resident taxpayers. The country of source would give such incentives when it wants to attract investments by non-residents, in other words, it wants to attract foreign investment. The effectiveness of the source country's strategy of using the tax system to attract foreign investment depends on the position taken by the country of residence of the investor to 'tax sparing'.<sup>273</sup>

If the residence country provides relief for international double taxation through the use of a tax credit paid, the tax incentives would be neutralised and thus have no benefit for such foreign investor.<sup>274</sup> The tax liability of the foreign investor will be the same in his country of residence, irrespective of the incentive, because the tax credit relief is only provided for foreign taxes actually paid. The tax incentives will only be effective if the country of residence of the foreign investor specifically provides for additional relief. Such relief would, for example, take the form of the country of residence of the foreign investor allowing the tax credit for the 'deemed' or 'notional tax',<sup>275</sup> that is, as if the foreign tax had been imposed. The assistance given to the country of source by the country of residence of the foreign investor by

---

<sup>273</sup> For a discussion, see Vogel (note 2) at 1255–1257; Peter Cussons and Richard Collier 'Tax Planning for Double Tax Relief' in John Dixon, and Malcolm Finney (eds) *Tolley's International Tax Planning Double Taxation Relief* (2002) London: Lexis Nexis 17–3 at 17–55 para 17.110–17.111.

<sup>274</sup> Ault et al (note 137) at 552 where it is stated that: 'Where the developed country uses the foreign tax credit method to relieve double taxation, any tax reductions or exemptions that the developing country may enact usually benefit the treasury of the developed country rather than the treaty investor'.

<sup>275</sup> Thuronyi (note 265) at 294 where he states that 'Tax sparing (credit for a notional tax paid) ...'.

recognising the incentive as a ‘deemed’ or ‘notional foreign tax’ is referred to as ‘tax sparing’.<sup>276</sup> As the application of tax sparing provisions are rare,<sup>277</sup> the practice of a country exempting the source income of foreign non-resident investors, where the source of that income is located in that country, does not assist in attracting foreign direct investment from countries where such income is also subject to tax.<sup>278</sup> On the contrary, it results in a loss of revenue for the source country and may effectively ‘subsidise’ the government of the residence country. It may, in fact, become a tax planning opportunity.<sup>279</sup> South Africa currently has tax sparing provisions in its double taxation agreements with Algeria, Botswana, Egypt, Greece, Ireland, Israel, Mauritius, Pakistan, Romania, Seychelles, Swaziland, Thailand, Tunisia and Uganda.<sup>280</sup>

---

<sup>276</sup> Knoll (note 14) at 4; OECD MTC (note 19) at 329; Phillip Baker *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital* (2005) London: Thomson/Sweet & Maxwell at 23–22. Olivier et al 2011 (note 14) at 466 where it states that ‘[t]ax sparing, ... is the allowance of a credit under a tax treaty by a residence-based contracting state for hypothetical or notional foreign tax “paid” to the other Contracting state. See p 466–470 for full explanation.

<sup>277</sup> Knoll (note 14) at 7–to 8; Schindel et al (note 59) at 43.

<sup>278</sup> OECD MTC 2010 (note 19) at 330; Baker (note 276) at para 77 p 2323.

<sup>279</sup> OECD MTC 2010 (note 19) at 330; Baker (note 276) 4 at para 75–76 p23–23.

<sup>280</sup> Article 23(2) and (3) of the Double Taxation Agreement entered into with Algeria *GG No 21303* dated 2000-06-21; Article 22(2) and (3) of the Double Taxation Agreement entered into with Botswana *GG No. 26342* dated 2004-05-12; Article 22(3) of the Double Taxation Agreement entered into with Egypt *GG No. 19706* dated 1999-01-22; Article 23(2) of the Double Taxation Agreement entered into with Greece *GG No. 24996* dated 2003-03-03; Article 23(6) of the Double Taxation Agreement entered into with Ireland *GG No 18552* dated 1997-12-15; Article 23(1)(b) and (2)(b) of the Double Taxation Agreement entered into with Israel *GG No 6577* dated 1979-07-13; Article 23(2) of the Double Taxation Agreement entered into with Mauritius *GG No. 18111* dated 1997-07-02; Article 22(2) and (3) of the Double Taxation Agreement entered into with Pakistan *GG No 19849* dated 1999-03-17; Article 23(3) of the Double Taxation Agreement entered into with Romania *GG No. 16680* dated 1995-09-27; Article 23(2) of the Double Taxation Agreement entered into with the Seychelles; *GG No. 25646* dated 2003-10-30; Article 22(2) of the Double Taxation Agreement entered into with Swaziland, *GG No. 27637* dated 2005-06-01; Article 23(3) of the Double Taxation agreement entered into with Thailand *GG No. 17409* dated 1996-09-03; Article 22(2) and (3) of the Double Taxation Agreement entered into with Tunisia *GG No 20728* dated 1999-12-15; Article 23(2) of the Double Taxation agreement entered into with Uganda, *GG No. 22313* dated 2001-05-24. The texts of these Double Taxation Agreements are available at <http://www.sars.gov.za>, last accessed 15 November 2012.

As illustrated above, the choice of the methods of relief affects equity and neutrality. In addition to the general policy direction chosen by a country, a country may apply different policy principles in respect of different types of investment, in particular to direct and portfolio investment.

#### ***3.4.5 Methods of relief applied in South Africa***

During this transitional period where tax was imposed on the income of South African residents, both in South Africa and in the country of the location of the actual source, the South African resident taxpayer could potentially have had available all three forms of relief – exemption, credit or deduction – to relieve the international double taxation. The form of the relief available to such a taxpayer would have been dependent on, *inter alia*, the categorisation of income, the form which the investment took and the location of the investment. The result of this was different forms of equity and neutrality, the latter implying ‘non-neutrality’. Given that the period has been characterised as transitional and many of the policies of South Africa were still in the analysis phase, it could be argued that this non-neutrality was acceptable in the short-term.

The different categories of income received by or accrued to South African residents and to which different methods of relief would apply in the event of international double taxation can be divided into the following categories:

- active income received or accrued by South African residents where the source of that income was located outside South Africa;
- passive income received by or accrued to South African residents where the source of that income was located outside South Africa; and

- dividend income received by South African residents where the source of that dividend income was located outside South Africa.

Whether or not provision was made to relieve or eliminate international double taxation depended additionally on whether the relevant taxpayer qualified as a 'resident'. For example, where a taxpayer did not qualify as a resident, tax would continue to be imposed on that non-resident where, assuming that all the other requirements for imposing tax were met, the source of that non-resident's income was located in South Africa. The taxation of non-residents income, whether passive or active, where the source of the income was located in South Africa, was therefore not affected by the change to the source-plus basis of taxation, except for the exemption of interest income received by or accrued to non-residents in certain circumstances.

The transition period policy objectives, flowing from the Katz Commission and its implementation by the South African government, seem to have been concerned with both ability-to-pay and competitiveness. Although this is reflected in the changes in the jurisdictional link in the change from source to source-plus, it is not necessarily reflected in the methods of relief provided for international double taxation because of the use of different methods of relief for international double taxation in the Income Tax Act. In order to further analyse the specifics of the changes made to the jurisdictional links and the methods to relieve international double taxation, the rest of this chapter uses the categories as set out in Chapter Two to analyse and compare inward and outward trade and investment against the criteria of equity and neutrality. These categories are:

1. Local and outward trade and investment by South African residents;
2. Outward trade and investment by South African residents and host country residents;
3. Local trade and investment by South African residents and inward trade and investment by non-residents.

### **3.5 Outward South African residents' trade and investment: local South African resident trade and investment**

#### **3.5.1 Overview**

A comparison of South African residents has to take into account the right to equality as reflected in s 9 of the South African Constitution.<sup>281</sup> The applicable equity principle may have been appropriate for the overall trade and investment policy but the approach also has to be in line with the Constitutional imperative of equality. An approach to equity requiring the tax burden to be just and equitable reflecting similarities and differences, that is, substantive equality<sup>282</sup> rather than nominal equality, would find resonance within the South African context.<sup>283</sup>

---

<sup>281</sup> Section 9(1) of the Constitution provides that:

(1) Everyone is equal before the law and has the right to equal protection and benefit of the law.

<sup>282</sup> Vogel *Intertax* Part III (note 5) at 396 where it is stated that 'principles of equality ostensibly require the equal treatment of individuals who are equal in all respects relevant to the legal rule in question. If similarly situated taxpayers are equal in this sense, the tax structure would be prohibited from discriminating among them by imposing different tax burdens. The argument could therefore be made that horizontal equity is an application of the requirement of the principle of equality'.

<sup>283</sup> Cheadle et al (note 61) at para 4.4.3 where it states that the application of s 9 requires that all law in South Africa, including legislation such as the Income Tax Act, conforms to the s 9 right to equality, which means that the tax burden should be 'just and appropriate in reflecting similarities and differences'. In other words, it must reflect substantive, and not just nominal or objective equality; 'the purposes of the equality right looks to a society where each person is accorded equal moral worth, and in which systemic inequality and disadvantage are eradicated and substantive equality is actively promoted'.

A substantive approach to equality requires that taxpayers in similar circumstances must be subject to the same tax burden. This may mean that the circumstances in which the taxpayer is earning the income must be taken into account. Factors which would cause the circumstances to differ in cross border trade and investment include:<sup>284</sup>

- the relevant risk factor;
- the environment in which the taxpayer is trading or investing;
- whether the taxpayer is contributing to a developed economy or to a developing one where the taxpayer might not be directly linked to the support of government to generate income; and
- the support and facilities provided by the relevant government to generate that income.

Although it can be argued that the first two factors also differ between trade and investment within the domestic economy, in the context of cross border activities it is referring to the risk attached to the country as a whole and the particular country environment in which the taxpayer is trading. These two factors are largely reflected in the last two factors which are particularly relevant to South Africa as a developing country. The last two factors are in fact the application of the benefit principle of

---

<sup>284</sup> For a discussion on these factors, see Vogel *Intertax* Part III (note 5) at 396.

equity which requires that more than the nominal income of taxpayers be used to determine equality.<sup>285</sup>

A more formal or nominal version of equality considers equally well-off taxpayers to be similarly situated. In other words, cognisance is only taken of the pre-tax nominal income, without taking into account the factors which might affect the origination of that nominal income. The principle of the equally well-off being similarly situated is a reflection of ability-to-pay equity and, given South Africa's skewed distribution of wealth, is likely to be supported in South Africa. While this view may be appropriate for individuals, it may not always be appropriate for the active income of companies, where the particular country environment giving rise to the pre-tax nominal income may differ. Therefore, it may be appropriate to have a different form of equity applicable to active income of companies as compared to income (both passive and active) of individuals.

The use, on the one hand, of the source basis of taxation and its concomitant use of the exemption method of relief for international double taxation of active income and, on the other hand, the use of the residence basis of taxation combined with the tax credit for passive income during the transition period, could be seen as acceptance of the argument that a distinction can be made along equity lines between active and passive income.

From a tax legitimacy and equity perspective (that is, the basis on which a country may levy tax), it can be argued that non-resident portfolio investors, as

---

<sup>285</sup> See Elkins (note 6) at 71 where reference is made to Dworkin and the distinction between 'equal treatment' and 'treatment as equals'.

compared to the non-resident direct investors, do not benefit to a great extent from the services or infra-structure of the country where the source of that portfolio investment is located. The non-resident portfolio investor, so it is argued, benefits mainly from the political and economic security provided by the country where the source is located whereas the non-resident direct investor clearly benefits from all the services and infrastructure provided by the local government to the same extent as the resident domestic enterprises. It therefore follows that from a country's legitimacy and equity perspective, the benefit principle of equity is more applicable to non-resident direct investment.<sup>286</sup> This argument justifies taxation of portfolio investment by the country of residence of that portfolio investor. Similarly, it justifies taxation of the direct investor by the country where the source of that direct investment income is located on the basis of the benefit principle of taxation.

A further argument said to justify taxation of portfolio investment in the country of residence of the portfolio investor is based on the capital which gives rise to the income being produced in the country of residence of the portfolio investor and the country of residence therefore being justified to tax the income arising from the capital.<sup>287</sup> According to Vogel, this argument presupposes that capital, 'once produced remains under an allegiance of its own to the state in which it was produced'.<sup>288</sup> The legislature may therefore choose to tax either 'income produced once and for all or to postpone part of its taxation and make up for this later by

---

<sup>286</sup> Vogel *Intertax* Part III (note 5) at 399–400.

<sup>287</sup> Vogel *Intertax* Part III (note 5) at 399.

<sup>288</sup> *Ibid.*

taxing the returns on re-investment'.<sup>289</sup> The second option of the legislature requires that account be taken of the factors used to give rise to the income which becomes the capital to be invested. Where that capital is invested and earns income, and the taxation of that income is said to be linked to the factors which originally gave rise to the capital, then the taxation of that income has to be split between the original income that gave rise to the capital and the second round of income that originates from the capital. This means that the legislator, with the knowledge that the income from the investment of the capital arises from the original income, must postpone a portion of the taxation of the original income. Vogel takes his argument further by stating that unless the residence state has chosen the second option, that is, the partial postponement of income taxation (which according to Vogel, no state has ever chosen),<sup>290</sup> a line of reasoning which attempts to justify the taxation of foreign capital income by referring to the origin of that income in the residence state is not conclusive.<sup>291</sup> He states that if taxation is postponed in this way, the postponement would have to apply to capital invested at home in the same way as to capital invested abroad.<sup>292</sup> According to Vogel, therefore, residence based taxation of portfolio investment income based on this argument is not justified.

Where the jurisdictional link and the method used to relieve or eliminate international double taxation results in a different treatment of residents, as in the case of the different treatment between active and passive income in South Africa during the transition period, such differential would have to be justified in

---

<sup>289</sup> Ibid. The term 'income' as used here includes capital.

<sup>290</sup> Ibid.

<sup>291</sup> Ibid.

<sup>292</sup> Ibid.

accordance with the constitutional imperative of equality, particularly in relation to persons who are being compared.

Although not related to the constitutional imperative of equality, and where the result of the implementation of a particular method of relief for international double taxation may give rise to inequality between South African residents, the inequality may be justified by the consideration of other policy principles in deciding the tax base and structure for cross border activities, such as the policy principle of neutrality. Neutrality requires that the policy choice is made between, on the one hand, neutrality in any given country irrespective of the place of residence of the originator or owner of the trade or investment and, on the other hand, neutrality between residents of a given country irrespective of where the return on the investment arises or where the source of the investment return is located.<sup>293</sup>

According to Vogel, neutrality is rarely discussed in relation to portfolio investment. For him, the taxation of interest derived from portfolio investment is neutral only if it does not change the market conditions of the country in which the debtor operates.<sup>294</sup> He states that Peggy Musgrave appears to assume that the same reasoning is required for direct and portfolio investment and Ganderberger's analysis equates loans with sales.<sup>295</sup> Vogel, in distinguishing between direct and portfolio

---

<sup>293</sup> Musgrave et al (note 2) at 569; Vogel *Intertax* Part II (note 13) at 311.

<sup>294</sup> Vogel *Intertax* Part II (note 13) at 316.

<sup>295</sup> Vogel *Intertax* Part II (note 13) at 315 where he refers to the arguments of Ganderberger which hold that the concept of capital import neutrality with regard to loans and sales are meaningless since the supplier in both cases does not compete as an entrepreneur in the country where the sale or portfolio investment is made. Vogel however did not find this argument convincing. According to him, the taxation of sales in the country of residence do not affect efficient factor allocation because sales do not transfer capital whereas in cross border loans there is the transfer of capital from one country to another and the question of the efficient allocation of capital is unavoidable.

investment, argues that whereas the benefit theory of equity and the same competitive environment is the main consideration in respect of direct foreign investment, the main consideration in portfolio investment is the issue of risk. If the country of the investor, as is mostly the case, has a residence basis of taxation, the tax imposed by the country of residence of the investor is shifted onto the debtor in the country where the source is located by the investor requiring a higher return. The result is that the return required from the country where the source is located has to be higher than the return of the country of residence to make up for the tax imposed by the country of residence, particularly where the country of residence of the investor is a developed country and the country where the source is located, is the developing country and the perceived risk is greater in the developing country.<sup>296</sup>

A numerical example illustrates this as follows:<sup>297</sup>

Country A investor gives a loan to a debtor in country B at the ordinary market interest rate of 5%. Country A did not initially tax residents on worldwide income but subsequently imposed a tax on a worldwide basis at 10%. For the investor to maintain the same after-tax profit, he will want to raise the interest rate to 5.56%. In a perfect capital market he would not be able to do so. But if the capital market does not operate perfectly, namely country A is sufficiently big to influence the international capital market by its taxation, or if most capital exporting countries proceed to impose a new tax, this new tax will result in an adjustment on quantities and prices which will result in a higher market rate of interest and a reduction of the

---

<sup>296</sup> Vogel *Intertax* Part II (note 13) at 316–317.

<sup>297</sup> Vogel *Intertax* Part II (note 13) at 316.

total amount of loans. Therefore, the burden of the new tax will be borne by the debtors in country B to the extent that the rate of interest has been increased.

According to Vogel, the above example illustrates the problem for developing countries that require foreign investment. If the developed countries which are the countries of residence of the owners of capital have high tax rates (in comparison to developing countries) and apply a residence basis of taxation, part of their tax burden on portfolio investment is shifted to the developing country, the country where the source of income, such as interest income, is located. This shifted tax burden together with the increased risk premium that applies to the developing world means that, in order to attract portfolio investment, the return on capital in the developing country must be considerably higher than in the country of residence of the investor. This of course is contradictory to the requirement of neutrality in that the return, which for foreign investment includes the risk element and the shifted foreign tax burden, would be different for domestic versus foreign investment. On the basis of this analysis, the worldwide taxation of portfolio investment combined with the tax credit as the method of relief in the country of residence is not neutral and, as is the case for direct investment, neutrality is only achieved if:

... the competitive situation of the enterprise into which the investment is made is controlling. In this context, the source of portfolio interest and dividend income is the place where the enterprise is situated.<sup>298</sup>

---

<sup>298</sup> Vogel *Intertax Part II* (note 13) at 317.

This means, according to Vogel, for both direct and portfolio investment, neutrality is achieved only when source is the jurisdictional link and/or the relief for international double taxation is granted by the exemption method.<sup>299</sup>

The situation may be different where, despite having a residence basis of taxation, portfolio investment returns are low in developed countries when compared to developing countries. Where the tax rates in developing countries are lower than those in developed countries or where non-resident portfolio investment is exempt in the country of the location of the source, it may mean an increase in portfolio investment in developing countries. If the portfolio investment is not the type of investment desired by the developing country (for example, it is mobile and easy to disinvest) the developing country may want to increase the costs of the investment, for example by imposing a withholding tax on certain types of portfolio investment returns which results in a higher tax burden than the tax imposed in the residence state. The problem with this approach is that it affects neutrality and equity.

Vogel's analysis would apply to South Africa only where a South African resident invested in a country that is 'less developed' than South Africa and where South Africa is seen as the creditor nation, such as where South Africa is used as a portal to invest into other African countries.

In order to further consider the equity and neutrality aspects of outward and inward trade and investment activities of South African residents with respect to active and passive income, the tax treatment of the different categories of income

---

<sup>299</sup> Vogel *Intertax* Part III (note 5) at 401–402.

will be analysed, namely business income, interest and royalty income, and dividend income. Furthermore, the legal form of the investor will be considered, namely branches or subsidiaries of controlled foreign companies, since the legal form of the investor affects the tax treatment of these categories of income.

### **3.5.2 Business income in general**

The retention during the transition period of the source basis of taxation for taxpayers whose source of active income was located outside South Africa,<sup>300</sup> and the concomitant application of the full exemption method of relief for such income, meant that there was potentially a difference between the taxes paid by South African residents on local and outward trade and investment. The potential differential between the taxes paid by South African residents on active income where the source of the income was located outside South Africa meant that ability-to-pay equity based on pre-tax nominal income, as a standard for formal equality, did not apply to all South African residents during the transition period. The implementation of the source basis of taxation in this manner would have undermined the economic policy and right to equality in s 9 of the South African Constitution<sup>301</sup> if it was required that all South African residents pay the same amount of tax on their pre-tax nominal income irrespective of the location of the source of their income and would have needed to be justified in terms of the limitation clause found in the Constitution.<sup>302</sup> If

---

<sup>300</sup> Namely income which did not fall into the s 9C deeming provisions.

<sup>301</sup> Section 9 of the Constitution.

<sup>302</sup> Section 36 of the Constitution provides that

(1) The rights in the Bill of Rights may be limited only in terms of law of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom, taking into account all relevant factors, including —

(a) the nature of the right;

(b) the importance of the purpose of the limitation;

the aim was to treat similarly situated taxpayers the same, taking into account the factors in the host country, then the choice of using the source basis of taxation for active income would have been in accordance with the benefit principle as a proxy for substantive equality under the assumption that South African residents would have paid the same amount of tax as other residents of the host country, where the source of the income was located. Thus, the South African residents would have paid tax on the same basis as their competitors in their host country of trade and investment. There would therefore have been substantive equity between businesses in a given country. In addition, these South African residents would have been tax neutral with respect to businesses in their host country and their business activities would have been competitive in that country.

### **3.5.3 *Interest and royalty income***

The deeming source provisions under s 9C applied to income received by or accrued to South African residents where the actual source of the interest and royalty income was not located in South Africa. Section 9C deemed the source of such income to be located in a South African source if the interest and royalty income was received by or accrued to a South African resident.<sup>303</sup> In addition to the deeming source

- 
- (c) the nature and extent of the limitation;
  - (d) the relation between the limitation and its purpose; and
  - (e) less restrictive means to achieve the purpose.

(2) Except as provided in subsection (1) or in any other provision of the Constitution, no law may limit any right entrenched in the Bill of Rights.<sup>7</sup>

<sup>303</sup> Section 9C of the Income Tax Act deemed interest and royalty income (included in the definition of investment income) which was received by or accrued to a resident, to be received by or accrued to such resident from a source within South Africa.

provisions under s 9C for foreign interest income, the source of local interest income was determined under the provisions of s 9(6) and (7).<sup>304</sup>

The effect of s 9C was the possibility that the South African resident taxpayer would pay tax both in South Africa and in the host country where the actual source was located. Relief for this international double taxation was provided in the Income Tax Act in the form of s 6*quat* by granting a limited tax credit for the taxes paid in the host (foreign) country.<sup>305</sup> In the event that the s 6*quat* credit did not apply because its requirements were not met, relief for this international double taxation was available by either claiming the foreign taxes as an expense in terms of s 11(*a*) read with s 23(*g*) of the Income Tax Act or in terms of an applicable double taxation agreement entered into between South Africa and the other contracting state. As indicated in Chapter Two, there is an argument that a foreign tax would not meet the requirements of s 11(*a*) and s 23(*g*) and therefore would not have been deductible.<sup>306</sup>

---

<sup>304</sup> By the Taxation Laws Amendment Act No. 30 of 1998. Section 9(6) provided that ‘any interest as defined in s 24J for the purpose of this Act be deemed to have been received or accrued from a source within the Republic, where such interest was derived from the utilisation or application in the Republic by any person of any funds or credit obtained in terms of any form of interest bearing arrangement’. Section 9(7) provided that: ‘For the purpose of subsection (6) the place of utilisation or application shall, until the contrary is proved, be deemed to be, in the case where such funds or credit is utilised or applied by (a) a natural person, the place where such person is ordinarily resident; or (b) a person other than a natural person, its place of effective management’.

<sup>305</sup> With the introduction of s 9C and s 9D into the Income Tax Act in 1997, the tax credit provided for in s 6*quat* was amended by the Income Tax Act No. 28 of 1997 to be in line to some extent with the Katz Commission 5th Interim Report (note 2) recommendations. The 1997 amendments to s 6*quat* in particular included references to the extended deemed source provisions found in s 9C and s 9D of the Income Tax Act. Section 6*quat* was again amended in 1999 in order to expand the relief given for other deemed source provisions (by the Revenue Laws Amendment Act No. 53 of 1999). This amendment provided for, *inter alia*, the addition of the following paragraph (c) to subsection (1), (c) any income payable to such resident from the republic, where such income is deemed to be from a source within the Republic in terms of the provisions of paragraphs (d), (d)*bis* and (f) of section 9(1).’

<sup>306</sup> See discussion in para 2.7.4 of Chapter Two of this thesis.

The impact of the tax credit and s 9C meant that all South African residents who received, or to whom interest or royalty income accrued, paid the same amount of tax irrespective of the location of the actual source of the interest or royalty income. Accordingly, the formal ability-to-pay principle of equity applied to these residents, except possibly where the host country imposed higher tax rates than South Africa. In that case, South African resident outward investors would bear an extra tax as a cost of their investment. In addition, at that time the version of s 6quat, as the unilateral method to relieve international double taxation, did not allow for the mixing of tax credits. The non-mixing of tax credits meant that where a South African resident taxpayer traded or invested in two jurisdictions, one where the tax rates were higher than in South Africa and the other where the tax rates were lower than in South Africa, the excess credits from the low tax jurisdiction could not be offset against the excess tax from the high tax jurisdiction in terms of s 6quat, the excess tax arising as a result of the application of the limited tax credit.<sup>307</sup> The application of the limited tax credit to tax paid on the net amount of income and the non-mixing of tax credits also had a restrictive impact. This was seen where the country of source imposed a withholding tax on the gross amount of income and the South African lender borrowed to raise the capital to lend to the foreign borrower, since the tax imposed on the gross amount was usually much higher than the relief

---

<sup>307</sup> South African National Treasury Explanatory Memorandum accompanying the Revenue Laws Act No. 59 of 2000, 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000'. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 30 September 2011. The statement is made in terms of the application of the limited credit as found in s 6quat and does not take into account the source requirement of s 6quat nor does it take into account the possibility of the application of double taxation agreements.

which was restricted to the South African tax on the net amount.<sup>308</sup> The possibility of a higher tax rate being imposed in the country where the actual source was located, the imposition of a withholding tax on the gross interest by the country of actual source and the non-mixing of tax credits meant that the competitiveness of a South African resident outward trader and investor was undermined. However, given that competitiveness is not a feature of passive income<sup>309</sup> and that both inward and outward interest and royalty income earners are more likely to be in similar circumstances with respect to factors influencing the pre-tax positions, the use of the foreign credit, which places both such inward and outward investors in the same post tax position, could be viewed as appropriate and in line with substantive equality.

#### ***3.5.4 Effect of the definition of residence***

The transition period's tax structure of treating all South African resident taxpayers who received or were entitled to interest and royalty income the same, irrespective of where the source of such interest and royalty income was located, implies that the applicable equity principle to these taxpayers was ability-to-pay equity. However, the role of the definition and interpretation of residence in determining who must be treated equitably and whose transactions must be neutral should be borne in mind. This is because the application of s 9C, and accordingly the relevant method of relief for international double taxation, depended on whether a taxpayer was classified as a resident in South Africa for tax purposes, or not.

---

<sup>308</sup> The proviso to the s 6quat credit as it read at the time stated that '... Provided that the rebate under this subsection shall not exceed so much of the normal tax payable by such resident as is attributable to the inclusion in his taxable income of the amount of income so included therein.....'

<sup>309</sup> See discussion in para 2.7.5 of Chapter Two of this thesis.

During the transition period, residence for companies was determined by the ‘place of effective management’ test while individuals were treated as tax-resident in South Africa if they were ‘ordinarily resident’ in South Africa.<sup>310</sup> Residence therefore did not include companies incorporated or established in South Africa or individuals living or present in South Africa for lengthy periods of time. The use of these tests for residence resulted in a limitation of the residence basis for passive income and thus also a limitation of ability-to-pay equity. In other words, equity in terms of the benefit principle still played a large role as did neutrality in the form of capital import neutrality as a result of the source basis of taxation and the exemption method of relief for international double taxation. The application of policy principles of equity and neutrality did not appear to be consistent because the benefit principle of equity still applied to those living in South Africa for long periods and to companies incorporated or established in South Africa, where both these individuals and companies benefited from the services and support in South Africa. In addition, the different definitions of residence for artificial legal entities in s 9C as compared to the original version of s 6quat meant that the s 6quat relief for international double taxation might not have been applied consistently.

The test for the residency of a company for the purposes of s 9C was whether or not the ‘place of effective management’ of the company was located in South

---

<sup>310</sup> In terms of s 9C of the Income Tax Act.

Africa.<sup>311</sup> By contrast, the original *s 6quat* test for the residency of a company was whether or not the company's management and control was located in South Africa.<sup>312</sup> The potential anomaly arising because of the difference between the definitions of residence as found in *s 9C* and *s 6quat* was eventually remedied by changing residence for the purposes of *s 6quat* to 'place of effective management'.<sup>313</sup> The problems, on the one hand, of the applicable version of equity or neutrality and on the other, of the limited implementation of residence through the definition of residence in *s 9C*, were not the only indicators that the introduction of a limited version of residency and the choice of method of relief for international double taxation, were made without a thorough analysis of the effects on cross border trade and investment.

### 3.5.5 *Legal form: Branch versus subsidiary*

As seen from the earlier discussion, the recommendations of the Katz Commission as implemented by, *inter alia*, *s 9C* resulted in a different tax liability depending on the classification of the income received by or accrued to the South African resident taxpayer where the source of the income was not located in South Africa. This differential treatment was also reflected in the legal form of that cross border

---

<sup>311</sup> The original version of *s 9C* inserted in the Income Tax Act by the Income Tax Act No. 28 of 1997 provided that a 'resident means any natural person who is ordinarily resident in the Republic and any person other than a natural person which has its place of effective management in the Republic'. The definition was amended by the Taxation Laws Amendment Act No. 30 of 2000 with effect from 23 February 2000 to include any person, other than a natural person, which is incorporated in South Africa.

<sup>312</sup> Prior to the amendment by the Income Tax Act No. 28 of 1997, resident was defined in *s 6quat* as meaning a person (other than a company) who is ordinarily resident in the Republic or a domestic company. Section 1 of the Income Tax Act at the time defined a 'domestic company' as a company which is managed and controlled in South Africa'. The definition of 'domestic company' was repealed by the Revenue Laws Amendment Act No. 59 of 2000.

<sup>313</sup> The Income Tax Act No. 28 of 1997 amended the definition of 'resident' in *s 6quat* to mean 'any natural person who is ordinarily resident in the Republic and any person other than a natural person which has its place of effective management in the Republic'.

investment or trade. This difference is due to the different legal forms through which direct investment may be made and furthermore due to the fact that passive income can arise from both direct and portfolio investment. In other words, the form of the trade or investment may have affected who qualified as a tax resident and what form of relief was available for international double taxation. Therefore, the choice of form affected the principles of equity and neutrality. These differences arose mainly because an outward resident trader or investor had a choice between establishing a branch, subsidiary, a partnership or even a business trust in the host country.<sup>314</sup> In addition to affecting equity and neutrality in relation to juridical double taxation, it also affected economic double taxation where a subsidiary could be taxed in the host country and the South African parent company taxed on the same income in South Africa.

Where outward investment takes the form of a branch or a partnership, the income which arises from a source outside the country of residence of the trader or investor is likely to fall into the category of business income, interest or royalty income. During the transition period, where the source of business income was not located in South Africa, it was exempt while interest and royalty income were deemed to be from a source located in South Africa in terms of s 9C. In other words, where the source of interest and royalty income of the branch of a South African resident company was located outside South Africa, such income fell into the scope of the s 9C deeming source provisions.

---

<sup>314</sup> If the investment takes the form of a partnership or a trust, then equity and neutrality will also be affected. These two forms of investment will not be considered.

Given that, for companies, residence was determined by ‘place of effective management’ the meaning and interpretation given to ‘place of effective management’ defined the ambit of residence and whether the income was that of a branch of a South African resident company. The possible interpretations given to place of effective management are discussed in Chapter Four; suffice it to say at this point that the interpretation may have determined the tax liability of companies.

By comparison, where outward investment took the form of a foreign incorporated subsidiary (South African subsidiary), the business income of that subsidiary was exempt in South Africa provided that the controlled foreign company rules did not apply. The return to its South African holding company (SA Holdco) could have been in the form of either interest income (where the subsidiary was financed by way of a loan), dividend income (where the subsidiary distributed dividend income in general and also where the subsidiary was financed through equity financing), and also potentially royalty income where the subsidiary used the intellectual property of the South African holding company. These three forms of passive income could have arisen from both direct and portfolio investment. It would take the form of portfolio investment where the South African resident was not in control or did not have a say in the company in which it invested and merely received income in the form of dividends, interest and royalties as a passive investor. If the South African holding company (SA Holdco) received foreign sourced income in the form of royalty and interest income from its foreign subsidiary, the income was exempt, except if s 9C applied. Section 9C applied if the place of effective management of SA Holdco was located in South Africa and, if it was, then it made

no difference whether the interest or royalty income was the return of direct or portfolio investment – the income fell within the scope of s 9C.

Whether the business income of a South African resident arose from the use of a foreign branch (where the source of that income was located in the same country as the foreign branch) or foreign subsidiary (where the subsidiary was established or incorporated in that foreign country and the source of its income was located in that foreign country), the foreign sourced business income of that branch or subsidiary was not taxed in South Africa. The business income of the branch was not taxed because the exemption method of relief for international double taxation applied by default as a result of the source basis of taxation while tax was not imposed on the subsidiary because both the location of the source of the income and the residency of that subsidiary were located outside South Africa.

Similarly, the returns in the form of interest and royalty income from both a branch and a subsidiary received by or accrued to the South African resident holding company fell into s 9C with the possibility of the s 6quat tax credit relief for international double taxation. In this sense, the form of outward investment by South African residents as defined appears to have the same result.

From a general legal perspective, the two major differences between a branch and a subsidiary are that, unlike a branch, a subsidiary may distribute dividends to its parent shareholder and it may defer the payment of interest, loans or dividends to its parent or holding company with the result that no income is received by or accrued to the parent or holding company. The result of this deferral means that there is a potential different tax treatment between a branch and a subsidiary, in particular in

relation to the timing of the receipt and accrual of the income and the tax paid. The different tax treatment of a foreign branch relative to a foreign subsidiary raises the issue of whether it is appropriate to compare these two forms of trading and investment and whether one should consider the separate legal or separate functional approach, particularly with respect to branches. The issue is raised because in order to consider income flows between a foreign branch and the resident company of which the branch is a legal extension, an assumption has to be made that the foreign branch is notionally separate from the resident company and that there are notional income and expenditure flows. Legal versus economic separate functionality, although an issue, does not affect the current analysis because the concern here is the different tax treatment that arises as a result of the use of source for branch income. Controlled foreign company rules are meant to overcome this distinction and, as an anti tax-avoidance measure, to create neutrality between a branch and a foreign subsidiary.

### ***3.5.6 Controlled foreign companies***

Without the controlled foreign company rules under s 9D, where the source of interest income and royalty income was located outside South Africa and the company was not tax-resident in South Africa, the income of this foreign company would not have fallen into the South African tax net. The result would have been a discrepancy between interest and royalty income earned by South African residents through a branch and a South African resident using a foreign subsidiary as a conduit to receive or be entitled to the interest and royalty income. Such a subsidiary could defer payment to the South African parent or holding company and thus defer the tax liability. As recommended by the Katz Commission, the controlled foreign company

rules introduced in 1988 were broadened in 1998 to include interest income and expanded to apply to all foreign entities.<sup>315</sup> The controlled foreign company rules were also expanded, from applying only to countries neighbouring South Africa, to all countries by not limiting the scope of the controlled foreign company rules to specific countries.<sup>316</sup> Section 9D defined a controlled foreign company as any foreign entity in which resident(s) of South Africa held more than 50% of the participation rights, or were entitled to exercise more than 50% of the votes or controls of such entity. It provided that the passive income of a controlled foreign company was deemed to be the income of the South Africa resident to the extent that the South Africa residents were participants in or otherwise entitled to the company's income.<sup>317</sup>

In line with the overall treatment in respect of anti tax-avoidance measures, the 1998 version of s 9D did not impose tax on the South African resident's portion of the controlled foreign company income where the foreign company was a resident in a designated country and the tax payable by the controlled foreign company in its country of residence was more than 85 per cent of the normal tax payable in South

---

<sup>315</sup> Katz Commission 5th Interim Report (note 2) at para 8.3.1.1, para 6.2.1.4.

<sup>316</sup> By the introduction of s 9D.

<sup>317</sup> Section 9D provided that a proportional amount of any investment received by or accrued to a controlled foreign company which 'bears to the total investment received by or accrued to such entity, the same ratio as the percentage of the participation rights of such resident in relation to such entity bears to the total participation rights in relation to such entity' is included in the income of the resident.

Africa.<sup>318</sup> The exemption method of relief for international double taxation of income, where tax was imposed in the country of residence of the controlled foreign company and in South Africa, as indicated above,<sup>319</sup> was used. The exemption method was used because the same amount of taxes would be collected by the South African fiscus if a tax credit was granted to relieve international double taxation. One concern with the use of the designated country list and the tax rate of the country of residence of the controlled foreign company, is that the workings of s 9D were dependent on the tax structure of the country of residence of the controlled foreign company. Furthermore, the application of s 9D could have been disturbed by the host country changing its tax structure. In addition, it meant that the South African revenue authorities, and by implication the South African government, treated foreign countries differently; this could have had political implications as it might have appeared that the South African government was promoting trade and investment with particular countries. The use of the tax rates and structures of the resident country to determine whether or not the return to the shareholder was exempt, also meant that no consideration was given to the risk factors and infrastructure of the country of residence of the controlled foreign company, that is,

---

<sup>318</sup> Section 9D(9)(d) provided that the provisions of s 9D shall not apply to investment income which is taxable in a country which the Minister of Finance has identified by notice in the *Government Gazette* as a country whose tax on income is determined on a basis which is substantially the same as that of South Africa. Section 9D(9)(a) provided that the provisions of s 9D 'shall not apply' where the foreign tax actually paid or payable in the foreign country, in respect of the proportionate amount to be included in the South African's residence income is more than 85% of the normal tax payable in South Africa, taking into account deductions or allowances under the taxation provisions of such foreign country in accordance with the proportionate ratio. This meant that the statutory rate of tax in a designated country had to be at least 27% per cent and that their determination of income tax coincided materially with that of South Africa. See Richard Jooste 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *SALJ* 473 at 484-486.

<sup>319</sup> *Ibid.*

no consideration of the benefit principle of equity and competitiveness in that country.

### 3.5.7 *Dividend income*

Foreign sourced dividend income received by or accrued to South African residents was not included in s 9C because foreign sourced dividend income was already included in the gross income of South African resident taxpayers in terms of paragraph (k) of the 'gross income' definition inclusions.<sup>320</sup> Contrary to the earlier treatment of foreign sourced dividend, by the time of the transition period foreign sourced dividend was generally exempt from tax in South Africa. Section 10(1)(k), the provision in the Income Tax Act which generally exempted dividend income from tax, provided that dividends received by or accrued to or in favour of any person were exempt except where, *inter alia*, such dividend income was distributed by a fixed property company.<sup>321</sup>

Based on the decision in *Boyd*,<sup>322</sup> dividend income of a South African company with its share register located in South Africa would be included in 'gross income', irrespective of the source of the business income. Given that dividend income was usually exempt in terms of s 10(1)(k) of the Income Tax Act, South

---

<sup>320</sup> Para (k) of the definition of 'gross income' which provides that: '... and for the purposes of this paragraph all dividends from sources outside the Republic received by or accrued to any person (other than a company) who is ordinarily resident in the Republic or received by or accrued to any company which is registered, managed and controlled in the Republic, shall be deemed to have been received by or to have accrued to such person or company from a source within the Republic'.

<sup>321</sup> Section 10(1)(k)(1) of the Income Tax Act as it read at the time provided that:  
 'To dividends (other than those distributed out of profits of a capital nature and those received by or accrued to or in favour of any person not ordinarily resident nor carrying on business in the Republic) distributed by a fixed property company as defined in s 1 of the Unit Trusts Control Act No. 54 of 1981, on shares included in a unit portfolio comprised in any unit trust scheme in property shares authorised under the said Act or ...

<sup>322</sup> *Boyd* (note 153).

African sourced dividend income did not form part of the taxable income of South African resident companies or individuals.

During the transition period and shortly prior to the introduction of the residence basis of taxation in 2001, s 9E was enacted as an interim measure, to 'deal with' the taxation of dividend income declared from non-South African sourced or foreign profits.<sup>323</sup>

According to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2000,<sup>324</sup> which accompanied the Taxation Laws Amendment Act No. 30 of 2000, the imposition of tax on foreign dividends received by or accrued to South African residents would bring South Africa closer to the 'internationally accepted tax principles for taxing foreign dividends'.<sup>325</sup> Foreign dividends were accordingly included in the calculation of the gross income of resident taxpayers.<sup>326</sup>

Under the initial version of s 9E, introduced in early 2000, a foreign dividend was deemed to be from a source located within South Africa<sup>327</sup> and was defined as:

... any dividend distributed by a company from profits derived by such company from a source outside South Africa which is not deemed to be

---

<sup>323</sup> Section 9E was introduced in 2000 by the Taxation Laws Amendment Act No. 30 of 2000.

<sup>324</sup> South African National Treasury Explanatory Memorandum accompanying the Taxation Laws Amendment Act No. 30 of 2000, 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2000'. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 15 November 2012.

<sup>325</sup> *Ibid* at 1.

<sup>326</sup> Para (k) of 'gross income' in s 1 of the Income Tax Act provided for the inclusion in 'gross income' of 'any amount received by or accrued by way of dividends including any amount determined in the provisions of section 9E in respect of any foreign dividend received by or accrued to any person who is a resident as defined in such section'.

<sup>327</sup> In terms of s 9E(2) 'any foreign dividend received by or accrued to a resident shall for the purposes of the definition of "gross income" in section 1, be deemed to have been received by or accrued to such resident from a source within the Republic'.

from a source within South Africa, or was deemed to be from a source within South Africa and has not been subject to tax in South Africa.<sup>328</sup>

This effectively meant that a South African resident company could also declare a foreign dividend. The definition differed from the interpretation given in *Boyd's*<sup>329</sup> case, because unlike in *Boyd's* case, the deciding factor in s 9E on whether the dividends are from foreign sources, was the location of the source of the business profits, as opposed to the place where the share register was located.

In terms of this initial version of s 9E, a 'resident' was defined as 'any natural person ordinarily resident in South Africa and any other person which is incorporated or has its place of effective management in South Africa'.<sup>330</sup>

A factor to consider in relation to the ambit of s 9E was that the section did not cover all foreign sourced dividend income due to the combination of the limited definition of 'foreign dividend' and the limited reach of residence at the time.

The second version of s 9E introduced by the Revenue Laws Amendment Act No. 59 of 2000 amended the definition of a foreign dividend to be included in 'gross income' by referring to the s 9E.<sup>331</sup> The definition of a foreign dividend was also amended to:

... a dividend received by or accrued to a person from any company that is either a foreign entity as defined in s 9D or a resident to the extent that is the

---

<sup>328</sup> Section 9E.

<sup>329</sup> *Boyd* (note 153).

<sup>330</sup> Section 9E(3). The residence requirement was in line with s 9C of the Income Tax Act.

<sup>331</sup> Paragraph (k) of the definition of 'gross income' provided for the inclusion of 'any amount received by or accrued by way of dividends including any amount determined in accordance with the provisions of s 9E in respect of any foreign dividend received by or accrued to any person who is a resident'.

dividend is declared from profits before it became a resident, plus deemed dividends.<sup>332</sup>

The definition of 'resident' was aligned to the general definition in s 1 of the Income Tax through the deletion of s 9C.

Although foreign dividends were subject to tax with a residence basis of taxation for dividend income, the initial version of s 9E provided a list of categories of foreign sourced dividend income which were exempt from tax in South Africa.<sup>333</sup>

The first version of s 9E exempted dividend income received by South African residents declared from non South African sourced business profits. The source had to be located in a designated country,<sup>334</sup> and tax had to be imposed in that designated country on those business profits on a basis substantially similar to that of South Africa with a statutory tax rate of at least 27%.<sup>335</sup> The second version of s 9E removed the designated country list and retained the substantially similar basis. The taxation of dividend income arising from business income where the source of that business income was located outside South Africa was aligned to the South African tax treatment of the income of foreign branches where the source of income of that foreign branch was not located in South Africa but in the country where the foreign branch was established. In addition, the use of the exemption method of relief for international double taxation meant that, like the South African resident taxpayers who received dividend income from a source located in South Africa, certain

---

<sup>332</sup> Section 9E(1).

<sup>333</sup> Section 9E(7).

<sup>334</sup> In terms of s 9E(7)(d), a designated country at the time was a country which had concluded a treaty for the prevention of double tax with South Africa.

<sup>335</sup> As stated in the South African National Treasury Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307).

dividend income declared from business income which did not have its source located in South Africa was also exempt.

The use of the exemption method not only relieved the possible juridical double taxation that would have been experienced by the South African resident recipient of the foreign dividend but also prevented economic double taxation by the South African fiscus. Economic double taxation would have arisen because the company was taxed on the business income in its country of residence. That business income would have been inclusive of the dividend income eventually distributed, and the same dividend income would have been taxed in the hands of the South African resident shareholder. By exempting the foreign dividend received by or accrued to the South African resident shareholder from tax in South Africa, economic double taxation of the dividend income in South Africa was prevented. It must be noted that although the use of the exemption method of relief in South Africa does relieve international juridical double taxation, since the South African resident shareholder is only subject to tax on the dividend income in the country of residence of the company distributing the dividends, it may not fully relieve economic double taxation of the underlying income earned abroad. The latter possibility of economic double taxation still exists because the country of residence of the distributing company may not provide relief for economic double taxation and may impose tax on the profits of the distributing company as well as on the dividend when distributed. The South African Treasury has cited the same amount of tax being paid

and collected and a reduced administrative burden for using the exemption method of relief in these circumstances.<sup>336</sup>

A second exemption of foreign dividend income was a *de minimis* exemption provision which exempted the foreign sourced portion of the dividends received by South African resident company shareholders where more than 25% of the total income of the South African resident company arose from a source located outside South Africa. The Explanatory Memorandum to the Bill indicated that this exemption was inserted in the Income Tax Act to 'reduce the administrative burden of computing the percentage of the foreign dividend to be included in the taxable income of the South African resident company'.<sup>337</sup> Another reason that could be given was the percentage of 25% was indicative of direct, as opposed to passive or portfolio, investment.<sup>338</sup>

The third exemption covered foreign dividends received by a South African resident if the investment income from which the foreign dividend was paid had already been included in the South African resident's income under the controlled foreign company provisions of s 9D or was included in the South African resident's income under any other provision of the Income Tax Act. This particular exemption relieved economic, not juridical, double taxation.<sup>339</sup>

In addition to relieving economic double taxation by providing the exemption method of relief, the Income Tax Act also made provision to relieve economic

---

<sup>336</sup> Ibid at 10.

<sup>337</sup> Ibid at 3.

<sup>338</sup> Section 9E(7).

<sup>339</sup> Section 9E(7).

double taxation by the use of a tax credit provided in s 6quat, read with s 9E.<sup>340</sup> Relief for economic double taxation was provided by allowing a tax credit for the underlying taxes paid by the company (that is, the taxes paid by the company on its business profits), where the distributing company was not tax resident in a designated country and the shareholding of the South African resident shareholder was less than 10%. The result was different tax treatment for foreign dividend income received by or accrued to South African residents depending on the tax system of the country of investment. Initially the treatment depended on whether such country was listed as a designated country, and the percentage of shareholding of the South African resident shareholder and other holding companies through which the South African resident shareholder held its shares.

The result of the different methods used to relieve international double taxation, both juridical and economic, through a combination of exemption and credit (and possibly deduction), together with the different consequences as illustrated above, did not bode well for equity considerations or for neutrality. The policy approach to the taxation of dividend income appears not to have considered these issues at all and it seems as if the amendments were done in an unstructured manner. This unstructured manner of amending the Income Tax Act and making provisions for juridical and economic double taxation of dividend income was subsequently recognised and reflected in the eventual amendments made to the taxation of dividend income.

---

<sup>340</sup> Section 6quat(1)(d) and s 6quat(1)(A).

### **3.5.8 Traditional business and e-commerce**

The above discussions of inward and outward trade and investment has concentrated on the traditional forms of business where a business operates either through a branch or a subsidiary and the income is clearly categorised as either business, interest, royalty or dividend income. The use of branches or subsidiaries in a given country also presupposes that a physical presence or a defined business activity of a company, its branch or subsidiary can be identified. Where such a physical presence or defined business activity could not be identified, such a business was most likely classified as a portfolio business which potentially gave rise to passive income.

One of the difficulties with using physical presence or a defined business activity as the test to distinguish between passive and active income, and also between portfolio and active income, is that physical presence in the traditional manner is no longer a requirement for an active business, such as in e-commerce.<sup>341</sup> As a result, it is difficult to distinguish between active and passive income. Using the traditional paradigm for direct investment and active income, the form of direct investment can either be done through the use of a branch or the establishment of a subsidiary and there is some benefit derived from the services and support of the host country. E-commerce, by virtue of not requiring the physical presence of the taxpayer, a branch, an agent, or a subsidiary, distorts this traditional paradigm. The use of electronic methods such as web servers, and internet service providers means that a business can operate in a host country without creating a physical presence and without needing much support in that host country. This raises the question as to the

---

<sup>341</sup> See Sijbren Cnossen (ed) *Taxing Capital Income in the European Union: Issues and Options for Reform* 2000 Oxford University Press; Avi – Yonah (note 101) at 1590.

applicability of the benefit principle of equity as the basis on which a government may impose tax on e-commerce transactions.

Thus, where a South African resident operates an e-commerce business from South Africa but in a foreign country, it can be questioned whether the host country or South Africa should impose tax and on what basis it may do so. Although the income earned by the South African based e-commerce business may be classified as business income, the non-use of the infrastructure of the host country may indicate that the host country cannot impose tax on the basis of the benefit principle of equity, especially if the server or internet service provider is located in South Africa. The lack of physical presence or even an agent makes it difficult for the host country to impose tax. South Africa may then be viewed as being able to impose tax on the basis of the benefit principle. If the server or internet service provider is located in the host country, the question of whether the host country will be able to impose tax on the income generated through the server or internet service provider will depend on whether the server or internet service provider is the location of the source of the income.

### ***3.5.9 Equity and neutrality between local and outward trade and investment by South African residents***

The above discussion on the comparison between local and outward investment by South African residents illustrates that the particular form of equity and neutrality applicable during the transition period depended on the category of income. The combination of the source basis of taxation, the source-plus basis of taxation, the exemption method of relief and the credit method of relief, is the reason for the different forms of equity and neutrality. It can be said that during this period, the

taxation of foreign sourced income of South African residents followed the traditional distinction between active and passive income with the former being exempt from tax in South Africa and tax being imposed on the latter.

### **3.6 Outward South African resident trade and investment: host country resident trade and investment**

The form of equity and neutrality when comparing outward South African resident investment and host country resident investment during the transition period also depended on whether the income fell into the s 9C deeming source provisions or not. The tax treatment of active business income received by or accrued to South African resident taxpayers remained the same during the period prior to democracy and the transition period because this income did not fall into the s 9C deeming source provisions.

For income which fell within the s 9C deeming source provisions, there could potentially have been a difference between the outward South African resident investor and the host country investor. Given that the unilateral relief for international double taxation for the s 9C income was in the form of a limited tax credit, this difference was largely dependent on the tax rates imposed by the host country. Where the tax rates in the host country were higher than the South African tax rates, the limited foreign credit found in s 6*quat* meant that the South African resident outward investor was at a disadvantage compared to the host country resident because the overall tax paid in this context would have been higher than the tax paid by the comparable investor or trader in the host country and the competitiveness of the South African resident investor would have been undermined. There would be no disadvantage in the event of an applicable double taxation

agreement providing full relief for the foreign tax paid by the South African residents. Where tax rates in South Africa and the host country were similar, the South African resident investor or trader would have been neutral as it would pay the same amount of tax. By contrast to the period prior to democracy, where tax rates in the host country were lower than tax rates in South Africa, the South African resident taxpayer would have been at a competitive disadvantage to the host country investor because the South African resident taxpayer was paying tax based on the higher South African tax rate.

However, as indicated earlier, competitiveness is not such a great concern for passive income as it is for active income. The concern with competitiveness only arises where the passive income is as a result of foreign direct investment and not portfolio investment.

Prior to the introduction of the source-plus basis of taxation, South African residents were able to undertake both portfolio and direct investment in other foreign countries, without the concern of international double taxation<sup>342</sup> because of the application of the exemption method of relief for income which had its source located outside South Africa. With the introduction of s 9C and the concomitant source-plus basis of taxation, and different methods of relief for international double taxation applying to portfolio and direct investment, different policy approaches to equity and neutrality applied. For portfolio investment in the form of interest and royalty income, the main method of relief was the *s 6quat* tax credit. However, for

---

<sup>342</sup> Except for portfolio investments in the s 9A countries, foreign dividends and the s 9 deeming provisions.

direct income, the full exemption method of relief applied. In addition, the exemption method of relief applied to passive income received by or accrued to a South African resident where the source of the passive income was located outside South Africa but the passive income was effectively connected to a permanent establishment of a South African resident located in a foreign country.<sup>343</sup> This provision, together with the exemption method of relief applying to active income where the source of the active income was located outside South Africa, meant that neutrality in the form of capital import neutrality applied to outward direct investment by South African residents, with these businesses being able to compete in the same conditions as others in that market. This was no different from the erstwhile source basis of taxation as the exemption was essentially the method of relief applied under source.

For those categories of portfolio investment income to which a credit applied, the efficiency policy objective of capital export neutrality applied. South African residents receiving such income were no longer competitive abroad from a tax perspective, as the type of neutrality being envisaged was that of capital export neutrality.

In addition, the return on portfolio investments to South African investors, depending on the tax rates in the host country of investment, had to take into account South African tax: this was not necessary for such investors prior to tax being imposed on such income. As compensation for the potential reduced return on their investment, such investors would have had to receive a greater gross return, for

---

<sup>343</sup> Section 9C.

example, an interest rate adjustment, which would only have been possible if South Africa was able to influence the market. With most capital exporting countries already imposing a tax on the worldwide income of their resident investors, such an adjustment would most likely already have been made because investors would have foreseen the possibility of not receiving full relief for the foreign taxes paid. In fact, the South African investors, prior to the deemed source provisions, might have been at a competitive advantage to other foreign investors within the host country because they would have received the full or gross passive income without a South African tax burden; whereas, the other foreign investors might have been subject to tax on their passive income in their residence states. In this context, the imposition of South African tax on the worldwide investment income of South African residents could be said to have placed South African investors in foreign countries on par with other foreign investors in the foreign host country.

### **3.7 Inward non-South African resident trade and investment: local South African resident trade and investment**

As was the case in the period prior to democracy, the tax treatment of non-resident investors largely remained the same in South Africa and was thus dependent on the tax treatment in the non-resident's country of residence.<sup>344</sup> The Katz Commission recommended the introduction of a non-resident's withholding tax on interest where

---

<sup>344</sup> Tax was imposed on non-residents, being those persons who did not qualify as 'residents' in terms of the definition of 'resident' in s 1 of the Income Tax Act, where the source of their income, either actual or deemed, was located in South Africa. The definition of 'gross income' in s 1 of the Income Tax Act provides for the inclusion in 'gross income' the income of non-residents where the source of the income received by or accrued to such non-residents is from a South African source.

interest was paid to a non-resident connected to a South African resident.<sup>345</sup> This recommendation was not implemented at the time.

### **3.7.1 Business income**

During the transition period, the taxation of business profits derived from a source in South Africa did not change and the same policy principles applied as during the period prior to democracy. Thus, there was no difference between whether a non-resident invested into South Africa by way of a branch or a subsidiary – income which had its source located in South Africa was included in ‘gross income’ of the taxpayer.

Income which had its source located in South Africa was included in the ‘gross income’ of the foreign investors. These foreign investors would most likely also have been taxed in their country of residence and would have sought relief in their own country of residence either by relying on the unilateral relief available or on the double taxation agreements entered into between South Africa and that country.

### **3.7.2 Interest and royalty income**

The tax treatment of interest and royalty income was dependent on whether a taxpayer was classified as a resident or a non-resident.<sup>346</sup> This distinction between a resident and non-resident not only determined whether such a taxpayer’s interest and

---

<sup>345</sup> Katz Commission 5th Interim Report (note 2) at para 6.2.2.7–6.2.2.8.

<sup>346</sup> Where a taxpayer was classified as a resident in terms of the application of s 9C, the worldwide interest and royalty income of such a taxpayer was deemed to be from a South African source and the income was included in the determination of the tax liability. Where a taxpayer did not meet the residence criteria, s 9C did not apply and interest and royalty income only played a role in such a taxpayer’s tax liability where the actual source and deemed source was located in South Africa.

royalty income, irrespective of the location of the source of that income, was taxed in South Africa but also determined whether such a person would be able to use the provisions in the Income Tax Act which exempted certain types of income received by or accrued to non-residents. This distinction between residents and non-residents could also have affected the legal form through which foreign investors and traders entered South Africa and how such investment or trade was financed. The legal form would have been an issue if companies that were incorporated or registered in South Africa were classified as a resident. Not only would such a subsidiary of an inward foreign investor be taxed on its worldwide passive income but it would also not be able to use the non-resident's relieving provision. With the test for 'residency' of a company under s 9E being limited to companies who had their place of effective management located in South Africa, this was not a concern.

The method of financing the inward trade and investment of non-residents is influenced by the relief given to interest income derived by non-residents from a source located in South Africa. Where interest income had its source located in South Africa, such interest income fell into the 'gross income' of both residents and non-residents but non-residents' interest income might have qualified for the exemption available at the time.<sup>347</sup> It is questionable whether this preferential treatment of non-residents is always justifiable. At one level it prevents international double taxation of the non-resident but at another level it means a loss to the South African fiscus and potentially a gain for the fiscus of the country of residence of the non-resident. In

---

<sup>347</sup> Section 10(1)(h), prior to its amendment by the Revenue Laws Amendment Act No. 59 of 2000, exempted interest income from taxation if the interest income was received by any person (other than a company) not ordinarily resident nor carrying on business in the Republic; or was an external company not carrying on business in the Republic.

addition, it also affects the form of investment by the non-residents because the exemption would apply where the non-resident's subsidiary is financed through a loan.

In order to prevent the abuse of capitalisation through loan financing, thin capitalisation and transfer pricing rules had to be considered. The Katz Commission recommended the exemption of interest income derived by non-residents from a South African source on the basis that the exemption would encourage foreign investment into South Africa.<sup>348</sup>

### **3.7.3 Dividend income**

Where a non-resident made an investment or traded in South Africa through incorporating a subsidiary in South Africa, the return to the foreign parent company in the form of a dividend distribution would have had the same result as a distribution of a dividend by a South African resident company to South African resident shareholders. In both cases the dividend income would have been exempt from tax in South Africa<sup>349</sup> and the payment of the dividend would generally have given rise to the payment of the Secondary Tax on Companies (commonly known as STC) by the distributing company.<sup>350</sup>

## **3.8 Summation**

The transition period introduced a partial residence basis of taxation, reflecting the traditional arguments that active income should be taxed in its country where the

---

<sup>348</sup> Katz Commission 5th Interim Report (note 2) at para 6.2.2.1; para 6.2.2.6–6.2.2.9.

<sup>349</sup> Section 10(1)(k) of the Income Tax Act as it read at the time. A distribution of a dividend from a South African resident controlled company to its South African resident holding company would have been exempt from STC in terms of s 64C.

<sup>350</sup> Section 64C of the Income Tax Act as it read at the time.

source of income is located while passive income should be taxed in the country of residence of the investor. It also granted relief for economic double taxation experienced by South African taxpayers earning dividends from South African companies. In this way, it maintained a balance with respect to equity and neutrality. It maintained the benefit principle for active income and ensured that in the event of a South African business operating offshore, such a business would be competitive while at the same time expanding the South African tax base by including foreign sourced passive income in the tax base.

As a country in transition, the steps taken by South Africa to enter the global economy and pursue the policy objectives to redistribute income, encourage exports and increase foreign investment, indicate that there was an underlying policy. The one area where the underlying policy approach appeared to be faltering was in the treatment of dividend income. The overall policy, it appears, was one of incremental steps into the global economy by combining 'ability-to-pay' and competitiveness despite the policy being introduced without a detailed analysis of the implementation in the Income Tax Act. The almost sudden change to a fully-fledged residence basis of taxation in 2001 somewhat undermined this transition process and set in motion a tax structure which needed constant amendments and adjustments, as reflected in the number of amendments made to the income tax legislation during the millennium period and beyond.

## 4 Chapter Four

### Millennium period and the change to residence

#### 4.1 Introduction

In 2001, a mere three years after the implementation of the Katz Commission's recommendations, South Africa's jurisdictional basis of taxation changed from the source-plus basis of taxation to a residence (worldwide) basis of taxation for all categories of income. The change resulted in the tax base being expanded to include income received by or accrued to South Africa residents from a source located outside of South Africa.<sup>351</sup> It is interesting to note that this change was in line with the prediction in the 1923 League of Nations report with respect to developing countries in that South Africa, classified as a developing country, eventually implemented a residence basis of taxation on entering the global market.<sup>352</sup>

The change in the jurisdictional basis of taxation meant that once again the default method of relief, in the event of international juridical double taxation, had to be considered. At the introduction of the residence basis of taxation, active business income which had its source located outside South Africa was exempt from tax in South Africa.<sup>353</sup> The use of the exemption method of relief for this active income

---

<sup>351</sup> The residence-basis of taxation was implemented with effect from years of assessment commencing on or after 1 January 2001 when the Revenue Laws Amendment Act No. 59 of 2000 came into effect.

<sup>352</sup> As noted by Schindel et al (note 59) at 32.

<sup>353</sup> In terms of s 9F inserted by the Revenue Laws Amendment Act No. 59 of 2000. Section 9F was repealed the Revenue Laws Amendment Act No. 45 of 2003. Section 9F read as follows:

'1) For the purposes of this section "designated country" means a designated country as defined in s 9E.

resulted in the jurisdictional basis of taxation commonly being referred to as ‘residence-minus’ basis of taxation.<sup>354</sup> This particular exemption was removed in 2004<sup>355</sup> and replaced with the tax credit as the method of relief for virtually all forms of income where the source of the income was located outside South Africa.<sup>356</sup>

The tax credit, which is currently still in place, does not provide relief for all South African residents experiencing juridical international double taxation; it is dependent on, *inter alia*, whether the source of the income is located in South Africa and the type or category of income.<sup>357</sup> In addition, as is the case for any residence based tax system which uses a tax credit, only those who qualify as a tax resident are eligible for relief in the form of the tax credit.<sup>358</sup>

In 2007, a deduction method of relief was introduced for certain foreign taxes paid. These foreign taxes may be treated as an expense when the source of the

2) The amount of any income which shall be exempt from tax in terms of the provisions of s 10(1)(kA), shall be so much of any amount received by or accrued during the relevant year of assessment to any company which is a resident from a source outside the Republic, which is not deemed to be from a source in the Republic, which has been or will be subject to tax in any designated country at a statutory rate of at least 27 per cent (after taking into account the application of the relevant agreement for the avoidance of double taxation, if any):.....

Section 10(1)(kA), as it read at the time, exempted from normal tax, ‘so much of any amount received by or accrued to any company which is a resident from a source outside the Republic as determined in accordance with the provisions of s 9F(2)’.

<sup>354</sup> See the Department of Finance, *Chapter Four Revenue Issues and Tax Proposals 2000* South African Budget Review at 84. Available at <http://www.treasury.gov.za/documents/national%20budget/2000/review/Chapter%204.pdf>, last accessed 26 November 2012.

<sup>355</sup> Section 9F was repealed by the Revenue Laws Amendment Act No. 45 of 2003 with effect from 1 June 2004.

<sup>356</sup> The exemption method still applied under limited circumstances such as in the event of employment income earned outside South Africa in terms of s 10(1)(o) of the Income Tax Act.

<sup>357</sup> The tax credit is provided by s 6quat as amended from time to time. Section 6quat(1)(a) provides that the rebate (namely, the foreign tax credit) must be deducted from the normal tax payable where the taxable income of any resident during a year of assessment includes ‘any income received by or accrued to such resident from any source outside the Republic’.

<sup>358</sup> *Ibid.*

income, on which that foreign tax is paid, is located in South Africa.<sup>359</sup> Despite this specific deduction being introduced, there is opinion that such a deduction would have been allowed under s 11(a) read with s 23(g).<sup>360</sup>

In addition to the factors influencing the type of relief for international double taxation available to the South African resident taxpayer, there are factors which affect the quantity of the allowable credit or deduction. These factors include, *inter alia*:

- the limitation on the amount of the foreign tax that can be credited against the tax payable in South Africa;
- the translation of income which has its source outside South Africa into South African tax concepts; and
- specifically, for relief in the form of the tax credit, the requirement that the foreign tax must be ‘proved to be payable’ and not be recoverable.<sup>361</sup>

---

<sup>359</sup> Section 6quat(1C) of the Income Tax Act, inserted by the Revenue Laws Amendment Act No. 35 of 2007.

<sup>360</sup> See discussion by Dachs (note 187) and also discussion in para 2.7.4 of Chapter Two of this thesis.

<sup>361</sup> South African Revenue Service Interpretation Note No.18 (Issue 2) ‘Rebate or deduction for foreign taxes on income’ 31 March 2009, available at <http://www.sars.gov.za>, last accessed 26 November 2012. The Note sets out the following requirements for the granting of the tax credit at 14–20:

- The taxes must be payable on income. According to South African Revenue Service, capital gains are included in the income on the basis of international practice;
- the taxes must be payable to a foreign government;
- the taxes should be proved to be payable in respect of an existing foreign tax liability and there must be an absolute and unconditional legal liability to pay the foreign taxes;
- the taxes must be payable without any right of recovery by any person;
- the taxes must be payable on amounts included in a resident’s taxable income.

The change in the tax base to include the worldwide income of South African residents without having to consider the location of the source of that income, and the consequent changes to the methods of relief, should have been reflective of a change in policy towards cross border trade and investment by the South African government. With the implementation of the residence basis of taxation and the provision of the tax credit as the default method of relief, this new policy approach should have been indicative of the ability-to-pay approach to equity and capital export neutrality.

Given the effect that any changes to the tax base, such as changing from a source to a residence basis of taxation, and changes to the methods of relief have on the policy considerations of equity and neutrality, one should be able to make the assumption that the implications for equity and neutrality were considered when these changes were implemented. As this chapter will show, this assumption was not necessarily valid when the changes to the jurisdictional link and methods of relief were implemented in 2001. This assertion is made on the basis of the number of subsequent amendments made to the Income Tax Act:

- in order to clarify certain cross border aspects of the Income Tax Act,
- to amend definitions,
- to amend the interaction between various cross border provisions and
- to prevent tax avoidance schemes through the use of the provisions of the Income Tax Act.

It is submitted that many of these amendments would have been unnecessary if the basic policy principles of equity and neutrality had been considered on the introduction of the residence basis of taxation and the tax credit. This chapter accordingly considers the effect of the implementation of the residence basis of taxation and the tax credit on equity and neutrality, and the manner in which the implementation resulted in continuous amendments to the Income Tax Act.

#### **4.2 Millennium period policy objectives**

It is said that the source-plus and the residence-minus bases of taxation result in the collection of the same amount of tax.<sup>362</sup> It is in this context that it could be stated that the policy objectives of the South African government's approach to cross border trade and activities did not change when the residence-minus basis of taxation was introduced, but were just implemented in a different manner.<sup>363</sup>

Whereas the first statement relating to the collection of taxes has some truth to it, two factors in particular negate the second statement with respect to the change to the residence basis of taxation in South Africa. The method of relief available to South African residents for active income which had its source located outside South Africa has changed since the introduction of the residence basis of taxation.<sup>364</sup> Furthermore, the definition of who qualified as a South African resident was amended when the jurisdictional link changed from source-plus to residence and the

---

<sup>362</sup> Ernest Mazansky 'South Africa changes to a Worldwide Tax System' (2001) 55 (4) *International Tax Bulletin* 138 at 138.

<sup>363</sup> Ibid.

<sup>364</sup> At the introduction of the residence basis of taxation, active income received from certain designated countries were exempt from tax. See the discussion in para 4.1 of this chapter and footnote 353 of this thesis.

definition of residence itself has undergone a number of changes since its initial introduction.<sup>365</sup> These changes would, prima facie, indicate a change in policy objectives.

Even if it is accepted that initially no change in the policy objectives was intended with the introduction of the residence basis of taxation and in fact, that no new policy was implemented, the question has to be asked – why change the manner of implementation?

In his 2000 Budget Speech, which introduced the residence basis of taxation, the then Minister of Finance referred to the need to broaden the South African tax base and globalisation as reasons for the change.<sup>366</sup> The assumption underlying this statement appears to be that a large number of South African resident taxpayers received or accrued income which had its source located outside South Africa and which fell outside the s 9C deeming provisions. Furthermore, although increased globalisation was given as a reason, there is a view that globalisation undermines the residence basis of taxation and that the source basis of taxation may be a more appropriate jurisdictional link in an increasingly global world.<sup>367</sup> Two further reasons for the change given by the then Minister of Finance were the relaxation of exchange

---

<sup>365</sup> See the discussion in para 4.4.1 of this chapter.

<sup>366</sup> National Budget Speech delivered by Trevor A. Manuel, Minister of Finance, Republic of South Africa on 23 February 2000 at 19. Available at <http://www.treasury.gov.za/documents/national%20budget/2000/speech/speech.pdf>, last accessed 26 November 2012. See Black et al (note 33) at 152, 156–157.

<sup>367</sup> Cockfield (note 102) at 608. See also Dale Pinto 'Exclusive source or residence-based taxation - is a new and simpler world tax order possible?' (2007) 61(7) *Bulletin for International Taxation* 277; Dale Pinto 'The need to reconceptualize the Permanent Establishment threshold' (2006) 60 (7) *Bulletin for International Taxation* 266.

control regulations<sup>368</sup> and the prevention of tax arbitrage opportunities.<sup>369</sup> Although exchange controls have since been eased, they have not been completely lifted and approval is still largely required when taking money or capital out of South Africa and the common monetary area.<sup>370</sup> Tax arbitrage may be a valid concern, but this concern was not completely removed with a move to the residence basis of taxation. On the contrary, the residence basis of taxation requires the enactment of complicated provisions such as controlled foreign company rules to prevent tax arbitrage.

The 2000 Budget, although giving reasons for the change to a fully-fledged residence basis of taxation, did not clarify whether and how the change would interact with the overall policy relating to cross border trade and investment such as, for example, whether cross border trade or investment should be encouraged or not. The aspects of the Budget which referred to the policy aspects of international trade and investment, made reference to:

- the fact that the involvement of South Africa ‘in the Southern African region [is] was steadily increasing’;<sup>371</sup>
- attracting ‘foreign savings and investment’ as an important part of the South African government’s strategy;<sup>372</sup> and

---

<sup>368</sup> Budget Speech by Trevor Manuel, Minister of Finance (note 366) at 9. See also Black et al (note 33) at 157.

<sup>369</sup> Budget Speech Ibid at 19; Black Ibid.

<sup>370</sup> The Common Monetary Area consists of South Africa, Lesotho, Namibia and Swaziland. See Oliver et al 2011 (note 14) at 714.

<sup>371</sup> Budget Speech Ibid at 8.

<sup>372</sup> Ibid.

- South Africa's ability to grow being dependent, in part, on 'improved export performance'.<sup>373</sup>

In line with the 2000 Budget Speech, the Explanatory Memoranda of the two bills introducing the legislation that implemented the residence-minus basis of taxation did not refer to an overall policy objective in the explanation to the change. The reasons given for the change in these two documents included the need for South Africa to follow acceptable international principles,<sup>374</sup> the need to ensure efficiency in administering the Income Tax Act,<sup>375</sup> and the implementation of anti-avoidance measures.<sup>376</sup>

According to Olivier, the main reason for the change to the residence-minus basis of taxation was the 'acceptable international principles'.<sup>377</sup> Her statement is based on the introduction of the change soon after a 1999 international tax symposium hosted by the South African Department of Finance, where 'international experts' expressed the view that South Africa was 'out of line with the rest of the world as far as the principle on which tax is levied is concerned', and that changing

---

<sup>373</sup> Ibid.

<sup>374</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 1 & 3.

<sup>375</sup> Ibid at 2, 4, & 10.

<sup>376</sup> Ibid at 7. See also 'South African Revenue Service and National Treasury Comments on Representations to the Portfolio Committee of Finance on the Revenue Laws Amendment Bill, 2000', where reasons were given for the change to a residence basis of taxation. The Comments also indicated the criteria applied in designing the residence-minus system. Available at [pmg.org.za/docs/2000/appendices/001025SARS&Treasurty.htm](http://pmg.org.za/docs/2000/appendices/001025SARS&Treasurty.htm), last accessed 18 August 2010.

<sup>377</sup> Olivier (note 92) at 22.

to the residence basis of taxation would align the South African tax system with accepted international norms.<sup>378</sup>

The problem with the concept of ‘international norms’ is that it is the ‘norms’ or accepted international practice of OECD member countries, which are developed countries with economies and economic policies which differ from that of South Africa and other developing economies. These differences include, *inter alia*, the size of the economies and the direction of investment flows.<sup>379</sup> A second problem with the view of ‘accepted international norms’ is related to the applicable method of relief to be used in the event of international double taxation. There is no real accepted international norm for the type of method of relief given by the resident country as is evidenced by the choice of the exemption or credit method of relief given to the resident country in the OECD MTC.<sup>380</sup> This is due to the differing policy concerns and their implications which result from applying different methods of relief. Examples of these might be whether it is important for South African businesses to compete on equal terms in host countries with competitors from other countries (capital import neutrality) or whether it is important for South African businesses to compete on equal terms with each other (capital export neutrality). Aligned to the view of acceptable international norms is the view that foreigners, who want to do business in and invest in South Africa, would have a greater

---

<sup>378</sup> Ibid. See also the Department of Finance, *Chapter Four Revenue Issues and Tax Proposals* (note 354) at 66 where it is stated that ‘In 1999, the Department of Finance hosted an international tax symposium to review the interim reports of the Katz Commission and assist government in responding to its recommendations. The rigorous debate at the tax symposium informed the proposals in this budget, as well as initiatives that will guide future tax reforms.’

<sup>379</sup> Eduardo Baistrocchi, ‘The use and interpretation of tax treaties in the emerging world: Theory and implications’ Reprinted from *British Tax Review* Issue 4 2008. Electronic copy available at <http://ssrn.com/abstract=1273089at360>, last accessed 10 February 2008.

<sup>380</sup> Articles 23A and 23B of the OECD MTC 2010 (note 19).

understanding of the South African tax system if taxes were imposed on the basis of residence, and if similar internationally accepted methods and concepts were used in the Income Tax Act.<sup>381</sup> It is debatable whether foreign investors would have a greater understanding given that each country adopts its own specific legislation and its own version of 'resident'. In addition, it is also debatable whether the change to residence would make much of a difference given that the source basis of taxation, with its emphasis on judicial interpretation, has largely been retained as the basis for imposing tax on those who do not qualify as residents.<sup>382</sup> The change may however affect the legal entity through which foreigners or non-residents do business in and invest in South Africa.

The policy objective with respect to non-resident inward trade and investment and the use of a South African subsidiary as a means to encourage investment into the rest of Africa was recognised by the South African government. Changes were accordingly made to the taxation of non-residents to reflect the policy of attracting inward foreign trade and investment into South Africa and the rest of southern Africa. This policy objective was initially implemented by the introduction of an

---

<sup>381</sup> The Katz Commission 5th Interim Report (note 2) at para 3.1.5.2 where the issue of 'International compatibility' is discussed, and reference is made to the 'internationalisation of concepts and terminology'. The Commission reported that '... possibly most important dimension of international compatibility relates to the clarity of a country's tax laws as they affect foreign trade partners or investors, or South African business investing or trading abroad. The Commission therefore accepts such clarity as an important objective of tax reform. In the international tax context, an important aspect of that clarity is the use of internationally recognisable tax concepts and terms. In a world where the two concepts of residence and source based systems are so close in their practical impact, using internationally familiar concepts and terminology contributes more the required international integration than the label carried by the system'. See also the Department of Finance '*Chapter Four Revenue Issues and Tax Proposals*' (note 354) at 84 where it states that the residence-based income tax for South African residents will '...bring the tax system in line with generally accepted norms for taxing international transactions'.

<sup>382</sup> The insertion of source rules in s 9 by the Taxation Laws Amendment Act No.24 of 2011 for interest, dividend and royalty income provides an exception to the reliance on the judicial interpretation of 'source.'

‘international headquarter company’, introduced at the same time as the residence basis.<sup>383</sup> For tax purposes, such a company was excluded from the definition of resident. In order to qualify as an international headquarter company the following criteria had to be met:<sup>384</sup>

- the entire share capital of the company had to be held by non-residents, with any indirect interest of residents or of any trust in the equity share capital not being greater than five per cent of the total equity share capital of the company; and
- 90 per cent of the value of the assets of the company had to represent interests in the equity share capital and loan capital of subsidiaries of the company which were not South African residents and in which such company held a beneficial interest of at least 50 per cent.

The controlled foreign company rules (s 9D), the foreign dividends provisions (s 9E) and the secondary tax on companies (s 64C) did not apply to such companies because an international headquarter company was classified as a non-resident.<sup>385</sup> The international headquarter company concept was repealed in 2004 and a similar concept was introduced in 2011.<sup>386</sup> The effectiveness of this company regime is discussed with respect to non-residents later in this chapter.<sup>387</sup>

---

<sup>383</sup> By the Revenue Laws Amendment Act 59 of 2000.

<sup>384</sup> Definition of ‘international headquarter company’ in s 1 of the Income Tax Act as it read at the time.

<sup>385</sup> Definition of ‘headquarter company’ in s 1 of the Income Tax Act as it read at the time.

<sup>386</sup> Repealed by the Revenue Laws Amendment Act No. 45 of 2003 and re-introduced by the Taxation Laws Amendment Act No. 7 of 2010.

<sup>387</sup> See discussion in para 4.6.1 of Chapter Four of this thesis.

### 4.3 Change in the millennium policy objectives?

The repeal and re-introduction of the headquarter company is but one example of the erratic changes made to the cross border rules in the Income Tax Act. Since the introduction of the worldwide basis of taxation in 2000, numerous changes have been made to the method of relief provided to South African resident taxpayers in the event of international double taxation and many changes have been made to the taxation of non-residents. Amendments affecting non-residents are the introduction of withholding taxes on royalties,<sup>388</sup> dividends<sup>389</sup> and interest (implemented with effect from 1 January 2013).<sup>390</sup> For South African residents, the change to the methods of relief for non-South African sourced active business income has also changed over time. The definition of who qualifies as a resident for South African tax purposes has also changed. In addition many of the changes introduced appear to be concerned with broadening the tax base<sup>391</sup> and with preventing or containing anti tax-avoidance schemes.<sup>392</sup>

The change to the meaning of residence, to the taxation of non-residents, and the systematic limitation of the exemption for active non-South African sourced

---

<sup>388</sup> Section 35 of the Income Tax Act.

<sup>389</sup> Section 64D–64N. By the Revenue Laws Amendment Act No. 60 of 2008 as amended by the Taxation Laws Amendment Act No. 17 of 2009 and the Taxation Laws Amendment Act No. 7 of 2010. The effective date of this withholding tax is 1 April 2012.

<sup>390</sup> Section 37I–37N. See the South African National Treasury Explanatory Memorandum on the Taxation Laws Amendment Act 7 of 2010 ‘Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010’ at 69–70. Available at <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=63735>, last accessed 26 November 2012.

<sup>391</sup> Budget Speech by Trevor Manuel, Minister of Finance (note 366) at 19.

<sup>392</sup> See South African Revenue Service *Discussion Paper on Tax Avoidance and s 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* November 2005. Available at <http://www.sars.gov.za/home.asp?pid=5981#>, last accessed 7 December 2012. Anti tax-avoidance measures introduced include the replacement of the s 103 anti-tax avoidance provision with a general anti avoidance rule in s 80A80L; amendments to the controlled foreign company legislation in s 9D and transfer pricing rules in s 31.

income as well as the extension of the limited tax credit mean that, since the introduction of the residence, the overall policy with respect to cross border trade and investment, particularly with regard to equity and neutrality, has either shifted or is not clearly discernible. If the policy has shifted then, although there may be good underlying reasons for the change, it does not appear as if the effect of the changes on equity and neutrality in cross border trade and investment were considered in the reasons for the changes. In particular it appears as if these changes are contrary to overall economic policy of trade and investment, especially in light of the following statements made by the Deputy Minister of Trade and Industry in 2004, where she stated that, given the state of the country prior to 1994, an

outbound oriented strategy was required. South Africa's integration into the global economy was a necessary imperative if there was any hope of achieving growth and development.<sup>393</sup>

Since the introduction of residence, the changes to the Income Tax Act and tax policy appear to be concentrated on measures being put in place to combat tax avoidance, as opposed to tax policy objectives.

However, before a conclusion can be reached on whether the changes did or did not affect the policy principles of equity and neutrality, the different parties and entities which trade and invest into and out of South Africa must be compared. The three categories that be will compared and considered are:

- outward and local trade and investment by South African residents;

---

<sup>393</sup> Address by the Deputy Minister of Trade and Industry (note 31).

- outward South African residents trade and investment and the host country trade and investment; and
- inward non-resident trade and investment and local South African resident trade and investment.

#### **4.4 Outward South African resident trade and investment: local South African resident trade and investment**

The comparison of trade and investment by South African residents into and out of South Africa has to take into account the tax treatment of the different categories of income as well as the different legal forms through which trading or investing can be done. However, before these factors can play a role, the taxpayer has to qualify as a resident or a non-resident. Just as the meaning and interpretation of source was of importance in the period prior to democracy, so too is the meaning and interpretation of residence in the millennium period.

##### ***4.4.1 Meaning and interpretation of residence***

During the transition period, natural persons were resident in South Africa if they were ‘ordinarily resident’ in South Africa.<sup>394</sup> The millennium period changes made to the Income Tax Act in 2001 expanded the ambit of residence to include a physical presence test.<sup>395</sup> Although it is submitted that the reasons for the change may have included the need for certainty in view of the ‘facts and circumstances tests’ required for ‘ordinarily resident’ and to align the South African definition to that of other

---

<sup>394</sup> In terms of s 9C of the Income Tax Act as it was at the time.

<sup>395</sup> Section 9C did not apply to individuals who lived in South Africa for extended periods and who had an intention to return to their home country. The Revenue Laws Amendment Act No.59 of 2000 introduced the definition of ‘residence’ into the s 1 of the Income Tax Act to include both the test of ‘ordinarily resident’ and the physical presence test for individuals.

countries,<sup>396</sup> the end result was an expansion of the ambit of residence. Similarly, the millennium period changes expanded the transitional period definition of residence for entities other than natural persons from the ‘place of effective management’ being located in South Africa<sup>397</sup> to also include ‘incorporation, establishment and formation’.<sup>398</sup> With the widening of the ambit of residency in the millennium period, it became easier to be classified as a South African resident for tax purposes. The purpose of the wider ambit was clearly to include companies registered or established in South Africa as well as natural persons who stayed in South Africa for extended periods. In order to ensure certainty and clearly define who or what falls into the residence definition, the meaning and interpretation of residence needed to be both consistent and clear.

This need for consistency in the Income Tax Act was expressed by the South African National Treasury in the Explanatory Memorandum on the Revenue Laws Amendment Bill of 2000 which accompanied the Revenue Laws Act.<sup>399</sup> The aforesaid Explanatory Memorandum explained the amendment of residence on the basis that the expanded definition of residence would be similar to that of other countries.<sup>400</sup> In other words, the expanded version of residence was to be based on

---

<sup>396</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 3–4.

<sup>397</sup> The Revenue Laws Amendment Act No. 59 of 2000 inserted the definition of ‘residence’ for ‘persons other than natural persons’. Residence was defined as ‘incorporated, established or formed in the Republic or which has its place of effective management in the Republic (but excluding any international headquarter company)’.

<sup>398</sup> Section 9C did not apply to legal entities registered and formed in South Africa with their place of effective management being located outside of South Africa. The residence system introduced was therefore quite limited. The Revenue Laws Amendment Act No. 59 of 2000 introduced the definition of ‘residence’ for persons other than natural persons as including a person which is incorporated, established or formed in South Africa or which has its place of effective management in South Africa.

<sup>399</sup> Revenue Laws Amendment Act No. 59 of 2000.

<sup>400</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 4.

the national legislation or domestic laws of other countries. It did not appear as if the equity or neutrality or South Africa's specific conditions were considered. The increase in the ambit affected the equitable basis on which South Africa taxed its expanded cohort of residents and also the equity relationships between those who, prior to the amendments, did not fall within the ambit of residency but did so after the amendments. It also affected who would be able to use the applicable methods to relieve international double taxation and who would be able to receive incentives applicable to non-residents.

*Does the residence test for individuals meet the policy objective of ability-to-pay equity?*

A pure worldwide or residence system presupposes that the country of residence imposes tax on all the income of its residents, including income which has its source located outside of a country, irrespective of whether the income received or accrued in the host country has been repatriated back to the country of residence.<sup>401</sup> Despite the residence basis of taxation being used by most countries, the definition and interpretation of residence differs from country to country with it being based on, *inter alia*, citizenship, nationality, ownership of assets, physical presence, establishment, incorporation, place of effective management, the place of

---

<sup>401</sup> In practice many residence-based countries make provision for certain foreign sourced income of their residents to be exempt and to allow for a deferral of non – repatriated income. These provisions are indicators of an impure world-wide or residence basis of taxation. See Cockfield (note 84) at 13; Hines (note 22) at 4–5 where he states that ‘The CEN concept is frequently invoked as a normative justification for the design of tax systems similar to that used by the United States, since that taxation of worldwide income on accrual and with provision of unlimited foreign credits satisfied CEN. This is not exactly the system that the United States uses, since taxpayers are permitted to defer home country taxation of certain unrepatriated foreign income and foreign tax credits are subject to various limits’; see also Schindel et al (note 59) at 45.

management and control.<sup>402</sup> This means that even though it may seem as though all countries impose tax on a residence basis, they may not necessarily do so on the same or similar basis. In addition, certain countries do not impose tax on certain types of income which has its source located outside that country, which means that the source basis of taxation is used only for certain types of income.<sup>403</sup> Therefore, the residence basis of taxation is not as uniform as many state it to be. The only uniform definition used for the residence of companies is found in the form of ‘place of effective management’ in the OECD and UN MTCs. Even this definition is subject to different interpretations by countries.<sup>404</sup>

For a natural person to be tax resident in South Africa, that person would either have to be ‘ordinarily resident’ in South Africa or would have to meet the physical presence test.<sup>405</sup> A natural person is ‘ordinarily resident’ in South Africa if South Africa is ‘the country to which such person would naturally and as a matter of course return to from his wanderings’.<sup>406</sup> The physical presence test only applies if the person is not ‘ordinarily resident’ and requires that the person be physically

---

<sup>402</sup> See Ault et al (note 137) at 431–446.

<sup>403</sup> Hines (note 22) at 4–5.

<sup>404</sup> Vogel *Intertax* Part I (note 87) at 223–224; See OECD MTC 2010 (note 19) Commentary on Article 4(3) at para 21–24. See also the observations on the Commentary by Italy at para 25, by France at para 26.3 and Hungary at 26.4. The IBFD Glossary (note 19) in explaining ‘place of effective management’ states that ‘...Its precise meaning varies from country and country and is primarily a fact based test.’

<sup>405</sup> Definition of ‘resident’ in s 1 of the Income Tax Act.

<sup>406</sup> *Cohen* (note 201), *Kuttel* (note 202).

present in South Africa for relatively substantial periods.<sup>407</sup> This definition of residence appears to be linked to the benefit principle of equity in that similarly situated persons would pay the same amount of tax. In the South African context, therefore, short term physical presence or the ownership of assets in South Africa is not required in order for an individual to be resident in South Africa, although these factors would be taken into account to determine ‘ordinarily resident.’

Although beyond the scope of this thesis, a question that needs answering is whether the basis for the decisions in *Cohen*<sup>408</sup> and *Kuttel*<sup>409</sup> are still applicable with the introduction of the residence basis of taxation. The question arises in the context of whether this interpretation of residence provides a sufficient link between South Africa and the resident on the basis of either ability-to-pay or the benefit principles of equity or Vogel’s sacrifice theory. If residence in these judgments is analogous to ‘centre of vital interest’ as per the OECD MTC tie-breaker rule,<sup>410</sup> then the answer should be in the affirmative. If not, then residence as interpreted is the incorrect interpretation ascribed for the purposes of worldwide taxation. For example, consider a natural person who, on the evidence, intends to return to South Africa some day

---

<sup>407</sup> Para (a) of the definition of ‘resident’ in s 1 of the Income Tax Act. On the introduction of this test in 2000 by the Revenue Laws Amendment Act No. 59 of 2000, the number of days required to become a resident in terms of the physical presence test was at least 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the three years of assessment preceding such year of assessment, and thirdly, for a period or periods exceeding 549 days in aggregate during such three preceding years of assessment. The number of days and years required were amended by the Revenue Laws Second Amendment Act No. 32 of 2005 and the physical presence test now requires that the number of days required to become a resident is at least 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment.

<sup>408</sup> *Cohen* (note 201).

<sup>409</sup> *Kuttel* (note 202).

<sup>410</sup> Article 4(2) of the OECD MTC 2010 (note 19).

and maintains family ties in South Africa. He also owns a house in and visits South Africa twice a year but has lived in country A for ten years. He operates a business in country A, and has done so for the past ten years. He earns both business profits and interest income. On the basis of ordinary residence, he could be resident in South Africa and taxed in South Africa on both his business and interest income – even though the link with South Africa is somewhat tenuous. In this respect, the test for residence of a natural person is potentially too wide – affecting the basis on which tax is levied and thus affecting the ability-to-pay basis of equity.

The test for residency of natural persons was amended in 2005.<sup>411</sup> The amendment increased the number of days required for a natural person to be tax resident in South Africa based on the physical presence test.<sup>412</sup> This change was apparently done to, once again, bring South Africa in line with accepted international practice.<sup>413</sup>

For persons other than a natural person, residence is defined in the Income Tax Act as a person who is ‘established, formed and incorporated’ in South Africa or a person which has its ‘place of effective management’ located in South Africa.<sup>414</sup>

The Income Tax Act does not provide an exact meaning or application of ‘place of effective management’ and the South African Supreme Court of Appeal has to date not pronounced on its meaning.

---

<sup>411</sup> By the Revenue Laws Second Amendment Act No. 32 of 2005.

<sup>412</sup> Section 3(1)(i) of the Revenue Laws Second Amendment Act No. 32 of 2005 amended the number of days and years.

<sup>413</sup> As stated in the South African National Treasury Memorandum on the Revenue Laws Second Amendment Act No. 32 of 2005, ‘Memorandum on the Revenue Laws Second Amendment Bill, 2005’ at 2–5. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 27 November 2012.

<sup>414</sup> Definition of ‘residence’ in s 1 of the Income Tax Act.

The only South African judgement dealing with ‘place of effective management’ is *The Oceanic Trust Company Ltd N.O. [in its capacity as the trustee for the time being of Specialised Insurance Solutions (Mauritius) Trust, MOBAA/OT/338] v The Commissioner for the South African Revenue Service*.<sup>415</sup> where the Western Cape High Court was asked to make a declaratory order on, *inter alia*, the ‘place of effective management’ and residency of a trust. The court declined to make such an order but indicated the factors that it considered pertinent in determining the location of the ‘place of effective management’.

The facts of *Oceanic* involved the Specialised Insurance Solutions (Mauritius) Trust which was registered in South Africa and its trustee, The Oceanic Trust Company Ltd, located in Mauritius.<sup>416</sup> An asset manager was appointed to manage the assets of the trust invested in South Africa.<sup>417</sup> One of the issues that had to be decided was whether or not the ‘place of effective management’ of the trust was located in South Africa.<sup>418</sup> In reaching its decision, the court indicated the key features that had to be considered in determining the ‘place of effective management’.<sup>419</sup> In doing so, the court largely relied on a United Kingdom decision of *Commissioner for Her Majesty’s Revenue and Customs v Smallwood and Anor*,<sup>420</sup> which dealt with ‘place of effective management’ as applied in a double taxation

---

<sup>415</sup> Unreported judgement of the Western Cape High Court of South Africa, delivered 13 June 2011. Available at <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=69556>, last accessed 27 November 2012.

<sup>416</sup> *Oceanic* (note 415) at para 19 and para 1 respectively.

<sup>417</sup> *Ibid* at para 4.

<sup>418</sup> *Ibid* at para 14.

<sup>419</sup> *Ibid* at para 54.

<sup>420</sup> [2010] ECWA Civ 778 as cited in *Oceanic* (note 415) at para 49.

agreement.<sup>421</sup> The court furthermore relied on the Commentary to the OECD MTC, albeit the version prior to its amendment in 2008,<sup>422</sup> to interpret ‘place of effective management’ as used in s 1 of the Income Tax Act.<sup>423</sup>

With ‘place of effective management’ not being defined or interpreted by our Supreme Court of Appeal, various academic writers and the South African Revenue Services (‘SARS’) have provided their views on the approach to be taken to locate the ‘place of effective management’.<sup>424</sup> These approaches show a range of interpretations from it being located at the place where the company is ‘managed on a regular day-to-day basis’ and operations are implemented,<sup>425</sup> to the place ‘where

---

<sup>421</sup> *Oceanic* (note 415) at para 50.

<sup>422</sup> *OECD Model Tax Convention on Income and on Capital: (Condensed Version) 2005 Paris: OECD* at 82 which reads as follows: ‘24. As a result of these considerations, the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time’.

<sup>423</sup> *Oceanic* (note 415) at para 54.

<sup>424</sup> For a discussion on the different authors views, see Olivier et al 2011 (note 14) at 27–29; South African Revenue Service Income Tax Interpretation Note No.6 ‘Residents: Place of Effective management (persons other than Natural Persons)’ issued 26 March 2002 provides a list of factors to consider in locating the ‘place of effective management with the emphasis being on the place where the company is managed on a regular day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised or where the Board of Directors meet. One of the factors to take into account is the place at which the Board of Directors meet and where they make their decisions. Available at <http://www.sars.gov.za/home.asp?pid=5993#>, last accessed 29 November 2012. See also Van De Merwe BA, ‘The place of effective management’ effectively explained’ (2006) 18 *SAMLJ* 121. Lynette Olivier, Riette Engels, Jennifer Roeleveld and Henk Wessels *Juta’s Income Tax* (revision service 15, 2010) Claremont: Juta & Co Ltd volume 1, Meyerowitz (note 27) at para 5.19. See also Clegg and Stretch (note 27) at para 8.3.2

<sup>425</sup> South African Revenue Services Interpretation Note No.6 Ibid. However, see also *Oceanic* (note 415) at para 20 where the Commissioner’s letter of assessment stated that ‘[i]n the end, the question as to where an entity’s place of effective management is located is one of fact and of substance over legal form. It will depend upon a conspectus of all the facts regarding the management and operation of the business.’ See also para 24 of the judgement where it is stated that ‘it is clear that the Respondent contends that the determination of the question of whether SISM’s ‘place of effective management’ is located in the Republic is a mixed question of fact and law’.

the shots are called',<sup>426</sup> to the place where the Board of Directors ('the Board') 'meet on the business of the company',<sup>427</sup> to 'the place where the central executive management is located'<sup>428</sup> and 'the place where the higher level of day-to-day running of the business takes place.'<sup>429</sup> The different views illustrate two possible approaches to attributing 'a place of effective management' to a company – either through looking for the 'directing mind' of the company or looking at the rules of a company as found in the company's documents, the common law and legislation.<sup>430</sup>

In *Oceanic*, the Western Cape High Court placed emphasis on the facts and circumstances test.<sup>431</sup> The court held that:

---

<sup>426</sup> Olivier et al (note 424) in the commentary on 'place of effective management' writes that the 'concept of "effective" indicates that the 'court is entitled to look at the substance of the operations'. The authors state further that where operations involve physical activity, at the first stage one must engage in the identification of the nature of the business of the taxpayer and then locate the place where such business is conducted. Due to the difficulty with this two stage test in respect of investment companies, the authors submit that at the first stage the question has to be amended to enquire 'where the shots are called', that is, where in effect are the key operational decisions taken.'

<sup>427</sup> Meyerowitz (note 27) at para 5.19 looks to the place where the Board of Directors ('the Board') 'meet on the business of the company'

<sup>428</sup> Clegg and Stretch (note 27) at para 8.3.2 where the authors write that '[t]he place of effective management is the place at which the central executive management is located. It is typically the place where the managing director exercises his function and is distinct from the place where the Board meets and where the day to day operational management is located'. As support for this view reference is made to the United Kingdom case *Untelrab* where the view was expressed 'that where senior executives of a company look to the executives of the parent company for advice or are instructed by such executives, the senior executives exercised their minds and thus 'managed and controlled' their company in the context of the UK tax legislation.'. See also *Oceanic* (note 415) at paragraph 54 where the court quotes para 24 of the Commentary on the OECD MTC from *Smallwood* (note 420).

<sup>429</sup> Olivier et al 2011 (note 14) at 28.

<sup>430</sup> Although beyond the scope of this thesis, it is apposite to mention that it is this aspect of a company which distinguishes it from a trust. A trust is deemed to be a person in terms of s 1 of the Income Tax Act while a company is a person in terms of the Companies Act No. 71 of 2008 and its legal status is determined by its incorporation and company documents. This legal status outside of the Income Tax Act does not exist for a trust. For a discussion on this general rule, see MJ De Waal and L Theron 'Die aard van die trust in die Suid-Afrikaanse reg-sikking na aanleiding van behoefte?' (1991) *TSAR* 499. It is submitted that an argument could be made that a different analysis and facts and circumstances may apply to companies and trusts.

<sup>431</sup> *Oceanic* (note 415) at 54.

... the question as to where an entity's place of effective management is located is one of fact and substance over legal form. It will depend upon a conspectus of all the facts regarding the management and operation of the business.<sup>432</sup>

Given the facts and circumstances test, it is unclear which level of management of a company or a trust would be seen as the 'place of effective management'. These differing views on the interpretation of 'place of effective management' could also be as a result of the dual role played by 'place of effective management' in South African tax legislation – it being both a jurisdictional link in terms of the Income Tax Act and a tie-breaker rule in terms of double taxation agreements entered into by South Africa.<sup>433</sup>

The reason for going through the various interpretations given to 'place of effective management' in the South African context is that it appears as if certain of the proposed interpretations have retained elements of source to determine 'place of effective management'. For example, the South African Revenue Service Income Tax Interpretation Note No. 6, stating that it could be the place where the company is managed on a day-to-day basis and where the decisions are implemented, contains elements of the test for source.<sup>434</sup> Similarly, the South African Revenue Service's draft discussion paper issued in 2011,<sup>435</sup> which has as its stated intention the

---

<sup>432</sup> Ibid.

<sup>433</sup> As indicated earlier, s 1 of the Income Tax Act provides for 'place of effective management' as one of the tests for the residency of company. The double taxation agreements entered into by South Africa with other contracting states follow the use of 'place of effective management' as the tie breaker rule as found in article 4 of the OECD MTC 2010 (note 19) where a company or more specifically, a person other than a natural person, is resident in both contracting states on the application of the domestic laws of the contracting states.

<sup>434</sup> South African Revenue Service Income Tax Interpretation Note 6 (note 424).

<sup>435</sup> South African Revenue Service *Discussion Paper on Interpretation Note 6 Place of Effective Management* issued in September 2011. Available at <http://www.sars.gov.za>, last accessed 29 November 2012.

refinement of the approach found in Interpretation Note No. 6<sup>436</sup> and clarifying the relevant facts and circumstances to take into account, still retains the activities elements of a source based system. This is evident by, for example, its emphasis on the ‘senior officers and executives who are responsible for’<sup>437</sup> first, the development, formulation and taking of the key decisions and second, ‘ensuring that the strategies and policies are carried out’.<sup>438</sup> The emphasis appears to be on the activities of these persons thereby linking ‘place of effective management’ to source. Similarly, Olivier et al provide an interpretation which considers the substance of the operation, identifying the nature of the business of the taxpayer and the location of this place of business.<sup>439</sup> If these elements of source are to be found in the interpretation of residence, it implies that South Africa might not have moved away completely from the source basis of taxation but has expanded the tax base through the use of residence as a proxy for source. Taxpayers who are resident in another country and doing business in South Africa might find themselves resident in South Africa and being taxed in South Africa on their worldwide income. As an illustration, consider a multi-national company operating through branches established in different countries. Where the multi-national does not qualify as a South African resident but has established a branch in South Africa, based on the principles of source the branch will be taxed in South Africa on the income which arises in South Africa only, but the income of the multi-national itself will not fall into the South African tax net. If the South African branch is used to ‘infiltrate’ into the rest of Africa and decisions

---

<sup>436</sup> Ibid at 12.

<sup>437</sup> Ibid at 12.

<sup>438</sup> Ibid at 12.

<sup>439</sup> Olivier et al 2011 (note 14) at 28–29.

are made and implemented in South Africa, there is the possibility, based on South African Revenue Service Income Tax Interpretation Note No. 6, that South African income tax will be imposed on the income of the multi-national, where South Africa is the place of effective management.<sup>440</sup> The possibility of this arising was to some extent alleviated by the exclusion of ‘international headquarter companies’<sup>441</sup> from the original definition of residence in 2001. When this exclusion was deleted in 2004 the possibility of the multi-national being resident and taxed on its worldwide income arose – although, with the expansion of taxation on the basis of residence, the ambit of the *s 6quat* tax credit relief also broadened. The dilemma has been recognised by the South African Revenue Service as indicated by the Draft Discussion Paper on the Interpretation Note issued by the South African Revenue Service in 2011,<sup>442</sup> especially in relation to the foreign subsidiaries of South African headquarter companies. The draft discussion paper proposes revisions to Interpretation Note No. 6 which, although taking into account the facts and circumstances of each case,<sup>443</sup> place emphasis on the senior officers or executives classified as the ‘second level of management’.<sup>444</sup> This level of management would be responsible for:

---

<sup>440</sup> South African Revenue Service, Income Tax Interpretation Note No. 6 (note 424).

<sup>441</sup> An ‘international headquarter company’ was defined in s 1 as a ‘company of which the entire share capital of which was held by persons who are not residents or trusts, and any indirect interest of residents or of any trust in such equity share capital does not exceed 5 per cent in aggregate of total equity share capital of such company and, 90 per cent of the value of the assets of such company represents interests in the equity share capital and loan capital of subsidiaries of such company which are not residents and in which such company holds a beneficial interest of at least 50 per cent.’

<sup>442</sup> South African Revenue Service *Discussion Paper on Interpretation Note 6 Place of Effective Management* (note 435).

<sup>443</sup> *Ibid* at 13.

<sup>444</sup> *Ibid* at 11–12.

(1) actually developing or formulating key operational or commercial strategies and policies for, or taking decisions on key operational or commercial actions by the company (regardless of whether those strategies, policies and decisions are subject to formal approval by a board or similar body), and

(2) ensuring that those strategies and policies are carried out.<sup>445</sup>

One of the potential problems with ‘place of effective management’ and source overlapping as well as having the same or similar tests and requirements is that if the ‘place of effective management’ is in South Africa, it may mean that the source is also located in South Africa. This overlapping would result in a South African resident taxpayer not being able to obtain s 6*quat* relief for juridical double taxation because in order to qualify for s 6*quat* relief, the source of the income must be located outside South Africa.<sup>446</sup> The use of the different terms, but with the same requirements and meaning cannot be correct especially where the two have different purposes. Therefore, ‘place of effective management’ and source must have different meanings if sense is to be made of both the tax base of South Africa and the relief for international double taxation provided in s 6*quat*.

If ‘place of effective management’ is the place where the central management and control are carried out by a board of directors<sup>447</sup> and if it is determined to be located in South Africa, a South African resident would get unilateral relief from double taxation in terms of s 6*quat* only if the source of its income is not located in South Africa. This means that:

---

<sup>445</sup> Ibid at 12.

<sup>446</sup> The taxpayer may qualify for relief in the form of a deduction in terms of s 6*quat*(1C) as discussed in para 4.4.6 of Chapter Four of this thesis.

<sup>447</sup> See Clegg and Stretch (note 27) at para 8.3.2.

- If the income is business activities income, then the business activities must take place outside South Africa.<sup>448</sup>
- If the income is interest income then prior to 1 January 2012, the s 9(6) deeming provision must not apply and the activities which give rise to the interest income must not take place in South Africa.<sup>449</sup> With effect from 1 January 2012, the s 9(2)(b) interest income source provisions must not apply.<sup>450</sup> In terms of the latter provisions, the source of interest income is in South Africa,
  - if the debtor is a South African resident, except where the interest is attributable to a permanent establishment outside South Africa<sup>451</sup> or
  - if the funds are used or applied in South Africa.<sup>452</sup>
- If the income is dividend income, the dividend income must not qualify as ‘foreign-sourced’ dividend income in terms of the definitions in s 1 of the Income Tax Act or in terms of s 9(2)(a) as amended by the Taxation Laws Amendment Act, No. 24 of 2011.<sup>453</sup> Where *Boyd’s*<sup>454</sup> case applies and a South African incorporated company distributes dividend income, the source of the income will always be in South Africa. The source rules for dividend income introduced by

---

<sup>448</sup> In terms of the application of the s 9(6) and (7) as inserted by the Taxation Laws Amendment Act No. 30 of 1998 and the South African source rules as interpreted by the case law.

<sup>449</sup> See *Lever Bros* (note 147); *First National Bank* (note 152).

<sup>450</sup> Section 9 has been amended with effect from 1 January 2012 by the Taxation Laws Amendment Act No. 24 of 2011 and applies in respect of amount received or accrued during years of assessment commencing on or after 1 January 2012.

<sup>451</sup> Section 9(2)(b)(i).

<sup>452</sup> Section 9(2)(b)(ii).

<sup>453</sup> Section 9(2)(a) and s 9(4)(a) read with the definitions of ‘dividend’ and ‘foreign dividend’ in s 1 of the Income Act.

<sup>454</sup> *Boyd* (note 153) or in terms of the definition of foreign sourced dividend income as amended over time.

s 9(2)(a), provides that the source of dividend income is in South Africa if the dividend, as defined in s 1 of the Income Tax Act, is distributed by a South African resident company. This would include South African incorporated and non-South African incorporated companies. Table 1 below illustrates the different treatment for dividend income depending on how the distributing company qualifies as a resident in the event that Boyd's case applies.

**Table 1: South African incorporated company vs place of effective management in South Africa**

	South African incorporated company	Place of effective management in South Africa but not incorporated in South Africa
Business income	Taxed in South Africa; source in South Africa	Taxed in South Africa; source in South Africa
Dividend income	Taxed in South Africa; source of dividend income in South Africa	Not taxed in South Africa, source of dividend income not in South Africa

- For royalty income of South African residents prior to 1 January 2012, the s 9 deeming provisions must not apply in order for source to be outside South Africa and, in addition, the intellectual thinking which gave rise to the intellectual property from which the royalty arises, must also not be in South Africa.<sup>455</sup> With effect from 1 January 2012, the s 9 source provisions must not apply.<sup>456</sup> In terms of the s 9(2)(c) and (d), the royalty source provisions, the source of royalty income is in South Africa,
  - if the royalty is paid by a resident, except where the royalty is attributable to a permanent establishment outside South Africa,<sup>457</sup>
  - or the intellectual property is used in South Africa.<sup>458</sup>

<sup>455</sup> *Millin* (note 154)

<sup>456</sup> Prior to 1 January 2012, s 9(1)(b) and (bA) applied as the relevant deeming source provisions. From year of assessment commencing on or after 1 January 2012, the source provisions of s 9(2)(c), (d),(e) and (f) must not apply. Section 22(1) of the Taxation Laws Amendment Act No. 24 of 2011 introduced the aforesaid amendments.

<sup>457</sup> Section 9(2)(c).

A further question which arises with the use of 'place of effective management' as a jurisdictional link is whether it has the same meaning when used in a double taxation agreement as in the Income Tax Act. The question becomes important when, on the application of a double taxation agreement between South Africa and the other country party to the double taxation agreement, there is a residence-residence conflict and residence has to be determined through the application of place of effective management as the tie-breaker rule. The chosen interpretation plays a role in deciding which country may levy the tax and which country should provide relief for the double taxation; it may also affect the form of investment into and out of South Africa. In this context of uncertainty about the definition of residence, it is difficult to apply the concepts of equity and neutrality. In order to apply these concepts and have a uniform understanding, the concepts of residence and source have to be uniformly defined and interpreted. If equity and neutrality had been properly considered in the development of the residency rules, these types of inconsistencies might not have arisen.

In 2003, a further complexity was added to the interpretation of residency by the addition of a proviso to the definition of residence.<sup>459</sup> In terms of the proviso, a resident taxpayer is treated as a non-resident if he, she or it is 'deemed to be exclusively a resident of another country for the purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation'.<sup>460</sup> A question which currently does not

---

<sup>458</sup> Section 9(2)(d).

<sup>459</sup> Inserted by the Exchange Control Amnesty and Amendment of Taxation Laws Act No. 12 of 2003.

<sup>460</sup> Proviso to definition of 'residence' in s 1 of the Income Tax Act.

have a resolution is whether such a taxpayer is treated as a non-resident for all purposes of the Income Tax Act or only for the 'purposes of the application' of the relevant double taxation agreement. It is the wording of the proviso, namely 'for the purposes of the application of any agreement' which, it is submitted, creates this uncertainty. This would affect the tax treatment of such a taxpayer, for example, in respect of whether tax is imposed on the worldwide income of such a taxpayer or only on income which has its source located in South Africa. Another example is the possibility of losing tax credits where such person ceases to be a tax resident and whether that person would qualify for certain non-resident incentives such as the exemption of income which would otherwise be included in taxable income. The interaction of this proviso in the Income Tax Act with double taxation agreements is discussed and analysed in Chapter Five of this thesis.<sup>461</sup>

From the above analysis, it can be said that in order to properly consider the methods of relief offered for international double taxation and the concomitant concerns of equity and neutrality, the legitimate basis on which tax is levied by the government must be clear, as must the meanings attributed to both residence and source. In addition, where a country intends to introduce a residence basis of taxation, the effect of the chosen meanings of residence must be considered against the background of who is compared and who receives certain treatment. This entails a consideration of the meanings, together with the methods used to relieve international double taxation, and the equity and neutrality effects of the chosen

---

<sup>461</sup> See para 5.8.1 of Chapter Five of this thesis.

meanings. It does mean that following international norms may not be appropriate for countries which have specific considerations.

Having indicated the problems associated with whom must be compared, the next part of the analysis is based on the assumption that the meaning or interpretation of residence is clear and certain with respect to who is regarded as a resident or as a non-resident. In order to reach a conclusion on equity and neutrality of South African residents' local and outward investment in relation to the method used to relieve international double taxation, the tax treatment of the different categories of income, especially the distinction between business profits (active income) and other income (passive income), will be considered.

#### **4.4.2 Business income**

With the introduction of residence and the concomitant repeal of s 9C in 2001<sup>462</sup> – where a South African resident traded or invested in a foreign country through the use of a branch ('foreign branch') or where the source of the income of the South African resident was not located in South Africa (foreign-sourced income) and tax was imposed on the same income of such resident in the host or source country – the default method of relief for international double taxation for such resident was the tax credit as provided in s 6quat of the Income Tax Act. The tax credit, as the default method of relief, applied to both active and passive income, giving an appearance of symmetry between active and passive income with the removal of the differential treatment created by the source-plus basis of taxation.

---

<sup>462</sup> There was no longer any need for these deeming source provisions with the world wide income of residents being subject to the income tax and s 9C was accordingly repealed by the Revenue Laws Amendment Act No. 59 of 2000.

However, this symmetry was undermined by the income received by or accrued to companies being exempt from tax in South Africa where the source of the income was located in, and the income was taxed in, designated countries. The exemption method of relief applied to income received by or accrued to companies where the actual and deemed source of the income was not located in South Africa, but was located in a designated country<sup>463</sup> and the income was subject to tax in the designated country at a statutory tax rate of at least 27 per cent.<sup>464</sup> Because of these exemptions, the residence basis of taxation as applied in South Africa in 2000 was termed residence-minus.<sup>465</sup> For foreign branches situated in non-designated countries, where profit was not taxed on a substantially similar basis as in South Africa or where the statutory tax rate was less than 27 per cent and tax was imposed on the income in that host country, the South African resident taxpayer would have been able to get relief for international double taxation through the use of either the tax credit<sup>466</sup> or, potentially, in terms of the general deduction theory.<sup>467</sup> The tax relief obtained for the double taxation would, of course, have differed depending on whether the taxpayer qualified for a credit or a deduction. The reason given for differentiating between the tax treatments of income arising in different countries appears to have been administrative as it was indicated that in the case of the ‘chosen

---

<sup>463</sup> The list of designated countries in GG No 21526 dated 2000-09-01 are: Algeria, Australia, Austria, Belgium, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, Korea (Rep), Lesotho, Malawi, Namibia, Netherlands, Norway, Poland, Romania, Slovak Republic, Swaziland, Sweden, Thailand, Tunisia, United Kingdom, United States of America, Zambia and Zimbabwe. See also Mazansky (note 362) at 141; Olivier et al 2004 (note 265) at 272.

<sup>464</sup> Paragraph (kA) of the s 1 definition of ‘gross income’ read together with s 9F and s 10(1)(kA) of the Income Tax act as inserted by the Revenue laws Amendment Act No. 59 of 2000. See the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 6–7.

<sup>465</sup> The Department of Finance, *Chapter Four Revenue Issues and Tax Proposals* (note 354) at 84; Explanatory Memorandum on the Revenue laws Amendment Bill, 2000 (note 307) at 2.

<sup>466</sup> Section 6quat.

<sup>467</sup> Section 11(a) read with s 23(g).

countries', the end result of applying the exemption method of relief would have been the same as applying the credit method of relief.<sup>468</sup> Although this may have been true if the only criteria were the tax structure and tax rate of the host country, the linking of the exemption to specific designated countries, namely countries with whom South Africa had entered into treaties for the relief of double taxation, seems to indicate an underlying political agenda which undermined the administrative reason as well as equity and neutrality on a number of grounds. These grounds included a differential treatment between local and outward South African residents on the one hand, and outward residents on the other, where a different tax treatment resulted from the choice of country in which such South African resident decided to trade or invest. The difference therefore undermined both the comparators of ability-to-pay and the benefit principles of equity – in other words, treating similarly situated persons differently irrespective of which equity benchmark was being used. Similarly, both capital export neutrality and capital import neutrality were undermined. South African resident taxpayers were not neutral between local or outward investment. In addition, they were not neutral with respect to outward investment as the method of relief was dependent on the chosen country of trade and investment.

#### *Tax treatment of losses*

A further factor which affects the neutrality and equity of cross border trade and investment is the non-allowance of foreign losses against the income of the South African resident company. Where a foreign branch of a South African resident

---

<sup>468</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 10.

company experiences a loss in the host country of investment, it will in all likelihood not be taxed in that country. So the issue of international double taxation does not arise at that point. However, the question is whether such loss should be offset against income of that company where the source of that income is located in South Africa. The Income Tax Act ring-fences such losses and provides that foreign losses can only be set off against income which has its source located outside South Africa and not against income which has its source located in South Africa.<sup>469</sup> According to the South African National Treasury the ring-fencing is needed in order to prevent the erosion of the South African tax base.<sup>470</sup> This erosion, according to the South African Revenue authorities, is possible on two grounds – uncertainty of the ‘magnitude’ of the losses and possible tax avoidance structures, for example a loss-making branch setting off the loss when not profitable and converting to a subsidiary once it is profitable. As the income of the subsidiary would be exempt from tax in South Africa, assuming that it falls outside of the controlled foreign company provisions, it would not be possible to recoup the losses previously allowed. Although there may be an anti-avoidance element, the non-allowance of losses means that a South African local company suffering losses is potentially at an advantage over a South African local company with profit-making South African branches but a loss-making foreign branch. The former company would not have to pay tax at all while the latter has to pay tax on its income which has its source located in South Africa. Ability-to-pay equity, which is used for South African resident companies with profits made on outward trade and investment, does not

---

<sup>469</sup> Section 20 of the Income Tax Act.

<sup>470</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 7.

apply when such companies are making a loss on outward trade and investment. This is clearly inequitable and non-neutral. Of interest is the amendment made to the Australian rules, with effect from 1 July 2008, permitting foreign losses to be offset against all domestic and foreign income.<sup>471</sup>

*Removal of designated country list*

The cross border policy with respect to income of foreign branches of South African resident companies in designated countries changed in 2003, as evidenced by the falling away of the exemption method of relief for active income which had its source located outside South Africa.<sup>472</sup> The exemption of such income was replaced with the tax credit as the method of relief for international double taxation. The designated country exemption was removed because it created ‘an impression that South Africa’s tax system favours certain countries over others’<sup>473</sup> and also because ‘many countries have hidden incentives that do not simply eliminate income or cannot be uncovered without a full understanding of the entire tax system involved’.<sup>474</sup> This reasoning indicates that the effects of having a designated country list were not fully analysed when initially introduced.

The change in the method of relief for international double taxation meant changes in the equity and neutrality approaches to business income of South African

---

<sup>471</sup> Simon Bowden and Viv Tadmore ‘Australia’ in *Cahiers De Troit Fiscal International: Key Practical issues to eliminate double taxation of business income* vol 96b (2011) The Hague:Sdu Uitgewers at 106.

<sup>472</sup> Section 9F of the Income Tax Act was deleted by the Revenue Laws Amendment Act No. 45 of 2003 with effect from 1 June 2004.

<sup>473</sup> South African National Treasury Explanatory Memorandum on the Revenue Laws Amendment Act No. 45 of 2003, ‘Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 28 November 2012.

<sup>474</sup> Ibid.

residents, where the source of that business income was located outside South Africa. The approach to equity changed from the benefit principle applicable to active income to ability-to-pay equity applying to virtually all forms of active and passive income. The approach to neutrality changed from capital import neutrality for active income to capital export neutrality for virtually all types of income.

The change in the neutrality policy principle applicable affected the competitiveness of the South African business operating in a foreign host country. It means that if South Africa wants to ensure competitiveness through using the tax system and still use the credit method to relieve international double taxation, it has to keep its tax rates below or equal to the tax rates of the countries where its residents trade through a foreign branch, particularly with respect to company tax rates. South African tax rates would therefore be dependent on the other country's tax structures and where trading partners change or amend tax rates or structures, South Africa would have to follow suit to maintain its competitiveness.

*Legal form: branch versus subsidiary*

The use of the limited tax credit to relieve international double taxation for foreign branches of South African resident companies means that the treatment of trade and investment through the operation of a branch would be the same, irrespective of whether the branch is located inside or outside South Africa. This, of course, does not apply where the host country of the foreign branch imposes taxes at rates which are higher than South Africa's or where the foreign branch makes a loss, as indicated

earlier.<sup>475</sup> Therefore, barring the two exceptions, for the business income of a branch, equity, on the basis of ability-to-pay and capital export neutrality would apply. As indicated earlier in para 2.3 of Chapter Two of this thesis,<sup>476</sup> although formal equity is met, it remains uncertain that substantive equity is met given the differences between the risks and environment faced by active businesses in different countries.

Without any specific provisions, the business income of a foreign non-resident subsidiary of a South African resident company or of a foreign non-resident company controlled by South African residents is not included in the South African tax base. The category of income received by the South African parent company or by the controlling shareholder would either be in the form of dividend, interest or royalty income, all of which could potentially be deferred. The treatment of these categories of income is discussed later in this thesis, in the context of the specific category of income received by South African residents. However, in general and without considering the specificity of each category of income, in order to ensure the same treatment for local and outward trade and investment, irrespective of the legal form through which such trade and investment is undertaken, provision has to be made for the tax treatment of the income received by such a non-resident foreign company. Given that controlled foreign company legislation would most likely cover such non-resident foreign companies, the treatment of controlled foreign companies under the Income Tax Act is discussed hereunder.

---

<sup>475</sup> At p 183–186 of para 4.4.2 of Chapter Four of this thesis.

<sup>476</sup> At p 26–30.

*Controlled foreign companies*

As indicated earlier,<sup>477</sup> controlled foreign company legislation was introduced in the form of s 9D in order to prevent the removal of both the source of income and the residence of the company from the South African tax net through the use of a non-resident foreign intermediary company.<sup>478</sup> In order to ensure equity on the grounds of ability-to-pay and capital export neutrality when comparing a controlled foreign company and a branch, tax must be imposed on all income received by the controlled foreign company and attributed to the South African resident participant. In terms of the initial treatment of the active income of a South African resident, where the source of that income was located outside South Africa, the active income of a controlled foreign company should have been exempt from tax in South Africa on condition that a tax similar to South African income tax was imposed on that controlled foreign company in a designated country. Similarly, a limited tax credit should have been provided where tax was imposed on the passive income of that controlled foreign company both in the hands of the South Africa resident participant and the controlled foreign company itself. To prevent economic double taxation in South Africa, the dividend income distributed to the South African resident participant by the controlled foreign company should have been exempt from tax in South Africa. In other words, income received by a controlled foreign company and attributed to the South African resident shareholder should largely follow the tax treatment of foreign sourced income received by South African residents. When the exemption method of relief was replaced by the tax credit for all foreign sourced

---

<sup>477</sup> See para 3.5.6 of Chapter Three.

<sup>478</sup> See Jooste (note 318) at 474.

income of South African residents, irrespective of whether the income was classified as active or passive, it was expected that this treatment would be applied for the active income of a controlled foreign company. This expectation did not arise as the active income of South African controlled foreign companies remained exempt from tax in South African.<sup>479</sup>

The ambit of the controlled foreign company provisions is also wider than wholly-owned subsidiaries of South African residents. A foreign company is treated as a controlled foreign company if more than 50 per cent of its ‘participation rights’ are held by South African resident(s).<sup>480</sup> It therefore includes foreign companies which are not subsidiaries. In addition, the concept of ‘participation rights’ is wider than being a shareholder of a company as it includes contractual rights to share in the profits of the company.<sup>481</sup> The net income of that controlled foreign company that is attributable to the South African resident shareholder or participant is calculated as if

---

<sup>479</sup> Section 9D(9). See Avi-Yonah (note 101) at 1593 where it is stated that ‘[m]ost corporate residence jurisdictions either exempt their multi-national foreign source active business income from taxation (Exempt) or permit multinational to avoid paying tax on income earned by foreign subsidiaries until the income is actually repatriated to the parent in the form of dividends or otherwise (deferral). For example, the US sub –part F – deferral applies to active business income earned by subsidiaries of US parent corporations abroad. The deferral does not depend on whether the income was taxed abroad’.

<sup>480</sup> Section 9D(1).

<sup>481</sup> See the definition of ‘participation right’ in s 9D(1). The definition as amended by the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 January 2012 and ‘participation rights’ is defined as

- ‘(a) the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company; or
- (b) in the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company;... ‘

that controlled foreign company is a resident with the exception of losses and certain deductions.<sup>482</sup>

When the active income of a foreign branch was still exempt from tax in South Africa, the neutrality between a branch and a controlled foreign company was partly introduced by exempting the income of a controlled foreign company from tax in South Africa where the income originated in one of the designated countries and where the income was effectively connected to a substantive business activity of the controlled foreign company.<sup>483</sup> The former exemption applied to the income of the controlled foreign company which was subject to tax in a designated country on a similar basis to that of South Africa at a statutory rate of at least 27 per cent.<sup>484</sup> Where the income of the controlled foreign company was not taxed at a rate of at least 27 per cent, the income of the controlled foreign company was subject to tax in the hands of the resident as it arose and any subsequent dividend declared by the controlled foreign company to the resident shareholder was exempt, thus relieving economic double taxation.<sup>485</sup>

According to Jooste, the reasoning behind the designated country exemption relates to the international law principle of tax credits where, if the foreign tax rate is much the same as the South African tax rate, little if any South African tax would result.<sup>486</sup> The income was therefore excluded to reduce the administrative burden on

---

<sup>482</sup> In terms of s 9D, the net income which is attributed to the controlled foreign company is done by treating the controlled foreign company as a resident with the exception of losses and deductions.

<sup>483</sup> Section 9D(9).

<sup>484</sup> Section 9 D(9)(a). See also Jooste (note 318) at 484–486.

<sup>485</sup> Section 9D(9).

<sup>486</sup> Jooste (note 318) at 486.

Revenue. This reasoning is based on the assumption that the reconstitution of the foreign income to South African income tax principles would not result in a different taxable income as compared to the income upon which the foreign tax was imposed.

A further exemption applied where the income of the controlled foreign company was effectively connected to substantive business activities of the controlled foreign company conducted through a permanent establishment.<sup>487</sup> According to Jooste, the rationale for the business establishment exemption was that it would not erode the South African tax base and the exemption would enhance international competitiveness.<sup>488</sup> The exemptions are linked to the initial practice of exempting foreign sourced active income and also recognise the benefit principle of equity and capital import neutrality, the latter ensuring that subsidiaries of South African parent companies are competitive in the host country of investment. The foreign business establishment exemption itself has exceptions and provides that the receipts and accruals which are not considered to be genuinely attributable to a foreign business establishment, are not exempt.<sup>489</sup> These exceptions are generally 'diversionary' income which reflects income arising in circumstances likely to lead to transfer pricing.<sup>490</sup> Where the controlled foreign company income does not fall within these provisions and the proportional income is attributed to the South African

---

<sup>487</sup> Section 9D(9)(b) provides that the provisions of this section 'shall not apply' where the investment income arises from and is effectively connected to substantive business activities of such controlled foreign company conducted through a permanent establishment'.

<sup>488</sup> Jooste (note 318) at 486. The term 'business establishment' was deleted by the Revenue Laws Amendment Act No. 20 of 2006 and was replaced by the term 'foreign business establishment' inserted by the Revenue Laws Amendment Act No. 20 of 2006.

<sup>489</sup> In terms of s 9D(9) the exemption does not apply where the income arises from the so-called diversionary (foreign) business income, the mobile (foreign) business income and the mobile (foreign) passive income. For a discussion of these categories, see Jooste (note 318) at 486–490.

<sup>490</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (note 390) at 77.

resident shareholder, with tax being imposed on this income in the hands of the South African resident shareholder, the s 6quat tax credit provides relief. Although not juridical double taxation, the s 6quat tax credit relieves economic double taxation by providing a limited tax credit to the South African resident shareholder of the controlled foreign company for the tax paid by the controlled foreign company on its income.<sup>491</sup>

With the removal of the country specific exemption for active business income of branches in 2004<sup>492</sup> and the replacement of the tax credit method of relief for international double taxation, the country-designated exemptions for controlled foreign companies were also removed. However, the business establishment exemption remained. The result was a different form of equity and neutrality for foreign branches of South African resident companies and for controlled foreign companies – a foreign branch had to use a limited tax credit to relieve international double taxation whereas the active income of controlled foreign companies was exempt.

From a policy perspective, and given that controlled foreign companies are a type of ‘look-through’ provision, there should be similar treatment for foreign branches and controlled foreign companies. The provisions relating to branches,

---

<sup>491</sup> Section 6quat(1A)(b)

<sup>492</sup> The exemption was repealed with effect from 1 June 2004 by the Revenue Laws Amendment Act No.45 of 2003.

subsidiaries and controlled foreign companies should reflect the same tax policy considerations as neither ownership of capital nor business format should matter.<sup>493</sup>

The 2007 Budget tax proposals presented by the South African Revenue Service stated that the

... rules require a careful balance between capital export neutrality (i.e. equal tax treatment for all South African-owned operations) and the opposing need for international competitiveness.<sup>494</sup>

This statement was made with regard to the controlled foreign company rules developed over the years and stated that any changes in the controlled foreign company rules would not deviate from the core philosophy developed. It further stated that the issues to be examined with regard to controlled foreign companies are:<sup>495</sup>

- the treatment of certain controlled foreign company mobile businesses as qualifying establishments;
- the treatment of royalties that are central to core active controlled foreign company business operations;
- offshore business operations that are subject to the controlled foreign company diversionary rules even though the controlled foreign company's activities represent no threat to South Africa's tax base;

---

<sup>493</sup> Although beyond the ambit of this thesis, the questions raised here may have relevance to the concept of capital ownership neutrality.

<sup>494</sup> South African Revenue Services, *Legal & Policy: Legislation 2006/2007 Budget Tax Proposals* at 24. Available at <http://www.treasury.gov.za/documents/national%20budget/2006/sars/B05Guide.pdf>, last accessed 28 November 2012.

<sup>495</sup> *Ibid.*

- the taxation of a controlled foreign company business operating in multiple countries within a single economic market; and
- the clarification of the ‘country of residence’ concept.

Examination of these issues is supported, however, the differential tax treatment of the legal form of outward trade and investment by South African residents is not dealt with. The effect of the foreign business establishment exemption means that instead of using a branch to do business in a foreign country, from a tax planning perspective it may be better to use a controlled foreign company: its income would be exempt whereas a limited tax credit would be the method of relief for international double taxation for a branch. The result is a distortion and non-neutrality. In addition, the income of a controlled foreign company which meets the foreign business establishment requirement would only be subject to tax in South Africa when it is received by the South African resident shareholder as dividend income. Such dividend income would, however, normally qualify for the ‘participation exemption’ found in s 10(1)(k).<sup>496</sup> In other words, there is a deferral of income, adding to the non-neutrality between the legal forms of trade and investment.

As in the United States of America, the problem with the deferral is that it differentiates between the forms of foreign investment and it may also result in

---

<sup>496</sup> See para 2.7.4 of Chapter Two and para 4.4.4 of Chapter Four of this thesis.

inefficient investment decisions and the geographical misallocation of resources.<sup>497</sup>

A similar criticism can therefore be raised, namely, if capital export neutrality is the main policy goal, then the deferral or exemption of foreign active business income should be limited and a tax credit should rather be granted in respect of active business income of controlled foreign companies. On the other hand, if capital import neutrality and foreign competitiveness is the main concern, then all foreign active income, irrespective of the form, should be exempt.

Table 2 directly below indicates the difference between the treatments of dividend income and active business income of a South African resident company, the foreign branch of a South African resident company and a South African controlled foreign company.

**Table 2: A comparison of dividend and active income of a South African resident company, a foreign branch of a South African resident company and a South African controlled foreign company**

	Active Business Income	Dividend Income
South African local trade and investment	South African resident company is taxed in SA.	South African resident shareholder is exempt from tax in South Africa in terms of s 10(1)(k.)
Trade and Investment through a controlled foreign company	Income of a controlled foreign company is not subject to tax in South Africa if it qualifies as a foreign business establishment or other exemption applies.	South African resident shareholder may be subject to tax when distribution is made, unless the participation exemption applies.
South African resident outward investment	South African resident company is given a limited tax credit for foreign taxes paid on the taxable income of its foreign branch.	South African resident shareholder is subject to tax unless the foreign dividend income qualifies for the participation exemption.

The differentials between the treatment of controlled foreign companies and foreign branches, with regard to the method of relief, will be even greater with the

<sup>497</sup> United States of America Joint Committee on Taxation 'Economic efficiency and structural analyses of alternative US tax policies for foreign direct investment' June 25 2008. Available at <http://purl.access.gpo.gov/GPO/LPS97274>, last accessed 29 November 2012.

proposed exemption of highly taxed controlled foreign companies even though the actual amount of tax collected by the South African fiscus may not differ.<sup>498</sup>

#### **4.4.3 Interest and royalty income**

With the introduction of the residence basis of taxation, the deeming source provisions in s 9C were repealed<sup>499</sup> and relief for international double taxation for taxpayers who received, or to whom interest and royalty income accrued, was provided by the s 6quat limited tax credit. The treatment of interest and royalty income is similar to business income. Therefore, if interest and royalty income is earned through a foreign branch with the source of that income located outside South Africa, the income would be included in the tax base of that South African resident taxpayer with the s 6quat limited tax credit available to relieve international double taxation where tax is also imposed on that income in the host country. Section 10(1)(i)(xv) provides a limited exemption for foreign sourced interest income received by or accrued to natural persons who qualify as South African residents.

---

<sup>498</sup> South African National Treasury Explanatory Memorandum accompanying the Taxation Laws Amendment Act No. 17 of 2009, 'Explanatory Memorandum on the Taxation Laws Amendment Bill', 2009 at 76 where it states that '[t]o be viewed as high-taxed, the "net income" of the CFC as an aggregate must be subject to a global level of foreign tax of at least 75% of the amount of tax that would have been imposed had the CFC been fully taxed in South Africa'. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 29 November 2012. It also states at 76 that '[t]he purpose of this high-taxed exemption (like the prior exemption within the special rulings process) is to disregard tainted controlled foreign company income if little or no South African tax is at stake once South African (section 6quat) tax rebates are taken into account'.

<sup>499</sup> Section 9C of the Income Tax Act was repealed by the Revenue Laws Amendment Act No. 59 of 2000.

#### ***4.4.4 Dividend income***

Dividend income declared from profits of South African resident companies is generally exempt from tax in South Africa,<sup>500</sup> but the tax treatment of dividends received by South African resident shareholders from non-resident companies (foreign dividends) has undergone a number of changes since the introduction of the residence basis of taxation. This discussion on foreign dividends is therefore not exhaustive and does not claim to deal with each aspect or change to the taxation of foreign dividends. The taxation of foreign dividends within the millennium period has the potential to constitute a thesis of its own. The following discussion only highlights certain aspects of the taxation of foreign dividends as are relevant to the methods of relief provided for international double taxation.

The exemption of dividend income received by South African resident shareholders from South African resident companies (domestic dividends) is justified on the basis that this income is already subject to tax by being included in the income of a South African resident company and the exemption is therefore to prevent economic double taxation of the dividend income. This means that for dividends distributed by South African resident companies, the only concern is the relief of economic double taxation – which can, and is, solved by the domestic legislation.

Since the change to the residence basis of taxation, tax has been imposed on the worldwide income of companies which meet the requirements of the test for residency, irrespective of the location of the source of the income. This means that,

---

<sup>500</sup> Section 10(1)(k) of the Income Tax Act provided for the exemption of dividend income received by a South Africa resident from a South Africa resident company where the latter was taxed in South Africa.

in order to relieve economic double taxation of the income where dividends were distributed to South African resident shareholders of such companies, the dividend income had to be exempt from tax in South Africa. Section 9E<sup>501</sup> was accordingly amended to provide for the taxation of foreign dividends in the hands of South African resident shareholders. It provided that foreign dividends received by or accruing to South African resident shareholders were to be included in the gross income of that resident.<sup>502</sup>

Where tax was imposed on these foreign dividends in South Africa, relief had to be provided for the possibility of international double taxation of the South African resident shareholder. Furthermore, consideration had to be given to whether relief would be provided for the underlying taxes paid by the distributing company; in other words, whether economic double taxation relief would be offered to the South African resident shareholders in respect of the foreign dividend income – particularly where the distributing company was involved in active business or the shareholding was the result of direct investment. These considerations added complexity to the cross border treatment of dividend income and also affected the equity and neutrality aspects of the legal form of cross border trade and investment. A further complication, where a subsidiary company is used for outward investment, is the application of controlled foreign company rules to the income earned by the

---

<sup>501</sup> The discussion on the exemption of the dividend income is limited to South African resident shareholders because the comparison in this context is between South African residents. For the sake of completion, it may be mentioned that it is appropriate to also exempt dividend income distributed to non-residents.

<sup>502</sup> By The Revenue Laws Amendment Act No. 59 of 2000. See also the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 17.

non-resident subsidiary company of a South African resident parent company where the parent company is entitled to foreign dividends.

*The exemption of foreign dividends*

Section 9E of the Income Tax Act, read together with s 10(1)(k), provided that foreign dividend income was exempt from tax in South Africa in certain circumstances.<sup>503</sup> The exemption of the foreign dividend was to ease the administration in determining the tax credit to be allowed<sup>504</sup> and, where applicable, to prevent economic double taxation. The exemptions included dividends received where the shareholding by South African residents in the foreign company was small (less than 10 per cent)<sup>505</sup> and where either the company or the shareholder was already taxed on the income of the company in South Africa.<sup>506</sup> Foreign dividends were also exempt where South African residents held more than 10 per cent of the shares and tax was imposed on the distributing company in its country of residence on a basis similar to South Africa.<sup>507</sup> This latter exemption provided neutrality for South African outward direct investment whether in the form of a branch or a subsidiary. At the time that s 9E was in place, the active income of South African residents – where the source of the income was located outside South Africa – was exempt from tax in South Africa, provided that the income was taxed in the host country on a basis similar to that of South Africa. In addition to the aforesaid exemptions, the Minister of Finance had discretion to exempt certain foreign

---

<sup>503</sup>Section 9E (7) read with s 10(1)(k) of the Income Tax Act. Section 9E was repealed by the Revenue Laws Amendment Act No. 45 of 2003 with effect from 1 June 2004.

<sup>504</sup>The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 10.

<sup>505</sup> Section 10(1)(k) of the Income Tax Act.

<sup>506</sup> Section 10(1)(k) of the Income Tax Act.

<sup>507</sup> Section 10(1)(k) of the Income Tax Act.

dividends remitted to South Africa.<sup>508</sup> This discretion was to be exercised where deemed necessary in the national interest and was subject to certain conditions.<sup>509</sup> It has been stated that the exercise of this discretion by the Minister can be viewed as a type of tax-sparing provision, in that it allowed a South African resident to retain the full benefit of a tax incentive granted by a foreign jurisdiction.<sup>510</sup>

Section 9E also exempted certain categories of dividend income from tax such as where the dividends were distributed from dual listed foreign companies on the JSE Securities Exchange.<sup>511</sup> Where South African residents received foreign dividends which fell into the exempt provisions, they were in the same position as shareholders who received dividend income from South African resident companies.

Where the foreign dividend income did not fall into one of the exempt provisions, and was included in the 'gross income' of the South African resident shareholder, s 9E(6) allowed a resident a choice between treating the foreign tax as an expense by deducting the foreign tax from its income or using the tax credit provision to relieve international double taxation.<sup>512</sup> Section 9E dealt with economic double taxation where a tax credit was the only relief available for juridical double taxation by:

---

<sup>508</sup> Section 9E(8A) of the Income Tax Act.

<sup>509</sup> In approving a project from which the aforesaid dividends would flow, s 9E(8A) provided that the Minister must have regard to the economic benefits of the projects for South Africa; the extent to which goods and services will be provided from the project for South Africa; the potential effect the project may have on the South African tax base; other assistance granted by the Government or the semi government for the project and any other criteria that the Minister may prescribe by notice in the Gazette.

<sup>510</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 10.

<sup>511</sup> Section 9E(7) as it was at the time.

<sup>512</sup> Section 9E(6) as it was at the time.

- calculating the quantity of the foreign dividend income to be included in ‘gross income’ with reference to the tax paid by the company distributing the dividend;<sup>513</sup> and
- determining whether or not the South African resident shareholder had a ‘qualifying interest’<sup>514</sup> in the distributing company.

Where a South African resident shareholder did not have a ‘qualifying interest’, the quantity of foreign tax taken into account to relieve international double taxation was determined, *inter alia*, by grossing up the foreign dividend by the amount of the withholding tax on the dividend.<sup>515</sup> Where a South African resident did have a qualifying interest, the foreign dividend was grossed up by both the underlying corporate taxes paid in respect of the profits from which the dividend was distributed as well as any withholding tax paid in respect of the dividend.<sup>516</sup> Economic double taxation was therefore relieved through the ‘grossing up’ method described earlier in paragraph 2.7.4 of Chapter Two of this thesis.

The above analysis illustrates that the imposition of tax on the foreign dividend income received by South African residents was dependent on a number of

---

<sup>513</sup> In terms of s 9E(4), if a South African resident had a ‘qualifying interest’, the foreign sourced dividend would have been grossed up by firstly, the amount of the underlying corporate taxes paid in respect of the profits from which the dividend was distributed and secondly, any withholding tax paid in respect of the dividend.

<sup>514</sup> The amount of the foreign sourced dividend to be included in the paragraph (k) definition of gross income was set out in s 9E(3) where a distinction was made between residents who have a qualifying interest and those who do not. Section 9E(1) defined a ‘qualifying interest’ as ‘of any person that person holds any direct interest of at least 10% in the equity share capital of any company and any direct interest of at least 10% held by any company in the equity share of any other company, which other company shall for the purposes of this definition be deemed to be a company in which any person holds a direct interest of at least 10%.’

<sup>515</sup> Section 9E(4).

<sup>516</sup> Section 9E(3) and (4).

factors. In addition, treatment of foreign dividend income differed from that of South African dividend income. In order to have the same treatment accorded to South African dividends, foreign dividend income either had to fall into one of the specific exemptions, or South African residents could choose either not to use a foreign subsidiary for their outward investment, or not to engage in outward investment. Since the tax treatment clearly impacted on their decisions, the imposition of taxes on foreign dividend income was not neutral.

*Repeal of s 9E and s 10 consolidations*

Section 9E was repealed in 2003.<sup>517</sup> Its repeal did not alter the tax treatment of foreign dividends as its provisions were mostly consolidated in the exemptions found in s 10(1)(k), the exemption of dividend income provision.<sup>518</sup> The s 10(1)(k) exemptions included the exemptions for dual listed companies and previously taxed South African income. The Ministerial exemption was removed as it was viewed as being ‘superfluous in light of the new exemption for more than 25 per cent foreign shareholding’.<sup>519</sup>

The rationale behind the repeal of s 9E was that it had the ‘unintended effect of discouraging dividend inflows’, particularly where South African resident taxpayers owned a ‘meaningful interest in a foreign subsidiary’ and delayed or avoided ‘the repatriation of dividends to avoid South African tax’.<sup>520</sup> This comment by the South African revenue authorities is perhaps an indication that it did not

---

<sup>517</sup> By the Revenue Laws Amendment Act No. 45 of 2003 with effect from 1 June 2004.

<sup>518</sup> Section 10(1)(k)(ii) of the Income Tax Act which exempted foreign dividend income under certain circumstances.

<sup>519</sup> Explanatory Memorandum on the Revenue laws Amendment Bill, 2003 (note 473) at 46.

<sup>520</sup> Ibid.

consider equity and neutrality in its decision to impose taxes on foreign dividend income. If it had, then this consequence would have been clear. The taxation of foreign dividends seems indicative of an eagerness to increase the South African tax base without fully considering all the consequences.

*Participation exemption for economic double taxation*

In addition to the consolidation of the tax treatment of foreign dividends in s 10(1)(k), the s 6quat indirect credit for economic double taxation was repealed and a participation exemption was introduced.<sup>521</sup> This meant that relief for economic double taxation was provided only where the participation exemption requirements were met with no other relief for economic double taxation.

The reason given for the removal of relief for economic double taxation was that:

... indirect tax credits are problematic in terms of enforcement and compliance because of the difficulties of tracing historic profits to applicable foreign taxes. Moreover, little reason exists to maintain this complex system for the small class of South African shareholders otherwise remaining within the indirect tax credits system (i.e. those between the 10 – 25% ranges). Even in these limited instances, efforts have been taken to mitigate the loss of indirect tax credits.<sup>522</sup>

The effect of the participation exemption is that dividend income from direct investment, where a shareholding of greater than 20 per cent is indicative of direct investment, is exempt from tax in South Africa and this results in the same treatment for South African dividends as for direct investment foreign dividends. But the tax

---

<sup>521</sup> The Revenue Laws Amendment Act No. 45 of 2003 repealed the s 6quat indirect credit and introduced the s 10(1)(k)(ii)(dd) exemption. The Revenue Laws Amendment Act No. 31 of 2005 reduced the participation exemption threshold to 20 per cent.

<sup>522</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003 (note 473) at 46.

treatment of income from a foreign subsidiary with a foreign business establishment and income from a foreign branch is not the same. Income derived *via* the former may be exempt, while the taxpayer has to rely on a limited tax credit to relieve double taxation.

It is interesting that South Africa, having initially introduced the use of credits to relieve both juridical and economic double taxation of foreign sourced dividend income, soon used an exemption method to relieve such double taxation on the grounds of its application being simpler. Again, there does not appear to have been any discussion with respect to the potential equity and neutrality consequences of the exemption.

Although the participation exemption was meant to apply to dividend income arising from foreign direct investment, the participation exemption provision did not indicate this. As a result, any foreign dividends from any type of foreign investment where the South African shareholder held more than 20 per cent of the shares were exempt in South Africa. Once again, it appears as if the relevant equity and neutrality issues were not considered. With the introduction of the participation exemption, the comparison between direct investment in the form of the subsidiary and in the form of a controlled foreign company should have been clear. The 2010 amendments to the Income Tax Act clarified this: it amended the participation exemption to ensure that it only applied to outward direct investment by providing that the participation

exemption would not apply to dividends received from a portfolio in any collective scheme in securities, or from a foreign financial instrument holding company.<sup>523</sup>

### *Foreign dividends in 2011*

Section 10B was inserted into the Income Tax Act in 2011, to deal with, *inter alia*, foreign dividends.<sup>524</sup> The section provides for the tax treatment of foreign dividends, as defined in s 1, as well as dividends paid or declared by a headquarter company.<sup>525</sup>

A foreign dividend is defined in s 1 of the Income Tax Act with respect to its treatment in the country of residence of the foreign company.<sup>526</sup> Subject to certain exceptions,<sup>527</sup> a foreign dividend is exempt from normal tax if received by or accrued to:<sup>528</sup>

---

<sup>523</sup>Section 10(1)(k)(ii)(dd) as amended by the Taxation Laws Amendment Act No. 7 of 2010. See also Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (note 390) at 71–73.

<sup>524</sup>Section 10B was inserted by the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 March, 2012 applicable to dividends received or accrued on or after that date insofar as it applies to any person that is a natural person, deceased estate, insolvent estate or special trust; and with effect from 1 April, 2012 applicable to dividends received or accrued on or after that date insofar as it applies to any person that is a person other than a natural person, deceased estate, insolvent estate or special trust.

<sup>525</sup>Section 10B is headed ‘Exemption of foreign dividends and dividends paid or declared by headquarter companies’ and s 10B(1) provides for the definition of a ‘foreign dividend’ as defined in s 1 or a dividend paid or declared by a headquarter company.

<sup>526</sup>Section 1 of the Income Tax Act defines a ‘foreign dividend’ as ‘any amount that is paid or payable by a foreign company in respect of a share in that foreign company where that amount is treated as a dividend or similar payment by that foreign company for the purposes of the laws relating to—

(a) tax on income on companies of the country in which that foreign company has its place of effective management; or

(b) companies of the country in which that foreign company is incorporated, formed or established, where the country in which that foreign company has its place of effective management does not have any applicable laws relating to tax on income,

but does not include any amount so paid or payable that—

(i) constitutes a redemption of a participatory interest in an arrangement or scheme contemplated in paragraph (e)(ii) of the definition of ‘company’; or

(ii) is deductible by that foreign company in the determination of any tax on income on companies of the country in which that foreign company has its place of effective management.

<sup>527</sup>Section 10B(4) and (5) provide for the exceptions.

<sup>528</sup>Section 10B(2) states that subject to subsection (4), there must be exempt from normal tax any foreign dividend received by or accrued to a person—...

- a person, either alone or together with other companies in a group of companies, who holds at least 10 per cent of the equity shares and voting rights in the company declaring the foreign dividend<sup>529</sup> – in other words, a participation exemption;<sup>530</sup>
- a person that is a company, and the foreign dividend is paid or declared by another foreign company that is resident in the same country as that person that is a company<sup>531</sup> – in other words, a previously taxed exemption;<sup>532</sup>
- subject to certain requirements, a person who is a resident to the extent that the foreign dividend is not greater than the amounts included in the income of that resident in terms of the controlled foreign company rules in s 9D<sup>533</sup> – in other words, a ‘country to country’ participation exemption for controlled foreign companies;<sup>534</sup>

---

<sup>529</sup> Section 10B(2)(a) states that ‘if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the total equity shares and voting rights in the company declaring the foreign dividend.

<sup>530</sup> South African National Treasury Explanatory Memorandum accompanying the Taxation Laws Amendment Act No. 24 of 2011, ‘Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011’ at 40. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 28 November 2012

<sup>531</sup> Section 10B(2)(b) states that ‘if that person is a company and the foreign dividend is paid or declared by another foreign company that is resident in the same country as that company.

<sup>532</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (note 530) at 40.

<sup>533</sup> Section 10B(2)(c) provides for the exemption of dividend income included in the income of a person who is a resident to the extent that the foreign dividend does not exceed the aggregate of all amounts which are included in the income of that resident in terms of s 9D in any year of assessment, which relate to the net income of... ..

<sup>534</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (note 530) at 40.

- a person from a listed share;<sup>535</sup> and
- subject to certain conditions, a natural person, deceased estate, insolvent estate or special trust.<sup>536</sup>

In addition to the s 10B exemption, s 6*sex*, also inserted in 2011,<sup>537</sup> provides a limited rebate or a credit for dividends tax on the income of foreign companies.<sup>538</sup> The rebate only applies to foreign dividends as defined in s 1 of the Income Tax Act and does not apply to dividends paid or declared by a headquarter company.<sup>539</sup>

The marginal tax rate for the taxation of foreign dividends has also been adjusted to ensure both domestic and foreign dividends are taxed at the same marginal rate.<sup>540</sup> The adjustment is to ensure that both domestic and foreign dividends, where included in the recipient's or shareholder's 'gross income', has a marginal tax rate of 10 per cent. The South African National Treasury considered the potential differential treatment of domestic and foreign taxes where the former was subject to the 15 per cent withholding tax and the latter would be included in the recipients 'gross income' (assuming that one of the exemptions did not apply) and taxed at a marginal rate of between 28 and 40 per cent.<sup>541</sup>

---

<sup>535</sup>Section 10B(2)(d) provides that 'to the extent that the foreign dividend is received by or accrues to that person in respect of a listed share and does not consist of a distribution of an asset in specie'.

<sup>536</sup>Section 10B(3).

<sup>537</sup>Section 6*sex* was inserted by the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 April, 2012.

<sup>538</sup>Section 6*sex*(2).

<sup>539</sup>Section 6*sex*(1) states that for the purpose of this section, 'dividend' means any dividend as defined in s 1, but does not include any dividend paid or declared by a headquarter company...

<sup>540</sup>Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (note 530) at 40. See s 64G(3).

<sup>541</sup>Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (note 530) at 39–40.

*Withholding tax on dividends*

In addition to the above treatment of dividend income, 2008 brought about further dividends treatment reform. Secondary Tax on Companies (STC), which was imposed on South African resident companies when a dividend was distributed, has been replaced by a dividends tax.<sup>542</sup> The dividends tax is levied at shareholder level.<sup>543</sup> The reason for the change was that STC ‘increased the cost of equity financing’<sup>544</sup> because ‘[i]nternationally, company dividends are generally taxed at the shareholder-level (as opposed to the company-level)<sup>545</sup> and this difference results in:

- STC reducing ‘the accounting profits of South African resident companies which places those companies at a ‘disadvantage compared to their international counterparts which do not bear any adverse accounting profit reduction when paying dividends’;<sup>546</sup>
- ‘ ... tax treaty limits on the rate of tax which may be imposed in respect of dividends generally’ having no effect;<sup>547</sup> and
- uncertainty because ‘foreign investors are generally unfamiliar with STC and its mechanics’.<sup>548</sup>

---

<sup>542</sup> By the Revenue Laws Amendment Act No.60 of 2008.

<sup>543</sup> Section 64G is headed ‘Withholding of dividends tax by companies declaring and paying dividends’ and was inserted by the Revenue Laws Amendment Act No. 60 of 2008. It was amended by the Taxation Laws Amendment Act No. 7 of 2010 and the Taxation Laws Amendment Act No. 24 of 2011 and came into operation on 1 April, 2012. The rate of 10 per cent in s 64E was amended to 15 per cent by the Revenue Laws Act No. 13 of 2012.

<sup>544</sup> South African National Treasury, Explanatory Memorandum accompanying The Revenue Laws Amendment Act No.60 of 2008. ‘Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008’ at 24. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 29 November 2012.

<sup>545</sup> Ibid.

<sup>546</sup> Ibid.

<sup>547</sup> Ibid.

The dividend tax affects shareholders who receive dividends declared by South African resident companies but it will not affect the taxation of South African resident shareholders as such dividend income will be exempt in their hands.<sup>549</sup> Provision is also made for a foreign credit for foreign taxes paid on foreign dividends received by the South African resident shareholder.<sup>550</sup>

The dividend tax is imposed on any dividend declared by a company other than a headquarter company<sup>551</sup> and it is the beneficial owner, namely, the 'person entitled to the benefit of the dividend attaching to a share',<sup>552</sup> who is liable to pay the dividend tax.<sup>553</sup> Certain categories of 'beneficial' owners are exempt from the dividend tax.<sup>554</sup> It is imposed on dividend income paid by both resident and non-resident companies<sup>555</sup> and, barring the exemptions, it appears as if an attempt is being

<sup>548</sup> Ibid.

<sup>549</sup> In terms of s 64F which provides that certain shareholders will be exempt from this dividends tax. The exemptions are related to whether the shareholder is the beneficial owner or not.

<sup>550</sup> Section 64N inserted by the Taxation Laws Amendment Act No. 17 of 2009 provides for the rebate in respect of foreign taxes on dividends with effect from 1 April 2012 and applicable in respect of any dividend declared and paid on or after that date

<sup>551</sup> Section 64E(1) provides that 'There must be levied for the benefit of the National Revenue Fund a tax, to be known as the dividends tax, calculated at the rate of 10 per cent of the amount of any dividend paid by any company other than a headquarter company'. The rate of 10 per cent in s 64E has been amended to 15 per cent by the Revenue Laws Act No.13 of 2012.

<sup>552</sup> The term 'beneficial owner' is defined in s 64D.

<sup>553</sup> In terms of s 64EA which provides that the liability for the tax is on :

'(a) beneficial owner of a dividend, to the extent that the dividend does not consist of a distribution of an asset in specie; or

(b) company that is a resident that declares and pays a dividend to the extent that the dividend consists of a distribution of an asset in specie, is liable for the dividends tax in respect of that dividend'.

<sup>554</sup> See s 64F which exempts a company which is a resident; the Government, a provincial administration or a municipality; a public benefit organisation approved by the Commissioner in terms of s 30(3), a trust contemplated in s 37A; an institution, board or body contemplated in s 10(1)(cA); fund contemplated in s 10(1)(d), a person contemplated in s 10(1)(t); a shareholder in a registered micro business, as defined in the Sixth Schedule, paying that dividend, to the extent that the aggregate amount of dividends paid by that registered micro business to its shareholders during the year of assessment in which that dividend is paid does not exceed the amount of R200 000; a person that is not a resident and the dividend is a dividend contemplated in paragraph (b) of the definition of "dividend" in s 64D. See also s 64FA.

<sup>555</sup> See s 64D where a 'dividend' is defined as, *inter alia*, 'any dividend or foreign dividend as defined in s 1 that is—

made to treat dividend income received by South African beneficial owners in the same manner, irrespective of whether the paying company is a resident or non-resident company.

*Definition of 'dividend'*

A further factor to influence the taxation of foreign dividends is the changing definition of 'foreign dividend'. The definition changed from the pre-democracy to the transition period, then again at the initial introduction of residence, then again with the repeal of s 9E and again in 2010.<sup>556</sup> The Explanatory Memorandum to the 2010 amendments to the definition of foreign dividend provides that:

... a foreign dividend should be defined with reference to the foreign income tax law treatment of a dividend or similar payment as determined by the country of incorporation, formation or establishment of the company making payment. This approach is in line with tax treaties. In the event that the foreign country does not have tax on income, reference must be made to that country's company law.<sup>557</sup>

This changing definition once again indicates that the equity and neutrality effect of the change were not considered initially as it is not clear what is being compared.

---

(a) paid by a company that is a resident; or  
 (b) paid by a company that is not a resident—  
 (i) if the share in respect of which that foreign dividend is paid is a listed share; and  
 (ii) to the extent that that foreign dividend does not consist of a distribution of an asset *in specie*.

<sup>556</sup> The definition of "foreign dividend" was inserted in s 1 of the income Tax Act by the Revenue Laws Amendment Act No. 45 of 2003. The proposed amendment by the Revenue Laws Amendment Act No. 60 of 2008 was deleted and substituted by the Taxation Laws amendment Act No. 7 of 2010 with effect from 1 January 2011. See also the amendments made to the s 9E definitions of 'foreign dividends'.

<sup>557</sup> Explanatory memorandum on the Taxation Laws Amendment Bill, 2010 (note 390) at 85.

#### 4.4.5 *The tax credit*

The equity and neutrality aspects of outward trade and investment by South African residents are also affected by the requirements for, and the quantification of, the tax credit. The requirements and quantification may also affect equity and neutrality because the application of the credit may be limited and would affect whether or not certain residents actually obtain relief for double taxation.

As stated by Ault, the tax credit provided has to take into account the creditable taxes, the limitations on the credit, the allocation of expenses to the foreign sourced income, the treatment of losses in the credit computation, the carry over of excess credit or limitation, the indirect credit for foreign taxes paid by foreign subsidiaries, and the interaction between the indirect credit and limitation system.<sup>558</sup>

Prior to the 2000 amendments, s 6quat limited the credits per country; that is, the tax credits of one country could not be used as a credit against tax on income from another country.<sup>559</sup> As recommended by the Katz Commission, s 6quat was amended to allow for tax credits from any country to be offset against income from other countries; that is, the onshore mixing of tax credits was allowed.<sup>560</sup> This meant that different tax rates between countries did not affect the overall tax position of the taxpayer. It also meant that where the outward South African trader or investor undertook operations in countries which had different tax rates, the ability to offset the full amount of the foreign taxes against all the foreign sourced income, resulted

---

<sup>558</sup> Ault et al (note 137) at p 452 para 3.1.1–p 464 para 3.1.6 where he discusses the ‘Issues in the structure of a foreign tax credit system’ under these headings.

<sup>559</sup> Amended by the Revenue Laws Amendment Act No. 50 of 2000. See Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 11.

<sup>560</sup> Ibid.

in a greater after-tax level of equity between the local and outward trader and investor. Those in similar pre-tax positions paid the same taxes, irrespective of where the income was earned or tax paid.

The 2000 Revenue Laws Amendment Bill<sup>561</sup> also proposed that unutilised credits be carried forward for seven years (as opposed to the three-year period which was in place). However, unutilised credits could no longer be set off against the secondary tax on companies.<sup>562</sup> In addition, the extension of the list of designated countries in s 9E to include non-treaty countries<sup>563</sup> also 'eliminated' excess credits, as such income would have been exempt with foreign credits not being a consideration.<sup>564</sup>

The pooling of all of a South African resident's income originating from sources located outside South Africa and the ability to credit the total amount of foreign tax paid prevents the problem which arose in the United Kingdom case of *George Wimpey International Ltd v Rolfe*<sup>565</sup> where it was stated that, in order to claim the credit relief in the United Kingdom, United Kingdom tax has to be charged in respect of the same income as that on which foreign tax is paid. The only requirement in s 6*quat* limited tax credit provision is that the amount on which the foreign tax is charged must fall into the taxable income of the taxpayer.

---

<sup>561</sup> Explanatory memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 11.

<sup>562</sup> *Ibid.*

<sup>563</sup> *Ibid* at 10.

<sup>564</sup> *Ibid* at 11.

<sup>565</sup> [1989] STC 609. Munro (note 268) at 43.

The result of the above ‘pooling’ and the same treatment of foreign sourced and South African sourced income of South African residents means the relevant South African tax rules, such as inclusions, exemptions and deductions apply to the ‘gross income’. In respect of deductions applicable to non-South African sourced income, the deductions must be incurred in the production of that non-South African sourced income, in accordance with the general deduction formula. Therefore, expenses and losses between South African and non-South African sourced income must be apportioned. The question that arises is how to apportion the expenditure. The question is relevant because it may affect the limitation of the credit which is given to the relevant taxpayer for the non-South Africa sourced income. The apportionment may affect equity in the form of ability-to-pay for South African residents and neutrality of the investments inside and outside South Africa. If certain expenses are deductible in South Africa but not if incurred offshore, then both equity and neutrality for South African residents would be undermined. The specific details of the method used to relieve international double taxation, and not simply whether it is a credit, exemption or deduction, affect the policy principles of equity and neutrality.

*‘Source’ requirement in s 6quat*

Another factor which may cause deviations from equity and neutrality in the application of the method used to relieve international double taxation, is the

requirement that the tax credit is only available if the source of the income, which is subject to international double taxation is not located in South Africa.<sup>566</sup>

Thus, despite the use of the residence basis of taxation to impose tax on the worldwide income of residents, the role of source has not been lost. It also means that the tax credit is not available for 'foreign-sourced' income but only for income which has its source located outside South Africa in accordance with South Africa's interpretation and deeming provisions applicable to source. 'Foreign sourced' income is defined as income that is not sourced in South Africa in accordance with South African source principles, and not by the host country's definition or determination of source.

The requirement that the *s 6quat* tax credit only be available where the source of the income is outside South Africa met with some criticism,<sup>567</sup> especially as source is determined according to the South African law and not according to the laws where the activity or business is taking place. The result was that, until the introduction of the specific deduction for foreign taxes where the source of the income was in South Africa, unilateral relief in the form of the tax credit relief was only available where the source of the income was located outside of South Africa.

---

<sup>566</sup> In terms of *s 6quat(1)* of the Income Tax Act. in order for a taxpayer to obtain a tax credit, the amounts received by and accrued to such taxpayer would have to fall within the general category of income received by or accrued to the resident taxpayer from a source outside the South Africa which is not deemed to be from a source within South Africa, or from a specific category

<sup>567</sup> See, for example the submission by Mr D Kruger on behalf of Business Unity South Africa, Finance Portfolio Committee, 24 October 2005, Hearings on the Draft Revenue laws Amendment Bill. Available at Parliamentary Monitoring Group, <http://www.pmg.org>, last accessed 31 October 2005.

At the hearings of the Draft Revenue Laws Amendment Bill on 24 October 2005, a submission was made that

... the reference to the “source” of income in section 6quat was inappropriate for a truly residence-based tax system and that it should be amended to provide relief to South African residents for all taxes payable on their worldwide income.<sup>568</sup>

The use of source as a limitation ensures that South Africa still taxes income under its former source basis of taxation and that the South African fiscus does not lose any taxes as a result of the application of the s 6quat limited tax credit. The same principle of equity thus still applies to all South African residents with South African sourced income as was the case before the change to the residence basis of taxation. The application of the principle would not be problematic if it reflected a particular approach to equity which was applied consistently throughout the Income Tax Act. The use of source as a condition ensures that South Africa retains its pre-worldwide tax revenue, but it does call into question the policy principles of equity and neutrality. Either the benefit principle, as envisaged by the source basis of taxation, still applies with the ability-to-pay principle applying to income whose source is located outside South Africa or the ability-to-pay principle applies to all income received by South African residents, irrespective of the location of the source of the income.

The inclusion of the deeming source provisions and not taking into account the source rules of the host country, means that the ability-to-pay principle is undermined. South African resident taxpayers, where the source rules of the host

---

<sup>568</sup> Ibid.

country differ, may not be able to get the tax credit relief to ensure that they are in the same position as South African taxpayers. For example, consider the case of *Commissioner for Inland Revenue v First National Bank*.<sup>569</sup> The issue under dispute in *First National Bank* was the location of the source of interest income. The court upheld the Commissioner's argument that the source of interest income was located in South Africa and not in the United States of America on the basis that all the activities which gave rise to the supply of the credit took place in South Africa.<sup>570</sup> Using this case as a basis of illustration, if tax were imposed on that interest income in both the United States of America and South Africa, under the residence basis of taxation, First National Bank would not be able to successfully obtain a tax credit for the tax paid in the United States of America simply because the source of that income would be located in South Africa and the *s 6quat* requirements would not have been met.

Because of the different meanings ascribed to source, the use of source as a limitation to the *s 6quat* credit may undermine capital export neutrality; in order for capital export neutrality to be achieved, all that is required is that the taxpayer pays the same amount of tax in his country of residence, irrespective of where the business or investment takes place. The addition of source as a requirement undermines this neutrality as neutrality depends on whether the host country, which levies tax, is doing it on the basis of the South African source rules, and not whether the taxpayer pays tax in that host country.

---

<sup>569</sup> *First National Bank* (note 152).

<sup>570</sup> *First National Bank* (note 152) at para 20.

According to the South African Revenue authorities,

[c]ountries are only prepared to surrender primary jurisdiction if the underlying activity (i.e. source) arises outside its border. South Africa is no different in this regard.<sup>571</sup>

Although correct, this statement presupposes that source is a uniform concept and that it is interpreted as being linked to the activity and not deemed or artificial source.

*Translation of non-South African sourced income into South African tax concepts*

A further factor which affects equity and neutrality between inward and outward trade and investment by South African residents is the requirement that the income arising from a source located outside South Africa be translated into South African tax concepts. This means that the tax rules of the host country are not considered when dealing with international double taxation. The translation seems to confirm an indirect deeming of income, which has its source located outside South Africa, as income which has its source located in South Africa. At one level it means that South African residents are all taxed in the same way, based on income in terms of South African law, and that the tax credit would only be given if tax were imposed on the same income both in South Africa and in the host country. The concern is that this approach does not recognise the differences in the tax structures of the host country and undermines the comparator of who is being taxed: namely, is it a comparison between income which has its source located in South Africa and income which does

---

<sup>571</sup> South African National Treasury, Explanatory Memorandum accompanying the Revenue Laws Amendment Act No.35 of 2007, 'Explanatory Memorandum on the Revenue Laws Amendment Bill', 2007 at 57. Available at <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=58738>, last accessed 29 November 2012.

not have its source located in South Africa or, is it a comparison between South Africa residents, irrespective of the location of the source of the income?

The formula provided for the calculation of the tax credit and the use of the source limitation means that in order to determine whether a South African resident taxpayer obtains relief from international double tax, income which has its source located outside South Africa has to be viewed and treated according to South African tax law principles. However, in the calculation of the credit, income which has its source located in South Africa must be separated from income which has its source located outside South Africa.

With respect to expenses, the 2009 South African Revenue Service Interpretation Note<sup>572</sup> states that general expenses incurred which are not directly attributable to income derived either domestically or abroad, for example head office expenses, must be apportioned between taxable income derived from –

- a source within South Africa or deemed to be within South Africa,
- and
- a foreign source (that is, a non-South African source),

based on any method which gives a fair and reasonable apportionment appropriate to the circumstances of the particular case.<sup>573</sup> There is no case law or authority to support this method. Therefore, reliance can only be placed on case law

---

<sup>572</sup> South African Revenue Service Interpretation Note No. 18 (note 361) at 23.

<sup>573</sup> Ibid.

where ‘apportionment’ has been allowed.<sup>574</sup> In addition, the provision of the Income Tax Act dealing with deductions, as interpreted by the South African courts, provides that an expense will be allowed as a deduction if, *inter alia*, it is incurred in the ‘production of income’ and ‘for the purposes of trade’. This means that once a distinction has been made between income which has its source located within South Africa and income with its source located outside South Africa, the applicable case law in respect of ‘incurred in the production of income’ and ‘for the purposes of trade’ will have to apply. This means that certain of the foreign expenses allowed under the foreign law might be disallowed where these requirements are not met. The South African Revenue Service’s motivation for the apportionment approach is concern that the tax credit can be inflated.<sup>575</sup> The possibility of an inflated value of the credit can only be due to the manner in which the limitation is calculated. In any event, this concern should be dealt with under the specific anti-avoidance rules such as transfer pricing. In order to ensure equity and capital export neutrality of South African residents’ local and foreign sourced income, there should not be a distinction between the treatment and apportionment of expenses incurred in or outside of South Africa and, yet, the South African Revenue Service Practice Note appears to be doing this.

One of the problems of applying the South African tax rules to income with its source located outside South Africa is that even if tax rates in South Africa and the host country are the same, the application of the credit and exemption methods of

---

<sup>574</sup> For example, *Tuck v CIR* 1988 (3) SA 819 (A), 50 SATC 98.

<sup>575</sup> The South African Revenue Service Interpretation Note No. 18 (note 361) at 23 states that the failure to allocate expenses to foreign activities could result in an inflated foreign tax credit.

relief may not give the same result, as would normally be the case when comparing the credit and exemption methods of relief. The amount of relief would differ because certain expenditure might not be recognised or might be over-recognised and the tax credit allowed might be distorted. Consequently, the tax credit is not a true credit for foreign taxes paid on foreign earned income. Therefore, the change of the default method of relief from exemption to credit has the potential to impact drastically on the competitiveness of South African residents abroad, irrespective of the tax rate of the country of source.<sup>576</sup>

#### *Comparable foreign tax*

A further example of the translation of non-South African sourced income into South African tax concepts is the requirement that, in order to determine whether or not a foreign tax qualifies as a tax on income, the basic scheme of application of the foreign tax must be compared with that of the Act.<sup>577</sup> The South African Revenue Service note states that foreign tax will be accepted as a tax on income only if the basis of taxation is substantially similar, despite s 6quat not making a reference to such a requirement.<sup>578</sup>

As authority for this proposition, the note refers to the United States of America case of *Mary D Biddle v Commissioner*<sup>579</sup> where it was held that in order for taxes paid to a host government to qualify as income tax, it must be shown that

---

<sup>576</sup> This statement is made without regard to the introduction of s 6quat(1)(C) deduction as this deduction method of relief was only introduced into the Income Tax Act in 2007 by the Revenue Laws Amendment Act No. 35 of 2007.

<sup>577</sup> South African Revenue Service Interpretation Note No. 18 (note 361) at 13.

<sup>578</sup> Ibid.

<sup>579</sup> (1938) 302 US 573.

the tax imposed by the host country fits the United States' concept of a tax on income. Similarly, in a South African context, the Practice Note continues, the foreign tax liability must be a tax on income within the South African concept of 'income' and the mere fact that it is regarded as a tax on income by the country levying the tax is not sufficient.<sup>580</sup> The precise nature of the foreign tax or duty must be determined. It is submitted that this is not a separate requirement and the reference to the United States case is not relevant for two reasons. The first is that the foreign tax must be paid on 'income' as defined within the Income Tax Act.<sup>581</sup> This means that income which has its source located outside South Africa must be included in 'gross income' and only then will the tax credit be available. It is therefore not necessary to determine the precise nature of the foreign tax or duty but merely to ensure that it is a tax on 'an amount' that forms part of 'gross income' in South Africa.<sup>582</sup> Secondly, the *Mary Biddle* case, in any event, deals with the different treatment of dividend income – being dependent on whether a country uses the classical or imputations system to tax corporate entities.

The United Kingdom case of *Yates v GCA International Ltd*<sup>583</sup> is a further example of the requirement that the foreign tax must correspond to the country of residence tax. The case also considered the issue of where the income in question arose.<sup>584</sup> This case is also distinguishable from *s 6quat* as the United Kingdom

---

<sup>580</sup> South African Revenue Service Interpretation Note No. 18 (note 361) at 13–14.

<sup>581</sup> Section 1 of the Income Tax Act defines 'income' as 'the amount remaining of the gross income of any person for any year or period of assessment after deducting thereof any amounts exempt from normal tax under Part I of Chapter II'.

<sup>582</sup> See the definition of 'gross income' in s 1 of the Income Tax Act.

<sup>583</sup> [1991] STC 157 ChD. Munro (note 268) at 38

<sup>584</sup> Cussons and Collier in John Dixon, and Malcolm Finney (eds) (note 273) at 17–3; Munro (note 268) at 34.

legislation at the time required the foreign tax to be charged on income or chargeable gains and correspond to United Kingdom corporation tax.<sup>585</sup>

*Foreign tax must be proved to be payable and not be recoverable*

Section 6quat provides that the tax credit is only available if the foreign tax is proved to be payable and is not recoverable. It ensures that a South African resident taxpayer does not have the benefit of a tax credit unless tax is actually paid in the host country. This means that s 6quat does not provide relief for economic double taxation unless specifically provided for, and does not provide tax sparing relief. The non-recognition of tax sparing is appropriate given South Africa's status as a developing and capital importing country.

*The limitation of the tax credit*

No version of s 6quat has ever provided for a full tax credit. The 1997 version limited the credit to the lesser of the actual foreign taxes payable and the normal tax attributable to the inclusion of the foreign income. Unused tax credits were allowed to be deducted from Secondary Tax on Companies.<sup>586</sup> Although this meant that,

---

<sup>585</sup> Munro (note 268) at 37–38.

<sup>586</sup> The s 6quat (1) proviso at the time stated that:

(a) the rebate under this subsection shall not exceed an amount which bears to the total normal tax payable the same ratio as the taxable income attributable to the income so included bears to the total taxable income<sup>7</sup>.

(b) where such sum of any taxes payable to the government of any such other country exceeds the rebate as determined in paragraph (a) of this proviso (hereinafter referred to as the excess amount), such excess amount (excluding so much of the excess amount relating to foreign tax paid or payable by any controlled foreign entity which distributes its profits in the form of dividends) may be deducted from any Secondary Tax on Companies which becomes payable after the determination of such excess amount, limited to an amount determined by applying the rate of the Secondary Tax on Companies to the profits attributable to the inclusion of the income contemplated in paragraph (a) of this subsection after the deduction of

(i) any normal tax paid or payable or;

(ii) such sum of taxes payable to the government of any such other country, whichever amount of the greater.

unlike the previous version of s 6quat, there was some relief for this excess tax, even if this relief was limited to companies who declared dividends and had to pay the Secondary Tax on Companies. The South African Revenue Service 2009 Practice Note No. 18 states that the purpose of the tax credit limitation is, *inter alia*, not to relieve all foreign taxation which could result in South Africa subsidising the tax base of the host country. However, its purpose is rather to ensure that in providing relief to South African residents from double taxation, South Africa's tax base is protected.<sup>587</sup> Subsidisation of the host country would result when the South African tax paid is less than the tax paid in the host country or when there is a difference between source as determined according to South African law and source as determined or defined in the host country. The limited tax credit can therefore be said to have a dual purpose – to relieve international double taxation and ensure that South African residents are not completely at a disadvantage internationally as well as to protect the South African tax base. The latter purpose arises as a result of expanding the tax base to residence and having to provide relief in the event of international double taxation. The limited tax credit provided by s 6quat does potentially undermine capital export neutrality where South Africa's tax rates are lower than its trading counterparts, which is to some extent alleviated by the ability to carry excess credits forward for seven successive tax years.<sup>588</sup> This means that to ensure capital export neutrality and not to disadvantage its residents, South Africa, as a capital importing country, has to consider the tax rates of its trading partners in setting its own tax rates. The room to increase its tax rates is therefore limited by the

---

<sup>587</sup> The South African Revenue Service 2009 Interpretation Note No. 18 (note 361) at 22.

<sup>588</sup> Section 6quat (1B).

tax rates of its trading partners, if South Africa wants to maintain capital export neutrality and at the same time ensure that its residents are not disadvantaged by the limited credit system.

The limitation of the tax credit is mitigated by the ability to carry forward the excess tax credit for seven years and use it against foreign taxes paid for those seven years.<sup>589</sup> The ability to carry forward the excess foreign tax means that the South African taxpayer may, in the first year of the obtaining the tax credit, suffer from international double taxation if it has an excess and, potentially, obtain relief if it can use the excess in the following tax years. It does undermine capital export neutrality, as the limited tax credit may affect a taxpayer's decision to invest or trade offshore and a South African resident taxpayer will not be neutral between investing in South Africa or offshore. It also undermines ability-to-pay as there is no longer equity between South African resident taxpayers investing or doing business in South Africa or offshore.

*Quantification of the limited s 6quat credit*

According to South African Revenue Service Interpretation Note 18, the s 6quat limitation translates into the following mathematical formula:

taxable income derived from all foreign sources (A)/ taxable income derived from all sources (B) x normal tax payable on (B).<sup>590</sup>

---

<sup>589</sup> The period was increased from three years to seven years when the residence system was introduced. See Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (note 307) at 11.

<sup>590</sup> The South African Revenue Interpretation Note 18 (note 361) at 22.

On a strict reading and application of the provisions of the Income Tax Act, the above formula should actually be phrased as follows:

taxable income derived from non-South Africa sources (A)/ taxable income derived from South Africa and non-South Africa sources (B) x normal tax payable on (B).<sup>591</sup>

Once more, source, as determined in terms of South African law, plays a role in the determination of the tax credit. The limitation takes into account foreign taxes paid, but only those taxes paid on income where the source of the income, as determined according to South African law, is not located in South Africa. The result is the non-recognition of foreign taxes where the country imposes tax on the basis of source, according to its own laws.

This use of source in the determination of whether a credit is available and, in the calculation of the actual credit, whether it can be seen as undermining capital export neutrality, also indicates a way of overcoming the tax base problem faced by capital importing countries when moving from a source basis of taxation to a residence basis of taxation. The methodology used by South Africa ensures that it maintains its source basis of taxation and adds another dimension to broaden tax bases. By changing to the residence basis of taxation, South Africa has not given up any of its tax base but has merely extended it. It has combined the basis on which tax is levied for residents, as defined, with the benefit principle still soundly in place and

---

<sup>591</sup> The *squat* limitation provision states that ‘the rebate under this subsection shall not exceed an amount which bears to the total normal tax payable the same ratio as the taxable income attributable to the income so included bears to the total taxable income’.

the ability-to-pay principle extended to income which has its source located outside South Africa. In not choosing a specific approach to equity, South Africa has a hybrid system of equity. Although probably correct from a developing country perspective, a concern is whether it is appropriate to have different forms of equity for South African residents being dependent on whether their investment is local or outward. If the policy is to encourage local investment by South African residents, with the extra tax being seen as the cost for investing offshore and as a penalty for removing capital from South Africa, then the different forms of equity may be justifiable.

A further problem with the quantification of the credit is the translation of the income from non-South African sources into South African rands and the translation of the foreign tax paid into South African rands. The translation is dependent on, *inter alia*, the applicable exchange rate which in turn is dependent on when and how the translation must take place. This depends on the exchange rate and the amounts involved may differ. Thus, not only do the tax rates of the country into which a South African resident invests and trades play a role in the equity and neutrality aspects of the tax structure but the exchange rates and the volatility of the exchange rates of the foreign country in relation to the South African rands also play a role. The method by which the translation is done has been amended a number of times since 2001, indicating a lack of policy in this regard.<sup>592</sup>

---

<sup>592</sup> See changes to s9D, s24I, s25D, s9Gs 9D, s 24I, s 25D, s 9G, para 43(1)–(4) of the 8th Schedule.

What about neutrality? From the perspective of a South African resident, capital export neutrality would be the applicable neutrality principle but whether this conforms to capital export neutrality as initially described by Musgrave is debatable, given the definition of residence that is applied.

#### **4.4.6 The deduction method of relief**

##### *Trade requirement in the deduction method*

Prior to 2007, where income was subject to tax both in South Africa and a host country but the South African source rules located the source of the income as being in South Africa, the only possible relief for such double taxation was in the general deduction formula. (Section 11(a) read with s 23(g).) Given the uncertainty surrounding the applicability of the general deductions formula, s 6quat was amended to introduce a specific deduction for foreign taxes paid on income which had its source located in South Africa.<sup>593</sup>

The specific deduction was introduced because according to the South African Revenue authorities:

[i]t has come to Government's attention that a number of countries are incorrectly claiming source jurisdiction in respect of services occurring within South Africa and accordingly claim that withholding tax is required. While South Africa is not prepared to give section 6quat rebates for South African source activities, South Africa is prepared to treat these foreign taxes as a deductible expense incurred in the production of income. This approach is not out of line with international practice. In particular, foreign taxes proved to be payable will be deductible. However, this deduction cannot exceed the underlying income giving rise to the foreign tax.<sup>594</sup>

---

<sup>593</sup> Amended by the Revenue Laws Amendment Act No. 35 of 2007.

<sup>594</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill 2007 (note 571) at 57.

One of the limitations to the availability of the deduction is the requirement that the income must arise from trading.<sup>595</sup> In other words, the deduction only applies to active and not passive income. Another limitation is the amount of the deduction allowed.<sup>596</sup>

The use of the deduction as a method of relief which treats the foreign taxes paid as an expense, as opposed to allowing the foreign tax to be deducted from the tax paid in South Africa, does not assist neutrality or equity. The difference between a rebate and a deduction is that while the deduction method treats the foreign taxes as an expense in computing the resident's taxable income in its resident country,<sup>597</sup> the rebate method of relief deducts the foreign taxes paid by the resident from the actual tax payable by the resident in its country of residence.<sup>598</sup> While the tax credit or rebate allows the foreign tax to be offset against the South African tax payable, the deduction method of relief allows the foreign tax to be deducted from 'income' where 'income' is defined as 'gross income less exemptions.'<sup>599</sup> In fact it introduces another version of neutrality – National Neutrality – in that the foreign tax is seen as an expense with all taxpayers within South Africa who earn the same income, having the same end result. The distinction between income which is not sourced outside South Africa and which is, as a result of trade, means that the policy approaches for

---

<sup>595</sup> Section 6quat(1C) of the Income Tax Act provides that where resident taxpayer carries on a trade, the resident taxpayer can deduct from his income, the sum of taxes on income proved to be payable by that resident to a host government, without any right of recovery by any person other than a right of recovery to carry back losses. Subsection (1D) limits the above deduction so that it does not exceed the total taxable income (prior to the deduction) attributable to income which is subject to tax.

<sup>596</sup> Section 6quat(1C)

<sup>597</sup> See Olivier et al 2011 (note 14) at 840.

<sup>598</sup> See Olivier et al 2011 (note 14) at 848.

<sup>599</sup> Definition of 'income' in s 1 of the Income Tax Act.

these types of income differ. The result is that different equity and neutrality principles apply for these types of foreign income and taxes.

As indicated by the specific limitations of the applicability of the deduction method, the s 6quat deduction has a limited application. Its application is limited by, *inter alia*, the following provisions:

- There is no choice between the deduction and the credit methods of relief. The deduction method can only be used if the credit method, both in terms of s 6quat and any relevant double taxation agreement, cannot be applied.
- Foreign taxes are only deductible against taxable income derived from the carrying on of any trade; that is, a deduction is not allowed against passive income.
- There is no carry forward of any excess amounts where the full amount of the foreign taxes paid is not deductible in terms of the limitation.

*Foreign tax credit, deduction and effect on equity and neutrality*

The manner in which the s 6quat tax credit and deduction is applied and calculated appears to undermine both equity and neutrality. South African residents investing offshore are treated differently depending on whether the tax credit and deduction requirements are met. The consequent relief or non-relief would affect ability-to-pay equity and neutrality between South African residents. The concern emphasised is one of tax avoidance and increasing the tax base. If relief is to be provided, then it should be done in a manner which is equitable and neutral. If not, then double non-

taxation will arise which is against the policy of encouraging outward investment by South African residents.

#### ***4.4.7 Transfer pricing***

The introduction of transfer pricing and thin capitalisation rules in s 31 of the Income Tax Act also meant that international double taxation, both juridical and economic, could result when these rules were applied.

Juridical double taxation arises, for example in this context, when, as a result of the application of transfer pricing provisions in a cross border transaction between a taxpayer and its foreign branch (or permanent establishment), a taxpayer's income is increased in one country and the other contracting state does not recognise the increase as a deduction for computing the branch's tax liability.<sup>600</sup> Economic double taxation arises where transactions take place between connected or related companies that are tax resident in different countries and as a result of the application of transfer pricing rules, an adjustment is made.<sup>601</sup> This adjustment increases the income of one of the companies and the increased payment is not recognised as a deduction for the paying company with the result that the paying company and the recipient company

---

<sup>600</sup> For example, consider a taxpayer resident in Country Y with a branch of permanent establishment in country X. Assume that the taxpayer provides services to the branch. If country Y makes an adjustment and increases the amount to what it considers it to be an arms-length amount, tax will be imposed on a larger sum in Country Y. If country X does not recognise that adjustment and does not allow the branch to adjust the amount deducted, tax will be imposed on the adjusted amount in both country Y and country X on the same taxpayer. See OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2001 Paris: France at p IV-1 para 4.2.

<sup>601</sup> Olivier et al 2011 (note 14) at 442.

both pay tax on the same income.<sup>602</sup> The adjustments made under the transfer pricing and thin capitalisation provisions found in s 31 of the Income Tax Act result in economic double taxation<sup>603</sup> as it deals with ‘any transactions, operation, scheme, agreement or understanding’ between two different taxpayers.<sup>604</sup>

If the South African taxpayer’s income is adjusted as a result of the application of the s 31 transfer pricing provisions, then, it is submitted, relief for the foreign taxes imposed on such adjusted income is provided in s 6*quat*.

#### **4.5 Outward South African resident trade and investment: host country trade and investment**

From the introduction of residence, until the exemption for certain host country trade and investment, the South African outward policy exhibited different policy objectives with respect to neutrality and equity, dependent on, *inter alia*, category of income and whether the income fell into a designated exempt category. The

---

<sup>602</sup> IBFD Glossary (note 19) provides the following statement with respect to economic double taxation in the definition of ‘Double taxation’: ‘... most commonly encountered in an international context, relates to transfer pricing where one jurisdiction makes an upward adjustment to the profits of a resident taxpayer in respect of a transaction with a related party resident in another jurisdiction without a corresponding adjustment (downwards) to the latter’s profits by the second jurisdiction.; Robert Couzin ‘Relief of Double Taxation’ (2002) 56 (6) *Bulletin for International Taxation* 266 at 266–268; OECD Transfer Pricing Guidelines (note 600) at pIV–1 para 4–2.

<sup>603</sup> Olivier et al 2011 (note 14) at 442.

<sup>604</sup> Section 31(1) of the Income Tax Act refers to an ‘affected transaction’ as ‘any transaction, operation, scheme, agreement or understanding where—  
(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—  
(i) (aa) a person that is a resident; and  
(bb) any other person that is not a resident;  
(ii) (aa) a person that is not a resident; and  
(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;  
(iii) (aa) a person that is a resident; and  
(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or  
(iv) (aa) a person that is not a resident; and  
(bb) any other person that is a controlled foreign company in relation to any resident, and those persons are connected persons in relation to one another;...’

introduction of the limited tax credit<sup>605</sup> in the form of *s 6quat*, as a method to relieve international double taxation, meant that neutrality in the form of capital import neutrality did not apply to South African residents investing or doing business in a host country. A limited credit has to be compared to a full tax credit. A full tax credit would be provided in the country of residence for the full amount of foreign tax paid in the host country whereas a limited tax credit is limited to the amount of tax that would have been paid in the country of country of residence. Thus where the foreign tax paid on income in the host country is greater than the tax that would have been paid in the country of residence on that same income, the full tax credit would allow for the full amount of the foreign tax to be credited against the tax paid in the country of residence. By contrast, the limited tax credit would limit the foreign tax to be credited up to the amount of tax that would have been paid on that income in the country of residence.

The limited tax credit also meant that South African residents' competitiveness in the host country, where the South African tax rates were higher than the tax rates of the host country, was affected. In addition to affecting the competitiveness of South African foreign businesses, this also gave rise to tax planning opportunities, especially when comparing foreign non-resident companies controlled by South African residents and foreign branches of South African resident companies.

---

<sup>605</sup> See discussion in para 1.1.2 of Chapter One of this thesis. See OECD MTC 2010 (note 19) at 309; Olivier et al 2011 (note 14) at 452–453.

#### ***4.5.1 Controlled foreign companies and branches***

Where a foreign subsidiary of a South African parent is also a controlled foreign company, and it meets the requirements of having a foreign business establishment in the host country, such income of the foreign subsidiary, even if it is attributed to the South African parent in terms of the controlled foreign company rules, is exempt from tax in South Africa in the hands of the South African parent shareholder. In other words, controlled foreign companies are still competitive where they meet the requirements for exemption under s 9D.<sup>606</sup> Consequently, foreign direct investment by South African residents should take the form of a controlled foreign company. Where the return to the South African parent company is in the form of dividend income, such foreign sourced dividend income is likely to be exempt from tax as the result of the application of the participation exemption.<sup>607</sup> Interest and royalty income paid to the South African resident parent form part of that South African resident's income where such income is not attributed to the South African resident parent under the controlled foreign company rules.

By comparison, a foreign branch is not necessarily as competitive. The foreign sourced business profits would be included in the tax base of the South

---

<sup>606</sup> Section 9D(9) provides for the exemption of certain forms or categories attributed to the participant in the controlled foreign companies.

<sup>607</sup> Section 10B(2) inserted by the Taxation Laws Amendment Act No. 7 of 2011. Prior to this amendment, s 10(1)(k)(ii)(dd) provided for the participation exemption as follows: 'if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 20 per cent of the total equity shares and voting rights in the company declaring the dividend, or 20 per cent of the total member's interest and voting rights in the co-operative declaring the dividend, which co-operative is established in terms of the laws of any country other than the Republic: Provided that this exemption must not apply in respect of any dividend received by or accrued to any person.....?'

African resident company, as would any interest and royalty income.<sup>608</sup> Any double taxation would be relieved through the application of the tax credit or deduction in accordance with the application of s 6quat relief and full relief for foreign tax paid may not always be available. In addition, losses suffered by the branch could not be offset against the South African sourced profits.<sup>609</sup> Except for the treatment of losses, foreign branches are treated the same as South African branches.

It is difficult to find a rationale for the differential treatment of foreign branches of South African residents and foreign subsidiaries of South African residents.

Economic double taxation arises when South African tax is levied both on the South African resident participant and on the foreign company in terms of the s 9D controlled foreign company rules.<sup>610</sup>

#### **4.6 Inward non-resident trade and investment: local South African resident trade and investment**

The source basis of taxation has remained the jurisdictional link for non-residents during the millennium period. The only difference has been the introduction of a headquarter company regime for non-residents, initially introduced in 2001 and

---

<sup>608</sup> The income of a branch is not separate from the South African resident company's income. In the case of a branch, the s 6quat credit of deduction will apply.

<sup>609</sup> The proviso to s 20(1)(a) provides that there cannot be set off against any amount a loss made from the trade carried on outside of South Africa.

<sup>610</sup> Olivier et al 2011 (note 14) at 442.

repealed in 2003.<sup>611</sup> Another attempt to introduce this type of incentive for non-residents was made in 2010.<sup>612</sup>

#### ***4.6.1 Headquarter company regime***

When first introduced in 2000, along with the residence basis of taxation, this particular type of company, although incorporated in South Africa, was excluded from the definition of resident.<sup>613</sup> This meant that South African income tax was not imposed on its worldwide income but only on income which had its source located in South Africa. It further meant that the controlled foreign company rules,<sup>614</sup> the foreign source dividend provisions,<sup>615</sup> the thin capitalisation and transfer pricing rules did not apply to such a company.<sup>616</sup> A company incorporated in South Africa would have qualified as an ‘international headquarter company’ if, first, all of its shareholders were non-residents and were not trusts; second, the indirect interests of South African residents or trusts were not greater than 5 per cent of the total shares or equity capital of the company; and third, 90 per cent of the value of the assets of the company was shares in and loans to subsidiaries of such company which were not residents and in which the company held a beneficial interest of at least 50 per cent.<sup>617</sup>

---

<sup>611</sup> Definition of ‘international headquarter company’ inserted in s 1 of the Income Tax Act as inserted by the Revenue Laws Amendment Act No.59 of 2000 and deleted by the Revenue Laws Amendment Act No. 45 of 2003.

<sup>612</sup> By the Taxation Laws Amendment Act No. 7 of 2010.

<sup>613</sup> The definition of ‘residence’ in s 1 of the Income Tax Act as inserted by the Revenue Laws Amendment Act No.59 of 2000.

<sup>614</sup> Section 9D of the Income Tax Act.

<sup>615</sup> Section 9E of the Income Tax Act.

<sup>616</sup> Section 31 of the Income Tax Act.

<sup>617</sup> The Definition of “international headquarter company” in s 1 of the Income Tax Act defined an ‘international headquarter company’ meaning ‘a company—

The non-application of the controlled foreign company and foreign dividend provisions meant that the income of wholly-owned foreign subsidiaries of the company would not be attributed to the company as shareholder and that dividends received from its foreign subsidiaries or foreign sourced income would not be taxed in South Africa. It would also not be subject to Secondary Tax on Companies. It is self-evident that such a company would be treated differently from a South African resident company and would be subject to a lesser tax burden. From the composition of the company's assets, such a company was likely to be a conduit holding company, not involved in active business in South Africa with 90 per cent of its income coming from foreign sourced dividends and foreign sourced interest income. The role and purpose of such a company would therefore be one of using South Africa as a base. In order for it to be used, such a company would have to be more attractive than using a branch established in South Africa. A branch of a non-resident would also only be taxed on its South African sourced income; the controlled foreign company and foreign dividends provision would not apply to it. However, unlike the branch, the incorporation of the company in terms of South African law also meant that, although the company was a non-resident for South African tax purposes, the company could be viewed as a resident in other countries, particularly where the jurisdiction of the parent company used 'incorporation' as its test for residency. The use of 'incorporation' to remove itself from the residence of another jurisdiction, and

- 
- (a) the entire equity share capital of which is held by persons who are not residents or trusts;  
(b) where any indirect interest of residents and of any trust in such equity share capital does not exceed five per cent in aggregate of the total equity share capital of such company; and  
(c) where 90 per cent of the value of the assets of such company represents interests in the equity share capital and loan capital of subsidiaries (which are not residents) of such company in which such company holds a beneficial interest of at least 50 percent.

not being a South African resident, meant that such company would not be able to use double taxation agreements or the *s 6quat* limited credit relief in the Income Tax Act in the event of international double taxation.

The provisions of the Income Tax Act that established the headquarter company regime were repealed in 2003.<sup>618</sup> The reason for the abolition of this type of company as set out in the Explanatory Memorandum to the Bill which proposed the abolition was two-fold.<sup>619</sup> It was stated that this company structure could be viewed as a ‘Harmful Preferential Tax Regime’<sup>620</sup> and ‘international pressure requires that regimes of this kind be eliminated’.<sup>621</sup> Second, the ‘regime was also ineffective’ because ‘in terms of Exchange Control Regulations, the South African Reserve Bank restricted the currency flow of 90 per cent foreign owned South African subsidiaries’.<sup>622</sup> In addition, ‘the IHC (the International Headquarter Company) was a non-resident for tax purposes and could not qualify for the benefits of certain Double Taxation Agreements entered into by South Africa with other countries’.<sup>623</sup>

The repeal of the international headquarter company within three years of its introduction, indicates that its introduction was perhaps not fully analysed, in relation to its interaction with the provisions of the double taxation agreements and its non-resident status. The relevant comparison was not done.

---

<sup>618</sup> By the Revenue Laws Amendment Act No. 45 of 2003.

<sup>619</sup> Explanatory Memorandum on the Revenue laws Amendment Bill, 2003 (note 473) at 38.

<sup>620</sup> *Ibid.*

<sup>621</sup> *Ibid.*

<sup>622</sup> *Ibid.*

<sup>623</sup> *Ibid.* See also Olivier et al 2011 (note 14) at 31.

Despite its removal in 2003 for the reasons given, the international headquarter company regime resurfaced in 2010 as the ‘gateway’ into Africa.<sup>624</sup> These proposals, introduced in the 2010 amending legislation and effective from 2011, sought to place South Africa as the conduit country for investment and trade into Africa.<sup>625</sup> Once again, the introduction of this type of company creates a different treatment of this type of company relative to other South African companies and also of non-residents generally.

Given the problems with the first attempt, how is this regime the same or different? It is the same in that the controlled foreign company rules, the foreign sourced dividend rules, the transfer pricing and thin capitalisation rules do not apply to this type of company. It is different in that the headquarter company is a ‘resident’ for tax purposes<sup>626</sup> and the application of the exchange control provisions to such companies have been relaxed.<sup>627</sup> There is a difference in the requirements needed to qualify as a headquarter company.<sup>628</sup>

Unlike the previous regime where the headquarter company was deemed to be a non-resident for all purposes, the 2010 regime only treats a qualifying holding

---

<sup>624</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (note 390) at 77.

<sup>625</sup> Ibid where it is stated that ‘South Africa is the economic powerhouse of Africa. South Africa’s location, sizable economy, political stability and overall strength in financial services make South Africa an ideal location for the establishment of regional holding companies by foreign multinationals. Furthermore, South Africa’s network of tax treaties provides ready access to other countries in the region. South Africa is therefore a natural holding company gateway into the region’.

<sup>626</sup> Section 9I of the Income Tax Act.

<sup>627</sup> South African Reserve Bank Exchange Control Manual, Section F. Available at <http://www.resbank.co.za/RegulationAndSupervision/FinancialSurveillanceAndExchangeControl/EXCMAN/Section%20O/Section%20O.pdf>, last accessed 29 November 2012. See also Oliver et al 2011 (note 14) at 709.

<sup>628</sup> The definition of “headquarter company” as inserted by the Taxation Laws Amendment Act No. 7 of 2010. The definition and requirements were amended by the introduction of s 9I by the Taxation Laws Amendment Act No. 24 of 2011.

company as a non-resident in certain circumstances. These include being treated as a non-resident for controlled foreign company purposes<sup>629</sup> and when paying dividends to qualifying holding company shareholders.<sup>630</sup>

The effect of the headquarter company regime is a differential treatment of non-residents on the one hand and residents, on the other. This differential will clearly impact on equity and neutrality, irrespective of which comparators are used. The result will be that South Africa will be guilty of engaging in 'harmful tax practices' as described by the OECD<sup>631</sup> and recognised by the Memorandum which repealed the earlier version of the headquarter company regime. The use of this headquarter company regime also clearly differentiates between those who are classified as residents and those classified as non-residents.

The use of a special regime to deal with headquarter companies raises the question of whether such a special regime is in fact necessary and whether or not South African residents should also not have this type or version of this regime applied to them. For example, if all the business profits were exempt, then South Africa could potentially be seen as an international headquarter company for all companies and not only for companies who qualify as headquarter companies. The application to all residents and non-residents would also deal with the concern of a harmful tax practice in that ring fencing is not a concern. However, it may mean that domestic investment suffers as it has been said that the exemption method creates

---

<sup>629</sup> Section 9D(2) as amended by the Taxation Laws Amendment Act No. 7 of 2010.

<sup>630</sup> Section 10B inserted by the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 March 2012.

<sup>631</sup> OECD Report *Harmful Tax Competition, an Emerging Global Issue* (1998) OECD Publications: Paris at 25-28.

incentives for investment abroad in low tax jurisdictions.<sup>632</sup> On the other hand, it creates the opportunity for being established as a headquarter company regime for residents and non-residents.

#### **4.6.2 Business income**

Where a non-resident did not fulfil the requirements of the international headquarter company regime, there was no difference in the basis of taxation of non-residents from the period prior to democracy, to the transition period and to the millennium period. Tax is still imposed on non-residents where the source of their income is located in South Africa, according to the South African tax rules. It therefore makes no difference to the taxation of business income from the South African perspective whether the non-residents' form of inward investment is in the form of a branch or a subsidiary – tax will be imposed on the business income of the non-resident, albeit on the basis of source for the branch and residence for the South African incorporated subsidiary.<sup>633</sup>

#### **4.6.3 Dividend income**

Subject to the provisions and application of a double taxation agreements, where a non-resident operates in South Africa through a subsidiary, the profits of the subsidiary are taxed in South Africa and the dividend income distributed by it are exempt from income tax in the hands of the recipient on the basis of s 10(1)(k) with economic double taxation being relieved. Such subsidiary would be taxed on the

---

<sup>632</sup> Becker and Fuest, 'Taxing Foreign Profits with International Mergers and Acquisitions' (2007) Working Paper 07/19 Oxford University Centre for Business Taxation at 2. Available at [http://www.sbs.ox.ac.uk/centres/tax/Documents/working\\_papers/WP0719.pdf](http://www.sbs.ox.ac.uk/centres/tax/Documents/working_papers/WP0719.pdf) last accessed 12 December 2007.

<sup>633</sup> This statement is made on the assumption that a branch is a 'permanent establishment' in terms of the relevant applicable double taxation agreement.

same basis as a South African company, including the imposition of the withholding tax on dividend income distributed to the shareholders, referred to as the 'beneficial owner' in s 64D of the Income Tax Act. The only difference would be the possible application of the controlled foreign company rules of the parent company's country of residence and the parent company being taxed on the dividend income in its country of residence. The application of the dividends article in the relevant double taxation agreement may determine the extent of the taxing rights of the parent company insofar as the parent company is the beneficial owner of the dividend income distributed by the South African subsidiary.<sup>634</sup> South Africa does not provide relief for such double taxation and any relief for economic double taxation would have to be provided by the parent country of residence.

#### **4.6.4 Interest and royalty income**

If non-residents are to be encouraged to invest in South Africa through loan financing, that is, if one wants to encourage residents to borrow from abroad, then consideration has to be given to exempt the interest income received by or accrued to non-residents.<sup>635</sup> If a withholding tax on interest income is imposed, such withholding tax should differentiate between a return from portfolio and from direct investment. Currently, interest received by or accrued to non-residents is exempt from tax in South Africa, with the exception of non-resident companies who have a

---

<sup>634</sup> The dividends article of the DTA would determine the taxing rights of the distributing and recipient country. For example see Article 10 of the OECD MTC 2010 (note 19) and Article 10 of the UN MTC (note 157).

<sup>635</sup> See Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (note 390) at 69.

permanent establishment in South Africa or a non-resident natural person who is physically present in South Africa for a period of at least 183 days.<sup>636</sup>

The provision for exemption of interest income where it is received by or accrued to a non-resident from a source located in a country can also be found in the United States of America. From 1984, foreign residents who earned portfolio income from a source located in the United States have been exempt from withholding tax on interest income.<sup>637</sup> The erstwhile withholding tax was removed as it enabled both the ‘United States government and US multinationals to borrow abroad without having to bear the cost of any withholding tax, which was likely to shift to the borrower anyway’.<sup>638</sup> It is said that as a result of this exemption, ‘Latin American countries suffered [from] capital flight’.<sup>639</sup> Given that countries such as the USA provide an exemption for interest income paid to non-residents, South Africa had to follow suit if it wanted to attract foreign capital.

This exemption means that there is different treatment of South African residents and non-residents, which appears to undermine ability-to-pay equity. In addition, it means that interest income earned within South Africa is not tax neutral. It also affects the form of the investment into South Africa in that interest income received by a South African branch of a non-resident company would not be exempt.<sup>640</sup> Not granting an exemption to a branch or an individual who is physically

---

<sup>636</sup> In terms of s 10(1)(h) of the Income Tax Act.

<sup>637</sup> Avi Yonah (note 101) at 1579–1580.

<sup>638</sup> Avi-Yonah (note 101) at 1580.

<sup>639</sup> Ibid at 1631.

<sup>640</sup> The exemption only applies where the non-resident company does not have a ‘permanent establishment’ in South Africa which would include a branch of a non-resident company.

present in South Africa appears to be a remnant of the benefit principle of equity which is not carried through in the exemption to non-residents. The exemption should apply where interest income is derived from portfolio investment by a non-resident and not where the interest is derived from business activities of the non-resident. This non-neutrality and non-equity problem has been identified by the South African National Treasury, even if the language used to describe the problem is one of international comparison and tax avoidance. Therefore, it has been proposed that the interest exemption be narrowed to 'limit the exemption of cross border interest to highly mobile instruments or debt incidentally associated with cross border trade'.<sup>641</sup> The proposal is to be implemented with effect from 1 January 2013 in the form of a withholding tax on interest<sup>642</sup> in terms of which only certain types of interest payments will be exempt.<sup>643</sup>

#### **4.7 Summation**

The above analysis shows that the tax treatment of both residents and non-residents has undergone a number of changes. These changes are continuing and are an attempt to close tax loopholes and tax avoidance schemes, many of which developed as a result of the different tax treatment of taxpayers depending on the legal form of the trade and investment; whether they were classified as residents; and the category of income. The unilateral tax relief for those classified as South African residents changed over time as did the tax incentives offered to non-residents. Even relief offered for economic double taxation changed. Many of these changes and

---

<sup>641</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (note 390) at 70.

<sup>642</sup> Part 1A, s 37I–37N was inserted by the Taxation Laws Amendment Act No. 7 of 2010 with effect from 1 January 2013, and applicable in respect of any interest that accrues on or after that date.

<sup>643</sup> Section 37K.

amendments could have been avoided if, with the change to the residence basis of taxation, the equity and neutrality consequences of the change had been fully considered. It was the initial stance taken which equated residence-minus with source-plus which affected the non-consideration of these basic principles which should underlie a tax structure and which should be fully considered prior to changes in the tax structure. Although the change to the residence basis of taxation and the concomitant methods to relieve international double taxation clearly affected the current evolving status of the South African Income Tax provisions relating to cross border trade and income, the resultant effect on double taxation treaties entered into by South Africa also warrants attention.

## **5 Chapter Five**

### **South African treaty relief**

#### **5.1 Introduction**

Prior to the restructuring of the South African tax system, the South African government had entered into Double Taxation Agreements ('double taxation agreements') with other governments in order to allocate taxing rights between the two treaty countries in the event of conflicting rights. During the transition and millennium periods, the South African government expanded the number of double taxation agreements it entered into and furthermore renegotiated some of the double taxation agreements entered into prior to these periods. As the application of double taxation agreements depends on 'residency' and double taxation agreements provide international double taxation relief, the change in the domestic law to the basis on which tax is imposed and to the method of relieving international double taxation, is likely to affect double taxation agreements entered into prior to any amendments made to the domestic law. The amendments may not only affect the application of double taxation agreements but may also affect the interaction between the relief offered in domestic law and double taxation agreements.

This chapter analyses the effect that the change from the source basis of taxation to the residence basis of taxation and the corresponding changes made to the unilateral method of relief for international double taxation had on double taxation agreements, particularly with respect to the criteria of equity and neutrality. In particular, it analyses the interaction between the relief for international double taxation provided in the Income Tax Act and the relief provided in double taxation agreements entered into by South Africa. The latter aspect particularly considers whether the same policy approach is reflected in both the unilateral relieving

provisions of the Income Tax Act and in the relevant provisions of double taxation agreements entered into by the South African government.

## 5.2 Background

The method of relief used in a double taxation agreement for the concurrent taxation of the same income in the state of residence of the taxpayer and in the other contracting state should be indicative of a country's policy approach to the taxation of the cross border income of its residents, as in the case of the unilateral method of relief found in domestic tax legislation. The method of relief for international double taxation found in double taxation agreements and in the domestic tax legislation should therefore be consistent and reflect the same policy, even though a different approach may be justifiable if there are particular trade and investment considerations in the case of a particular country. Both the UN and OECD MTCs give recognition to the different policies with respect to equity and neutrality as provided in the method of relief for international double taxation by the country of residence.<sup>644</sup>

It should however be borne in mind that double taxation agreements may not necessarily reflect South Africa's complete cross border trade and investment policy because the objectives of double taxation agreements and unilateral relief may differ. The objectives of double taxation agreements, as stated in the OECD MTC, are to relieve juridical double taxation<sup>645</sup> which may indicate a trade and investment agenda

---

<sup>644</sup> Article 23 of the OECD MTC 2010 (note 19) and Article 23 of the UN MTC (note 157). Both the OECD and UN MTCs provide alternative wording that may be chosen by the resident contracting state to relieve double taxation, depending on the policy approach.

<sup>645</sup> OECD MTC 2010 (note 19) at 1.

and to ‘address other issues, such as the prevention of tax evasion and non-discrimination’.<sup>646</sup> The objectives of unilateral provisions are more general and may also relieve economic double taxation.<sup>647</sup>

Where double taxation agreements are entered into between developed and developing countries and taxing rights have to be allocated to one of the countries, concern is often raised with regard to the division of taxes between these countries where developed and developing countries are seen as unequal, both in the political relations and in respect of the income flows.<sup>648</sup> Two issues in particular are raised in relation to this unequal relationship in cross border trade and investment. The first issue is whether the use of tax treaties as a ‘distributive function between developed and developing countries’<sup>649</sup> should be encouraged, and the second issue is whether developing countries should use tax treaties to attract foreign investment, particularly when it is possible to design a tax system to achieve the same objective without entering into treaties.<sup>650</sup> A third issue, which is more practical, is the need to have an effective mechanism for the collection of taxes from non-residents.<sup>651</sup>

The main problem of the ‘distributive’ function is the fairness of the allocation of the tax revenues between the two competing countries. The structure of the OECD MTC provides for the reciprocal flows of tax revenue between the two contracting states only if the investment and trade flows between the two countries

---

<sup>646</sup> Ibid at 10. See also Olivier et al 2011 (note 14) at 277.

<sup>647</sup> Oliver Ibid.

<sup>648</sup> Baistrocchi (note 379) at 353.

<sup>649</sup> Jaques Sasseville, ‘The Role of Tax Treaties in the 21<sup>st</sup> century’ (2002) 56(6) *Bulletin for International Taxation* 246 at 247–248.

<sup>650</sup> Ibid at 246.

<sup>651</sup> Ibid at 248.

are equal.<sup>652</sup> Where only enterprises of the country of residence invest and trade in the country of 'source' country, the allocation of the taxing rights in terms of the OECD MTC for the flows of income between the two countries is not necessarily balanced. This is especially the case where double taxation agreements are entered into between developing and developed countries with the income, in terms of the OECD MTC, being largely allocated to the country of residence, that is, the developed country.<sup>653</sup> The allocation of the taxing rights of business income to the country of 'source' is dependent on whether there is a permanent establishment located in the country of source. In the event that a permanent establishment is located in the country of source, the country of source is allocated the right to tax the income attributed to that permanent establishment. The concept of a permanent establishment may differ from the source requirements of the domestic law of the country of source and it may limit the source country's taxing rights. The taxing rights for business income by the source country under the UN MTC is less limited than under the OECD MTC as the UN MTC has a broader definition of permanent establishment.<sup>654</sup> The allocation of the taxing rights of other income such as dividends, interest and royalties is largely allocated to the country of residence of the recipient.<sup>655</sup> The UN MTC allows higher withholding taxes on passive income in the

---

<sup>652</sup> Reuven Avi Yonah, 'Double Taxation Treaties: An Introduction' at 3–5. Available at <http://ssrn.com/abstracts=1048441>, last accessed 28 July 2009; Antoni Hugo Figueroa 'International Double Taxation: General Reflections on Jurisdictional Principles, Model Tax Conventions and Argentina's Experience' (2005) 59(8) *Bulletin for International Taxation* 379 at 382.

<sup>653</sup> Brian J. Arnold, Jacques Sasseville and Eric Zolt 'Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21<sup>st</sup> Century' (2002) 56(6) *Bulletin for International Taxation* 233 at 238–239.

<sup>654</sup> For example Article 5(3) of the UN MTC (note 157) at provides that construction sites establish a permanent establishment within a period of six months while Article 5(3) of the OECD MTC 2010 (note 19) provides for a period of 12 months.

<sup>655</sup> Articles 10, 11 and 12 of the OECD MTC 2010 (note 19) and UN MTC (note 157) respectively.

source country.<sup>656</sup> The potential distortion caused by the allocation of the taxing rights between the two countries is exacerbated in cases where the developing country tries to encourage inward investment from the developed country through the use of tax incentives which the developed country then neutralises by imposing tax on the worldwide income of its residents. With the source of the business profits, interest, royalty and dividend income – the returns of the inward investment – being located in the developing country and flowing to the developed country, the developing country where the source of the income is located should not be expected to give up its rights to tax that income and have those rights allocated to the developed country, where the recipient of the income is resident, because of the possibility of a reduction in its tax revenues. Where the two countries have reciprocal in and out flows of income, as in the case of two developed countries, the reduction in the tax revenues in one of the countries as a result of the application of the double taxation agreement would not arise. Where a developed and developing country have entered into a double taxation agreement, it can be said that the rules of the double taxation agreements which allocate the right to tax income derived in the ‘source’ country to the ‘residence’ country result in unfair allocation of the taxing revenues of the developing countries.<sup>657</sup> The developing country, it is argued, should only enter into double taxation agreements with a developed country if the developed country were willing to provide tax-sparing credits for the incentives offered by the

---

<sup>656</sup> Articles 10(1) and 11(2) of the OECD MTC 2010 (note 19); Articles 10(2), 11(2) and 12(2) of the UN MTC (note 157).

<sup>657</sup> Figueroa (note 652) at 385–386.

developing country.<sup>658</sup> A further reason for developing countries not to enter into double taxation agreements is that their residents are said not to have substantial foreign source income.<sup>659</sup> Given these issues, why do developing countries still enter into double taxation agreements? The reasons given include trade relations and foreign investment.<sup>660</sup> It is said that the main purpose of treaties for developing countries is to promote investment from abroad and ‘reassure foreign investors about the stability of the framework within which investors will be taxed’.<sup>661</sup>

As indicated earlier in this Chapter in paragraph 5.2, given that ‘residence’ and the taxing rights of the resident state are given priority in the OECD MTC with the source state’s taxing rights

- for business income being dependent on the ambit or extent of the ‘permanent establishment’ concept, and
- for passive income on the level of withholding taxes,

the UN MTC attempts to overcome this residence bias of the OECD MTC by limiting the scope of the ‘permanent establishment’ exclusion and providing for

---

<sup>658</sup> Figueroa (note 652) at 385; Vogel (note 2) at 1173 and 1255; see also Thuronyi (note 265) at 22 where it is stated that ‘[i]n developing countries, the effectiveness of investment incentives depends in part on tax rules in the investor’s home country (tax sparing under double taxations or exemptions, either under tax treaties or unilateral rules’.

<sup>659</sup> Arnold et al (note 653) at 235.

<sup>660</sup> Arnold et al (note 653) at 235; Avi Yonah (note 652) at 14.

<sup>661</sup> Baistrocchi (note 379) at 353.

higher withholding taxes on interest, dividends and royalties, thereby increasing the taxation rights of the source country.<sup>662</sup>

The distributive effects of double taxation agreements are dealt with under the concept of inter-nation equity. It will be considered where the preferred allocation to the country of 'residence' under the OECD and UN MTC may undermine inter-nation equity.

### **5.3 Treaty relief in South Africa**

The form of double taxation agreements entered into by South Africa, whether prior to or after the introduction of the 'residence-based' system, is, like most countries, largely based on the OECD MTC. Although it is accepted that double taxation agreements entered into by contracting states are based on the OECD MTC, the direct use of the OECD MTC without taking into account a country's particular economic status and policies has been questioned. In South Africa the 1986 Margo Commission recommended that double taxation agreements entered into by South Africa be adjusted to protect South Africa's interests as a capital importing country with a developing economy.<sup>663</sup> The Margo Commission was particularly concerned with treaty rates applicable to withholding taxes on portfolio income (dividend, interest and royalty income) and recommended a renegotiation or termination of treaties not favourable to South Africa.<sup>664</sup> The concern expressed by the Margo Commission is a reflection of potential asymmetry discussed earlier in Chapter

---

<sup>662</sup> Avi Yonah (note 652) at 7. See Articles 10, 11 and 12 of the OECD MTC 2010 (note 19) and UN MTC (note 157).

<sup>663</sup> Margo Commission (note 6) at para 36.36 p 401.

<sup>664</sup> Ibid.

Three, paragraph 3.5.1 and which results when a developing country such as South Africa enters into a double taxation agreement with a developed country. The application of the provisions of a double taxation agreement based on the OECD MTC resulted in South Africa, as the capital importing host country, giving up or limiting its right to tax income originating in South Africa. In addition, in combination with the exemption of foreign source income (in terms of the Income Tax Act at the time of the Margo Commission), it meant that double taxation agreements based on the OECD MTC placed South Africa in an unfavourable position in terms of tax revenue collected. In contrast to the concern of the 1986 Margo Commission, the 1996 Katz Commission concluded that 'any concerns as to a competitive disadvantage in double tax treaty negotiations are unfounded or would be addressed even further by the new system proposed' by it.<sup>665</sup> This proposed new system was the 'source-plus' system as discussed in Chapter Three.<sup>666</sup> It was envisaged that the 'source-plus' basis of taxation would counter the double loss to the South African fiscus of the source basis of taxation and the double taxation agreements' bias to the state of residence because it introduced a residence basis of taxation for passive income. Whether or not double taxation agreements entered into by South Africa are more favourable to South Africa or to the other contracting state is largely academic because South Africa continued to enter into double taxation agreements during each of the three periods (for various reasons). Of importance for this chapter is the interaction of the method of relief in double taxation agreements and in the domestic legislation in the context of the changes to the jurisdictional link

---

<sup>665</sup> Katz Commission 5th Interim Report (note 2) at para 3.1.5.2.

<sup>666</sup> Katz Commission 5th Interim Report (note 2) at para 3.2.

as the basis for the tax system from the period prior to democracy to the millennium period and whether double taxation agreements have reflected the same policy as the Income Tax Act.

#### **5.4 Pre-democracy period**

Prior to democracy, the South African government entered into double taxation agreements despite the exemption method of relief being automatic in its domestic legislation. With the exemption method of relief being automatic for non-South Africa sourced income of South African residents, the possibility of double taxation of the aforesaid income was minimal. Double taxation of the income only arose where:

- there was a clash between income which, according to the South African tax law, had its source located in South Africa but which also had its source located in another country, according to the tax rules of that country, and
- where the actual source of income was located in another country but the South African Income Tax Act deemed the source of the income to be located in South Africa.

Where tax was imposed on non-residents in respect of income which had its source located in South Africa, and that same income was taxed in the non-resident's country of residence, the relief for international double taxation was either granted in the form of South Africa exempting the income (for example, interest income received by or accrued to non-residents) or in the form of relief provided by the

respective country of residence. This relief by the country of residence was either unilateral tax relief or relief provided in the relevant double taxation agreement.

The South African government entered into double taxation agreements in the period prior to democracy, not purely to relieve double taxation for the income of South African residents which had its source located outside South Africa but for other considerations as well. These were, for example, the development of trade relations with other countries and to stimulate investments into South Africa by residents of other contracting states by ensuring that the South African sourced income of those non-residents was not subject to double taxation. Horak, writing in 1991, noted that treaty negotiation was not a high priority in South Africa 'because of the perception of treaties by developing countries as being instruments of sacrifice in favour of developed countries'.<sup>667</sup> The justification for this view in the South African context included:

- South Africa as a capital importing country with the flow of investment largely being into South Africa and the return of the investment flowing outwards, would lose relatively more in reducing the source basis of taxation on such flows;<sup>668</sup>
- At the time of the article in 1991, tax was imposed mainly in South Africa on the source basis of taxation which implied that the South African government would not be 'compensated for the loss of tax

---

<sup>667</sup> Horak, J DD 'South Africa Tax treaties – Principles of negotiation' (1991) 4 *Juta's Foreign Tax Review* 48.

<sup>668</sup> Horak *ibid* at 48; See Arnold et al (note 653) at 235.

revenues resulting from the treaty concessions by collecting tax on income earned outside of South Africa'.<sup>669</sup> In other words, there was not sufficient reciprocal inward and outward flow between South Africa and other countries, especially where the other country was a developed country with a residence basis of taxation; and

- Tax treaties concluded by South Africa with developed countries were based on the OECD MTC 'which catered for the needs of developed and not those of a developing country'.<sup>670</sup>

As indicated in Chapter Two, paragraph 2.2, with South Africa largely being a closed economy at the time, with pariah nation status, the concern of international double taxation of income derived by residents was not a major concern. Where South Africa did enter into double taxation agreements prior to democracy,<sup>671</sup> the relevant relieving provisions generally allowed the South African resident taxpayer to elect either the credit or exemption method of relief.

## 5.5 The transition period

The role of double taxation agreements to relieve double taxation for South African residents gained importance during the transition period when the possibility of both host country and South African taxation of foreign-sourced income of South African residents increased as a result of the introduction of the 'source-plus' basis in 1998.

---

<sup>669</sup> Horak *ibid* at 48.

<sup>670</sup> Horak *ibid* at 48.

<sup>671</sup> The following Double Taxation Agreements entered into prior to democracy and which are still in existence, provided for such an election: Israel *GG* 6577 dated 1979-07-13, Malawi *GG* 1479 dated 1971-08-13, Germany *GG* 3898 dated 1973-05-25; Zambia Proclamation No. 174 of 1956 and 60 of 1960, Zimbabwe *GG* 1234 dated 1965-09-24.

The South African treaty network increased substantially, especially after ‘residence’ was introduced. This is evidenced by the number of double taxation agreements entered into increasing from 20 in 1990<sup>672</sup> to 70 in 2012. The double taxation agreements which were re-negotiated and the new double taxation agreements entered into by South Africa in the late 1990s indicate a change of policy in respect of equity and neutrality. In general, the election between the exemption and credit method of relief fell away for concurrent taxation and those methods were replaced by the limited credit method. This differed from the relief offered in the Income Tax Act at the time, where an exemption was provided for business income through the use of the source basis of taxation whereas the double taxation agreements provided a credit. Although, in general, the full exemption method of relief still applied where the double taxation agreements provided for exclusive taxation by the resident country (such as in the case of the absence of a permanent establishment in terms of Article 7 of the OECD and UN MTCs’,<sup>673</sup> the business profits article), two double taxation agreements entered into by South Africa, namely Iran and Ireland, applied the exemption with progression for exclusive taxation.<sup>674</sup>

The choice of the credit method of relief in double taxation agreements was in line with the double taxation relief provided for interest and royalty income in the Income Tax Act.<sup>675</sup> Whether the actual credit provided was the same, and whether the same conditions were required for the credit, is considered later in this chapter.

---

<sup>672</sup> Ernst Mazansky, ‘South Africa’s Treaty network – Why is South Africa the Meat in the Sandwich’, (2009) 63(4) *Bulleting for International Taxation* 145 at 146.

<sup>673</sup> Article 7 of the OECD MTC 2010 (note 19) and Article 7 of the UN MTC (note 157).

<sup>674</sup> Iran *GG* 19637 dated 1998-12-22; Ireland *GG* 18552 dated 1997-12-15.

<sup>675</sup> Section 6quat of the Income Tax Act provided relief in the form of a limited foreign tax credit.

At this point it suffices to state that the form of the relief, namely the tax credit, was the same in both the unilateral and bilateral relieving provisions for passive income in the form of, *inter alia*, interest and royalty income.

## 5.6 Millennium change

The millennium change to full residency enhanced the importance of the double taxation agreements. Like the double taxation agreements entered into between 1997 and 2001, those entered into after 2001 reflected the policy change to capital export neutrality with the main method of relief for the foreign earned or sourced income of South African residents being the limited tax credit.

With regard to the relief offered in double taxation agreements in the 2003 edition Olivier et al states that:

South Africa has predominantly chosen the credit method, [but] some of the older double taxation agreements still allow South Africa to choose whether or not to exempt the relevant income or to provide credit.<sup>676</sup>

Olivier et al further states that South Africa has adopted the credit method because income derived from foreign states may still be subject to South African tax to the extent that the tax rate in the foreign state is less than the rate applicable in South Africa.<sup>677</sup>

---

<sup>676</sup> Olivier et al 2003 (note 35) at 432.

<sup>677</sup> Ibid; Olivier et al 2011 (note 14) at 464.

### 5.7 Interaction between unilateral and double taxation agreements relief

Although a taxpayer can elect either unilateral<sup>678</sup> or double taxation agreements relief, the end result of the choice should, in accordance with the principles of equity and neutrality, not be different. It can, of course, be argued that the provision of a choice indicates that a different result is envisaged. Both s 6quat and double taxation agreements entered into by South Africa consider the 'residence' of the taxpayer and the category of the income in the granting of relief.<sup>679</sup> As indicated earlier in this chapter at paragraph 5.6, recent double taxation agreements entered into by South Africa use the credit method of relief where tax is imposed on South African residents in both contracting states and the South African revenue authorities are required to give relief to the South African resident taxpayer. There are, however, a number of differences between the s 6quat and double taxation agreements requirements, as well as the determination of the quantity of the tax credit. The differences that will be considered are:

- the definition of 'resident',
- the taxes covered,
- the different 'source' country taxation regime,
- the categorisation of income,

---

<sup>678</sup> Section 6quat.

<sup>679</sup> Section 6quat(1) provides that '... where the taxable income of any resident ...' while Article 1 of the OECD MTC 2010 (note 19) and on which double taxation agreements entered into by South Africa provides that '[t]his Convention shall apply to persons who are residents of one or both of the Contracting States.'

- the quantification of the income to be exempted where the exemption method applies in the double taxation agreements, and
- the quantification of the tax credit.

These differences will be discussed when comparing the categories of taxpayers identified in earlier chapters.<sup>680</sup>

## **5.8 Outward South African resident trade and investment: local South African resident trade and investment**

### **5.8.1 Definition of 'residence'**

In order to obtain relief from international double taxation through the application of a treaty, the taxpayer seeking such relief must first be a resident in one of the states. As discussed earlier in Chapter Four,<sup>681</sup> the uncertainty with respect to the scope of the definition and interpretation of the 'place of effective management', both within the context of the Income Tax Act and the tie-breaker rules in double taxation agreements, will affect the certainty of the application of a double taxation agreement. In addition, in some double taxation agreements the test for residence differs from that of the Income Tax Act as indicated by Appendix 1 to this thesis. This may impact on the relief available to a South African resident, with the result that tax exposure may influence the person's decision where to trade and invest.

A proviso was added to the definition of 'residence' in the Income Tax Act in 2003<sup>682</sup> to deal with the problem of dual residency.<sup>683</sup> In terms of the proviso, if a

---

<sup>680</sup> See discussion in para 2.6 of Chapter Two of this thesis.

<sup>681</sup> See discussion in para 4.4.1 of Chapter Four of this thesis.

<sup>682</sup> By the Exchange Control Amnesty and Amendment of Taxation Laws Act No. 12 of 2003.

taxpayer is tax resident in South Africa but is a resident of the other contracting state in terms of the application of the relevant double taxation agreement, then such resident is deemed not to be a resident of South Africa for the purposes of the Income Tax Act.<sup>684</sup> The Explanatory Memorandum<sup>685</sup> which introduced the proviso stated that the

relationship between the definition of ‘resident’ contained in the Income Tax Act and the definition of “resident” contained in agreements for the avoidance of double taxation is unclear.<sup>686</sup>

and that

[i]t is technically possible for a taxpayer to qualify as a foreign resident for tax treaty purposes (thereby being eligible for tax treaty benefits) while remaining a resident for Income Tax purposes in terms of the definition in the Act. This situation creates an unintended third category of taxpayers with uncertain status.<sup>687</sup>

Canada has a similar provision, where a ‘dual resident corporation is considered to be a resident in another country pursuant to the provisions of a tax treaty (it) is deemed not to be a resident of Canada for all purposes’.<sup>688</sup> According to Ault, the provision ‘has been reasonably effective in preventing most of the tax

---

<sup>683</sup> See the South African National Treasury Explanatory Memorandum on the Exchange Control Amnesty and Amendment of Taxation Laws Act No. 12 of 2003 ‘Explanatory Memorandum on the Exchange Control Amnesty and Amendment of Taxation Laws Bill, 2003’ at 35–36. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last last accessed on 16 November 2012.

<sup>684</sup> Definition of ‘resident’ as found in s 1 of the Income Tax Act. The proviso reads as follows ‘ ... but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.’

<sup>685</sup> Explanatory Memorandum on the Exchange Control Amnesty and Amendment of Taxation Laws Bill, 2003 (note 683) at 36.

<sup>686</sup> Ibid.

<sup>687</sup> Ibid; see also the unreported decision of *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61 (8 May 2012). Available from [sars.gov.za](http://www.sars.gov.za), last accessed on 29 August 2012.

<sup>688</sup> Ault et al (note 137) at 443.

planning advantages of dual' resident companies.<sup>689</sup> As the provision only applies to treaty countries, dual resident companies can still be used for tax planning with non-treaty countries.<sup>690</sup> One of the differences with the South African version of the proviso is that its ambit is wider than dual resident companies because the proviso does not indicate that it deals only with companies. While Australia and the United Kingdom have provisions to deal with dual resident companies, France, Germany, the Netherlands and Japan do not have such special provisions.<sup>691</sup>

The assertion in the Explanatory Memorandum that the possibility of dual residence results from the interaction between the Income Tax Act and a double taxation agreement requires further analysis, as does the role of the proviso in actually preventing the occurrence of such dual residency.

On the question of whether dual residency results from the interaction between the Income Tax Act and double taxation agreements, the interaction between the Income Tax Act and double taxation agreements as stipulated in s 108 of the Income Tax Act must be considered. Section 108(1) provides, *inter alia*, that double taxation agreements shall 'have effect as if enacted' in the Income Tax Act.<sup>692</sup> The result is that a double taxation agreement must be read as being part of the Income Tax Act.<sup>693</sup> Although most treaties make reference to the definition of 'residence' as determined by the domestic law, that is, the Income Tax Act in the

---

<sup>689</sup> Ibid.

<sup>690</sup> Ibid.

<sup>691</sup> Ibid at 444.

<sup>692</sup> Section 108(1) and (2) of the Income Tax Act.

<sup>693</sup> It is worthwhile mentioning that the court in *Tradehold* (note 687) at paragraph 17 stated that '[ a] double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict'.

case of South Africa, the treaty residence rules and the Income Tax Act residency rules may differ in two circumstances. The first is where the treaty has its own definition of 'residence' which either differs from the definition in the Income Tax Act or which provides a definition of 'residence' where residence is not defined in the Income Tax Act. An example of the former is found in the double taxation agreement entered into between Egypt and South Africa where residence in South Africa is defined as:

any individual who under the laws of South Africa is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa.<sup>694</sup>

An example of the latter is found in the double taxation agreement entered into between Germany and South Africa which was entered into at the time when South Africa used 'source' as its jurisdictional link.<sup>695</sup> Article 3(1)(g)(aa) of the aforesaid treaty defined 'residence' in South Africa as:

any person (other than a company) who is ordinarily resident in South Africa for the purposes of South African tax and any company which is incorporated, managed or controlled in South Africa.

The second circumstance is where a taxpayer is resident in both contracting states and residency has to be determined by the residency tie-breaker test as illustrated by Article 4(2) and (3) of the OECD and UN MTCs.<sup>696</sup>

---

<sup>694</sup> Article 4(1)(b) of the Double Taxation Agreement entered into between South Africa and Egypt, GG No 19706 dated 1999-01-22.

<sup>695</sup> GG No 3898 dated 1973-05-25.

<sup>696</sup> Article 4(2) and (3) of the OECD MTC 2010 (note 19); Article 4(2) and (3) of the UN MTC (note 157).

It is submitted that in either of the two circumstances where, as a result of the treaty's different resident rules or tie-breaker rules, residence is assigned to one of the contracting states, the taxpayer will be treated as a non-resident in the other contracting state. In this sense, the proviso potentially confirms the non-residence status of the South African taxpayer where the treaty assigns residence to the other contracting states. The mischief which the proviso seeks to remedy as an anti tax-avoidance measure is where the taxpayer is a non-resident for the purposes of the application of the treaty but retains residency in terms of the application of the Income Tax Act.<sup>697</sup> This would occur, for example, where a company which is incorporated in South Africa, has its 'place of effective management' located outside South Africa.

This role of the proviso was confirmed by the South African Supreme Court of Appeal in the unreported case of *Commissioner for the South African Revenue Service v Tradehold Ltd*,<sup>698</sup> where the court considered the application of a double taxation agreement.<sup>699</sup> The pertinent issue in the case was whether the Article, in the double taxation agreement entered into between South Africa and Luxembourg,<sup>700</sup> dealing with the allocation of the taxing of capital gains<sup>701</sup> included a deemed

---

<sup>697</sup> Explanatory Memorandum on the Exchange Control Amnesty and Amendment of Taxation Laws Bill, 2003 (note 683) at 35–36; Olivier et al (note 14) at 32–33.

<sup>698</sup> *Tradehold* (note 687).

<sup>699</sup> The proviso to the definition of 'residence' applied with effect from 26 February 2003 and provides that '[b]ut does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between Governments of the Republic and that country for the avoidance of double taxation'.

<sup>700</sup> GG No 21852 dated 2000-12-06.

<sup>701</sup> Article 13(4) of the double taxation agreement provided that 'Gains from the alienation of any property other than that referred to in paragraph 1, 2 and 3, shall be taxable only in the contracting state of which the alienator is a resident.'

alienation of a capital asset or only an ‘actual’ alienation.<sup>702</sup> The taxpayer was a company incorporated in South Africa and on 2 July 2002 a decision was made to move all board meetings of the taxpayer to Luxembourg. It was accepted by the parties and the taxpayer that this decision resulted in the ‘place of effective management’ of the taxpayer being moved to Luxembourg. Despite the change of ‘place of effective management’, the company remained tax resident in South Africa on the basis of its incorporation in South Africa.<sup>703</sup> The court did not discuss whether the taxpayer was a dual resident, namely whether it was a resident of both South Africa and Luxembourg.<sup>704</sup> On the assumption that the taxpayer was a dual resident, the application of the tie breaker rule in Article 4(3) of the relevant double taxation agreement, meant that the taxpayer would have been resident in Luxembourg.<sup>705</sup> The tax issue arose as a result of the deeming provision found in paragraph 12 of the Eighth Schedule,<sup>706</sup> the so-called exit tax, where a change in residence would result in the taxpayer being deemed, *inter alia*, to have sold its assets and having to pay capital gains tax on the notional proceeds of that deemed sale. The court, in considering the application of Article 13(4), the capital gains article, Article 4(3), the

---

<sup>702</sup> *Tradehold* (note 687) at para 10–13.

<sup>703</sup> Section 1 of the Income Tax Act provided that a company would be resident in South Africa if it is ‘incorporated, established or formed in the Republic or which has its place of effective management in the Republic ....’

<sup>704</sup> Article 4(1) of the SA–Luxembourg DTA provides that:

For the purposes of this Convention, the term "resident of a Contracting State" means:

- a) in Luxembourg, any person who, under the laws of Luxembourg, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, but this term does not include any person who is liable to tax in Luxembourg in respect only of income from sources in Luxembourg or capital situated therein;
- b) in South Africa, any individual who is ordinarily resident in South Africa and any other person which has its place of effective management in South Africa; and ...

<sup>705</sup> Article 4(3) of the SA–Luxembourg DTA provides that:

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.

<sup>706</sup> Paragraph 12 of the Eighth Schedule to the Income Tax Act.

tie-breaker rule and the proviso to the definition of 'residence' in the Income Tax Act, held that when the taxpayer changed its residence by moving the 'place of effective management' to Luxembourg, the provisions of the double taxation agreement applied and Luxembourg had the exclusive right to impose tax on the capital gains, even though it was a deemed sale.<sup>707</sup>

Dual residency in a treaty context will affect tax treatment where a company trades or invests in more than two countries and uses its dual residency to obtain relief in both countries that are party to the treaty. In other words, the company embarks on treaty shopping. The use of the proviso is therefore, it is submitted, largely an anti tax-avoidance provision.

One question that seems to be unanswered is whether the non-resident status of the party, on application of the proviso, applies only 'for the purposes of the application' of the agreement, as per the wording of the proviso, or for all purposes. If the former, then the value of the proviso is limited to the allocation of the taxing rights between the two contracting states and it is only for the purposes of that particular double taxation that the taxpayer is a non-resident for South African taxation. The use of the proviso as a measure of certainty and as an anti tax-avoidance measure would, it is submitted, only avail where the proviso deems the resident to be a non-resident for all purposes. A further consideration is whether such

---

<sup>707</sup> *Tradehold* (note 687) at para 26. A proposed amendment to the legislation to counter the decision in *Tradehold* has been made by the South African National Treasury in the 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012' at 110–111. The proposed amendment provides that a persons' year of assessment will be deemed to end 'the day before the person becomes a resident of another country'. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 13 August 2012.

a deemed non-resident would be a resident for the purposes of a treaty between South Africa and another third contracting state. For example, the application of a double taxation agreement between South Africa and country A results in the taxpayer being a resident of country A and being deemed not to be a resident of South Africa. In terms of the double taxation agreement between South Africa and country B and the application of South Africa's domestic law, the same taxpayer could be a resident of South Africa. Does the taxpayer still qualify as resident of South Africa for the purposes of the country B double tax relief or does the country A deeming provision apply? Given that the proviso refers to the 'application of a double taxation agreement', and not 'for all purposes', it could be argued that the taxpayer is only a non-resident for the application of the double taxation agreement between South Africa and country A and that the proviso does not apply to the application of the double taxation agreement between South Africa and country B.<sup>708</sup>

### 5.8.2 Taxes covered

The continuous changes to the Income Tax Act and, with the addition of new taxes such as the withholding taxes on dividends,<sup>709</sup> interest,<sup>710</sup> and the repeal of taxes such as the Non-Residents Shareholders' Tax<sup>711</sup> and Secondary Tax on Income,<sup>712</sup> have meant that treaties either need to be renegotiated to provide for these changes or, if

---

<sup>708</sup> See Brian Arnold 'The 2008 Update of the OECD Model: An Introduction' (2009) 63(5) *Bulletin for International Taxation* 178 at 179.

<sup>709</sup> Section 64D–64N inserted by the Revenue Laws Amendment Act No. 60 of 2008 and substituted by the Taxation Laws Amendment Act No.17 of 2009 with effect from 1 April 2012.

<sup>710</sup> Section 37I–37N inserted by the Taxation Laws Amendment Act No.7 of 2010 with effect from 1 January 2013.

<sup>711</sup> Repealed by the Income Tax Act No. 21 of 1995.

<sup>712</sup> The replacement of the Secondary Tax on Income with the Dividends Tax commenced with Revenue Laws Amendment Act No. 60 of 2008 and phasing out of the secondary tax on companies is still currently underway.

not renegotiated, then potentially the relief available in treaties for South African residents would be limited. This is illustrated in *CSARS v Volkswagen*<sup>713</sup> where the issue in dispute was whether the non-residents' tax on shareholders was equivalent to the secondary tax on companies. The imposition of different taxes meant that the taxpayer was not entitled to relief as the specific tax was not listed in the relevant treaty and the tax was not substantially similar to the taxes listed.

The court in *Volkswagen* held that the taxpayer was not entitled to use the treaty relief provisions because the tax in question, the Secondary Tax on Companies, was not dealt with in Article 2(3) and (4) of the double taxation agreement between Germany and South Africa.<sup>714</sup> In comparing the Secondary Tax on Companies with the listed Non-Residents Shareholders' tax, the court, relying on commentary from various sources,<sup>715</sup> held that the Secondary Tax on Companies was 'not a tax on dividends or taxation of dividends but is a tax imposed on the company declaring the dividends'.<sup>716</sup> The judgement is particularly important as it raises the issue of which taxes are covered by Article 2(4) and are 'identical or substantially similar taxes which are subsequently imposed in addition to, or in place of, the

---

<sup>713</sup> 70 SATC 195.

<sup>714</sup> Articles 2(3) and (4) of the double taxation agreement entered into between Germany and South Africa GG No 3898 dated 1973-05-25 read as follows:

'(3) The existing taxes to which this Agreement shall apply are, in particular:

in the Republic of South Africa:

the normal tax;

the undistributed profits tax;

the non-resident shareholder's tax;

the non-resident tax on interest;

the provincial income tax;

and all other taxes on persons or on the incomes of persons which are chargeable in South Africa;...

(4) This Agreement shall also apply to any identical or substantially similar taxes which are subsequently imposed in addition to, or in place of, the existing taxes'.

<sup>715</sup> *Volkswagen* (note 713) at 203.

<sup>716</sup> *Ibid.*

existing taxes'. With the introduction of the Withholding Tax on Dividends in 2012<sup>717</sup> and the imminent Withholding Tax on Interest,<sup>718</sup> the question has to be asked whether relief will be available for double taxation resulting from the imposition of these two withholding taxes.

It could be argued that the withholding tax on dividends that has already been introduced and the soon to be introduced withholding tax on interest fall within the ambit of the relevant articles because the tax is imposed on the person receiving the income, not the person paying or distributing the payment. Once this is answered the next question is whether these newly introduced taxes are 'identical or substantially similar taxes' to the listed taxes. If one considers the double taxation agreement under discussion in this case, then these new taxes are 'identical or substantially similar' to the 'normal tax, the undistributed profits tax, the non-resident shareholder's tax, the non-resident tax on interest, the provincial income tax and all other taxes on persons or on the incomes of persons which are chargeable in South Africa' as listed in Article 2(3). However, it is submitted that these new withholding taxes may not qualify as taxes for which relief is to be given in the application of double taxation agreements as they are not identical or substantially similar, both in relation to the category of income and the persons upon whom the tax is imposed.

### ***5.8.3 Categories of income difference***

A further difference between s 6quat and double taxation relief is that all categories of foreign sourced income are included under s 6quat whereas the double taxation

---

<sup>717</sup> Part VIII of the Income Tax Act, sections 64D–64N.

<sup>718</sup> Part 1A of the Income Tax Act, sections 37I–37N.

agreement relief depends on the category of income. The tax credit provided in s 6quat applies irrespective of the type of foreign sourced income included in 'gross income'. By contrast, double taxation relief may differ depending on the type or category of income. The potential differences will therefore be considered in relation to different categories or types of income and investment.

#### **5.8.4 Business income**

The first difference between relief offered in the Income Tax Act and the double taxation agreement in respect of business income, is that the former will give relief if the 'source' is located in the host country whereas the latter gives relief if there is 'permanent establishment' in the host country. Under a double taxation agreement, where the relevant income qualifies as 'business income', the residence country has the exclusive right to tax that income unless the business operates in the host country through a permanent establishment located in that host country.<sup>719</sup> Therefore, if South Africa is the residence country of the business, whether or not South Africa has the right to impose tax or provide relief will depend on whether or not that South African business has a permanent establishment in the host state.

Although both 'source' and 'permanent establishment' are based on the same concept of allowing the country in which the activity giving rise to the income is located to have the right to tax that income, the meanings and interpretations given to these two concepts are different. The South African concept of source was discussed in Chapter Two and it should therefore be apparent that an application of the two concepts may give rise to different taxing rights. This difference is particularly

---

<sup>719</sup> Article 7 of the UN MTC (note 157) and of the OECD MTC 2010 (note 19).

apparent in the context of e-commerce, where the OECD MTC Commentaries has largely accepted that a server, under certain circumstances, can be a 'permanent establishment' whereas it is unlikely, given the South African source rules, that a server can be seen as the location of the source of income.<sup>720</sup>

The second difference is between the forms of relief provided in s 6quat for business income and the form of relief that South Africa has to provide in the double taxation agreement in the event of a permanent establishment being located in the host country. Although the credit method is the most used method, there are still a few double taxation agreements in existence which allow a South African resident taxpayer to elect either the credit or the exemption method as indicated earlier in this in paragraph 5.4. This is clearly still a relic of the pre-democracy source basis of taxation.

The possible differences between the application of a double taxation agreement or the Income Tax Act for business income can be demonstrated by considering the difference where the source of income or permanent establishment of a South African resident is located in the host country. Where the source of income is located in the host country but that 'source' income is not derived *via* a permanent establishment, s 6quat will provide a tax credit for host country taxes, whereas the double taxation agreement will grant South Africa the exclusive right to tax. Either way, the South African resident taxpayer will pay the same amount of tax in South Africa and ability-to-pay equity and capital export neutrality will apply. Where the

---

<sup>720</sup> OECD MTC 2010 (note 19) at paragraphs 42.2–42.10. See also Tracy Gutuza 'Tax and e-commerce: Where is the source' 2010 127(2) *South African Law Journal* 328.

tax rates in the host country are higher than that of South Africa, the taxpayer's overall tax burden will initially be higher than that of a local investor or trader. A taxpayer may elect to apply the *s 6quat* credit instead of applying the double taxation agreement because the excess tax credits can be carried forward to successive tax years. On a practical level, where the South African tax rate is lower than that of the country where the business is carried on or situated, the end result of the application of the *s 6quat* tax credit or application of the double taxation agreement will be the same for the taxpayer. However, it does mean that whether or not South African businesses can be competitive in a foreign market is dependent on the tax rates in that foreign market. While the choice may not affect inter-individual equity on the basis of ability-to-pay, the election of a *s 6quat* tax credit or the double taxation agreement relief, would make a difference to inter-nation equity. In the former election, South Africa has to provide a credit for the taxes paid whereas in the latter, South Africa gets the sole taxing rights. From an inter-nation equity perspective, and in the context of South Africa as developing country, it may be more appropriate to have the double taxation agreement, rather than the *s 6quat* credit, apply. The election also affects the basis on which South Africa levies taxes, that is the benefit principle or sacrifice principle as discussed in Chapter Two.

It raises the question of whether it is appropriate to allow a taxpayer an election which, although not affecting inter-individual equity, affects the equitable basis on which South Africa levies tax. It is worthwhile noting that India does not allow an election but only allows the use of the unilateral tax credit where there is no

double taxation agreement or where the double taxation agreement does not apply.<sup>721</sup> Singapore has a similar provision.<sup>722</sup>

If the South African resident's business operates through a permanent establishment in the other contracting state but, on the application of the South African source rules, the source is located in South Africa, s 6quin will allow for a deduction of the taxes paid from income,<sup>723</sup> whereas the relief as per the double taxation agreement will depend on the relief provided in Article 23, the relieving article. As this relief is most likely to be in the form of a credit (except where the double taxation agreement was entered into prior to democracy), there would be a difference in equity and neutrality. Whereas the double taxation agreement seems to be in line with the policy approach to ability-to-pay equity and capital export neutrality, the Income Tax Act is not. The introduction of the deduction method was to alleviate the taxes paid in the host country where the South African source rules were not aligned with the source rules of the host country.<sup>724</sup> It therefore seems that the deduction was introduced to alleviate complaints by taxpayers but it does not assist with allocation internationally. In addition, it undermines equity and neutrality between local and outward trade and investment by South African residents because the use of the deduction potentially results in the local trader and investor paying

---

<sup>721</sup> Kuntal J. Dave & Mayur B. Nayak 'India' in *Cahiers De Troit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/ IFA at 343–364. Available electronically at <http://www.ibfd.org>. last accessed 25 October 2010.

<sup>722</sup> Lee Fock Hong 'Singapore's budget for 2008 – For an Innovative Economy and Superior Prospects for Growth; (2008) 62(5) *Bulletin for International Taxation* 191 at 192–193.

<sup>723</sup> In terms of s 6quin inserted by the Taxation Laws Amendment Act No. 24 of 2011 with effect from 1 January 2012.

<sup>724</sup> The deduction method was introduced by s 6quat (1C) and (1D) and inserted by the Revenue Laws Amendment Act No. 35 of 2007.

more tax in South Africa than the outward investor, whereas overall, the outward investor will pay more tax than the local investor. It does however have a reduced effect on inter-nation equity because both countries would have received some taxes, as is the case for the tax credit. The one criticism of this analysis is the assumption that it is possible for a business to qualify as a permanent establishment but not as the location of 'source'. This possibility exists in the realm of e-commerce, where a server can qualify as a permanent establishment, but it does not meet the South African 'source' requirements of physical presence and activity by the taxpayer. The inconsistencies between 'source' and 'permanent establishment' would not arise if 'source' and 'permanent establishment' had the same meaning, or if *s 6quat* used 'treaty language'.

Even though a tax credit is the general method of relief for international double taxation, the form of business used to carry out that business makes a difference. The possible forms include a permanent establishment or having the source in that other contracting state. These two forms usually mean that the business is carried on through the same legal business entity except possibly when the permanent establishment is a dependent agent in terms of Article 5(5) of the OECD and UN MTCs.<sup>725</sup> The business can also be carried out through the use of a separate legal entity – either through the dependent agent permanent establishment or a subsidiary. The choice is important simply because of the different types of income which they produce. If the same business entity is used, then the income is likely to be business income falling under the business profits article of the double taxation

---

<sup>725</sup> Article 5(5) of the OECD MTC 2010 (note 19); Article 5(5) of the UN MTC (note 157).

agreements whereas if a subsidiary is used, the type of income is likely to be dividend income, interest income or royalty income. In addition, a subsidiary is likely to qualify as a controlled foreign company in the country of residence of its shareholders.

As indicated earlier in this paragraph, where a South African resident carries on business in another country, and that host country taxes that business income, the method of relief for the resultant double taxation will differ depending on whether *s 6quat* or double taxation agreements relief is applied. Assuming the taxpayer meets the 'residence' requirements of both the Income Tax Act and the double taxation agreement and that residence is determined as being in South Africa, *s 6quat* will provide relief, either in the form of a tax credit or a deduction; whereas, the double taxation agreement entered into by South Africa may provide relief either in the form of a credit or an exemption, depending on the date of entry of the double taxation agreements. In effect, three possible methods of relief, depending on the relevant double taxation agreements, are available to the South African resident taxpayer who suffers double taxation. This is partly the result of certain older double taxation agreements not having been renegotiated and different requirements having been set for each type of relief.

The current application of the double taxation agreements entered into prior to democracy has the effect of allowing a South African resident, who derives income from sources within these double taxation agreements countries, to elect either the exemption method of relief or a limited tax credit. Although this does appear to be an indication of inconsistent application of policy at the time, with no specific policy of capital import neutrality or capital export neutrality, the chance of

the double taxation agreements actually being used by South African residents at the time of the above double taxation agreements being entered into would have been minimal. Given that the only foreign sourced income potentially subject to tax in South Africa at that time was foreign sourced dividend and interest income, the election would only apply to these specific types of foreign sourced income. The problem of inconsistency arose when the 'residence-minus' and 'source-plus' systems of taxation were introduced, with the concomitant change in policy and the unilateral method of relief. The inconsistency arises as a result of the method of relief provided in these double taxation agreements differing from the unilateral method of relief found in the Income Tax Act. The renegotiation of these double taxation agreements with the method of relief being amended should therefore be a matter of importance as illustrated by the South African government through the number of double taxation agreements that have been renegotiated with the method of relief changing to being a limited tax credit.

All double taxation agreements entered into by the South African government after 1997 grant a limited credit as the method of relief for South African residents, ensuring, on the face of it, that double taxation agreements and the Income Tax Act follow the same general policy. The application of the *s 6quat* credit and the double taxation agreement may have different results simply because the requirements of each differ. This differentiation may have an influence on the choice of country with which a South Africa resident taxpayer carries on business. If this is the intention of the different requirements and it can be justified, then there is no reason for concern. But if this is not intentional and cannot be justified then these requirements need to

be made consistent. It can also be argued that the choice given between using s 6quat and the double taxation credit relief is an indication that such differences may arise.

Section 6quat(2) provides that the tax credit 'shall not be provided in addition to' double taxation agreements relief but 'may be granted in substitution' to such double taxation agreements relief. The section does not directly indicate whether it is the government or the taxpayer who can choose which method of relief should be applied or whether domestic law overrides the double taxation agreements or vice versa, in the event that the two methods yield different results. Olivier et al refers to the South African Revenue Service Interpretation Note No. 18 (issue 2)<sup>726</sup> where it was confirmed 'that a taxpayer may elect not to claim a rebate in terms of s 6quat but rather to claim the relief provided for by the treaty, if available'.<sup>727</sup> Oliver further states that '[t]he taxpayer will obviously do this if the tax treaty relief is more beneficial'<sup>728</sup> and that the taxpayer has the right to choose, 'except where the relevant tax treaty specifically requires that South Africa provide a tax credit'.<sup>729</sup>

Although both the Income Tax Act and double taxation agreements entered into by South Africa provide relief in the form of a credit, s 6quat is clear that the credit is limited whereas the limitation on double taxation agreement credit is not always that clear. It could be argued, depending on the wording of the particular double taxation agreement, that the double taxation agreement credit is a full tax credit. There are those double taxation agreements which refer back to South African

---

<sup>726</sup> Olivier et al 2011 (note 14) at 455.

<sup>727</sup> Olivier et al 2011 (note 14) at 455.

<sup>728</sup> Ibid.

<sup>729</sup> Ibid.

law and it may then be argued that this reference links the double taxation agreement credit to the *s 6quat* limited credit. This difference between a full or limited tax credit may influence the choice of place of trade and investment.

#### **5.8.5 Interest, royalty income and dividend income**

The relief provided in the double taxation agreement relieving provision also applies to income derived from the use of capital, namely income in the form of dividends, interest and royalties. The articles which allocate the taxing rights between the country in which these income forms arise and the country to which they are paid, distinguishes between direct and portfolio foreign investment through the use of permanent establishment.<sup>730</sup> Where the relevant income arises from a permanent establishment situated in a particular country, the article dealing with business income applies, as the permanent establishment is indicative of direct investment.<sup>731</sup> The application of the business profits articles means that the country of residence of the company will have to provide relief as articulated in the relieving Article 23 of the double taxation agreement.<sup>732</sup> The treatment would be in line with that of *s 6quat*. Where the income does not arise from a permanent establishment situated in a host country, and the income is by default portfolio income, the state of residence of the income recipient is allowed to tax the income.

---

<sup>730</sup> Article 10, the Dividends article as illustrated in the OECD MTC 2010 (note 19) and the UN MTC (note 157). Article 11, the Interest article as illustrated in the OECD MTC 2010 (note 19) and the UN MTC (note 157). Article 12, the Royalties article as illustrated in the OECD MTC 2010 (note 19) and the UN MTC (note 157).

<sup>731</sup> Article 7 of both the OECD MTC 2010 (note 19) and the UN MTC (note 157).

<sup>732</sup> In both the OECD MTC 2010 (note 19) and UN MTC (note 157), the article referred to is Article 23A or Article 23B, the Methods for the Elimination of Double Taxation.

Applying the OECD MTC, the state of residence of the recipient of passive royalty income has the exclusive right to that royalty income which means that the state in which the royalty income arises, and from which it is paid, must exempt that royalty from tax. Thus where a South African resident earns royalty income through the use of its intellectual property in another DTA country, such income will only be taxed in South Africa. The result is the same tax burden for local and outward royalty income. The *s 6quat* relief will provide a limited tax credit to the licensor and, depending on the tax rates in the host country, the licensor will have the same tax burden as local investors and traders. The exemption of the source country and the provision of the limited tax credit as relief by the country of residence would result in the same tax burden for local and outward traders and investors but as indicated earlier in para 5.3, it would have a different effect on the taxes collected by the South African fiscus.

For both dividend and interest income, the state of residence of the recipient may tax, as may the state of residence of the payer, the host country. However, the double taxation agreements generally restrict the right of the host country to specified limits. Relief for such host country taxes would have to be sought in the double tax agreement relieving provision which is likely to be a tax credit as discussed above. The double taxation agreements entered into by South Africa do not provide relief for economic double taxation experienced by the South African shareholder and it may therefore be prudent for such a shareholder to apply the

Income Tax Act rather than the treaty where the participation exemption is available.<sup>733</sup>

A further difference between the application of the s 6quat relief and the double taxation credit relief for dividend, royalty and interest income is that the s 6quat relief looks to the 'source' of the income as a prerequisite to relief being provided whereas double taxation agreements look to place of residence of the recipient and that of the distributing company.<sup>734</sup>

Another factor which affects the differences between the application of the Income Tax Act and double taxation agreements is the different definitions given to dividends, interest and royalty income. This will affect the application of the double taxation agreement and the policy applying to such forms of income.

For example, the Income Tax Act defines 'dividends' as:

any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company,  
 ...<sup>735</sup>

The OECD Model defines a dividend in Article 10(3) as:

---

<sup>733</sup>In terms of s 10B(2) inserted by the Taxation Laws Amendment Act No. 7 of 2011. Prior to this amendment, s 10(1)(k)(ii)(dd) provided for the participation exemption See discussion in para 4.4.4 of Chapter Four of this thesis.

<sup>734</sup>The s 9 Source of Income rules inserted by the Taxation Laws Amendment Act No. 24 of 2011 alleviates this particular difference. Article 10(1) of the OECD MTC 2010 (note 19) provides that '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. Article 11(1) provides that 'Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State'. Article 11(5) provides, *inter alia* that 'Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State'. Article 12(1) provides that 'Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State'.

<sup>735</sup>Definition of 'dividend' in s 1 of the Income Tax Act.

... income from shares, ‘jouissance’ shares or ‘jouissance’ rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.<sup>736</sup>

While the Income Tax Act requires the amount transferred or applied to be for the benefit of or on behalf of any person, the OECD MTC has a broader definition.

### ***5.8.6 Approach to controlled foreign companies***

It is argued that controlled foreign company legislation is incompatible with Articles 7 and 10 of the OECD Model<sup>737</sup> because controlled foreign company rules tax a foreign corporation on its foreign source earnings without its having a permanent establishment in the residence jurisdiction of the controlled foreign company, ‘which arguably violates Article 7’ (the violation occurs because it requires no tax on business profits absent a permanent establishment) and taxes it on undistributed dividends.<sup>738</sup> According to Avi-Yonah, Article 7 was written as a limitation on source jurisdiction, not on residence jurisdiction. In his opinion, therefore, controlled foreign company rules redefine the residence of the controlled foreign company and this is permissible under Article 4.<sup>739</sup> Once a controlled foreign company is a resident, there is no double taxation agreement limit on the residence based taxation of all the controlled foreign company’s income.<sup>740</sup> His analysis is based on controlled foreign companies being viewed as residents, which is not the way in which

---

<sup>736</sup> Article 10(3) of the OECD MTC 2010 (note 19).

<sup>737</sup> Article 7 and 10 of the OECD MTC 2010 (note 19).

<sup>738</sup> Reuven Avi-Yonah ‘Back to the Future? The potential revival of territoriality’ (2008) University of Michigan Law School, Public Law and Legal Theory Working Paper Series, Working Paper 114 at 5. Available at <http://ssrn.com.abstract=1185423>, last accessed 28 July 2009.

<sup>739</sup> Ibid.

<sup>740</sup> Ibid at 5.

controlled foreign companies are treated within South Africa's controlled foreign company provisions.

Section 9D, the South African controlled foreign company provisions, reflects the decision by the UK Court of Appeal Judgement in 1997 by providing that the amount taxed in the hands of the South African resident is a notional amount.<sup>741</sup> In the case of *Bricom Holdings v Inland Revenue Commissioners*<sup>742</sup> the court, in considering the relationship between provisions of double taxation agreements and controlled foreign company legislation, held that in order to determine whether the controlled foreign company income was taxed in the United Kingdom, the relevant double taxation agreement had to be ignored. In *Bricom*, the taxpayer, Bricom Holdings was a subsidiary of a United Kingdom company, BGL. Bricom held all the shares in Spinneys, a company resident in the Netherlands. As a result of certain business transactions, Spinneys made a loan to BGL and received interest from this loan. It was common cause that Spinneys met the requirements of a being a controlled foreign company of Bricom.

The issue in question was whether the interest paid by BGL to Spinneys was to be taxed in the hands of Bricom on the basis of the relevant United Kingdom controlled foreign company legislation. The application of Article 11(1) of the United Kingdom–Netherlands double taxation agreement with respect to the relationship between Spinneys and BGL meant that the interest income would only

---

<sup>741</sup> Section 9D(2) provides that 'There shall be included in the income for the year of assessment of any resident (other than a resident that is a headquarter company) who directly or indirectly holds any participation rights in a controlled foreign company ... an amount equal to ...'.

<sup>742</sup> 1997 WL 1104065; *Bricom Holdings Ltd v IRC* 1997 STC 1179 (CA).

be taxed in the Netherlands. Article 11(1) of the United Kingdom–Netherlands double taxation agreement provided that interest arising in one of the states and derived and beneficially owned by a resident of the other state, would only be taxed in that other state. The court held that the double taxation agreement provisions which gave relief from United Kingdom tax prevailed over United Kingdom domestic taxing legislation.

The next question then was how to deal with the taxation of the interest income in the hands of Spinneys as it qualified as a controlled foreign company of Bricom. The profits of the controlled foreign company would be apportioned to the United Kingdom resident shareholder. The court held that the controlled foreign company was resident outside the United Kingdom and the United Kingdom could not impose tax on the controlled foreign company. In accordance with United Kingdom legislation, the chargeable profits of the controlled foreign company had to be determined and used as a measure to determine the amount to be apportioned to the United Kingdom resident shareholder taxpayer as well as the amount on which the tax had to be charged. The court held that the interest received by the controlled foreign company was not included in the sum apportioned to the controlling shareholder and on which tax was charged. The interest merely provided a measure by which notional sum had to be calculated and that notional sum was then apportioned to the taxpayer and tax was charged accordingly.

In other words the controlled foreign company was not a resident, whether actual or deemed, subject to tax. Likewise, the wording of s 9D provides that an amount is included in the income of the South Africa resident who is a participant in the controlled foreign company and that amount is determined by reference to the net

income of the controlled foreign company. The result is that within the South African context, controlled foreign companies are not covered by double taxation agreements, nor are the South African residents to whom the controlled foreign companies are attributed.

In order to ensure that a controlled foreign company does not incur double taxation, unilateral provisions have to be provided to relieve possible double taxation. The treaty would not be able to assist and in addition the provisions of the treaty, which gives the sole taxing rights to the country of residence as in the case of business income and royalty income where there is no permanent establishment, are rendered ineffective by the controlled foreign company provisions.

In summary, the differences between the relief offered in *s 6quat* as the unilateral method of relief and relief offered in double taxation agreements entered into by South Africa, seem to indicate that the two possible provisions relieving international double taxation are not consistent. Although the use of the residence basis of taxation and the credit method of relief are found in both, implying a policy of ability to pay equity and capital export neutrality, the fact that a different result will be obtained depending on whether *s 6quat* or the double taxation agreement is used, implies that the choice is non-neutral and non-equitable.

A different result is possible due to the differences in:

- the definition of who qualifies as a resident;
- the different taxes which are covered in double taxation agreements as compared to *s 6quat*;

- the definitions of the different categories of income;
- the effect of controlled foreign company legislation; and
- the different ways in which the tax credit is calculated.

## **5.9 Outward South African resident trade and investment: host country trade and investment**

### ***5.9.1 Business income***

The comparison of the tax treatment of business income of the South African outward trader and investor with that of traders and investors in the host country is dependent on whether or not the South African trader or investor has a permanent establishment and/or a source in the host country and also on the tax rates in the host country. As articulated earlier in paragraph 5.2, if the source of income is located in the host country but such 'source' does not qualify as a 'permanent establishment', the double taxation agreement grants South Africa the sole taxing rights whereas the Income Tax Act provides a limited tax credit. While such a taxpayer would be treated the same as his South African local competitors, depending on the tax rates, such a taxpayer may not be as competitive in the host country. Where there is a permanent establishment but no source in the host country according to the South African source rules, the Income Tax Act may provide relief in the form of a deduction while the double taxation agreement will grant a tax credit. Whether or not such an operation will be competitive in the host country will depend on the relevant tax rates.

### ***5.9.2 Interest and royalty income***

As the South African outward investor will be the recipient of the interest income, such interest income may be taxed in South Africa in the hands of the recipient

taxpayer as well as in the country of residence of the distributing company, the host country. The credit provided in the double taxation agreement relieving provision for the tax paid in the host country may influence the decision whether such investments will be undertaken in a host country because it does not take into account the risks and benefits in that host country if tax rates in that host country are higher than South Africa's tax rates. Likewise, the double taxation treatment of royalty income, which would allocate taxing rights to South Africa as the country of residence of the recipient, would mean that the use of intellectual property in a host country might not be competitive depending on the tax rates in the host country.

### **5.9.3 Dividend income**

The South African shareholder may be taxed in both South Africa and in the country of residence of the distributing company, and the credit in the double taxation relieving provision will have the same result as when s 6quat applies, except if the participation exemption<sup>743</sup> applies or if the distributing company qualifies as a controlled foreign company.<sup>744</sup> If the former then such dividend income will be exempt<sup>745</sup> and if the latter, it will depend on whether the income of the distributing company was taxed in the hands of the shareholders according to the controlled foreign company rules.<sup>746</sup>

---

<sup>743</sup> Section 10B(2) inserted by the Taxation Laws Amendment Act No. 7 of 2011. Prior to this amendment, s 10(1)(k)(ii)(dd) provided for the participation exemption.

<sup>744</sup> Section 9D.

<sup>745</sup> In terms of either s 10B(2) or s 10(1)(k)(ii) depending on the relevant year of assessment.

<sup>746</sup> In terms of s 9D.

## **5.10 Inward non-South African resident trade and investment: local South African resident trade and investment**

### ***5.10.1 Business income***

The taxation of a non-resident within the context of the double taxation agreement depends on whether such non-resident has a permanent establishment in South Africa or if the source of such income is in South Africa. If such non-resident has a permanent establishment in South Africa then the double taxation relieving provision of its country of residence will apply. As seen in Appendix 2 of this thesis, the methods of relief provided by other contracting states with which South Africa has entered into double taxation agreements may range from a credit to an exemption with progression. The tax credit requires that the foreign tax be credited against the domestic tax while the exemption with progression requires that the foreign sourced income, although exempt in the country of residence of the recipient, is taken into account to determine the tax rate applicable to the income being taxed in the country of residence.<sup>747</sup> If the latter, then such non-resident may be quite competitive in South Africa irrespective of the tax rates in its country of residence. Where such a resident does not have a permanent establishment in South Africa, its country of residence will have the exclusive right to tax such income, with the result that South Africa will lose tax revenue, irrespective of whether the source of such income is located in South Africa. It is this aspect which creates a problem for inter-nation equity where a business from a developed country does not meet the permanent establishment requirement but meets the source requirement and yet the country of source has to give up its taxing rights. Depending on the tax rates in the country of

---

<sup>747</sup> Vogel (note 2) at 28; Ault et al (note 137) at 467; Olivier et al 2011 (note 14) at 444; IBFD Glossary (note 19). See discussion at paragraph 2.7.2 of Chapter Two and footnote 163 of this thesis.

residence of the business, and in particular where such income is exempt in South Africa, such businesses may have an advantage over South African inward investors and traders.

### **5.10.2 Interest and royalty income**

As interest payments to non-residents are not taxed in South Africa<sup>748</sup> it is unlikely that the interest article will be used for non-residents, except in the unlikely circumstance that the definition of interest differs and such interest income does not fall under the exemption provisions in South Africa but does fall under the double taxation interest article.

A withholding tax on interest is to be introduced with effect from 1 January 2013.<sup>749</sup> This withholding tax on interest is to be imposed ‘at a rate on of 10 per cent of the amount of any interest that is regarded as having been received or accrued from a source within’ South Africa ‘in terms of s 9(2)(b)’ and is ‘received by or accrued to any foreign person that is not a controlled foreign company’.<sup>750</sup> Section 37K provides for exemptions from the withholding tax on interest and these exemptions include foreign persons where that foreign person:

- is a natural person who was physically present in South Africa for a period exceeding 183 days in aggregate during that year;

---

<sup>748</sup> In terms of s 10(1)(h) of the Income Tax Act.

<sup>749</sup> The effective date is provided by the Taxation Laws Amendment Act No. 24 of 2011.

<sup>750</sup> Section 37J inserted as part of Part 1A the Taxation Laws Amendment Act No. 7 of 2010 with effect from 1 January 2013.

- at any time during that year carried on business through a permanent establishment in South Africa; or
- is a controlled foreign company as defined in s 9D.

As royalty income is only taxed in the country of its recipient in terms of the OECD and UN MTC royalty's article,<sup>751</sup> the non-resident, as in the case of a no permanent establishment scenario, may be competitive in South Africa depending on the rates in its country. South Africa does levy a royalties withholding tax for royalty income paid to non-residents but this provision would be overridden by the treaty.<sup>752</sup>

### ***5.10.3 Dividend income***

In terms of a double taxation agreement, where a dividend is paid to a non-resident shareholder by a South African resident company, South Africa is entitled to impose tax on such dividend but such tax may be limited. As dividends paid from South African resident companies are exempt from tax in South Africa, such a shareholder may only pay tax in its country of residence. This may place those shareholders at a disadvantage to South African shareholders because those shareholders may be paying more tax than their South African counterparts.

---

<sup>751</sup> In accordance with Article 12 of the OECD MTC 2010 (note 19) and UN MTC (note 157).

<sup>752</sup> Section 35 of the Income Tax Act.

### 5.11 Comparison with other countries

According to Dave and Nayak, India primarily follows the UN MTC and India double taxation treaties will usually contain tax sparing provisions,<sup>753</sup> the credit method of relief and the allocation of income to the ‘source’ country with respect to royalty and ‘other income’.<sup>754</sup> According to Cockfield, the Indian government ‘has complained in the past that traditional international tax principles and practices, based to a large extent on the OECD model tax treaty, do not result in a fair sharing on the international income tax base’ and further that ‘[t]here is at least anecdotal evidence that India may becoming more aggressive in assessing non-resident investors to increase revenues from India based operations.’<sup>755</sup>

This anecdotal evidence is supported by the 2012 Indian Supreme Court of Appeal case, *Vodafone International Holdings B.V. v Union of India & Another*<sup>756</sup> where the Indian revenue authorities sought to impose tax on the capital gains arising from the sale of the share capital of a company resident in the Cayman on the basis that the company, whose shares were being sold, whilst not tax resident in India, held underlying assets in India. In essence the sale of a capital asset (shares) took place between two non-residents outside India.<sup>757</sup> The revenue attempted, *inter alia*, to use

---

<sup>753</sup> The tax sparing provision would provide that where tax allowances and incentives are granted, for example to enhance economic development, the allowance or incentive would essentially be disregarded in determining the foreign tax credit. The tax paid in the host country would be deemed to include the tax which would have been paid but for the allowance or incentive. See Olivier et al 2011 (note 14) at 466–470.

<sup>754</sup> Dave et al (note 721) at 340–341.

<sup>755</sup> Cockfield (note 84) at 21.

<sup>756</sup> The Supreme Court of India, Civil Appellate Jurisdiction, Civil Appeal No. of 2012. Available from the IBFD at [http://ip-online2.ibfd.org/collections/ttcd/html/cl\\_in\\_2012-01-20\\_1-fulltext.html](http://ip-online2.ibfd.org/collections/ttcd/html/cl_in_2012-01-20_1-fulltext.html), last accessed 27 August 2012.

<sup>757</sup> Ibid at para 89 of the judgement of S.H Kapadia, CJI.

a deeming provision<sup>758</sup> to argue that under the section ‘it can “look through” the transfer of shares of a foreign company holding shares in an Indian company and treat the transfer of shares of the foreign company as equivalent to the transfer of shares of the Indian company on the premise that section 9(1)(i) covers direct and indirect transfers of capital assets’.<sup>759</sup> The court rejected this argument by the revenue authorities on the basis of the interpretation of the section and that the section could not be ‘extended to cover indirect transfers of capital assets/property situate in India’.<sup>760</sup> The court also confirmed that all tax planning in terms of which a taxpayer is allowed to arrange his or her affairs to pay the least amount of tax ‘is not illegal/illegitimate/impermissible’.<sup>761</sup>

The two South American countries surveyed have chosen to follow a different model tax convention. According to Figueroa, Argentina does not follow the OECD MTC in its treaties and assigns more taxing powers to the source

---

<sup>758</sup> Ibid at para 71. Section 9(1)(i) of the Indian Income Tax Act which, *inter alia*, deemed ‘all income accruing or arising, whether directly or indirectly ... through the transfer of a capital asset situate in India’.

<sup>759</sup> Ibid at para 71.

<sup>760</sup> Ibid.

<sup>761</sup> Ibid at para 89. Ibid at para 90 of the judgement of K.S. Radhakrishan, J.

country,<sup>762</sup> indicating that its double taxation agreements are more in line with the UN MTC.<sup>763</sup> By contrast and like South Africa, Brazil bases its double taxation agreements on the OECD MTC.<sup>764</sup>

## 5.12 Summation

From the above comparisons, the equity and neutrality aspects of double taxation agreements relief attempt to follow that of the Income Tax Act through the use of the tax credit as the dominant relieving provision. However, because the requirements for treaty relief and unilateral relief differ, the two can have a different result. Thus, although the policy may be the same, the end result may differ. Although such a

---

<sup>762</sup> Antonio Hugo Figueroa 'Argentina' in *Cahiers De Droit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/ IFA at 105 states that:

'As can generally be observed from the income tax law in force in many countries, in Argentina there is a marked difference in favor of taxation at source compared with the OECD model convention. Treaty negotiations by Argentina have been held within a framework following the UN model tax convention, although its methodology does not differ essentially from that of the OECD model convention'

and at 122 states that

'Argentina, along with a large number of countries, does not follow the OECD model convention in its negotiations. It has adopted, structurally, the UN model convention with modifications. The confusion, still present in Argentina, comes from the similarity of this model to the former and the little or no knowledge of the UN model convention on the part of some local and foreign professionals who carry out activities in the private sector. It should be pointed out that, for obvious reasons, in general it is not usual to study or analyze the UN model convention in international seminars or courses overseas, particularly in developed countries. In any case, and merely to meet the general reporters' requirements, the OECD model is taken as the basis for the replies'. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

See also Schindel et al (note 59) at 79 where it is stated that 'As for the types of income discussed in this report, the treaties concluded by Argentina show a clear tendency towards assigning more taxing powers to the source country as compared to the OECD model'.

<sup>763</sup> Figueroa (note 652) at 386. where he states, *inter alia* that 'At this point of the analysis, it should be pointed out that it is a mistake to assume that Argentina has adopted the OECD Model as does a certain doctrine or as indicated in some reports by the OECD's technical areas. In fact, the UN Model was adopted as the basis ever since the Model appeared, with the modifications necessary in the treaties with capital-exporting countries, as determined by the political authorities. In this stage, the decision to negotiate cannot be considered part of the country's negotiating policy, but rather a decision by the government in connection with its own particular objectives'.

<sup>764</sup> Schindel et al (note 59) at 80 where it is stated that 'Treaties signed by Brazil and Denmark provide more taxing rights to the source country than the OECD model, but only with respect to pensions. For all other items of income and capital gains, these countries follow the position adopted by the model'.

difference may well be intended, for example where a treaty provides greater relief in order to encourage trade and investment, where such a difference results in inequity between South African residents' local and outward investment or between inward non-residents and South African investment, it needs to be clear that such differences are intended. It is submitted that the difference between the treatment under 'source' and 'permanent establishment' may not always be justifiable and in this regard it may well be appropriate to consider using 'permanent establishment' instead of 'source' or consider using an expanded version of 'permanent establishment' in double taxation agreements in order to ensure consistency.

It is also apparent from the discussion that as a developing country, South Africa's competitiveness is dependent on the tax rates of its developed trading counterparts. This places a limitation on the tax rates, particularly the tax rates of companies if South Africa is to be competitive both in respect of outward trade and investment by South African companies and inward investment by non-residents. It may add an administrative burden on the South African legislature and National Treasury as they have to ensure that South African tax rates are not out of line with those of their trading counterparts. In addition, it may affect the amount of revenue that they can raise from company taxation. This administrative burden arises partly from the residence based system combined with the tax credit but it also arises from the need to ensure that inward investors are not burdened by extra taxation for which they will not get relief in their country of residence.

## **6 Chapter Six**

### **Jurisdictional links and methods of relief in other jurisdictions**

#### **6.1 Introduction**

Although source and residence, and their concomitant methods of relief have different policy implications, very few countries have adopted source or residence as their exclusive jurisdictional link and likewise, very few have adopted one specific method of relief.<sup>765</sup> According to a study published by Figueroa,<sup>766</sup> in 2005 there were fewer than a dozen countries which still used source and the exemption method of relief exclusively.<sup>767</sup> Most countries therefore adopt residence as the jurisdictional basis of taxation and according to Olivier, most countries have adopted the credit method of relief as a general approach<sup>768</sup> with the exemption method being applied in certain circumstances where foreign sourced income is thought to have been taxed in similar circumstances at comparable rates. In addition to residence, most countries impose tax on non-residents where the source of the non-resident's income is located within that country's territory.

For the period prior to democracy, South Africa was one of the few states with exclusive source taxation. The change in the jurisdictional link from source to residence during the transition and millennium periods is indicative of South Africa choosing to follow the international trend of residence as the jurisdictional link and, the credit method of relief as the default method of relief. As indicated earlier in the

---

<sup>765</sup> Olivier et al 2011 (note 14) at 10.

<sup>766</sup> Figueroa (note 652) at 381.

<sup>767</sup> Schindel et al (note 59) at 40 where he refers to an article by Figueroa, Antonio Hugo, "Doble Tributación Internacional. Inmovilismo o Adecuación a la Nueva Realidad Mundial", *X Congreso Tributario*, CPCECABA, Buenos Aires (2003), 121 listing these countries as Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore, Uruguay.

<sup>768</sup> Olivier et al 2011 (note 14) at 443.

thesis, the choice of this method does mean that cross trade and investment by South African residents, in particular active and direct business operations, are potentially at a disadvantage as full relief for international double taxation is not necessarily available.

The first part of this chapter considers the methods of relief provided to the residents of other contracting states for their trade and investment activities being undertaken in South Africa, as it indicates whether or not their businesses are able to compete on an equal footing with South African businesses within the territorial boundaries of South Africa. The second part of this chapter considers the methods of relief provided by other countries in their domestic legislation to determine whether the choice made by South Africa is in line with international practice, particularly in relation to South Africa's position as a developing country.

## **6.2 The method of relief of the other contracting state in double taxation agreements entered into by South Africa**

Appendix 2 to this thesis provides a survey of the methods of relief given to residents of other contracting states in double taxation agreements entered into by South Africa. The table in Appendix 2 illustrates the prevalence of the credit method of relief. The majority of the states provide relief in the form of the limited tax credit,<sup>769</sup> and when using the exemption method of relief, do so by way of exemption with progression combined with the limited credit for certain types of income, in

---

<sup>769</sup> For example see the following countries listed in Appendix 2: Algeria, Australia, Belarus, Botswana, China, Taiwan, Croatia, Cyprus, Czech Republic, France, Ghana, Hellenic Republic, India, Indonesia, Israel, Italy, Japan, Korea, Kuwait, Lesotho, Malawi, Malta, Mauritius, Malaysia, Mozambique, Namibia, New Zealand, Nigeria, Oman Sultanate, Pakistan.

particular, dividend, interest and royalty income.<sup>770</sup> It would seem that the use of the limited tax credit under South African double taxation agreements as a method of relief is therefore in line with the majority of international practice.

Of particular interest is the use of the combination of a limited tax credit for concurrent taxation by South Africa and the other contracting state, and the use of exemption with progression by the other contracting state where South Africa has been granted exclusive taxation.<sup>771</sup> If the tax paid in South Africa is equal to or less than the tax paid in these particular contracting states, then the effect of the use of exemption with progression for the exclusive taxation is the same as for the limited tax credit. Given that the type of neutrality found in *s 6quat* is that of capital export neutrality, it would seem that in order to ensure consistent policy, the exemption with progression should also be used by South Africa for exclusive taxation in double taxation agreements.

Some countries also provide relief for economic double taxation in their treaties for their resident companies investing in South Africa through a subsidiary or associated company. This is done by allowing the credit or exemption with progression to take into account the tax paid in South Africa by the South African company on its profits when a dividend is paid to a shareholder company in that

---

<sup>770</sup> For example, see the following countries listed in Appendix 2: Austria, Belgium, Bulgaria, Germany, Hungary, Luxembourg, Netherlands, Poland.

<sup>771</sup> For example, see the following countries listed in Appendix 2: Brazil, Egypt, Ethiopia, Finland, Iran, Ireland, Norway.

other country.<sup>772</sup> This may of course provide an incentive for non-residents investing in South Africa where they do so through using a subsidiary resident in South Africa.

The methods of relief chosen by South Africa in its double taxation agreements are largely in line with those of the other countries with which it has entered into double taxation agreements. In order to bring the South African's *quot* policy in line with the double taxation agreement policy, consideration must be given to the inclusion of the exemption with progression where the other contracting state has exclusive taxation.

### **6.3 Jurisdictional link and methods of relief in domestic tax law**

In order to determine whether the choice made by South Africa with respect to residence and the limited tax credit is in line with international tax practice, this chapter undertakes a brief survey of the jurisdictional links used, and methods of relief granted, by other countries. The countries have been grouped into African countries, Australasia, Europe and the Americas, both South and North. The African, Asian and South American countries have been chosen as comparators of developing countries while the North America, Australia and European countries are to illustrate the developed world. The United Kingdom has been chosen as the European representative because of its close links with South Africa, and its influence on South

---

<sup>772</sup> For example, see the following countries listed in appendix 2: Australia, Belgium, Cyprus, Finland, Germany, Ghana, Ireland, Japan, Luxembourg, Mauritius, Malaysia, Mozambique and Nigeria. The specific requirements for the relief in the taxation agreements differ.

African legislation and case law. In addition, the United Kingdom is in the process of reviewing the tax treatment of the active offshore businesses of its residents.<sup>773</sup>

The overview will indicate that many African countries still use source as the basis of taxation while the Asian countries exhibit a mix of source and residence. Brazil and Argentina, like South Africa, have changed their jurisdictional basis from source to residence, but their methods of relief differ.<sup>774</sup> The United States of America and Canada have developed their residence based over time and their rules are therefore more complex but it seems like ‘residence’ combined with a tax credit for unilateral relief has always been the chosen method of dealing with cross border trade and investment.<sup>775</sup>

#### 6.4 African countries

The Margo Commission in 1986 recognised the need for tax harmonisation between South Africa and its neighbours,<sup>776</sup> and stated that this was to be taken up ‘as a

---

<sup>773</sup> See [http://www.hm-treasury.gov.uk/tax\\_foreign\\_branches.htm](http://www.hm-treasury.gov.uk/tax_foreign_branches.htm), last accessed 14 June 2011; [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm), last accessed 14 June 2011.

<sup>774</sup> Schindel et al (note 59) at 63; Vincent Oscar Diaz ‘Argentina’ in *Cahiers De Troit Fiscal International: Unilateral methods to prevent Double Taxation* vol 66b (1981) Kluwer Law International at 173. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010. Rubens Branco ‘Brazil’ in *Cahiers De Troit Fiscal International: Source and residence: A new configuration of their principles* vol 90a (2005) Amersfoort Sdu Fiscal & Financiele Uitgewers/IFA at 205–209. Available electronically at <http://www.ibfd.org>, ;last accessed 25 October 2010. Figueora (note 762) at 105 and 109; Thuronyi (note 265) at 32 where he states that ‘The Latin American countries have historically followed a territorial approach to international taxation, although this is now being abandoned’. Also at 287 where he states that ‘The territorial approach has now been almost universally abandoned, as countries such as Argentina, Israel, Venezuela, and South Africa have switched to a worldwide approach’.

<sup>775</sup> See Harris (note 4) at 295.

<sup>776</sup> Margo Commission (note 6) at para 26.53–26.56 p 403.

matter of urgency'.<sup>777</sup> In 2004, eighteen years after this recognition, the Deputy Minister of Trade and Industry stated that:

Africa is central to our global economic strategy ... the imperative is for us to contribute to the economic regeneration of the continent by integrating with Southern Africa and linking our economy with key economies on the rest of the continent.<sup>778</sup>

Despite this call for harmonisation and integration, the various regional bodies have not embarked on income tax harmonisation. These regional bodies include the COMESA-EAC-SADC Tripartite,<sup>779</sup> which has expressed an intention for the establishment of an African Free Trade Zone,<sup>780</sup> and the New Partnership for Africa's Development (NEPAD).<sup>781</sup> Although the documents establishing these bodies make reference to trade taxes and the harmonisation of these taxes, no direct reference is made to the harmonisation of income tax rules.

At a southern African regional level, the Southern African Development Community Treaty ('SADC') Treaty<sup>782</sup> includes as its objectives the achievement of

---

<sup>777</sup> Margo Commission (note 6) at para 2.223 p 31, para 26.56 p 403.

<sup>778</sup> Address by the Deputy Minister of Trade and Industry (note 31).

<sup>779</sup> COMESA is the 'Common Market for East and Southern Africa'; EAC is the 'East African Community'; and SADC is the 'Southern African Development Community'.

<sup>780</sup> The decision was made at a Tripartite Summit held in 2008. For information, see <http://www.comesa-eac-sadc-tripartite.org/>, last accessed 16 November 2012.

<sup>781</sup> The New Partnership for African Development (NEPAD) was agreed to in 2001 with the objective of addressing poverty and under-development in Africa. It identified the integration of Africa into the global economy and the use of regional co-operation and integration as methods to address the objectives. It furthermore identified the need to increase investment, capital flows and funding and to provide an African owned framework for development as the foundation for partnership at regional and international levels. Information available at <http://www.nepad.org>, last accessed 03 May 2011.

<sup>782</sup> Signed by the Heads of State on 17 August 1992, in Windhoek, Namibia. Available at <http://www.sadc.int/index/browse/page/120>, last accessed 16 November 2012. There are 15 Southern African countries which form this community, namely Angola, Botswana, Democratic Republic of Congo (DRC), Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe.

development and growth.<sup>783</sup> Article 5(2) of the Treaty states that in order to attain its objectives, SADC shall, *inter alia*:

secure international understanding, co-operation and support, and mobilise the inflow of public and private resources into the Region.<sup>784</sup>

Article 6.1 of the *General Undertakings* article provides that:

member states undertake to adopt adequate measures to promote the achievement of the objectives of SADC, and shall refrain from taking any measure likely to jeopardise the sustenance of its principles, the achievement of its objectives and the implementation of the provisions of this Treaty.<sup>785</sup>

Article 21, indicates the areas of co-operation which include, *inter alia*, co-operation to foster regional development and integration on the basis of balance, equity and mutual benefit.<sup>786</sup> Article 21.2 further provides that member states:

shall, through the appropriate institutions of SADC, coordinate, rationalise and harmonise their overall macro-economic and strategies, programmes and projects in the areas of co-operation.

One of the areas of co-operation set out in Article 21.3 is trade, industry, finance, investment and mining.<sup>787</sup> These SADC treaty principles, objectives and undertakings have to be borne in mind when any of the SADC countries embark on introducing tax incentives and initiatives, and tax reform. Given South Africa's economic position within the region, any tax reform process undertaken by South Africa has to take these principles, objectives and undertakings into account, particularly in relation to who and what is to be compared. The ultimate objective of

---

<sup>783</sup> Article 5.1 of the SADC Treaty.

<sup>784</sup> Article 5(2)(i) of the SADC Treaty.

<sup>785</sup> Article 6.1 of the SADC Treaty.

<sup>786</sup> Article 21(1) of the SADC Treaty.

<sup>787</sup> Article 21 (3) of the SADC Treaty.

the SADC Treaty is the economic integration of the member states and it is within this context that tax reform initiatives within South Africa have to be considered.<sup>788</sup>

The SADC countries have entered into a Memorandum of understanding on Co-operation in Taxation and Related matters which recognises:

the need to take such steps as are necessary to maximise the co-operation of member States in taxation matters and to harmonise the tax regimes of the member States in accordance with Articles 21 and 22 of the SADC Treaty.<sup>789</sup>

Article 4 (1) of the Memorandum of Understanding provides that:

member states will endeavour to achieve a common approach to the treatment and application of tax incentives and will, amongst other things, ensure that tax incentives are provided for only in tax legislation.

Article 4.2 provides a list of tax incentives which are allowed, while Article 4.3 provides a list of tax incentives which a member state will endeavour to avoid. These include harmful tax competition which would be evidenced by zero or low effective tax rates, a lack of transparency, lack of effective exchange of information, restricting tax incentives to particular taxpayers (usually non-residents), promotion of tax incentives as vehicles for tax minimisation or the absence of substantial activity in the jurisdiction to qualify for tax incentives. In terms of Article 4.3 a member state will also endeavour to avoid introducing legislation that 'prejudices another Member

---

<sup>788</sup> The 1992 pre-ambule of the SADC Treaty (note 763) provides that the purpose of the treaty is to, *inter alia*, 'to promote the interdependence and integration of the national economies for the harmonious, balanced and equitable development of the Region'; to 'mobilise our own and international resources to promote the implementation of national, interstate and regional policies, programmes and projects within the framework for economic integration'.

<sup>789</sup> Available at [http://www.sadc.int/files/4413/5333/7922/Memorandum\\_of\\_Understaning\\_in\\_Cooperation\\_in\\_Taxati\\_on\\_Related\\_Matters.pdf](http://www.sadc.int/files/4413/5333/7922/Memorandum_of_Understaning_in_Cooperation_in_Taxati_on_Related_Matters.pdf), last accessed 5 January 2013.

State's economic policies, activities, or the regional mobility of goods, services, capital or labour'.

Considered as a whole, the role of South Africa or that of any African country party to these groupings is to assist with the development of the region. Therefore, regional and African development is high on the agenda of these forums with tax law also being integrated into the development goals. It is within the context of these objectives, principles and undertakings that South Africa must be seen to adhere to and comply with its tax reform initiatives, which includes changing the basis on which it imposes tax and grants relief for international double taxation.

Most of the African countries listed, as can be seen in Appendix 3 to this thesis, still operate on a 'source' basis and if there is to be trade and commercial harmonisation as envisaged by NEPAD, the basis of income taxation will have to be harmonised. This means that such countries may have to change their basis of taxation to residence (or all change to a source basis) and reconsider the methods with which they relieve international double taxation. It is in this context that the lessons from the South African experience are particularly pertinent. The change in the basis of taxation has to consider the equitable basis on which a state may impose tax, inter-individual equity and neutrality. This process entails a comparison of relevant categories of taxpayers and any differences between the categories have to be clear and justified. These comparators have to be identified at the beginning of such a change and the tax legislation has to consider the effects of the proposed changes on each of the comparators to ensure that the equity and neutrality have been considered. This would prevent the inconsistencies which arose during the South

African experience which led to constant amendments resulting in a fragmented tax structure which created much uncertainty in the tax legislation.

### **6.5 India and Australia**

A brief survey of the jurisdictional links and methods of relief for Australia and India are indicated in Appendix 4 to this thesis.

Australia has amended its tax credit provisions with effect from 1 July 2008, providing greater relief for international double taxation.<sup>790</sup> It now allows the pooling of credits and for excess credits to be carried forward.<sup>791</sup>

A comparison with India in particular shows that South Africa by choosing the credit method, is largely on par with that of similar developing countries. However, unlike South Africa, India does not allow a choice between the unilateral method of relief and the treaty relief, which means that many of the discrepancies between the unilateral and treaty relief do not arise.<sup>792</sup>

### **6.6 South American countries**

Brazil can be regarded as an excellent comparison with South Africa because of its similar features such as the existence of an 'upper middle class, semi industrial economy that followed a largely inward looking, state-led import substitution regime

---

<sup>790</sup> Bowden et al (note 471) at 113–114. But see Ault et al (note 137) at 463 where he writes that 'Australia previously allowed a five year carry forward of excess credits, but this was abolished in the simplification of the regime in 2008 as a counterbalance to the removal of the previous four baskets, with transitional relief for excess foreign credits of the previous five years. Under the current worldwide limitation, no carryover of excess credits is permitted'.

<sup>791</sup> Bowden Ibid.

<sup>792</sup> Dave et al (note 721) at 343–344; Sachit Jolly and Sunil D. Shah 'India' in *Cahiers De Troit Fiscal International: Key practical issues to eliminate double taxation of business income* vol 96b (2011) The Hague: SDU uitgewers at 373.

for most of the second half of the twentieth century'.<sup>793</sup> Brazil was under military rule for almost 20 years and, like South Africa, had a largely closed economy. Brazil became a democracy in 1988 with the enactment of a constitution which also affected the tax system.<sup>794</sup>

As seen from Appendix 5 to this thesis, Brazil, like South Africa, imposes tax on a residence basis and provides relief by way of a limited tax credit.<sup>795</sup> Brazil also provides relief for international economic double taxation by means of an indirect credit in certain circumstances.<sup>796</sup>

In 1932, Argentina, a capital importing country like South Africa, structured its income tax provisions on the basis of source.<sup>797</sup> In 1999, the residency basis of taxation was introduced and unilateral relief is provided by way of a tax credit granted for taxes 'actually paid on income earned abroad by the application of an analogous tax'.<sup>798</sup> This appears to be fairly similar to the way that the tax credit is applied in South Africa.

Both Brazil and Argentina make provision for the taxation of controlled foreign income. Argentina distinguishes between passive and active income of such controlled foreign companies, with the controlled foreign company rules applying to

---

<sup>793</sup> *The Political Economy of Taxation in Developing Countries: Challenges to Practitioners* The World Bank Group in collaboration with DFID, March 2008 at 22. See Schindel et al (note 59) at 64 for a discussion on Brazil.

<sup>794</sup> Celina Souza 'Brazil's Tax System: The Dilemmas of Policy Reform' Canadian Foundation for the Americas Policy Paper, February 2005 at 2. Available at [http://www.focal.ca/pdf/Brazil\\_Souza-FOCAL\\_Brazil%20Tax%20System%20Reform%20Dilemmas\\_February%202005\\_FPP-05-02\\_e.pdf](http://www.focal.ca/pdf/Brazil_Souza-FOCAL_Brazil%20Tax%20System%20Reform%20Dilemmas_February%202005_FPP-05-02_e.pdf) Souza, last accessed 04 September 2012; Branco (note 774) at 205.

<sup>795</sup> Schindel et al (note 59) at 64.

<sup>796</sup> Ibid.

<sup>797</sup> Figueroa (note 762) at 60.

<sup>798</sup> Schindel et al (note 59) at 63.

passive income.<sup>799</sup> Argentina also uses a blacklist that ‘includes countries, territories and special regimes considered to be of low or zero taxation’.<sup>800</sup> Brazil’s controlled foreign company provisions apply to foreign subsidiaries of Brazilian resident companies and, like South Africa, the income is taxed before it is distributed as a dividend.<sup>801</sup>

## 6.7 North American countries

Although the economies of Canada and the USA differ from that of South Africa, it is useful to consider the similarities between the cross border trade and investment rules with respect to double taxation relief. Both the USA and Canada tax on a worldwide basis, with the USA imposing tax on all those who qualify as US citizens.<sup>802</sup> Both countries provide relief for international double taxation in the form of a limited tax credit,<sup>803</sup> with Canada exempting dividends paid from active business income where the income is from countries ‘with which Canada has a tax treaty, or since 2008, a tax information exchange agreement’.<sup>804</sup> The USA also allows for the subsidiaries of US companies, that is, controlled foreign companies, to pay US taxes only when certain categories of income are remitted to the USA. In other words, it allows a deferral of this income.<sup>805</sup> In a simplified statement, the taxation of the

---

<sup>799</sup> Schindel et al (note 59) at 70.

<sup>800</sup> Schindel et al (note 59) at 70.

<sup>801</sup> Schindel et al (note 59) at 71.

<sup>802</sup> Ault et al (note 137) at 431–432.

<sup>803</sup> Ault et al (note 137) at 448 where it is stated that: ‘The United States makes most use of the credit approach ... and ‘w]ith respect to the specific systems, the United States employs a foreign tax credit for most foreign income, although there is a limited exemption for foreign-earned income’ and at 449 where it states that ‘Canada uses both the foreign tax credit method and an exemption system for certain income’.

<sup>804</sup> Ault et al (note 137) at 450.

<sup>805</sup> Ault et al (note 137) at 477–479; Avi-Yonah (note 101) at 1593–1594.

active categories of income is deferred.<sup>806</sup> Likewise, Canada defers the taxation of active income.<sup>807</sup>

## **6.8 United Kingdom**

The United Kingdom also taxes on a worldwide basis with a limited tax credit as relief for international double taxation.<sup>808</sup> It is in the process of reviewing the treatment of foreign sourced income and it seems as if the UK will be exempting certain types of foreign sourced income, in particular in relation to controlled foreign companies.<sup>809</sup>

## **6.9 Summation**

South Africa's change from source to residence has precedent in other similar jurisdictions such as India, Argentina and Brazil. Similarly, the use of the limited tax credit is uniform, as is the use of controlled foreign company rules. However, differences arise in the application of the tax credit with respect to the requirements for the application of the tax credit, as well as the different definitions ascribed to who and what qualifies as a resident.

---

<sup>806</sup> See Ault et al (note 137) at 478 for a more detailed explanation.

<sup>807</sup> See Ault et al (note 137) at 479 where he states that: 'Thus, in Canadian legislation, deferral is eliminated only for passive income, known as foreign accrual property income (FAPI), which is directly taxable regardless of the level of foreign tax imposed on the income'.

<sup>808</sup> Ault et al (note 137) at 449 where it is stated that: 'Until recently, the United Kingdom predominantly used the credit system'.

<sup>809</sup> See [http://www.hm-treasury.gov.uk/tax\\_foreign\\_branches.htm](http://www.hm-treasury.gov.uk/tax_foreign_branches.htm), last accessed 14 June 2011; [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm), last accessed 14 June 2011.

## **7 Chapter Seven**

### **Findings, conclusion and recommendations**

#### **7.1 Introduction**

The restructuring of the South African Income Tax Act to deal with the effects of cross border trade and investment provided an ideal case study to analyse the methods used to relieve, or eliminate, international double taxation in a recently opened developing economy. It provided an opportunity to set out a theoretical framework and the considerations that should be taken into account when changing the basis on which income tax is imposed. Such a change will, in turn, affect the methods used to relieve or eliminate international double taxation.

The methods used to relieve or eliminate international double taxation in cross border trade and investment were analysed in the context of whether 'source' or 'residence' was used as the basis of taxation for cross border trade and investment. The starting point of an analysis of the methods used to relieve international double taxation is therefore the choice between 'source' and 'residence'. Within the context of South Africa, this choice was illustrated by the change over five years, from 1998 to 2003. Prior to 1998, tax was almost exclusively imposed on the basis of the source of the income being located in South Africa. From 1998 onwards, the tax base was expanded to include certain non-South African sourced income received by or accrued to South African residents. First of all, the deemed source provisions were expanded and then, from 2001, tax was imposed on the worldwide income of South African residents but exempting business income. Finally in 2003, the exemption for business income was removed, resulting in tax being imposed on the worldwide income of South African residents. During these three periods, the basis on which tax was imposed on non-residents remained the same, namely that tax was still imposed

on non-residents on the basis of the source of their income being located in South Africa.

The change in the basis on which tax is imposed, particularly where the change is from imposing tax on income with its source located in a given country, to imposing tax on the residents of a given country, means that a method to relieve or eliminate international double taxation for those classified as residents, must be chosen. This method can either be the exemption, credit or deduction method and, within these three methods, a choice must be made with respect to the manner in which it is to be applied.

The two basic principles which, it is often stated, should underlie or be considered in the design of any system of taxation are equity and neutrality. Furthermore, the combination of the choice of the basis of taxation and the method chosen to relieve international double taxation should reflect the policy goals of a government in relation to the principles of equity and neutrality. The principle of equity provides that taxpayers should have equitable treatment; in cross border trade and investment, this can be reflected as either the benefit principle or ability-to-pay principle of equity. The benefit principle of equity provides for the equitable treatment between those persons whose income is derived from, or originated in, a country as a result of the services rendered and the support provided by that country. The tax paid is consideration for the benefits which allowed the income to be produced within that territory. By contrast, the ability-to-pay principle of equity provides for the equitable treatment of the residents of a country based on their nominal pre-tax income. The tax paid is related to the pre-tax income. The neutrality principle is based on the assumption that an assumed efficient market should not be

affected by taxation and further that a taxpayer should be neutral between the decisions to trade and invest in a particular country.

Fiscal legislation is one of the tools used by a government to implement its policy approach to cross border trade and investment. Therefore, it should follow that the approaches to equity and neutrality, as implemented by the choice of source or residence, as well as the method used to relieve international double taxation, should reflect a government's policy approach to cross border trade and investment. Within the context of South Africa, this involved an analysis of the combined effect of the change from 'source' to 'residence' and the change from the exemption method of relief being the default method of relief, to the credit method of relief being that default method.

A taxpayer will be affected by the changes in the basis on which tax is imposed and the method used to relieve international double taxation, insofar as the taxpayer becomes tax resident in a country, as a result of the change, and has to seek relief from international double taxation. The residence or non-residence status of a taxpayer, as a factor which affects the methods of relief for double taxation, was therefore considered through the lens of equity and neutrality. This aspect of 'residence' was extended to consider the legal form through which such a resident or non-resident may trade or invest, and also to consider the category of income which is received by or accrued to such a resident or non-resident. The juxtaposition of resident and non-resident, the legal form used, and the category of income, allowed a comparison of the equity and neutrality aspects of both residents and non-residents. Factors such as the definition and interpretation of residence, the legal form of trade and investment into and out of South Africa and the treatment of different forms or

categories of income, were taken into account. Therefore, this aspect of the analysis was formulated to consider and analyse three comparator relationships allowing the equity and neutrality aspects of cross border trade and investment to be considered in relation to these three comparisons. This enables a benchmark to be set for who and what is to be compared when considering equity and neutrality in cross border trade and investment. The three comparator relationships used in the study are:

- a comparison of outward and local trade and investment by South African residents;
- a comparison of the outward trade and investment by South African residents with traders and investors of the host country; and
- a comparison of inward trade and investment by non-residents with local trade and investment by South African residents.

The use of the three comparators as a benchmark indicates a process that a country should use when considering a change in its basis of taxation and the resultant change in its methods to relieve international double taxation. First, the reasons for changing the tax base must be compatible with the equitable basis on which tax is imposed. Second, the method of relief must be compatible with the chosen policy principles of equity and neutrality. This implies that equity and neutrality have been considered, both in the reasons for changing the tax base and in the choice of the appropriate method of relief. Finally, a comparison must be done between the tax treatment of residents and non-residents on the one hand, and between inward and outward trade and investment, on the other. The comparison would indicate whether there is equity and neutrality between these roles players as

well as between their activities. It is within this framework that the method chosen to relieve international double taxation must be analysed. The two consistent elements of the framework are the equity and neutrality considerations at each of the three stages. This implies that in structuring a cross border regime, both through domestic legislation and double taxation agreements, the over-arching consideration or, put another way, the underlying basis, has to be equity and neutrality.

The three-step structure for analysing the methods used to relieve international double taxation, with an underlying basis of equity and neutrality, provides a process to analyse changes and their effects. The resultant knowledge should prevent constant amendments and restructuring of the domestic legislation in relation to a country's cross border regime. In addition, if the process starts with equity and neutrality as the over-arching principles, it may also prevent the proliferation of tax planning schemes and structures as these possibilities would have been identified in the comparison process.

This process was used to analyse the South African approach to relieving or eliminating international double taxation and to answer the questions posed by this thesis.

## **7.2 What policy approach to equity and neutrality is reflected in the Income Tax Act?**

The analysis of the methods used to relieve international taxation from just prior to democracy until 2012 shows clear evidence that the cross border treatment of those classified as tax resident in South Africa has changed. Furthermore, the cross border treatment of South African residents' trade and investment has changed in a number of ways.

Prior to democracy, the issue of tax residency did not play a major role in determining whether or not relief was obtained for international double taxation because income tax was imposed on those persons whose source of income was located in South Africa. This economy at that time was characterised as a closed economy, with stringent exchange controls. It could therefore be argued that the use of source as the basis for taxation was not a true reflection of equity and neutrality. It can however be said that the use of the source basis of taxation implied, indirectly, that the exemption method of relief applied to income earned or received by South African residents from a source located outside South Africa. It can also be stated that the equitable basis on which tax was levied in South Africa was the benefit principle of taxation. This benefit principle applied to both residents of, and non-residents trading or investing in, South Africa. The applicable policy principle for inter-individual equity was the benefit principle, with capital import neutrality being the applicable neutrality principle.

A comparison of local and outward trade and investment by South African residents found that there was a potential difference between the post-tax incomes where the pre-tax incomes were the same. The difference arose as a result of the different tax rates and tax practices applicable in South Africa and in the host country of trade and investment. Inter-individual equity on the basis of ability to pay, therefore, did not apply. Instead recognition was given to circumstances under which the income arose and the country circumstances which gave those benefits. This meant that where South African residents traded in or invested in a foreign host country, the South Africa residents were competitive with host country traders and

investors and potentially at an advantage to those who were resident in other jurisdictions which imposed tax on the basis of residence.

A comparison of local trade and investment by South African residents and inward trade and investment by non-residents, indicates that although the benefit principle of equity applied to both residents and non-residents, in certain circumstances, non-residents were given preferential treatment when receiving or accruing income in the form of interest income. This particular exemption was (and still is) viewed as an incentive for non-residents to invest capital in South Africa. The relief for international double taxation, as provided in double taxation agreements entered into between South Africa and other contracting states was probably of greater importance for residents of the other contracting state than for South African residents. During this period the approach to equity was based largely on the benefit principle of equity and the approach to neutrality was based on capital import neutrality.

The legal form of the investment made a difference insofar as the foreign sourced income of a company or other legal entity was exempt while the foreign dividends received by the South African shareholders were not necessarily exempt from tax in South Africa. In addition, relief for economic double taxation experienced by the South African resident shareholder was not always provided.

The South African sourced dividend was also treated differently depending on whether it was received by a South African resident shareholder or a non-resident shareholder. The former was exempt from tax while the non-residents shareholders tax was imposed on the latter.

During the period between 1994 and 2000, referred to in this thesis as the transition period (so-called because the South African income tax system was undergoing a restructuring), the policy approach to equity and neutrality changed for South African residents. The change in the basis of taxation from 'source' to 'source-plus' meant that both the exemption and credit method of relief were used to relieve international double taxation for those who were tax resident in South Africa, depending on the category of income. The exemption method of relief still applied where the non-South African sourced income was active business income. However, non-South African sourced interest income or royalty income was deemed to be from a source located in South Africa, if it was received by a South African resident taxpayer, and a tax credit was provided in the event of international double taxation. The tax treatment of non-residents remained largely the same.

The introduction of a partial residence basis of taxation reflected the traditional argument that active income should be taxed in its country of source while passive income should be taxed in the investor's country of residence. It also allowed relief for economic double taxation experienced by South African residents earning foreign dividend income. In this way, it maintained a balance with respect to equity and neutrality. It maintained the benefit principle for active income and ensured that where South African businesses operated offshore, such businesses would be competitive. At the same time, it expanded the South African tax base by including foreign sourced passive income in the tax base. The basis upon which tax was imposed was a combination of the benefit and the ability-to-pay principles, depending on the perspective of the benefit principle and whether the taxpayer was a resident or a non-resident. During this period, both the benefit principle and ability-

to-pay principles to equity were reflected in the Income Tax Act. Similarly both capital import and capital export neutrality were reflected. This dual reflection with respect to South African residents was justifiable on two grounds – first, on the basis that the benefit principle of equity and the neutrality principle of capital import neutrality do not necessarily apply to passive income. The second was that a country in transition can justify a dual approach as a process of restructuring. As a country in transition, South Africa's steps taken to enter the global economy indicate that there was an underlying policy of applying the steps incrementally.

During this period, the role and importance of double taxation agreements increased. The use of residence for certain categories of income meant that the methods of relief contained in double taxation agreements had to be considered in the light of the changes to the basis of taxation. Given that most of the double taxation agreements entered into at the time provided relief in the form of a choice between a credit and a deduction, there was inconsistency between the relief offered in the Income Tax Act and the relief offered in double taxation agreements.

Along with the changes to source and to the methods of relief, this period is also characterised by the introduction of anti tax-avoidance measures in relation to cross border transactions, particularly the outward trade and investment transactions of South African residents. As these anti tax-avoidance measures affected whether tax was imposed on income received by or attributed to South African residents, the method used to relieve international double taxation of these measures had to be considered. For controlled foreign company anti tax-avoidance measures, the method of relief for income attributed to the South African resident shareholder varied

according to the category of income attributed to that shareholder – both the exemption method of relief and the credit method of relief applied.

A further factor that should have affected the choice of equity during the transition period was the enactment of the South African Constitution containing a Bill of Rights. In particular the Right to Equality as reflected in s 9 of the South African Constitution should have been taken into account in the approach to equity. It is submitted that whereas the difference in the equity approach to foreign-sourced active and passive income, with the former reflecting the benefit principle and the latter the ability-to-pay principle, may have been appropriate for the overall trade and investment policy, the approach should also have been consistent with the Constitutional imperative of equality. It is further submitted that an approach to equity that requires the tax burden to be just and equitable and to reflect similarities and differences, that is, substantive equality rather than formal equality, would find resonance within the South African context.

In 2001, a residence or worldwide basis of taxation was introduced which meant that all foreign sourced income, irrespective of the category, was included in the 'gross income' of the South African resident taxpayer. The almost sudden change to a fully-fledged residence system in 2001 to an extent undermined the earlier transitional process. It set in motion a tax structure which needed constant amendments and adjustments, as reflected in the number of amendments made to the structure of the Income Tax Act during the millennium period, and which continues to do so. The equitable basis on which tax was imposed changed from the benefit principle to the ability-to-pay principle for all South African residents and the emphasis was on the same pre-tax earnings being taxed the same, irrespective of

where such income was earned or the factors which gave rise to such income. The category of income which initially had differential treatment was foreign sourced active income which originated in certain designated countries. Depending on the country and its tax rates, the income was exempt from tax in South Africa. Thus initially, a comparison of inward and outward trade and investment by South African residents would have provided a different form of equity and neutrality, depending on whether or not the income from such trade and investment originated in a designated country. The differential treatment for non-residents was also found in the introduction of the headquarter company regime that provided non-resident investors and traders with the possibility of using this particular structure.

The legal form of such outward investment was not material as the treatment of a branch or a controlled foreign company subsidiary was the same due to the latter applying the designated country rules. This period was therefore characterised by the legal form of the outward investment not affecting the method of relief.

The one concern was the choice of the method of relief because it appeared that all three methods of relief were potentially available to the taxpayer. Furthermore, where both the Income Tax Act and the double taxation agreement provided a tax credit as the method of relief, the application and method of quantification in the two provisions differed.

In 2003, the exemption for income from designated countries was removed and the limited tax credit was introduced for all foreign sourced income received by or accrued to South African residents, except where the South African resident was a participant or shareholder in a controlled foreign company and the income from such

controlled foreign company was active income and did not fall into one of the specific provisions. Thus for all purposes, the applicable equity principle for South African residents was the ability-to-pay principle and capital export neutrality was the applicable neutrality principle.

The exception of the application of the exemption method of relief to active income of controlled foreign companies, which is still retained in the current version of s 9D, means that a different form of equity and neutrality applies to participants or shareholders of such controlled foreign companies. The use of the exemption method of relief for active income means that the benefit principle of equity applies and that the controlled foreign company is able to compete in its country of residence. By contrast, a limited tax credit is provided for foreign sourced income of a branch. Thus a different form of equity and neutrality exists for controlled foreign companies and branches, which means that there is the possibility of arbitrage through the use of a different legal form. This difference needs to be justified or remedied.

In 2008, the introduction of the deduction method of relief in s 6quat meant that the methods of relief became a combination of the tax credit and the deduction method. The combination of these two methods means that outward South African residents are treated differently, depending on whether the tax credit or the deduction is applicable, and also whether the requirements for these methods of relief are met, with the potential for non-relief. The different treatment and the requirements for these methods of relief mean that there is inconsistency in the approach to equity and neutrality. It is submitted that this inconsistency is a result and a consequence of the emphasis on tax avoidance and increasing the tax base. The result is continuous changes to prevent tax avoidance without taking into account the effect of such

changes on equity and neutrality. The consequence of not having equity and neutrality as an overarching policy principle means that taxpayers will continue to use the non-equity and non-neutral provisions to avoid paying taxes, resulting in further amendments to prevent this tax avoidance. The end result is a cycle which can only be stopped by means of an overarching policy approach to equity and neutrality.

### **7.3 How do the methods of relief chosen by South Africa compare with the methods of other countries?**

Except for those countries which still impose taxes on the basis of source, the imposition of tax on a worldwide basis together with the use of the limited tax credit is in line with the practice of other countries. Comparable countries such as India, Brazil, and Argentina impose tax on a worldwide basis and provide a limited tax credit as relief for international double taxation.

Although in the process of changing this, many African countries still use the source basis of taxation with very few having controlled foreign company legislation. It therefore appears that the foreign sourced income of their residents is not that important to many African countries.

Although the residence basis of taxation with the limited tax credit appears to be the choice for the countries surveyed, the specific details of the definition of residence, and the application of the tax credit and controlled foreign company rules, differ. The only comment that can be made with respect to the comparator countries is that on a superficial level, ability-to-pay equity and capital export neutrality appear to be the policy choices. However, as seen from the study of the South African tax system, as a substantive level, this may not necessarily be the end result.

#### **7.4 Is the method of relief found in the Income Tax Act consistent with the method of relief found in double taxation agreements?**

The use of the tax credit in both the Income Tax Act and in double taxation agreements appears to be an indication that the two provisions providing relief from international double taxation are consistent, giving the same equity and neutrality result. However, because the requirements for treaty relief and unilateral relief differ, the two can have a different result. Thus, although the policy might be the same, the end result may differ; although, such a difference may well be envisaged. An example of this is where a treaty provides greater relief in order to encourage trade and investment and such a difference results in inequity between South African residents' local and outward investment or between inward non-residents' and South African investment. It needs to be clear that such differences are intended. It is submitted that the difference between the treatment of income, in particular business income, under 'source' and 'permanent establishment' may not always be justifiable; in this regard it may be appropriate to consider using 'permanent establishment' instead of 'source'. Alternatively, it may be appropriate to consider using an expanded version of 'permanent establishment' in double taxation agreements to ensure consistency between the application of a double taxation agreement and the Income Tax Act in the taxation of non-residents and the relief provided for residents. For non-residents, the difference lies in whether the income attributed to South Africa is taxed on the basis of the 'source' of the income being located in South Africa, in the event of the application of the Income Tax Act or on the basis of a 'permanent establishment' being located in South Africa, in the event of the application of the double taxation agreement. For residents, the relief provided is dependent on whether the 'source' of the income is located in the host country, in the

event of the application of Income Tax Act, or whether the 'permanent establishment' is located in the host country, in the event of the application of the double taxation agreement.

#### **7.5 Does the method of relief take into account equity and neutrality?**

The methods of relief, as applied both in terms of the Income Tax Act and in the double taxation agreements provided with South Africa, at the very least have to be consistent with the Right to Equality as found in s 9 of the Constitution. Where this equality requirement is not met, and taxpayers are not treated on an equitable basis, this non-equity has to be justifiable in terms of s 36 of the Constitution. One area that would require such a justification would be differential treatment of outward investments by South African residents when the legal forms differ; that is, the different methods of relief applying to the active income of a branch relative to a subsidiary. A second area would be the differential treatment of losses depending on whether they are incurred inside or outside South Africa. This ring fencing of foreign losses has to be considered particularly in the light of countries such as Australia allowing such foreign losses to be offset against Australian sourced income.<sup>810</sup> A third area is the different forms of relief available in the Income Tax Act, compared to the relief provided in double taxation agreements. In addition, the alignment of the quantification and requirements between these two locations of relief, namely the Income Tax Act and double taxation agreements, may have to be justified, especially in the light of the taxpayer being able to choose between relief provided in these two locations. A fourth area is the differential treatment based on the category of income

---

<sup>810</sup> Bowden et al (note 471) at 106.

and whether or not a person qualifies as a resident or a non-resident. This differential treatment is evidenced by the differential treatment of South African sourced dividend income and foreign sourced dividend income received by South African residents and also by the differential treatment of interest income, depending on whether this interest income is received by or accrued to a resident or a non-resident. A fifth area that needs to be considered is relief for economic double taxation and the application of the participation exemption to a specific South African shareholding in the foreign company.

The five areas mentioned above indicate that there is no uniform approach to equity or neutrality with respect to the chosen methods of relief. The approach taken is dependent on the category of income, the legal form of such trade and investment and also whether or not the foreign branch makes a profit or a loss. These variables lend themselves to facilitating tax planning schemes and tax arbitrage.

It is also apparent from the discussion that, as a developing country South Africa's competitiveness is dependent on the tax rates of its developed trading counterparts. This places a limitation on tax rates, particularly the tax rates of companies if South Africa is to be competitive both in respect of outward trade and investment by South African companies and inward investment by non-residents. It may add an administrative burden on the South African National Treasury and other relevant government departments to ensure that South African tax rates are not out of line with those of their trading counterparts. In addition, it may affect the amount of revenue that can be raised from company taxation. This administrative burden arises partly from the residence based system combined with the tax credit and also from

the need to ensure that inward investors are not burdened by extra taxation for which they will not get relief in their country of residence.

## **7.6 Recommendations**

The use of the tax credit as the default method to relieve or eliminate international double taxation is in line with international tax practice as seen from the brief survey of countries. Nevertheless, the restructuring of a country's tax system when a formerly closed economy enters the international global market requires an analysis of the effect of such restructuring on the residents of such a country. The methods used to relieve or eliminate international double taxation should follow the trade and investment policies of a country, and should not purely be concerned with tax avoidance or expanding the tax base. The choice of method affects both the equity and neutrality of residents with respect to cross border trade and investment. It is therefore imperative that when a country embarks on a change in its jurisdictional link which would affect its cross border trade and investment, it does so taking into account the effect that such change would have on equity and neutrality through the choice of the method it chooses to relieve international double taxation.

The use of South Africa as a case study shows that, in order to ensure a smooth transition from 'source' to 'residence', the methods used to relieve or eliminate international double taxation must be analysed through the lens of equity and neutrality. The choice of the method of relief must reflect the policy approach of government with respect to outward and inward trade and investment. In order to do this, a comparison must be made between all the parties affected. Therefore, it is recommended that a comparison be made between the effects of the method of relief on inward and outward trade and investment of residents of a country; on outward

trade and investment of residents and of the host country traders and investors; and on inward trade and investment by residents and by non-residents. These comparisons would have to take into account the different legal forms which trade and investment can and do take. In this way, equity and neutrality becomes the starting and over-arching principle for any cross border tax restructuring process when considering the methods used to eliminate double taxation.

This approach must be applied for relief offered in both the Income Tax Act and double taxation agreements. To ensure consistency and at the same time to ensure that the political and economic dynamics of double taxation agreements are preserved, it is recommended that the election between relief offered in the Income Tax Act and in double taxation agreements be removed. In preference, the approach of countries such as India<sup>811</sup> should be followed; the unilateral relief in the domestic legislation would only be used in the absence of a double taxation agreement.

---

<sup>811</sup> Dave et al (note 721); Jolly et al (note 792) at 373.

**List of Appendices**

Appendix 1: Treaties where the test for residence differs from the test in the Income Tax Act.

Appendix 2: Methods of relief provided by other contracting states with which South Africa has entered into double taxation agreements.

Appendix 3: Selected African countries' jurisdictional links and methods of relief.

Appendix 4: India and Australia: Jurisdictional links and methods of relief.

Appendix 5: Argentina and Brazil: Jurisdictional links and methods of relief.

**Appendix 1: Treaties where the test for residence differs from that of the Income Tax Act**

DTA country	Individuals	Other legal persons
Algeria	Ordinarily resident in SA	POEM <sup>812</sup> in SA
Australia	Ordinarily resident in SA	POEM in SA
Austria	Ordinarily resident in SA	POEM in SA
Belgium	Ordinarily resident in SA	POEM in SA
Canada	Ordinarily resident in SA	POEM in SA
China (People's republic)	Ordinarily resident in SA	POEM in SA
China (Taiwan)	Ordinarily resident in SA	POEM in SA
Croatia	Ordinarily resident in SA	POEM in SA
Cyprus	Ordinarily resident in SA	POEM in SA
Czech Republic	Ordinarily resident in SA	POEM in SA
Denmark	Ordinarily resident in SA	POEM in SA
Egypt	Ordinarily resident in SA	POEM in SA
Finland	Ordinarily resident in SA	POEM in SA
France	Ordinarily resident in SA	POEM in SA
Germany	Ordinarily resident in SA	Any company which is incorporated, managed or controlled in SA
Hellenic Republic	Ordinarily resident in SA	POEM in SA
Hungary	Ordinarily resident in SA	Any legal person which is incorporated, managed or controlled in SA
India	Ordinarily resident in SA	POEM in SA
Indonesia	Ordinarily resident in SA	POEM in SA
Iran	Ordinarily resident in SA	POEM in SA
Ireland	Ordinarily resident in SA	POEM in SA
Italy	Ordinarily resident in SA	POEM in SA
Japan	Ordinarily resident in SA	POEM in SA
Korea	Ordinarily resident in SA	POEM in SA
Lesotho	Ordinarily resident in SA	POEM in SA
Luxembourg	Ordinarily residents in SA	POEM in SA
Malawi	Any person ordinarily resident	Any person ordinarily resident
Malta	Ordinarily resident	POEM in SA

---

<sup>812</sup> Abbreviated form of 'Place of Effective Management'.

Mauritius	Ordinarily resident in SA	POEM in SA
Namibia	Ordinarily resident in SA	POEM in SA
Norway	Ordinarily resident in SA	POEM in SA
Pakistan	Ordinarily resident in SA	POEM in SA
Poland	Ordinarily resident in SA	POEM in SA
Romania	Ordinarily resident in SA	
Russian Federation	Ordinarily resident in SA	
Seychelles	Ordinarily resident in SA	POEM in SA
Singapore	Ordinarily resident in SA	POEM in SA
Slovak Republic	Ordinarily resident in SA	POEM in SA
Sweden	Ordinarily resident in SA	POEM in SA
Thailand	Ordinarily resident	POEM in SA
Tunisia	Ordinarily resident	POEM in SA
Uganda	Ordinarily resident	
USA	Ordinarily resident	
Zambia	Ordinarily resident in SA	Business is managed and controlled in SA

**Appendix 2: Methods of relief provided by other contracting states with which South Africa has entered into double taxation agreements**

Residence country	Business income – PE in SA	Economic <b>double taxation on dividends</b>	Dividend <b>income</b>	Interest <b>income</b>
Algeria	Limited credit	No provision	Limited credit	Limited credit
Australia	Limited credit	Limited credit takes into account SA tax paid by a SA resident company on profits out of which it pays a dividend to an Australian resident company which controls at least 10% of the voting power of the SA resident company.	Limited credit	Limited credit
Austria	Exemption with progression		Limited credit	Exemption with progression
Belarus	Limited credit		Limited credit	Limited credit
Belgium	Exemption with progression	Dividends derived by a Belgian resident company from a SA resident company shall be exempt from the corporate income tax in Belgium under the conditions and within the limits provided for in Belgian law.	Limited credit	Limited credit
Botswana	Limited credit		Limited credit	Limited credit
Brazil	Limited credit; exemption with progression where income is exempt in terms of the convention		Limited credit	Limited credit
Bulgaria	Exemption with progression		Limited credit	Limited credit
Canada	Limited tax credit with exemption with progression for income exempt in terms of the Convention	A Canadian resident company allowed a credit for dividends received by it out of the exempt surplus of its foreign affiliate resident in SA.		
China (People's republic)	Limited credit		Limited credit	Limited credit
China (Taiwan)	Limited tax credit		Limited credit	Limited credit
Croatia	Limited credit		Limited credit	Limited credit
Cyprus	Limited credit	Limited credit to take into account tax paid by a SA resident company on its profits out of which it pays a dividend to a Cypriot resident company.	Limited credit	Limited credit

Czech Republic	Limited credit		Limited credit	Limited credit
Denmark	Limited credit; exemption with progression for exempt income		Limited credit	Limited credit
Egypt	Limited credit; exemption with progression for exempt income		Limited credit	Limited credit
Ethiopia	Limited credit, exemption with progression for exempt income.		Limited credit	Limited credit
Finland	Limited credit; exemption with progression for exempt income	Dividends paid by a SA resident company to a Finnish resident company which controls at least 10 per cent of the voting power in the SA resident company shall be exempt from Finnish tax.		
France	Limited credit		Limited credit	Limited credit
Germany	Exemption with progression except for certain types of dividend, interest and remuneration income for which a limited tax credit is provided	Exemption with progression where dividends paid by a SA resident to a German resident company which owns at least 25% of the voting shares of the SA resident company.	Limited credit for certain categories	Limited credit for certain categories
Ghana	Limited credit	Limited credit takes into account the tax paid by a SA resident company on the income out of which the dividend is paid to a Ghanaian resident company which controls at least 10 per cent of the capital of the SA resident company paying the dividends.	Limited credit	Limited credit
Hellenic Republic	Limited credit		Limited credit	Limited credit
Hungary	Exemption with progression with a limited tax credit for Article 10 income; exemption with progression for exempt income			
India	Limited credit		Limited credit	Limited credit
Indonesia	Limited credit		Limited credit	Limited credit
Iran	Limited tax credit;		Limited credit	Limited credit

	exemption with progression for exempt income			
Ireland	Limited credit; exemption with progression for exempt income	The limited credit takes into account the SA tax paid on profits out of which dividends are paid to an Irish resident company which controls at least 10 per cent of the voting power in the SA resident company paying the dividend.	Limited credit	Limited credit
Israel	Limited credit		Limited credit	Limited credit
Italy	Limited credit		Limited credit	Limited credit
Japan	Limited credit	The limited credit takes into account tax paid by the SA resident company on its income out of which the dividend is paid to an Japanese resident company which owns at least 25% of the voting shares or total shares issued by the SA resident company.	Limited credit	Limited credit
Korea	Limited credit			Limited credit
Kuwait	Limited credit		Limited credit	Limited credit
Lesotho	Limited credit		Limited credit	Limited credit
Luxembourg	Exemption with progression except for art 10 and art 18(1).	Dividends received by a Luxembourg resident company from SA sources are exempt in Luxembourg, provided that the Luxembourg resident company owns at least 10 per cent of the capital of the company paying the dividends and this company is subject in SA to an income tax corresponding to the Luxembourg corporation tax.	Limited credit	
Malawi	Limited credit			
Malta	Limited credit		Limited credit	Limited credit
Mauritius	Limited credit	The limited credit shall take into account any additional tax paid in the case of a dividend income in SA by the company on the profits out of which the dividend is paid and borne by the recipient of the dividend. The credit shall take into account SA tax paid by the SA resident company on the profit out of which the dividend was paid to the Mauritian	Limited credit	Limited credit

		resident company which control at least 10 per cent of the capital of the SA resident company paying the dividend.		
Malaysia	Limited credit	The credit to take into account the SA tax paid by a SA resident company on the income out of which the dividend is paid to a Malaysian resident company which owns not less than 25 per cent of the voting shares of the company paying the dividend.	Limited credit	Limited credit
Mozambique	Limited credit	The credit shall take into account the SA tax paid by a SA resident company on the portion of profits out of which the dividend is paid to Mozambican resident company who controls at least 25 per cent of the capital of the company paying the dividend.	Limited credit	Limited credit
Namibia	Limited credit		Limited credit	Limited credit
Netherlands	Exemption by reduction and limited credit		Exemption by reduction and limited credit	Exemption by reduction and limited credit
New Zealand	Limited credit	Excludes the profits out of which the dividend was paid.	Limited credit	Limited credit
Nigeria	Limited credit	Credit to take into account the SA tax paid on the SA resident company profits from which the dividend is paid to a Nigerian resident company which controls at least 10 per cent of the voting power in the company paying the dividend.	Limited credit	Limited credit
Norway	Limited credit; exemption with progression for exempt income		Limited credit	Limited credit
Oman Sultanate	Limited credit		Limited credit	Limited credit
Pakistan	Limited credit		Limited credit	Limited credit
Poland	Exemption with progression		Limited credit	Limited credit
Portugal	Limited credit; exemption with progression for income exempt in terms of the convention		Limited credit	Limited credit
Romania	Limited credit; tax sparing		Limited credit	Limited credit

	provision			
Russian Federation	Limited credit			
Saudi Arabia	Limited credit		Limited credit	Limited credit
Seychelles	Limited credit; tax sparing provision		Limited credit	Limited credit
Singapore	Limited credit	Where a dividend paid by a SA resident company to a Singaporean resident company which owns not less than 10 per cent of the share capital of the SA resident company, the credit shall take into account the SA tax paid by that company on the portion of its profits out of which the dividend is paid.	Limited credit	Limited credit
Slovakia	Limited credit		Limited credit	Limited credit
Swaziland	Limited credit; tax sparing provision		Limited credit	Limited credit
Sweden	Limited credit; exemption with progression for exempt income	Dividends paid by a SA resident company to a Swedish resident company shall be exempt from Swedish tax according to the provisions of Swedish law governing the exemption of tax on dividends paid to Swedish company by subsidiaries abroad.		
Switzerland	Exemption with progression		Limited tax credit or lump sum reduction or partial exemption of such dividends	Limited tax credit or a lump sum reduction or partial exemption of such interest
Tanzania	Limited credit		Limited credit	Limited credit
Thailand	Limited credit; tax sparing provision		Limited credit	Limited credit
Tunisia	Limited credit; tax sparing provision	Where a dividend is distributed by a company which is a resident of a Contracting State to a resident of the other Contracting State who owns, directly or indirectly, not less than 5 per cent of the share capital of the distributing co, the deduction in subparagraph (a) shall take into account the tax paid by that company on the profits out of which the dividend is paid.		
Turkey	Limited credit; exemption with progression for exempt income		Limited credit	Limited credit

Uganda	Limited credit; exemption with progression for exempt income		Limited credit	Limited credit
Ukraine	Limited credit		Limited credit	Limited credit
UK	Limited credit	Where a dividend is paid by a SA resident company to a UK resident company 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 SA tax for which credit may be allowed under the provisions of sub-paragraph (a) of this paragraph) the SA tax payable by the company in respect of the profits out of which such dividend is paid.		
USA	Limited credit	Credit where a USA company owns at least 10 per cent of the voting stock of a company which is a resident of SA and from which the USA company receives dividends; the SA income tax paid by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.		
Zambia	Credit		Limited credit	Exempt

**Appendix 3: African countries' jurisdictional links and methods of relief**

Country	Jurisdiction link for residents	Foreign sourced business income	Foreign sourced interest income	Foreign sourced dividend income	Foreign sourced royalty income	Method of relief for residents	Non-residents treatment
Angola <sup>813</sup>	Source basis	Exempt	Exempt in Angola.	Exempt in Angola	Exempt	Exemption method of relief implied by the use of source	Taxed on Angolan sourced income with certain types of incentives which exempt income
Botswana <sup>814</sup>	Actual and deeming source provisions; the latter applies to income which has accrued to a resident of Botswana in respect of investments made outside of or any business carried on outside Botswana	Taxed to the extent that it is remitted or paid into a bank account in Botswana	Taxed to the extent that the deeming source provisions apply	Taxed to the extent that the deeming source provisions apply	Taxed to the extent that the deeming source provisions apply	Ordinary credit; treaty relief is mandatory	Dividends withholding tax which is available as a credit against the addition company tax
Ghana <sup>815</sup>	Residence where the income is brought into or received in Ghana	Taxed in Ghana unless attributable to a permanent establishment of that resident outside Ghana	Taxed in Ghana	Taxed in Ghana in the form of a withholding tax on dividends	Taxed in Ghana	Foreign tax credit granted on a source-by-source basis with no provision for carry-over of excess credit.	Taxed in Ghana on basis of source but are incentives for non-residents

<sup>813</sup> P. Dias de Almeida, 'Angola - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 02 Sep 2011.

<sup>814</sup> J. Amos, 'Botswana - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 02 Sep 2011.

<sup>815</sup> K. Munyandi, Ghana - Corporate Taxation, Country; Business and Investment; Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Kenya <sup>816</sup>	In general source based	Taxed in Kenya if it relates to a foreign branch of a resident entity from a business partly carried on in Kenya and partly outside of Kenya	Not taxed in Kenya	Not taxed in Kenya	Not taxed in Kenya	Unilateral relief is provided by way of deducting the foreign tax as an expense. Double taxation agreements, usually have the credit method of relief.	
Malawi <sup>817</sup>	In general source based, unless deeming source provision applies	Exempt	Exempt	Exempt unless the dividend is attributable to the taxable income of a company incorporated in Malawi	Exempt unless related to usage of Malawi-source intellectual property	In both domestic and treaty situations, Malawi relieves double taxation using a limited credit method, on a source-by-source basis.	The gross taxable income of a non-resident company is taxable in Malawi. Dividends, certain interest payments, royalties, commissions and fees are subject to a final withholding tax of 10 per cent.
Mauritius <sup>818</sup>	Residence					A limited tax credit. Treaty relief is mandatory and not optional. Excess credit cannot be carried forward to a subsequent year.	

<sup>816</sup> F. Omond, 'Kenya' - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.10.06; F. Omond, 'Kenya - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

<sup>817</sup> K. Munyandi 'Malawi - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011; K. Munyandi 'Malawi - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Namibia <sup>819</sup>	Source basis in terms of the Income Tax Act of 1981 as amended	Exempt unless deeming provisions such as the proceeds from any contract made in Namibia	Exempt unless fall into deeming provisions such as for interest received by or accrued to a residence company.	Exempt unless fall into deeming provisions such as certain dividends received by or accrued to a resident company	Exempt unless fall into deeming provisions	Unilateral relief is by way of the ordinary tax credit; no provision for carrying forward of credits and no provision for economic double taxation. Where available, treaty relief is mandatory.	Withholding taxes on dividends, interest and royalty payments. Certain types of interest payments to non-residents are exempt.
Uganda <sup>820</sup>	Residence	Taxed in Uganda	Taxed in Uganda	Taxed in Uganda	Taxed in Uganda	Unilateral relief is a limited tax credit	Withholding taxes on dividends, interest and royalties received by non-residents
Nigeria <sup>821</sup>	Residence	Taxed in Nigeria	Taxed in Nigeria	Taxed in Nigeria	Taxed in Nigeria	Only grants unilateral double tax relief for Commonwealth countries and the Republic of Ireland, according to a percentage calculation. DTA relief is in the form of ordinary tax credit and is optional.	Withholding taxes on dividends, interest and royalties paid to non-residents. Certain types of interest income of non-residents are exempt.

<sup>818</sup> R. Hamzaoui, 'Mauritius - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

<sup>819</sup> J. Amos, 'Namibia - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011. J. Amos 'Namibia - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

<sup>820</sup> P. Namubiru & K. Munyandi, 'Uganda - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011. P. Namubiru, & K. Munyandi, 'Uganda - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Zambia <sup>822</sup>	Source with deeming source provisions	Exempt except for income to a resident company arising from a business partly in Zambia and partly outside Zambia	Interest income of a resident from a source outside Zambia is included in the income of that resident.	Dividend income of a resident from a source outside Zambia is included in the income of that resident.	Exempt	Unilateral relief by way of the credit method, on a source-by-source basis. Quantity of tax credit depends on the whether use a treaty or a DTA.	Withholding tax on interest, royalties, dividends, gross business income of a non-resident
Zimbabwe <sup>823</sup>	Source with deeming source provisions	Exempt except where deeming source provisions apply such as income from the contract for the sale of goods within Zimbabwe	Exempt unless it is interest income received by a person ordinarily resident in Zimbabwe which is deemed to be from a Zimbabwe source	Exempt unless it is foreign sourced dividend income received by a person ordinarily resident in Zimbabwe which is deemed to be from a Zimbabwe source	Exempt unless it is royalties, payment for knowhow, for the use of or the right to use a patent, design, copyright, trademark, film, which is deemed to be from a Zimbabwe source	Unilateral relief and treaty relief by way of a limited tax credit, on a source-by-source basis	Interest income received by a non-resident is exempt from tax. A withholding tax is imposed in respect of gross dividends and royalties.

<sup>821</sup> K. Munyandi, 'Nigeria - Corporate Taxation, Country Surveys' IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.10.06; F. Yusuf, 'Nigeria - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

<sup>822</sup> K. Munyandi, 'Zambia - Corporate Taxation, Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011; K. Munyandi, 'Zambia - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

<sup>823</sup> K. Munyandi, 'Zimbabwe - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011; K. Munyandi, 'Zimbabwe - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

**Appendix 4: Asian countries' and Australian jurisdictional links and methods of relief**

Country	Jurisdictional link	Foreign sourced business income	Foreign sourced interest income	Foreign sourced dividend income	Foreign sourced royalty income	Method of relief for residents	Controlled foreign company rules	Economic double taxation	Foreign sourced losses/expenses
Australia <sup>824</sup>	Residence	Foreign active branch income and capital gains of companies is exempt	Taxed in Australia	Taxed in Australia unless the participation exemption (10 per cent shareholding by Australian or an Australian related company) applies.	No exemption in domestic law for royalties	Limited tax credit; unused credits carried forward.	Taxes foreign passive income on a current basis	Participation exemption where the taxpayer has a voting interest of 10 per cent or more	With effect from 1 July 2008, Australian rules permit foreign losses to be offset against all domestic and foreign income.
India <sup>825</sup>	Residence basis in a receipt, and not a not remittance basis	Residence basis		Taxed in India		Unilateral limited tax credit.	No effective controlled foreign company regime	Relief provided for dividends derived from an Indian company which has paid dividend distribution tax in India	No specific rules

<sup>824</sup> Bowden et al (note 471).

<sup>825</sup> Dave et al (note 721); Jolly et al (note 792).

**Appendix 5: South American countries' jurisdictional links and methods of relief**

Country	Jurisdictional link	Foreign sourced business income	Foreign sourced interest income	Foreign sourced dividend income	Foreign sourced royalty income	Method of relief for residents	Controlled foreign company rules	Economic double taxation relief	Foreign source losses/expenses
Argentina <sup>826</sup>	Residence	Taxed in Argentina. Taxation of foreign sourced active business income is deferred until an actual dividend is distributed.	Taxed in Argentina	Dividends from subsidiaries or portfolio investments located overseas are exempt unless equalisation tax applies.	Taxed in Argentina	Unilateral tax credit with a five year carry forward period. DTAs provide a credit except for treaties with Bolivia, Brazil and Chile.	Have CFC rules for passive income derived by a company in a low tax jurisdiction	In certain circumstances for dividends distributed by subsidiaries incorporated abroad	Can only offset foreign losses against foreign source income. Expenses incurred outside Argentina can only be computed against foreign source income.
Brazil <sup>827</sup>	Residence	Taxed in Argentina				Limited direct tax credit on income of any kind	Have CFC rules for profits earned by its foreign controlled or affiliated companies where the shareholding is more than 10 per cent	Economic double taxation is relieved in certain circumstances such as where dividends are distributed by a Brazilian resident company to both resident and non-resident shareholders.	

<sup>826</sup> Information from Schindel et al (note 59); Figueroa (note 762).

<sup>827</sup> Information from Schindel et al (note 59); Branco (note 774).

## **BIBLIOGRAPHY**

### **Primary sources**

#### **Indian Case law**

*Vodafone International Holdings B.V. v Union of India & Another* The Supreme Court of India, Civil Appellate Jurisdiction, Civil Appeal No. of 2012. Available from the IBFD at [http://ip-online2.ibfd.org/collections/ttcltd/html/cl\\_in\\_2012-01-20\\_1-fulltext.html](http://ip-online2.ibfd.org/collections/ttcltd/html/cl_in_2012-01-20_1-fulltext.html), last accessed 27 August 2012.

#### **South African case law**

*Boyd v Commissioner for Inland Revenue* 1951 (3) SA 525 (A).

*Commissioner for Inland Revenue v Epstein* 1954 (3) SA 689 (A), 19 SATC 221.

*Commissioner for Inland Revenue v Kuttel* 1992 (3) SA 242 (A), 54 SATC 298.

*Commissioner for Inland Revenue v Lever Bros* 1946 AD 441; 14 SATC 1.

*Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (AD).

*Cohen v Commissioner for Inland Revenue* 1946 AD 174, 13 SATC 362.

*Commissioner for South African Revenue Services v Volkswagen* 70 SATC 195.

*First National Bank of Southern Africa Ltd v Commissioner for South African Revenue Service* 64 SATC 245.

*Kerguelen Sealing & Whaling Co Ltd v Commissioner for Inland Revenue* 1939 AD 487.

*Millin v Commissioner for Inland Revenue* 1928 AD 207, 3 SATC 170.

*Tuck v Commissioner for Inland Revenue* 1988 (3) SA 819 (A), 50 SATC 98.

*The Oceanic Trust Company Ltd N.O. [in its capacity as the trustee for the time being of Specialised Insurance Solutions (Mauritius) Trust, MOBAA/OT/338] v The Commissioner for the South African Revenue Service*, unreported judgement of the Western Cape High Court of South Africa, delivered 13 June 2011. Available at <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=69556>, last accessed 27 November 2012.

*Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61 (8 MAY 2012). Available from [sars.gov.za](http://sars.gov.za), last accessed on 29 August 2012.

#### **United Kingdom case law**

*Bricom Holdings v Inland Revenue Commissioners* 1997 WL 1104065; *Bricom Holdings Ltd v IRC* 1997 STC 1179 (CA).

*George Wimpey International Ltd v Rolfe* [1989] STC 609.

*Yates v GCA International Ltd* [1991] STC 157 ChD.

#### **Case law of the USA**

*Mary D Biddle v Commissioner* (1938) 302 US 573.

#### **South African Legislation**

Constitution of the Republic of South Africa, Act No.108 of 1996.

Income Tax Act No. 58 of 1962, as amended from time to time.

Income Tax Act No. 88 of 1965.

Income Tax Act No. 89 of 1969.

Income Tax No. 94 of 1983.

Income Tax Act No. 85 of 1987.

Income Tax Act No. 21 of 1995.

Income Tax Act No. 28 of 1997.

Taxation Laws Amendment Act No. 30 of 1998.

Revenue Laws Amendment Act No. 53 of 1999.

Taxation Laws Amendment Act No. 30 of 2000.

Revenue Laws Amendment Act No. 59 of 2000.

Exchange Control Amnesty and Amendment of Taxation Laws Act No. 12 of 2003.

Revenue Laws Amendment Act No. 45 of 2003.

Revenue Laws Amendment Act No. 31 of 2005.

Revenue Laws Second Amendment Act No. 32 of 2005.

Revenue Laws Amendment Act No. 35 of 2007.

Revenue Laws Amendment Act No. 60 of 2008.

Taxation Laws Amendment Act No. 17 of 2009.

Taxation Laws Amendment Act No. 7 of 2010.

Taxation Laws Amendment Act No. 24 of 2011.

Revenue Laws Act No. 13 of 2012.

### **Treaties and conventions**

*Organisation for Economic Development and Co-operation Model Tax Convention on Income and on Capital* (Condensed Version) 2005 Paris:OECD.

*Organisation for Economic Development and Co-operation Model Tax Convention on Income and on Capital* (Condensed Version) 2010 Paris: OECD.

*United Nations Model Tax Convention between Developed and Developing Countries* New York: United Nations (2001). Available at <http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf>, last accessed 21 November 2012.

*United Nations Model Tax Convention between Developed and Developing Countries* New York: United Nations (2011) Available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf), last accessed 21 November 2012.

### **List of Double Taxation Treaties entered into by South Africa with other contracting states**

Algeria	GG No 21303 dated 2000-06-21
Australia	GG No 20761 dated 1999-12-24
Australia Protocol	GG No 31721 dated 2008-12-23

Austria	GG No 17965 dated 1997-04-30
Belarus	GG No 25914 dated 2004-01-15
Belgium	GG No 19437 dated 1998-11-02
Botswana	GG No 26342 dated 2004-05-12
Brazil	GG No. 29073 dated 2006-07-28
Bulgaria	GG No 27517 dated 2005-04-22
Canada	GG No 17985 dated 1997-05-07
China (People's Republic of)	GG No 22041 dated 2001-02-02
Croatia	GG No 18460 dated 1997-11-21
Cyprus	GG No 19638 dated 1998-12-22
Czech Republic	GG No 18603 dated 1998-01-07
Denmark	GG No 16891 dated 1995-12-22
Egypt	GG No 19706 dated 1999-01-22
Ethiopia	GG No 28494 dated 2006-02-10
Finland	GG No 16862 dated 1995-12-01
France	GG No 16681 dated 1995-09-27
Germany	GG No 3898 dated 1973-05-25

Ghana	GG No 29856 dated 2007-05-18
Greece	GG No 24996 dated 2003-03-03
Hungary	GG No 17438 dated 1996-09-13
India	GG No 18545 dated 1997-12-12
Indonesia	GG No 19766 dated 1999-02-16
Iran	GG No 19637 dated 1998-12-22
Ireland	GG No 18552 dated 1997-12-15
Israel	GG No 6577 dated 1979-07-13
Italy	GG No 19823 dated 1999-03-08
Japan	GG No 18391 dated 1997-10-27
Korea	GG No 16918 dated 1996-01-26
Kuwait	GG No 29815 dated 2007-04-20
Lesotho	GG No 17948 dated 1997-04-22
Luxembourg	GG No 21852 dated 2000-12-06
Malawi	GG No 1479 dated 1971-08-13
Malaysia	GG No 29021 dated 2006-07-13
Malta	GG No 18461 dated 1997-11-21

Mauritius	GG No 18111 dated 1997-07-02
Mexico	GG No 33460 dated 2010-08-24
Mozambique	GG No 31983 dated 2009-03-13
Namibia	GG No 19780 dated 1999-02-19
Netherlands	GG No 31797 dated 2009-01-23
Netherlands Protocol	GG No 31795 dated 2009-01-23
New Zealand	GG No 26798 dated 2004-09-17
Nigeria	GG No 31241 dated 2008-07-22
Norway	GG No 17504 dated 1996-10-15
Oman	GG No 25913 dated 2004-01-15
Pakistan	GG No 19849 dated 1999-03-17
Poland	GG No 17201 dated 1996-05-16
Portugal	GG No 31720 dated 2008-12-23
Romania	GG No 16680 dated 1995-09-27
Russian Federation	GG No 21395 dated 2000-07-20
Rwanda	GG No 33475 dated 2010-08-27 3
Saudi Arabia	GG No 31796: dated 2009-01-23

Seychelles	GG No 25646 dated 2003-10-30
Singapore	GG No 18599 dated 1998-01-02
Slovak Republic	GG No 20409 dated 1999-08-25
Spain	GG No 30837 dated 2008-03-12
Swaziland	GG No 27637 dated 2005-06-01
Sweden	GG No 16890 dated 1995-12-27
Switzerland	GG No 31967 dated 2009-03-06
Taiwan	GG No 17408 dated 1996-09-03
Tanzania	GG No 30039 dated 2007-07-04
Thailand	GG No 17409 dated 1996-09-03
Tunisia	GG No 20728 dated 1999-12-15
Turkey	GG No 29464 dated 2006-12-11
Uganda	GG No 22313 dated 2001-05-24
Ukraine	GG No 27150 dated 2005-01-10
United Kingdom	GG No 24335 dated 2003-01-31
United States of America	GG No 18553 dated 1997-12-15
Zambia	See Proclamations No. 174 of 1956 and 60 of 1960

Zimbabwe	GG No 1234 dated 1965-09-24
----------	-----------------------------

**Official documents, publications and reports****List of South African National Treasury Explanatory Memoranda**

Explanatory Memorandum on the Income Tax Bill, 1997. Available at <http://www.sars.gov.za/home.asp?pid=2631#>., last accessed 15 November 2012.

Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 30 September 2011

Explanatory Memorandum on the Taxation Laws Amendment Bill, 2000. Available at <http://www.sars.gov.za/home.asp?pid=2631#>., last accessed 15 November 2012.

Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 28 November 2012.

Explanatory Memorandum on the Exchange Control Amnesty and Amendment of Taxation Laws Bill, 2003. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 16 November 2012.

Memorandum on the Revenue Laws Second Amendment Bill, 2005. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 27 November 2012.

Explanatory Memorandum on the Revenue laws Amendment Bill 2007. Available at <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=58738>, last accessed 29 November 2012.

Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008. Available at <http://www.sars.gov.za/home.asp?pid=2631#>; last accessed 29 November 2012.

Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 29 November 2012.

Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010. Available at <http://www.sars.gov.za/Tools/Documents/DocumentDownload.asp?FileID=63735>, last accessed 26 November 2012.

Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 28 November 2012.

Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012. Available at <http://www.sars.gov.za/home.asp?pid=2631#>, last accessed 13 August 2012.

#### **South African Revenue Services Interpretation Notes**

South African Revenue Service Income Tax Interpretation Note No. 6 'Residents: Place of Effective management (persons other than Natural Persons).' 26 March 2002. Available at <http://www.sars.gov.za/home.asp?pid=5993#>, last accessed 29 November 2012.

South African Revenue Service Interpretation Note No.18 (Issue 2) 'Rebate or deduction for foreign taxes on income' 31 March 2009. Available at <http://www.sars.gov.za>, last accessed 26 November 2012.

#### **South African government commissions**

The Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa' RP 86/1970.

The Commission of Enquiry into the Tax Structure of the Republic of South Africa, RP 34/1987.

The Commission of Enquiry into Certain Aspects of the Tax Structure of South Africa, GG 15924, *Regulation Gazette* 5378 of 1994. Available at <http://www.treasury.gov.za/publications/other/katz/default.asp>, last accessed 13 November 2012.

The Fifth Interim Report of the Katz Commission titled 'Basing the South African Income Tax System on the Source or Residence Principles – Options and Recommendations.' Available at <http://www.treasury.gov.za/publications/other/katz/5.pdf>, last accessed on 13 November 2012.

### **Other**

National Budget Speech delivered by Trevor A. Manual, Minister of Finance, Republic of South Africa on 12 March 1997. Available at <http://www.info.gov.za/speeches/1997/000223318p2003.htm>, last accessed 15 November 2012.

National Budget Speech delivered by Trevor A. Manual, Minister of Finance, Republic of South Africa on 23 February 2000. Available at <http://www.treasury.gov.za/documents/national%20budget/2000/speech/speech.pdf>, last accessed 26 November 2012.

South African Revenue Service and National Treasury Comments on Representations to the Portfolio Committee of Finance on the Revenue Laws Amendment Bill, 2000. Available at [pmg.org.za/docs/2000/appendices/001025SARS&Treasurty.htm](http://pmg.org.za/docs/2000/appendices/001025SARS&Treasurty.htm), last accessed 18 August 2010.

Department of Finance, *Chapter Four Revenue Issues and Tax Proposals 2000* South African Budget Review. Available at <http://www.treasury.gov.za/documents/national%20budget/2000/review/Chapter%204.pdf>, last accessed 26 November 2012.

Address by Trevor Manuel, the South African Minister of Finance at the time, at the Annual Conference of the International Bar Association on Thursday 24 October 2002, title 'The South African Tax Reform Experience since 1994'. Available at [http://www.treasury.gov.za/comm\\_media/speeches/2002/20022102501.pdf](http://www.treasury.gov.za/comm_media/speeches/2002/20022102501.pdf), last accessed 13 November 2012.

Address to the Royal Institute of International Affairs by Lindiwe Hendricks, the South African Deputy Minister of Trade and Industry at the time, titled 'South Africa's Economic Re-Integration into the World Post-1994,' published 09 June 2004. Available at <http://www.info.gov.za/speeches/2004/04062511151001.htm>, last accessed 13 November 2012.

Submission by Mr D Kruger on behalf of Business Unity South Africa, Finance Portfolio Committee, 24 October 2005, Hearings on the Draft Revenue laws Amendment Bill. Available at Parliamentary Monitoring Group, <http://www.pmg.org>, last accessed on 31 October 2005.

South African Revenue Services: Legal & Policy: legislation 2006/2007 Budget Tax Proposals. Available at <http://www.treasury.gov.za/documents/national%20budget/2006/sars/B05Guide.pdf>, last accessed 28 November 2012.

South African Revenue Service *Discussion Paper on Tax Avoidance and s 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* November 2005. Available at <http://www.sars.gov.za/home.asp?pid=5981#>, last accessed 7 December 2012.

South African Revenue Service *Discussion Paper on Interpretation Note 6 Place of Effective Management* issued in September 2011'. Available at <http://www.sars.gov.za>, last accessed 29 November 2012.

*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 2001 Paris: France.

South African Reserve Bank Exchange Control Manual, Section F. Available at <http://www.resbank.co.za/RegulationAndSupervision/FinancialSurveillanceAndExchangeControl/EXCMan/Section%20O/Section%20O.pdf>, last accessed 29 November 2012.

### **Websites**

COMESA-EAC-SADC Tripartite summit. Available at <http://www.comesa-eac-sadc-tripartite.org/>, last accessed 16 November 2012.

New Partnership for African Development website. Available at <http://www.nepad.org>, last accessed 03 May 2011.

Southern African Development Community Agreement. Available at <http://www.sadc.int/index/browse/page/120>, last accessed 16 November 2012.

Southern African Development Community Memorandum of Understanding on Cooperation in Taxation and Related matters. Available at

[http://www.sadc.int/files/4413/5333/7922/Memorandum\\_of\\_Understanding\\_in\\_Cooperation\\_in\\_Taxation\\_Related\\_Matters.pdf](http://www.sadc.int/files/4413/5333/7922/Memorandum_of_Understanding_in_Cooperation_in_Taxation_Related_Matters.pdf), last accessed 5 January 2013.

### **Foreign country documents and reports**

United States of America Joint Committee on Taxation 'Economic efficiency and structural analyse of alternative US Tax policies for foreign direct investment' June 25 2008. Available at <http://purl.access.gpo.gov/GPO/LPS97274>, last accessed 29 November 2012.

United Kingdom Treasury information at [http://www.hm-treasury.gov.uk/tax\\_foreign\\_branches.htm](http://www.hm-treasury.gov.uk/tax_foreign_branches.htm), last accessed 14 June 2011.

United Kingdom Treasury information at [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm), last accessed 14 June 2011.

### **Books, chapters, journal articles, theses, conference proceedings and other papers**

Amatucci, Andrea (ed) *International Law* (2006) The Netherlands: Kluwer Law International.

Amos, J 'Botswana - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 02 Sep 2011.

Amos, J 'Namibia - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Amos, J 'Namibia - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Anderssen, Krister 'An Economist's View on Source versus Residence Taxation. The Lisbon Objectives and Taxation in the European Union' (2006) 60 *Bulletin for International Taxation* 395.

Arnold, Brian 'The 2008 Update of the OECD Model: An Introduction' (2009) 63(5) *Bulletin for International Taxation* 178.

Arnold, Brian 'Threshold requirements for Taxing Business profits under Tax Treaties' (2003) 57 (10) *Bulletin for International Taxation* 476.

Arnold, Brian J.; Sasseville, Jacques & Zolt, Eric 'Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century' 2002 56(6) *Bulletin for International Taxation* 233.

Ault, Hugh & Arnold, Brian J. *Comparative Income Taxation: A Structural Analysis* 3ed (2010) The Netherlands: Kluwer Law International.

Avi-Yonah, Reuven 'Back to the Future? The potential revival of territoriality' (2008) University of Michigan Law School, Public Law and Legal Theory Working Paper Series, Working Paper 114 at 5. Available at <http://ssrn.com.abstract=1185423>, last accessed on 28 July 2009.

Avi-Yonah, Reuven 'Double Tax Treaties: An introduction;' Available at <http://ssrn.com/abstracts=1048441>, last accessed on 28 July 2009.

Avi-Yonah, Reuven 'Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113(7) *Harvard Law Review* 1573.

Baistrocchi, Eduardo 'The use and interpretation of tax treaties in the emerging world: Theory and implications' Reprinted from *British Tax Review* Issue 4 2008. Electronic copy available at <http://ssrn.com/abstract=1273089at360>, last accessed 10 February 2008.

Baker, Phillip *Double Taxation Conventions: a Manual on the OECD Model Tax Convention on Income and on Capital* (2005) London: Thomson/ Sweet & Maxwell.

Becker, Johannes & Fuest, Clement 'Taxing Foreign Profits with International Mergers and Acquisitions' (2007) Working Paper 07/19 Oxford University Centre for Business Taxation. Available at [http://www.sbs.ox.ac.uk/centres/tax/Documents/working\\_papers/WP0719.pdf](http://www.sbs.ox.ac.uk/centres/tax/Documents/working_papers/WP0719.pdf), last accessed 12 December 2007.

Black, Phillip; Calitz, Estian & Steenekamp, Tjaart *Public Economics for South African Students* 2ed (2003) Cape Town: Oxford University Press.

Bolnick, Bruce *Effectiveness and Economic Impact of Tax Incentives in the SADC Region* Technical Report submitted to USAID/RCSA. USAID/RCSA, SADC Tax Subcommittee, SADC Trade, Industry, Finance and Investment by Nathan-MSI Group.(2004). Available at [http://pdf.usaid.gov/pdf\\_docs/PNACY929.pdf](http://pdf.usaid.gov/pdf_docs/PNACY929.pdf), last accessed 14 November 2012.

Bowden, Simon & Tadmire, Viv 'Australia' in *Cahiers De Troit Fiscal International: Key Practical issues to eliminate double taxation of business income* vol 96b (2011) The Hague:Sdu Uitgewers.

Branco, Rubens 'Brazil' in *Cahiers De Droit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/ IFA. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

Cassidy, John *How Markets Fail: the Logic of Economic Calamities* (2009) London: Penguin Books Ltd.

Cheadle, H., Davis, D. & Haysom, N. (eds). *South African Constitutional Law: The Bill of Rights* (2004) Durban: Lexis Nexis (electronic version).

Clegg, David & Stretch, Rob *Income Tax in South Africa* (2010) Durban: Lexis Nexis (electronic version updated 2011).

Cnossen, Sijbren (ed) *Taxing Capital Income in the European Union: Issues and Options for Reform* 2000: Oxford University Press.

Cockfield, Arthur *Purism and Contextualism with International Tax Law Analysis: How Traditional Analysis Fails Developing Countries*. Queen's University Faculty of Law, Legal Studies Research Paper Series, working paper No.0703. Available at <http://ssrn.com/abstract=989770>, last accessed 14 November 2012.

Cockfield, Arthur J. 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles' (2006) 56 (12) *Bulletin for International Taxation* 606.

Cockfield, Arthur J. *Examining Policy Options for the Taxation of Outbound Direct Investment* (September 1, 2008). Advisory Panel on Canada's System of

International Taxation Research Report, September 2008. Available at SSRN: <http://ssrn.com/abstract=1456485>, last accessed 14 November 2012.

Cussons, Peter and Collier, Richard 'Tax Planning for Double Tax Relief' in Dixon, John & Finney, Malcolm (eds) *Tolley's International Tax Planning Double Taxation Relief* (2002) London:Lexis Nexis.

Couzin, Robert 'Relief of Double Taxation' (2002) 56 (6) *Bulletin for International Taxation* 266.

Dachs, Peter 'Foreign Taxes Levied' (2006) 20 *Tax Planning* 138.

Dave, Kuntal J. & Nayak, Mayur B. 'India' in *Cahiers De Droit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/IFA. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

De Waal, MJ & Theron, L 'Die aard van die trust in die Suid-Afrikaanse regsikking na aanleiding van behoefte?' (1991) *TSAR* 499.

Dias de Almeida, P, 'Angola - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org> , last accessed 02 Sep 2011.

Diaz, Vincent Oscar 'Argentina' in *Cahiers De Troit Fiscal International: Unilateral methods to prevent Double Taxation* vol 66b (1981).Kluwer Law International. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

Editor 'Plugging the Holes' (1955) 4 *The Taxpayer* 61.

Editor 'Taxing dividends: an unfair discrimination' (1960) 9 *The Taxpayer* 61.

Editor 'Tax credits on foreign dividends' (1965) 14 *The Taxpayer* 18.

Editor 'Taxation of Foreign Dividends: Credit in respect of Foreign Taxes payable' (1955) 4 *The Taxpayer* 151.

Editor 'Taxation of Foreign dividends' (1961) 10 *The Taxpayer* 81.

Editor 'Taxing Dividends from Non-Union Sources' (1955) 4 *The Taxpayer* 141.

Editor, 'Taxation of Foreign Dividends' (1956) 5 *The Taxpayer* 25

Editor, 'Source of Income' (1971) 20 *The Taxpayer* 71.

Elkins, David 'Horizontal Equity as a Principle of Tax Theory' (2006) 24 *Yale Law and Policy Review* 43.

Emslie, TS; Davis, D.M, Hutton, S.J., Olivier, L *Income Tax Cases and Materials* 3ed (2001) Cape Town: The Taxpayer.

Figueroa, Antonio Hugo 'International Double Taxation: General Reflections on Jurisdictional Principles, Model Tax Conventions and Argentina's Experience' (2005) 59(8) *Bulletin for International Taxation* 379.

Figueroa, Hugo 'Argentina' *Cahiers De Droit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/ IFA. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

Graetz, Michael *Foundations of International Income Taxation* (2003) New York: Foundation Press.

Gutuza, Tracy 'Tax and e-commerce: Where is the source' 2010 127(2) *South African Law Journal* 328.

Hamzaoui, R 'Mauritius - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

*Harmful Tax Competition, an Emerging Global Issue* ((1998) OECD Publications: Paris.

Harris, Peter *Corporate Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* (1996) Amsterdam: IBFD Publications.

Head, John G. & Krever, Richard (eds) *Tax reform in the 21st Century: A Volume in Memory of Richard Musgrave* (2009) The Netherlands: Kluwer Law International.

Herman, Doron *Taxing Portfolio Income Global Financial Markets* (2002) Amsterdam: IBFD

Hines, James 'Should Countries try to Tax Foreign Income' 2009 (5) The James Hausman Tax Law and Policy Workshop: Law and Economics Workshop, WS 2006-2006. Available at [http://taxprof.typepad.com/taxprof\\_blog/files/Hines.pdf](http://taxprof.typepad.com/taxprof_blog/files/Hines.pdf), last accessed 16 November 2006.

Hong, Lee Fock 'Singapore's budget for 2008 – For an Innovative Economy and Superior Prospects for Growth' (2008) 62(5) *Bulletin for International Taxation* 191.

Horak, J DD 'South Africa Tax treaties – Principles of negotiation' (1991) 4 *Juta's Foreign Tax Review* 48.

International Bureau of Fiscal Documentation *International Tax Glossary* (2012). Available at <http://www.ibfd.org>, last accessed 5 November 2012.

Jolly, Sachit & Shah, Sunil D 'India' in *Cahiers De Troit Fiscal International: Key practical issues to eliminate double taxation of business income* vol 96b (2011) The Hague:Sdu Uitgewers.

Jooste, Richard 'The Imputation of Income of Controlled Foreign Entities' (2001) 118 *SALJ* 473.

Kaufman, Nancy 'Fairness and the Taxation of international income' (1998) 29 *Law and Policy in International Business* 145.

Kaufman, Nancy H. 'Equity considerations in International Taxation; (2001) 26 *Brooklyn Journal of International Law* 1465.

Kemmeren, Eric 'Source of income in globalising economies: Overview of the issues and a plea for an origin-based approach' (2006) 60 (11) *Bulletin for International Taxation* 430.

Kerrie, Sadiq 'Unitary taxation – a case for global formulary apportionment' (2001) 55(7) *Bulletin for International Taxation* 275.

Knoll, Michael S. *International Competitiveness, Tax Incentives, and a New Argument for Tax Sparing: Preventing Double Taxation by Crediting Implicit Taxes.* (2008) University of Pennsylvania Law School, Institute for Law and Economics (2008) Research Paper No.08–21. Available at <http://ssrn.com/abstract=1259927>, last accessed 09 September 2008.

Lang, Joachim and Englisch, Joachim 'A European Legal Tax Order Based on Ability to Pay' in Andrea Amatucci (ed) *International Law* (2006) The Netherlands: Kluwer Law.

Mazansky, Ernest 'South Africa changes to a Worldwide Tax System' (2001) 55(4) *International Tax Bulletin* 138.

Mazansky, Ernst 'South Africa's Treaty network – Why is South Africa the Meat in the Sandwich', (2009) 63 (4) *Bulleting for International Taxation* 145.

Meyerowitz, David *Meyerowitz on Income Tax 2007–2008* (2008) Cape Town: The Taxpayer.

Musgrave, Peggy 'Sovereignty, Entitlement, and Co-operation in International Taxation' (2001) 26 *Brooklyn Journal of International Law* 1335.

Munro, Alastair *Tolley's Double Taxation Relief* 6ed (2003) London: Lexis Nexis.

Munyandi, K 'Ghana - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>. last accessed 07 Sep 2011.

Munyandi, K 'Ghana - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Munyandi, K 'Malawi - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>. last accessed 07 Sep 2011.

Munyandi, K 'Malawi - Corporate Taxation', Country Surveys IBFD. Available at <http://wwwwww.ibfd.org>, last accessed 07 Sep 2011.

Munyandi, K 'Nigeria - Corporate Taxation, Country Surveys' IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.10.06

Munyandi, K 'Zambia - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Munyandi, K 'Zambia - Corporate Taxation, Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.10.06

Munyandi, K 'Zimbabwe - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Munyandi, K 'Zimbabwe - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.10.06

Musgrave, Richard & Musgrave, Peggy *Public Finance in Theory and Practice*. 5ed (1989) New York: McGraw-Hill.

Namubiru, P & Munyandi, K 'Uganda - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Namubiru, P & Munyandi, K 'Uganda - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Olivier, Lynette & Honiball, Michael *International Tax: A South African Perspective* 5ed (2011) Cape Town: Siberink CC.

Olivier, Lynette & Honiball, Michael *International Tax: A South African Perspective* 4ed (2008) Cape Town: Siberink CC.

Olivier, Lynette & Honiball, Michael *International Tax: A South African Perspective* 3ed. (2005) Cape Town: Siberink CC.

Olivier, Lynette ; Brincker, Emile & Honiball, Michael *International Tax: A South African Perspective* 2ed (2004) Cape Town: Siberink CC

Olivier, Lynette ; Brincker, Emile & Honiball, Michael *International Tax: A South African Perspective* (2003) Cape Town: Siberink CC.

Olivier, Lynette, Engels, Riette, Roeleveld, Jennifer and Wessels, Henk *Juta's Income Tax* (revision service 15, 2010) Claremont: Juta & Co Ltd

Olivier, Lynette 'Residence-based taxation' 2001 *TSAR* 20.

Omond, F 'Kenya - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Omond, F 'Kenya - Corporate Taxation', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.10.06

Pinto, Dale 'The Need to reconceptualize the Permanent Establishment threshold' (2006) 60(7) *Bulletin for International Taxation* 266.

Pinto, Dale 'Exclusive source or residence-based taxation - is a new and simpler world tax order possible?' (2007) 61(7) *Bulletin for International Taxation* 277.

Repetti, James 'Democracy and Opportunity: A new paradigm in equity' (2008) 61 *Vanderbilt Law Review* 1129.

Ring, Diane 'International Tax Relations: Theory and Implications' (2007) 60 *Tax Law Review* 83.

Sasseville, Jaques 'The Role of Tax Treaties in the 21st century' (2002) 56(6) *Bulletin for International Taxation* 246.

Schindel, Angel & Atchabahian, Adolfo 'General Report' in *Cahiers De Troit Fiscal International: Source and Residence: A New Configuration of their Principles* vol 90a (2005) Amersfoort: Sdu Fiscal & Financiele Uitgewers/ IFA. Available electronically at <http://www.ibfd.org>, last accessed 25 October 2010.

Schon, Wolfgang 'International Tax Coordination for a Second-Best World (Part I)' (2009) 1(1) *World Tax Journal* 67.

Shaheen, Fadi 'International Tax Neutrality: Reconsideration' (2007) 27 *Virginia Tax Review* 203.

Smith, Adam *The Wealth of Nations* (Edited by Edwin Cannon: New York: Bantam Dell 2005) 1776.

Souza, Celina 'Brazil's Tax System: The Dilemmas of Policy Reform' Canadian Foundation for the Americas Policy Paper, February 2005 at 2. Available at [http://www.focal.ca/pdf/Brazil\\_Souza-FOCAL\\_Brazil%20Tax%20System%20Reform%20Dilemmas\\_February%202005\\_PP-05-02\\_e.pdf](http://www.focal.ca/pdf/Brazil_Souza-FOCAL_Brazil%20Tax%20System%20Reform%20Dilemmas_February%202005_PP-05-02_e.pdf) Souza, last accessed 04 September 2012.

Spitz, B. K. 'Double Taxation' (1988) 1 *Juta's Foreign Tax Review* 69.

The Political Economy of Taxation in Developing countries: Challenges to Practitioners The World Bank Group in collaboration with DFID, March 2008.

Thuronyi, Victor *Comparative Tax Law* (2003) The Hague: Kluwer Law International.

Van Blerck, Marius 'Company –shareholder Taxation in South Africa: Single or Double Taxation?' (2003) 57(12) *Bulleting for International Taxation* 567.

Van De Merwe BA, 'The place of effective management' effectively explained' (2006) 18 *SAMLJ* 121.

Van den Noord, Paul & Heady, Christopher *Surveillance of Tax Policies: A Synthesis of Findings in Economic Surveys*. OECD (2001) Economics Department Working Papers No. 303.2001 OECD. Available at <http://oecd.org/eco/eco>, last accessed 4 July 2003.

Van der Berg, Servaas; Burger, Ronelle & Louw, Megan 'Post Apartheid South Africa: Poverty and distribution trends in the era of globalisation.' (2007) Research Paper No. 2007/57 UNU/Wider 1. Available at [http://www.wider.unu.edu/publications/working-papers/research-papers/2007/en\\_GB/rp2007-57](http://www.wider.unu.edu/publications/working-papers/research-papers/2007/en_GB/rp2007-57), last accessed 24 August 2011.

Vann, Richard J. 'General Report' in *Cahiers De Troit International: Trends in company shareholder taxation: single or double taxation?* vol 88a (2003). Available at <http://www.ibfd.org>, last accessed 25 October 2010.

Vogel, Klaus 'The Justification for Taxation: A Forgotten Question' (1988) 33 *American Journal of Jurisprudence* 19.

Vogel, Klaus 'Worldwide vs. source taxation of income – a review and re-evaluation of arguments (Part I)' (1988) 8-9 *Intertax* 216.

Vogel, Klaus 'Worldwide vs source taxation of income – a review and re-evaluation of arguments (Part II)' (1988) 10 *Intertax* 310.

Vogel, Klaus 'Worldwide vs source taxation of income – a review and re-evaluation of arguments (Part III)' (1988) 11 *Intertax* 393.

Vogel, Klaus Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD and UN Model Tax Conventions for the Avoidance of Double Taxation on Income and on Capital, with particular reference to German Treaty Practice 3ed (1997). Hague: Kluwer Law International.

Vogel, Klaus 'Which Method should the European Community Adopt for the Avoidance of Double Taxation' (2002) 56(1) *Bulletin for International Taxation* 4.

Williams, R.C *Income Tax in South Africa: Law and Practice* 4ed (2006) Durban: Lexis Nexis Butterworths.

Yusuf, F 'Nigeria - Business and Investment', Country Surveys IBFD. Available at <http://www.ibfd.org>, last accessed 07 Sep 2011.

Yoingco, Angel Q, 'The Study Group on Asian Tax Administration and Research' (2004) 10 (4) *Asia-Pacific Tax Bulletin* 187.