

A Comparative Analysis of the Concept
Of Fiscal Jurisdiction in Income Tax Law

By

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“It is a truth universally acknowledged, that in all business transactions, tax is a cost like any other, and, like any other, it ought to be – if the business is to remain competitive – no greater than it has to be...”

Milton Grundy, *The World of International Tax Planning*, 1 July 1983, p. 1.

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Abstract:

The purpose of this dissertation is to analyse the definitional rules of fiscal jurisdiction as well as the tax consequences resulting from the application of these rules, as implemented in the national tax law of the chosen jurisdictions. In essence, there are two main rules, which give content to the chosen theory of fiscal jurisdiction, mainly source and residence. It is trite that globalisation of the world's economies poses certain problems for international tax policy. Companies and individuals are becoming more mobile and therefore are able to exploit tax differences between states.

In consideration of the natural concern of governments that they should get an acceptable share of the profits generated by international businesses, this research study analyses the bases through which a country could claim the right to tax. The plasticity of these two key concepts (source and residence) may well subvert a country's ultimate tax objective because of the potential for exploitation of ambiguity in the search for effective avoidance. The residence tax system and its implications have been analysed mainly from the South African perspective, and where necessary, the analysis has sought reference in other jurisdictions such as the United Kingdom and the United States. The source principle of taxation and its effects have also been studied from the South African context, with a comparative approach from Hong Kong.

It has been found that the countries considered in this research have, in various ways, adopted different combinations of subjective factors for tax liability in their domestic tax laws. At the same time, the relentless search of additional tax revenue, has led countries to implement in their tax laws, stringent anti-avoidance measures designed to prevent the deferral of tax, for instance on foreign source income. Factors such as the increasing complexity of modern business and the greater sophistication of tax planning techniques have contributed to this state of affairs.

Thus, this dissertation highlights that competition between governments, in the face of international economic integrity, may lead countries to adopt tax rules, which though they

follow the usual international standards, are nevertheless very complex in application and administration. This can maintain the problem of international double taxation and lead to excessive or unpredictable compliance burdens.

It is shown how countries in the exercise of their fiscal jurisdiction can move towards harmonisation of rules and common interpretation of the tax base in the application of their national tax legislation.

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Part I: General introduction

When the Katz Commission came out with its recommendation on certain aspects of tax structure of South Africa in its fifth report, it did recognise in the first chapter that we were now living in the era of international economic integration, where the tax system affecting a country's own citizens or residents activities transacted abroad or within the domestic jurisdiction needed to carefully balance domestic and international economic objectives.¹

In the global world, countries need to maintain orderly tax regimes to promote international trade. Consequently, there is a need for accepted rules and conventions limiting any one country's rights to tax its own citizens or residents operating or investing abroad, or the citizens or residents of other countries operating domestically. Therefore with trade and investment increasingly becoming transnational, different jurisdictions have also started to reinforce or extend the basic principles by which to levy tax on income generated by international economic activity, be it in terms of a source or residence system.

In various analyses of the international tax law problems, fiscal jurisdiction is always associated with double taxation and the consequent agreements for relief. A great amount has been written about double taxation agreements, or the international law aspect of tax,² although the analysis of their application in the South African context in view of the fundamental change of the tax jurisdiction still needs to be explored. This may be the subject matter of a different research work.

Very little international tax literature has focused mainly on the analysis of the definitional rules of fiscal jurisdiction in income tax law. The challenge of this research is therefore to analyse the common factors for tax liability and their application on

¹ See the *Fifth Interim Report of the Commission of Enquiry into certain aspects of the Tax Structure of South Africa* (the Katz Commission), Government publication, Department of Finance, March 1997, chapter 1, p. 1.

various selected transactions purely from the income tax law context, not really as understood in numerous double taxation agreements, but from the national tax laws perspective. This is because with or without tax agreements, different countries still encounter problems associated with the interpretational rules of fiscal jurisdiction. This intellectual venture has become crucial because the main jurisdiction considered (South Africa) has gone through the process of reshaping its tax system with a move from what is known in the international tax lexicon as a 'source plus' to a 'residence minus' system based on a combination of a dominant residence tax system coupled with the application of source rules on non-residents' income.

While the understanding and interpretation of the definitional rules of South African fiscal jurisdiction is the centre of this study, I realised in identifying the statutory rules and South African case law having an international element, that the principle applied in most cases, referred to the practice adopted in other jurisdictions.

Thus, because of the narrow focus of the South African international income tax law, I intend for the purpose of this dissertation to look for guidance and illumination on certain selected issues to other jurisdictions which are relevant for this comparative study. Even within the South African context, I do not intend to go through every aspect of tax jurisdiction. I plan to concentrate on some limited issues of crucial importance, following the legislative amendments that took place in 2000 with regard to source and residence, and try to compare them with similar positions in the chosen jurisdictions such as Hong Kong, the United Kingdom and the United States.

This thesis is on the examination of the key operational concepts of tax, that is, source and residence, as they are employed to implement a theory of fiscal jurisdiction. In particular, this thesis has sought to examine and evaluate the changes that have taken place in South Africa over the past five years (from 1997) as the tax system has changed from source to residence. In short, this thesis is not about theories of fiscal jurisdiction

² See for instance, the publication by Jeffery, R.J, *The Impact of State Sovereignty on Global Trade and International Taxation*, 1999.

but rather the most appropriate connecting factor or operational concept for a tax system, in particular within a developing economy like South Africa.

Another objective of this research in its comparative view, is to show that globalisation of the world's economies calls for integration, and to achieve this, there should be a spontaneous movement towards harmonisation of rules, as well as a greater interest on the part of local tax practitioners in the tax systems of other countries.

To make this comparative analysis more useful and consistent, I chose in comparison to South Africa which is a typical hybrid system, jurisdictions belonging to the same family of income tax laws, and which apply either exclusively one tax system such as the source principle (Hong Kong) or mainly residence concept (the United Kingdom or the United States). The aim is to analyse the rules of fiscal jurisdiction with South Africa, being the centre of focus, while considering comparable similar situations either in the dominantly source system such as Hong Kong, or in the main residence tax system such as the United Kingdom or to some extent the United States.

Due to the reform of the tax system in South Africa, culminating in the passing of Act 59 of 2000, which came into effect for years of assessment commencing on or after 01 January 2001, most of the deeming source provisions previously applicable in section 9 of the Income Tax Act have been repealed in the new legislation.³ It is therefore important to analyse the effect of the repealed legislation in the South African context, as it affects the taxation of non-residents.

Similarly, on the implementation of a fully-fledged residence based tax system, all types of income, including non-investment income (active income) became subject to tax on the residence basis. Thus, issues of fiscal jurisdiction for instance, vis-à-vis controlled

³ For example, certain investment income of a foreign investment company in Botswana, Lesotho, Namibia and Swaziland was imputed to South African residents (s 9A); income accruing in respect of any business carried on by a South African resident as the owner or charterer of any ship or aircraft [s 9(1)(c)]; income accruing to a South African resident as lessor of a container [s 9(1)(cB)]; any gain made by a South African resident in respect of a banker's acceptance or similar instrument [s 9(5)]. See also ss

foreign entities and foreign dividend application rules which are of current international practice needs to be analysed and understood mainly from the South African perspective with relevant comparative situations in the United Kingdom and the United States.

To remain within the scope and objectives of this research, I decided not to include a discussion of the interpretation of tax rules of double tax agreements. I nevertheless relied, particularly in studying the concept of residence, on the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention interpretation of the definitional rules mainly as applicable in the case of legal entities. This is because most of the jurisdictions (including South Africa) have now come to adopt this final tie-breaker (place of effective management) in their domestic tax laws, even if its interpretation varies from one country to another.

Because of the ever-changing nature of tax laws, the scope of this research is to focus on the analysis of the legislation and relevant case laws, as they are effective and applicable in all chosen jurisdictions up to 7 October 2002, date of submission of this thesis.

In the South African context, this comparative research will furnish an interesting laboratory, by helping a better appreciation of the application of source and residence rules in view of the new tax legislation, while offering a comprehensive analysis of selected issues of the international practice relating to the concept of fiscal jurisdiction.

1. Structure of the research

This research study is divided in five parts.

Part I deals with the academic analysis of the concept of fiscal jurisdiction, in trying to find a proper definition, the scope and extent of the concept as well as the importance of such study and the problems that it exposes.

9(1)(cA); 9(1)(d)bis and 9(1)(f). Sections 9(1)(c), 9(1)(d)bis and 9(1)(f) and 9A were repealed by the Revenue Laws Amendment Act 59 of 2000.

Part II concentrates on the policy analysis of the taxation by source and residence and the evolution of the South African tax system. This part analyses the rationale from the regulatory and academic perspectives for taxing on the basis of source and residence, including discussion on the legal theories of fiscal jurisdiction. In addition, this part focuses on the process by which South Africa has switched from a dominantly source tax system to a dominantly residence based tax system, and discussing the reason for this fundamental change.

Part III deals with a comparative analysis of the concept of residence and its tax consequences, mainly from the South African context with particular reference to its application in the United Kingdom and the United States. The first section of this part reveals that residence tests vary from one jurisdiction to another, through the implementation of different subjective factors. The South African tax legislation combines the physical presence test with the 'facts and circumstances' approach of ordinary residence. While in the United Kingdom for instance, the residence criteria (including domicile) are extremely wide and rely heavily in the case of individuals on intention and calculation of lengths of stay. On the other hand, the United States rules on residence differ from those of both South Africa and the United Kingdom in some crucial and interesting respects.

With regard to legal persons, South Africa has adopted in addition to the incorporation test, the OECD tie-breaker rule of 'place of effective management' in its test of residence. The United Kingdom is focusing in terms of its second criterion to the residence rules on the 'place of central management and control' and the United States' test of residence is based solely on the formal legal connection of the place of incorporation.

The second section of this part discusses the implications of imposing tax on the worldwide basis. This section mainly focuses on the analysis of the statutory anti-avoidance provisions laid down by the chosen jurisdictions to prevent deferral of tax on different kinds of foreign income. This study analyses from a South African perspective,

with particular references where relevant to jurisdictions such as the United Kingdom and the United States, the factors which determine if, when and how much is payable on foreign income received or accrued to resident taxpayers. Basically, this section discusses issues revolving around the tax implications of foreign employment income, the controlled foreign entity rules, and the foreign dividend application rules.

Part IV analyses from a comparative approach, the principles and application of source system and its tax consequences in both South Africa and Hong Kong. From the South African perspective, the discussion of the source concept is still relevant not only to non-residents who are subject to tax on their source income, but also in relation to South African residents who carry on trade offshore and sustain losses therefrom.

The first section of this part discusses the source concept from a judicial interpretation and shows that the source system is an enigmatic concept on which it is difficult to set a statutory definition. An important element in this section from the South African perspective, is the adoption of the 'rule' approach, which provides a better understanding of the determination of source of particular income.

The second section focuses on the analysis of the selected actual and deemed source provisions that are still applicable to non-residents in South Africa and compare them with similar circumstances in Hong Kong.

This part reveals that apart from some similarity of approach between the Hong Kong courts and the South African courts, a string of ambiguous court decisions has proven that Hong Kong courts have not analysed the issue of source with any consistency. Thus, it means that irrespective of the jurisdiction considered, the crucial area where guidance can be given is on the source concept because its interpretation is mostly subject to philosophical problems that may give rise to absurd results.

Part V contains the general conclusion and recommendations. The first point from the various analyses is that any of the tax principles, be it source or residence, has its own

disadvantages, and it is preferable for a country to adopt a tax system that is appropriate to the circumstances of its economy.

This part evaluates in summary, whether the most important reasons for the radical change to the residence basis of taxation in South Africa are justified. It questions in the light of detailed analysis throughout the thesis whether for instance, the new South African income tax dispensation is really protecting the tax base from exploitation and to overcome the challenge of the open economy. In addition, in consideration of the comparative analysis of similar tax systems, this part discusses whether the South African tax system in its interpretation and application of rules of fiscal jurisdiction is now more in line with international practice. In conclusion, this part provides recommendations in order to minimise the complexities arising from the application of the South African rules of fiscal jurisdiction.

2. Theoretical analysis of the concept

2.1 The meaning of jurisdiction in international law

The concept of jurisdiction itself has been the subject of controversial arguments and has been approached by academics on international law in different ways. The majority of writers and institutions who have studied the subject of jurisdiction divide this concept into more than one dimension.

Beale defines jurisdiction as 'the power to create rights such as will be recognised by other states as valid: it is a common conception of all nations.' He further noted that a broader meaning of the word is more accurately used in connection with the designation of a concept that includes proscription, adjudication and execution.⁴

⁴ See Beale, J, *A treatise on the conflict of laws*, 3 vols, (New York 1935), p. 308-309.

Jennings⁵ considers the term jurisdiction as 'the authority to affect legal interests', and contends that there are three aspects of jurisdiction, mainly executive, legislative and judicial jurisdiction.

Thus, while it is generally accepted that jurisdiction refers to the capacity of a state to make a rule of law, whether this capacity be exercised by the legislative branch or by some other branch of government, it is still a matter of controversy as far as the position of international law is concerned in the exercise of a state's jurisdiction.

Contemporary writers such as Harris see in the term jurisdiction, 'the power of a state under international law to govern persons and property by its municipal law.'⁶ This view is shared by Wallace, who, in recognising that the jurisdiction of a state is to prescribe, adjudicate and enforce the law, goes further to state that international law does not prescribe rules requiring the exercise of jurisdiction and it is restricted principally with the propriety of the exercise of state jurisdiction. Thus the exercise of state jurisdiction remains a discretionary matter for the state concerned.⁷

It may be agreed that a state's municipal law governs the exercise or the non-exercise of jurisdiction. However, it is relevant to mention the distinction noted by Martha to the effect that while a state may have jurisdiction to prescribe in certain circumstances, its jurisdiction to enforce the prescribed rule may, as a matter of international law be restricted by the territoriality principle.⁸ Thus, to some extent, international law and international economic integration circumscribe a state's freedom and set the limits within which a state may be free to act.

For instance, international economic integration restricts the effective choice available to states in the exercise of their jurisdiction if they want to maximise the benefits flowing from such integration. As Dunning puts it:

⁵ *The limits of state jurisdiction*, 32 Nordisk Tidsskrift for international ret, 1962, p.202.

⁶ Harris, D. J, *Cases and materials on international law*, 2ed, 1983, p.210.

⁷ Wallace, R. M. M, *International law*, 3ed, 1997, p. 111

‘Unless a country is completely isolated from the rest of the world, any sovereignty it enjoys is bound to be constrained, in the sense that whatever decisions it chooses to take are, to some extent, influenced by forces beyond its jurisdiction.’⁹

It is necessary to give a general definition of the multi-aspect notions of jurisdiction because as Danziger noted, the problem of jurisdiction consequently arises when the actions of a state purport to affect foreign persons, things or events.¹⁰ A national tax system requires a legal justification for imposing tax, not only on residents of the particular country but also on non-residents. This legal justification is to be found in the principle of fiscal jurisdiction which constitutes the subject of this research.

Consequently, while the legislative aspect of jurisdiction must be analysed, the state’s ability and capacity to enforce is particularly relevant in relation to international tax law because it determines the efficacy of the system. A proper definition and understanding of the attributions of fiscal jurisdiction is the key to any meaningful attempt to solve international taxation problems.

2.2 Fiscal jurisdiction: A definition

It is a universal principle that the inherent right of the state to tax is limited to its jurisdiction. This is due to the fact that taxation usually involves a relation between a state and its own subjects. Thus, the jurisdiction to tax may be defined as the legal and factual power of a state to levy taxes over either the taxable person or the taxable object.

As Martha puts it, a state can only have jurisdiction to tax if there is a fiscal attachment, that is, if there is a legal relationship between the holder of fiscal jurisdiction and the fiscal subject by virtue of the presence of fiscal facts.¹¹

⁸ Martha, R. S. J, *The jurisdiction to tax in international law, theory and practice of legislative fiscal jurisdiction*, 1989, p.62.

⁹ See Dunning, JH, *Multinational Enterprises and the Global Economy*, 1993, p. 529.

¹⁰ See Danziger, E, *International income tax, the South African perspective*, July 1991, p.3.

¹¹ *Ibid*, p. 46.

If it is assumed that states have inherent right to claim taxes on income accrued or received by the taxpayer within their jurisdiction, the question that may be asked is whether the exercise of that jurisdiction would not conflict with the right of other states which are entitled under international law to apply their laws to the same facts.

This raises the issue of the attributes or *raison d'être* for a state to levy taxes. In other words, what are the crucial tests for determining the extent or legitimacy of state jurisdiction in matters of taxation?

2.3 Extent and scope of fiscal jurisdiction.

2.3.1 The tax law relationship

Some writers on international law are of the view that, a state can only levy taxes if there is a 'genuine connection' between the state and the taxpayer (by virtue of personal attachment) or between the state and the transaction or property in respect with which the tax is levied.¹² To this view, Martha suggests that a state can only claim a right to exercise fiscal jurisdiction if a legal connection is established between that state and the targeted fiscal subject.¹³

As Martha argues further, the first fundamental element of fiscal attachment is the personal fiscal attachment, serving to explain the direct relationship between the holder of fiscal jurisdiction which might be the state or an international organisation, and the fiscal subject or object of taxation, which is determinative for the legality of the exercise of fiscal jurisdiction.¹⁴ This notion of attachment when applied to legal subjects such as natural or juristic persons, can be said to derive as a result of personal sovereignty (nationality) which affords to states the legal title to prescribe conduct, impose obligation, and confer rights to their subjects, even where they are outside the sphere of validity of the national legal order as it was decided in the American case of *Cook v*

¹² See Akehurst, M, "Jurisdiction in International Law", 1972/1973, 46 *British Yearbook of International Law*, p. 145.

¹³ *Op cit*, p.46.

¹⁴ *Op cit*, p.182.

Tait.¹⁵ The direct relationship can also exist as a result of territorial sovereignty (fiscal domicile, residence) or through functional sovereignty.

The relationship between the state and the fiscal subject can also be indirect, known as economic fiscal attachment, arising when the object of taxation is located in the taxing state (referring to property and source of income within the taxing state).

The second element of fiscal attachment called functional fiscal attachment is exercised in areas where international law allows states to exercise certain functional powers in connection with specific rights such as the cases of continental shelf, exclusive economic zone, or in the flight information regions.

All these elements of fiscal connections depend on the extent to which the taxpayer is fiscally liable and therefore subject to the holder of fiscal jurisdiction taxing power. Thus the tax liability of a fiscal subject can be either unlimited, for example, when the holder of fiscal jurisdiction can assess the taxpayer on his worldwide income (taxation on the basis of nationality, domicile or residence) or limited corresponding with the economic fiscal attachment (taxation on the basis of source).¹⁶

As discussed above, there are various types of tax law relationship between the tax creditor who claims the tax and the tax debtor who actually pays that tax.¹⁷ The core of this research is to focus on the main elements of personal and economic attachment between the taxpayer and the holder of fiscal jurisdiction.

As stated in the definition of fiscal jurisdiction, this principle deals with the right and power of a state to impose taxes as a result of the exercise of supreme authority of sovereignty. For academic purposes, some writers have argued that international law has no role to play in matters of taxation. Norr on that issue asserts that:

¹⁵ (1936) 265 U.S 47.

¹⁶ See the well-articulated explanation given by Martha in his summaries and concluding remarks, *op cit*, p. 182.

‘No rules of international law exist to limit the extent of any country’s tax jurisdiction...[and] within its own legal framework a country is free to adopt whatever rules of tax jurisdiction it chooses.’¹⁸

While Beale in his argument states that ‘the determination of jurisdiction ... is with us a question of our own law, and not of a generally accepted doctrine of the law of nations.’¹⁹

If it is agreed that there are no rules of international law which limit the extent of a state fiscal jurisdiction, this would raise the question as to whether a state can with regard to the totality of powers that it may have under international law pursuant its sovereignty, exercise its fiscal jurisdiction in an unwarranted manner.

Thus, if fiscal jurisdiction is an attribute of sovereignty, it must follow that the jurisdiction of state to tax must be confined to events that are subject to this sovereignty. This calls for an identification of the limits of state sovereignty for a proper exercise of its fiscal jurisdiction. This is because as Martha puts it:

‘...[I]f jurisdiction is an attribute of sovereignty, then it is necessarily so that the limits of fiscal jurisdiction are similar to those of national sovereignty. Consequently, identifying the limits of sovereignty is tantamount to identifying the limits of every type of jurisdiction, including tax or fiscal jurisdiction.’²⁰

It is therefore important to analyse the extent to which a sovereign nation power to tax is impeded by self-imposed statutory limitations and to find out whether there are any limitations either spatial, personal or functional deriving from the essence of sovereignty.²¹

¹⁷ Expression used by Swanepoel, E, “The source of income in South African income tax and the inward and outward structuring of investments into and out of South Africa”, LLM thesis (UCT), 1990, p. 182.

¹⁸ Norr, M, “Jurisdiction to Tax and International Income”, 1962, 17 *Tax Law Review*, p. 431; also found in Martha, *op cit*, p. 12.

¹⁹ See Beale, *op cit*, p. 36.

²⁰ Martha, *op cit*, p. 32.

2.3.2 Fiscal jurisdiction and sovereignty.

It is recognised among writers that sovereignty is one of the fundamental concepts in international law. It has been a subject of academic interest as to whether fiscal jurisdiction could be equated with the concept of sovereignty. Some writers relate fiscal jurisdiction as being synonymous to sovereignty and it has the same application in all areas of law.²² This view is supported by Knechtle who states that:

‘Tax (or fiscal) jurisdiction, i.e, sovereignty in the sphere of fiscal law, means “the non-derivative sovereignty of a state”, which is in principle, internally as well as externally unlimited, and which manifests itself vis-à-vis other states in exercising sole (exclusive) authority in respect of acts of legislation, administration and justice within its territorial power sphere. Thus, tax jurisdiction is a consequence of a state territorial sovereignty, i.e, of territory of the body politic.’²³

On the other hand, writers such as Martha argues that fiscal jurisdiction is only a specie of the genus ‘sovereignty’ and jurisdiction should be distinguished from sovereignty because the doctrine of jurisdiction deals with the question of whether and under what circumstances a state has the right of regulation, while the sovereignty is the concept by virtue of which jurisdiction is exercised.²⁴

This is expressed in the analogy made by Jeffery to the effect that sovereignty refers to the bundle of rights and competences which go to make up a nation state, while jurisdiction is related to particular rights from that bundle, namely a state’s right of regulation.²⁵ Mann also formulates the relationship by saying that: ‘jurisdiction is an aspect of sovereignty, it is coexistent with it and indeed, incidental to but limited by the state’s sovereignty.’²⁶

²¹ See Wurzel, H, “Foreign Investment and Extraterritorial Taxation”, 1938, *Columbia Law Review*, p. 812.

²² See Buhler, O, *prinzipien des internationalen steuerrechts*, 1964, p.130; also commented by Martha, *op cit*, p. 13.

²³ See Knechtle, A, *Basic problems in international fiscal law*, 1979, p. 34.

²⁴ See Martha, *op cit*, p.13.

²⁵ See Jeffery, RJ, *op cit*, p. 26.

²⁶ Mann, M, *The doctrine of jurisdiction in international law*, III, Rdc, 1964-I, I, p.30.

This means that jurisdiction is an essential attribute of sovereignty which is more of a *conditio sine qua non* for the fiscal jurisdiction.

Because the taxing power of a state derives from sovereignty and sovereignty is omnipotence and connotes absoluteness, it follows that for the concept of sovereignty to have a valid sense, it is essential to circumscribe time, space, people, and matters over which sovereign states in the exercise of their fiscal jurisdiction are supreme. That delimitation of the supremacy of the state may either be territorial, personal or functional.

2.3.3 The Territorial fiscal sovereignty.

This type of fiscal sovereignty deals with the issue of the rules and legislation of a state, as they apply to all persons and objects within the area subject to its spatial supremacy. It refers to geographical boundaries or to what Martha called in his theory of spatial sphere of validity, the absolute territorial supremacy.²⁷

According to Wallace, the territorial sovereignty is the favoured basis for state jurisdiction²⁸ and for that matter, the state has unlimited jurisdiction to regulate conduct which occurs in its territory, persons who are present in that territory, things that are situated there and acts that take place outside the territory but which have an effect within its territory.²⁹

Thus, because a state has virtual unlimited authority over the affairs of persons and things within its territorial sphere, the territorial sovereignty cannot be rendered inapplicable by the fact that aliens do not recognise the foreign taxing state as their own sovereign. For while they cannot for this reason be compelled to pay taxes to it on the ground of political allegiance (imposed by citizenship or nationality), they may nevertheless become subject to taxation by virtue of the territorial sovereignty of the

²⁷ See Martha, *op cit*, p. 33.

²⁸ See Wallace, *op cit*, p.112.

²⁹ See Danziger, *op cit*, p. 4.

foreign power whenever their presence, property or economic activity may be located within its jurisdiction, sometimes referred to by writers as economic allegiance.³⁰

This was well illustrated by Judge Loder in the *Lotus case* who stated that:

‘The principles of absolute and exclusive jurisdiction within national territory apply to foreigners as well as to citizens or inhabitants, and the foreigners can claim no exemption from the exercise of such jurisdiction, except so far as he may be able to show either: 1) that he is, by reason of some special immunity, not subject to the operation of the local law, or 2) that the local law is not in conformity with international law.’³¹

As far as international law is concerned on the issue of territorial sovereignty, it is clear as it was stated in the *Lotus case* by the permanent court of international justice that:

‘[N]ow the first and foremost restriction imposed by international law upon a state is that...it may not exercise its power in any form in the territory of another state. In this sense, jurisdiction is certainly territorial, it cannot be exercised by a state outside its territory except by virtue of a permissive rule derived from international custom or from a convention.’³²

As stated in the judgment of the *Lotus case*, the territorial fiscal sovereignty deals with the situation of economic loyalty to a sovereign state that may result either by reason of the quality of the taxpayer (his residence or domicile in the case of individuals) or the place of incorporation or the place of effective management when it applies to legal persons. The relevant link to territoriality might also result by virtue of the origin of income or any economic activity having an effect on that territory (real or deemed source) as it might apply because of the situs of the property.

In terms of fiscal jurisdiction, the territorial connection may be subject to certain exceptions:

The first one deals with the situation where persons, things or economic activity might be situated within the territorial limits of the state, but be immune from jurisdiction and therefore limiting the power of the state to enforce the tax. In such cases, as recognised

³⁰ See Albrecht, *op cit*, p. 149.

³¹ See the *Lotus case* (France v Turkey), PCIJ reports series A no 10 (1927); Oppenheimer's *international law*, (1992), 9ed, vol 1, edited by Sir Robert Jennings and Sir Arthur Watts 478; 564.

³² *Id*, p. 18-16; also cited by Barrie, G.N, "The Friendly Posse and the Disregard for Territorial Jurisdiction", 1996, vol 113, SALJ, p. 578.

by Albrecht, the subject or object of taxation is within the power of the taxing state but not within its jurisdiction. As he stated further, the state power to tax might also be limited by the nature of jurisdiction. Then, a state might have jurisdiction over an alien's property but not over his person and may levy a personal tax that it then proceeds to enforce against the property. Or it might have jurisdiction over the alien's person and levy a tax upon his property that it attempts to enforce against his person.³³ Such laws although enforceable would be considered to be beyond the jurisdiction of the taxing state.³⁴

The second exception to the territorial fiscal sovereignty deals with occasions where the state may legitimately claim the exercise of its jurisdiction outside its territory.

If the contemporary view of international law is correct that a state has exclusive right and unlimited power to legislate in relation to its territory without regard to external factors, it means that a state applying for example, the residence basis of taxation might want to tax the worldwide income of its residents and probably that might result in extraterritorial application and effect. The justification for this unlimited fiscal liability might be based on the international law concept of objective territoriality by which a state can exercise jurisdiction over acts that take place outside its territory but having an effect within its territory.

Theoretically, it may be argued that there is no territorial boundary to national taxation and then states are not obliged to take into account the effect of their tax laws on international trade nor are they required to consider international comity when framing those laws.³⁵ This view is also supported by Knechtle who argues that:

'Thus, in this case of tax jurisdiction, though emanating from territorial sovereignty, breaks the territorial bounds of the state and extends to tax objects beyond its national territory. This spatial extension of tax jurisdiction is possible, because states can bring to bear the whole pressure of their administrative machinery or residents in their state territories. Such comprehensive subjection

³³ See Albrecht, A.R, *op cit*, p. 153.

³⁴ That is what is referred to by Quereshi, A.H,("The freedom of a State to legislate in fiscal matters under general international law", *Bulletin of International Fiscal Documentation*, 1987, p. 17) as the minimum standard for the treatment (fiscal protection) of aliens. This issue deals with the jurisdictional immunities and privileges in relation to taxation accorded to governments and their instrumentalities.

³⁵ See Danziger, *op cit*, p. 5.

of the property and income of a tax subject is regarded by the holders of tax jurisdiction as legitimate by virtue of the fact that the owner of the taxable property or recipient of the taxable income is resident in their territories (residence, universality, totality-principle).³⁶

For instance, under the residence basis of taxation, a resident of a state is liable on all income accrued or received by him irrespective of the foreign origin. Indirectly, as stated by Albrecht, the effects of taxation may reach aliens who are far beyond the jurisdiction of the taxing state, for example, in case of an internal tax on exports which is passed on to foreign consumers in the form of higher prices.³⁷

Nevertheless, the extent of territorial fiscal sovereignty encounters problems of effectiveness when it comes to the enforcement of their tax laws extraterritorially.³⁸

For the matter of practical necessity, it means that a state might not be able to adopt extraterritorial administrative measures to enforce compliance with its tax laws. The reasons are twofold:

First, as a general rule, states do not enforce fiscal legislation of other countries,³⁹ and in the practical application of this, the courts of most countries do not entertain a claim by a foreign government for its taxes or recognise or enforce a foreign revenue law judgment.⁴⁰

The second point that forms a fundamental aspect of international law is known as the principle of international comity, that is, the mutual respect which nations have for each other gives rise to the recognition which they share as to the field over which each can

³⁶ See Knechtle, *op cit*, p. 36.

³⁷ See Albrecht, *op cit*, p.153; though this deals specifically with indirect tax, which is outside the core of this research.

³⁸ This rule of non-enforcement might also happen sometimes territorially. For example, in theory, a non-resident who derives any income from a source-country, even if only in the course of one day is subject to tax thereon, but the collection of that short duration income might be a different matter and non-compliance in many situations might occur here.

³⁹ See Spitz, B, *International tax planning*, 1982, 2nd ed, p.21.

⁴⁰ This rule does not necessarily mean that courts would uphold transactions or agreements conspiring or which are knowingly designed to violate the revenue law (such as fundamental tax evasion schemes) of a foreign and friendly state; see the case of *Emery v Emery* (1959) Ch 410; (1959), 1 All E. R 577, where an English court refused to recognise a transaction carried out in contravention of the United States revenue law. See also *Regazzioni v K C Sethia* (1959) 2 QB, 490.

legislate.⁴¹ This means that because of the principles of equality of states and sovereignty, a state cannot exercise jurisdiction over persons or property in another state even for a legitimate claim without the other state's consent.

The result of this consideration is that for the effectiveness of the state's tax laws (referring to the enforcement and supervision of that law), it is essential that those who are within the scope of the legislation must be within the territorial jurisdiction of the sovereign nation which enacts it, for otherwise, the tax would be an empty gesture of the sovereign power.⁴²

2.3.4 The personal fiscal sovereignty.

This is another fundamental test by which a state may fiscally impose tax on those facts that are subject to its supremacy. This form of supremacy deals with the right of state to extend its laws to regulate conduct and attach legal consequences to the conduct of these persons (natural and juristic) wherever they may be.⁴³

For income tax purposes, the fiscal attachment in this case is based on nationality or citizenship, and as Prof Stuyt puts it:

'...[A] legal relation exists between that state and individuals (its population) by virtue of their "nationality" conferred on them by the state according to its domestic law. This legal relation continues even if the "nationals" (citizens or subjects) of a given state leave the territory of that state.'⁴⁴

In consideration of the international law principle of political allegiance, nationals of a state owe to that state loyalty and therefore the state has the right to demand the

⁴¹ See Pearce-Crump, D, "Commonwealth Citizenship and British Income Tax Law", 1996, vol 113, SALJ, p. 418.

⁴² See Albrecht, *op cit*, p. 153, (referring to the note in *Columbia Law Review*, 29, 1929, p. 782) to the effect that, 'the power to tax...is a mere gesture of sovereign pride and authority when unaccompanied by a correlated power to collect.'

⁴³ See Martha, *op cit*, p. 43.

⁴⁴ Stuyt, A, *General principles of law, as applied by international tribunals to disputes on attributions and exercises of state jurisdiction*, 1946, p. 96.

necessary means from those subject to its laws. This accords Allix' view that: 'there is nothing to prevent a state's taxation of its nationals in respect of property abroad.'⁴⁵

Thus a person, possessing the nationality of a taxing state, can be held liable for his full worldwide profits from whatever sources they are derived. This was illustrated in the American case of *Cook v Tait*,⁴⁶ where Cook, a citizen of the United States living in Mexico was taxed by the competent American fiscal authority on his income derived from sources within Mexico. He brought the matter to court on the point:

'[W]hether Congress has power to impose a tax upon income received by a native citizen of the U.S, who at the time the income was received, was permanently resident abroad and domiciled in the city of Mexico, the income being from rent and personal property located in Mexico.'

The court held that the authority to tax is not always incidental to the *lex situs*. Moreover, it is equally independent of the domicile of the subject.

The plaintiff was fiscally liable on the basis of a formal relationship between the United States and the citizen (nationality link) regardless of the fact that the subject's domicile and his source of income was outside the United States.⁴⁷

However, certain authors contend that the taxation of nationals on the global basis through the application of the universality principle by which the state takes into consideration the total financial capacity of the nationals, is unacceptable. It is deemed undesirable to extract tax from non-resident nationals in the light of international economic integration.

It is correct to argue that while the state of nationality may want to impose taxes on its citizens abroad (because of a juristic link), practically, it may be difficult for the enforcement and collection of these taxes, if the taxpayer in question does not voluntarily comply or does not own assets in the country. For instance, how would a

⁴⁵ See Allix, *La condition des étrangers au point de vue fiscal*, 1937, 61 Rdc, p. 559.

⁴⁶ (1924) 265 U.S 20.

⁴⁷ Case commented by Martha, *op cit*, p. 49.

state taxing on the basis of nationality, enforce the tax of its nationals permanently residing abroad and earning all their income from foreign sources?

Secondly, the globalisation of the nations' economies has improved the international movement of persons and capital. Thus, taxation on the basis of nationality has become very anachronistic and sources of conflict of jurisdictions.⁴⁸ As Mann writes:

'[B]etween the national and his home country no problem of international jurisdiction can arise, but it is open to question whether the state of the national's residence is not itself in certain circumstances so injured as to entitle it to complain of the implications of taxation on the basis of nationality.'⁴⁹

Furthermore, Jeffery questions the validity of nationality as a basis for exercising fiscal jurisdiction on the ground that it does not have the flexibility to deal with some of the issues which arise in the context of international economic integration. As he sees it, fiscal jurisdiction must have an economic foundation, so that in order to be entitled to tax a person the state should be providing economic benefits to that person in return. The problem is that there is no necessary economic link between a person and the state of his citizenship.⁵⁰

Consequently, because of the inefficiency of the nationality concept of fiscal jurisdiction, Mann favoured the doctrine of 'closeness of connection' or 'genuine link' as the basis of taxation which is actually an attribute to the idea of economic allegiance, and in that context, he argues that:

'The conclusion then is, that a state has (legislative) jurisdiction, if its contact with a given set of facts is so close, so substantial, so direct, so weighty, that legislation in respect of them is in harmony with international law and its various aspects including the practice of states, the principle of non-interference and reciprocity and demands of interdependence.'⁵¹

⁴⁸ See Buhler, O, *Prinzipien des Internationalen Steuerrechts* (1964), 130, pp. 165/166; and L. Von Bar, *Theorie und praxis des internationalen privatrechts*, 319 (2ed), 1889; cited by Martha, *op cit*, p. 67.

⁴⁹ See Mann, *op cit*, p. 117.

⁵⁰ *Op cit*, p. 170.

⁵¹ *Id*, p. 49.

2.3.5 The functional fiscal sovereignty.

This conceptual antecedent of fiscal jurisdiction deals with the situation where international law allows a state to exercise taxing powers on a functional basis in connection with specific rights, such as the cases with the continental shelf, the exclusive economic zone, or the flight information regions as developed by Martha on his theory of spatial sphere of validity.⁵² Professor Riphagen states in his study of this concept that:

‘A sovereign state being traditionally considered to be composed of a “government”, “subjects” and a “territory”, one is naturally inclined to look for application of a concept of “functional sovereignty” in those cases where there is said to be stateless “domain”, and in situations where there seems to be some form of “government” but no territory, i.e, in the case of international organisations enjoying a measure of “independence”. Indeed, in both cases, there are all sorts of legal phenomena which could be covered by the notion of “functional sovereignty”.’⁵³

Thus, for the purposes of functional fiscal sovereignty as recognised by Vann, the question whether the tax jurisdiction of a country extends to all activities on the continental shelf must be clarified. If the territorial sea is treated as part of a country under international law, the country’s jurisdiction should extend to the natural resources of the sea and seabed of the continental shelf, and jurisdiction would then be effected to the extent of the exercise of the country’s sovereignty.

For instance, as Vann stated further, in a case of a floating hotel owned by a non-resident and moored on the continental shelf, if the tax jurisdiction of a country is limited by reference to its sovereign powers under international law, the country cannot tax the profits of the hotel; whereas, it could do so, if its sovereignty covers all activities on the continental shelf.⁵⁴

⁵² See Martha, *op cit*, p. 182.

⁵³ See Riphagen, W, “Some reflexions on ‘Functional Sovereignty’” 1974, *Netherlands Yearbook of International Law*, p.227; also Riphagen, W, “The Jurisdiction of the Coastal State”, in *the Future of the Law of the Sea*, 1973, 154/162: and cited by Martha, *op cit*, p. 44.

⁵⁴ See explanation by Vann, R. J, “International Aspects of Tax”, chapter 18, p. 734, in Victor Thuronyi (ed), *Tax law Design and Drafting*, 1998, 2ed, IMF.

3. The relevance of the study fiscal jurisdiction

As discussed above, the power to impose tax is an attribute of sovereignty by which a state can regulate the affairs of persons and things subject to its authority. Theoretically, it is argued that there are no limitations on the nation's power to impose taxes.⁵⁵

Every state has tax laws of some kind. Thus as one state's tax law can be shaped into particular forms, so the tax laws of all other states tend to differ for individual reasons. The expanding role of government in society and increased government expenditures have given rise to a relentless search for additional tax revenues. This is complemented by the idea that improvements in means of communication and transportation, coupled by the fact that in this global world economy, the majority of states have adopted a policy of progressively liberalising trade and international investment.

Consequently, as the barriers of exchange control have been relaxed or removed, so too have the fiscal constraints on overseas investments. This facilitates international economic and social intercourse and supports the proposition that interests in the effect of commercial activities and the resulting need to regulate them can no longer be localised within national boundaries. Harold Maier argues that these increasingly complex inter-relationships between national, social and economic interests foster a recognition by the world community that there are situations where both national and community interests are served by permitting a nation to address under its laws, activities carried on outside its national borders.⁵⁶

Therefore, due to the factors of mobility of persons and capital, many countries have been led, as Arnold puts it, to succumb to the temptation to extend their tax jurisdiction.⁵⁷ Thus fiscal jurisdiction as we will discover in this research can lend itself to extra-territorial effect and application.

⁵⁵ See comments by Arnold, B, *op cit*, p. 1.

⁵⁶ See Maier, H. G, "Jurisdictional Rules in Customary International Law", chapter 4, p. 65, in *Extraterritorial jurisdiction in theory and practice*, 1996.

⁵⁷ See Arnold, *op cit*, p.1.

The ease with which money and other assets can be moved in and out from one country to another increases the significance of the study of the concept of fiscal jurisdiction because it involves the understanding of how the tax systems of different countries interact. This can be manifested for instance, when cross-border investments occur, or when there is a flow of funds in some other form between two or more nations.⁵⁸

This study of fiscal jurisdiction is relevant because, far from being exclusively focused on the international law aspect of tax,⁵⁹ it involves a complex study of comparative tax law. This research thus includes the study of positive tax laws of South Africa with comparative elements derived from other jurisdictions such as Hong Kong, the United Kingdom and the United States, in order to understand the position from a national point of view when the taxation of income with a foreign element is concerned.

4. The problems posed by the concept of fiscal jurisdiction.

In the global open economy, investors find it difficult to limit the number of steps in a transaction. Consequently, at an international level, it will be difficult to limit the number of jurisdictions through which a transaction passes.

It is a universal assumption, as Ogley puts it, that every jurisdiction will want to tax in one form or another, any profit arising on a transaction which passes through it. Thus, the greater the number of countries through which profits flow, the greater the likelihood of their erosion through taxation.⁶⁰ Wurzel illustrates this particularity well as follows:

‘[T]ypical cases of extra-territorial taxation are found along with a fiction or a technical definition by a foreign country which reaches into the home country of a taxpayer and claims a share in the profit accruing there on the ground that its protection made some contribution real or constructive to such accrual.’⁶¹

⁵⁸ See Ogley, A, *The principles of international tax: A multinational perspective*, 1994, p.1.

⁵⁹ On which there are extensive writings; see Martha, *op cit*, note 8 and Jeffery, *op cit*, note 2

⁶⁰ *Id*, p. 172.

⁶¹ See Wurzel, *op cit*, p. 849.

The first issue that can be raised is that if the scope of fiscal jurisdiction determined solely by the legislative policy of the taxing state can be exercised even extraterritorially, then, what is the extent of the right to tax extraterritorial income in terms of jurisdiction? In respect of what types of income, property, transaction, or arrangement? In other words, when a transaction involves a foreign element, who may be taxed and on what may the tax levy?

Although a state may legitimately want to tax extraterritorial income by virtue of jurisdiction, other states may also concurrently claim jurisdiction on the same facts and in respect of the same income.⁶² Then, while one state may extend its fiscal jurisdiction, this could lead to other states applying the same retaliatory measures and consequently, double or multiple taxation may be imposed on the same income.⁶³

The concurrence of fiscal jurisdiction may arise when two or more states are legally entitled to apply their laws to the same facts. This may happen in practice through a combination of many fiscal facts.

The free circulation of persons, services, goods and capital has led to the confrontation of interests of the relevant national borders and caused more complex international taxation problems.

It is argued that if all countries were to tax on a territorial basis, that is, taxing only income arising within their geographical boundaries (by restricting their tax net to domestic source), international double taxation would not be a problem. However, this

⁶² This is subject of course, to the question that may arise as to whether the taxes levied by different countries are comparable

⁶³ The problems posed by double taxation, where the same income or property gets caught within the tax jurisdiction of more than one country at the same time, will be considered in the research in an international aspect. This must be distinguished from internal or domestic double taxation. For example, where one tax jurisdiction imposes tax twice in respect of the same taxable event and person. On the other hand, the term 'domestic double taxation' does not refer to the situation where the divisions of federal states enjoy parallel taxing powers, i.e, where tax is imposed on the income of a person by both the central government and one or more political sub-divisions of the country. In this latter instance, the double taxation is technically closer to international rather than domestic double taxation. See comments on domestic double taxation, by Spitz, *op cit*, p. 24; also discussed by Arnold, *op cit*, p. 75.

leads to the question, what if two or more nations claimed the same income as domestic source income as a result of different source rules?⁶⁴

The tests for source are often vague and ill-defined, thus even in countries that have accorded substantially similar treatment to the notion of source and whose judicial decisions constitute persuasive authority in other countries (Australia and South Africa for instances), the respective tax authorities and even the highest courts may well come to different conclusions in a similar case.⁶⁵

As frequently occurs, many countries tax on the basis of both the status of the taxpayer and the origin of the income. This is generally effected through a combination of residence taxation and source taxation. For instance, where a company is engaged in cross-border investment, the country in which it is resident (the home country) may seek to tax profits arising from the overseas country (the host country) in which the investment has been made. At the same time, the host country will invariably seek to tax profits arising within it, and considering the higher level tax rates that prevails in the world's economies today, the tax burden can become very onerous.⁶⁶

The issue that can be raised here is what are the consequences and the possible solutions for lack of international compatibility as to the definition of connecting factors for tax liability?

Furthermore, with the expansion of global electronic communication *via* the internet for example, this has an impact on international trade investment. The classic jurisdictional rules applying to taxes are generally based on concepts of physical geography, and as electronic commerce is not bound by physical geography, it may become difficult for taxpayers and government to determine jurisdiction and revenue rights. Consequently, if the basic source concept and the traditional residency notion based on the strong

⁶⁴ Arnold, *op cit*, p. 1.

⁶⁵ Spitz, *op cit*, p. 26.

⁶⁶ See Ogley, *op cit*, p. 1; also found in Arnold, *op cit*, p. 73.

connection between the personal and economic relations (of a taxpayer) and a specific location are weakened by technological changes, then what will be the implications?

In order to avoid consistent distortion of international investment, the necessity for relief is clear on the grounds of equity and neutrality. The question that arises is to the kinds of relief which would be appropriate in such circumstances?

Generally, the tax policy of a state should not affect a person's choice to reside or invest domestically or abroad.⁶⁷ Then, there is a need for states to grant different types of unilateral tax relief.

This calls for another question as to whether it would be wise to place too great faith in those forms of relief. As Ogley writes, where the profits benefit from an exemption or other privileged treatment in a particular jurisdiction, there is always a danger that the legislation will be amended and the favourable treatment withdrawn.⁶⁸ Furthermore, unilateral relief provisions provided by states sometimes reflect considerable differences in form as well as in scope.

Some authors maintain that there is a need for international norms or agreements in the resolution of conflicts of fiscal jurisdiction in order to avoid double taxation.⁶⁹ This explains why many jurisdictions enter into double taxation agreements in order to promote trade by giving investors the assurance that they will not be subject to double taxation. But it is still a controversial question whether these agreements entirely solve international double taxation problems, because there is for instance, a need within the agreements for a mutual understanding and interpretation of international convention and terminology. When more than one state claims fiscal jurisdiction over an income arising within their territory, it is often the problem in the absence of proper

⁶⁷ See Arnold, *op cit*, p. 55.

⁶⁸ See Ogley, *op cit*, p. 172.

⁶⁹ See Martha, *op cit*, p. 155, who is of the view that the definition of connecting factors must be regulated by international law. While Maier, *op cit*, p. 81, considered that conflicts of jurisdiction could be solved through bilateral agreements.

interpretation of the agreements as regards which state has the exclusive right to tax that income.

An attempt at the solutions to these issues presented by the concept of fiscal jurisdiction will constitute the basis of the research that will focus on the comparative approach of the chosen jurisdictions' international income tax law.

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Part II: Policy analysis of the taxation by source and residence and the evolution of the South African tax system

Introduction:

The traditional approach to establishing fiscal jurisdiction is founded on the territorial and personal bases of jurisdiction as discussed in part I of the research.

Fiscal jurisdiction depends on the existence of a connecting factor, which is a genuine link between the taxing state and the subject or object sought to be taxed. Factors that will create an exposure to tax in a particular country may relate either to the quality of the taxpayer (such as nationality, residence, or domicile), to the income (real or deemed source) or to the *situs* of the property.

It has become trite to observe that economic globalisation has reduced the sovereignty of nations in respect of taxation. In a world where capital is highly mobile, market forces may limit a nation's choices in the taxation of income from capital in a number of ways. However, it is the trend in the international arena that, only few states are still applying an exclusive system of taxation. This means that most countries have implemented a combination of different connecting factors in the search for additional revenues. As a result, some countries which tax on the source basis, have also extended their tax net to include some forms of income from foreign sources. On the other hand, residence-based systems have compromised by the taxation of residents of other countries if they derive their income from within the domestic economy. While in the nationality system of taxation, aliens are usually taxed if their income is derived from that territory.

Under the traditional doctrine, the fundamental jurisdictional connection is the territorial basis, defined for the purposes of this work to refer to jurisdiction over persons, matters and things within the geographic boundaries of a state. Thus, the first section of this part of the research will concentrate on the policy discussion based on the territorial attachment between the taxing state and the taxpayer. The focus here is on the analysis of the justification for taxing on the basis of source and residence.¹

¹ The exclusive taxation on the basis of nationality or citizenship has become anachronistic though larger economies like the United States does not see any problem with nationality as a basis for exercising jurisdiction to tax. As argued by Jeffery (op cit, p. 49), the key to the question whether

The second section of the research will consider from the South African perspective, the evolution of its tax system which has undergone some major changes in the application of source and residence principles.

1 Rationale for the taxation on the basis of source

Different views have been advanced by writers in favour of taxation of income exclusively on the basis of source. In an attempt to justify the entitlement of the state to tax income deriving from its jurisdiction, Stratford CJ explained the rationale for source taxation in the case of *Kergeulen Sealing and Whaling Co Ltd v CIR* by stating that:

‘... [T]he equity of the levy (of tax) 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 the recipient may live.’²

Thus, the right to tax exclusively on the territoriality principle is *per se* justified on the basis of a link between any economic activity and a specific location.³

In terms of analysis of this principle, it has been argued that the source basis of taxation applies when there is an economic attachment of the taxpayer to the taxing state. Put differently, the source principle is a system of taxation in which the fiscal attachment is based on the link between the income to be taxed and the territory of the state imposing the tax. As Plasschaert argues, the source basis of taxation derives from the fact that:

nationality (particularly as it applies to individuals) is a valid fiscal jurisdictional base lies in the economic foundation of fiscal jurisdiction and the linking of this with the receipt of economic benefits from the state. Thus, nationality based as it is on the idea of political, not economic allegiance, does not provide the required link and should therefore be seen as an exceptional basis for the exercise of jurisdiction. That is why it will not be considered in this research which will target specifically the source and residence fiscal jurisdiction.

² (1939) AD 487, 10 SATC 363.

³ This economic relation or allegiance justifying the application of source of principle is also found in the works of prominent scholars such as Harding, (*Double taxation of property and income, A study in the judicial delimitation of the conflicting claims of taxing jurisdiction advanced by the American States*, 1933) who in the development of the theory regarding the state’s right to tax and the territorial limits of this right stated that: ‘It appears that the state may tax all property, goods, labor, services and the like, which have become identified with the economic structure of the state, by incorporation into or integration with the business mechanism so defined... the right to tax then depends upon the fact that the economic wealth is being used in the coordinated economic task of the social group; that is producing utility or wealth or service in connection with, as part of, and because of the economic solidarity of the social group.’ Also cited by Vogel, *op cit*, p. 221.

‘[I]ncome must be subjected to taxation in the country in which it originates, irrespective of whether the income accrues to a non-resident or to a resident taxpayer.’⁴

He adds that countries applying only the residence basis of taxation would therefore forego any tax claim on income which originated within their borders but which accrued to non-residents. Due to the fact that the non-resident enjoys the opportunity of earning income in the state and thus benefits from the organisation of the state, he may accordingly be asked to contribute by way of taxes. Because the source country provides facilities which enable income to be earned there or allows non-residents to earn income and compete with residents of the taxing state, non-residents should be taxed as a result of that economic connection from sources in that state.⁵

An explicit analysis of the source concept is given by Klimowsky who developed the idea of qualitative and quantitative aspects of every source of income.

According to him, the qualitative aspect relates to the activity or property which gives rise to the income, irrespective of the personal status of the taxpayer. This constitutes some types of activity with qualitative elements of source of income such as trade, professions, labour and services. However, there can be no source determination unless the income is quantified. Thus, the quantitative aspect relates to the manner in which the activity or the property of the taxpayer is applied to earn the income as well as his identity.⁶

With reference to the same point, Klaus Vogel argues that ‘source’ is not an *a priori* concept and has to be defined in the context of the legal rules governing a particular problem according to the same criteria that led or have led to establish that rule. In other words, the source principle in general is not a natural, self-defining concept in

⁴ See Plasschaert, SRF, “The Design of Scholastic and Global Systems of Income Taxation: The International Dimension”, 1981, *International Bureau of Fiscal Documentation*, 409.

⁵ See Plasschaert (*op cit*, p. 409/410) who further stated that: ‘In the source country, inputs have been put to fruition by the non-resident, production is greatly facilitated by intermediate public goods such as transport facilities, provided by the host government. A political argument which carries a nationalistic taint is that foreigners have been allowed to operate in the national economy and to compete with domestic entrepreneurs. Finally, in countries in which foreigners supply a substantial part of productivity resources, as is typically the case in the developing world, the adoption of only the residence principle would involve a significant loss of revenue.’ Also cited and commented by Danziger, *op cit*, p. 87.

terms of types of connection that establishes the 'source' of income. On the other hand, the source concept could only be referred to the state which in some way or the other is connected to the production of income in question or to the state where value is added to a good.⁷

Following the above analysis, it is clear that the justification for the source principle is based on the benefit theory of taxation. Under this theory, the host country is entitled to impose tax on non-residents to cover the costs they impose on the public sector, including the cost of pollution that their activities impose on residents.⁸

In support of the benefits justification for source-based taxation, it might be argued that multinationals are sometimes able to earn pure economic profits such as rents by taking advantage of some specific feature of a country. A multinational might, for instance, engage in business in a developed country to gain access to its large market of affluent consumers. In either situation, the multinational enterprise earns a higher before tax rate of return on its investment than it could have earned elsewhere. The host country should be entitled to tax the multinational enterprise on these location specific rents. Furthermore, raising revenue by taxing these rents is efficient because the tax will not distort the taxpayer's economic decisions.⁹

Another possible justification for a source-based corporate income taxation is that it serves as a means for the source country to regulate the corporate activity that takes

⁶ See Klimowsky, "The 'Source of Income' in Municipal and International Taxation", 1960, XIV *International Bureau of Fiscal Documentation*, p. 66. It is also well illustrated by Danziger, *Op cit*, p. 84/85.

⁷ See Vogel, K, *op cit*, p. 223.

⁸ See Green, R, "The Future of Source-based Taxation of the Income of Multinational Enterprises", 1993, *Cornell Law Review*, vol 79, p. 29. He argues that the problem with this rationale is that the income tax in general and the corporate income tax in particular cannot plausibly be viewed as a form of benefit fee or effluent charge. In his view, there is no definite relationship between a corporate's taxable income and the costs that the corporation imposes on the public sector. A corporation's taxable income depends significantly on the outcomes of the business risks that the corporate undertakes whereas the costs the corporation imposes on the host country are generally independent of those outcomes. Moreover, foreign direct investment often provides substantial benefits to the host country independently of any tax revenue. Consequently, it is likely that these benefits sometimes exceed the costs that the corporate taxpayer imposes on the host government. See also Mc Lure, C.E, "Substituting Consumption-based Direct Taxation for Income Taxes as the International Norm", (1992), 45 *National Tax Journal*, 145-149.

⁹ Green (*op cit*, p.30/31) rejects this argument on the basis that the corporation income tax does not distinguish between location-specific rents and normal return on equity capital or rents that are specific to the multinational rather than the country. As he argues, a multinational might be able to obtain rents because of its ownership of unique manufacturing knowledge which it can exploit by building a factory anywhere in the world. It is not clear why the country that the multinational happens to choose as the location for the factory should have a special entitlement to tax the normal return on the investment in

place within its borders. For instance, a country might wish to use taxation as an instrument to provide incentives or disincentives for corporate investment or saving, to restrict monopoly power or the absolute size of firms, or to constrain profits in connection with the imposition of direct controls over wages and prices. Although taxation can be a useful device for accomplishing these purposes, the corporate income tax generally would not be the most suitable form of taxation to employ if these were truly the objectives of the tax.¹⁰

1.1 The power theory

One of the best explanations for source-based taxation relates to the power that the government has to impose taxes. The core of the concept of fiscal jurisdiction is to be found in the power of a state to create interests.¹¹

According to the power theory, fiscal jurisdiction is the result of the power of the taxing state over the tax subject or object.¹² In the equation of fiscal jurisdiction with physical power, Stimson argues that:

‘The fundamental principle of jurisdiction is simple enough. Jurisdiction is physical power. A sovereign state has no physical power over persons and property outside its territory.’¹³

Fiscal jurisdiction depends on the extent to which a tax claim can be enforced. Consequently, whenever an entity can or actually exercises its physical power, it has fiscal jurisdiction.

In the context of the source principle, the description of the power theory gives rise to some limits. For instance, a state may, in some circumstances, have physical power over persons and objects within its territory without having fiscal jurisdiction (cases

the factory or even the firm-specific rents, the practical effect will be to discourage multinationals from investing in the country.

¹⁰ *Ibid.*

¹¹ See Wurzel, *op cit*, p. 825.

¹² See Danziger, *op cit*, p. 19.

¹³ See Stimson, *Jurisdiction and power to tax*, 1933, 111 criticised in his theory by Martha, *op cit*, p. 19. This theory was relied on in the American case of *Burnet v Brooks*, where the Supreme Court approved of an estate tax on property situated within the United States, when the decedent was a British citizen and a resident of Cuba, on the basis that, the property was:

‘[W]ithin the reach of the power which the United States by nature of its sovereignty could exercise as against other nations and their subjects without violating any established principle of international law.’¹³

of jurisdictional immunities of diplomats) or there may be situations where a state has no physical power, but can legitimately claim the right to tax.

However, as correctly pointed out by Green,¹⁴ there is one pragmatic justification for the source principle that goes beyond *force majeure*. The country of source is generally in the best position to enforce a tax on transnational income. That is probably why in the international tax context, the benefit principle has been offered as a rationale for the permanent establishment test, so that unless a company has a permanent establishment, it is not likely to benefit significantly from public services.¹⁵ The source country can monitor transnational income by requiring local firms and financial intermediaries to report the income payments they make and withhold taxes on such payments. The residence country, by contrast, has no jurisdiction over such foreign entities and must rely on less effective means to ensure compliance.

1.2 The contractual theory

This theory justifies the taxation on the basis of source by suggesting that taxation is the payment for goods and services received from the taxing state on the basis of a presumed contract between the holder of fiscal jurisdiction and the fiscal subject.¹⁶

This theory has been formulated by Saredo who maintains that the state's right to tax is essentially a contractual one, and is a result of a bilateral contract between the state and the taxpayer.¹⁷

If the right to tax is based on a contract, then to what extent is the fundamental aspect of contract present in the agreement?¹⁸ It may be argued that a person who voluntarily goes to a foreign country and buys property or engages in economic activity may be said to have impliedly agreed with the foreign state to pay its taxes. However, it might

¹⁴ *Op cit*, p. 31.

¹⁵ See Mc Lure, C. E, "Globalization, Tax Rules and National Sovereignty", August 2001, *Bulletin for International Fiscal Documentation*, vol 55, no 8, p. 336,

¹⁶ See Hobbes, T, *Leviathan* 181 (1651); also found in Martha, *op cit*, p. 21.

¹⁷ See Saredo, *Traité des lois*, 1871, 779; Griziotti, *Recueil des cours*, 1926, 13, p. 31.

¹⁸ This theory was explicitly rejected by the Appellate Division of the state of New York, in *Colorado v Harbeck* (1921), 189 N. Y. AD 865, on the argument that the state of Colorado could not file suit for the enforcement of its revenue laws on the basis that a tax was due as a contractual obligation.

be difficult to apply the same rules to the situation of inheritance tax when an alien non-resident finds himself liable to foreign tax through no voluntary act of his own.¹⁹ The question that arises is whether, by accepting the property, the taxpayer consequently concludes a contract in which he consents to taxation. Is there any real freedom of contract between the state and the taxpayer?

According to Albrecht, the alien taxpayer must pay his taxes whether he has agreed to do so or not, and the contract is not even subject to negotiation regarding its terms because the state is free to fix the 'price'. Thus the parties do not stand on an equal footing, and the terms of the contract are unilaterally imposed by the state which can vary them at will, or may alter or abolish existing taxes and introduce new ones, spending the proceeds as it likes without any obligation to consult the alien taxpayer.²⁰

However, as Albrecht contends further, there are some situations in which the right to tax aliens for example may be affected by a contract:

The first situation is when the contract exists between the alien taxpayer and the taxing state which sets out the nature and the amount of taxation to be allowed.²¹

The second situation may happen when two or more states have concluded a treaty on the taxation of aliens.²²

1.3 The ethical or 'retributive' theory

This theory found its early analysis in the writings of Griziotti, who considered that, the right to tax has an ethical basis rather than a juridical or political one. It derives its origins and foundation in the sovereignty of the state.²³ It follows that consideration of fairness have to some extent influenced the development of rules of international law

¹⁹ See Albrecht, *op cit*, p. 146; also in Martha, *op cit*, p. 21.

²⁰ *Id*; also discussed by Wurzel, *op cit*, p. 832.

²¹ See the agreement between the Imperial government of Persia and the Anglo-Persian oil Co Ltd of 29 April 1933, in League of nation official journal (July-December, 1933), annex 1467, p. 1653.

²² For example, as Albrecht (*op cit*, p. 147) stated, this category deals with treaties designed to prevent double taxation, to avoid unfair discrimination, or to establish special privileges.

²³ Griziotti, *op cit*, p. 5.

affecting the right to tax. Thus, from the source tax perspective, taxation in the ethical sense is a return for advantages or benefits received from the state.²⁴

There are limits established by ethical principles and generally recognised in practice which restrict the exercise of the sovereignty of states in imposing taxation.

The determination of the contribution of the individuals to the needs of the society depends on two main factors:

Firstly, anyone who forms part of an economic community must contribute according to his earnings to the cost of such community;

Secondly, anyone who benefits from the social activity ought to pay taxes to that community, as well as any person fit or capable to contribute to the collective life of the society.²⁵

The weakness of this theory is that, there is no clear and generally accepted standards of fairness in the right to tax for example aliens and thus, no objective parameters of what is 'just' can be said to exist.

1.4 Other principles and policy considerations

It is also argued that taxation on the basis of source supports the following principles:

1.4.1 Equity

The source principle favours the principle of equity. Some writers consider that under the worldwide system of taxation, there is discrimination between residents and non-residents. Non-residents are often taxed at a flat rate on gross income and even when they are taxed on a net basis, they are denied some personal allowances and other deductions that are allowed to resident taxpayers. While the source country treats all

²⁴ See Albrecht, *op cit*, p. 146.

²⁵ See Martha, *op cit*, p. 20. Albrecht (*op cit*, p. 148) has criticised Griziotti on the combination of ethical principle of taxation and ability to pay principle. He argues that the rule by which the taxpayer should pay according to the advantages which he receives from the state cannot be reconciled with the rule that he should pay according to his capacity, unless it is assumed rather unrealistically that capacity is a measure of the advantages received.

income earned within its jurisdiction equally, whether a resident or a non-resident earns the income.²⁶

1.4.2 Neutrality

Taxation on the basis of source may be justified on the ground of capital import neutrality; that is to say neutrality as an objective tax system does not affect or interfere with personal or investment decision, and consequently, it promotes the most efficient allocation of resources. On that basis, since the tax burden on residents and non-residents is the same, neither will enjoy any tax advantage in doing business within the country. Territoriality as the basis of taxation is then neutral insofar as it permits non-residents to compete equally in a particular country with residents of that country.²⁷ Apart from the question of entitlement, there is an argument for an international system of purely source-based corporate income taxation on the ground that it would promote global economic efficiency. In particular, such a system would be neutral with respect to the international allocation of world savings and ownership of capital.²⁸

Taxing on the principle of source of income permits the reduction of international double taxation to the extent that all the source countries would only claim tax on domestic source income under the same applicable tax rules.

In addition to the motivation emphasising enjoyment of the source country's resources as noted in the *Kergeulen's* case,²⁹ a source system is also justified by the degree to which it ensures fair competition between taxpayers in the particular jurisdiction and taxpayers (competitors) from other jurisdictions. It follows that the application of the source principle of taxation secures the objective of neutrality and equal competition for both inward and outward investment, while protecting a country's capital and human skills.

²⁶ See Arnold *op cit*, p. 66.

²⁷ *Ibid*, p. 69.

²⁸ See OECD, *Taxing Profits In A Global Economy: Domestic And International Issues* 39-42 (1991); Horst, T, "A Note on the Optimal Taxation of International Investment Income", (1980) 94 *Q.J Econ* 793.

2. Rationale for taxing on the basis of residence

Although the justification for a country in imposing a source-based income tax on non-residents is universally accepted, some writers have argued that this justification is difficult on theoretical grounds.³⁰ Green has maintained the view that source-based taxation is difficult to reconcile with the prevailing theory of the income tax as a means of allocating the cost of government among individuals on the basis of ability to pay. As he contends, it is an attempt by government to tax income on the basis of source that gives rise to income shifting and to tax competition among governments. In addition, Avi-Yonah³¹ argues in the analysis of the US source system that the fact that each category of income has its own source rule causes significant transactional complexity as taxpayers try to manipulate the source of income so that the resulting substantive tax rule will be to their advantage. Moreover, the differentiation between the various categories is very difficult and gives rise to much litigation and elaborate regulatory exercises.

Thus, the ultimate solution would be to move to an international tax system that uses residence as an exclusive basis for tax jurisdiction.³²

In the writings of Hugo de Groot, there is a suggestion that the adoption of residence as the connecting factor is based on the jurisprudential protection theory of fiscal jurisdiction.

As Grotius contends, if a sovereign state incurs expenses by providing security and protection of trade to strangers, it has a right to reimburse itself by the imposition of moderate and reasonable duties.³³ In other words, the importance of the residence concept in taxation, as expressed by Stratford CJ in *Kergeulen Sealing & Whaling Co Ltd v CIR* is based on the fact that:

‘[P]resumably, ... 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.’³⁴

²⁹ *Op cit*, note 2.

³⁰ See Green, *op cit*, p. 70. See also Plambeck, C. T., “The Taxation Implications of Global Trading”, (1990), 48 *Tax Notes* 1143.

³¹ See Avi-Yonah, R.S., “Making Sense of US International Taxation: Six Steps toward Simplification”, 2001, *Bull For International Fiscal Documentation*, vol 55, p. 494.

³² See Green, *op cit*, p. 70.

³³ See Hugo de Groot, *De jure belli ac Pacis*, 1625, 2.2.14, 1-2, cited by Danziger, *op cit*, p. 54.

³⁴ (1939) AD 487, 10 SATC 363.

Because of the economic security which individuals and groups enjoy in a country either by benefiting from the laws of the land or relying on its resources (though they may be nationals of other countries), it is justifiable to formulate a system in which the beneficiaries of national expenditure share in this cost, be it by direct or indirect taxation.³⁵

2.1 The protection theory

As mentioned above, this theory as the basis for residence tax jurisdiction derives from the proposition that, if a state grants protection to a resident person, his property or activities, the state is entitled to tax that person, his property or activities.³⁶

Arnold³⁷ reconciles the protection theory with the benefit provided by the state of residence. Because government services must be funded from tax revenues, those who benefit from the services should pay for them. Protection is the qualitative as well as the quantitative prerequisite for extra-territorial taxation. As Arnold puts it, residents of a country clearly derive significant benefits from a wide range of government expenditures, whether their income is earned from foreign or domestic sources or from a combination of the two.³⁸ This can even justify the taxation of foreign income of a resident alien although his foreign assets cannot be protected directly.

Wurzel argues that a resident is able to make a country of his stay the economic center of his activities, directing his business in any part of the world from this centre under the protection of the laws of that country. As he continues:

‘[P]rotection is effectively granted not only by political measures in cases of conflict with foreign powers but also by the economic center of his activities, directing his business in any part of the world from this center under the protection of the laws of this country.’³⁹

³⁵ See the argument of Plasschaert, SRF, *op cit*, p. 409, who stated that the benefits enjoy by the resident in a state derive from the inflow of factors of production which have been nurtured by educational and other outlays of the home country government.

³⁶ See Danziger, *op cit*, p. 5.

³⁷ *Op cit*, p. 12.

³⁸ See Arnold, B, J, *The Taxation of Controlled Foreign Corporations: An International Comparison*, 1986, *Canadian Tax Paper*, no 78, p. 2.

However, the benefit theory may give rise to some problems. The question arises as to who benefits from the public expenditures and the extent of the benefit. For instance, as a class, residents who earn foreign source income benefit less from public spending in their country of residence than residents who earn exclusively domestic source income. For the former, the income in question is generated under substantially different circumstances in other jurisdictions.⁴⁰ On the other hand, non-residents who earn income from a country by reason of employment or a business carried on there can be said to benefit significantly from the country's public expenditure.

On the practical application, there appear to be several solid grounds for preferring the principle of residence to source, particularly as it applies to individuals. On a pragmatic ground, Avi-Yonah argues that individuals can only be resident in one place at any given time. Thus residence for individuals is a relatively easy concept to establish, and in fact, it is possible to set down bright-line rules for determining the fiscal residence of individuals. On the other hand, determining the source of income is a highly problematic endeavour, and in most cases, income will have more than one source. Consequently, if one jurisdiction is to be given the primary right to tax individuals, the residence jurisdiction is an obvious candidate.⁴¹

With regard to the residence-based taxation of corporate income, Green maintains that it would be possible to devise a residence-based system at the corporate level by obtaining international agreement on the definition of corporate 'residence' and giving the residence country exclusive jurisdiction to impose the corporate income tax. It would be difficult to justify such an allocation on theoretical grounds, however,

³⁹ See Wurzel, *op cit*, p. 829.

⁴⁰ However, this argument may be less convincing because it ignores the fact that even for a resident who earns exclusively foreign source income, the state of residence of the taxpayer has enabled him to accumulate capital, to develop intangible property or to acquire a capital asset, which are invested offshore, and that the taxpayer does not actively use the infrastructure of the other state where another taxpayer uses the capital or asset.

⁴¹ See Avi-Yonah, R. S. "The Structure of International Taxation: A proposal for Simplification", (1996) 74 *Texas Law Review*, p. 1311. The problem with enforcing residence-based taxation of individuals is very practical. As many writers argue even developed countries find it hard to effectively enforce residence-based taxation on the global income of individuals, especially from tax havens, and developing countries find this task impossible. Thus, as portfolio investment grows and becomes increasingly more mobile, this problem becomes more and more acute. See Giovannini, A & James Hines, Jr "Capital Flight and Tax Competition: Are There Viable Solutions to Both Problems?", (1991) in *European Financial Integration* 172. Bird, R.M "Income Tax Reform in Developing Countries: The Administrative Dimension", (1983) 37 *Bull. FOR INT'L FISCAL DOCUMENTATION* 7.

except to the extent that the residence of a corporation is a good proxy for the residence of its individual shareholders. Moreover, if corporations have flexibility to choose their country of residence, as would likely be the case, the result would be tax competition among countries to induce corporations to become residents. The end result might be the effective elimination of corporate income taxation, at least for multinational enterprises.⁴²

2.2 Key principles and Policy considerations

Taxation on a worldwide basis can also be justified by the key principles of equity, neutrality and efficiency.

2.2.1 Equity

The application of the principle of equity for residence tax purposes is based on the idea that taxpayers earning the same amount of income (whether derived from domestic or foreign sources) should pay the same amount of tax (horizontal equity) or that taxpayers should be taxed in accordance with their capacity or ability to pay (vertical equity). Fairness of the tax system is one of the main reasons for taxing residents on their worldwide income.

Vann⁴³ correctly argues that when a country adopts a progressive income tax rate scale for individuals, it is usually motivated by the idea that it is fair for higher-income individuals to pay proportionally more of their income as tax. However, unless the individual is taxed on worldwide income, this goal may not be achieved for an individual with income from more than one country. If the progressive tax rates are the same in each country and each country taxes only on a source basis, an individual

⁴² See Green, *op cit*, p. 70. As recognised further by Green (p. 72), a pure residence-based taxation for corporate income does present several potential problems. First, if each country continued to maintain its own definition of the corporate income tax base, corporations would have to calculate their taxable income under the rules of each country in which any of their ultimate individual shareholders resided. Second, enforcement would be difficult, because each country would have to monitor the worldwide operations of every multinational enterprise in which any of its residents were shareholders. Another substantial obstacle to moving to a residence-based system would be that it would alter the international division of the tax base in favour of countries that are net capital exporters (residence countries) to the detriment of countries that are net importers of capital (source countries).

⁴³ *Op cit*, p. 749.

receiving income from each country will pay less tax in total to both countries than an individual who receives the same total amount of income from only one of the countries. This is doubly unfair because not only are the two like individuals taxed differently, but individuals are obviously encouraged to split their income between the countries; an avenue that is more likely to be used by a high-income taxpayer.

On the same point, Avi-Yonah contends that because most individuals can only be resident in one place, distributional concerns can be effectively addressed only in the country of residence. If the personal income tax is to have a significant redistributive function through progressive rates, it is necessary to include all income (including foreign source income) in the measurement of the taxpayer's ability to pay. There may be no problem of horizontal equity in taxing differently two equivalently situated taxpayers, only one of whom invests abroad and earns low-taxed income there, as long as the other has the same choice of investments open to him. However, there is a significant problem of vertical equity in taxing an investor with a low level of domestic earnings and with high foreign earnings that are not taxed abroad in the same way that a person with low domestic earnings is taxed.⁴⁴ This problem can be resolved if the residence jurisdiction is allowed to tax on foreign source income that is not taxed abroad (or is taxed at lower effective rates) and allows a credit for foreign taxes, but it is much simpler to address the issue if the residence jurisdiction is given the exclusive right to tax all income of its residents.

2.2.2 Neutrality

Taxation on the basis of residence as supported by economists, promotes capital export neutrality. Exempting foreign source income is an inherent incentive for residents to invest abroad. The goal of capital export neutrality (CEN) requires that the decision to invest in a given location not be affected by tax rates; otherwise, investments that yield the highest returns on a pretax basis will not be made because the after-tax return will be lower, causing global welfare (based on allocative

⁴⁴ See Avi-Yonah, *op cit*, note 41, p. 1312. For further comments on the concepts and norms of horizontal and vertical equity, see Kaplow, L & Repetti, J, "Horizontal and Vertical Equity: The Musgrave/ Kaplow Exchange", (1992) 1 *FLORIDA. TAX REV.* 605. See also Musgrave, R, "Horizontal Equity, Once More", (1990) 43 *NAT'L TAX. J.*, p. 113.

efficiency) to be diminished.⁴⁵ Thus, in a world with many taxing jurisdictions with varying rates, capital export neutrality is best achieved by taxing all investors at their residence country's rate.

2.2.3 Efficiency

Taxation of residents on their global income broadens a country's revenue base, limits scope for tax avoidance and non-taxation. If residents of a country have significant amounts of foreign investment, the taxation of foreign source income may add substantially to tax revenues, even after relief is provided in respect of foreign taxes.⁴⁶ On the political level, the residence of individuals, to some extent overlaps with their political allegiance. In democratic countries, it is considered important for individuals to have a right to participate (through their representatives) in deciding how much tax they have to pay. The converse is even more significant because democratic legislatures have a preference for raising taxes on foreigners precisely because they cannot vote. Thus, taxation based on residence is a useful, though far from perfect, proxy for taxation with representation.

2.2.4 Cyberspace advantage

In the era of electronic commerce, where current views of tax principles has become extremely vague, it can be argued that the residence-based tax system is more suitable to deal with the issue of jurisdiction in cyberspace transactions. It is therefore fair to say that in the digital economy, the jurisdictional rules of residence may be more dependable and less subject to manipulation than those governing source-based taxation. As Swanepoel⁴⁷ contends, it will often be easier to establish a connecting factor with reference to a resident as opposed to the source of particular income and it

⁴⁵ CEN is generally considered by economists to be superior to capital import neutrality (CIN) as a welfare-enhancing principle. It is argued that CEN is needed to achieve an efficient allocation of the world's investments, while CIN is needed for an efficient allocation of savings, which is considered to be a less important goal. See Mc Lure, C, "Substituting Consumption-based Direct Taxation for Income Taxes as the International Norm", (1992) 45 *NAT'L TAX J* 145/146. See also Frisch, D, "The Economics of International Tax Policy: Some Old and New Approaches", (1990) 47 *TAX NOTES* 581.

⁴⁶ This policy may be difficult to apply in the jurisdictions which adopt a residence tax system while maintaining some form of exchange control regulations.

⁴⁷ See Swanepoel, E, "E-Commerce and Tax Questions", 13 *Taxgram*, July 1999.

is thus likely that residence will be the preferred test in respect of the taxation of electronic commerce.

Accordingly, in the case of individuals for example, a country will generally be able to enforce its tax claims against residents, probably because the taxpayer or at least some of his assets will be within the country's jurisdiction, whereas a single-source country is unlikely to know the total income of a non-resident taxpayer and will face enforcement problems in relation to income arising outside the country. In addition, the tax residence country could minimize the erosion of the tax system by adopting alternative legislative factors for tax liability. In application to individuals, the physical presence test could be combined with other subjective criteria such as the place of vital economic interest.

In the case of companies, though the ease with which the place of effective management and the place of incorporation tests for residence can be manipulated without necessarily substantively altering the way the company conducts its business, transactions over the internet raises the possibility for tax residence countries to use different criteria for tax liability. Thus, in order to avoid the erosion of the national tax base and to legitimately claim the right to tax, it is suggested that the determination of residence with regard to companies, could be the location of the server that hosts the home web of the company, as that would be the place where the day-to-day running of the company takes place.⁴⁸ On the other hand, Doernberg⁴⁹ contends that if it were deemed desirable to change the definition of residence for legal entities in light of technological advances, one possibility (though not commercially justifiable in some instances) would be to extent conventional residence tests to move closely to the consideration of residence of the participants, be they shareholders, directors or managers, in determining the residence of an entity, without completely forsaking the traditional tests.⁵⁰

⁴⁸ See Buys, C.R., "The Taxation of Electronic Commerce in South Africa", 1998, LLM thesis (UCT), Part IV, p. 13. It could on the other hand be argued that adopting the location of the server as the place of residence in an e-commerce environment would be far removed from the management of the company which seems to indicate a human activity.

⁴⁹ See Doernberg, R & Hinnekens, L, *Electronic Commerce and International Taxation*, 1999, p. 333.

⁵⁰ This approach may be effective in some cases, but it may be unjustifiable to adopt a broad definition of residence for legal entities in terms of residence of investors. First, the tax net would be widened to include all foreign incorporate companies, even those that conduct legitimate business activities. Secondly, there would be practical problems with the enforcement of taxation of foreign companies. It

In conclusion, it seems appropriate from a policy viewpoint, for the country taxing on the basis of personal allegiance of the taxpayer to be the one that takes account of the taxpayer's attributes.

3. The evolution of the South African tax system

3.1 Historical background to the South African's fiscal jurisdiction

The first income tax law in South Africa was based on the principle that income tax should be levied on the income originated within the Union (as it then was).⁵¹ This was incorporated in the Additional Taxation Act 36 of 1904 (Cape), which in its section 42 defined 'income' as 'any gains or profits derived or received from any source within this colony.'⁵²

The source principle was adopted in the first Union income tax legislation called the Income Tax Act 28 of 1914, which 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 whatever in the Union...'

The source principle was preserved in subsequent tax legislations: the Income Tax Consolidation Act 41 of 1917, the Income Tax Act 40 of 1925 and the Income Tax Act 31 of 1941 which defined 'gross income' as including receipts and accruals 'from any source within the Union or deemed to be within the Union.'

The source concept was maintained in the Income Tax Act, no 58 of 1962, in its section 1 which then read as follows:

'In this Act, unless the content otherwise indicates-... "gross income" in relation to any year or period of assessment means, in the case of any person,

may be difficult to gather information necessary to determine their tax liability and once determined, the collection of tax would be difficult unless the company voluntarily complied or had assets in the jurisdiction that imposed the tax. See also Sandler, D, *Tax Treaties and Controlled Foreign Companies Legislation*, 1998, 2ed, p. 4.

⁵¹ See the Katz Commission, 5th report, *op cit*, p. 3.

⁵² It should be noted that before 1910, tax on the income of individuals was levied only in the Cape Colony and Natal. Thus, the Taxation Act 36 of 1904 was only applicable in the Cape Colony while a similar tax was imposed in Natal by Act 33 of 1908. Colonial legislation also made provision for a tax to be levied on the taxable income of mines, namely Act 16 of 1907 in the Cape Colony, Act 43 of 1899 in Natal, and Ordinances 25 of 1903, 8 of 1904, 15 of 1907 and 24 of 1907 in the Orange Free State. The Mining Taxation Act 6 of 1910 consolidated the laws relating to the taxation of mines in the Union. See Clegg, D & Stretch, R, *Income Tax in South Africa*, December 2001, vol 1, Service Issue 20, p. 1-4.

the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature...'⁵³

Several investigations concerning the appropriateness of the source concept have been made in South Africa.

In 1951, the Steyn Committee⁵⁴ did not favour the source principle on the argument that, the application of the source principle as a connecting factor made it possible for persons who derived their income from non-South African sources to reside in the Union and enjoy the protection of the state without making any direct contribution by way of income tax to the fiscus.

The Minister of Finance identified the tax avoidance schemes as being linked to a source basis in his 1955 budget speech:

'Under existing legislation income received from foreign sources is not taxable. With the purpose of avoiding super tax, certain Union nationals or persons resident in the Union, transferred their shares in local companies to companies which were specially formed for this purpose outside the boundaries of the Union. Profits earned in the Union are then paid to the foreign company which in its turn distributes it as dividends to its shareholders in the Union. Since such dividends are regarded as income received from sources outside the Union, it is not taxable here. This is a clever plan intended to rob the state of its legitimate tax revenue – and I use the word rob purposely – and this cannot be allowed to continue...'⁵⁵

However the Commission recommended that the source system should be maintained on the grounds of perceived complexity of changing to a residence system where, for instance, it would necessitate the granting of double taxation relief which would probably entail giving a credit for foreign taxes and that for such credit to be effective and equitable, the legislation would have to be complex, and the limited gain benefits to the revenue unless a large amount was earned by South African residents in other countries and was taxed at lower rates than the rates imposed in South Africa.

⁵³ See Danziger, *op cit*, p.13/14; also found in Swanepoel, *op cit*, p. 18.

⁵⁴ *First Report of the Committee of Enquiry into the Income Tax Act* (The Steyn Committee Report), UG No. 75-1951(Pretoria: The Government Printer); para. 68, p. 19.

⁵⁵ See Coetzee, H.A, "Residence and Corporate Taxation", (March 1988) 1 *Foreign Tax Review* 17.

In 1970, the Franszen Commission⁵⁶ recommended the opposite for the following reasons:

Firstly, more income was beginning to flow into South Africa without being taxed. Secondly, the source-basis of South Africa could no longer be reconciled with its economic interests due to the fact that South Africa's major trading partners were adopting a worldwide system and the residence basis was enhancing the individual's ability to pay considering the realities of international tax arrangements.

The Commission recommended a change from source basis to residence basis of taxation, so that the gross income of South African residents would include income from both South Africa and foreign sources, while non-residents would be taxed on income from South African sources.

As Danziger⁵⁷ commented, the justification given for these recommendations was based on particular grounds:

First, the amount of foreign source income earned by South African residents had increased consistently since the Steyn Committee report, and in that light, the Income Tax Act had already deviated from a pure source basis through the introduction of various deeming provisions.

Secondly, double taxation agreements have been concluded or were being negotiated with South African trading partners. The double taxation agreements practice had developed equitable principles for the allocation of taxes between source and residence states. As a result, South Africa, by taxing on the source basis, unilaterally surrendered the benefits of this allocation with a resultant loss to the fiscus.

The above recommendations were accepted by the government in its subsequent white paper subject to the provision that further study would be taken on certain facets of the recommendations. The Franszen Commission on the matter of change to residence basis was, however, never implemented by way of legislation.⁵⁸

The Margo Commission (1986/87)⁵⁹ reviewed the whole issue comprehensively. It recognised that two reasons would favour a residence basis of taxation. First, with the

⁵⁶ *Commission of Enquiry into Fiscal and Monetary Policy in South Africa* (The Franszen Commission Report). Taxation in South Africa: Second Report. RP 86/1970 (Pretoria: The Government Printer 1970), para. 20.

⁵⁷ See Danziger, *op cit*, p. 15.

⁵⁸ See the Katz Commission, 5th Report, chap 2, p. 3.

⁵⁹ *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (The Margo Commission Report), RP 34/1987 (Pretoria: The Government Printer 1987), para. 26-3.

lifting of the exchange control regulations, the residence system might be helpful in limiting the consequential tax avoidance. Secondly, the source-basis was exposed to schemes of tax avoidance through the other countries in the rand monetary area, and thus a worldwide taxation would help to counter this.

This commission recommended that subject to the possibility of extending some of the existing source provisions, the source basis of taxation should be preserved. This was based on the consideration that:

The legislation for and the administration of a worldwide system would be considerably more complex than the existing system because it would impose considerable burdens on the fisc, especially in relation to companies and trusts operating in foreign jurisdictions.

The second reason was that while income inflow from off-shore was increasing, the failure of a source system to tax such income made relatively little difference to the yield as in terms of international convention, South Africa would have to grant credit for the foreign taxes already paid; and moreover, the fiscal benefits that might be derived from a worldwide basis would be reduced as and when the South African tax rates were reduced. The Margo Commission recommendations were accepted by the government in its White Paper.⁶⁰

The 1997 Katz Commission Report recommended a major move towards a residence-based tax system in South Africa. It suggested that considering the relaxation of the exchange controls and the need to protect the South African capital base, the hybrid system of taxation through the implementation of deeming provisions as to source (by adopting residence as an important second connecting factor) particularly in the areas of investment income (passive income) was the appropriate one, which reconciled with the international trend towards a globalised economy.⁶¹

The argument of the Commission was based on the fact that following globalisation, no country in the world has sensibly applied any tax system exclusively.

⁶⁰ See Katz Commission, *op cit*, chap 2, p. 3.

⁶¹ See Jooste, R, "The Imputation of Income of Controlled Foreign Entities", 2001, *SALJ*, vol 118, part 3, p.473.

The Commission acknowledged the criticism that one problem with the then source based system of taxation in South Africa was how to prevent the movement of capital and business offshore following the possible relaxation in exchange control regulations. Another attack to the source system was that as South Africa became more internationally accepted, and in view of the extensive network of double taxation agreements being negotiated, a source basis of taxation was putting South Africa out of step with its trading partners. Thus, it became easier to manipulate the source basis of taxation and the treaty provision to eliminate the tax altogether on income received.⁶²

Notwithstanding the need to encourage South African businesses to become reintegrated with the world economy, the Katz Commission did not find it necessary to recommend a change from source to residence, because from the perspective of collecting revenue, adopting a residence or source basis would make little, if any, difference as regards direct investment (active income). As regards passive investment, a residence or worldwide system would bring a revenue advantage. Thus, the Commission recommended a partial extension of the current system to counter the expected outflow of funds in order to generate foreign income in low tax jurisdictions. The Commission proposed the introduction of a permanent establishment concept in the South African Income Tax Act. This provision dealing with the treatment of non-residents carrying on business in South Africa would be similar to the Organisation for Economic Cooperation and Development (OECD) model double taxation convention concept but with a wider scope akin to the United Nations model convention provisions. This implied that with regard to active income, non-residents would only be subject to the South African tax if they carried on business in South Africa through such a permanent establishment. On the other hand, the Commission proposed that active income generated through the equivalent of a permanent establishment abroad should be exempt from South African tax, which means that the source principle would apply, whereas passive income should be taxed on the worldwide basis.⁶³

⁶² See the Katz Commission, *op cit*, chap 3, p. 6; See also Holland, K.J, "The Viability of a Residence-Based Tax System in South Africa", (1996), LLM thesis (UCT), p. 53.

⁶³ See the Katz Commission, *op cit*, chap 3, p. 11.

To counter abuse of the system by routing 'passive income' through an intermediate company offshore to change the income to tax exempt dividends, the Commission proposed the introduction of controlled foreign corporation rules which would function to attribute such passive income received by a controlled foreign corporation to the shareholders or controllers in South Africa.

To prevent the potential avoidance or deferral of tax to South African residents, who invested in offshore investment funds and did not repatriate any income until maturity or retirement, the Commission consequently recommended the introduction of anti-avoidance rules similar to the so-called foreign investment fund (FIF) rules in Australia. Such rules function to attribute income to the investor on an accrual basis, usually applying a formula calculation which takes the capital invested as basis.

The Commission also identified the problem associated in defining the enigmatic source of income, and considered that though a detailed codification of this crucial concept was not desirable, it nevertheless suggested a move towards internationally intelligible principles to be interpreted according to the circumstances of each case. The Commission also recognised the need to combine the two elements of presence and activity in determining the source of income. The Report introduced rules to determine the source of certain items of income (for instance the source of interest) and also provided for apportionment of income to its respective source location as opposed to the current 'dominant cause' approach.⁶⁴

Most of the recommendations of the Katz Commission were incorporated into the South African Income Tax Act, in substance effective from 1 July 1997.⁶⁵

3.2 The fundamental change

Notwithstanding the recommendations of the Katz Commission, the move to a residence-based tax system for South Africa was perhaps an inevitable development considering increased globalisation of South African commerce and also the advent of e-commerce. Reliance on a source-based system alone would certainly result in an

⁶⁴ See the Katz Commission, *op cit*, chap 5, p. 15; See also Holland, *op cit*, p. 55-58.

⁶⁵ This was achieved through the insertion of sections 9C and 9D in the Act by the Revenue Laws Amendment Act 59 of 2000.

ever-increasing amount of tax revenue being lost as transactions were being sourced in other countries or concluded over the internet. Without a stronger reliance on residence as a basis for taxation, it would have been difficult for the South African Revenue Service to exercise jurisdiction effectively over commerce in a global context. It was also contended that there were advantages to be gained by South Africa through harmonising its tax system with those of its trading partners, many of whom applied a residence-based tax system.

With the support of the view that there were improvements at the Revenue offices in terms of administrative facilities, the reservations expressed by the Katz Commission were no longer altogether applicable. A step closer to an entirely residence-based system was taken in 2000 when foreign dividends also became taxable in the hands of South African residents.⁶⁶

During the Minister of Finance's speech of 23 February 2000, it was announced that a residence basis of taxation would replace the source basis of taxation with effect from years of assessment beginning on or after 01 January 2001 (and in the case of individuals from the year of assessment commencing on or after 01 March 2001).⁶⁷ The legislation to give effect to the Minister's announcement received presidential assent in November 2000 and is contained in the Revenue Laws Amendment Act.⁶⁸

With the passing of the Revenue Laws Amendment Act of 2000, the circle was completed with all income, including non-investment income (that is active income) becoming subject to a residence-based system.⁶⁹ The South African tax authorities chose to upgrade our tax system to the level which is applied in first world countries, that is, instead of basing liability for tax on income derived from sources within South Africa, to tax residents of South Africa on their worldwide income and non-residents on their income from sources within South Africa. Accordingly, the change brought about by the statutory amendments has made the taxation of residents all-embracing

⁶⁶ Foreign dividends were included through the insertion of section 9E in the Act by the Revenue Laws Amendment Act 59 of 2000, which became operative in respect of any foreign dividend received or accrued to a resident on or after 23 February 2000.

⁶⁷ See section 76(2) of the Revenue Laws Amendment Act 59 of 2000

⁶⁸ Act of 59 of 2000 as published in the Government Gazette, no 21848, vol 426 dated 06 December 2000.

⁶⁹ See Jooste, *op cit*, p. 473.

without regard to the nature or source of the income or the source of the funds producing the income.⁷⁰

The new residence tax system has nevertheless been subject to certain exemptions or exclusions which have their justification in the context of economic considerations affecting the operations of residents in countries outside South Africa, as well as administrative considerations involving the reduction of the rebates required in order to avoid double taxation. Apart from the exemptions and exclusions, South Africa has entered into double taxation agreements with a large number of countries. These agreements will, in respect of various types of income have an impact on their taxation in the hands of residents. But, under the previous regime of taxing on the basis of source, the existence of double tax agreements was detrimental to the South African Revenue where it was required to yield tax in favour of the other country. This was because of the residence of the taxpayer there though the income had its source in South Africa, but not the reverse in respect of income having had its source in the other country and accruing to South African residents.

In summary, the most important reasons for the radical change to the residence basis of taxation in South Africa⁷¹ are:

- To place the income tax system on a sounder footing thereby protecting the South African tax base from exploitation.
- To bring the South African tax system more in line with international tax principles.
- The relaxation of exchange control and the greater involvement of South African companies offshore.
- To cater more effectively for the taxation of e-commerce.

⁷⁰ See "The Revenue Laws Amendments Act", (Editorial note), *The Taxpayer*, October 2000, vol 49, no 10, p. 181.

⁷¹ It would be seen through analysis in this research of the South African fiscal jurisdiction, in comparison with selected aspects of the right to tax of some of its trading partners, whether it was appropriate in the South African context to undergo such a radical change of tax system.

Part III: A comparative study of the concept of residence

Introduction:

Various countries have used the connecting factor of residence as a fundamental basis for fiscal jurisdiction. This principle derives from the recognition in international law of the territorial sovereignty by which states may legitimately exercise jurisdiction over persons and property within their geographical boundaries. In other words, a country is entitled to the extent of its supreme sovereignty to regulate conduct which occurs in its territory, persons who are present in its territory, things that are situated there, and acts which take place outside its territory but have effects within its territory.

The functional term 'fiscal residence' or 'fiscal domicile'¹ is used to refer to a legal relationship that exists between a fiscal subject and the holder of fiscal jurisdiction. Expressed differently, the fiscal attachment that justifies the residence concept is the close connection and personal ties to the country. Unlike the source principle where fiscal jurisdiction is based on economic attachment, the fiscal nexus between the taxpayer and the state that justifies the tax liability on the basis of residence is the personal status of the taxpayer. The term 'resident' can comprise both citizens and aliens having the territorial link required by the pertinent legal order.²

The principle of residence has invariably become a central concept in the international tax rules of the domestic tax law of many countries in the world. South Africa itself has implemented for years of assessment commencing on or after 1 January 2001, a radical shift from the hybrid source basis to the residence based tax system, which is justified to

¹ Fiscal domicile is the term used in most continental civil law countries to refer to residence. For instance, in France, it is translated into 'domicile fiscal'. Thus, in the strict sense, it is distinguished from the concept of domicile as understood in the common law system.

² It is argued by Martha (*op cit*, p. 90) that it is anomalous to speak of residence with respect to citizens, because by virtue of personal sovereignty, a state such as the United States of America may impose tax on its citizens on the basis of political allegiance, irrespective of their place of residence. Furthermore, in the context of the United States, the term 'domiciliary jurisdiction' is the preferred expression used to justify the jurisdiction to tax the income based on the personal status of the taxpayer. See *American Law Institute, Federal Income Tax Project* (International aspects of U.S Income Taxation 6, 1987).

be appropriate to the circumstances of its economy and in line with the international practice.

With the emerging idea of globalisation and developments in electronic commerce, many fundamental tax concepts currently used in tax jurisdictions around the world will be challenged.³ However, although electronic commerce will have the effect of exposing serious flaws in the world's tax systems for instance by posing the problems of identification of the taxpayer or specific transaction information, residence based tax systems will be more suited and effective in an e-commerce environment. It has been commonly speculated in various jurisdictions that:

'The growth of new communication technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible to apply traditional source concepts to link an item of income with a specific geographic location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere...'⁴

In consideration of the international practice, it is unlikely today to enter into tax treaties without the concept of residence being included in domestic tax law. Moreover, this concept forms the main basis for tax liability in the Models of double taxation agreements such as the OECD, which is followed by the most developed trading countries in the world.

The specific characteristic of the residence concept is that fiscal residence is the place where a person (whether natural or juristic) is subject to unlimited fiscal liability.⁵ It is thus of prime importance to define fiscal residence in order to assess the scope of taxation.

³ See 'Globalisation and Tax', *The Economist*, 29 January 2000.

⁴ Cited by Bernard du Plessis and Viljoen, M, "Taxation of E-commerce: Income Tax" (PriceWaterhouseCoopers document), referring to the arguments on the demise of the source basis of taxation advanced by the US Internal Revenue Service and the Australian Taxation Office (ATO).

⁵ However, most of the jurisdictions nowadays apply the so-called 'residence-minus' system whereby residents of a country are taxed on their global income subject to some relief on their foreign income being taxed abroad, while non-residents are only taxed on their income sourced in that territory.

The main purpose of the research in this part will be to analyse the criteria of taxation based on residence (including domicile) and its specific tax implications in income tax law as applied in South Africa and the United Kingdom with reference also made where relevant to the application of the residence rules in the United States.

1. The general understanding of the meaning of ‘residence’

In terms of the traditional approach to the interpretation of statutory enactments, known as the cardinal rule, the literal meaning of the wording of a provision must be ascertained by the use of ordinary grammatical rules. For the purpose of legal interpretation, a word must be given its normal everyday meaning, as it is understood by the language of the time. Thus, the concept of residence, which is the subject matter of this study can be better described by analysing it first, as it is understood in the general sense or would bear ‘in the speech of plain men’.⁶

The ordinary person sees in the term ‘residence’ as the actual place where one resides. Because ‘residence’ and its allied words are not always specifically defined in the legislative provisions, the leading dictionaries are frequently quoted in cases and discussions concerning the meaning of the expressions ‘resident’ and ‘residence’.⁷

In *Levene v CIR*,⁸ the presiding judge quoted the Oxford English dictionary meaning of the familiar word ‘reside’, which means ‘to dwell permanently or for a considerable time, to have one’s settled or usual abode, to live in or at a particular place.’ On the other hand, the Chambers’ Twentieth Century dictionary defines the adjective ‘resident’ as ‘dwelling in a place for some time’ and in turn, defines the verb ‘to dwell’ as ‘to abode’ or ‘to remain’.

⁶ See *Lysaght v IRC*, 1928, 13 TC 511 at 536, per Lord Warrington of Clyffe; Steinberg, W, “An examination of the relevance of the concept of residence” June 1991, LLM thesis (UCT), p. 5.

⁷ See Piper, GSF and Deadman, WB, *Residence and Domicile for UK tax purposes*, 1981, p. 1.

⁸ (1928), AC 217, 13 TC at 505.

Although the grammatical meaning of the term ‘residence’ could not be used in all circumstances, these standard definitions at least have provided some kind of common sense starting point. They have therefore been helpful in numerous judicial interpretations of the meaning of residence.

Depending on the facts of the case, residence has been interpreted in the ordinary sense by the courts as different from a mere passing by or a casual visit, and thus meant a person’s home or one of his homes for the time being.⁹ In giving a general definition of the concept of residence, Murray CJ in *H v COT*, stated that: ‘it is a man’s home, where he sleeps at night after his day’s work is done.’¹⁰ This view gives rise to the question as to whether a person who decides to sleep at different places every night would be said to be resident in each of those places. For that matter, Murray CJ pointed out in referring to numerous cases that, ordinarily, an individual may well at one and the same time have more than one residence and may reside in more than one place.¹¹

On the other hand, in another approach to interpretation of the literal meaning of residence, Viscount Sumner in *Lysaght v CIR* held that:

‘Grammatically, the word “resident” indicates the quality of the person charged and is not descriptive of his property, real or personal. To ask where he has his residence is often a convenient form of inquiry but only as leading to the question: Then where is he resident himself? I think the distinction, though often points doubt, has too often been overlooked in the arguments in the reported cases...’¹²

There is no doubt that the concept of residence is well known to tax practitioners. As it was stipulated by Murray CJ referring to the term ‘reside’:

‘It occurs very frequently in statutes dealing with diverse subjects, is capable of more than one meaning, and such meaning has to be ascertained by consideration of the object and intention of the particular Act in which it occurs.’¹³

⁹ See *Robinson v COT*, 1917, TPD 542, 32 SATC 41.

¹⁰ (1960) 2 SA 695 (SR), 23 SATC 292, 1960 *Taxpayer* 155.

¹¹ See Murray CJ, *ibid*, citing the cases of *Biro v Minister of Justice*, 1957, 1 SA 234 (T) at 239; *Buck v Parker* 1908, TS 1100; *Naef v Mutter*, 31 LJCP 359; *In re Bowie* 16 CH D 486.

¹² (1928) AC 234. As Viscount Sumner further pointed out in *Levene’s case* (1928, 13 TC 486 at 502): “The words are plain and it is only their application that is haphazard and beyond all forecast.”

For the purposes of income tax, the term ‘residence’ is ambiguous. There is considerable variation in the detailed rules of the various jurisdictions as to what constitutes the residence of persons (natural and juristic).¹⁴ Although a statutory definition of the term ‘residence’ can be found in some jurisdictions, residence differs from domicile and nationality in that generally, residence for tax purposes is a question of fact that must be determined by the circumstances of each particular case.

1.1 The OECD tie-breaker rules on ‘residence’

In the provisions of the domestic tax laws and tax treaties defining residence, some indication has been given relating to the important factors that are most often used in the determination of residence.¹⁵ In the case of individuals, consideration has been based either on the permanent home of the taxpayer within the jurisdiction, the maintenance of a dwelling for the taxpayer’s occupation within the jurisdiction (habitual abode), or the centre of the taxpayer’s personal and economic interests (such as directorships and other business and social connections) or his physical presence.

With regard to legal entities in general, factors that have created a legal formal connection with a country include the place of incorporation, the head office and the place of management (be it central management and control or effective management).

In terms of article 4(2) of the OECD Model Convention, where an individual is a resident of both contracting states, then his status shall be determined as follows:

¹³ See *H v COT*, 1960, 2 SA 695 (SR); 23 SATC 292. This concept is also better analysed in the case of *CIR v Kuttel*, 1992, (3) SA 242 (A); 1992 *Taxpayer* 150.

¹⁴ See Arnold, *op cit*, p. 66. It has also been argued that taxation by residence can therefore become controversial when the rules by which residence status is determined produce artificial results. See analysis by Edge, S, “Taxation – by source or by residence?” in Dyson, J, *Recent tax problems: Current legal problems*, 1985, p. 74.

¹⁵ See the OECD Model Tax Convention on Income and on Capital (OECD on Fiscal Affairs, vol 1, updated as of 29 April 2000). The OECD tie-breaker provisions specifically set out in article 4 (2) & (3) certain tests to be used in determining the status of a person who is resident in more than one jurisdiction at the same time. The objectives of the OECD tie-breaker rules is to give one of the contracting states the right to tax. Although the OECD Model reflects the interests of its member states (developed countries), its provisions have widely been used by emerging countries like South Africa in negotiating double taxation agreements.

- He shall be deemed to be a resident of the state in which he has a permanent home available to him. In the order of the tie-breaker rules, the availability of a permanent home is the first criterion used to resolve the problem of dual residence in the case of a natural person. Generally, it refers to the place where the taxpayer has his closest personal bonds or relationships or the place where the taxpayer stays for more than a short period of time.¹⁶ A ‘permanent home’ as explained in the OECD Model Commentary is any suitable accommodation, whether owned or not, if it is ready and available at all times continuously (as opposed to occasionally) for the taxpayer’s use.¹⁷ Thus, unlike the term ‘permanent home’ used in general to ascertain domicile (as in the United Kingdom), ‘permanent’ according to the OECD Commentary means that the individual must have arranged and retained the home for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of a short duration.
- If the individual has a permanent home available to him in both states, he shall be deemed to be a resident of the state with which his personal and economic relations are closer (so-called ‘centre of vital interests’). Thus, if a country represents a person’s place of vital economic interests, residence may be inferred although the taxpayer is absent from the country during the whole tax year in question. It is on that basis that in the Italian case concerning the famous opera singer Luciano Pavarotti, the Italian government claimed although Pavarotti was only present in the country for few days (and therefore not subject to the ‘183 day’ rule), he was nevertheless resident in Italy because his companies there (located in the city of Modena) represented his vital economic interests, another criterion for residency.¹⁸ The court held that based on the centre of vital interest criterion, Pavarotti was liable to tax in Italy.

¹⁶ See Lyons, S.M, *International Tax Glossary*, revised 3ed, 1996, p. 226.

¹⁷ See Rohatgi, R, *Basic International Taxation*, 2002, p. 72.

¹⁸ Case analysed in the *Economist*, 29 January 2000, p. 16.

- If the state in which the taxpayer has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either state, he shall be deemed to be a resident of the state in which he has an habitual abode. 'Habitual abode' relates to the state where the taxpayer spends most of his time, regardless of purpose. It relies on the frequency or duration of his stay in a contracting state over a sufficient period.¹⁹ The consideration of the duration of an individual's presence as the territorial link for fiscal residence has been materialised in various jurisdictions under the 'physical presence' test of residence.²⁰
- If the taxpayer has an habitual abode in both states or in neither of them, he shall be deemed to be a resident of the state of which he is a national. Nationals with reference to natural persons are defined as individuals possessing the nationality of a contracting state. Although nationality is one of the criteria used in the tie-breaker rule of the OECD Model, the non-discrimination clause of the OECD Model provides that foreign taxpayers should not suffer discriminatory taxation by reason of their nationality.
- If the taxpayer is a national of both states or neither of them, the competent authorities of the contracting states shall settle the question by mutual agreement. Thus, the mutual agreement procedure can only be initiated if the above criteria are definitely not satisfied.

In terms of article 4(3) of the OECD Model, there is only a final tie-breaker applicable to persons other than individuals, in determining their residence, namely where the place of effective management is situated. The interpretation of effective management for dual

¹⁹ See Rohatgi, *op cit*, p. 72.

²⁰ In South Africa, the habitual abode test was recognised in the court decisions of *H v COT* (1960, 2 SA 695 SR) and *Robinson v COT* (1917, TPD 542) long before the general application of the residence basis of taxation in that an individual would only be resident for income tax purposes, if it is part of the ordinary regular course of life to live in a country for a period of time each year with a degree of permanence sufficient to characterise his physical presence there as more than that of a mere bird of passage.

resident corporate entities varies widely.²¹ The place could be interpreted as mentioned by Vogel²², as meaning either:

- Where the factual and effective day-to-day management takes place; or
- Where the top level or policy making body makes its decision; or
- Where the shareholder control is situated.

The OECD Commentary update has now defined the place of effective management as:

‘the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. It is the place where senior management (for instance the board of directors) makes business decisions and takes corporate actions. An entity may have more than one place of management, but it can only have one place of effective management at any one time.’²³

2. Jurisdictional approaches to the determination of residence

Introduction

This section analyses the criteria used for determining fiscal residence in the national tax law of South Africa, the United Kingdom and the United States. The section focuses on the analysis of the determination of residence as it applies to individuals, companies and other entities in those three jurisdictions.

With respect to individuals, the South African tax system is restricted to the use of the common term ‘residence’ (although based on the two tests of ordinary residence and physical presence) and does not recognise the principle of domicile for income tax purposes. The United Kingdom is chosen because the concept of residence is its principal determinant of chargeability to tax. The term ‘residence’ for income tax purposes is not a legal concept in the United Kingdom. However, because it is based on a mixture of

²¹ See Rivier, J.M, IFA Cahiers, Vol. 72A, General Report, 1987.

²² See Vogel, K, *Klaus Vogel on Double Taxation Conventions – A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital with Particular Reference to the German Treaty Practice*, 1991, 2ed, p. 104-106.

²³ See the OECD Commentary: article 4, para 24; also cited by Rohatgi, *op cit*, p. 73.

statutes, case law and tax practice, there must be reliance on the wide range of judicial interpretation in ascertaining the residence of taxpayers.²⁴

Unlike South Africa, the United Kingdom adopts a much wider approach in ascertaining the taxpayer's liability by the use of different tests for different forms of residence. Under the current system, liability to tax individuals in the United Kingdom is based on the interplay between three concepts connecting taxpayers with the United Kingdom, namely, residence, ordinary residence and domicile.²⁵

To make this comparative study more diverse, the United States rules on 'residence' is also analysed in this section because they differ from those of both South Africa and the United Kingdom in some crucial and interesting respects. Generally, for United States income tax purposes with regard to individuals, all citizens and resident aliens (green card holders) are treated as tax residents, regardless of their actual residence. In addition, the United States recognises the 'substantial presence' test as a factor for determining the individual's residence, which is closer to the time-based rule of physical presence applicable in South Africa and the United Kingdom.

Some connecting factor is also necessary to enable a country to assert jurisdiction to tax legal entities effectively. Residence is usually the most important issue in establishing a legal entity's tax responsibility. There are considerable variations in the rules of various countries as to what constitutes the residence of legal entities in general and companies in particular. With regard to companies for instance, this section analyses the formal legal connection that attaches a company to a country (place of incorporation), which is the sole connecting factor for a company's residence in the United States. In addition, the substantial economic tie (be it the place of central management and control or place of

²⁴ This is adopted in practice and explained in the Inland Revenue publication, *Residence and non-Residents Liability to Tax in the United Kingdom*, IR 20 (November 1993); also cited by Crump, DP, "Commonwealth Citizenship and British Income Tax Law", 1996, SALJ, vol 113, p. 419.

²⁵ In principle, for income tax purposes, acquiring or renouncing work and residence permits, and/or citizenship does not impact on the taxpayer's United Kingdom residence/domicile status, although the act of acquiring or revoking British citizenship may be a contributory factor in the United Kingdom determination of an individual's domicile.

effective management) which is the additional criterion for a company's residence in the United Kingdom and South Africa is also considered in this research.

The question that arises in consideration of the particular instances in the chosen jurisdictions is how difficult it is to determine the residence of persons.

1.1 The case of natural persons

A) South Africa

Introduction

Prior to 1 January 2001, the South African income tax system was traditionally based on the principle of source where income accrued to or received by a person (whether resident of the Republic or not) was only taxed in South Africa if it derived from a source within the Republic.

From 1 July 1997, the implementation of certain deeming provisions in the Act resulted in South Africa adopting a hybrid system whereby the dominant connecting factor was source but with a number of instances in the Act in which the place of residence was made the test for the levying of taxation.²⁶

The concept of residence is not unfamiliar in the South African tax law. The place of residence has long assumed importance in relation to the application of provisions of the double taxation agreements that the South African government has concluded with its trading partners.²⁷

²⁶ The most important provisions of the legislation introducing the concept of residence as a connecting factor on certain types of income are sections 9C, 9D, and 9E recognising certain types of income to be taxable in South Africa although they were derived from foreign sources.

²⁷ South Africa has adopted the residence concept in most of its tax treaties particularly those with developed countries such as the United Kingdom, the Netherlands and Germany. The tax treaties generally take cognisance of the possibility of dual residence of a taxpayer. In such cases, a sequence of tests is provided ending with criteria commonly known as 'tie-breakers', aimed at avoiding the situation in which a taxpayer could be recognised by the Revenue authorities of both the contracting states as a resident

The tests for ascertaining the fiscal residence of individuals has been clearly stated in the Act in section 1 through the combination of two different factors, namely, ordinary residence and physical presence in the Republic.²⁸ The inclusion of these criteria is distinct from the composite term 'ordinary residence' that was previously used in a number of references in the legislation to ascertain the taxpayer's residence status.

Thus, in terms of section 1 of the Act, 'resident' in relation to individuals means a:

- a) natural person who is-
 - i) ordinarily resident in the Republic; or
 - ii) not at any time during the year of assessment ordinarily resident in the Republic, if such person was physically present in the Republic-
 - aa) For a period or periods exceeding 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 preceding such year of assessment; and
 - bb) for a period or periods exceeding 549 days in aggregate during such three preceding years of assessment:
Provided that-
 - A) for the purposes of items (aa) and (bb) a day shall include a part of a day; and
 - B) where a person who is a resident in terms of this subparagraph is outside the Republic for a continuous period of at least 330 full days after the day on which such person ceases to be physically present in the Republic, such person shall be deemed not to have been a resident from the day on which such person so ceased to be physically present in the Republic.

Although one of the tests for residence in section 1 (ordinary residence) has not itself been defined, the concept has over the years been examined from time to time by the South African courts, and much of the judicial comment in the South African case law draws strongly on the United Kingdom cases where residence is the prime connecting

simultaneously of their respective states. See Broomberg & Kruger, *op cit*, part II, p.153; van Dorsten, JL, Horak, JDD, "International tax planning: Legal aspects, Part 2", 1991, 4 *Juta's Foreign Tax Review*, 9/10.

²⁸ See para (a) (i)(ii) in section 1 of the 'resident' definition in relation to individuals.

factor giving rise to fiscal responsibilities.²⁹ It has been recognised in some judicial decisions in South Africa that the question whether a person is ‘resident’ or ‘ordinarily resident’ in a country is one of fact, which must be answered with regard to the circumstances of each case.³⁰

Unlike the United Kingdom, the concept of domicile has not been adopted as a test for fiscal purposes in South Africa. Thus, residence is not necessarily determined as being where a person is domiciled, as a person can be domiciled in a country without being resident there and vice versa.³¹

A-1 Background to the judicial analysis of ‘residence’ and ‘ordinary residence’

The manner in which the courts have over the years interpreted the word ‘residence’ is relevant to the understanding of ‘ordinary residence’.

In *Robinson v COT*,³² the taxpayer had resided in South Africa for the previous two-and-a-half years, but maintained that he was a resident of the United Kingdom where his permanent home was. He claimed an exemption from income tax on interest earned on the basis that he was not resident in South Africa.

The court held that the taxpayer was resident in South Africa despite his contention that his habitual place of residence was the United Kingdom and that it was always his intention to return to the United Kingdom.

In his findings, Mason J distinguished between the concepts of ‘residence’ and ‘permanently resident’ and stated that residence need not be of a permanent nature, but

²⁹ See the analysis of the application of the United Kingdom residence tax system, where the law there makes use of three different concepts, namely, ‘residence’, ‘ordinary residence’ and domicile.

³⁰ See *Cohen v CIR*, 1946 AD 174; 13 SATC 362. *Soldier v COT*, 1943, SR 130.

³¹ See *Ex Parte Minister of Native Affairs*, 1941 AD 53.

³² 1917, TPD 542; 32 SATC 41. At the time of the *Robinson’s* case, the issue was one of residence and not whether the taxpayer was ‘ordinarily resident’ in South Africa and the legislation then granted exemption on source interest if the taxpayer was not resident in South Africa. Thus, in determining the meaning of ‘residence’, time was a factor in *Robinson’s* case.

where a stay exceeded a casual visit, the intention was more one of permanent residence. Thus, the fact of the stay of the taxpayer exceeding what was considered to be a casual visit suggested that he was resident in South Africa.

Bristowe J in a concurring judgment went on to say that:

‘It appears therefore that if a man sets up an establishment in a country and lives there at intervals he is resident in that country; however many similar residences he may have elsewhere. And the result is the same whether the establishment is for a defined period or whether the intention expressed or to be implied from the circumstances is to prolong the arrangement for a period exceeding the limit (whatever that may be) of a casual visitation. If the case is one of physical presence without an establishment a similar test must be applied. When the intention is to prolong the presence beyond the possible limits of a casual visit, and that intention is not abandoned, it seems to me that that intention would constitute residence, the intention of course being gleaned from all the circumstances of the case.’³³

As the above case reveals, when a person visits the Republic year after year, so that his visits become in effect part of his habit of life and the annual visits are for a substantial period of time, it would be difficult to resist a challenge that that person is resident in the Republic. In other words, if it is a part of an individual’s regular course of life to live in a particular place with a degree of permanence sufficient to characterise his physical presence there, he must be regarded as being ‘resident’ in that place in the ordinary sense of the term. On the other hand, a visitor who maintains no place of abode in the Republic, whose visits are not habitual but occasional only cannot be regarded as ‘resident’ or ‘ordinarily resident’ in the Republic.

In the decision whether an individual is merely a casual or temporary visitor to a particular area and therefore does not possess the personal quality of a ‘resident’, the nature and cause of his physical presence in that area must be taken into account.³⁴

A distinction between ‘residence’ and ‘ordinary residence’ was first drawn in *Soldier v COT*,³⁵ where ordinary residence was said to be a narrower concept than residence. In

³³ At 518.

³⁴ See *H v COT*, 1960, 2 SA 695 (SR); 23 SATC 292.

that case, the issue was whether the taxpayer who was resident in South Africa and was serving as a volunteer in the Southern Rhodesian armed forces, was 'ordinarily resident' in Southern Rhodesia.

Tredgold CJ answered the question in the negative and said that the taxpayer was ordinarily resident in South Africa. He based this view on the following factors: the taxpayer's home was in South Africa; the professional practice which he had carried on there for 38 years was still being run by his partner for their joint benefit; his wife was resident there; and he intended to return there on his discharge from the armed forces.

As the learned judge concluded: 'Placed at its lowest it seems to me that the use of the word "ordinarily" seems to emphasise that the residence must be settled and certain and not temporary and casual.'³⁶

In *H v COT*,³⁷ it was suggested that if there is a difference between 'residence' and 'ordinary residence', a taxpayer was ordinarily resident in the place where his permanent place of abode was, where his belongings were stored, which he left for temporary absences and to which he regularly returned after such absences.

As analysed above, the two concepts of 'residence' and 'ordinary residence' from the judicial point of view are clearly not identical. Although the judicial decisions suggest both concepts refer to more than occasional visits to a particular country, the term 'ordinary residence' has a somewhat narrower meaning than the word 'resident'.³⁸

Because the determination of ordinary residence depends on the facts and circumstances of a particular case, it is crucial to identify the factors set down by the courts in relation to this test.

³⁵ 1943, SR 131.

³⁶ At 133.

³⁷ *Op cit*, at 292.

³⁸ In the British court decision of *Thomson v Minister of National Revenue*, (1946 SCR 209) it was established that, the expression 'ordinary residence' carries a restricted signification and though first

A-2 Ordinary residence

a) The 'real home' test

Physical presence is a requirement in order to establish mere residence, but it is not a conclusive test for determining whether an individual is ordinarily resident in the Republic. This is because once physical presence is established, a person may be held to be ordinarily resident in a country though at any given time or even throughout the whole tax year, he is absent from the country.

This was the basis of the decision of the Appellate Division of the Supreme Court in the landmark case of *Cohen v CIR*.³⁹ Cohen had been absent from the Republic on business in the United States for a period longer than a year. He claimed that as income tax was an annual tax and he had not been in the Republic for the entire year of assessment, he had not been ordinarily resident for that year and was consequently not subject to super tax on dividends he had earned.

Schreiner JA expressed the view that it was an unquestioned fact that the attribution of 'residence' status required actual physical presence in the country at some time, but that 'it would certainly be giving to residence a special or technical, indeed a highly artificial meaning, if one required the physical presence to have existed during the year of assessment.' It was further said that the effect of physical presence in a country persisted 'so as to prolong that residence after departure from the country' and that it then became a question of fact, unrelated to tax years, whether the taxpayer had retained his 'residence' status in the country.⁴⁰

Schreiner JA, after reviewing some of the United Kingdom decisions on the meaning of ordinary residence, pointed out that the precise effect to be given to the term 'ordinarily'

impression seems to be that of preponderance of time, ordinary residence is held to mean residence in the course of the customary mode of life, and it is contrasted with special or occasional or casual residence.

³⁹ 1946, AD 174; 13 SATC 362.

⁴⁰ At 187.

is linked with the question whether a person can be ‘ordinarily resident’ in more than one country. He went on to say that:

‘If, though a man may be “resident” in more than one country at a time, he can only be “ordinarily resident” in one, it would be natural to interpret “ordinarily” by reference to the country of his most fixed or settled residence...[H]is ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and would be described more aptly than other countries as his **real home**. If this suggested meaning were given to “ordinarily” it would not, I think, be logically permissible to hold that a person could be “ordinarily resident” in more than one country at the same time.’⁴¹ (my emphasis)

Cohen’s case confirmed the interpretation that the term ‘ordinary resident’ connotes residence in a place with some degree of continuity, other than accidental or temporary absences. It is the character in which a person is physically present in a country that is the determining factor because ‘the physical presence in a country must be combined with a continuity which would rather exclude any element of chance.’⁴²

Thus, physical presence in the country for a temporary visit, for instance, a holiday, business trip or for short study purposes, is not sufficient to constitute ordinary residence for tax purposes in the Republic.

Holland⁴³ correctly argues that in deciding the *Cohen’s* case, the court felt that taxation based on the concept of where a person was ordinarily resident could not depend on the period of time spent in a country as circumstances outside the taxpayer’s control could affect the true intention of the taxpayer. Unlike the early cases on residence such as the *Robinson’s* case, where time was a factor, the length of stay did not have a bearing on the decision reached by the court in the *Cohen’s* case, for the purpose of deciding where the taxpayer was ordinarily resident. Instead, the court relied on the taxpayer’s intention

⁴¹ At SATC 371. Although the court in *Cohen’s* case confirmed that the taxpayer could indeed be mere resident in more than one country, Schreiner JA nevertheless rejected the British judicial decisions where it has long been held that a person could be ordinarily resident in two places at a time.

⁴² See *Simon’s taxes*, 1977, 3ed, E.S 124.

⁴³ See Holland, K, “To be or not to be ordinarily resident”, 1998, 12 *Tax Planning* 135 at 136.

which was always to return in the Republic at some date in the future.⁴⁴ And it was remarkably pointed out by Davis AJA, the words ‘not ordinarily resident in the Union’ excluded at least any person whose permanent or real home was in South Africa and who was temporarily absent therefrom, even if the temporary absence was for a long period. For instance, if a person, ordinarily resident in the Republic, decided to travel around the world for a year long vacation, although he might be out of the country for an entire year of assessment, his ordinary residence would still be in the Republic, and he would therefore be resident for tax purposes.⁴⁵

The purpose of the visit and the intention of the taxpayer’s absence from the Republic were highlighted in the following case of *ITC 1170*,⁴⁶ where the meaning of ‘ordinarily resident’ was considered for the purposes of section 9(1)(d)bis of the Act (as it then was). In that case, the taxpayer, who had been born and educated outside South Africa, and was not a South African citizen, had taken up residence in South Africa in 1959. He was employed by a South African company, and he owned a house in the country. During the 1970 tax year, he was sent by his employer to the United States for business purposes for 14 months. At the time of his departure, he had intended to remain overseas indefinitely, if he could find employment there. During his absence from South Africa, his house was let and his salary paid by his South African employer. He was unable to find employment overseas, and on his return to South Africa, he continued in employment with the same employer. It was held that during his absence overseas, the taxpayer had been ordinarily resident in South Africa. In arriving at this conclusion, Watermeyer J took into account the taxpayer’s ownership of a house in South Africa; his employment by a South African company; his parents’ residence in South Africa; the operation of a local bank account; his return to the country at the end of the trip and his residing in the country after that time; and his failure to acquire ‘ordinary residence’ status abroad as shown by the fact that the United States tax authorities regarded him as a non-resident alien temporarily present in the United States.

⁴⁴ *Ibid*, at 136.

⁴⁵ See Schroeder, R, “Not ordinarily resident inside equals ordinarily resident outside”, 2000, 14 *Tax Planning*, 68/69.

⁴⁶ 1973 *Taxpayer* 33; 34 SATC 76.

The Appellate Division revisited the concept of ‘ordinary resident’ in the case of *CIR v Kuttel*.⁴⁷ In that case, the taxpayer left South Africa to set up a business in the United States and established a permanent home there. His visits to South Africa, following his departure, were infrequent and for a short duration. He liquidated as many of his South African assets as he was entitled to do under the exchange control regulations and remitted as much of his income as possible to the United States. The assets retained in South Africa were of an interest and dividend nature, which he claimed as tax free under the then sections 10(1)(h) and 10(1)(k) of the Act on the basis that he had taken up permanent residence in the United States and that he was therefore not ordinarily resident in South Africa. The Appellate Division held unanimously that Kuttel was not ordinarily resident in the Republic during the relevant years and was thus entitled to those exemptions.

In delivering the judgment, Goldstone JA (with Corbett CJ, Smalberger JA, Kumleben JA and Harms AJA concurring) stated that ‘ordinarily resident’ did not simply mean ‘resident’. It meant something different, and in his opinion, its scope was narrower than just ‘resident’.⁴⁸ He went on to adopt the formulation of Schreiner JA in *Cohen’s* case, as well as the dictum of Lord Denning MR in *Rv Barnet London Borough Council: Ex Parte Shah*, by stating that:

‘Ordinary residence would be the country to which he [individual taxpayer] would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and would be described more aptly than other countries as his real home.’⁴⁹

Because the policy of the legislature in providing the exemptions in question was to ‘encourage investors from outside the Republic to invest their money in the Republic’, there was ‘no warrant for giving an extended meaning to the words (ordinary residence)’.⁵⁰

⁴⁷ 1992, 3 SA 242 (A); 54 SATC 298.

⁴⁸ At 304

⁴⁹ See the *Cohen’s* case, *op cit*, note 39.

⁵⁰ At 306.

Applying that meaning to the words in the exemption provisions, Goldstone JA found that at the relevant times, Kuttel was not ordinarily resident in the Republic. He took with him to the United States all the assets he was entitled to remove from South Africa. But for the exchange control regulations, he would have taken all of them. Since he could not do so, he had no choice but to make the most advantageous use of those assets that he was forced to leave behind. His visits to South Africa were not what one could describe as a 'return home'. The fact that he kept his house in Llanduno and did not let it while away was not inconsistent with the point that his usual or principal residence was now in the United States. He had sound financial reasons for retaining an interest in immovable property, these being to procure a hedge against a fall in the value of the rand against the dollar and to provide a place to live in when he visited Cape Town; and those interests did not change the character of his residence.⁵¹

Kuttel's case reiterated the principle that as a principle of law although not conclusive,⁵² a natural person could only have one 'real home'. Goldstone JA, finding in favour of the taxpayer, stated that a person's place where he was ordinarily resident was one of habitual abode as opposed to frequent physical presence.⁵³

As Clegg⁵⁴ argues, if a taxpayer cannot be ordinarily resident in more than one country at the same time, then any absence from that country must surely be temporary. If it were not temporary, it would be because he had chosen a new domicile in another country or at least moved his 'real home' there.

Unfortunately, the terms 'real or permanent home' and 'temporary absence' were not defined in *Kuttel's* case. This raises the question, how long must an absence from the

⁵¹ For an extensive analysis of this case, see Cleaver, B, "SA Revisited: Residence Lessons for the Emigrant", 1993, 7 *Tax Planning* 65 at 66.

⁵² This is because the issue whether or not an individual could have more than one real home was left open by the court and the decision given was *obiter*.

⁵³ See also ITC 1501 (1989, 53 SATC 314) where the court held that the legislator intended 'ordinary residence' to mean that the taxpayer's permanent or principal home is in South Africa. Thus, the term 'ordinary residence' implies that a person cannot be ordinarily resident in more than one country.

⁵⁴ Clegg, DJM, "Residence - Part I: No ordinary residence", 1990, 3 *Juta's Foreign Tax Review*, 70 at 73.

country be considered ‘temporary’ for the purposes of ordinary residence in the Republic?

i) Temporary absence and real home

The issue of ‘temporary absence’ from the Republic in the determination of an individual’s residence was considered in *CIR v Whitfield*⁵⁵ for the purposes of section 9(1)(d)bis (as it then was).⁵⁶ The taxpayer who was permanently resident and employed in the Republic earned his salary mostly through commission on sales concluded by him on behalf of his employer in Lesotho, the Ciskei and the Transkei. The issue to be decided was whether the taxpayer who spent most of his time outside the country in the course of his employment, was only temporarily absent from the Republic for the purposes of section 9(1)(d)bis of the Act.

Zietsman JP held for the majority judgment that section 9(1)(d)bis deemed income to be derived from a source within the Republic, where a person was *inter alia* ordinarily resident but absent from the Republic during an absence, which was other than temporary, but at the same time not permanent by reason of such person’s ordinary residence. The expression ‘temporary absence’ in section 9(1)(d)bis meant ‘of a limited duration’ rather than ‘not permanent’. Referring to the case, the commission had been earned during absences which were a regular pattern of the taxpayer’s employment and were not ‘temporary’ in the sense contemplated in section 9(1)(d)bis. Moreover, as the court concluded, the section applied to persons ordinarily resident in the Republic, and it would seem to be a contradiction in terms to say that a person ordinarily resident in the country was permanently absent from the Republic.

Accordingly, it was argued, following the above case that in applying the provisions of section 9(1)(d)bis, care should be taken not to equate or confuse ‘temporary absence’

⁵⁵ 1993, 2 SA 236 (E); 55 SATC 158.

⁵⁶ Section 9(1)(d)bis has been repealed in the Act in relation to the determination of the deemed source of employees’ foreign income. However, the principle analysed in the cases in respect to this provision is still relevant for the purposes of ascertaining the ordinary residence status of taxpayers.

with 'ordinary residence'. A taxpayer might be ordinarily resident in the Republic, yet his absence might not be 'temporary'. The taxpayer may contemplate returning to South Africa which is his real home, but an absence from the country cannot be regarded as temporary on that account alone.

ii) Date on which an individual becomes or ceases to be ordinarily resident in South Africa

A practical problem that may arise in the determination of residence status, is that if the operation of a provision in the Act is premised on ordinary residence status, whether that status must exist for the whole of the tax year, or whether it must only exist at the date to which the provision relates.

In *Cohen's* case, Schreiner JA declined to rule on the question whether assuming the taxpayer's status could change during the course of the tax year, the operative date for applying a tax exemption in respect of dividends (which exemption depended on the taxpayer not being ordinarily resident in South Africa), was either the date of receipt or accrual of the dividends or some other date. In the same case, Davis AJA expressly assumed that in order to benefit from the exemption, the taxpayer must not have been ordinarily resident in South Africa at any time during the tax year, and 'certainly not at the date in respect of which the assessment is made, namely, the close of the tax year.'⁵⁷ Davis AJA, however, left the question open whether it was sufficient for the taxpayer not to be ordinarily resident on the date on which the dividends were declared, even if he was ordinarily resident at some other time during the tax year.

Danziger⁵⁸ argues that whether the taxpayer's 'ordinary residence' must endure during the whole of the tax year or not depends on the interpretation of the particular legislative provision in issue. In the absence of any statutory indication in the Act, the relevant time at which a taxpayer must be ordinarily resident or not in order to qualify for an exemption

⁵⁷ At 189.

⁵⁸ *Op cit*, p. 44.

from income tax is at the date of accrual or receipt of the (gross) income concerned. It is questionable that the relevant date might be the last day of the tax year as assumed (*obiter*) by Davis AJA. This is because income tax is levied for the whole of the tax year and there seems to be no reason why ordinary residence status should depend on the position on the last day of the tax year.⁵⁹

On this issue, the South African Revenue Service (SARS) states in its guideline to the interpretation of 'ordinary residence' that a natural person who became ordinarily resident, will become a resident as from a specific date. That date will be the date on which he became ordinarily resident in the Republic. Thus, immigrants into South Africa will be South African residents from the first day of arriving in South Africa. It follows that an individual will not be taxable in the Republic on any income earned outside the Republic prior to the date on which he became ordinarily resident in South Africa, unless it was deemed to be of a South African source and was therefore taxable in terms of South African source rules.⁶⁰

On the other hand, SARS also made it clear in its interpretation note that an individual who emigrates from South Africa to another country will cease to be a resident as from the date he emigrates. Presumably, emigrants will be taxed as ordinarily resident until the date of departure. Thus for the rest of the year, they will neither be ordinarily resident nor resident.⁶¹

Meyerowitz⁶² submits correctly that if the taxpayer's real home is outside the Republic, it will not matter that he makes periodic visits to South Africa even on a regular basis. This is where an immediate conflict used to arise within the case law. Before the statutory inclusion in the Act of the 'physical presence' rule as an additional test of residence in South Africa, the element of intention relied on in the 'real home' approach could lead to tax planning opportunities in the case of individuals visiting or who were seconded to

⁵⁹ See notes on 'Residence and carrying on business' by Emslie, TS, Davis, DM, & Hutton SJ, *Income Tax Cases and Materials*, 1995, 2ed, p. 963.

⁶⁰ *SARS' Interpretation Note*, no 3, 4 February 2002.

⁶¹ *Ibid*, p. 6.

South Africa for periods of up to five years, but who always intended to return to their home countries. The question was, at what stage did the length of stay in the Republic imply that the taxpayer's intention had changed? Could an individual be considered not ordinarily resident in South Africa, if he made it clear that his intention remained to eventually return to his home country, notwithstanding the fact that he was physically present in the country for say 10 years?

iii) **Situation of taxpayers with 'dual real home' or 'no real home'**

The issue of interpreting the 'real home' test becomes even more crucial as Wilson⁶³ views it in this era of globalisation dominated by cyberspace transactions where individuals can carry on their activities without any fixed place of abode (internet gypsies). It is quite feasible for a person to set up a 'real home' in a foreign country and to maintain a 'real home' in the Republic. Is this person 'not ordinarily resident' in the Republic by virtue of the fact that he has a 'real home' elsewhere?

On the same line of argument, Meyerowitz⁶⁴ suggests that on the adopted formulation of ordinary residence in which a taxpayer can only have one real home, a person who cannot prove that he has a 'real home' anywhere will not have discharged the onus of proving that he is not ordinarily resident in the Republic, and thus not subject to tax on his worldwide income.⁶⁵ For instance, as stated above, formal emigration would be a way of demonstrating that South Africa is no longer considered to be the individual's real home and of proving any claim that the person is not ordinarily resident in the Republic.⁶⁶

This seems to lay down the proposition that if a person is 'not ordinarily resident' in the Republic, he must be 'ordinarily resident' outside the country. However, if this principle were applied, it would seem to overlook the situation in which a person's peculiar

⁶² See Meyerowitz, D, *Meyerowitz on Income Tax*, 2000/2001 at s 13.10.

⁶³ See Wilson, S, "Carrying on business: The emigration year", 2000, 14 *Tax Planning* 6.

⁶⁴ *Op cit*, s 13.10.

⁶⁵ Meyerowitz's argument on this aspect was based on the analysis of section 10(1)(hA) as it applied then. In terms of section 82 of the Act, the burden of proof that an amount is not liable to tax under the South African tax law rests on the person claiming the non-liability.

lifestyle may lead him not to have a real home anywhere in the world. A common feature of multinational corporations is that certain staff are virtually permanent wanderers. This scenario could also possibly be claimed, for instance, by a performer in a travelling circus or an artist who lives aboard a cruise ship. In these situations, it might be argued that such an individual would be 'not ordinarily resident in the Republic' but also 'not ordinarily resident outside the Republic', that is in any other country. In this case, the individual would escape the ordinary residence test and the only test applicable to him in relation to his residence status will be whether or not he complies with the physical presence test in South Africa.

Consequently, the 'anomalies' argument put forward by the court in the *Cohen's* case⁶⁷ in applying the 'real home' test seemed to overlook the need for certainty which could be attained by accepting that a particular pattern of physical presence in South Africa would give rise to 'ordinary residence' status. The test of ordinary residence does not rely on any numerical basis, but refers to intention or state of mind of the individual rather than physical presence. Its application is likely to create difficulties. Taxpayers who have physically left the country (but have not formally emigrated) and subsequently returned after a period of time will argue that there had been a change of intention and that upon departure from the country, they ceased to be ordinarily resident in South Africa.⁶⁸

It is correctly formulated by Danziger⁶⁹ that the 'real home' approach in general postulates vague criteria and it is a subjective test. It does not assist with the determination whether a taxpayer who is a citizen of and domiciled in South Africa, but whose mode of life involves extensive absences from the country, loses his 'ordinary residence' status.

⁶⁶ See Mosupa, F, "Who pays which taxman now?" 2002, vol 9, Part IV, *Juta's Business Law*, p. 160.

⁶⁷ See the remarks of Davis AJA in that case at 189.

⁶⁸ This loophole has been closed by the statutory adoption of the 'physical presence' test in section 1 (a)(ii) of the Act as a complementary test of residence for tax purposes. See Badenhorst, M, "Overview of Tax Changes", 19 April 2002, *Financial Mail*, p. 97. See also "Tax Update" (Special Edition), January 2001, *Deneys Reitz Attorneys Publication*, p. 2.

⁶⁹ *Op cit*, p. 43.

In order to clarify the application of 'ordinary residence', SARS⁷⁰ has suggested in its interpretation note that the circumstances of a person must be examined as a whole and the personal acts of the individual must receive special attention. This is because the cessation of ordinary residence is very much a factual issue, so much that the facts which may be conclusive in the case of one taxpayer may not be so in another. Considering the judicial decisions on the issue of ordinary residence, the following factors (although not intended to be exhaustive) will therefore be relevant in determining where an individual is ordinarily resident:

- The most fixed and settled place of residence;
- The habitual abode, that is, present habits and mode of life;
- The place of business and personal interests;
- The status of the individual in the country, that is whether he is an immigrant, his work permit periods and conditions;
- The location of his personal belongings;
- His nationality;
- His family and social relations (schools, church);
- His political, cultural or other activities;
- His application for permanent residence;
- His period of stay abroad; purpose and nature of his visits;
- His frequency of and reasons of visits.

iv) Is there any difference between 'real home' and domicile?

For South African tax purposes, the concept of domicile has not been used as the test for income tax liability. In the current South African case law on the meaning of residence, the concept of domicile has long been distinguished from residence.⁷¹

⁷⁰ See Income Tax Interpretation Note, no 3, prepared by the Law Administration Division of SARS, 4 February 2002, updated on 22 March 2002.

⁷¹ See *Ex Parte Minister of Native Affairs*, 1941 AD 53.

In *Cohen*'s case, Schreiner JA made it clear that in ascertaining the ordinary residence of an individual:

'This might not be his country of domicile, for it might not be his domicile of origin and he might not have formed the fixed and settled intention which "excludes all contemplation of any event on the occurrence of which the residence would cease" which is necessary to bring into existence a domicile of choice.'⁷²

However, the learned judge concluded that a person's ordinary residence would be 'the country to which he would naturally and as a matter of course return from his wanderings.'⁷³

This latter formulation of the 'real home' test has given rise to the argument that if there is any distinction between domicile and ordinary residence, it can only be a narrow one. However, *Cohen*'s case supported further by *Kuttel*'s case seems to clarify the difference between domicile and 'real home' by affirming that the subjective intention required for the acquisition of a domicile of choice is not required for the acquisition of ordinary residence status, and that if objective criteria are satisfied, then it can be concluded that ordinary residence status has been acquired.⁷⁴ In addition, SARS⁷⁵ reiterated in its interpretation note that although it is not possible to lay down hard and fast rules in determining 'ordinary residence', the concept should also not be confused with the terms 'domicile', 'nationality' and the concept of emigrating and immigrating for exchange control purposes.⁷⁶

Thus, although the intention of the taxpayer is also a key element in ascertaining his ordinary residence, the test is not the same as that for determining a person's domicile which requires the further enquiry as to the permanence of his intent to leave a previous place. Generally speaking, ordinary residence and domicile do change simultaneously because the facts and intention which establish one are usually sufficient to establish the other. However, there is no necessary identity.

⁷² 24 SATC 557. Schreiner JA was referring to the domicile case of *Johnson v Johnson*, 1931, AD 391.

⁷³ At 557.

⁷⁴ See Danziger, *op cit*, p. 38/39.

⁷⁵ See Interpretation Note no3, *op cit*, p.4.

Accordingly, if the taxpayer has adopted a foreign country as his place of 'usual or habitual abode or real home', he ceases to be ordinarily resident in the Republic. This is different in the case of domicile, where as long as the necessary (permanent and indefinite) intention is present, an individual might still be domiciled in a country although he has a fixed place of abode elsewhere.

To this point, Clegg⁷⁷ correctly comments that one may decide permanently to leave South Africa (though one might be obliged to return on occasion to attend to business affairs), but this does not necessarily mean that one simultaneously decides to move permanently to any other country. If there is no such decision and the individual is to become a wanderer, then domicile remains unchanged if the existing domicile is that of the person's origin. If the person was born in a different country, then that domicile of origin would re-establish itself at the time that he permanently leaves the country of his domicile of choice. In both these cases, the individual would no longer be ordinarily resident in the country he has just left and it is quite probable that he would establish a residence or ordinary residence in some other country depending on his intention and the facts of the case.⁷⁸

Furthermore, for the purposes of South African income tax, the 'real or permanent home' used to describe the ordinary residence status of an individual should be interpreted in the same way as the 'permanent home' used in the OECD Model, as one of the tests to determine the residence of individuals in the case of dual residency in two contracting states. Unlike the term 'permanent home' as used in general to ascertain domicile for United Kingdom tax purposes, 'permanent' according to the OECD Commentary means that 'the individual must have arranged and retained the home for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.'⁷⁹

⁷⁶ The factor of nationality could be used as a test for ordinary residence if other objective criteria are non-existent.

⁷⁷ *Op cit*, p. 74.

⁷⁸ See the British position for further reference as to the application of domicile in general.

In conclusion, 'permanent or real' is being used in the South African tax context as the opposite of 'temporary or transitory', rather than in the sense of 'for ever more or everlasting'.

A-3 The 'physical presence' test

As analysed above, the South African case law interpretation of the 'real home' test for determining whether an individual is ordinarily resident in the Republic has proven to be futile and somewhat unreliable, providing little certainty for the individual and practitioner alike. There was therefore a need to introduce in addition to the 'real home' test, some quantitative rules for establishing the existence of residence; that is, rules which in some instances look solely at the actual actions of the person concerned and not at any intent which he might have.

In his Budget speech in early 1995, the then Minister of Finance admitted that there were clearly difficulties in determining where a person is ordinarily resident. He went to say that it was felt that many taxpayers were abusing the then section 10(1)(h) interest exemption by claiming to have emigrated from the Republic, though they still spent much time in the country.⁸⁰ With the general application of the concept of residence as the basis for tax liability, it was therefore logical that a 'physical presence' test limit should be implemented to tax all types of income of natural persons present in the Republic for a specific period, if they do not qualify as ordinarily resident in the Republic.

⁷⁹ See Vogel, *op cit*, article 4, p. 82.

⁸⁰ Section 10(1)(h) of the Act had the effect of exempting from tax interest received or accrued from certain qualifying investments by any person not ordinarily resident nor carrying on business in the Republic, and section 10(1)(hA) made provision for the exemption of tax on interest received by or accrued to a person 'who is ordinarily resident outside the Republic'. Following *Kuttel's* case, section 10(1)(hA) was amended with the enactment of section 10(1)(hA)(iv) which introduced the 'bright-line' or the '183 day' clause, whereby a natural person who was normally not ordinarily resident in the Republic, would only qualify for the interest exemption if he was physically absent from the Republic for a period of at least 183 days in aggregate, and provided that he did not carry on business in the Republic during the year of assessment in which the interest was accrued or received. The section 10(1)(hA) exemption has been extended to apply to South African source interest distributed to qualified non-residents, be they individuals or companies.

Consequently, the Act provides the additional test of residence in section 1(a)(ii), which is any natural person who is not at any time during the year of assessment ordinarily resident in the Republic is nevertheless resident, if such person was physically present in the Republic:

aa) For a period or periods exceeding 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 preceding such year of assessment; and

bb) for a period or periods exceeding 549 days in aggregate during such three preceding years of assessment:

Provided that-

A) for the purposes of items (aa) and (bb) a day shall include a part of a day; and

B) where a person who is a resident in terms of this subparagraph is outside the Republic for a continuous period of at least 330 full days after the day on which such person ceases to be physically present in the Republic, such person shall be deemed not to have been a resident from the day on which such person so ceased to be physically present in the Republic.

This second test is a time based and more objective rule. A person will therefore only become a resident of South Africa in the fourth tax year in which that individual is physically present in the Republic for another 91 days or more, provided that during the three preceding years, the individual has exceeded the minimum period of 549 days of physical presence in the Republic. The purpose of the individual's presence in South Africa is irrelevant. Thus, this day test applies irrespective of the purpose or nature of the visit or presence in the Republic.

The effect of the physical presence test is that an individual who is not ordinarily resident in South Africa qualifies as a resident by counting days. If the individual meets all the requirements for the 'physical presence' test, he then becomes a resident as from the first day of the year of assessment during which the criteria are met.⁸¹ With regard to the

⁸¹ A natural person's year of assessment in South Africa starts on 1 March and ends on the last day of February in the subsequent year. See SARS' Interpretation Note, no 4, 4 February 2002, p.2.

physical presence test, a taxpayer is able to decide whether to be resident or not, provided that he avoids being ordinarily resident, in which case physical presence is irrelevant. Thus, for instance, the chain will be broken in the case of an individual who, though present in the country for at least 91 days per tax year (during three years), does not however meet the 549 days requirement in those three years.

Accordingly, while the inclusion of a proper 'physical presence' test is welcome in the South African tax law, the formulation provided in this one would still leave the tax system open to manipulation by taxpayers. Taxpayers could take advantage of the physical presence test by not meeting the 549 days requirement. It might also be possible for individuals to be physically present in the Republic for more than 91 days each of the three preceding tax years (while claiming to have their real home elsewhere), but would not set foot in the country in the fourth tax year, or be present here in the fourth tax year for less than 91 days. It is therefore probable that the definition relating to physical presence gives non-residents, particularly those whose business or employment requires their presence in South Africa, the possibility of organising themselves in a way which would keep their income from non-South African sources outside the net of South African Revenue. Thus, for expatriates seconded to South Africa and not deemed to be resident in terms of the two tests of residence, they will be taxed on their South African earnings only in terms of the source rules, unless a relevant double tax agreement denies South Africa the right to impose the tax.

The physical presence rule has also created a loophole in South African law by the fact that unlike legislation in other jurisdictions, the South African legislation does not provide that a person will retain his South African residency until a new residency is obtained.

The 91 and 549 day periods should only be in aggregate. Continuous daily presence is not required. However, in counting days, a day includes a part of a day. Thus, both the day of arrival and departure are included in the count. For instance, if a resident leaves the Republic on an aircraft that takes off at 00:01 in the morning, he will be deemed to have

been in the Republic for that day. Meanwhile a person who arrives in the Republic at 23:55 would be regarded to be present in the Republic for a full day.⁸² In certain circumstances, it may be very difficult to ascertain whether a person has been physically present in South Africa for the required number of days. This may be the case when persons in possession of dual passports use one passport to leave the country and the other to re-enter the country. Unless the two passports are linked to each other, SARS is placed in a difficult position. In any case, what becomes very important for the individual taxpayer is to make sure to get the necessary stamps in his passport upon leaving or entering the country.

In the application of the physical presence test, continuous presence is important in one aspect. If an individual resident (not a person ordinarily resident) is physically outside the Republic for a continuous period of at least 330 full days, that person will be deemed not to have been a resident from the day immediately after the day of departure.⁸³ The 330 day period can span the end of a tax year. So for instance, if the taxpayer departs South Africa on 1 December in year 4 and remains out until after the lapse of 330 days, he will be liable for tax as a resident in respect of accruals in year 4 but for no year thereafter unless he returns and completes the required three year cycle.⁸⁴ As correctly argued by Stein,⁸⁵ the 330 days exemption rule will apply to a person only if he has met the physical presence test by virtue of being physically present in South Africa for more than 91 days in the year of departure. It is therefore clear the period of 330 days may also extend over two years of assessment. The first of these years is the one in which the individual was last considered to be a resident in terms of physical presence test; that is the year in which he spent his last 91 day period in South Africa. The second year of assessment will be the immediately succeeding year of assessment. The individual will be deemed to be a non-resident from the commencement of the 330 day period. The individual's tax status will

⁸² See SARS' Interpretation note, no 4, p.2.

⁸³ See para (B) of the proviso to the definition of 'resident'. This exemption relies on continuity of the absence from the Republic for the periods of 330 days. The taxpayer will not meet this exemption if he returns to the Republic even for half a day during that period.

⁸⁴ See the "Editorial: Revenue Laws Amendment Act", October 2000, *The Taxpayer*, p. 182/183.

⁸⁵ See Stein, M, "The importance of Residence: And how it ends", 2001, *15 Tax Planning* 78/79.

therefore change from the day on which he became non-resident. Thus, he will have to be away for 330 days before he can show that he has qualified as a non-resident.⁸⁶

An individual may be regarded as resident in more than one country, for instance, where he is resident in South Africa by virtue of physical presence and ordinarily resident in another country, resulting in liability for tax in both countries. This problem is usually resolved by either a double tax agreement or by unilateral tax relief provided by one or both of the countries. South Africa grants unilateral relief by way of a credit given in South Africa for foreign taxes paid.⁸⁷

B) The United Kingdom

Introduction

In the case of natural persons, the United Kingdom legislation refers to different criteria to specify the nature and quality of the association between a person and a place. Although residence *simpliciter* has been recognised in various judicial decisions and adopted by parliament as a primary indicator of chargeability to income tax, other elements such as ordinary residence and domicile also act as strong connecting factors between the taxpayer and the United Kingdom. Furthermore, as was stated by Lord Denning MR in *R v Barnet London Borough Council, ex parte Nilish Shah*⁸⁸: ‘It is a point on a scale which ranges from mere presence in this country, through “resident”...to “domicile”...’ As articulated by Crump,⁸⁹ the further one moves along the scale from presence to domicile, the more adhesive and less easily broken the association becomes.

This section explains, as established by case law and applied in the Statement of Practice of the Revenue, how an individual’s residence, ordinary residence, and domicile can be identified for the purposes of the United Kingdom income tax law.

⁸⁶ See Silke, J et al, op cit, p. A.12.

⁸⁷ See the application of section 6 quat of the Act.

⁸⁸ (1982) QB 688 (CA) at 720; 1982. 1 ALL ER 698 at 704.

⁸⁹ *Op cit*, p. 420.

B-1 Residence

Although mere residence within the United Kingdom is the primary criterion of tax liability since the earliest days of income tax, the term has never been fully defined for taxation purposes. The legislation on the meaning of residence is much based on the tax practice by the Inland Revenue resulting from a mixture of a few statutory pronouncements and the interpretation of case law.

The general principle is that someone is resident where he is living for a time in that tax year.⁹⁰ Residence has to do with physical location and duration, and is not reliant on a permanent address or occupation of an accommodation. Presence in the United Kingdom alone is sufficient.⁹¹

In the United Kingdom, the determination of residence has in some early cases been subject to factual enquiry. It may be helpful at this stage to analyse some relevant extracts from the early legal judgments on an individual's residence.

The leading case dealing with the problem of applying the concept of residence was in *Re Young*.⁹² In that case, a master mariner was physically in the United Kingdom for 88 days in the year ended 5 April 1875. He rented a house in Glasgow, which his wife and family occupied, and to which he habitually returned when he was not on an overseas voyage. Yet he claimed that because he spent only a small part of the year in the United Kingdom, he was not resident. The question before the court was whether an individual who has his home in the United Kingdom but is at particular times abroad for long or short periods, has ceased to be resident or is abroad 'for the purpose only of occasional residence'. The presiding judge discussed this question in relation to the facts of the case and held that:

'I have no doubt myself that if a man has an ordinary residence in this country, it does not matter much whether he is absent for a greater or a shorter period of each year from that residence or from the country itself. That is a thing that depends a

⁹⁰ See Williams, DW, Morse, GK, Salter, D, *Principles of tax law*, 1996, 3ed, p. 461.

⁹¹ See *Reid v IRC*, 1926, 10 TC 673.

⁹² (1875) 1 TC 57.

good deal on a man's occupation, or it may be on his tastes and habits, especially in the latter case, if he is a man not requiring to be engaged in business for his maintenance.'

The learned judge went on to say that Young clearly had a residence in Glasgow where his wife and family lived and it was also clear that he had no residence anywhere else, unless a ship could be called a residence, which he thought it never had been: 'A residence, according to the ordinary meaning of the word, must be a residence on shore, a dwelling in a house. A residence is a dwelling place on land...' In considering the purpose of the taxpayer's visit abroad, the court concluded that: 'He may live on shore or on board the ship according to his mind, but he goes there, not for occasional residence, not for residence at all, but for the purposes of his trade.'

The judgment established several principles that can be broadly summarised as follows:

- There does not need to be constant personal presence for the individual to be regarded as resident;
- If a person is usually resident in the United Kingdom, he will be regarded as remaining resident throughout any period of temporary absence, except in some special cases such as overseas full time employment.
- Whether a period of absence is temporary will depend upon the reasons for absence and the intention of the individual. It will not depend simply upon the length of absence, because as articulated by Lord President in the course of his judgment, 'temporary absence may be for a very long time, and I think it may be temporary because it may be in prosecution of some special purpose.'

The *Young* case is therefore of great importance and has the merits of establishing some general rules governing the determination of residence for individuals.⁹³

⁹³ Elaborate rules have evolved since this case based on the practice of the United Kingdom tax authorities. The principle as held in the *Young* case that the length of the period of absence is irrelevant if the absence is temporary and is simply for the performance of a specific purpose, was reaffirmed in another case

A person may be in the United Kingdom without ever acquiring a ‘settled or usual abode’⁹⁴, but that will not necessarily prevent him from being attributed with the status of United Kingdom residence. As Viscount Sumner said:

‘Although setting up an establishment in this country available for residence at any time throughout the year of charge, even though used but little, may be good ground for finding its master to be “resident” here, it does not follow that keeping up an establishment abroad and none here is incompatible with being “resident here” if there is other sufficient evidence of it’⁹⁵

This was clarified two years earlier by the court in *Reid v IRC*,⁹⁶ holding that the duration of a person’s presence may alone be sufficient to transform mere presence into residence.

As the judge went on to say:

‘[T]ake the case of a homeless tramp, who shelters tonight under a bridge, tomorrow in the greenwood and as the unwelcome occupant of a farm outhouse the night after. He wanders in this way all over the United Kingdom. But will anyone say he does not live in the United Kingdom? – and will anyone regard it as a misuse of language to say he resides in the United Kingdom. In his case there may be no relation with family or friends, no business ties, and none of the ordinary circumstances which create a link between the life of a British subject and the United Kingdom; but even so, I do not think it could be disputed that he resides in the United Kingdom. There are no other and very different kinds of tramps, who – being possessed of ample means, and having the ordinary ties of birth, family, and affairs with the United Kingdom or some part of it – yet prefer to enjoy those means without undertaking the domestic responsibility of a home, and who move about from one house of public entertainment to another – in London today, in the provinces tomorrow, and in the highlands the day after. They too are homeless wanderers in the United Kingdom. But surely it is true to say they live in the United Kingdom, and reside there? The section of the Act of Parliament with which we are dealing speaks of persons “residing”, not at a particular locality, but in a region so extensive as the United Kingdom.’⁹⁷

The above principle was confirmed by Sargant LJ in *Levene v IRC* who stated in the following words that:

‘[To] determine that when an individual has a home here in the ordinary sense he is taxable; but they do not determine that he cannot have a home here unless he has an establishment here. It seems to me that an individual may so arrange his

involving a mariner, *Rogers v CIR* (1875, 1 TC 225). See also a different judgment in *Turnbull v Solicitor of Inland Revenue*, 42 Scot LR.

⁹⁴ This was used by Lord Cave in *Levene v IRC*, 1928, 13 TC 486.

⁹⁵ See *Lysaght v IRC*, 1928, 13 TC 511 at 528.

⁹⁶ (1926) 10 TC 673.

⁹⁷ At 679.

life as to constitute an hotel his residence in the sense of being his home; and although, if he stays at a series of hotels in different places in the United Kingdom, he may not be resident in the ordinary language at anyone of those places, he may yet be resident in the United Kingdom.⁹⁸

The above judicial decisions clarify that under the United Kingdom income tax law, residence requires in every case the physical presence of the taxpayer in the United Kingdom during some portion of the tax year at least. However, the issue remains as to find out at what moment does actual bodily presence becomes legal residence under the British tax law. In other words, when does a mere passer-by or a casual visitor acquire the quality of residence?

i) The '183-day' rule

In terms of section 336 of the United Kingdom Taxes Act⁹⁹, a person who is in the United Kingdom for some temporary purpose only and not with a view or intent of establishing his residence there and who has not actually been present in the United Kingdom at one time or several times for a period equal in aggregate to six months in the year of assessment is not chargeable as a United Kingdom resident, but that a person who has so actually resided shall be so chargeable for that year.

The Inland Revenue emphasises in its practice note that an employee on assignment to the United Kingdom for two to three years will be treated as a United Kingdom tax resident, provided that he does not purchase accommodation and that certain other conditions are met. If the individual does not meet the two years condition, then he will be resident for any tax year in which he spends at least 183 days in the United Kingdom.

Each tax year must be viewed as a whole, and if an individual meets the test of residence, he will be chargeable to United Kingdom tax on the basis that he is resident for the entire tax year. Therefore, on the strict basis as was established by judicial decisions, it is the period in terms of hours which is important. This principle was established in the case of

⁹⁸ *Op cit*, at 499.

Wilkie v CIR,¹⁰⁰ where the court held in deciding whether a temporary visitor had actually resided in the United Kingdom for a period equal to six months, periods of time in terms of hours were relevant for days of less than total residence.

In that case, Mr Wilkie (who was clearly non-resident for both of the fiscal years 1946/7 and 1948/9) had arrived in the United Kingdom at about 2 p.m, on 02 June 1947, and he remained in the country continuously until about 10 a.m, on 02 December 1947. The rule that states that a person will be regarded as resident for any tax year in which he is present for six months or more, was invoked by the Revenue, who claimed that, in their method of reckoning, Mr Wilkie had exceeded this period of time. They included the whole of the days of arrival and departure as days in the United Kingdom. He was therefore present in the United Kingdom for 184 days in the year and had passed 183 days in the country.

The court held however that the law was concerned with the exact proportion of the year during which he was present, and Mr Wilkie was able to show that he was within the United Kingdom for 182 days and approximately 20 hours, out of a total of 366 days in the year 1947/8 (1948 was a leap year).

Donovan J allowing Mr Wilkie's appeal went on to say that:

‘There is nothing in the language of the Rule to prevent hours being taken into computation; but that, on the other hand, since what has to be determined is the period of actual residence it is legitimate to do so.’¹⁰¹

Following *Wilkie's* case, the United Kingdom tax authorities, in view of difficulties arising in applying the strict rule, by concession for income tax purposes, consider now in practice six months as 183 days, ignoring whether it is a leap year or not and normally ignoring the days of arrival and departure. The Revenue guidance on the six-month rule is that a person:

‘[W]ill always be resident if he is here for six months or more in the year. There are no exceptions to this rule. Six months is regarded as equivalent to 183 days, whether or not the year is a leap year. For this purpose a count is made of the total

⁹⁹ See the Act of 1988.

¹⁰⁰ (1951) 32 TC 495 at 508.

¹⁰¹ At 511.

number of days spent in the United Kingdom during the year whether the stay is of one period only or a succession of visits. Under present practice days of arrival and days of departure are normally ignored.’¹⁰²

ii) The ‘91-day’ rule

Section 336 of the Taxes Act¹⁰³ infers that a person may be resident in the United Kingdom although he has been present there for less than six months, provided that his presence has met a ‘residential quality’.¹⁰⁴ Thus, for residence purposes, an individual who has a permanent residence abroad and who comes to the United Kingdom for a period shorter than 183 days may still be a United Kingdom resident if he satisfies an alternative test of the British residence, based on a 91-day annual average presence over a period of four or more years, even if he does not maintain a home there.¹⁰⁵

This test originated from leading judicial decisions where the courts recognised that an individual may be resident if his visits to the United Kingdom are sufficiently frequent and substantial to form part of his normal way of life. The visits will then be taken to indicate an intention to establish or retain residence in the United Kingdom.

For instance, in *Levene v CIR*,¹⁰⁶ Mr Levene (until March 1918) a British subject, leased a home in London. He surrendered the lease and then sold his furniture. He went abroad and did not return until July 1920. From July 1920 until January 1925, he spent between four to five months each year in the United Kingdom. His visits were to obtain medical advice for himself and his wife, to visit relatives and the grave of his parents, to take part in certain Jewish religious observances and to deal with his income tax affairs. In January 1925, he leased a flat abroad. He expected to continue to visit the United Kingdom, but not to the same extent as in the past.

¹⁰² See the Inland Revenue booklet IR 20, para 8. It should be noted that this ‘rule of thumb’ has been criticised (see Piper, *op cit*, 17) on the basis that it tended to encourage the practice among many foreign residents of recording only the nights they spent in the United Kingdom for the purpose of determining their residence status.

¹⁰³ See the Act of 1988; Financial Act 1993, section 208(1)(4).

¹⁰⁴ See Williams et al, *op cit*, p. 461.

¹⁰⁵ See the Revenue Pamphlet IR 20, para 2.10 for method of averaging; see also the Revenue Pamphlet IR 131, SP 2/91, 19 March 1991.

¹⁰⁶ (1928) 13 TC 486, HL.

The House of Lords held that Mr Levene was resident and ordinarily resident in the United Kingdom for the years 1920/1921 to 1924/1925.¹⁰⁷

The principle established that a presence of relatively short duration in a succession of tax years may be sufficient to acquire a residence status in the United Kingdom was confirmed in the House of Lords decision of *Shah v Barnet London Borough Council*,¹⁰⁸ dealing with the entitlement of overseas students to British education grants.¹⁰⁹

Lord Scarman in giving the judgment noted that:

‘A man’s abode in a particular place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of short or long duration...’¹¹⁰

In summary, a person is a resident in the United Kingdom if he satisfies one of the following requirements:

- He intends to stay as a temporary visitor (less than two years) and his physical presence exceeds an aggregate of 183 days or more in that year. If the stay is likely to last for two years or more, the individual is a resident from the date of arrival;
- If the annual visits to the United Kingdom average 91 days or more over four consecutive tax years, he is resident from the fifth year. If the visits are planned, the individual may be regarded as resident from the start of the visits.

B-2) Ordinary residence

As analysed above with residence *simpliciter*, ordinary residence is also a major factor in determining a person’s fiscal status for a particular year.

Under the British income tax law, the term ‘ordinary residence’ has no technical or special meaning, and must therefore be given its natural or ordinary meaning.

¹⁰⁷ See also *Kinloch v CIR*, 1929, 14 TC 736.

¹⁰⁸ (1983) 1 ALL ER 226.

¹⁰⁹ This case will be extensively analysed under the ‘ordinary residence’ section.

¹¹⁰ At 235.

The question whether a person possesses this attribute signified by that term is a matter not of law but of fact.¹¹¹

Over the years, the legislature has tended to use the concept of ordinary residence as a second connecting factor for tax liability in the United Kingdom in order to prevent individuals from avoiding taxation merely by ceasing to be resident for tax purposes. The application of the concept of ordinary residence for example prevents an individual using a brief departure from the United Kingdom as a technique for avoiding income tax, and therefore it imposes on an individual a much greater burden of proof if he wishes to establish 'non-residence'.

The general principle as established by judicial authorities is that before a person may be attributed with United Kingdom ordinary residence status, he must prove to have established there a regular, habitual mode of life which has been voluntarily adopted, which serves one or more settled purposes and which possesses a continuity that has persisted despite any temporary absences of whatever duration. The term 'ordinary residence' is a more elusive and adhesive concept which suggests a greater permanence than simple residence.¹¹²

However, the courts together with the Revenue authorities have found some difficulties in deciding not only the nature of ordinary residence, but also its distinction from mere residence.

i) The nature of ordinary residence

Although the question whether a person is ordinarily resident in the United Kingdom is based on the 'facts and circumstances' approach, the meaning of the term 'ordinarily resident' is a matter of statutory interpretation. This term was considered by Lord Clyde LP in *Reid v IRC*, where he stated that:

¹¹¹ See Booth, *op cit*, p. 53.

¹¹² See *R v Barnet London Borough, ex p Shah*, 1980, 3 ALL ER 679 at 681.

‘The argument was that the meaning of the word “ordinarily” is governed – wholly or mainly – by the test of time or duration. I think it is a test, and an important one; but I think it is only one among many. From the point of view of time, “ordinarily” would stand in contrast to “casually”. But [Miss Reid] is not a “casual” visitor to her home country; on the contrary she regularly returns to it, and “resides” in it for a part – albeit the smaller part – of every year. I hesitate to give the word “ordinarily” any more precise interpretation than “in the customary course of events”, and anyhow I cannot think that the element of time so predominates in its meaning that, unless [Miss Reid] “resided” in the United Kingdom for at least 6 months and a day, she could not be said ‘ordinarily’ to reside there in the year in question.’¹¹³

Rowlatt J reiterated the above point by stating in *Levene*’s case that:

“‘Ordinarily’ may mean either preponderatingly in point of time or time plus importance, or it may mean habitually as a matter of course, as one might say in the ordinary course of a man’s life, although in time it might be insignificant. I think that “ordinarily” does not mean preponderatingly, I think it means ordinary in the sense that it is habitual in the ordinary course of man’s life, and I think a man is ordinarily resident in the United Kingdom when the ordinary course of his life is such that it discloses a residence in the United Kingdom...’¹¹⁴

In illustrating the point that ordinary residence is concerned with the general background behind a person’s residence, Viscount Sumner said in *Lysaght*’s case that:

‘My Lords, the word “ordinary” may be taken first. The Act on the one hand does not say “usually” or “most of the time” or “exclusively” or “principally”, nor does it say on the other hand “occasionally” or “exceptionally” or “now and then”, though in various sections it applies to the word “resident”, with a full sense of choice adverbs like “temporarily” and “actually”. I think the converse to “ordinarily” is “extraordinarily” and that part of the regular order of a man’s life, adopted voluntarily and for settled purposes, is not extraordinary. Having regard to the times and duration, the objects and the obligations of Mr Lysaght’s visits to England, there was in my opinion evidence to support and no rule of law to prevent a finding that he was ordinarily resident, if he was resident in the United Kingdom at all.’

The meaning of ordinary residence was again presented as an issue in the case of *R v Barnet London Borough, ex parte Shah*, where Lord Denning said:

‘If there be proved a regular, habitual mode of life in a particular place, the continuity of which has persisted despite temporary absences, ordinary residence is established provided only it is adopted voluntarily and for a settled purpose.’¹¹⁵

¹¹³ *Op cit*, at 673.

¹¹⁴ *Op cit*, p. 493.

¹¹⁵ *Op cit*, at 236.

Thus, the analysis of the above judicial decisions has shown that ordinary residence has to do with an individual's regular order of life in a particular place. Ordinary residence denotes a place where the taxpayer normally lives or is 'habitually resident'. As the court confirms in *Shah's* case, if by reason of the taxpayer's voluntary presence in the United Kingdom in pursuit of one or more settled purposes, he made his presence there part of the regular order of his life, and thus attracted to himself the status of ordinary residence, his absence from the United Kingdom will not affect that status provided that the absences are temporary, occasional or accidental.

While it is Inland Revenue practice in the United Kingdom not to treat an individual as being resident in any year in which he is not physically present in the United Kingdom at all,¹¹⁶ physical presence, as decided in case law, is not the conclusive test for the determination as to whether an individual is ordinarily resident, because it is the character in which a person is physically present in the country that is the determining factor. Accordingly, for income tax purposes, a person can remain ordinarily resident though physically absent from the country throughout the year.¹¹⁷ The concepts of 'residence' and 'ordinary residence' are not identical, and while the residence *simpliciter* status may be lost (for instance, if the taxpayer has not been physically present there during the tax year, or has come for a short duration), ordinary residence has a broader meaning and it is a quality which is less easily acquired and less easily shed than mere residence.¹¹⁸

ii) Intention

The contention of intention used by the British Revenue authorities is related to the *de minimis* period after which the taxpayer will be considered ordinarily resident.

The general rule is that:

¹¹⁶ See IR 20, para 8.

¹¹⁷ See for example to this effect, section 334 of the Taxes Act 1988, by which Commonwealth and Irish citizens who have been ordinarily resident in the United Kingdom and leave for occasional residence abroad are regarded as being resident in the United Kingdom. Though the term 'occasional residence' is not defined in the Act, its meaning was analysed in the *Levene's* case and *Reid v Clark*, 1985, 3 WLR 142, 129 SOL Jo 469, 1985 STC 323.

¹¹⁸ It is therefore possible in this case, for a person to be ordinarily resident without being resident.

‘A person who comes to the United Kingdom, whether to work here or not, will be ordinarily resident from the date of his arrival if it is clear that he intends to remain here for three years or more.’¹¹⁹

Thus, ordinary residence is presumed when an individual comes to the United Kingdom with the intention of either living permanently or remaining there for at least three years. When such intention exists, it is likely that the individual will be regarded as ordinarily resident even if he is absent from the United Kingdom for part of the time, including a whole tax year. Furthermore, where a person arrives in the United Kingdom with no definite intention as to the length of his stay, but subsequently decides to remain permanently, he will normally be regarded as ordinarily resident from the date of arrival if he made the decision in the tax year of arrival, or he will be ordinarily resident from the beginning of the tax year in which he made that decision. Where there is no evident change of intention, but the individual stays in the United Kingdom, he will be deemed ordinarily resident from the beginning of the year of assessment following the third anniversary of physical presence. This would not of course obviate his mere residence status in any year in which he was physically present in the United Kingdom for at least 183 days.¹²⁰

Intention may be inferred by reference to particular circumstances. For instance, if an individual acquires accommodation for his use in the United Kingdom in circumstances that imply that he will stay at least three years (by purchase or in terms of a lease of at least three years), he will be treated as ordinarily resident either from the date of arrival or from the beginning of the tax year in which the accommodation becomes available, whichever is the later. Intention may also be strongly presumed if an individual’s arrival in the United Kingdom or decision to stay there coincides with their severing of ties with elsewhere. In other words, the attribution of ordinary residence to an individual in the United Kingdom need not take long if the person has no ordinary residence elsewhere.¹²¹

¹¹⁹ See IR 20, para 26.

¹²⁰ See Whitfield, D, “Work Secondments of Individuals – A Multinational Focus on the Tax Implications in the Receiving Country: The United Kingdom” 1998, *Tax Planning International Review*, p. 4.

¹²¹ See Booth, *op cit*, p. 77.

Thus, in determining which category applies in any particular circumstance, it is necessary to consider all the facts, that is, the individual's intention and what the normal living pattern will be. Moreover, in an attempt to close the loopholes as to the difficulty to infer intention, the United Kingdom Inland Revenue has also expressly considered that residence and ordinary residence may be attributed to an individual from the frequency of his visits, even if temporary.

iii) Continuity of residence

In the application of its '91 day' rule, the Inland Revenue states that:

'If it is clear when [a visitor] first comes he proposes to make such visits [i.e, visits for four or more consecutive years which will average three or more months per tax year], he may be treated as resident and ordinarily resident in the United Kingdom from the start.'¹²²

By analogy, it can be presumed that a person previously resident abroad might decide to move to the United Kingdom for a period of at least four years but would nevertheless be treated as short term visitor if he intended to stay for less than 91 days per year on average. An example of this could be the case of an individual previously resident abroad who takes up a post as manager of a group's European operations, which would involve work in several countries. If such a person expects that the job will last for at least five years and relocates his spouse and family to the United Kingdom with an intention from the outset to spend two months of each year in the United Kingdom and the rest of the time in some part of Europe, then the visits in each year are for a temporary purpose only and the individual will be treated as a short-term visitor and not resident in the United Kingdom for each year in which certain limits are not exceeded.¹²³

The above rule derives from judicial interpretations to the effect that ordinary residence necessitates the establishment of an annually recurrent pattern of residence *simpliciter*.

¹²² IR 20, para 21.

¹²³ See Goldworth, JG, "UK Inland Revenue Review Booklet on UK Residence for Tax Purposes" July 1994, *Tax Notes International*, p. 26.

In *Levene's* case, Lord Hanworth MR referred to the interpretation of these terms by stating that:

'I find it difficult to attach any distinction of meaning to the word "ordinarily" as affecting the term "resident", unless it be to prevent facts which would amount to residence being so estimated, on the ground that they arose from some fortuitous cause, such as illness of the so-called resident or of some other person, which demanded his continuance at a place for a special purpose otherwise than in accordance with his own usual arrangement and the shaping of his movements.'¹²⁴

On appeal, Viscount Cave LC reiterated that:

'The expression "ordinary residence"... connotes residence in a place with some degree of continuity and apart from temporary absences. So understood, the expression differs little in meaning from the word "residence" as used in the Acts; and I find it difficult to imagine a case in which a man while not resident here is yet ordinarily resident here.'¹²⁵

To confirm the relation of residence with ordinary residence, Lord Denning's interpretation of the words 'ordinary resident' expands Viscount's Cave's phrase 'with some degree of continuity' into 'habitually and normally' and takes ordinary residence to be residence *simpliciter* which is customary, usual and confirmed by habit.¹²⁶

Accordingly, the above cases are authority for the Inland Revenue proposition that where a person visits the United Kingdom, year after year, so that his visits become part of his life and habit, and the annual visits are for a substantial period of time, he could be said to be resident and ordinarily resident there. However, even if visits of three or more months' average duration per tax year are sufficient to establish residence *simpliciter* status, the attribution of ordinary residence status can follow only if the visits were voluntarily and in pursuit of a settled (as opposed to a casual or temporary) purpose.

Thus, in determining whether visits average 91 days or more in the United Kingdom, the Statement of Practice¹²⁷ allows for the exclusion of any days spent in the United Kingdom due to exceptional circumstances, such as illness or because the element of

¹²⁴ *Op cit*, at 496.

¹²⁵ At 507.

¹²⁶ See the *Shah's* case, *op cit*, note 112.

¹²⁷ See SP 2/91.

constraint is present, like the case of enforced presence by reason of kidnapping or imprisonment or the case of displaced persons (refugees).¹²⁸

Because ordinary residence may be inferred by the continuous visits of an individual in the United Kingdom for a specific period, the same individual may also have an ordinary residence elsewhere, and is merely making short intermittent visits in the United Kingdom. In that case, the problem of dual ordinary residence may arise.

In British tax law, it has long been established as a principle of law that a person can be ordinarily resident in more than one country. Early in *A-G v Coote*,¹²⁹ one of the questions was whether Sir C. H. Coote could possess the quality of United Kingdom residence for a year of assessment during which he undoubtedly possessed the quality of Irish residence.

The court found that his Irish residence was no barrier at all. Baron Wood went to say:

‘It is no uncommon thing for a gentleman to have two permanent residences at the same time, in either of which he may establish his abode at any period, and for any length of time. This is just such a case.’¹³⁰

In *Reid*'s case, the judge stated that:

‘I am not sure that there is anything impossible in a person “ordinarily resident” in two places, though no doubt he cannot be physically present in more than one place at the same time.’¹³¹

This was subsequently confirmed by Rowlatt J in *Levene*'s case where he held that:

‘I think ...that a man can have two ordinary residences not because he commonly is to be found at those places, but because the ordinary cause of his life is such that he acquires the attribute of residence at those two places.’¹³²

In summary, a person is ordinarily resident if he intends to reside or if he resides habitually in the United Kingdom. The ordinary residence depends on the intention when

¹²⁸ This exemption does not apply to calculation under the 183-day rule. See also Booth, *op cit*, p. 57.

¹²⁹ (1817) 2 TC 385.

¹³⁰ At 386; see also *Pittar v Richardson*, 1916, 116 LTR 823.

¹³¹ *Op cit*, at 356/368.

entering the country, the type of accommodation (permanent or temporary) and the actual period of his stay. An individual is ordinarily resident from the date of arrival if he intends to stay in the country for three years or more. Otherwise, he is ordinarily resident in the tax year after the three year period in the country is over, provided he lives in temporary accommodation. A person will also be ordinarily resident if he makes annual visits to the United Kingdom averaging three months or more over a four year period.

B-3) Domicile¹³³

Introduction

As analysed above, the connecting factors for tax liability in the United Kingdom are not only based on the physical facts of residence but also on the metaphysical facts of intention which form the core of domicile. Domicile for United Kingdom tax purposes is the bond that is very difficult to break. The combination of the United Kingdom residence and domicile imposes unlimited fiscal liability on the taxpayer. In a number of instances, particularly as far as income tax is concerned, the domicile of an individual may be of more importance than his residence.

The concept of domicile itself is primarily a non-tax issue, and therefore has no unique meaning in the context of taxation. Domicile has been said to be: 'that legal relationship between a person ... and a territory subject to a distinctive legal system which invokes the system as [that person's] personal law.'¹³⁴ Thus, domicile as a long established concept of general law, is a country or location to which each individual is subject by virtue of its being his permanent home.¹³⁵ Accordingly, Lyons submits correctly that domicile is at one and the same time a very general concept concerned with the entirety of a legal system, and a highly personal concept having important effects upon specific

¹³² *Op cit*, at 494.

¹³³ The United Kingdom is one of the exceptional jurisdictions, including other Commonwealth countries such as Australia, which is still using the concept of domicile in matters of taxation as the most adhesive of the territorial connecting factors in the case of individuals.

¹³⁴ See *Henderson v Henderson*, 1967, 77 at 79; also cited by Lyons, T, "The reform of the law of domicile", 1993 *British Tax Review*, vol. 1-6, p. 43.

individuals and their families in a large number of areas, such as for purposes of marriage, divorce, property ownership or taxation.¹³⁶

Domicile determines the civil status of an individual and is strictly different from nationality or citizenship which are concerned with his political status. Thus, holding a passport of a country does not necessarily mean that one is domiciled there, although in some circumstances (such in the United States, Brazil or the Phillipines), one can be subject to tax on that basis.¹³⁷

Because the concept of domicile relates to the general law, an individual cannot simultaneously have different domiciles for different purposes. He cannot be domiciled in one jurisdiction for taxation purposes but in another for say matrimonial purposes. That is the reason why establishing domicile in the United Kingdom context can have more far-reaching consequences than merely becoming resident there.¹³⁸

An individual's domicile may also be important in the determination of 'residence' for the purposes of double taxation treaties or arrangements.¹³⁹

i) Analysis of the concept of domicile.

Because domicile is a general legal concept, many of the judicial decisions on domicile have been concerned with matters outside the field of taxation. However, those cases have just as much relevance as those that involve the question of taxation.

¹³⁵ See Piper, *op cit*, p. 44.

¹³⁶ *Op cit*, p. 43.

¹³⁷ See Crump, *op cit*, p. 421. See also www.lea-white.com/taxation-domicile.html

¹³⁸ However, Lyons (*op cit* at 43) has strongly argued that there is no reason why a person should not have different domiciles in different contexts. Whether or not a person should be linked with a legal system is a very different question from whether a person should be linked with a tax system. The first is fundamentally concerned with relatively stable cultural matters, the second with transitory financial ones. Therefore, given that connecting a person with a tax system is a very different matter from connecting a person to a legal system generally, there is no reason why different connecting concepts should not be employed.

¹³⁹ See for instance, article 4 of the OECD Model Tax Convention and some British double tax treaties. In an international tax context, domicile is a confusing term because it is the French equivalent of 'domicile

Early in *Whicker v Hume*, Lord Cranworth said that ‘by domicile we mean home, the permanent home.’¹⁴⁰ A person is domiciled in the country where he has his permanent home and intends to settle there permanently and indefinitely. At any given moment in a person’s life or at the moment of his death, the domicile singles out from among all the territories in the world, the one territory in which (irrespective of where he happens to be or where he happens to reside or ordinarily reside) that person has his real or permanent home.¹⁴¹

ii) General principles

Important guidelines have been established dealing with the acquisition of domicile and therefore providing different categories of domicile as follows:

- No person can be without a domicile.¹⁴² The rule derives from the practical necessity of connecting every person with some system of law by which a number of his legal relationships may be regulated.¹⁴³

As Lord Westbury stated in the leading case of *Udny v Udny*:

‘It is a settled principle, that no man shall be without a domicile, and to secure this result the law attributes to every individual as soon as he is born the domicile of his father, if the child is legitimate, and the domicile of the mother if illegitimate. This has been called the domicile of origin, and is involuntarily.’¹⁴⁴

Since the domicile of the child’s father may be the father’s domicile of origin which itself may be derived from the father’s father, a domicile of origin may be transmitted through several generations no member of which has ever lived in the country of domicile of origin.¹⁴⁵

fiscal’, which means residence for tax purposes. Thus in contrast to many Civil Law jurisdictions, the United Kingdom uses rules to ascertain domicile quite distinct from those governing residence.

¹⁴⁰ (1858) 7 HLC 124 (HL) at 160, 11 ER 50 at 64. This was confirmed by Barry JP in *Mason v Mason*, (1885) 4 EDC 330 at 337.

¹⁴¹ See Booth, *op cit*, p. 180.

¹⁴² See *Udny v Udny*, 1869, LR 1 SC & DIV 441 at 457, per Lord Westbury.

¹⁴³ See Mc Clean, J.D, *Morris: Conflicts of Laws*, 1993, 4 ed, p. 14.

¹⁴⁴ (1869) LR & Sc & DIV 444 at 457.

¹⁴⁵ See *Peal v Peal*, 1930, 46 TLR 465; *Grant v Grant*, 1931, Sc 238.

- No person can simultaneously have more than one domicile.¹⁴⁶ This rule also springs from the necessity of connecting every person with some one legal system by which a number of his legal relationships may be regulated.
- An existing domicile continues until it is proved that a new domicile has been acquired. Hence the burden of proving a change of domicile lies on those who assert it. For instance, under the British law, the domicile of origin is difficult to change unless it can be shown that the person has moved on, or intends to move into a separate legal jurisdiction and intends to reside there indefinitely.¹⁴⁷ At the same time, if an individual is domiciled outside the United Kingdom before arrival and does not intend to make the United Kingdom his permanent home, then generally that individual is unlikely to become a British domiciliary by simply taking up United Kingdom residence.

The burden of proving a change of domicile is a very heavy one. Taking into consideration the number of cases decided by the House of Lords involving the question of domicile, there appears to be an almost irrebuttable presumption against a change because there are only few cases in which it was held for example that a domicile of origin had been lost.¹⁴⁸

In summary, case law has revealed three categories of domicile that can be distinguished in the United Kingdom:

- The domicile of origin: acquired by every person at birth, and imposed by operation of law. A legitimate child takes the domicile of his father; an illegitimate child, the domicile of his mother; and a foundling, the place where he is found.
- The domicile of dependent persons (children under 16, mentally disordered persons) is the same as and changes with the domicile of the person on whom the dependent person is legally dependent. In the United Kingdom, a wife acquires

¹⁴⁶ *IRC v Bullock*, 1976, STC 409 at 414, per Buckley LJ.

¹⁴⁷ See *Bell v Kennedy*, 1868, LR. 1 Sc & DIV 307.

the husband's domicile if married before 1 January 1974. If married after that date, her domicile status is dependent on her origin or choice.

- A domicile of choice can be acquired by every independent person through the combination of residence and intention of permanent and indefinite residence. Although these two elements must be present, they need not necessarily occur at one and the same time. The intention may either precede or succeed the establishment of the residence.¹⁴⁹ Thus, it was decided in the case of *Mrs F & S2 (personal representatives of F deceased) v CIR*¹⁵⁰ that a new domicile of choice may be acquired while the individual is continuing to be resident in the domicile of origin, but only if the residence in the domicile of choice is the 'chief residence'.

An intention (*animus manendi*) to reside in the United Kingdom indefinitely with no present intention to return to another country will satisfy the test of domicile. In order to avoid acquiring a British domicile it will be essential to demonstrate an intention to return to another country on a clearly foreseen and reasonably anticipated contingency. The more specific those intentions are the better. Residence however long in a country will not result in the acquisition of a domicile of choice if the necessary intention is lacking.¹⁵¹ On the other hand, following the judicial decisions,¹⁵² the United Kingdom Revenue now considers that if an individual taking up residence intends to reside indefinitely, it is assumed that the individual has displaced the domicile of origin by acquiring a domicile of choice.¹⁵³ Mc Clean correctly argues that the length of the residence is not important in itself. It is only important as evidence of intention. A person can acquire a domicile in a country if he has the necessary intention, after residence for even part of a day.¹⁵⁴

¹⁴⁸ See Mc Clean, *op cit*, p. 19.

¹⁴⁹ See Piper, *op cit*, p. 46; Forsyth, CF, *Private international law*, 2 ed, p. 103/105; also analysed by Steinberg, W, "An examination of the relevance of the concept of residence", June 1991, LLM thesis (UCT), p. 13; Ngwafor, E, *Family law in Anglophone Cameroon*, 1993, p. 27.

¹⁵⁰ (2000) SPC 219, SSCD 1; see also *Anderson v CIR*, (1998) SPC 147, SSCD 43.

¹⁵¹ See *Jopp v Wood*, 1865, 4 DJ & S. 616; *IRC v Bullock*, 1976, 1 WLR 1178.

¹⁵² See *Udny v Udny*, 1869 LR 1 SC & DIV 441.

¹⁵³ See Saunders, N, "Benefits of fiscal residence for non-domiciled individuals", March 1996, *Info Tax SATR* (CD ROM)

¹⁵⁴ *Op cit*, p. 18.

Thus, a domicile of choice can replace the domicile of origin only if both the intent of an individual and the factual pattern of life dictate this.

C) The United States

Introduction

With regard to natural persons, the United States imposes income tax on the worldwide income of United States citizens and residents as defined in section 7701(a)(30) of the Internal Revenue Code (IRC).¹⁵⁵ For a foreign national, the reach of United States income taxation depends at the threshold on ‘residence’. For United States immigration and tax purposes, an individual who is not a United States citizen is termed an ‘alien’. The concept of ‘residence’ for United States tax purposes has become somewhat atomised. It differs slightly for foreign nationals and United States citizens. Thus, residence is also a factor in the taxation of United States citizens, although to a lesser degree.¹⁵⁶

The determination of United States residence by inquiry into case specific factors ended with the adoption of a statutory definition of a ‘resident alien’ in 1984, codified as section 7701(b). The most important feature of section 7701(b) is that it classifies as resident aliens, two categories of individuals, who are therefore subject to federal income tax on their worldwide income, irrespective of source.¹⁵⁷ In terms of section 7701(b), the United States residence is tied first, to the immigration status of foreign nationals under the ‘permanent residence or green card’ test; secondly, the basis for tax liability depends also on the length of time spent in the United States. The latter element is extensively elaborated in a test of ‘substantial presence’ in the United States. However, both tests contain special rules and exceptions, particularly in relation to the substantial presence

¹⁵⁵ Unless otherwise indicated, all section references to the United States Internal Revenue Code are to the Internal Revenue Code of 1986, as amended (IRC).

¹⁵⁶ For instance, a United States citizen residing outside the United States may be allowed to exclude earned income from taxation under section 911 of the IRC. See Isenbergh, J, “Foundation of US International Taxation”, 2001, *Tax management: Foreign Income Portfolios*, p. A-6.

¹⁵⁷ See Bissel, T, “US Income Taxation of Non-Resident Alien Individuals”, 1999, *Tax Management: Foreign Income Portfolios*, p. A-3.

test. Thus, an alien will be taxed as a United States resident if he meets one of the above tests.

C-1) Analysis of the tests of residence

i) The permanent residence (green card) test

Under this test, an alien is treated as a resident alien if he is a ‘lawful permanent resident of the United States’ at any time during the calendar year.¹⁵⁸ The Internal Revenue Code provides that an alien is a lawful permanent resident of the United States if:

- The individual has been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws.¹⁵⁹
- And such status has not been revoked, or has not been administratively or judicially determined to have been abandoned.¹⁶⁰ In terms of regulatory section 301 of 7701(b), the abandonment of a green card will not terminate the alien’s resident status for federal income tax purposes unless the abandonment is recognised by the United States immigration authorities by means of either an administrative or judicial determination. Thus, an alien who wishes to terminate his resident alien status for tax purposes should always take affirmative steps to abandon his green card. If he simply ceases using it without informing the United States immigration authorities and allows it to become invalid with the passage of time, under the provision of the United States immigration laws, he will nevertheless continue to be classified as a resident alien for tax purposes.¹⁶¹

¹⁵⁸ See section 7701(b)(A)(i) of the Internal Revenue Code.

¹⁵⁹ Generally, an alien has this status if the Immigration and Naturalisation Service has issued him with an alien registration card which is known as a ‘Green Card’. See Oates, M, “Work Secondments of Individuals: A Multinational Focus on the Tax Implications in the Receiving Country- The United States”, 1998, *Tax Planning International Review*, p. 7.

¹⁶⁰ See section 7701(b)(6).

ii) The substantial presence test

The ‘substantial presence’ test of section 7701(b)(3) brought a largely arithmetic test of United States presence as the core element of United States residence. This test represents an attempt by the legislature to provide objective ‘mechanical’ criteria for non-immigrant aliens who spend more than a nominal amount of time in the United States in a calendar year.

a) The actual physical presence

As a general rule in terms of section 7701(b)(3) of the Inland Revenue Code, if an alien is physically present in the United States for 183 days or more in the calendar year, he is a resident alien for the year under the substantial presence test. This is the simpler form of substantial presence test based on the actual physical presence of the taxpayer for at least 183 days in the United States, irrespective of the nature of the visit, the intention of the taxpayer or any stronger or more permanent connection that he may have to another country.¹⁶² Thus, a foreign tourist falsely arrested for a crime and detained in the United States beyond 183 days becomes a United States resident.¹⁶³

The closer analysis of the ‘substantial presence’ test indicates that it is divided into two forms. In addition to the requirement of actual physical presence in the United States, another criterion known as the ‘look back’ rule is based on the combination of physical presence and time carried over from earlier years that can classify an alien as a resident alien even if he spends less than 183 days in the United States during the calendar year.

b) Substantial presence by carryover of days or the ‘look back’ rule

The second form of the substantial presence takes into account not only time spent in the United States during the calendar year, but also days spent in the two preceding calendar

¹⁶¹ See Bissel, *op cit*, p. A-5.

¹⁶² See sections 7701(b)(1) (A) (ii) and 7701 (b)(3).

¹⁶³ See Isenbergh, *op cit*, p. A-7.

years, which are added to days in the calendar year in measuring substantial presence. Days from the two preceding years are accorded less weight in the total, however, than the days of the actual calendar year. The 'look back' test is therefore applied as follows:

If an alien is present in the United States for at least 31 days of the current calendar year, he may be classified as a resident alien if the sum of the following equals 183 days or more:

- The actual days in the United States in the current year; plus
- One third of his days in the United States in the immediately preceding year; plus
- One sixth of his days in the United States in the second preceding year.¹⁶⁴

For instance, consider an alien who was physically present in the United States for 120 days in each of the years 1999, 2000 and 2001. To determine whether or not the alien met the substantial presence test for 2001, the full 120 days of presence in 2001 should be added to 40 days in 2000 (one third of 120) and 20 days in 1999 (one sixth of 120). Since the total for the three year period is 180 days, the alien would not be considered a resident under the substantial presence test for 2001.

The effect of the above criterion is to include periods of protracted but less concentrated presence in the United States as periods of United States residence. However, United States residence does not arise solely by carryover of days from earlier years. A minimum physical presence of at least 31 days in the United States is required at all events for substantial presence.¹⁶⁵ For example, assume that a citizen of a foreign country was physically present in the United States for 360 days in the calendar year 1999, 342 days in 2000 and 30 days in 2001. He is a resident alien for the years 1999 and 2000, but not for 2001, although the formula provides for 204 'deemed days' in the United States in 2001 ($30 + 342/3 + 360/6 = 204$) under the three year look back rule. He is a non-resident alien for 2001 because he does not satisfy the 31 day threshold test of section 7701(b)(3)(A)(i).

¹⁶⁴ Section 7701(b)(3)(A) of the Inland Revenue Code.

¹⁶⁵ Section 7701(b)(3)(A)(i) of the Inland Revenue Code.

c) The daycount rules

In applying the substantial presence test, an alien must in principle include any day on which he spent any time at all within the United States. Physical presence for any part of a day is counted as a full day.¹⁶⁶ However, there are special exceptions in determining the days of presence in the United States. A stop in the United States for less than 24 hours by an alien in transit between two points outside the United States is not counted.¹⁶⁷ However, the regulations provide that if the alien ‘attends a business meeting’ while in the United States, even if it is ‘within the confines of the airport’, he will not be considered to be in transit.¹⁶⁸ Days are not counted when an alien is unable to leave the United States because of a medical condition that developed while he was in the United States.¹⁶⁹ Days are also not counted when an alien is considered to be an ‘exempt individual’.¹⁷⁰

d) Special exceptions in relation to the foreign ‘tax home’ and ‘closer connection’

If an alien satisfies the substantial presence test, he may still be treated as a non-resident alien, provided:

- He is present in the United States for less than 183 days during the year; and
- He maintains a tax home in a foreign (non-United States) country during the year; and
- He has a closer connection during the year to that foreign country.¹⁷¹

This exception to the substantial presence test does not apply to foreign nationals who have applied for lawful permanent residence in the United States or who have pending an application for adjustment of their immigration status.¹⁷²

¹⁶⁶ Section 7701(b)(3)(A)(ii) of the Inland Revenue Code.

¹⁶⁷ Section 7701(b)(7)(C) of the Inland Revenue Code.

¹⁶⁸ Regs section 301 of 7701(b) -3(d) of the IRC.

¹⁶⁹ Section 7701(b)(3)(D)(ii) of the IRC.

¹⁷⁰ An exempt individual is an alien present in the United States as a foreign government employee [section 7701(b)(5)(B)]; a teacher or trainee [section 7701(b)(5)(C)]; a student [section 7701(b)(5)(D)]; or a professional athlete [section 7701(b)(5)(A)(iv)].

¹⁷¹ Section 7701(b)(3)(B) of the IRC.

Neither the nature of a 'tax home' nor a 'closer connection' to a foreign country is immediately apparent from the statute. The notion of 'tax home' in the Inland Revenue Code is derived from section 162(a) which allows deductions to taxpayers away from home in pursuit of business. Generally, the Internal Revenue Service considers that any individual's 'tax home' is the place where he has the centre of his employment or self-employment. Thus, if he spends one year of working time away from the place of his original work, his tax home is deemed to shift to the new location, although fact patterns can arise in which it is unclear whether an individual's work at the new location is continuous enough to result in a change of tax home.¹⁷³ For practical purposes, resident aliens should assume that in determination of residence under section 7701(b), their 'tax home' is their business or professional centre of gravity rather than where they live.

Section 7701(b) is even more unclear on the question of a 'closer connection' to a foreign country. In determining whether or not an alien has a closer connection to a foreign country, the Internal Revenue Service will look to the facts and circumstances surrounding the alien's ties to the foreign country, compared to his ties in the United States.¹⁷⁴ In practice, the section 7701(b)(3)(B) exception provides protection from resident alien status principally for aliens who are resident in countries that do not have a double tax agreement with the United States. Aliens resident in most treaty countries would usually be protected from resident alien status without the need for this exception, because the 'tie-breaker' rules in the treaty would usually result in their being classified as treaty country residents, and thus as non-resident aliens for United States tax purposes.¹⁷⁵

¹⁷² Section 7701(b)(3)(C) of the IRC.

¹⁷³ See Bissel, *op cit*, p. A-8.

¹⁷⁴ Under the regulations section 301.7701(b)-2(d), the Internal Revenue Service would consider factors such as the location of permanent home, family ties, personal belongings, membership in social and religious organizations, driver's licences, bank accounts and even voting.

¹⁷⁵ Regs. Section 301.7701(b)-(7) of the IRC.

e) Beginning and end of United States residence

An important feature of section 7701(b) is that it does not classify an alien as a resident alien or non-resident alien for the entire taxable year. Instead, the rules permit certain aliens to qualify as 'dual status' aliens if they satisfy the green card test or the substantial presence test for only part of the year. There are special rules for the first and last years of residence that limit United States residence to part of the year. The rules differ for United States residence based on immigration status or substantial presence.¹⁷⁶

An individual who becomes a green card holder during the year (and does not meet the substantial presence test) becomes a resident on the first day of presence in the United States as a lawful permanent resident.¹⁷⁷ Thus, an individual who becomes a lawful permanent resident of the United States on September 1 is a United States resident only from September 1 to the end of the year, even if he was physically present earlier in the United States.

A foreign national who meets the substantial presence test becomes a United States resident on the first day of presence in the United States during the calendar year.¹⁷⁸ However, there is a provision to exclude up to 10 days of presence in the United States if certain conditions are met with regard to a closer connection to a foreign country.¹⁷⁹ If both tests (substantial presence and green card) are met in the same year, the earlier of the two dates is applied as the starting date.¹⁸⁰ An alien may be able to elect (subject to certain conditions) to be treated as a resident for the entire first tax year, although he may only satisfy the green card or substantial presence tests later in the year.¹⁸¹

¹⁷⁶ See Isenbergh, *op cit*, p. A-9.

¹⁷⁷ Section 7701(b)(2)(A)(ii) of the IRC.

¹⁷⁸ Section 7701(b)(2)(A)(iii) of the IRC.

¹⁷⁹ Section 7701(b)(2)(C) of the IRC.

¹⁸⁰ See Oates, *op cit*, p. 7.

¹⁸¹ Section 7701(b)(4) of the IRC.

In the final year of residency, the residency termination date is the last day the person is physically present in the United States if he satisfied the substantial presence test.¹⁸² If the person met the green card test, the residency termination date is the first day on which he is no longer a lawful permanent resident of the United States.¹⁸³ The termination date may be the later of these dates if both tests are met.

1.2 The case of legal persons

A) South Africa

Introduction

This section analyses the concept of residence from a South African perspective as it applies to legal persons (be it companies, trusts, deceased estates).

As with the question of residence of individuals, the enquiry into the residence of legal persons is not new within the South African tax context. The South African case law has long occasionally considered the meaning of residence of artificial persons albeit in a different perspective.¹⁸⁴

Even under the dominant source based tax system, several provisions in the Income Tax Act attached tax consequences to the residence of legal entities.¹⁸⁵ Thus, prior to 1 January 2001, the definition of residence, particularly in relation to legal entities, depended on the specific tax consequences provided by the legislation.¹⁸⁶ With the

¹⁸² Section 7701(b)(2)(B)(iii) of the IRC.

¹⁸³ Section 7701(b)(2)(B)(ii) of the IRC.

¹⁸⁴ For instance, in the judicial decisions of *TW Beckett & Co Ltd v H Kromer Ltd*, 1912 AD 324 at 334; *Dairy Board v John T Rennie & Co (Pty) Ltd*, 1976, 3 SA 768 (W) at 771; *Estate Kootcher v CIR*, 1941 AD 256, the residence of companies were considered for jurisdictional purposes, and it was concluded that a company resided in law where the registered office was, but it might also reside at the place where its principal place of business or central control was situated.

¹⁸⁵ For that matter, section 1 of the Act before the amendment by the Act 59 of 2000 used to state the tax implication of companies, by defining domestic company in contradistinction with external company.

¹⁸⁶ For instance, the section 10(1)(hA) exemption in relation to South Africa source interest referred to 'management and control' in defining a company's residence. This was different from the application of section 31 in relation to the tax consequences of providing financial assistance in international agreements,

implementation of the residence-based taxation, there was a need for a more coherent approach in terms of the application of the test of residence for legal entities. The new legislation is intended to bring a uniform meaning of residence applicable to any legal entity. Thus, section 1(b) of the Act defines residence of legal persons as:

‘Person other than a natural person which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic (but excluding any international headquarter company).’¹⁸⁷

In other words, in the relevant provisions of the Income Tax Act, two tests have been established to ascertain the residence of legal entities, that is, the place of incorporation or the place of effective management of the entity in question.¹⁸⁸

While the incorporation test can be easily satisfied as a matter of formality, the place of ‘effective management’ has not been defined in the Act. It is clear that in ascertaining where a particular legal entity will be regarded as being resident for tax purposes under the latter test, the facts and circumstances of each case will have to be considered.¹⁸⁹

which was based (and still applicable in terms of the practice note) on ‘management or control’. On the other hand, when sections 9C and 9D came into operation on 1 July 1997 for the taxation of foreign investment income, they referred to ‘place of effective management’ for the company’s residence and that was maintained in section 9E (which applies to foreign dividends and which came into operation from 23 February 2000).

¹⁸⁷ Thus, to qualify as a resident in terms of section 1(b) of the Act, the entity must be a person. This automatically excludes relationships such as partnerships and similar institutions that lack legal personality under the South African tax law.

¹⁸⁸ As a consequence therefore, all specific definitions of domestic company, external company, and South African company have been deleted by sections 2(a), 2(b), 2(c) of the Amendment Act 59 of 2000. Although the section 1(b) definition of residence in the Act intends to apply to all situations where a legal entity’s residence is in question, certain provisions of the Act still apply a specific meaning to company residence. For instance, the Practice Note, no 7 (dated 6 August 1999) in relation to financial assistance in international agreements provided in section 31 of the Act, still refers to ‘management or control’ in defining a company’s residence. It can be argued that because the practice note only provides the South African Revenue Service’s (SARS) guidelines in the application of specific legislation and is not intended to be binding, the section 31 reference to ‘management or control’ should be interpreted in accordance with section 1(b) of the Act. See SARS Interpretation Note no 6 on ‘the place of effective management’, dated 26 March 2002.

¹⁸⁹ There has not been any uniformity in applying this test even in countries which are members of the OECD, which uses this test in its Model Tax Convention [article 4(3)] as the unique tie-breaker in the case of dual residency of a legal entity in two contracting states. Malcolm Gammie correctly argues that [“International tax avoidance: A United Kingdom perspective” in Lindencrona, G, Lodin, S, Wiman, B, (ed) *International studies in taxation: Law and Economics*, 1999, p. 125], although there is significant degree of co-operation between countries on income taxes through the OECD, the latter work concentrates on how taxing rights ought to be allocated between competing jurisdictions, rather than on the agreement of a common tax base. That is why OECD measures have accordingly had limited success in resolving the more serious problems of international tax avoidance.

a) Specific exclusion

The section 1(b) definition of residence specifically excludes an 'international headquarter company' from being a resident even though it may be incorporated, established or formed, or may have its place of effective management in South Africa. The international headquarter company is defined in section 1 of the Act as a company:

- a) The entire equity share capital¹⁹⁰ 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 5% in aggregate of the total equity share capital of such company; and
- c) Where 90% 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%.¹⁹¹

In essence, a company is an international headquarter company if at least 90% of its assets represent shares and loans to non-resident subsidiaries of such company in which such company has a beneficial interest of at least 50% at the fiscal year-end.¹⁹²

The rationale for granting this concession is to encourage multinational companies to base their regional headquarters in South Africa and therefore to protect the international competitiveness of South Africa. For instance, this exemption may be useful to foreign companies setting up regional headquarters in South Africa with a view to using the country as a base for operations in Africa.

Consequently, a company that qualifies as an international headquarter company and is not a resident of South Africa, is not subject to tax on its worldwide income, but only on its receipts and accruals from a source within or deemed to be within South Africa.¹⁹³

¹⁹⁰ The term 'equity share capital' is defined in section 1 of the Act. In essence, it excludes preference share capital.

¹⁹¹ This definition was inserted in the Act by section 2(f) of the Amendment Act 2000.

¹⁹² The first two conditions (a) and (b) also apply for the entire year of assessment.

Because the definition of ‘resident’ excludes any international headquarter company, the result of this exclusion is that the provisions of section 9D (relating to income of a controlled foreign entities), and of section 9E (relating to the taxation of foreign dividends) will not apply to such a company.¹⁹⁴ In addition, as secondary tax on companies (STC) is only imposed on South African resident companies, an international headquarter company is also not subject to STC on dividends declared.¹⁹⁵

While the exclusion of the international headquarter company from the definition of ‘resident’ has the effect of attracting foreign investment and improving South Africa’s position as the gateway to Africa, one of the major drawbacks is that the international headquarter company is not treated as a South African resident for double tax treaty purposes. Thus, the international headquarter company may not qualify for treaty benefits, which means for example that any relief on withholding tax paid abroad will not apply.¹⁹⁶ In addition, an international headquarter company is subject to the South African exchange control regulations, which seems to be contrary to the intention of this concession. The reason is that foreign investors need a guarantee that their investment is secure and that should they wish to disinvest, they will be allowed to do so with no major restrictions.¹⁹⁷

A.1 The ‘place of incorporation’ test

Under section 1(b) of the Act, a legal person that is incorporated, established or formed in South Africa qualifies as a resident for income tax purposes, although it may be effectively managed abroad. The inclusion of the incorporation test in the South African

¹⁹³ See para (ii) of the gross income definition in section 1 of the Act.

¹⁹⁴ See Silke, *op cit*, p. A-13.

¹⁹⁵ The United Kingdom also introduced the international headquarter company (IHC) regime in its tax law in 1994 as a special tax concession in order to attract holding companies to the United Kingdom. The IHC enabled foreign income dividends to be paid to shareholders without the provisions of the Advanced Corporation Tax (ACT). Since the ACT provisions were abolished in April 1999, the IHC is no longer relevant in the United Kingdom. However, this tax amendment has made the United Kingdom a more attractive base for holding companies.

¹⁹⁶ See Casey, A, “The Impact of Residence-based Tax on South African Companies”, March 2001, Accountancy SA, p. 3.

¹⁹⁷ See Du Toit, C, “Gays, Residence and Headquarter Companies”, 3 November 2000, *Finance Week*, p. 45.

tax legislation closes the loophole previously present in the Act in which it was possible for a company incorporated in South Africa, to be excluded from a particular provision of the Act simply by having its place of effective management outside South Africa.¹⁹⁸

The Act does not define ‘incorporated, established or formed’ for the purposes of section 1(b). The principle behind this test is that those corporations that are incorporated in, established, registered or created under the laws of a particular country are taxable there. A company is ‘incorporated’ when it is formed under the authority given by a legislative enactment, or operating under a charter or under articles drafted in accordance with the laws of a particular country. When properly incorporated, the company is endowed with a legal personality separate from that of the persons who own its shares. As a corporate entity, it has the right to carry on business, to own property, to assume obligations, and to sue and be sued in its own name. It may be liable to tax on its profits and gains according to the jurisdiction in which it lies.¹⁹⁹

It is submitted that a company that is formed and incorporated in South Africa in terms of section 32 of the Companies Act,²⁰⁰ is a resident because of its formation and incorporation, irrespective of where it is effectively managed or where it carries on its business.²⁰¹ However, the registration of a foreign company as an ‘external company’ for company law purposes does not amount to incorporation, formation or establishment, and it will therefore not be a resident, unless it is also effectively managed in South Africa.

¹⁹⁸ See for instance, the reference to a company’s residence in sections 9C and 9D (as they then were).

¹⁹⁹ See the statement of Buckley LJ, announcing the importance of the place of incorporation test of companies for United Kingdom tax residence purposes when he held in *American Thread Co Ltd v Joyce* (1911/12, 6 TC 1 & 163) that: ‘A corporation, like an individual, may have more than one place of residence. The place of residence which immediately occurs to mind as presumably its place of residence is the place of incorporation. That has been spoken of in some of the cases as the place of its birth, it is the place of its birth, but it is more than that, it is the place whose laws may determine its status, it is according to the law of that place that it is a corporation; and therefore it is not only its birth but its status which depends upon the place in which its incorporation takes place, and it would be difficult, I think, to hold under any circumstances the place of its incorporation may not, for some purpose at any rate, as for instance with regard to jurisdiction, be always the place of residence.’

²⁰⁰ 61 of 1973.

²⁰¹ See *Silke*, *op cit*, p. A-12.

A.2 The ‘place of effective management’

a) Companies

The second criterion for determining the residence of legal entities is referred to in section 1(b) of the Act as the place of effective management. The Act has not provided any clue as to the meaning of ‘place of effective management’. The closest concept, which is a subject of a fair body of case law is that of the place of ‘central management and control’ in which a few cases in the South African tax law dealing with this issue, have relied on the highly persuasive value of the United Kingdom decisions, where the place of management and control has long been established for determining a company residence.

Nevertheless, the use by the legislature of a different terminology (place of effective management) must surely indicate a desire to apply a concept different from the place of central management and control.²⁰² It is argued that the word ‘effective’ in the phrase ‘effective management’ has a subjective content and its interpretation can differ depending on the particular circumstances of a case.²⁰³ The *Little Oxford Dictionary*²⁰⁴ defines ‘effective’ *inter alia* as ‘operative; impressive; producing intended results.’ The term ‘effective management’ is somehow viewed as being ambiguous, describing either the nature of management or the level of management and management decisions.

However, the reference to the ‘place of effective management’ as the test for legal entities’ residence is now widely used in most of the double tax agreements concluded by South Africa with other countries. The OECD Model Tax Convention in its Commentary now defines the term ‘place of effective management’ as:

‘The place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. Thus, it is the place of the top management that makes the policy decisions and takes actions affecting

²⁰² See Silke, *op cit*, A-12.

²⁰³ See Van der Merwe, BA, “Residence of a Company- The Meaning of ‘Effective Management’”, 2002, 14 SA Merc LJ, p. 80.

²⁰⁴ (1996), p. 3.

the whole entity. An entity may have more than one place of management but it can only have one place of effective management at any one time.²⁰⁵

Due to the lack of statutory definition or proper judicial guidance in South Africa, the issue remains as to how the ‘place of effective management’ test is applied by the South African Revenue Services (SARS).

i) South African Revenue Services (SARS)’ interpretation and application

In the income tax interpretation note no 6,²⁰⁶ SARS provides guidelines as to how it interprets the meaning of the term ‘place of effective management’ of an entity for the purposes of the definition of a ‘resident’ in the Act. According to the interpretation note, the concept of effective management is not the same as shareholder-control or control by the board of directors, as the concept of management focuses on the company’s purpose and business and not on the shareholder function. The interpretation note highlights that in order to determine the meaning of ‘place of effective management’, one should keep in mind that it is possible to distinguish between:

- The place where central management and control is carried out by a board of directors;
- The place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/ regular/ operational management and business activities; and
- The place where the day-to-day business activities are carried out or conducted.

Accordingly, as a general approach, SARS’ view is that the place of effective management is ‘the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding

²⁰⁵ See the OECD Commentary, article 4, para 24, updated as of April 29, 2000. Also cited by Rohatgi, *op cit*, p. 146.

²⁰⁶ Dated 26 March 2002.

control is exercised, or where the board of directors meet. Management by these directors or senior managers refers to the execution and implementation of policy and strategy decisions made by the board of directors. Thus, practically, if these management functions are carried out at one location, that location will be the place of effective management, which may or may not be the same as the place where the company's business activities are actually conducted. However, if the management functions are not carried out at one place, due to the use of distance communication and technology (such as telephone, internet or video conferencing), SARS' view is that the place of effective management is where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented, that is, where the business activities are conducted. If the business activities themselves are conducted at various locations, one needs to determine the place with the strongest economic nexus.

ii) Consideration of facts and circumstances

Because no hard and fast rules can be laid down in determining the place of effective management, the interpretation note (no 6) sets out a non-exhaustive list of relevant factors that should be examined on a case-by-case basis in determining the place of effective management, which are:

- Where the centre of top level management is located;
- Location of functions performed at the headquarters;
- Where the business operations are actually conducted;
- Where controlling shareholders make key management and commercial decisions in relation to the company;
- Legal factors such as the place of incorporation, formation and establishment, the location of the registered office and public officer;
- Where the directors or senior managers or the designated manager who are responsible for the day-to-day management reside;
- The frequency of the meetings of the entity's directors or senior managers and where they take place;

- The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- The actual activities and physical location of senior employees;
- The scale of onshore as opposed to offshore operations;
- The nature of powers conferred upon the representatives of the entity, the manner in which those powers are exercised by the representatives and the purpose of conferring the power to the representatives.

In conclusion, it is likely that the courts will test the term ‘place of effective management’ in due course. Thus, until there is more consensus regarding the meaning of this term, it is better for taxpayers to exercise more conservative tax planning around the issue of the place of effective management of their companies. Thus, SARS regards the place of effective management to be the place where the highest level of day-to-day management of the activities of the business takes place, that being the place where the executive directors and management conduct the company’s business. This is not necessarily the place at which the directors hold their meetings, or the place where strategic and policy decisions are made and ultimate control is (which is more closer to central management and control)²⁰⁷, but rather it is the place where the actual operations of the company are managed on a day-to-day basis. In this line, Davis suggests that if an offshore party must exercise discretion, or can alone implement any decision taken, and this is a *sine qua non* for management decision, then management elsewhere cannot be regarded as effective.²⁰⁸ Thus, a distinction must be drawn between executive and non-executive management. A manager who performs executive duties actively takes part in the day-to-day decisions of the business and is effectively charged with the responsibility of running it. In contrast, non-executive management serves as consultants to the executive management to bring their particular expertise or experience to bear on the decisions of the executive management.

²⁰⁷ This view is held by Meyerowitz, D (“Sections 9C and 9D Revisited”, 1998, Taxpayer 81; and in “Editorial: The Revenue Laws Amendment Act”, October 2000, Taxpayer 183, vol 49) who relies on the United Kingdom case of *Wensleydale’s Settlement Trustees v CIR* (1996, SPC 73) where DA Shirley held that the place of effective management is where the shots are called, that is where the board of directors meets to make the key decisions.

²⁰⁸ See Davis, DM, Olivier, L, & Uquhart, G, *Juta’s Income Tax*, 2000, vol 1, para 9D-5.

b) Other legal persons

Early in some judicial decisions, it was established that other fictitious persons such as estates, trusts, clubs and associations were capable of having a residence and being resident.²⁰⁹

Section 1(b) of the Act made it clear that the definition of residence applies to any person other than a natural person, therefore implying that any artificial person will be subjected to the same test of residence.²¹⁰

Accordingly, trusts and estates are resident in South Africa if they are incorporated, established or formed, or if they have their place of effective management in South Africa.

The place of incorporation of these artificial persons is a matter of fact and each case must be decided on its own merits.²¹¹ It is submitted that the place of effective management of trusts and estates will normally be the place where the trustees meet to deal with the affairs of the trust, or where the trustees leave the management to a particular trustee, the place where he functions on behalf of the trust.²¹² It is further argued by Meyerowitz²¹³ that if the trustees have delegated their authority to an agent, the place of effective management will, until the mandate is withdrawn, be where the agent carries out his mandate.

Thus, the place of where the assets of the trusts or estates are effectively managed is crucial in determining their place of residence.

²⁰⁹ See *Nathan's estate v CIR*, 1948 (3) SA 866 (N), 15 SATC 328; *CIR v Jagger & Co (Pty) Ltd*, 1945 CPD 331, 13 SATC 430.

²¹⁰ Before the amendment to the Act, section 1 used to define 'person' in relation to legal entities as including deceased estates and trusts (refer also to section 25B of the Act) for the purposes of income tax, unlike in other jurisdictions such as the United Kingdom.

²¹¹ See Silke, *op cit*, p. A-13.

²¹² See Meyerowitz, *op cit*, October 2000, Taxpayer 183.

²¹³ *Ibid*.

B) The United Kingdom

B.1 The incorporation test

For United Kingdom income tax purposes, the question of the relationship between a company's place of incorporation and its place of residence first came before the courts in *A-G v Alexander*,²¹⁴ concerning the Imperial Ottoman bank which was a company incorporated in Constantinople that had taken over and continued to carry on the business of a London bank. The court rejected the bank's contention that a company could be resident only in the country of its incorporation.

Further in 1904, in *Goerz & Co v Bell*,²¹⁵ Channell J held that the company concerned in the case was resident in the United Kingdom despite the fact that it had been incorporated in South Africa.

Later in *Egyptian Delta Land & Investment Co Ltd v Todd*,²¹⁶ the court considered the submission that a company could only exist because of the law that gave it birth, and therefore could only reside in that place where its creative law was maintained. In delivering the judgment, Viscount Sumner said that:

'This expression of opinion can only mean that for both British and foreign companies alike the test is where on the facts (including among all the others the fact of incorporation here or there) the company's business is really directed and carried on.'²¹⁷

However, the common law principle established in judicial decisions that the place of a company's incorporation was not determinative of its place of residence in the United Kingdom, was modified in 1988 by the statutory recognition of the place of incorporation

²¹⁴ (1874) LR 10 Exch 20.

²¹⁵ (1904) 2 KB 136.

²¹⁶ (1928) 14 TC 119.

²¹⁷ At 151. Early in *The Swedish Central Railway Co Ltd v Thompson* (1923/25, 9 TC 342), Viscount Cave LC in analysing the place of incorporation test did not make any binding guideline when he held that: 'I am not at present prepared to say that registration in the United Kingdom would be sufficient proof of residence there; that point does not arise in this case, and I express no opinion upon it. But, however that may be, I am satisfied that the fact of registration together with other circumstances which were found by the commissioners to exist, were sufficient to enable them to arrive at their finding.'

as an additional test of company's residence. From 15 March 1988, any company incorporated in the United Kingdom became resident there for tax purposes.²¹⁸

There are circumstances in which residence of a legal entity is determined without reference to the incorporation test. The exception to the principle that all companies incorporated in the United Kingdom with effect from 15 March 1988 will be United Kingdom resident relate to most companies which prior to 15 March 1988 were carrying on business and had ceased to be United Kingdom resident as a result of a Treasury consent. These companies will only become United Kingdom resident in relation to the incorporation criteria if they cease trading in which case they will be deemed resident from that date or 15 March 1993, whichever is later. Companies which have carried on business prior to 15 March 1988 and were not resident in the United Kingdom prior to this date (for instance, incorporated in the United Kingdom but not resident), will become resident companies on 15 March 1988 unless before.²¹⁹

B.2 The central management and control test

It is possible for income tax purposes for companies to have a more substantive connection with a geographical locality and therefore become part of the law that closely reflects reality than a law that turns on the location of a formal act of incorporation which may have occurred many years ago. Courts and legislatures have tried other alternative corporation rules. In the United Kingdom context, this additional test of residence is known as the place of central management and control.

The application of the 'central management and control' test is difficult in practice because of the largely factual nature of the test. The question whether any particular company may be regarded as being managed and controlled in the United Kingdom is

²¹⁸ Section 66 of the Finance Act, 1988.

²¹⁹ See Saunders, G, & Antczak, G, *Tolley's on Corporation Tax*, 2001/2002, p. 603.

one of fact, the answer to which will be dependent upon all the circumstances of a particular case.²²⁰

It is therefore important for a proper understanding of the development and application of this concept of residence to look at and explore the decided cases and the Inland Revenue statement of practice.

i) Application of the test: Case law

The general principle derived from the landmark case of *De Beers Consolidated Mines v Howe*,²²¹ where residence was found to be where the real business is carried on, and such place being where the central management and control actually abides. In this case, De Beers was a company registered in South Africa that was involved in diamond mining. The company's head office was located in South Africa but it maintained other offices in both South Africa and London. The day-to-day decisions were made in South Africa where the diamond mines were located. Major decisions were made in London. In determining the company's residence, Lord Loreburn held that:

‘In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business...’²²²

As the learned judge stated further:

‘[I]t is clearly established that the majority of directors and life governors live in England, where the directors meet. Meetings in London are meetings where the real control is always exercised in practically all the important business of the company, except the mining operation. London has always controlled the negotiation of the contract with the diamonds and other assets, the working and

²²⁰ The ‘facts and circumstances’ approach for determining the central management and control of companies was made clear by Lord Loreburn in *De Beers Consolidated Mines v Howe* (1906, 5 TC 198) where he said that: “It remains to be considered whether the present case falls within that rule. This is a pure question of fact to be determined, not according to the construction of this or that regulation or byelaw, but upon a scrutiny of the course of business and trading.” The consideration of the facts of a particular case in ascertaining the corporate residence for tax purposes was also highlighted by Viscount Sumner in *Egyptian Delta Land & Investment Co Ltd v Todd* (1928, 14 TC 119) and confirmed in *Bullock v Unit Construction Co Ltd* (1959, 38 TC 712).

²²¹ 1906, STC 198.

²²² At 212/3.

development of mines, the application of profits, and the appointment of directors. London has always controlled matters that require to be determined by the majority of all directors, which include all questions of expenditure, except wages, materials...at the mines, and a limited sum which may be spent by the directors at Kimberley.’²²³

The court ruled that since the principal office was in the United Kingdom and the majority of directors met there, the company was resident in the United Kingdom.²²⁴

The test propounded by Lord Loreburn above was subsequently applied to the effect that in general, a company is managed and controlled at the place or office where the directing power of the affairs of the company is exercised. The expression ‘management and control’ is usually interpreted to mean control by directors rather than shareholders. Moulton LJ stated in *Stanley v Gramophone & Typewriter Ltd*,²²⁵ that the control in question is that which relates to the highest level of management of a company’s business and must not be confused with the control which vests in a company’s shareholders *per se*. In other words, a company does not attract residence status in the United Kingdom simply because its shares, or the bulk of them are owned or held by persons resident in the United Kingdom. In expressing that opinion, Phillimore J made it clear in *Kodak Ltd v Clark*,²²⁶ that:

‘One must not make the jump from “control” to “carrying on business”. A company may control another company...or an individual may control a company, but it does not necessarily follow that because the individual controls the company or the company controls the company...that the business carried on by the...company controlled is necessarily a business carried on by the controller; and particularly is that the case where the controller is the company.’²²⁷

In summary, the test of corporate residence for United Kingdom tax purposes strictly involves the identification of the place of central management and control. Although the shareholders can with no doubt, by virtue of their votes control the corporation (such as

²²³ At 213.

²²⁴ The *De Beers* case was based on the same principle established in the early cases of *A-G v Alexander* (1874, 10 ex 20); *Calcutta Jute Mills Co Ltd v Nicholson* (1876, 1 TC 83); and *Cesena Sulphur Co Ltd v Nicholson* (1876, 1 TC 89).

²²⁵ 1908, 5 TC 358.

²²⁶ 1901, 4 TC 549.

compelling directors to do their will), it does not follow that the incorporators are managing the corporation.²²⁸

In applying the *De Beers* test, the courts in the United Kingdom have identified various elements in determining corporate residence, which range from the location of the passive management and control, the delegated management and control, policy-making and decisions for financing.

Generally, the central management and control of the company is considered to be where the decision making (including the raising and allocation of funds) takes place,²²⁹ which in some cases, may be the parent company of a subsidiary or a single individual who makes all the decisions. It might be found that the central management and control of a company is actually being exercised unconstitutionally by a single shareholder or by a group of shareholders rather than by those who have the constitutional right to exercise management and control. This was already recognised in the Revenue statement of practice which stated that:

‘In some cases...central management and control is exercised by a single individual. This may happen when a chairman or managing director exercises power conferred by the company’s articles and the other board members are little more than cyphers, or by reason of a dominant shareholding or for some other reason. In those cases, the residence of the company is where the controlling individual exercises his power.’²³⁰

As far as subsidiary companies are concerned, this principle is well illustrated by Oliver,²³¹ in his so-called ‘clockwork residence theory’. As the theory goes, the clockwork subsidiary is one which has been established by the parent company for a particular purpose. The parent company at the time of establishment lays down the parameters within which the subsidiary is to operate and thus effectively prevents the directors of the subsidiary from achieving any independence or flexibility in the decisions

²²⁷ At 582; also extensively analysed by Sheridan, D, “The Residence of Companies for Tax Purposes”, 1990, *British Tax Review*, p. 93/94.

²²⁸ See Hamilton J’s judgment in *American Thread Co v Joyce*, 1911, 6 TC 1 at 32/33.

²²⁹ See *Calcutta Jute Mills Co Ltd v Nicholson* (1876, 1 TC 83); *Cesena Sulphur Co Ltd v Nicholson* (1876, 1 TC 88); & *San Paulo (Brazilian) Railway Co Ltd v Carter* (1895, 3 TC 407)

²³⁰ Statement of Practice (SP) 6/83 at para. 6.

which they may take. All the major decisions will therefore have been taken at the time when the subsidiary was being established; its role and the way in which it will perform it are predetermined, and any subsequent discretionary action by the subsidiary directors is effectively excluded. Therefore, in a case where the parent company is managed and controlled and thus resident in the United Kingdom, then so will the subsidiary company be resident in the United Kingdom though it may be carrying on its operation abroad and purport to have a board of directors who meet abroad.

The above principle originated from the speeches of Viscount Simonds and Lord Ratcliffe in the landmark case of *Bullock v Unit Construction Co Ltd*,²³² where the learned judges made it clear that central management and control is a *de facto* concept and that once it has been established that central management and control is being exercised by a particular person or group of persons, it will be irrelevant that such management and control ought to be exercised by some other person or group of persons. In this case, Unit Construction company, a United Kingdom resident subsidiary of Alfred Booth company, a United Kingdom parent company, made subvention payments to three of its fellow subsidiary companies in East Africa (Kenya) and claimed those payments were under Financial Act 1953, section 20, permissible deductions in arriving at its profits for tax purposes. This would have been so only if the three Kenyan subsidiaries were also resident in the United Kingdom, but the Inland Revenue contended that they were not. The three subsidiaries had been incorporated in Kenya and their articles of association expressly placed their management and control in the hands of their directors and required directors' meetings to be held outside the United Kingdom. That being so, the three Kenyan subsidiaries must, said the Revenue, be resident outside the United Kingdom.

In the House of Lords, Viscount Simonds laid down the principle that:

‘Nothing can be more factual and concrete than the acts of management which enable a court to find as a fact that a central management and control are exercised in one country or another. It does not in any way alter their character

²³¹ Oliver, J.D.B, “Company Residence: Four Cases”, 1996, *British Tax Review*, no 5, p. 505.

²³² 1959, 38 TC 712.

that in greater or lesser degree the irregular or unauthorised or unlawful. The business is not less managed in London, because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution, however imperative. If indeed, I must disregard the facts as they are because they are irregular, I find a company without any central management at all for though I may disregard existing facts, I cannot invent facts which do not exist and say the company's business is managed in Kenya and it is the place of central management which however much or little weight ought to be given to other factors essentially determines its residence. I come therefore to the conclusion that truly, no precedent can be found for such a case that it is the actual place of management, not the place in which it ought to be managed which fixes the residence of a company.'

The court therefore held that because the subsidiaries' management and control have been taken over by the directors of the parent company in London, the former were resident in the United Kingdom. The late Mr Frank Heyworth Talbot, QC was recorded as arguing that 'the peculiar feature in the present case is that the board of the African subsidiaries did not function at all at the material times even as a rubber stamp.'²³³

The *Union Construction* case therefore confirms the rule that to locate the *de facto* policy-making body within a company will thus be to locate that company's central management and control.²³⁴ The place where the board of directors meets is important but not conclusive.

Tacit exercise of the right of central management and control through passive oversight (such as the delegation of management and control to lower level of managers) is no less real than management and control which manifests itself in active intervention in the affairs of the business, and is no less *de facto* because of it.

This was recognised in *Calcutta Jute Mills v Nicholson*,²³⁵ where Baron Huddleston held that the central management and control of the Calcutta Jute Mills, though ostensibly

²³³ 1960, AC 351 at 355.

²³⁴ This principle was adopted early in the cases of *New-Zealand Shipping Co Ltd v Thew* (1922, 8 TC 208), where the court held that though it was a New Zealand company with New Zealand directors, the overall management and control lay with a separate London board. See also *San Paulo (Brazilian) Railway Co Ltd v Carter* (1895, 3 TC 407); and *American Thread Co v Joyce* (1913, 6 TC 1).

²³⁵ 1876, 1 TC 83.

exercised by a director in India, was actually exercised from the company's office in London where the board of directors met. The director in Calcutta was, for all his powers, a mere delegate and one had therefore, to look beyond him to the delegators from whom his powers had been derived and by whom they were being sustained.

The expression 'head and brain' has often been used as an alternative to 'central management and control' to identify those who are at the centre or higher level of decision making in the company.²³⁶

In a case of *Re Little Olympian Each Ways Ltd*,²³⁷ though not a tax case but dealing with a summons by which some of the respondents to a petition under section 459 of the Company Act 1985, sought security for their costs from the petitioner Supreme Travel's Ltd (shareholder in Little Olympian), under the Rules of the Supreme Court.

One of the issues was whether Supreme Travel Ltd, which was incorporated in Jersey, was 'ordinarily resident out of the jurisdiction'. The company argued that though its board meets in Jersey, the real central management and control was exercised by one of its directors, Mr Lemos, in England.

As the company asserted, Mr Lemos made the strategic decisions relating to the company and 'in particular' in relation to the current litigation.

The court held that a Jersey board might accommodate Mr Lemos but it meets, gives instruction from time to time to Withers (the company's solicitor), opens a bank account, and is kept informed of developments and asks itself whether implementation of any particular proposals of Mr Lemos are consistent with the best interests of the company and its shareholders who do not include Mr Lemos.

Lindsay J concluded that he saw a company incorporated in Jersey, with a Jersey registered office, with Jersey resident shareholders, with a Jersey board, with a Jersey

²³⁶ See for instance, statements of Halsbury LC in *San Paulo (Brazilian) Railway Co Ltd v Carter* (1895, 3 TC 407 at 410); & Hamilton J in *American Thread Co Ltd v Joyce* (1913, 6 TC 1 at 18).

²³⁷ (1994), 4 ALL ER 561, CHD; case also cited and analysed by Oliver, *op cit*, p. 506.

secretary and with a board that meets as such and which has not surrendered its powers nor had them removed but rather which operates them within what it conceives to be the law of Jersey. Thus, the central management and control of the company was in Jersey.²³⁸

In *Unigate Guernsey Ltd v Mc Gregor*,²³⁹ subsidiaries of a United Kingdom resident parent company were held to be resident where their boards met and their business was transacted, as they did function in giving effect to the parent company's wishes, notwithstanding that they were complaisant to the parent's will.

In the *Unit Construction* and *Re Little Olympian* decisions, the courts highlighted the very fine dividing line between subsidiary companies being complaisant to the will of the parent company but actually functioning in giving effect to those wishes, and boards, which did not function at all even as rubber stamp.²⁴⁰ Although a board might do what it was told to do, it did not follow that the management and control of the company lay with another, so long as the board exercised their discretion (through the veto) when coming to their decision and would refuse to carry out an improper or unwise transaction.²⁴¹

In the recent case of *R v Da Costa, Chipping and Dimsey*,²⁴² the issue related to Chipping's management and control of the company in the United Kingdom. It was alleged that the Jersey companies were all resident in the United Kingdom due to the fact that 'their business was really conducted by Mr Chipping and he conducted them in the United Kingdom'. The prosecution argued that the companies were liable to corporation tax on their profits and that Chipping knew this to be the case and in not disclosing this fact, he had attempted to deceive the Revenue into believing that they were centrally managed and controlled abroad. Chipping denied this and claimed that the central

²³⁸ At 574 d. See also *Union Corporation Ltd v CIR*, 1952, 34 TC 207. This case could be compared with other international approaches in relation to the concept of central management and control, in the specific connection between subsidiary and the parent company. See for example, *New Zealand Forest Product Finance N.V v CIR* (1995, 17 N.Z.T.C 12073); *Esquire Nominees Ltd v The commissioner of taxation of the Commonwealth of Australia* (1971/73, 129 CLR 177); & *Victoria Insurance Co Ltd v Minister of National Revenue* (1977, CTR 2443).

²³⁹ 1996, SPC 55, SSCD 1.

²⁴⁰ See statements by Frank Heyworth Talbot, QC in the *Unit Construction* case, 1950 AC 351 at 355.

²⁴¹ See Oliver, *op cit*, p. 520.

²⁴² 1999, STC 846.

management and control was effected from Jersey and that he acted purely as a commercial consultant to the numerous companies. It was found that Chipping was giving instructions from the United Kingdom. Of interest is the fact the judge, in attempting to determine where the central management and control was located, looked more to the day-to-day running of the company.²⁴³

Identification of the person or group of persons who exercise *de facto* central management and control does not, of course, conclude the question of a company's residence. There remains the other step of ascertaining the place from which they exercise that central management and control.

The principle laid down by the *De Beers* case was that a company is resident for tax purposes where the real business is carried on, which is in principle where the directors meet and conduct their business and exercise the powers conferred upon them.

It would be unwise as correctly argued by Oliver²⁴⁴ to take this principle in isolation and to conclude that reliance can be placed solely on the place of board meetings. If the central management and control of a company can be wherever the directors chose to meet to take their decisions, it would be easy for directors who may all be residents in the United Kingdom to decide to take the corporate jet together for a trip once a month to a tax haven like Bermuda for their board meeting at a small office they maintain there.

Lord Loreburn in the *De Beers* case was suggesting that one should look beyond the mere fact that, say on one or two occasions per year, certain professional persons in a foreign place meet formally to pass and sign agreed minutes. As contended by Booth,²⁴⁵ even if central management and control is in the hands of the directors, their place of meeting will not determine the company's place of residence if their meetings there are merely a matter of form. This was stated in the early Revenue Statement of Practice to the effect

²⁴³ This case is also analysed by Saunders, R & Dean, M, "The effects of *Dimsey*: How Far Reaching Is This Case?", October 1999, *International Tax Systems and Planning Techniques*, p. 9.

²⁴⁴ *Ibid.*

²⁴⁵ *Op cit*, p. 163.

that, the place of directors' meetings is significant only in so far as those meetings constitute the medium through which central management and control is exercised.²⁴⁶

ii) The Inland Revenue Practice

In an attempt to clarify the implication of the case law on the concept of residence for companies, the Revenue has issued a Statement of Practice²⁴⁷ which does not lay down rigid guidelines, nor review the whole concept of a company's residence. The Revenue's approach is that a foreign company may become tax resident if the central or overriding management and control is deemed to be in the United Kingdom. The authorities would look at factors such as:

- Where the highest level of control is exercised;
- Where the actual management and control is exercised (for instance, the use of shadow directors);
- Where the directors have board meetings;
- Where the decision-making processes and management meetings take place; or
- Where the controlling individuals or shareholders exercised their powers.²⁴⁸

Also of interest in the Statement of Practice is the concept of central management and control in contradistinction to the place of effective management. In most cases the two places are likely to be the same but the United Kingdom Revenue accepts that effective management may, in some cases, be found at a place different from the place of central management and control. This could happen, for example, where a company is run by executives based abroad but the final directing power rests with non-executive directors who meet in the United Kingdom. In such circumstances the company's place of effective management might well be abroad but it might be centrally managed and controlled (and therefore resident) in the United Kingdom.²⁴⁹

²⁴⁶ See Statement of Practice (SP) 6/83.

²⁴⁷ Statement of Practice (SP) 1/90 of January 9, 1990, replacing SP 6/83.

²⁴⁸ Also analysed by Rohatgi, *op cit*, p. 152.

²⁴⁹ See Para 22 of SP 1/90.

This distinction was considered by the court in deciding the question of the place of effective management in the case of *Trustees of Wensleydale's Settlement v CIR*.²⁵⁰

The case concerned the residence of a trust under the United Kingdom and Irish treaty.²⁵¹ There were two trustees. One trustee was resident in the United Kingdom and the other trustee was resident in the Republic of Ireland. The trustees argued that being a person other than an individual, they were to be regarded as a resident of the Republic under article 4(3) of the treaty because the place of effective management of the trust was situated in the Republic.

The Special Commissioner DA Shirley noted that there was no reported decision in which the phrase 'place of effective management' has been considered. In relation to a company, he added that the place of effective management is the place where its business is managed and controlled.

In arriving at his decision, he referred to the German interpretation of the concept, as analysed by Vogel,²⁵² to the effect that the 'centre of top level management' was a good description of the place of effective management.²⁵³

Thus, the Special Commissioner went on to find that as a question of fact, the place of effective management of the trust was in the United Kingdom, and as he added: '...it is where the shots are called, to adopt a vivid transatlantic colloquialism.'²⁵⁴

The judgment found that, the shots were called by the donor in a settlement and not by the trustees and consequently the place of effective management was where the donor was.

By adopting the centre of top level management as the test in interpreting the place of effective management in the United Kingdom, the Special Commissioner in the

²⁵⁰ (1996) SPC 73; 1996, STC (SCD) 241.

²⁵¹ Double taxation relief (taxes on income) (Republic of Ireland) Order 1976, SI 1976 no 2151.

²⁵² Klaus Vogel, *op cit*, 1991, p. 105; also cited by Oliver, *op cit*, p. 528.

²⁵³ 1996, STC (SCD) 241 at 250b.

Wensleydale Settlement case seems to reject the approach followed in the Statement of Practice of the Revenue to the effect that the place of effective management may be dissociated from the central management and control of the company.

In all cases, the Revenue will seek to determine whether a major objective of the existence of any particular factors bearing on residence is the obtaining of tax benefits from residence and non-residence, and to establish the reality of the central management and control.²⁵⁵

B.3 The trust residency

Determining the residence of a trust is important, because residence renders the trust liable to tax on foreign source income. However, because many jurisdictions such as the United Kingdom do not recognise the separate legal personality of the trust, the determination of its residence may be a difficult matter.

In the United Kingdom, trust residency is assessed by reference to the trustees. Previously the Revenue had considered that a trust was resident for income tax purposes in the United Kingdom if just one of the trustees was a United Kingdom resident.

However, in *Dawson v IRC*,²⁵⁶ the House of Lords held that section 18(1)(a)(i) of the Taxes Act 1988 required all persons entitled to the income to reside in the United Kingdom. Lord Keith went on to say that the trust's residence was determined by looking at whether all the trustees were United Kingdom resident. This case allowed any trust to avoid tax on foreign income purely by having a non-resident trustee.

The Finance Act 1989 in sections 110-111 and section 151 brought the law into line with the former Revenue practice. Thus, when a settlement has one trustee who is a British resident and one trustee who is a non-resident, the trust is treated as a United Kingdom

²⁵⁴ At 19; at 250j.

²⁵⁵ See Saunders, G & Antczak, G, *op cit*, p. 605.

²⁵⁶ 1988, STC 684.

resident unless the settlor was neither resident, ordinarily resident, nor domiciled in the United Kingdom when the trust was set up or when funds were provided for it.²⁵⁷

As a general rule therefore, the Revenue practice in line with section 110 of the Finance Act 1989 in determining the residence of the trust is based on the following factors:

- Where all the trustees are non-resident, then the trust is not resident for income tax purposes;
- Where all the trustees are resident, then the trust is resident for income tax purposes;
- Where there is a mixed residence of trustees, but not necessarily a majority, then the residence status of the trust will depend on the status of the settlor at the time that the funds were provided. The trust will be non-resident only where the settlor was not resident, nor ordinarily resident and non-domiciled in the United Kingdom when he put funds into the settlement.²⁵⁸

C) The United States

Introduction

Like individuals, legal entities have a legal connection to the United States, often relating to their origin or formation. The United States uses the place of incorporation as the exclusive test in determining the basic jurisdiction to tax persons other than individuals. As defined in section 7701(a)(30) of the Inland Revenue Code (IRC), United States persons include individual citizens or residents of the United States, domestic partnerships, domestic corporations, trusts that have specific connection to the United States and estates that are not 'foreign'. Thus, the distinction that the United States makes

²⁵⁷ As stated in the Finance Act 1989, the assessment could be made in the name of either of the trustees. However, the residence of a trust in the United Kingdom depends on the particular tax consequences. Thus, in relation to capital gains tax, a body of trustees is treated as being resident and ordinarily resident in the United Kingdom unless, under section 69(1) of the TCGA 1992, the general administration of the trust is ordinarily carried on outside the United Kingdom and the trustees, or the majority of them, are not resident, or are not ordinarily resident in the United Kingdom.

²⁵⁸ See Wisdell, A, "Residence of Trusts in the United Kingdom", June 1999, *Tax Planning International Review*, vol 26, p. 16.

is between ‘domestic’ and ‘foreign’ entities, and not between resident and non-resident entities. Although this status is not exactly assimilable to the ‘nationality’ or ‘citizenship’ of individuals for the purposes of taxation and regulation of entities, it is somewhat analogous. In many instances, the term ‘situs’ is used to describe the legal status that identifies an entity with the United States.²⁵⁹

The United States tends to impose in their tax treaties, some form of reservation clause whereby it only accepts the place of incorporation or organisation as the final tie-breaker for ascertaining the residence of companies. If the other party is not prepared to agree with this test, dual-resident companies are excluded from the benefits of the treaty.²⁶⁰

C.1 Corporations

The notion of ‘residence’ is not significantly associated with corporations in respect of United States taxation. The status of a corporation as ‘domestic’ or ‘foreign’ is tied to its place of incorporation. Corporations ‘created or organised’ in the United States or chartered under the laws of the United States or of any state are ‘domestic’ corporations.²⁶¹ Thus, corporations not incorporated in the United States are regarded for tax purposes as ‘foreign’ corporations with fiscal residence outside the United States.²⁶²

Because the notion of corporation residence is an element of other tax systems, however, there are rules coordinating United States and foreign taxation of United States corporations that have foreign ‘residence’ in another tax system. The problem is not the double taxation of income, which is generally minimized by the foreign tax credit, but the advantageous double use of losses in different tax environments.²⁶³

²⁵⁹ See Isenbergh, J, “Foreign Income: Foundation of US International Taxation”, 2001, *Tax Management*, p. A-3. The United States income tax based on the classical system, is imposed at two levels: (i) federal tax administered by the Internal Revenue Service, and (ii) state taxes based on the state tax laws, regulations and administrative practices. In addition, various taxes may be levied at the local level. The federal taxable income is usually the basis for the state and local taxes. See Rohatgi, *op cit*, p. 332.

²⁶⁰ See for instance, articles 3(1)(g) & 4(1) of the DTA between Australia and the United States. See also the analysis by Vann, *op cit*, p. 733; & Oliver, *op cit*, p. 534.

²⁶¹ Section 7701(a)(4) of the IRC.

²⁶² Section 7701(a)(5) of the IRC.

²⁶³ See Isenbergh, *op cit*, p. A-10.

C.2 Other legal persons

a) The situs of trusts

There is a two-part test in section 7701(a)(30)(E) of the IRC for determining the situs of a trust. A trust is a United States person (that is a domestic trust) if:

- A court within the United States is able to exercise primary supervision over the administration of the trust; and
- One or more United States persons have the authority to control all substantial decisions of the trust.

The first test is referred to as the 'court test', and the second as the 'control test'. Both tests must be met to establish a domestic trust.²⁶⁴

A domestic trust must be subject to the authority of some American court and controlled by United States fiduciaries. It is thus sufficient to this end for a trust instrument to specify that it is governed by the laws of any state, and for fiduciaries who are United States persons to hold a majority of the fiduciary power beyond veto by any foreign fiduciary. The twin tests of the situs of a trust are to some degree overlapping because who has authority to control a trust itself depends on what courts may exercise the power of supervision over the trust. Because the statutory test of the situs of the trusts is determined largely by objective elements that are often within the taxpayer's control, it is generally accommodating.²⁶⁵

i) The 'court test'

It may be difficult to apply this test to a trust that has never appeared before a court, especially in a state that has sparsely developed decisional law. The regulation established a safe harbour court test, which is satisfied if:

- The trust instrument does not direct that the trust be administered outside the United States;

²⁶⁴ In terms of section 7701(a)(31)(B), a foreign trust is any trust that is not a domestic trust.

²⁶⁵ See Isenbergh, *op cit*, p. A-12.

- The trust is in fact administered exclusively in the United States; and
- The trust is not subject to any automatic migration provision.

The term ‘primary supervision’ means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. The administration of the trust in turn means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including *inter alia*, maintaining the books and records of the trust.

ii) The ‘control test’

The regulation defines ‘control’ by a United States person as ‘having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions’.²⁶⁶

The ‘substantial decisions’ of a trust consist of the authority or obligation to ‘make under the terms of the trust instrument and applicable law that are not ministerial.’²⁶⁷ The control test is not met, however, if certain actions by a government or creditors cause control to shift from United States persons.²⁶⁸ The control test must be satisfied independently of the safe harbour for the court test.

b) The situs of estates

The IRC defines ‘foreign estates’ in section 7701(a)(31)(A) as an estate taxed as a foreign person. The definition does not indicate to any extent when or how a given status is established. Most of the time, the residence of the decedent determines the situs of an estate for income tax purposes. However, this is subject to further difficulties. An individual’s residence may not be the same for income tax and estate tax purposes. Therefore, the situs of an estate, in theory at least, may be different for different tax

²⁶⁶ Reg. S301.7701-7(d)(1)(iii).

²⁶⁷ Reg. S301.7701-7(d)(1)(ii).

²⁶⁸ Reg.S301.7701-7(d)(3).

purposes. In practice, a decedent's residence for estate tax purposes may determine all aspects of its taxation, including income taxation, if only because the shadings of situs and residence may be hard for executors and tax authorities to sort out. It is therefore desirable to avoid primary administration of a foreign decedent's estate in the United States.

3. The concept of residence and the tax consequences

Introduction

The most important characteristic of the residence-based tax system is that residents are, in principle, subject to tax on their worldwide income. Thus, foreign source income received by the recipient will usually be taxed after it has accrued or been received as income in the country of residence of that recipient. If a jurisdiction were to treat non-resident corporations, including certain other foreign entities, as taxable entities separate from their resident shareholders even if those shareholders own all the shares of the foreign corporations, it will be possible to defer or avoid the tax on such income at home, until it is repatriated. This can be done by receiving the income in an intermediary entity located in a tax-free or low tax jurisdiction.²⁶⁹

Some countries may totally exempt foreign source income by giving priority to the free circulation of capital or they may only exempt certain categories of income.²⁷⁰ Thus, for countries that exempt foreign source income, deferral is not a concern. However, in order for a residence-based tax system to be effective, it is essential that it draws into the tax net, income earned from foreign sources.²⁷¹ If such income is not taxed, it is simply

²⁶⁹ The deferral of the residence country's tax is beneficial only to the extent that the foreign tax payable by the foreign corporation is less than the residence country's tax payable by the resident shareholders, and the benefit is maximised when the foreign tax imposed on the income of the foreign corporation is minimised.

²⁷⁰ For instance, jurisdictions such as South Africa, in recognising the growing mobility of the workforce exempts in its income tax law, income derived by employees during extended periods of absence from the country. Other jurisdictions also exempt categories of income such as pensions from foreign sources or foreign source business income.

²⁷¹ See Jooste, *op cit*, p. 473.

shifted and kept in foreign entities in tax havens and preferential regimes until repatriated.

Many countries using the residence basis of taxation, regard this deferral as an unjustifiable loss of tax revenue. It violates the fundamental principles of equity and capital export neutrality since the residents who invest abroad have a tax advantage over those who invest at home.²⁷² Consequently, some countries prevent their residents from accumulating funds offshore through for example, exchange control restrictions. But, with the global relaxation of exchange control regulations, many countries have implemented specific anti-avoidance provisions to ensure that there is no deferral of taxes on foreign income. These anti-avoidance provisions include the enactment of controlled foreign entity (CFE) or corporation (CFC) rules which require that the tax due on the foreign profits, whether distributed or not, be paid in the country of residence. Other measures involve taxing the foreign income only when it is finally repatriated to the country of residence. For instance, the taxation of dividends arising from foreign sources, on the ground that the underlying profits from which the dividends were declared have not been subject to tax in the country of source.

This section analyses, from a South African perspective, with particular references, where relevant, to other jurisdictions such as the United Kingdom and the United States, certain factors which determine whether tax is payable on foreign income received by or accrued to resident taxpayers. For South African tax purposes, this section focuses on those provisions of the South African income tax Act which regulate:

- The amount of the foreign income which must be included in the resident's taxable income;
- The timing of the inclusion; and

²⁷² See Rohatgi, *op cit*, p. 374. South Africa has been implementing strong measures against the deferral of foreign source income. The Minister of Finance in his Budget presentation for the 2002/2003 financial year, has proposed the introduction of a provision which will subject 'deemed' foreign income to income tax where a taxpayer has not accounted satisfactorily for assets that are invested abroad. The deemed foreign income is to be calculated by applying the official rate of interest to, presumably, the value of the offshore asset (or at least, to the asset that SARS deemed the taxpayer to have offshore). Presumably, this will mean that where a taxpayer has invested his foreign investment allowance of R 750000 in a non-

- Whether or not the income qualifies for exemption.

The categories of income considered for the purposes of this section include foreign employment income, foreign pensions, income derived from controlled foreign entities and foreign dividends.²⁷³

3.1 South Africa

3.1.1 Foreign employment income

South Africa taxes its residents on their worldwide income. With the above in mind, the taxation of individuals has a significant impact on the viability of implementing a specific structure. In circumstances where the individuals are required to render services abroad for either the South African or the foreign employer, there may be situations where the employee is subject to tax in South Africa and in the foreign jurisdiction. To counter the potential liability to double taxation, relief is provided either in terms of double taxation agreements, or through the provisions contained in the South African Income Tax Act.

In terms of section 10(1)(o)(ii) of the Act, an exclusion is provided for services rendered by South African resident employees outside South Africa so as to enable employers to compete in international markets. Section 10(1)(o)(i) of the Act exempts officers and crew members of a ship engaged in international transport from tax on their remuneration as officers and crew if they were outside the Republic for a period or periods exceeding 183 days in aggregate during the year of assessment. The Revenue Laws Amendment Act of 2000 extended the scope of section 10(1)(o)(i) by including within the exemption in terms of section 10(1)(o)(ii), remuneration accruing to a resident taxpayer in respect of services rendered outside South Africa for and on behalf of his employer if he was outside the Republic –

income producing investment, or has spent such allowance abroad, he will be required to provide proof of this to discharge the onus that the amount of 'deemed foreign income' should not be subject to tax.

- For a period or periods exceeding 183 full days in aggregate during any 12 months period commencing or ending during a year of assessment; and
- For a continuous period exceeding 60 full days during the period of 12 months.²⁷⁴

In general, in terms of the above provision, South African resident employees who render services outside South Africa may enjoy exemption from South African tax on their income (but will remain liable for tax on any other income derived from South Africa or abroad) provided that their foreign employment satisfies certain requirements.

South African resident employees who are assigned to render services outside South Africa for long periods may be in a position to take advantage of this exception. This will be the case when the employee will be outside South Africa for a total period of more than 183 days (that is about six months) provided that if he returns to South Africa during this period, at least one of the periods of absence from South Africa is more than 60 consecutive days.

While the full period of 183 days need not be continuous, a period exceeding 60 days must be continuous. It is the '60 consecutive days' requirement that may prove problematic in obtaining this tax exemption.²⁷⁵ If, for any reason, for example, illness or other unforeseen circumstances, the employee returns to South Africa and the required period of absence has not been achieved, the employee will be subject to tax in South Africa. Accordingly, any income that is *prima facie* linked to the employee's South African employment is subject to tax in South Africa. But any portion linked to the performance outside South Africa would be covered by section 10(1)(o)(ii) of the Act having only the difference, if any, to be subject to South African tax.

²⁷³ For the purpose of limiting the scope of the research, I will not cover tax implications in relation to other foreign source income such as the income derived from foreign trusts or the tax implications arising from foreign exchange gains and losses.

²⁷⁴ Section 10(1)(o)(ii) was inserted in the Act by section 13(1)(p) of the Act 59 of 2000.

²⁷⁵ See Mitchell, L, "Working Abroad: Careful Planning Required", 2001 *Tax Planning* 60.

Clegg and Smith²⁷⁶ argue in this context that if the employer pays an employee his annual bonus and the bonus payment is made while the employee is rendering services outside South Africa, such bonus is not attributable in its entirety to services rendered outside South Africa. Thus, the portion of the annual bonus as is ascribed to services rendered inside South Africa would be subject to tax in South Africa.

The 183-day period may span more than one year of assessment provided that all days fall within the same period of 12 months. At the same time, the 12-month period does not have to be measured in the tax year itself but can span two tax years. Section 10(1)(o)(ii) refers to ‘full days’. Thus, the days of departure from and arrival in South Africa will count as days of being physically present in South Africa. There may be a concern in relation to ‘in transit travel’ for South African resident employees, who for example, while working abroad, have to stop at one of the South African airports even for half a day en route to a foreign destination, like a short holiday in a third country. In practice, the view of the South African Revenue Service (SARS) is that if a South African employee is in transit at one of the South African airports and does not proceed through customs, he will not have breached section 10(1)(o)(ii) as he is in international territory.

Although section 10(1)(o)(ii) is designed primarily to accommodate South African employers who engage South African residents on foreign assignments for protracted periods of time, the wording of this provision is not however, restricted to employment by South African employers.²⁷⁷

From a pay-as-you-earn (PAYE) perspective, if it is clear that the employee will be outside South Africa for the more than 183 days (of which more than 60 will be continuous), the employer would not be required to withhold PAYE on the salaries paid to the employee for the services rendered abroad.²⁷⁸ Where the probable period of

²⁷⁶ See Clegg, D, & Smith, A, “The Travel Component: Offshore Service”, 2001, 15 *Tax Planning* 122 at 124.

²⁷⁷ However, for South African exchange control purposes, a South African resident may retain his foreign-earned income offshore if it is earned as a result of rendering services outside South Africa for a non-South African employer.

²⁷⁸ As provided in paragraph 2(1) of the Fourth Schedule to the Act.

absence cannot be determined, the employer should withhold PAYE and issue a tax return to the employee. Should the employee have ultimately spent more than 183 days outside South Africa and complied with section 10(1)(o)(ii), then he would be entitled to a refund from SARS. Alternatively, the employer can approach SARS before the employees leave South Africa for their work abroad to set out the practical difficulties of determining whether or not it is required to withhold PAYE. SARS could be requested to issue a directive that the employer need not withhold employees' tax in circumstances where the employees are reasonably expected to meet the conditions of section 10(1)(o)(ii). However, despite such a directive, the employer may have to pay any amount due to SARS, together with penalties and interest, should the employee fail to comply with the provisions of section 10(1)(o)(ii).²⁷⁹

Section 10(1)(o)(ii) of the Act only applies to employees and not to self-employed individuals.²⁸⁰ Similarly, the provision does not apply where the employer is the government of South Africa.²⁸¹

3.1.2 Foreign pensions

The transition to the taxation of income from foreign sources, in the hands of a resident, created some difficulties with regard to pensions. Pensions payable by approved South African retirement funds have as income thereto, contributions made by employers and employees which have been allowed in terms of sections 11(k), 11(l) and 11(n) of the Act. This is not the case with foreign pensions.²⁸²

The recipient of a foreign pension is therefore at a disadvantage compared to local pensions. The Revenue Laws Amendment Act of 2000 recognised the administrative

²⁷⁹ See paragraphs 5(1) & 6(1) of the Fourth Schedule to the Act.

²⁸⁰ This exemption does not therefore apply to individuals rendering services as independent contractors, agents or in partnership.

²⁸¹ See the proviso to section 10(1)(o)(ii) which states that this exemption does not apply in respect of any remuneration derived from services rendered outside the country for or on behalf of any employer contemplated in section 9(1)(e) of the Act, which includes employers in the national or provincial spheres of government or any public entity if 80 per cent or more of the expenses of such entity is defrayed from funds voted by parliament.

burden that would be placed on SARS coupled with the potential negative impact on foreigners considering retirement in South Africa if foreign pensions were subject to tax.

As a result, an interim measure (initially for three years) was made available to exempt from tax in South Africa, the following pension receipts and accruals:

- Any amount received by or accrued to any resident under the social security system of any country²⁸³; or
- Any pension received by or accrued to a resident from a source outside the Republic, which is not deemed to be from a source in the Republic in terms of section 9(1)(g), in consideration of past employment outside the Republic.²⁸⁴

Thus, if a resident receives a non-governmental pension for services rendered partly in and partly outside the Republic, the portion of the pension relating to the services outside the Republic is not deemed to be from a source in the Republic and will qualify for the exemption.²⁸⁵ It is understood that this exemption for foreign pensions is currently under review.²⁸⁶ If the foreign pension were finally made subject to tax in South Africa, SARS would justify this on the grounds of the policy consideration of equity. Kosie Louw²⁸⁷ has previously argued that if high net worth foreigners who retire in South Africa were excluded from the provisions of the Act, there would be no parity in terms of the legislation.

3.1.3 The controlled foreign entity rules (CFEs)

Introduction

With the advent of the relaxation of its exchange control regulations and as part of its overall effort to reduce its tax rates by widening the tax base, South Africa introduced

²⁸² See Meyerowitz, *op cit*, *Taxpayer*, October 2000, p. 185.

²⁸³ See section 10(1)(gC) (i) of the Act inserted by section 13(1)(d) of the Amendment Act of 2000.

²⁸⁴ Section 10(1)(gC)(ii) inserted by section 13(1)(d) of the Amendment Act of 2000.

²⁸⁵ See Silke, *op cit*, p. A-33.

²⁸⁶ See the guideline to the residence basis of taxation for individuals- prepared by the Law Administration Division of SARS, 22 March 2002.

controlled foreign entity (CFE) legislation with effect from 1 July 1997. As a result, a residence-based taxation system was implemented in respect of ‘passive’ income following the Katz Commission recommendation in its 5th Report.²⁸⁸ The CFE rules in the old section 9D²⁸⁹ were specifically designed as an interim anti-avoidance measure exempting foreign income from taxation in South Africa if generated by way of active foreign trade and foreign capital.²⁹⁰

With the introduction of the worldwide taxation system in 2001, one important characteristic of the system was how to address all types of income earned by South African owned foreign companies and other South African owned foreign entities of a similar nature. The concern was that the failure to impose immediate tax on all types of foreign income would lead to a deferral by taxpayers shifting their income to foreign entities and delaying repatriation for years or never repatriating the funds at all. South Africa’s attempted solution to this deferral was the expansion of the then section 9D of the Act, to include in the gross income of South African qualified shareholders all types of income earned by CFEs.²⁹¹

The overall effect of the current section 9D is to tax the South African shareholders of foreign entities on the income earned by the foreign entities as if those foreign entities had immediately repatriated their foreign income as it was earned. Thus, section 9D does this by imputing the foreign income to the South African owners as and when it is earned by the foreign entity.²⁹²

²⁸⁷ *Sunday Times*, October 8, 2000.

²⁸⁸ This was achieved through the insertion of the then sections 9C and 9D in the Act by section 9(1) of the Act 28 of 1997. Section 9A of the Act, repealed by Act 59 of 2000, also imputed certain investment income of South African owned companies in Botswana, Namibia, Lesotho and Swaziland to their South African owners. The term ‘passive’ income was defined in the old section 9C to comprise annuity income, interest, rent, royalty and any income of a similar nature.

²⁸⁹ Prior to its amendment by Act 59 of 2000.

²⁹⁰ See Lester, M, “How Wide is Worldwide: Residence-based Tax”, June 2002, *Accountancy SA*, p. 14.

²⁹¹ Section 9D(2) of the Act was amended by section 10(1)(f) of the Amendment Act 59 of 2000. The enactment of section 9D was in line with international law, which does not allow South Africa to directly tax foreign entities on their foreign source income, even if those foreign entities are completely owned by South African residents. Although the current section 9D still refers in its title to investment income, it is a misnomer because the provision deals with all types of income derived by CFEs.

The provisions of section 9D can be structured in four analytical parts as follows:

- Determining which foreign entities fall within section 9D;
- Determining which South African residents must include a portion of the foreign entity's income under section 9D;
- Determining which forms of a foreign entity's income potentially create an inclusion under section 9D; and
- Analysing a number of exemptions from the operation of section 9D.²⁹³

The study of the operation of the CFE rules in section 9D, particularly from the income tax perspective, is therefore critical because this determines whether a resident will be taxed in South Africa on income earned offshore by CFEs.

A) CFEs subject to section 9D

The determination of the applicability of section 9D depends first on whether the income is generated by a 'foreign entity' and secondly whether the entity is 'controlled' by South African shareholders.

Thus, the first test is to consider the definition of 'foreign entity' in terms of section 9D. In terms of section 9D(1), a 'foreign entity' is defined as any person (other than a natural person or a trust) which is not:

- a resident, or
- which is a resident but where such entity is as a result of the application of the provision of any agreement entered into by the Republic for the avoidance of double taxation is treated as not being resident.²⁹⁴

²⁹² See Jooste, *op cit*, p. 474.

²⁹³ See Engel, K, "National Treasury's Detailed Explanation to Section 9D of the Income Tax Act", June 2002 in www.Finance.gov.za

²⁹⁴ This definition was inserted in the Act by section 10(1)(c) of Act 59 of 2000, which changed the previous definition of foreign entity included in the Act in 1997. Before the year of assessment commencing on or after 1 January 2001, a foreign entity was defined in the Act as meaning any person, other than a natural person, which has its place of effective management in a country other than the Republic.

In terms of the above definition of foreign entity, it is not clear how the determination as to whether or not an entity is a legal person is to be made; that is if it should be in terms of the law under which it is formed, or in terms of local law.

There are a number of entities which are formed in foreign jurisdictions which are not recognised or available under the local law, or which could lead to problems if any attempt is made to categorise them either as legal persons or not legal persons under local law.²⁹⁵ However, it is argued that foreign entities contemplated in section 9D mainly include foreign companies or foreign business organisations of a similar nature under foreign law. Thus, these foreign entities do not include foreign partnerships and similar institutions, which lack legal personality, and accordingly the income earned by them is not imputed to the South African partners in terms of section 9D, but will be deemed to have been immediately received by them in any event.²⁹⁶

On the other hand, a foreign trust is specifically excluded from the definition of foreign entity in terms of section 9D(1). Therefore, for a trust that is formed or effectively managed outside South Africa, income accruing to it cannot be imputed to beneficiaries under section 9D. The result is that foreign trust's income will only be taxable in the hands of South African beneficiaries when a distribution of the trust's income takes place.²⁹⁷

The second part of the definition of foreign entity makes it clear that it is possible due to the working of a double tax agreement entered into by South Africa, for a resident to qualify as a CFE. However, to the extent that the net income of a CFE is subject to tax in South Africa in terms of the source rules, it will not be imputed to its related South African residents.²⁹⁸

²⁹⁵ See Davis et al, *op cit*, p. 9D-8.

²⁹⁶ See Jooste, *op cit*, p. 477; See also Engel, *op cit*, p. 3.

²⁹⁷ The avoidance of tax through the use of offshore trusts is dealt with by sections 7(5), 7(8), and 25B of the Act. Prior to the amendment of section 9D by Act 59 of 2000, a trust could have qualified as a CFE but this had very little practical effect since very few offshore trusts have beneficiaries with vested rights and discretionary trusts would not have constituted CFEs.

Before income derived by a foreign entity will be taxable in the hands of a South African resident, the foreign entity has to be a CFE as defined. In order for a foreign entity to qualify as ‘controlled’, South African residents must hold, whether individually or jointly, and whether directly or indirectly, more than 50% of the participation rights, or must be entitled to exercise more than 50% of the votes or control of such entity.²⁹⁹ In order to fully appreciate what constitutes a CFE for South African tax purposes, it is important to analyse the wording of the definition as provided in section 9D(1) of the Act.

Subject to the qualifying percentage of more than 50%, there are two important elements that must be present to constitute a CFE: The South African resident shareholder must either possess the participation rights, or he³⁰⁰ must be entitled to the voting rights or control of such foreign entity.

A-1) Meaning of ‘participation rights’

A participation right is defined as the right to participate directly or indirectly, in the capital or profits of, dividends declared by, or any other distribution or allocation made by any entity.³⁰¹ The definition of participation rights is extremely wide and includes shares with different classes of rights. Thus, participation rights include shares representing equity share capital as well as other forms of shares such as cumulative preference shares or redeemable preference shares.³⁰² It is argued that the term ‘participation rights’ is defined broadly in order to ensure that South African taxpayers cannot enter into convoluted share arrangements as a means of controlling foreign entities while avoiding tax under section 9D.³⁰³

²⁹⁸ See section 9D(9)(e) of the Act.

²⁹⁹ See section 9D(1) of the Act.

³⁰⁰ Assuming it is an individual. In any case the criteria is the same for the resident shareholder which is a company.

³⁰¹ See section 9D(1) of the Act.

³⁰² However, convertible debentures, options and similar interests do not qualify as participation rights because these instruments do not represent a participation interest until converted into shares.

³⁰³ See Engel, *op cit*, p. 3.

A right in the definition of ‘participation rights’ means a legally enforceable right, a vested right and not a contingent right. In the case of dividends for instance, shareholders do not have a right to dividends until distributed by the company.³⁰⁴ The reference in the definition of a CFE to the holding of participation rights ‘indirectly’ covers holding through a nominee or agent. It is argued on the other hand that indirectly holding in the definition of a CFE does not cover holding through an entity or an entity which itself holds legal title to the participation rights in question. This is because the term ‘hold’ in the sense of the definition of CFE is considered as commented by Davis³⁰⁵ to mean own or hold for one’s own benefit as opposed to holding for the benefit of another.

Thus, where a local resident holds all the shares in an offshore company, which in turn holds all the shares in a wholly owned offshore subsidiary, the person holding the participation rights in the second company is the first company and not the local resident who neither owns nor possess these rights. For example, if a CFE (1) holds 100% of the participation rights in a CFE (2), it is difficult to see how a South African shareholder, with more than 50% of participation rights in the CFE (1), could have a ‘right’ (even indirectly) to participate in the profits of the CFE (2), because the CFE (1) already holds all the rights. However, Jooste³⁰⁶ contends that considering the anti-avoidance nature of the CFE rules in section 9D, this interpretation is too narrow and the legislation does not appear to limit the participation rights to 100%.

The term ‘participation rights’ is a plurality which can be constituted by any right to capital, profit, distribution or allocation made by a foreign entity. The words ‘capital’ and ‘profits’ are not defined in the provisions of section 9D(1) and these terms are imprecise since different shareholders may have different rights with regard to capital on liquidation and to dividends. An absurdity may therefore arise if for example, a South African

³⁰⁴ Where for instance, an individual is a beneficiary of a discretionary trust which holds all the shares in a company, he does not have the right to participate in dividend declaration by that company. The trust has that right. As beneficiary, he has a right to any distribution which might be made to him by the trustees. This is not the same as a right to the dividends, and cannot even be construed as an indirect right to those dividends, since there is in fact no certainty that those dividends will be distributed to him. He does however have an indirect right to dividends of this type where the trust is not discretionary and he has a vested right to all or part of the annual income. See Davis, *op cit*, p. 9D-8.

³⁰⁵ *Op cit*, p. 9D-7.

resident owns 100% of the rights to capital in a foreign entity and a non-resident owns 100% of the rights to income. Would it be possible in this case to say that the South African resident holds more than 50% of the participation rights? It is submitted that the definition of participation rights should be interpreted to mean that a resident needs only hold more than 50% of the individual types of rights.³⁰⁷

The term 'distribution' implies some kind of outflow from the entity, and this is not necessarily the case with the term 'allocation' which is much wider and will cover a situation where no outflow takes place.³⁰⁸

A-2) The exercise of the right to vote or control of a CFE

Another aspect of the definition of a CFE is that South African residents must be entitled to exercise directly or indirectly more than 50% of the votes or control of a foreign entity. This means for instance that if a foreign company has issued 100 ordinary shares of which a South African individual owns 50 and a foreign individual owns 50, and the South African resident and foreign individual have a voting agreement in terms of which the South African individual decides all the tie-votes, the result is that the foreign company qualifies as a CFE. This is because the power to decide all tie-votes provides the South African individual with control over the foreign company. It appears therefore that votes in a foreign company controlled by a South African resident through a voting agreement with the holders thereof would qualify as votes that the resident is 'indirectly' entitled to exercise, and would be counted in determining whether the foreign entity is a CFE.³⁰⁹

On the other hand, it is argued that in the South African context, the voting power test does not look to indirect control (though the words 'direct or indirectly' are used in the definition of a CFE) via an interposed controlled entity or *de facto* control. For example, if a South African resident owns 51% of shares in a CFE (1), and the CFE (1) in turn

³⁰⁶ *Op cit*, p. 477.

³⁰⁷ See Clegg, D, "Foreign Investment Trusts", 1997, 11 *Tax Planning* 106.

³⁰⁸ See Davis, *op cit*, p. 9D-9.

owns 60% of the shares in another foreign company (CFE 2), it is questionable whether the second company (CFE 2) would be a CFE of the South African resident on the basis of voting power or control.³¹⁰

The term 'control' in the definition of a CFE may have a wide application. For instance, a South African resident who holds the majority of voting shares in a foreign company, may automatically exercise control over that company. On the other hand, Jooste³¹¹ argues that it is possible in the case of a company that where the shareholders are widely dispersed, the ability to exercise well below 50% of the votes in the company may be sufficient to control the company. Thus, if South African residents do not have 50% of the votes in a foreign entity, but have the authority to appoint the board of directors, it may be argued that they have control over the foreign entity.³¹² This gives rise to the issue whether the 'more than 50%' in the definition of a CFE qualifies the word 'votes' or 'control'. As Jooste³¹³ pointed out, if the 'more than 50%' requirement qualifies the word 'control', then the wording of the provision of section 9D(1) is vague because it is questionable whether we can have degrees of control. In other words, what is meant by 'more than 50% of control' in the definition of a CFE?

A-3) What is the meaning of 'jointly' in the definition of a CFE in section 9D(1)?

While there may be no trouble with the meaning of 'individually' in the definition of a CFE, the 'joint' holding of participation rights or votes or control may raise certain difficulties. It is not clear under section 9D(1) whether the word 'jointly' connotes some co-operation or relationship between the residents concerned, so that totally independent investors who in aggregate hold more than 50% of a foreign entity, would not result in that foreign company being a CFE. As correctly pointed out by Jooste,³¹⁴ if two South African residents jointly hold more than 50% of the participation rights in a foreign

³⁰⁹ In addition, it is contended that the holding of an option to shares in a company does not represent an indirect entitlement to the exercise of the votes attaching to those shares. See Jooste, *op cit*, p. 476.

³¹⁰ See Davis, *op cit*, p. 9D-8.

³¹¹ *Op cit*, p. 477.

³¹² See Olivier, L, "Controlled Foreign Entities", May 2001, *Accountancy SA*, p. 12.

³¹³ *Op cit*, p. 477.

company, does the word ‘jointly’ mean that they must have a ‘common purpose’ or must be ‘acting in concert’ in relation to their holdings, though they may be totally unconnected and with none of them suspecting that the entity in which they hold an interest is CFE?

Jooste argues that something more than a mere aggregate holding is envisaged by the word ‘jointly’, if not the legislature would have substituted the word ‘jointly’ with ‘aggregate’ as stated in the proviso to section 9D(2). Thus, if ‘jointly’ does mean with ‘common purpose’, presumably the word would cover holdings in a CFE by connected persons and holdings by persons who have entered into a ‘shareholders’ agreement’ with regard to their votes in the CFE.

In addition, if ‘jointly’ means ‘with common purpose’, it is possible that all the participation rights and all the votes in a foreign entity could be held by South African residents and yet, because they are all held independently of each other (without a common purpose), the foreign entity would not qualify as a CFE and accordingly none of its income will be imputed to the South African residents. It is doubtful that this is what was intended by the legislature because the aim of section 9D was to prevent one or more South African residents from keeping their foreign sourced income out of the South African tax net by shifting it to a CFE.

A-4) Exclusion for *de minimis* owners of widely held foreign entities in the definition of a CFE

An exception to the definition of CFE was added by the second Revenue Laws Amendment Act in 2001 for listed companies and foreign unit trusts (or collective investment schemes), both of which are widely held.³¹⁵ In terms of this exception, holders of less than 5% of the participation rights in these entities are deemed to be non-residents.

³¹⁴ *Op cit*, p. 476.

³¹⁵ The definition of a CFE in section 9D(1) was extended by the proviso that in determining whether residents jointly hold more than 50% of the participation rights of any foreign entity which is listed on a recognised exchange or which is a scheme or arrangement contemplated in paragraph (e)(ii) of the

The rationale of this proviso is to avoid ownership tracking problems associated with *de minimis* shareholders in large-scale foreign entities.³¹⁶ This exception therefore recognises the difficulties, in situations where South African residents take up an interest in a foreign listed company or collective investment scheme, of knowing the extent to which the other shareholders may be South African residents. Thus, for example, if a South African resident holds 40% of the shares in a listed foreign company and the remaining 60% is held independently by other South African residents who all hold less than 5%, the foreign company is not a CFE.³¹⁷

The 5% *de minimis* test does not apply if connected persons own more than 50% of the foreign entity. This anti-connected person restriction is aimed at preventing a group of economically linked parties from utilising the *de minimis* test as an artificial means for undermining the ‘more than 50%’ control threshold.

B) The imputation of the CFE’s income to the South African residents

Once it is established that a foreign entity is a CFE, the proportional amount of net income earned by the CFE, based on a resident’s participation rights in that CFE, will be included in the income of the South African resident for the year of assessment during which the CFE’s year-end falls. This is in terms of section 9D(2) which provides that:

‘There shall be included in the income for the year of assessment of any resident contemplated in the definition of “controlled foreign entity” in subsection (1), an amount equal to the proportional amount of the net income of such entity for the foreign tax year of such entity which ends during such year of assessment of such resident, which bears to the total net income of such entity during such foreign tax year, 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...’

definition of ‘company’ in section 1, except where connected persons hold more than 50% of the participation rights of that foreign entity, scheme or arrangement, any person who holds less than 5% of the participation rights of that foreign entity shall be deemed not to be a resident. The proviso was added by section 22(1) of Act 60 of 2001, effective from 1 January 2001, for year ends of CFEs which end during the year of assessment of a resident, which commences on or after that date.

³¹⁶ See Engel, *op cit*, p. 5.

Thus, the determination of the proportional amount to be included in the income of a resident = Net income of the CFE x resident's participation rights in the CFE

Total participation rights in the CFE

However, the application of section 9D(2) is extended by the proviso to the effect that in tax years commencing in calendar year 2001, any resident holding or entitled (whether alone or together with a resident or non-resident connected person) to less than 10% in aggregate at all times during the foreign tax year, of the participation rights and voting rights in a CFE, must not include the proportionate amount of the net income of that CFE in his income.³¹⁸

For example, if a foreign entity is a CFE of South African residents, but one of the resident holders holds alone or with connected persons only 9% of the participation rights, none of the net income of the CFE will be imputed to that resident. However, though the resident is relieved from including any portion of the net income of the CFE in his income by virtue of the non-qualification under the 10% rule, he is required to include in his income any foreign dividends accrued to him from the CFE. The resident's shareholding is nevertheless taken into account in the determination of whether or not the foreign entity is a CFE.³¹⁹

As correctly pointed out by Jooste,³²⁰ it appears that in determining whether the 10% rule applies in relation to a particular resident, only direct holdings of participation rights by the resident and connected persons in relation to such resident must be taken into consideration. It also appears that the 'entitlement' to exercise less than 10% of the voting rights covers only direct entitlement. This situation may lead to absurd results probably unintended by the legislature.³²¹ Thus, for instance, if only direct individual holdings of participation rights are to be taken into account, it is possible that a resident through indirect holdings, may in fact control the CFE and yet because his direct individual

³¹⁷ See Huxham & Haupt, *op cit*, p. 278/279.

³¹⁸ See proviso to section 9D(2) of the Act.

³¹⁹ See Kolitz, M, "Tax on Foreign Income II: Foreign Entities", 2001, 15 *Tax Planning* 112.

³²⁰ *Op cit*, p. 478.

³²¹ The proviso to section 9D(2) does not use the word 'indirectly' which is used in the definition of a CFE in section 9D(1).

holding of participation rights in the CFE is less than 10%, he will avoid section 9D under the 10% rule.

The 10% threshold is designed to prevent this defined income rule from applying to minority owners who have no practical say over the business of the CFE.

Section 9D(2) is also subject to the timing rules for the imputation of the CFE's income to the South African resident. Thus, the South African shareholder must include the CFE's income during his year of assessment in which the CFE's foreign tax year ends. For instance, let us assume that a South African company with a year of assessment beginning on 1 March and ending on 28 February owns all the shares of a CFE. The CFE has a year of assessment equals to the calendar year and generates R100,000 of net income during the year 2002. In terms of the timing rules, the R100,000 of the CFE's income must be included in the South African company's year of assessment running from 1 March 2002 and ending 28 February 2003 because the R100,000 of the CFE's net income arose in the CFE's tax year which ends on 31 December 2002.³²²

Thus, it is questionable whether the legislation means that a resident who has an interest in a CFE and disposes it before the year end of the CFE, will have no proportionate inclusion of the CFE's income in his income. Conversely, whether a resident acquiring a participation right in a CFE shortly before the CFE's year-end will have to bring to account the entire year's income of that CFE in proportion to his holdings. It is contended that the equitable interpretation should be that if an interest in a CFE is disposed of between the year end of the CFE and the year end of the resident, the attribution of the CFE's income will still take place since it 'accrued' when the resident still held an interest.³²³

³²² See Engel, *op cit*, p. 6.

³²³ See Jooste, *op cit*, p. 483. He also argues that this interpretation gives rise to difficulties because unless the CFE can, and is prepared to disclose to the South African resident what income has accrued to it at the

C) Calculation of the net income of the CFE

The net income of the CFE is computed in accordance with the South African tax principles as if the CFE has been a resident.³²⁴ This means that the South African Income Tax Act must be applied in determining the gross income of the CFE, income, deductions and allowances as if the CFE was a South African taxpayer.³²⁵

The calculation of the net income of the CFE is subject to important income tax qualifications. First, the deductions and allowances which may be taken into account are limited to the income received. Thus, deductions and allowances are ring-fenced and limited to the amount of the CFE's income.³²⁶ In other words, while the net income of a CFE is imputed to the South African resident, the latter cannot deduct net losses of a CFE.³²⁷

The justification for this anti-loss rule is to ensure that the residence basis of taxation does not result in the erosion of the current South African tax base, and there may be no information available relating to the extent of foreign losses.³²⁸ Although the net loss of the CFE cannot be set off against a South African resident's taxable income, the net loss is not simply eliminated. It is carried forward to the immediately succeeding year and treated as an assessed loss of the CFE in that year for the purposes of section 20 of the Act.³²⁹

relevant times, it would be factually impossible for either the resident or SARS to determine what income is to be imputed to the resident.

³²⁴ See section 9D(2A) of the Act, inserted by section 10(1)(g) of the Amendment Act 59 of 2000. This amendment solved the issue that existed whether taxable income has to be calculated with reference to foreign or South African law.

³²⁵ This determination requires the CFE to maintain two sets of tax books: one for the home country and one for South Africa. This administrative practice is essential if the CFE's income is to be kept on par with domestic income.

³²⁶ See section 9D(2A)(a).

³²⁷ As pointed out by Casey (*op cit*, p. 3), a CFE can never realise a loss for South African tax purposes. Thus, if a South African resident makes a loan to a CFE, no deduction is allowed for any exchange loss resulting from that transaction with a CFE, or with any connected person in relation to the CFE, unless and to the extent that the income (interest) attributable to the transaction in question is included in the net income of the CFE for the purposes of section 9D(2A) of the Act.

³²⁸ See Jooste, *op cit*, p. 480. It is contended that this anti-loss rule is consistent with the anti-loss rule for foreign branch losses, which similarly cannot be used as an offset against South African source income.

³²⁹ See section 9D(2A)(b) of the Act.

The net loss of a CFE cannot also be set off against the net income of another CFE.³³⁰ It is clear that as far as assessed losses are concerned, CFEs are in a worse position than other entities. Although foreign deductions may generally not be offset against local income, foreign losses incurred by entities other than CFEs may be offset against income derived from another foreign trade. For instance, if a South African resident has a CFE in country (1) in respect of which an assessed loss is made, this loss cannot be offset against income from another CFE in country (2). However, had the foreign entities not been CFEs, the loss could have been offset against the income. In that situation, it can be argued that CFEs are penalised. This second anti-loss rule can be justified because South Africa does not have group tax rules for losses.

Another important qualification in the calculation of the net income of the CFE is that no deduction is allowed for passive income such as interest, royalties or rentals paid by one CFE to another.³³¹ The circumstances envisaged by this provision are those in which the amount of net income of CFE (1) to be imputed to a particular South African resident is being calculated, and another CFE (2) is a CFE in relation to the resident. Thus, in such circumstances, in calculating the net income of CFE (1), any interest, royalties or rentals paid by CFE (1) to CFE (2) are not deductible.³³²

The net effect of this provision is that such inter-group transactions are removed from inclusion on a consolidation basis, which is to the advantage of taxpayers, given the limitation of the set-off of losses.

³³⁰ Ibid.

³³¹ See section 9D(2A)(c) of the Act. Conversely, the corresponding amount received by the other CFE is not attributable to the South African resident in terms of section 9D(9)(fA) of the Act. However, contrary to section 9D(2)(c), the exemption from income taxation provided in section 9D(9)(fA) extends in addition to interest, royalties and rental, to income of a similar nature and exchange differences, provided that the CFEs must be part of the same group of companies.

³³² See Jooste, *op cit*, p. 471. Section 9D(2A)(c) only applies where the qualified passive income is 'paid', as compared to 'payable' under section 9D(9)(fA) of the Act.

C-1) Net income of the CFE and transfer pricing adjustments

Under section 9D(2A), the net income of the CFE which is to be included in the South African resident's income will be calculated as if the CFE were a South African resident. There is therefore an argument that the transfer pricing rules of section 31 of the Act apply to the determination of the net income of a CFE. Thus, since the net income must be determined as though the CFE was a resident, the relationship between that CFE and a foreign connected person must be determined on the basis that the CFE is resident and the other entity is a non-resident.³³³

It appears that the perceived transfer pricing problem arises not directly from the provision of section 31(2), but arises 'by proxy' through the provision of section 9D(2A) of the Act. Thus, technically SARS is within its right to assess taxpayers on this basis, and has indicated its intention to make transfer pricing adjustments to inter-CFE transactions if the requirements of section 31(2) are satisfied and provided that none of the exemptions in section 9D apply.³³⁴ This means that all inter-CFE transactions should be entered into on an arm's length basis. For example, when an interest free loan is extended by one CFE to another, the provision of section 9D(2A) would apply separately to each in the determination of the respective income that must be imputed to the South African resident shareholders. Thus, if CFE (1)'s net income is being determined for attribution purposes, it will be deemed to be a resident, but CFE (2) will not be deemed to be a resident. In turn when the net income of CFE (2) is being determined, it would be deemed to be a resident, but not CFE (1). As a result, when applying section 9D(2A), the loan between CFE (1) and CFE (2) would satisfy the requirements of section 31(2), that is, a non-arm's length loan between a deemed resident and a non-resident connected person, and this may result in a transfer pricing adjustment being made to CFE (1)'s profits. CFE (1)'s taxable income may then be upwardly adjusted by an amount equal to

³³³ Section 31(2) of the Act applies *inter alia*, to transfer pricing situations deriving from financial assistance provided in an international agreement, for example, between a resident and a non-resident.

³³⁴ See Joubert, D, "International Financing Problems: Controlled Foreign Entities and Transfer Pricing", 2002, 16 *Tax Planning* 28.

the interest that could have been charged on the loan had it been made on arm's length basis.³³⁵

If SARS succeeds in including the interest derived from the transfer pricing adjustment in the income of the lending CFE, the question arises as to whether the inter-CFE interest exemption in section 9D(9)(fA) would apply to prevent it from being imputed to the South African resident shareholder.

On this issue, the opinions of the tax writers are divergent. It is contended that since passive income (including interest in this case) are not taken into account (because they are exempted) as between qualified CFEs, in practice therefore, the transfer pricing adjustments will be applied primarily to the prices paid or charged for goods and services. On the other hand, Joubert³³⁶ correctly argues that the exemption provided under section 9D(9)(fA) would not be available, mainly because the transfer pricing adjustment is a one-sided adjustment to the profits of the lending CFE, in that the imputation for the lending CFE does not give rise to an equivalent notional expense in the borrowing CFE. Thus, it would be artificial to regard it as being in the nature of interest when it does not meet the common law characteristic of interest and because the Act does not specifically deem the adjusted amount to be interest.³³⁷

It may be argued on the other extreme that it is difficult to accept the validity of the analysis that a transfer pricing adjustment is competent between CFEs. In this sense, the transfer pricing adjustment for inter-CFE transactions may be seen as an abusive exercise of its discretion by SARS, because the intention of section 31 was never to bring within its scope transactions between persons who are by definition non-residents. Thus, applying the transfer pricing provisions of section 31 for inter-CFE transactions appears to run contrary to the intention of the legislature in enacting section 31 of the Act.

³³⁵ See Joubert, *op cit*, p. 29.

³³⁶ *Ibid*, p. 30.

³³⁷ See also the analysis on this issue by Clegg, D, "Transfer Pricing Adjustments: Finance within Foreign Groups", 2002, 16 *Tax Planning* 58.

D) Currency Conversion rule

In terms of section 9D(2A), the taxable income of the CFE is determined in a foreign currency. The taxable income so determined must be converted to South African currency on the last day of the foreign tax year of the CFE.³³⁸ The exchange rate to be applied is the ruling exchange rate at that date, or any other exchange rate, or rates, as the Commissioner may approve, determined with reference to the ruling exchange rate during such year.³³⁹

There is relief from immediate imputation of income in terms of section 9D where the income may not immediately be remitted to South Africa because of restrictions imposed by the source country. In terms of section 9F(3), such income shall be included in the resident's gross income in the tax year of remittance. Thus, in this case, it is possible that the ruling exchange rate that is required to be used for the conversion calculation may not be related to the exchange rate on the date on which the funds are finally remitted to South Africa should they be so remitted.

This gives rise to the further question: what if the amount actually remitted to South Africa differs from the amount calculated in terms of the conversion rule? Will the provisions of section 24I apply to either include the difference in taxable income of the resident or allow it as a deduction from income?

The answer could be found in the conversion rule of section 6quat(4). In claiming the foreign tax credit, the conversion rule of section 6quat(4) for foreign tax paid requires that the amount of the foreign tax paid on the net income of the CFE be converted at the ruling exchange rate applicable:

- Either on the date that the foreign tax was paid; or

³³⁸ See section 9D(6) of the Act.

³³⁹ Section 9D(6) was amended by section 10(1)(i) of Act 59 of 2000. Under the old section 9D(6), a resident could choose a conversion date prior to the end of the tax year.

- At the ruling exchange rate at the end of the year of assessment if the tax is not paid by that date.³⁴⁰

E) Exemptions from section 9D

Section 9D(9) of the Act provides various instances in which the net income of the CFE will be exempt and therefore will not be attributed to the South African resident.³⁴¹

E-1) The designated country exemption

In terms of section 9D(9)(a)³⁴² of the Act, the provisions of section 9D(2) do not apply to the receipts and accruals of a CFE which is a company³⁴³ where:

- The receipts and accruals have been or will be subject to tax on income in a designated country at a statutory rate of at least 27%;³⁴⁴ or
- After taking into account the application of the relevant double tax agreement; without any right of recovery by any person, other than a right of recovery in terms of an entitlement to carry back losses during any year of assessment to any prior year of assessment; notwithstanding the fact that the entity may as a result of an assessed loss not be liable for tax.

From the provision of section 9D(9)(a), it is clear that the mere fact that a specific country is indicated as designated country³⁴⁵ is not sufficient. In addition, the income of

³⁴⁰ See Kolitz, M, "Tax on Foreign Income III: Other Influential Factors", 2001, 15 *Tax Planning* 127 at 131.

³⁴¹ The exemptions are analysed in this section only with regard to income tax.

³⁴² Amended by section 22(1)(d) of Act 60 of 2001, effective from 1 October 2001.

³⁴³ The designated country exemption only applies if the CFE is a company, as expressly stated in section 9D(9)(a) of the Act. Because a foreign entity cannot be a natural person or a trust, it would be assumed that it must be a company. It appears that a reference in section 9D(9)(a) of the CFE as being a company is superfluous because in any case, all CFEs must be companies. See Kolitz, M, "Tax on Foreign Income II: Foreign Entities", 2001, 15 *Tax Planning* 115.

³⁴⁴ The statutory rate is 13,5% in the case of capital gains.

³⁴⁵ The term 'designated country' is mentioned in section 9D(1) and section 9E(1) and defined in section 9E(8) of the Act. In terms of the latter provision, the Minister of Finance may designate, by notice in the Gazette, countries to be 'designated countries' if they meet all the following requirements:

- The country has a tax on income that is determined on a basis that is substantially the same as that of the Republic;

the CFE must be subject to tax³⁴⁶ in that designated country at least at a 27% statutory tax rate. The proviso to section 9D(9)(a) further stipulates that where a country imposes tax on a CFE at a progressive scale of statutory rates, the highest rate must be at least 27%.³⁴⁷

In applying the minimum statutory rate of 27%, any relevant double tax agreement must be taken into account.³⁴⁸ It means that if a taxpayer falls within the tax system of a particular country, but the provisions of a double tax agreement take him out of the tax net (for example in the case of CFEs), the exemption in section 9D(9)(a) is not applicable. Similarly, should a company be subject to a 27% tax rate, but the shareholders for instance, have the right to recover the tax paid by the company, the exemption is also not applicable. On the other hand, if a company is in principle subject to a minimum of 27% tax rate, but due to for instance, the existence of an assessed loss, it does not pay any tax, the exemption is still applicable.³⁴⁹

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- The country has a statutory rate of tax on companies of at least 27% without any right of recovery by any person (other than a right of recovery in terms of an entitlement to carry back losses arising during any year of assessment to any prior year of assessment);
 - The country complies with any other requirement that the Minister may prescribe by regulation.

The following countries were listed as 'designated countries' by GN 866 GG 21526 of 1 September 2000: Algeria, Australia, Austria, Belgium, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, Republic of Korea, Lesotho, Malawi, Namibia, Norway, Poland, Romania, Slovakia, Swaziland, Sweden, Thailand, Tunisia, United Kingdom, United States of America, Zambia and Zimbabwe. Contrary to the previous requirement for designation, section 9E(8) does not stipulate that to qualify for designation, the foreign country should have a double tax agreement with South Africa. The current designated country list set above is under consideration by SARS. It is expected that a new list will be announced in the near future and some countries will be removed from the current list of designated countries. It is understood that SARS' criteria for determining whether a country should fall on the designated list will depend on whether the country has a tax system similar to South Africa; whether it operates a residence based system of taxation; and whether it has implemented capital gains tax legislation.

³⁴⁶ The second Revenue Laws Amendment Act of 2001 substituted the term 'generated' in a designated country with 'subject to tax'. This was intended to avoid the complication arising where the income accruing to a company in a designated country could be generated in a non-designated country and therefore not benefit from the exemption. Thus, in terms of section 9D(9)(a) exemption, the income of the CFE does not necessarily have to be generated in a designated country, as long as it is subject to tax there, irrespective of the origin. Vogel (*op cit*, p. 226) considers that the term 'subject to tax' means something distinct from that of a liability to pay tax. It is thus argued that 'subject to tax' in a country means that the income must be taxable as opposed to such income actually having been taxed in that country. See Davis, D, "Taxation of Foreign Dividends: LIFO", January 2002, *Taxpayer*, p. 14.

³⁴⁷ However, the legislation does not deal with situations where the jurisdiction may have different rates for different types of income.

³⁴⁸ Section 9D(9)(a) of the Act.

³⁴⁹ This confirms that the statutory rate of 27% does not refer to an effective tax rate. See Olivier, *op cit*, p. 12; See also Jooste, *op cit*, p. 485.

E-2) The business establishment exemption

If a CFE operates a business establishment in a foreign country, the provisions of section 9D(2) do not apply to the net income that is attributable to the business establishment.³⁵⁰

The effect of section 9D(9)(b) is that the net income of the CFE resulting from the business establishment is therefore deferred until distributed as dividends to the South African resident shareholders.

A 'business establishment'³⁵¹ is broadly defined in section 9D(1) as a place of business with:

- An office, shop, factory, warehouse, farm or other structure which is used or will continue to be used by the controlled foreign entity for a period of not less than one year;³⁵²
- A mine, oil or gas well, a quarry or any other place of extraction of natural resources;³⁵³ or
- A site for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of comparable magnitude which lasts for a period of not less than six months,³⁵⁴

Whereby the business of the entity is carried on, and where –

- The place of business is suitably equipped with on-site operational management, employees, equipment and other facilities for the purpose of conducting the primary operation of the business;³⁵⁵ and

³⁵⁰ Section 9D(9)(b) of the Act.

³⁵¹ The South African income tax law uses the term 'business establishment', which bears some relationship to the permanent establishment definition contained in article 5 of the OECD Model Tax Convention and used in most double tax agreements. However, unlike the permanent establishment definition in article 5 of the OECD, the business establishment definition in the South African context does not for example cover the carrying on of business in a country in the form of a branch. In addition, it applies different criteria with regard to the time limit placed on the use of the qualified fixed locations.

³⁵² The one-year use requirement can be satisfied by direct ownership or by lease. However, the word 'use' implies some level of activity with regard to the structure. Thus, the mere possession of ownership or leasing rights is insufficient. See Engel, *op cit*, p. 9.

³⁵³ These places satisfy the fixed location test *per se* without regard to time. Operation of these places demonstrates a clear level of permanence in the foreign location involved because the geographically unique nature of the holding makes that holding immobile in practice.

³⁵⁴ This site meets the location test as long as it lasts for a period of not less than 6 months. The 6-month requirement is designed simply to ensure that the CFE is providing an activity that amounts to more than a temporary service. See Engel, *op cit*, p. 9.

- The place of business is used outside the Republic for a bona fide business purpose (other than the avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by the Act or by any other law administered by the Commissioner).³⁵⁶

Even to the extent that a CFE satisfies the business establishment requirements, the exemption will not apply to receipts and accruals derived from diversionary transactions and mobile passive income.

i) Diversionary transactions

This exclusion covers transactions where the possibility of transfer pricing exists between a CFE, which is a company and South African connected persons and certain types of income.

In terms of section 9D(9)(b)(i) of the Act, if a CFE engages in a sale or service transaction with a connected South African resident, transfer pricing inconsistent with arm's length pricing in accordance with section 31 creates deemed income imputed to the South African resident shareholder.³⁵⁷

³⁵⁵ This criterion indicates that not only must the business have a fixed location, but the fixed location must also have some economic substance. This substance must be shown in terms of operation. In operational terms, the substance element ensures that the business is not only existing on paper or is a disguised form of passive income. Thus, it would be impossible for all activities of a business establishment to be outsourced to third party suppliers. In addition, it is not sufficient to have employees who cannot take management decisions at the foreign business. Persons who take the operational decisions also need to be present. Accordingly, as Clegg argues, if the subsidiary relies on timeshare office, occasional foreign board meetings and a timeshare administrator who calls at the office twice a week to open and send post which originated in the parent's head office, this exemption cannot be met. See Clegg, D, "Residence-Based Tax: It is a Wider Horizon through the Offshore Tax Maze", April 19, 2002, *Financial Mail*, p. 96.

³⁵⁶ In terms of this business purpose, the business must have a bona fide business reason for operating abroad rather than in South Africa. In assessing this business purpose test, the Commissioner need not have regard to the requirement of the general anti-avoidance provisions of section 103(1) of the Act. It is sufficient if on the facts of the case, the reason for having the business outside South Africa is to avoid, postpone or reduce tax.

³⁵⁷ By imputing the income of the CFE to the South African owner, section 9D effectively creates a penalty over and above the adjustment imposed by section 31.

The section 9D(9)(b) exemption does not apply if the CFE's sale of goods to a connected South African resident fails to qualify for the higher business activity standard in terms of section 9D(9)(b)(ii) (aa), unless the sale falls into one of the following three categories:

- When the CFE purchases goods that are physically located in the country in which it is resident;³⁵⁸
- When the CFE engages in foreign production activities that involve more than minor assembly or adjustment, packaging, repackaging and labelling;³⁵⁹ or
- When the CFE sells a significant quantity of similar goods to unconnected persons at comparable prices.³⁶⁰

The section 9D(9)(b) exemption does not apply if a CFE sells goods to foreign residents or unconnected South African residents and those goods were initially purchased from connected South African residents, unless the sale falls into one of the following three categories:³⁶¹

- When the CFE purchases only an insignificant amount of materials, parts or ingredients from connected South African residents;³⁶²
- When the CFE engages in foreign production activities that amount to more than minor assembly or adjustment, packaging, repackaging and labelling;³⁶³ or
- When the CFE delivers its goods within the CFE's country of residence.³⁶⁴

The section 9D(9)(b) exemption will not apply in the case of services performed by a CFE for a connected South African resident, unless the following requirements are met:³⁶⁵

- The services relate directly to the creation, extraction, production, assembly, repair, or improvement of goods and the goods at issue are utilised outside South Africa;³⁶⁶ or

³⁵⁸ See section 9D(9)(b)(ii)(aa)(A).

³⁵⁹ See section 9D(9)(b)(ii)(aa)(B).

³⁶⁰ See section 9D(9)(b)(ii)(aa)(C).

³⁶¹ See section 9D(9)(b)(ii)(bb).

³⁶² See section 9D(9)(b)(ii)(bb)(A).

³⁶³ See section 9D(9)(b)(ii)(bb)(B).

³⁶⁴ See section 9D(9)(b)(ii)(bb)(C).

³⁶⁵ See section 9D(9)(b)(ii)(cc).

³⁶⁶ See section 9D(9)(b)(ii)(cc)(A).

- These services relate directly to the sale and marketing of goods produced by a connected South African resident, and the goods are sold to unconnected persons for delivery within the CFE's country of residence.³⁶⁷

ii) Passive income

The business establishment exemption will also not apply to passive receipts and accruals of the CFE in the form of interest, dividends, royalties, rentals, annuities, insurance premiums and income of a similar nature, notwithstanding the fact that the CFE may have a business establishment as defined.³⁶⁸

However, certain exceptions exist for passive income such as:

- Where the passive income does not exceed 5% of the CFE's total receipts and accruals;³⁶⁹ or
- Where the passive receipts and accruals arise from the principal trading activities of any banking or financial services, insurance or rental business.³⁷⁰

The principal trading activity exception is subject to anti-avoidance rules, which excludes passive income received or accrued from any:

- Resident connected person or a resident who holds at least 5% of the participation rights in that CFE,³⁷¹ or
- Resident where the income received is part of tax avoidance scheme.³⁷²

³⁶⁷ See section 9D(9)(b)(ii)(cc)(B).

³⁶⁸ See section 9D(9)(b)(iii). Passive receipts and accruals also consist of capital gains derived from the disposal of assets that generate the qualified passive income and all forms of currency gains.

³⁶⁹ See section 9D(9)(b)(iii)(aa). This *de minimis* rule is justified for administrative convenience.

³⁷⁰ See section 9D(9)(b)(iii)(bb). The purpose of the principal trading activity exception is to ensure that a CFE is not merely a finance or a treasury operation with an objective to avoid section 9D.

³⁷¹ See section 9D(9)(b)(iii)(bb)(A).

E-3) Income already taxable in South Africa

In terms of section 9D(9)(e),³⁷³ the CFE's net income will not be imputed to the South African resident to the extent that it is included in the South African taxable income of the CFE. This exemption applies where the income of the CFE is derived from an actual or deemed South African source and is aimed at avoiding situations of double taxation. Thus, if a CFE earns a South African source income and the income is also imputed to the CFE's South African owners, an unacceptable double counting would arise.

However, as correctly argued Jooste,³⁷⁴ if as a result of double tax agreement, the South African income of a CFE is not taxed in South Africa, the exemption is not available because it is not 'included in the taxable income of the CFE'.³⁷⁵ Consequently, South African residents cannot avoid tax on South African income by operating through CFE's located within the South African tax treaty network. This is equitable because the income would have been taxed if earned directly by the South African residents.

E-4) The related and intra-group exemptions

Section 9D contains provisions that allow related CFE's to shift income among one another without attracting any South African tax implications. These provisions recognise that in order to internationally competitive, multinational structures frequently contain foreign affiliates acting as a single economic unit. The multilevel nature of these structures is for example, aimed at isolating risk in particular countries in which economic activities arise, by mainly reducing foreign tax as opposed to South African tax.³⁷⁶

³⁷² See section 9D(9)(b)(iii)(bb)(B). The passive income of such banking, financial services, insurance or rental business is subject to the proviso that it is derived mainly from persons who are not connected persons in relation to that CFE.

³⁷³ Inserted by section 10(1)(m) of Act 59 of 2000.

³⁷⁴ *Op cit*, p. 498.

³⁷⁵ As stated in section 9D(9)(e).

³⁷⁶ See Engel, *op cit*, p. 21.

Thus, in relation to income tax, section 9D provides two exemptions from tax in recognition of these concerns.

E-5) Dividend income from a related CFE

The provisions of section 9D will not apply to any proportional amount of net income attributable to a South African resident, to the extent that this relates to a foreign dividend that was declared to a CFE that is a company by another company that is also a CFE in relation to the resident.³⁷⁷

Thus, a CFE can receive dividends from another related CFE without being subject to section 9D, provided that both CFEs qualify as a CFE in relation to the same South African resident. Section 9D(9)(f) therefore allows a South African multinational group to reinvest such dividend income offshore without it falling into the South African tax net. It is contended that the rationale for the exemption is that the earnings underlying the dividends are either earnings from a CFE business establishment or are already taxed directly.³⁷⁸

E-6) Intra-group CFE debts, licences, leases, currency gains or income of a similar nature

The provisions of section 9D would not apply when a CFE receives interest, royalties or rental income, income of a similar nature and currency gains on exchange items from another CFE as long as both the payor and payee CFEs are part of the same group of companies.³⁷⁹

³⁷⁷ See section 9D(9)(f).

³⁷⁸ See Jooste, *op cit*, p. 499.

³⁷⁹ See section 9D(9)(fA). This provision was expanded to include 'income of a similar nature' and any exchange difference in terms of section 241 with operation from 1 January 2001. It is questionable whether 'income of a similar nature' may include deemed interest or royalty income arising from transfer pricing adjustments. However, insurance premiums and management fees have not been included under section 9D(9)(fA) and will therefore not be granted exemption under this provision.

The group concept involved in this provision has the same meaning as the group concept found in section 41 for company restructuring.³⁸⁰ This exemption allows South African multinationals to utilise finance or treasury foreign subsidiaries as a tax-free means of channeling collective group loans, licences and leases or transactions of a similar nature. This kind of structure allows a group to borrow within a single administrative structure and to create opportunities for reduced group rates.³⁸¹

Although section 9D(9)(fA) should be read in conjunction with section 9D(2A)(c) which specifically prohibits the deduction of interest, royalties and rentals paid by one CFE to another, the provisions of section 9D(9)(fA) state that the qualified income must be 'payable' and not 'paid'.³⁸²

F) Reporting requirement

It is essential that South African residents who have a qualified holding in a CFE must be aware of their holding in respect of the section 9D imputation of their CFE's income. Thus, section 72A is aimed at facilitating the gathering of such information by placing a huge administrative burden on certain residents.

Section 72A requires every resident who at any time during the year of assessment:

- Directly or indirectly holds not less than 10% of the participation or voting rights in a CFE; and
- Together with connected persons holds more than 50% of the participation rights or voting rights to submit a return to the Commissioner.³⁸³

Section 72A itself does not provide any sanction for failure to comply with the provision. However, in terms of section 9D(11), the business establishment exemption,³⁸⁴ the related

³⁸⁰ That is 75% or more equity share ownership.

³⁸¹ See Engel, *op cit*, p. 22.

³⁸² The old provision referred to 'paid' as in section 9D (2A)(c).

³⁸³ See section 72A(1). The proviso to this provision states that it is the resident with the largest participation right (not voting right or control) who is required to submit the return.

³⁸⁴ See section 9D(9)(b).

CFE dividend exemption³⁸⁵ and the related CFE interest, rent, royalties, currency gains and income of a similar nature exemption³⁸⁶ will not be available if the taxpayer fails to comply with section 72A.³⁸⁷

3.1.4) The taxation of foreign dividends

Introduction

Local dividends have long been exempted completely from income tax in South Africa by virtue of the amendment of section 10(1)(k) of the Act in 1991.³⁸⁸ At that stage, it was thought that the amendment was unlikely to raise problems because the company declaring the dividends was subject to tax. In addition, the system of secondary tax on companies (STC) implemented in 1994 was ideal for the collection of corporate tax from South African companies that did not receive foreign income.

However, as South Africa emerged from its isolation and with the relaxation of exchange control regulations, tax planning opportunities quickly arose as follows:

- South African resident companies started to establish branches and subsidiaries in tax havens (captives);
- Agency agreements, commissions, insurance premiums and transfer pricing procedures were used to channel income from South Africa to captives;
- Captives received the income, paid no tax and remitted the income to the parent company in South Africa by way of the section 10(1)(k) exemption.³⁸⁹

Thus, the above procedure generated the idea of taxing dividends from foreign sources because the underlying profits from which dividends were declared would not have suffered South African tax.³⁹⁰ Section 9E was therefore introduced to deal with the

³⁸⁵ See section 9D(9)(f).

³⁸⁶ See section 9D(9)(fA).

³⁸⁷ See Jooste, *op cit*, p. 501.

³⁸⁸ By section 12(1)(b) of Act 129 of 1991.

³⁸⁹ See Lester, *op cit*, p. 14.

³⁹⁰ See Davis, *op cit*, *Taxpayer*, January 2002, p. 11.

determination of the amount of foreign dividends to be included in the gross income of the South African resident received or accrued on or after 23 February 2000, or which accrued before 23 February 2000, but were received on or after that date.³⁹¹

Section 10(1)(k) was then amended to exclude the exemption in respect of foreign dividends.³⁹² However, in order to avoid double taxation, two categories of relief measures have been introduced in the current section 9E that is: an exemption for certain dividends under section 9E(7) and credit relief for foreign tax payable on foreign dividends included in the taxable income of residents under section 6quat.

The complexity of section 9E is compounded by the fact that it is based on two versions which apply for two different periods. The first version applies for the period from 23 February 2000 until 28 February 2001. During this period, section 9E effectively operated on the residence basis within a source based tax system.³⁹³ In that interim phase, foreign dividends were essentially dividends paid by a company out of profits derived from a source outside South Africa.

The second version of section 9E applies to foreign dividends received by or accrued to a South African resident after 1 March 2001 onwards (in the case of individuals) and after 1 January 2001 (in the case of companies). This second version was necessitated by the introduction of the residence basis of tax and a fundamental change in the meaning of 'foreign dividend' was inserted in section 9E.

This section of the research seeks to deal with the second version and to examine the mechanisms of the current section 9E.

³⁹¹ See *SARS' Interpretation Note* No 2 of 1 February 2002.

³⁹² Section 10(1)(k)(i)(dd) was inserted by section 26(1)(b) of Act 60 of 2001 and deemed to have come into operation on 23 February 2000, and provides that the usual dividend exemption is not available for foreign dividends.

A) Definition of ‘foreign dividends’

The term ‘foreign dividend’ means any dividend³⁹⁴ received or accrued to any person from any company, which is either a ‘foreign entity’ as defined in section 9D or which is a ‘resident’ to the extent that the dividend is declared from profits derived by the company before it became a resident.³⁹⁵

A-1) Specific inclusion

The definition of ‘foreign dividend’ contains an anti-avoidance provision aimed at preventing taxpayers from avoiding tax on foreign dividends by making distributions to shareholders other than by way of dividends.³⁹⁶ Thus, in terms of section 9E(1)(a), a foreign dividend is extended to:

- Any amount deemed to have been distributed as contemplated in section 64C(3)(a), (b), (c), or (d) of the Act.³⁹⁷
- By any company which is a CFE;
- To such person or any resident who is a connected person of such person;
- To the extent that the company could have distributed a dividend to such person from profits which have not been subject to tax in the Republic;
- If none of the provisions of section 64C(4) apply other than section 64C(4)(g) and (h).³⁹⁸

³⁹³ See Davis, *op cit*, p. 12.

³⁹⁴ As defined in section 1 of the Act.

³⁹⁵ See section 9E(1) of the Act.

³⁹⁶ For instance by providing a loan to shareholders.

³⁹⁷ Section 64C(3) deems certain distributions to be deemed dividends for STC purposes such as the distribution for the benefit of a connected person (a); the release of an obligation (b); the payment of a debt (c); and any application for the benefit of a connected person (d). It appears that deemed dividends as mentioned in section 64C(3)(e), arising as a result of transfer pricing adjustments in section 31 are not considered to be foreign dividends for the purposes of section 9E(1) and are therefore excluded from the specific inclusion of the latter provision.

³⁹⁸ Section 64C (4) deals with the exemption to certain deemed distributions. For instance, a loan which bears a market related rate of interest or a rate of interest not less than the ‘official rate of interest’. The definition of ‘foreign dividend’ was amended from 27 July 2001 to include in foreign dividends certain amounts previously excluded by section 64C(4)(g) and (h). These inclusions are loans made by a CFE to its holding company and to another company directly or indirectly held by its holding company, and loans made by a company to another company where the equity share capital of both companies is held by the same shareholders, irrespective of the location in which the borrower uses the funds.

The provisions of section 9E(1)(a) do not apply to amounts distributed by a company which is being wound up or liquidated out of profits of a capital nature, other than capital profits derived from the disposal of another company which had disposable profits which would not have been excluded from the provisions of paragraph (b).³⁹⁹

B) Amount of foreign dividend inclusion

The amount of the foreign dividend to be included in the gross income of the South African resident, in terms of para (k) of the definition of the term 'gross income' in section 1, must be determined in accordance with the provisions of section 9E(3) and (4), unless the taxpayer makes an election in terms of section 9E(6) of the Act.

The percentage shareholding of a resident to whom a foreign dividend accrues is decisive in determining the amount to be included in his gross income. Thus, section 9E(3) distinguishes between shareholders with a substantive investment or qualifying interest (that is holding at least a 10% shareholding) and portfolio shareholders (holding less than a 10% shareholding).

In terms of section 9E(3)(a), the amount to be included in the gross income of the South African resident is the proportionate amount⁴⁰⁰ of the profit⁴⁰¹ from which the dividend is distributed, before taking into account any foreign tax⁴⁰² on income in respect of such

³⁹⁹ With the repeal of paragraph (b) of section 9E(1), which came into operation on 1 October 2001, the disposal of shares in a non-resident entity is no longer included in the definition of 'foreign dividend'. Prior to 1 October 2001, proceeds from a sale of shares in a foreign entity which had undistributed profits which had not been subject to South African tax constituted a (deemed) foreign dividend to the extent of those undistributed profits. With the introduction of capital gains tax, the proceeds of such sale is now included in the resident's income as a capital gain, but is no longer considered revenue income in the form of deemed foreign dividends.

⁴⁰⁰ The term 'proportionate amount of the profit' in relation to a shareholder is defined in section 9E(1) as an amount which bears to the total profit, the same ratio as this shareholding bears to the total shareholding. If there are different classes of shares, the expression 'total shareholding' refers only to the total of the class of shares of which the shareholding is part, and the expression 'total profits' means the total profits attributable to that class of shares.

⁴⁰¹ There is no definition in section 9E of the word 'profit'. It is contended that it would presumably include both revenue and capital profits. See Kolitz, *op cit*, 2001, 15 *Tax Planning* 93.

⁴⁰² The term 'foreign tax on income' is also not defined in section 9E. In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2000 (WP 1- 00 at 6), the word 'income' in the expression 'foreign tax on income' includes profits, income and gains. It also states that foreign taxes on

profit and before taking into account any withholding tax paid in respect of such dividend if such resident:

- For his own benefit; or
- In the case of a company, together with any other company in a group of companies⁴⁰³ of which such company forms a part, hold for their own benefit,
- At least 10% of the equity share capital⁴⁰⁴ in the company declaring the dividend.

Section 9E(3)(a) is subject to two provisos that:

- The dividend is deemed to be distributed from the most recent profits unless the resident proves otherwise;⁴⁰⁵ and
- When the company derives its profits by way of dividends and from other sources of profits, the dividend is deemed to have been declared on a proportionate basis.⁴⁰⁶

Section 9E(3) in these provisos introduces a LIFO (last in, first out) principle which means that the dividend is deemed to have been distributed from the profits most recently derived, unless the resident taxpayer can prove otherwise in the form prescribed by the Commissioner. On the other hand, if profits consist of dividends and other sources of income, the 'gross up' of the dividend must be calculated on a deemed proportionate basis.

The issue that arises is the extent of the interaction between the two provisos. It may be asked whether section 9E(3) does not create an ambiguity in respect of the interaction

income will include taxes imposed by national and certain lower tiers of government in the foreign country and capital gains tax. Thus, for the purposes of section 9E(3)(a), the amount of the proportionate share of the profit to be included in the gross income of the South African resident would be the amount before the deduction of any of these taxes. See de Koker et al, *Silke Tax Yearbook*, p. A-17.

⁴⁰³ The term 'group of companies' is defined in section 9E(1) as a controlling company and one or more other companies which are controlled companies, in relation to the controlling company. A 'controlled company' in turn, is defined as a company in relation to which another company is the controlling company. And a 'controlling company' in relation to any other company, is defined as a company which is a resident and which holds for its own benefit, whether directly or indirectly, through one or more companies, in the group of companies of which all the companies in question form part, shares in the other company constituting not less than 75% of the equity share capital of the other company.

⁴⁰⁴ As defined in section 1 of the Act.

⁴⁰⁵ Proviso (aa) to section 9E(3)(a) of the Act.

⁴⁰⁶ Proviso (bb) to section 9E(3)(a).

between the two provisos in relation to foreign dividend payments. Judge Dennis Davis⁴⁰⁷ argues that unlike proviso (aa), there is no election in terms of proviso (bb), because the taxpayer does not have an option to prove in a prescribed manner that the proportionate system should not operate in the same manner as he may be able to prove that the LIFO system should not be applicable. He goes on to correctly contend that the inter-relationship between the two provisos is that: except where the taxpayer proves otherwise, the dividend must be deemed to have been distributed in terms of the LIFO principle. In all circumstances, where the source of the dividends is made up of dividends received by the declaring company as well as other sources of profits, the dividend which falls within the scope of section 9E must be deemed to have been declared on the proportionate basis from such dividends and other sources of profits; in both cases subject to the LIFO principle. Thus, because both provisos cannot operate simultaneously on the same amount of dividends, the LIFO proviso takes precedence over the apportionment proviso in (bb) which will apply only to the balance after the LIFO basis has been exhausted.

In terms of section 9E(3)(b), in the case of portfolio shareholder who does not hold at least 10% (for his own benefit or in the case of a company in a group of companies for its own benefit) of the equity share capital of the company declaring the dividend, the amount to be included in gross income of the South African resident is the amount of the dividend declared before the deduction of the amount of any withholding tax paid in respect of the dividend.

It is clear in the wording of section 9E(3) that the amount to be included in gross income is the 'grossed up' amount of a foreign dividend as opposed to the actual dividend.⁴⁰⁸

⁴⁰⁷ *op cit*, *Taxpayer*, January 2002.

⁴⁰⁸ See the definition of dividend in para (k) of the gross income definition in section 1 where the concept of 'grossed up' appears.

C) The look-through principle of section 9E(4)

Section 9E(4) provides that in determining the proportionate amount of the profit to be included in the income of a resident shareholder who holds at least 10% of the equity share capital of a company that declares a foreign dividend, as required by section 9E(3)(a), any profits derived by any other company in which the company that distributes the dividend has an interest, that have been distributed to that company in the form of dividends must be taken into account, if the resident has a qualifying interest⁴⁰⁹ in the other company.⁴¹⁰

Thus, the shareholder who holds at least 10% of the equity share capital has to look through the company declaring the dividend and include his proportionate share of the profit of that company in his gross income. In determining his proportionate share of the operating profit, it may be necessary to look through more than one layer of shareholdings.⁴¹¹ Therefore, in terms of section 9E(4), the look through is not confined to the company declaring the dividend, but is applied to companies from which the declaring company has received dividends. As Koltz put it, in the situation of section 9E(4), the shareholder must 'drill down' to the profits of the other company in order to quantify the amount of the foreign dividend to be included in his gross income.⁴¹²

⁴⁰⁹ In terms of section 9E(1) of the Act, the term 'qualifying interest' of any person means:

- Any direct interest of at least 10% held by such person in the equity share capital of any company; and
- Any direct interest of at least 10% held by any company contemplated in paragraph (a) in the equity share capital of any other company, which other company shall for the purposes of this definition be deemed to be a company contemplated in paragraph (a) in which such person holds a direct interest of at least 10%.

⁴¹⁰ As in section 9E(3)(a), LIFO and proportionate income principles also apply throughout in terms of section 9E(4)(a) & (b) of the Act.

⁴¹¹ De Koker, *op cit*, p. A-17.

⁴¹² Where the South African resident's shareholding is at least 10%, the aggregate of any withholding tax and foreign tax paid on income paid in respect of the foreign dividends included in the gross income of a resident, may be deducted from the South African normal tax payable in South Africa by the resident on that dividend received. In the case of portfolio shareholder (holding less than 10%), only the withholding tax paid in respect of the amount of the foreign dividend included in gross income may be deducted from the South African normal tax payable. Therefore, no rebate may be claimed by a portfolio shareholder for any foreign tax on income imposed in respect of the profit from which the dividend is distributed. The

D) Election in respect of gross income inclusion

A resident may elect that only the net amount of a foreign dividend received (rather than the gross up for the taxes paid), after the deduction of foreign taxes, be included in his gross income.⁴¹³

In terms of section 9E(6)(a), if a shareholder who holds at least 10% of the equity share capital of the company that declares the dividend makes the election, the amount to be included in his gross income is the amount of the profits from which the dividend is declared, after the deduction of any foreign tax on income and any withholding tax paid in respect of the dividends. On the other hand, in terms of section 9E(6)(b), if a portfolio shareholder who holds less than 10% of the equity share capital of the company that declares the dividend, makes the election, the amount to be included in his gross income is the amount of the dividend after the deduction of any withholding tax paid in respect of the dividend.

The rationale of section 9E(6) is to reduce the administrative and compliance burden of determining the underlying corporate and withholding tax imposed on the foreign dividend.⁴¹⁴

The election must be made on an annual basis and is binding on all foreign dividends received by or accrued to the resident during the year of assessment in respect of which it is made. If the election is made, a deduction is effectively granted for the foreign taxes imposed on the dividend that are included in the gross income of the resident. The foreign taxes deducted from the foreign dividend may therefore not be taken into account in calculating the amount of the foreign tax credit relief.⁴¹⁵

deduction for foreign tax suffered may not, however, exceed the South African normal tax payable in respect of that income. See section 6quat of the Act.

⁴¹³ See section 9E(6) of the Act.

⁴¹⁴ See de Koker, *op cit*, p. A-18.

⁴¹⁵ See section 6quat (1B)(e).

It is contended that whether the election will hold any advantages for a resident other than administrative benefits, will depend on the particular circumstances of the resident, for instance, the rate of South African tax payable on the foreign dividend and the foreign rate of tax paid. However, the election is likely to be made where the South African resident has an assessed loss, or possibly, where foreign taxes result in unutilisable excess credits.⁴¹⁶

E) Dividends distributed to and by unit portfolios

In terms of section 9E(5)(a)(b),⁴¹⁷ where a dividend is declared to any unit portfolio (that has a portfolio shareholding in the foreign company), it will be deemed to have been declared directly to the unit holders to the extent that such dividend is declared to the holders of units by the unit portfolio. The effect of section 9E(5) is that the unit holders, will be liable for the tax on the foreign dividends, rather than the unit portfolio itself.

Unit holders who are natural persons will, however, qualify for the section 10(1)(i)(xv) basic interest and dividend exemption for the foreign dividends included in their gross income, if the foreign dividends are not otherwise exempt from tax.⁴¹⁸ They will also be able to claim section 6 credits in respect of foreign tax paid on dividends against their South African tax liability.

⁴¹⁶ A taxable 'foreign dividend' as defined in section 9E(1) is for STC purposes, excluded from the dividends accrued which may be deducted from dividends declared for the purposes of calculating the net amount of the company declaring the dividend, in terms of section 64B(3). Where a foreign dividend is subject to income tax in the hands of a South African resident, the latter will not be able to claim an STC credit in respect of the foreign dividend. However, exempt foreign dividends in terms of section 9E(7) are deductible at arriving at net dividends declared.

⁴¹⁷ Amended by section 23(1)(b) of Act 60 of 2001, effective retrospectively from 23 February 2000.

⁴¹⁸ In terms of section 13(1)(a) of the Taxation Laws Amendment Bill (B 26-2002), the basic foreign dividends and interest from sources outside South Africa will only be exempt up to R 1000, effective from the commencement of assessment years ending on or after 1 January 2003, as compared to the previous *de minimis* exemption of R 4000 for individuals below the age of 65 and R 5000 for persons aged above 65. See also SARS Interpretation Note No 2 (second version), 28 August 2002.

F) Deduction of interest incurred in the production of foreign dividends

Interest incurred in purchasing shares which produce dividends would normally not qualify for deduction in terms of the general deduction formula in section 11(a) and the 'carrying on of trade' requirement in section 23(g) of the Act. Because taxable foreign dividends are 'income' as defined in section 1, expenditure incurred in earning taxable foreign dividends meets the requirement of the general deduction formula of being 'in the production of income'.⁴¹⁹ However, expenditure incurred in earning taxable foreign dividends would usually not meet the trade requirement under section 23(g) and would therefore not be deductible.

Section 9E(5A)⁴²⁰ consequently provides a special deduction in order to alleviate the problem, notwithstanding the provisions of sections 11(a) and 23(g). Section 9E(5A) overrides the 'trade' requirement to a certain degree in that it allows a resident to deduct interest actually incurred in the production of income derived from both exempt and taxable foreign dividends.⁴²¹

In terms of section 9E(5A)(a), a deduction is allowed for interest actually incurred in the production of foreign dividends against the income of a resident in any year of assessment in the form of taxable foreign dividends.⁴²² Thus, interest paid on a loan used to purchase the shares in a company that declares a foreign dividend would qualify for the deduction. However, in terms of the proviso to section 9E(5A)(a), the amount of interest deductible for a particular year of assessment is limited to the amount of income derived from foreign dividends during that year of assessment.⁴²³

⁴¹⁹ See de Koker, *op cit*, p. A-21.

⁴²⁰ Amended by section 23(1)(c) of Act 60 of 2001, effective retrospectively from 23 February 2000.

⁴²¹ See SARS' Income Tax Interpretation Note no 2, 1 February 2002.

⁴²² Taxable foreign dividends equal gross foreign dividends less exempt foreign dividends. Exempt foreign dividends comprise dividends exempt under section 9E(7) and the *de minimis* interest and foreign dividend exemption available to individuals under section 10(1)(i)(xv) of the Act, which will be limited to R 1000 from the commencement of assessment years ending on or after 1 January 2003. See SARS Income Tax Interpretation Note No 2 (second version) of 28 August 2002.

⁴²³ Previously in the old section 19 of the Act, it was sufficient for such foreign dividends to be included in the gross income of the resident. Income for the purpose of section 9E(5A)(a) is defined as gross income less exempt income. See section 1 of the Act.

In terms of section 9E(5A)(b), interest incurred over and above the taxable foreign dividends is not deductible in that year. Because some of the foreign dividends are exempt, a part of the excess interest is deemed to be incurred in the production of that exempt income, and is therefore not deductible. The excess interest must first be set off against the exempt foreign dividends. The remaining excess interest is carried forward to the following tax year and is deductible against taxable foreign dividends in that year.

SARS has indicated in Interpretation Note no 2⁴²⁴ that if for any year of assessment, the amount of exempt foreign dividends is equal to or greater than the amount of excess interest, then the balance of excess interest carried forward to the following year of assessment is equal to nil.

The provisions of section 9E(5A) have an inequitable effect in that a full deduction in respect of the resident taxpayer's expenses in producing the foreign dividends is not granted. As section 9E(5A) only deals with interest incurred in the production of taxable foreign dividends, any other expenditure incurred in earning the dividends such as commission or professional fees, and any losses arising from outstanding dividends that prove to be bad, will be deductible only in the limited circumstances where the holding of the shares to earn the dividends constitutes the carrying on of a trade by the resident.

G) Exempt foreign dividends

Section 9E(7) exempts in certain circumstances foreign dividends declared or deemed to have been declared to South African resident shareholders. It is contended that this is in line with international practice, where it is acceptable to completely exempt certain foreign dividends in most cases for administrative purposes in circumstances where the tax payable on the underlying profits is of such magnitude that a credit of virtually the full amount of the domestic tax will have to be granted.⁴²⁵

⁴²⁴ Dated 1 February 2002.

⁴²⁵ See the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2000 at 3.

G-1) The listed company exemption

Under section 9E(7)(c), foreign dividends declared by a company listed on the Johannesburg Stock Exchange (JSE) to a resident and connected person owning less than 10% of the equity share capital (portfolio investor) will be exempt from tax in South Africa. In addition, more than 10% of the shareholding of the company at the time of the declaration of the dividend must be held collectively (in aggregate) by residents. If the company was not listed on the JSE on 23 February 2000, the exemption will apply upon approval by the Commissioner, which he may grant on application by the company, having regard to whether or not the profits of the company were generated in a designated country and the tax rate at which the profits from which the dividend was declared was, or will be taxed.

The rationale for this exemption is to address the administrative implications of the tax in respect of a large number of portfolio shareholders and its potential impact on the South African market and economy. In addition, the requirement for approval by the Commissioner was introduced to remove the possibility of foreign companies operating in low tax rate countries listing on the JSE after 23 February 2000 in order to exploit this exemption.⁴²⁶

G-2) The designated country exemption

Section 9E(7)(d) exempts any dividend distributed directly or indirectly to the South African resident who holds a qualifying interest (at least 10% shareholding) in a foreign company to the extent that the profits from which the dividend is declared are or will be subject to tax in a designated country at a company income tax statutory rate of at least 27%.⁴²⁷

⁴²⁶ See Explanatory Memorandum at 4.

⁴²⁷ The statutory tax rate is 13,5% for capital gains. See the analysis of the designated country test under the CFE exemption of section 9D(9)(a) in note 342. Section 9E(9)(7)(d) was amended from its original

G-3) The CFE exemption

In terms of section 9E(7)(e), any dividend declared by a company will be exempt to the extent that the profits from which the dividend is distributed:

- i) Relates to the income which is or will be included in the income of the shareholder of such company in terms of section 9D.⁴²⁸
- ii) Is or will be subject to tax in the Republic in terms of the Act;⁴²⁹
- iii) Have otherwise been included in the taxable income of the shareholders in terms of paragraph (a) of the definition of 'foreign dividends';⁴³⁰
- iv) Arose directly or indirectly from any dividends declared by any company which is a resident.⁴³¹

G-4) Dividend exemption under section 9E(7)(f)

Section 9E(7)(f) exempts any dividend declared by a company out of profits derived by such company, either:

- By way of any foreign dividend which is exempt from tax in terms of the provisions of section 9E(7);
- Or any dividend which would have been exempt had it been declared on or after 23 February 2000.

introduction so that profits do not need to have been generated in a designated country, but only need to be subject to tax in a designated country at the required rates.

⁴²⁸ Thus, the provision deals with the dividend exemption on income already subject to tax in the South African resident's income as a result of the CFE rules.

⁴²⁹ This provision deals with the exemption on income already subject to tax in South Africa under the source rule.

⁴³⁰ This provision exempts dividends already subject to tax in South Africa in the shareholder's hands as deemed foreign dividends in terms of section 64C.

⁴³¹ This provision deals with the situation where for instance, a foreign company holds shares in a South African company, and therefore receives dividends on profits distributed by the South African company. Section 9E(7)(e)(iv) thus prevents the situation in which the dividends declared by the foreign company to the South African resident would have been subject to tax in terms of section 9E.

G-5) Ministerial exemption

- The Minister may grant exemption from the application of section 9E in respect of a project approved by the Minister;⁴³²
- The Minister may withdraw any exemption granted in terms of section 8A, in the event of any condition not being complied with.⁴³³

H) Currency conversion rule

In terms of section 9E(10), the foreign dividend must be converted into South African Rands at the rate of exchange ruling on the date the dividend accrued to the South African resident. For the purposes of determining the foreign tax credit of section 6quat, the foreign taxes paid are converted to South African Rand at the same rate used for the dividend. In this case then, there is consistency between the conversion rates used for the conversion of the dividend and for the conversion of the foreign tax paid on it.

3.1.5 Income from foreign sources

Foreign income that is required to be included in the South African resident's taxable income may also comprise the resident's own receipts and accruals.⁴³⁴ However, in terms of section 9F, the South African tax consequences in respect of the foreign income derived by the South African resident carrying trade outside South Africa (for instance through a branch) depend on whether the resident is a natural person or a company.⁴³⁵

An exemption is provided for in section 9F(2), read together with section 10(1)(kA), for an amount of income 'received by or accrued...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,

⁴³² See section 9E(8A) of the Act.

⁴³³ See section 9E(8B) of the Act. The effect of this tax sparing concession is that the taxpayer will be able to repatriate the benefits of the tax incentives enjoyed in the foreign country. Previously, such benefits would have been lost when the dividends were brought onshore.

⁴³⁴ In fact because of the worldwide basis of taxation, the resident's income from anywhere is in principle required to be included in his 'gross income' as defined in section 1 of the Act.

which has been or will be subject to tax in a designated country at a statutory rate of at least 27 per cent... without any right of recovery by any person...⁴³⁶

Thus the section 9F(2) exemption for the South African resident's foreign source income is only available to a company. It is not available to a natural person who is therefore required to include his foreign receipts and accruals in his South African taxable income though they were earned in a designated country. The South African individual in this case only has to claim a rebate in terms of section 6quat for the foreign tax paid. The effect of this discrimination between natural persons and companies provided in section 9F(2) is that the South African tax payable by two taxpayers who earn the same amount of foreign income differs materially.⁴³⁷

In terms of section 20 of the Act, losses generated by foreign trade (for instance carrying on trade through a foreign branch) are ring-fenced. Thus, if the foreign trade results in an assessed loss, such loss may be set off against other foreign trade income but may not be set off against any income from carrying on a trade in South Africa.⁴³⁸

A) Currency conversion rule

In terms of section 25D⁴³⁹ of the Act, the amount of taxable income derived by a resident from a source outside South Africa (other than by way of foreign dividend) must be determined in the relevant currency of the country from which the income is derived, and

⁴³⁵ See Kolitz, *op cit*, 2001, 15 *Tax planning* 127.

⁴³⁶ In terms of section 9F(1), the requirements for the qualification as a designated country are the same as provided in section 9E(8), and the same provision as regards progressive tax rates has been legislated for in section 9F(2).

⁴³⁷ See Kolitz, *op cit*, p. 128. In contrast, the designated country exemptions for foreign dividends in section 9E(7)(d) and for the net income of a CFE in section 9D(9)(a) are available for both companies and individuals.

⁴³⁸ See Huxham and Haupt, *op cit*, p. 277. The intention of SARS is to protect the South African tax base against the use of losses to shelter South African taxable income and the subsequent conversion of the branch to a subsidiary, which may then meet the requirements of the business establishment test. See Casey, *op cit*, p. 4.

⁴³⁹ Inserted by section 33 of Act 59 of 2000 and operative with effect from years of assessment commencing on or after 1 January 2001.

the taxable income must be converted to the South African Rand by applying the ruling exchange rate on the 'last day of the relevant year of assessment'.⁴⁴⁰

Section 25D has also provided guidelines for calculating foreign exchange gains and losses relating to income derived by a South African taxpayer from a foreign branch (that is a permanent establishment). If the branch keeps its financial records in the currency of the country in which the branch's permanent establishment is situated, thus, the net income of the branch is converted to Rands at the appropriate rate on the last day of the South African's taxpayer financial year.⁴⁴¹ However, if the foreign branch does not qualify as a permanent establishment, or if it keeps its financial records in a currency other than the official currency of the country in which it is located, then the income and expenditure of the branch must be calculated in South African Rand on ongoing basis.⁴⁴²

B) The timing of the income inclusion

The ruling exchange rates that are required to be used for the conversion calculation of section 25D may not be related to the rates ruling on the date that the funds are finally remitted to South Africa. This is in terms of section 9F(3), which requires that if the foreign amount received by or accrued to any person⁴⁴³ may not be repatriated in South Africa because of exchange control restrictions in the country of source, it will not be included in the taxable income of the South African resident until the restriction no longer applies.⁴⁴⁴ And as with section 9D, the question may arise that if the amount remitted actually differs from the amount calculated in terms of section 25D, will the provisions of section 24I apply? The answer to this query lies in section 6quat(4) dealing with the conversion rule applicable on the foreign tax payable.

⁴⁴⁰ In terms of section 25D(a), the Commissioner may also approve any other averaged rate, taking into account the ruling exchange rates during such year of assessment.

⁴⁴¹ See section 25D(a) of the Act.

⁴⁴² See section 25D(b) of the Act.

⁴⁴³ Contrary to section 9F(2), section 9F(3) applies to both companies and natural persons.

⁴⁴⁴ Section 9F(3) also applies in terms of source country restriction imposed on the repatriation of CFE's net income in terms of section of section 9D.

Thus, the conversion rules of section 25D, section 9F(3) and the rules applicable in section 9D(6) and 9E(10) demonstrate that the net tax payable in South Africa is not only influenced by different tax rates, but is also affected by the ruling exchange rates.

3.2 The United Kingdom

3.2.1 The controlled foreign corporation (CFC) rules

Introduction

CFC legislation was introduced in the United Kingdom by the Finance Act of 1984, as a direction-based legislation, that is, it could only operate when the Board of Inland Revenue made a direction. The legislation has been subject to a number of changes in the most recent budgets. In the Finance Act 1998, changes were made to bring the legislation within the Corporation Tax Self-Assessment, as well as certain changes to the exempt activities test for holding companies.⁴⁴⁵

As a result, the legislation then applied automatically where all the necessary conditions are met, rather than only following a board's direction. United Kingdom's companies would thus be required to include details of significant interests in CFCs in their tax returns and to self-assess any CFC tax due. The Finance Act 2000 brought further changes in the exempt activities test, introduced measures to counter the use of designer tax rates and widened the definition of control. The rules governing the acceptable distribution policy exemption were also changed both in the Finance Act 1999 and the Finance Act 2001.⁴⁴⁶

⁴⁴⁵ See Leegaard, T, "CFC legislation --- Recent Changes to the Acceptable Distribution Policy Exemption", 2001, IBFD, p. 293.

⁴⁴⁶ The changes made by the Finance Act 1999 apply to dividends paid on or after 9 March 1999, and the changes made by section 82 of the Finance Act 2001 apply to dividends paid by a CFC on or after 7 March 2001 for accounting periods ending on or after that date.

The analysis of the CFC rules in this section from the United Kingdom perspective will focus specifically on the definition of a CFC, the basis of charge and the available exemptions from the CFC rules.

A) Definition of a CFC

In terms section 747(1)(2) of ICTA 1988, a company which is resident outside the United Kingdom, controlled by persons resident in the United Kingdom, and subject to a 'lower level of taxation' in the territory in which it is 'resident' is a CFC.⁴⁴⁷

The basic concept of the legislation is that it makes a charge on United Kingdom shareholders of companies' resident in low tax jurisdictions, CFCs on a proportionate interest of the company's profits, but not its capital gains.⁴⁴⁸

For a foreign company to be controlled, United Kingdom shareholders must have an interest of more than 50%.⁴⁴⁹ The United Kingdom rules, however, follow a wider definition of control following the changes in the Finance Act 2000. Thus, with effect from 21 March 2000, 'control' of a company is defined for these purposes as the power of a person to secure that the affairs of the company are conducted in accordance his wishes, either by means of shareholding or voting power in or in relation to the company or any other company, or by virtue of any powers conferred by the articles of association or other document regulating the company or any other company. Two or more persons together having such power are taken as controlling the company.

In determining whether a person has such control, a wide range of rights and powers is attributed to him, in so far as not already so attributed.⁴⁵⁰ These include future rights and

⁴⁴⁷ In terms of section 249 of Finance Act 1994, a company that is non-resident as a result of a double tax agreement entered into by the United Kingdom, is treated as resident outside the United Kingdom.

⁴⁴⁸ See Leegaard, *op cit*, p. 294. There are provisions in the capital gains tax legislation dealing with the attribution of capital gains of closely CFCs to United Kingdom resident shareholders.

⁴⁴⁹ See section 756(3) of ICTA 1988.

⁴⁵⁰ Section 755D(5)-(11) of ICTA 1988.

powers of certain connected and other persons. The ownership requires in the definition of control may be direct, indirect or constructive.⁴⁵¹

Consequently, if there is less than 50% United Kingdom control, the control test is nevertheless satisfied where there are two persons who control the company together. The requirements are that the United Kingdom resident person controls at least 40% of the company and that the other person controls at least 40%, but not more than 55%.⁴⁵²

The extended definition of control reflected the fact that it is increasingly common for multinational companies to carry on business through joint venture companies.⁴⁵³

A-1) Lower level of tax

i) Designer rate of tax regimes

In terms of the United Kingdom CFC legislation, the foreign company must be resident in a country where there is a lower rate of tax than in the United Kingdom. Currently, low tax is defined as a foreign tax liability (actually paid) in respect of profits (other than capital profits) that is less than 75% of the United Kingdom tax payable in the same accounting period had the CFC been resident in the United Kingdom.⁴⁵⁴

Because some offshore countries have introduced regimes that are specifically designed to enable companies to avoid United Kingdom CFC rules, anti-avoidance rules were introduced by the Finance Act 2000 in the United Kingdom, aimed at dealing with the application of 'designer tax rates'. Thus, in terms of the 'designer tax rates' provisions,⁴⁵⁵

⁴⁵¹ See Rohatgi, *op cit*, p. 390; ICTA 1988, section 755D; Finance Act 2000, Sch 31 para 4(1); see also Saunders & Antczak, *op cit*, p. 160.

⁴⁵² See Finance Act 2000, Sch 31 para 2.

⁴⁵³ See the analysis of the change of the definition of 'control' in the United Kingdom by Medori, C, "UK to strengthen CFC legislation", 2000, *Tax Planning International Review*, p. 11'12.

⁴⁵⁴ See Finance Act 1998, Sch 17 para 5.

⁴⁵⁵ Effective from October 1999.

companies in certain listed jurisdictions, which allow the use of negotiable tax rates, will be subject to CFC rules regardless of the level of taxes actually paid.⁴⁵⁶

B) Basis of charge

The United Kingdom CFC rules affect only companies⁴⁵⁷ resident in the United Kingdom. Where a part of a CFC's 'chargeable profits'⁴⁵⁸ is apportioned⁴⁵⁹ to the United Kingdom resident company, a sum equal to corporate tax at the 'appropriate rate'⁴⁶⁰ on those profits, less the part of the CFC's 'creditable tax'⁴⁶¹ (if any) so apportioned, is chargeable on the company as if it were corporation tax.⁴⁶²

⁴⁵⁶ See Finance Act 2000, Sch 31 para 3; see also Rohatgi, *op cit*, p. 390. Currently, the countries listed under the 'designer tax rates' regimes are Guernsey, Jersey, Isle of Man, Gibraltar and Ireland.

⁴⁵⁷ This is not applicable to individuals as there are special provisions dealing with individuals' use of low tax jurisdictions such as powers under section 739 et seq. ICTA 1988 to assess individuals on income and benefits derived from the transfer of assets abroad.

⁴⁵⁸ The term 'chargeable profits' of a CFC for an accounting period are the total profits (but excluding chargeable gains), as defined for corporate tax purposes, on which on the assumption set out in ICTA 1988, Sch 24 and after allowing for any available deduction from these profits, it would be chargeable to corporate tax for the period. Double tax agreement exemptions which may have applied to income of the CFC are of no application in relation to the computation of chargeable profits. See *Bricom Holdings Ltd v CIR*, CA 1997, 70 TC 272.

⁴⁵⁹ Prior to the commencement of self-assessment, an apportionment of chargeable profits and creditable tax is made according to the respective interests of those with an interest in the CFC at any time during the 'accounting period' in question. The Board may attribute to each such person an interest corresponding to his interest in the CFC's assets available for distribution in a winding up. If the CFC is not a trading company, the Board may treat a loan creditor as having an interest to the extent to which the CFC's income has been, or is available to be, applied against his loan capital or debt. Interest held in a fiduciary or representative capacity may be apportioned among identifiable beneficiaries. The Board has a general power, subject to those specific provisions, to make the necessary apportionment on a just and reasonable basis. See section 752 of ICTA 1988; see also Saunders and Antczak, *op cit*, p. 166.

⁴⁶⁰ The 'appropriate rate' is the full corporate tax rate (or average rate) applicable to the accounting period in which ends the CFC's 'accounting period' whose 'chargeable profits' are subject to the apportionment. See Finance Act 1998, Sch 17, para 1(4)(5).

⁴⁶¹ The 'creditable tax' of a CFC's accounting period is the aggregate of:

The double tax relief, in respect of tax on income brought into account in determining chargeable profits of the period, which would be available on the assumption set out in ICTA 1988, Sch 24 and assuming the company to be liable to corporate tax on those chargeable profits;

- The set-off available under ICTA 1988, section 7(2) (sums received under deduction of income tax) against those chargeable profits on the assumption, Sch 24;
- The amount of any income or corporate tax actually charged in respect of those chargeable profits, less any such tax which has been or falls to be repaid to the CFC. See Finance Act 1998, Sch 17, para 6(6).

⁴⁶² A credit is allowed for the foreign taxes paid by the CFC on the attributed income. The United Kingdom tax paid under the CFC rules is included in the underlying tax credit when the dividends are subsequently received from the CFC. The CFC trading losses can in certain circumstances be carried forward indefinitely. See Savory, J, "UK CFCs leave Room for Manoeuvre", June 1999, *International Tax Review*.

No charge arises however, unless at least 25% of the CFC's 'chargeable profits' for the period in question is apportioned either to the United Kingdom resident company or to persons 'connected' or 'associated' with it.⁴⁶³

C) The exemption from the charge

There are a number of exemptions from application of the CFC legislation.⁴⁶⁴ The CFC charge may be avoided if the CFC satisfies any of the following tests:

i) De minimis test

This exception applies if the total chargeable profits of the CFC attributable to the United Kingdom shareholders do not exceed UKP 50,000 in a twelve-month accounting period, or less than 25% of the income attributed to them.

ii) 'Excluded country regulations' test

The United Kingdom provides a 'white list' of non-low tax countries, and a second list of conditionally excluded countries, under its excluded countries regulations. Thus, if a company is exempted under that list, the CFC rules do not apply to them, provided not more than 10% of its commercially quantified income (pre-tax) is derived from non-local sources.⁴⁶⁵

The rationale for introducing the 'white list' is probably an assumption that there is no involvement in United Kingdom tax avoidance, given the territories listed and the nature of such company's income.

⁴⁶³ See Finance Act 1998, Sch 17, para 1(3)(4).

⁴⁶⁴ See Finance Act 1998, Sch 17, para 3.

⁴⁶⁵ See Rohatgi, *op cit*, p. 390. The non-local source income is also subject to a *de minimis* threshold of UKP 50,000.

iii) The 'acceptable distribution policy' (ADP) test

A CFC is excepted from apportionment under this test if it pursues an acceptable dividend distribution policy exemption for the accounting period.⁴⁶⁶

The basis for the acceptable distribution policy exemption is that there will be no charge on the United Kingdom shareholder company, provided that the foreign company remits not less than 90% of its net chargeable profits in the form of dividends.⁴⁶⁷ The distributions must be made within 18 months of the ending of the foreign company's relevant accounting period. If this test is satisfied, then the accounting period to which the dividend is related, is an ADP exemption period.

A dividend paid by a CFC after 8 March 1999 for an accounting period ending after that date is disregarded for these purposes to the extent that the relevant profits in relation to the dividend derive from dividends or other distributions paid to the CFC at any time to which section 208 of the ICTA 1988 applied, or would have applied had the CFC then been United Kingdom resident. A dividend paid by a CFC to a company is also disregarded for these purposes unless it is taken into account in computing the recipient's company's income for corporate tax and in relation to a dividend paid after 6 March 2001, for an accounting period ending after that date, it is not so chargeable under Case I of Schedule D, or if so chargeable, the payment is not involved in a United Kingdom tax avoidance scheme.

When the CFC's accounts are drawn up in a foreign currency, they do not have to be translated into sterling for these purposes. A dividend equaling 90% of the appropriate foreign currency profits will meet the test.⁴⁶⁸

⁴⁶⁶ Accounting periods of trading CFCs beginning after 27 November 1995, and of non-trading CFCs ending after 29 November 1993.

⁴⁶⁷ For the ADP exemption to apply, the dividends from the CFC must be paid to United Kingdom residents. It is not sufficient to make distributions to intermediary holding companies resident outside the United Kingdom. However, if such a company makes a distribution to United Kingdom residents out of dividends received from a CFC, the test may be satisfied. See Leegaard, *op cit*, p. 295.

iv) Exempt activities test

The objective of this test is to exempt companies with no real presence or genuine commercial operation (such as a business establishment) in the country of residence. This test requires that the foreign company is effectively managed⁴⁶⁹ abroad and not engaged in non-qualifying business activities.⁴⁷⁰

The foreign company should also not receive substantial dividend income from other CFCs, unless they are themselves engaged in exempt activities. There are also special rules applicable to holding companies (be they holding companies, local holding companies or superior holding companies), provided the companies held fall within the exempt activities test.

v) The motive test

The CFC charge may also be avoided in the United Kingdom if the United Kingdom company can demonstrate that the CFC's primary purpose is bona fide commercial activities, and not to achieve a reduction of United Kingdom taxes or to divert profits from the United Kingdom.

vi) The public quotation test

This condition is met by the CFC if it is a publicly listed company in a recognised stock exchange in its country of residence and the public beneficially holds at least 35% of its

⁴⁶⁸ See Saunders & Antczak, *op cit*, p. 277.

⁴⁶⁹ The requirement that the CFC's business affairs be 'effectively managed' in the territory of residence is not regarded as satisfied unless the number of employees in the territory is adequate to deal with the volume of the company's business, and unless any services provided for persons resident outside the territory (other than through a branch or agency liable to the United Kingdom tax on its profits or gains, or for arm's length consideration through any other person so liable) are not in fact performed in the United Kingdom (or are merely incidental to services performed outside the United Kingdom). See Saunders, *op cit*, p. 185.

⁴⁷⁰ Non-qualifying business income includes income from (i) investment business (passive income); (ii) dealing in goods for delivery to or from the United Kingdom or to or from connected or associated persons (e.g. re-invoicing companies); and (iii) certain wholesale, distributive and financial businesses. The Finance Act 2000 has extended the provisions to include all intra-group services. See Rohatgi, *op cit*, p. 39).

voting shares. Moreover, the ‘principal members’⁴⁷¹ of the company should not hold more than 85% of the voting shares.

3.2.2 The taxation of foreign dividends

Foreign dividends are fully taxable in the United Kingdom on the gross amount, subject to tax credits for foreign taxes paid. Unilateral relief is available in respect of foreign taxes suffered on a per-source limitation basis. The United Kingdom also grants direct and indirect tax credits on dividends received from a foreign company and its lower-tier subsidiaries, provided that the United Kingdom corporate shareholder holds at least 10% voting control at each level.⁴⁷²

Thus, individuals and companies with less than 10% participation rights are only entitled to a direct tax credit. A United Kingdom company may also elect to claim the foreign tax credit as an expense. However, it cannot elect to take part as credit, and part as expense.

3.3 The United States

3.3.1 The controlled foreign corporation (CFC) rules

Introduction

The United States enacted comprehensive anti-avoidance legislation in 1962 (subsequently expanded under the Tax Reform Act 1986). Subpart F, the familiar name for sections 951 through 964 of the code⁴⁷³ consists of a set of special rules for taxing certain United States shareholders of CFCs.

⁴⁷¹ A principal member is a person who, together with his associates, own more than 5% of the voting power of the company.

⁴⁷² See Rohatgi, *op cit*, p. 330.

⁴⁷³ The Code refers to the Internal Revenue Code of 1986.

The provisions of Subpart F were introduced in an effort to prevent United States taxpayers from using foreign corporations to defer United States federal income tax on certain foreign source income.⁴⁷⁴

Ordinarily, foreign corporations are subject to United States federal income tax only to the extent that they earn:

- Income from a trade or business within the United States; or
- United States source income.

Thus, prior to the adoption of Subpart F, a United States taxpayer could effectively defer United States federal income tax on certain foreign source income by ensuring that such income was earned through a foreign corporation. The foreign source income earned by the foreign subsidiary of the United States taxpayer would generally not be subject to United States federal income tax until such income was repatriated. As a result, the foreign operations of the United States corporations could avoid United States federal income tax indefinitely.

Subpart F was introduced to prevent such indefinite and potentially infinite deferral. Subpart F does not alter the United States federal income tax consequences for corporations. Rather, Subpart F alters the United States federal income tax rules for certain United States shareholders (US shareholders) of certain foreign corporations (CFCs), requiring such shareholders to recognise as income certain earnings of such foreign corporations as though such earnings had been distributed as current dividends.

The methodology for determining if there is a CFC is based on the followings:

- Define certain United States owned corporations as CFCs;
- Identify 10% shareholders who are United States persons (US shareholders);
- Tax US shareholders currently on offending income, known as 'Subpart F income'.⁴⁷⁵

⁴⁷⁴ See Westin, R, *International Taxation of Electronic Commerce*, 2000, p. 469.

⁴⁷⁵ *Ibid*, p. 470.

The purpose of this section is to analyse from the United States perspective, what constitutes a CFC, the charge to the US shareholders on the earnings of the CFC and the available exemption from the CFC rules.

A) Definition of a CFC

A CFC for United States tax purposes is a foreign corporation over 50% of whose stock is held by US shareholders (either alone or collectively) in terms of vote or value (whichever is greater) at any time during its taxable year.⁴⁷⁶

A US shareholder is defined as a United States person, who directly or indirectly, owns 10% or more of the foreign company's voting interest.⁴⁷⁷ A United States person includes a United States citizen or resident individual, a domestic partnership, a domestic corporation, and an estate or trust.⁴⁷⁸

The foreign corporation must be controlled for an interrupted period of at least 30 days during its fiscal year for the CFC to apply.⁴⁷⁹ Both the control and ownership tests include direct, indirect and constructive ownership rules. The 50% ownership and voting requirement of section 957(a), coupled with the 10% voting threshold for United States shareholders, determine the patterns of ownership test that create CFCs. If non-US shareholders (and this includes United States persons who hold less than 10% of the voting power) own at least 50% of the value and voting power of a foreign corporation, then it is not a CFC.

⁴⁷⁶ See section 957(a) of the Code. It is argued that this definition is disjunctive. A preponderance either of voting power or of stock by value constitutes control. Thus, because more than 50% of voting power or value is required for control, ownership divided exactly equally (i.e, 50-50) between United States and foreign persons leaves a foreign corporation beyond the reach of Subpart F. See Isenbergh, J, "Foreign Income: Foundation of US International Taxation", 2001, *Tax Management*, p. A-66.

⁴⁷⁷ See section 951(b) of the Code.

⁴⁷⁸ See section 7701(a)(30) of the Code.

⁴⁷⁹ See Rohatgi, *op cit*, p. 391.

Thus, if a United States citizen owns 50% of the value and voting power of a foreign corporation and another six unrelated United States citizens each own less than 10%, it is not a CFC.⁴⁸⁰

The smallest number of United States persons that can hold the entire ownership of a foreign corporation without creating a CFC is 7. The smallest number of United States persons that can hold equal ownership interests in a foreign corporation without creating a CFC is 11 (each owning 9,09% of the stock).⁴⁸¹

The treasury regulations provide that in determining the voting power, the facts and circumstances of each case must be taken into account.⁴⁸² The regulations add that US shareholders will be treated as having control:

- If they have the power to elect a majority of the board of directors;
- If they have the power to elect all the members of the board of directors and also have the power to directly or through an agent to break a deadlock of the board of directors; or
- If in some other way they can exercise indirectly the powers of a board of directors.⁴⁸³

B) The income of a CFC subject to the United States federal income taxation

Current taxation of US shareholders of CFCs arises under section 951(a). Certain profits (Subpart F income) of the CFC are taxable currently on the US shareholders on the last day of its fiscal year, even when they are not distributed (ownership test).⁴⁸⁴ These profits are attributed to them pro rata to their shareholding (direct or indirect) to the extent that they are entitled to the profit distribution, and included in their tax return.

⁴⁸⁰ Thus, in the case of *Framatone Connectors USA, Inc et al v Commissioner* (case cited in the *World Trade Adviser*, March 2002, p. 12), the Tax Court ruled in favour of the Inland Revenue Service and held that a foreign corporation was not a CFC for the year in issue because its sole US shareholder did not own more than 50% of the voting power or the value of the foreign corporation.

⁴⁸¹ See Isenbergh, p. A-66.

⁴⁸² See Regs. S 1.957 - 1(b).

⁴⁸³ See decided cases on voting power such as *Kraus v Commissioner*, 490 F. 2d 898 (2d Cir. 1974); *C.C.A, Inc v Commissioner*, 64 TC, 137 (1976); and *Koehring Co v Commissioner*, 538 F. 2d 313 (7th Cir. 1978).

⁴⁸⁴ Section 952 (a) of the Code.

Subpart F or 'tainted income' is generally defined to include, among other things, 'foreign base income'. In turn, foreign base company income includes 'foreign personal holding company income', which is made up of seven general categories of income, namely:

- Dividends, interest, rents, royalties and annuities (passive income);
- Gains from certain property transactions;
- Gains from commodity transactions;
- Foreign currency gains;
- Income equivalent to interest;
- Certain net income from notional principal contracts and payments in lieu of dividends received in certain equity lending transactions.⁴⁸⁵

An important exception exists to the general inclusion of dividend and interest income as foreign personal holding company income. Section 954(c)(3)(A) of the Code provides that foreign personal holding company income will not include dividends and interest received by a CFC from a related person (generally referring to ownership of stock representing 50% or more of the voting power or value of the related corporation) which:

- is either a corporation created or organized under the laws of the same foreign country as such CFC; and
- has a substantial part of its assets used in its trade or business located in such same foreign country.⁴⁸⁶

This so-called same country exception ensures that a US shareholder will not be taxed under Subpart F on dividends received by a CFC from a related corporation where the US shareholder would not have been taxed on undistributed income had it owned the stock of the related corporation directly. Accordingly, the subsidiaries of a United States corporation operating within a single country may transfer funds between themselves as

⁴⁸⁵ See section 954 of the Code.

⁴⁸⁶ Similarly, rents and royalties are excluded from foreign personal holding company income if received by a CFC from a related entity for the use of property within the same country in which the CFC is organised. See section 954 (c)(3)(A)(ii) of the Code.

required by their respective operating needs without adversely affecting such United States corporation's federal income tax liability.⁴⁸⁷

i) Case law

In *Textron v Commissioner*,⁴⁸⁸ the Tax Court held that a United States corporation that required to place the shares it acquired in a United Kingdom corporation into a voting trust, must still include in its income currently the Subpart F income earned by the United Kingdom corporation, because the trust was a grantor trust.

In 1989, Textron, a United States corporation, acquired 95% of the shares of Avdel, a United Kingdom corporation that had been a competitor. The Federal Trade Commissioner sought to enjoin the acquisition as a restraint of trade and, pending determination of the case, the US District Court required Textron to place the shares into a voting trust. Under the terms of the voting trust, the rights to all voting power of the shares were vested in an independent trustee, and Textron had no right to manage the operations of Avdel. Any dividends from Avdel, were paid by the trustee to Textron after deduction of associated expenses.

It was decided that Avdel was a CFC because United States persons, that is, the trust held by 95% of the shares. However, the Tax Court held that the Subpart F income would not be currently included in Textron's income under the CFC regime, because it did not hold the Avdel shares directly or through a foreign entity. Even though the income was not includable to Textron under the anti-avoidance rules, the Tax Court went on to hold that the voting trust was a 'grantor trust' under United States law, and therefore, the Subpart F income included in the income of the trust, as a US shareholder of the CFC, would flow through to Textron as grantor of the trust.

⁴⁸⁷ Foreign tax credits are granted to corporate taxpayers for the taxes paid by the CFC. Subsequent dividends are excluded from income. Unused CFC losses can be carried forward indefinitely. See Rohatgi, *op cit*, p. 392. See also Kral, K et al, "US CFC rules Cast a Wide Net", *International Tax Review*, February 1995.

C) Exemptions

The gross foreign base company income (excluding oil-related income) is subject to several exclusions. For instance, CFC rules do not apply in cases where either:

- The effective rate of foreign tax is 90% or more of the maximum United States federal corporate tax rate (currently 90% of 35% which is equal 31,5%);⁴⁸⁹ or
- If the Subpart F income does not exceed the lower of 5% of its total gross income and US\$ 1 million per year (*de minimus* rule).⁴⁹⁰ However, if the Subpart F income total exceeds 70% of its gross income, then the entire gross income (including otherwise exempt income) is deemed to be tainted (*de maximus* rule).⁴⁹¹

3.3.2 The taxation of foreign dividends

Foreign dividends are generally taxable in the United States. A foreign tax credit is available in respect of foreign taxes suffered. If the United States resident owns more than 10% of the shares in the foreign company, it will be entitled to a foreign tax credit in respect of both the underlying corporate taxes suffered and the withholding taxes suffered on its proportionate share of the profits from which the dividend is declared.

Foreign tax credits in the United States are subject to certain limitations and anti-avoidance rules. For instance, the credit for foreign taxes paid or deemed paid is limited to the United States tax on the foreign source portion of the worldwide income based on separate limitation or 'baskets'. Any unused tax credits may be carried back two years and forward five years.⁴⁹²

⁴⁸⁸ 117 TC 67.

⁴⁸⁹ See section 954(b)(4) of the Code.

⁴⁹⁰ See section 954(b)(3)(A) of the Code.

⁴⁹¹ See section 954(b)(3)(B) of the Code. See also Rohatgi, *op cit*, p. 392.

Concluding remarks

The analysis of the concept of residence for income tax purposes in this part of the research has mainly highlighted the point that many jurisdictions are using or emphasising different formal or subjective criteria, no matter how incoherent and ineffective they may be, in their definition of residence for tax purposes, and would leave the treaty law the task of resolving overlapping taxation which may result from such domestic taxation.

As this study shows in relation to particular countries considered, the South African tax system has become more uniform, by adopting a single denomination of residence (based on two factors) for individuals. However, the problem remains in relation to the application of ordinary residence, in which reliance on the existing case law has not eliminated the confusion created by the necessity to infer intent in determining the 'real home' in a particular case.

Furthermore, the physical presence test relies heavily on classification principles of mathematics. This is similar to some extent to the 'substantial presence' test adopted in the United States as one of the criteria for the determination of the individual's residence.

On the other hand, the scope of residence in the United Kingdom tax law is extremely wide probably because it has been fragmented into different classes and application. In many ways, the United Kingdom tax system has become impractical, especially in the light of the growth of multinational companies and cross-border movement. Grosvenor states that with regard to individuals, taking into consideration the vast range of people who work and visit the United Kingdom, a single residency principle may simplify calculations.⁴⁹³

⁴⁹² See Rohatgi, *op cit*, p. 333.

⁴⁹³ See Grosvenor, R, "A Discussion on the Concept and Significance of Residence for Individuals, Partnerships, Companies and Trusts for Tax Purposes" in www.jumper.demon.co.uk/rev2htm

With regard to the residence of legal entities, the analysis throughout this research has shown that it is justifiable for jurisdictions (including South Africa and the United Kingdom) to adopt multiple tests for ascertaining their residence for tax purposes.

Although the exclusive use of the place of incorporation test such as in the United States for income tax purposes has the merit of providing certainty and predictability for corporate taxpayers, it is however arbitrary, mechanistic and unrelated to economic reality.⁴⁹⁴ This test is subject to abuse and therefore largely within the control and manipulation of the taxpayer. Prebble argues that the place of incorporation test is even more formalistic than a rule that says that people remain forever resident for fiscal purposes where they are born.⁴⁹⁵

In South Africa, the understanding of the place of effective management is now better understood under the Interpretation Note.⁴⁹⁶ However, the ease with which the place of effective management, the central management and control and the place of incorporation tests can be manipulated without necessarily substantially altering the way an entity conducts its business is still a matter of great concern. Thus, an approach to the definition of residence for legal entities is dependent on a shared acceptance by the international community.

Doernberg⁴⁹⁷ argues that if it were deemed desirable to change the definition of residence for legal entities for instance in the light of technological advances, one possibility would be to extend conventional residence tests to more closely consider the residence of participants (be it shareholders, directors or managers) in determining the residence of an entity, without completely forsaking the traditional tests.

While this approach may be effective in some cases, it may be unjustifiable to adopt a broad definition of residence of legal entities in terms of residence of investors.

⁴⁹⁴ See Arnold, *op cit*, p. 66; Vann, *op cit*, p. 733.

⁴⁹⁵ Prebble, J, "Ectopia, Tax Law and International Taxation", 1997, *British Tax Review*, no 3, p. 389.

⁴⁹⁶ See Interpretation Note no 6, dated 26 March 2002.

⁴⁹⁷ See Doernberg, R & Hinnekens, L, *Electronic Commerce and International Taxation*, 1999, p. 333.

Sandler⁴⁹⁸ comments that first, the tax net would be widened to include all foreign incorporated corporations including those that conduct legitimate business activities. Moreover, there would be practical problems with the enforcement of taxation of foreign companies. It may be difficult to gather the information necessary to determine their tax liability, and once determined, the collection of tax would be difficult unless the company voluntarily complied or had assets in the jurisdiction that imposed the tax.

This part of the research has also focused on the tax implications derived from the application of the residence tax system. In the jurisdictions studied, that are South Africa, United Kingdom and the United States, it has been shown that specific anti-avoidance measures have been implemented in order to prevent resident taxpayers from deferring tax on foreign source income. It is argued that in the absence of international cooperation, countries must preserve the integrity of their income tax systems through unilateral actions.

With the increasing mobility of capital comes the increasing ability of residents of a country to avoid its income tax provisions. To counter this, the countries considered have implemented anti-avoidance measures such as the controlled foreign entity (CFE) rules to restrict the use of low tax regimes by residents. Such measure is generally designed to preserve equity within a domestic tax regime in much the same manner as transfer pricing provisions.

As this research has shown, the CFE rules for all countries share one common feature, which is the taxing mechanism. Thus, in all CFE rules, certain income of certain foreign corporations is taxable to the resident shareholders of such corporations as the income is earned without any need for the income to be distributed. In addition, be it in South Africa, United Kingdom or in the United States, the application of the CFE rules is limited to foreign corporations that are controlled by residents or in which residents own a substantial interest. Accordingly, when the income of the CFE is not taxed because of

⁴⁹⁸ See Sandler, D, *Tax Treaties and Controlled Foreign Corporation Legislation*, 1998, 2ed, p. 4.

the application of some kind of relief, it is finally subject to tax in the residence country when repatriated in the form of foreign dividends.

This study shows that the scope of the operation of the CFE rules is limited depending on the jurisdiction in question, to various forms of passive, mobile income and perceived abuses of certain related-company transactions. On the other hand, there may also be an exemption where the CFE is engaged in 'legitimate' location specific business activities in the tax haven.

With the implementation of the CFE rules in South Africa, the tax laws have become too complex for companies with foreign affiliates to argue for exemption, because of for instance, the complex provisions of the law dealing with the definition of business establishment in section 9D. On the other hand, it is argued that the South African CFE rules applicable in section 9D follow international norms favouring a balanced approach between pure anti-deferral regime and international competitiveness. Thus, section 9D achieves this balance by favouring international competitiveness (that is exemption) where the income stems from active operation. Anti-deferral (that is immediate taxation) applies where the income stems from passive investments or from transactions that meet objective criteria with a high tax avoidance risk.⁴⁹⁹

⁴⁹⁹ See Engel, *op cit*, p. 2.

Part IV: A comparative analysis of the application of source rules

Introduction

This part of the research intends to examine the application of the source principle of taxation as derived from the judicial tests, as well as the effect of source rules on the taxation of the taxpayer's income from South African and Hong Kong perspectives.

Before the introduction of the worldwide basis of taxation in South Africa, the definition of 'gross income' as it then was, did not distinguish between residents and non-residents.¹ In most cases, taxpayers resident and non-resident in South Africa were liable to tax only on receipts and accruals from within or deemed to be within South Africa. With the introduction of the residence based tax system, taxpayers who are resident as defined in the amendment to section 1 of the Act, are liable to be taxed in South Africa on their worldwide income. Taxpayers who are non-residents are liable to be taxed only on their receipts and accruals from sources within or deemed to be within South Africa. The amendment was made to the definition of gross income by inserting section 2(c) of the Revenue Laws Amendment Act 59 of 2000, which reads as follows in relation to non-residents:

'...[T]he total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic during the year or period of assessment, excluding receipts and accruals of a capital nature...'²

From a South African perspective, the issue of source is no longer relevant in the case of residents, because as indicated above, they are now taxable on their worldwide income. However, it may still be relevant to South African residents who conduct offshore trade and sustain losses therefrom. This is because section 20 of the Act, which allows the set-off of losses against income, does not allow the set-off of a loss arising from carrying on a trade outside South Africa against the income arising from a trade in the Republic.

¹ Prior to the introduction of the residence tax system in South Africa, 'gross income' was defined in section 1 of the Act in relation to any year of assessment, in the case of any person, as the total amount in cash or otherwise, received or accrued to a person from a source within or deemed to be within the Republic, excluding amounts of a capital nature.

With regard to non-residents who are now subject to tax on a source basis, the discussion of the source principle is still of particular importance. The relevance of the source principle is also recognised in the context of double tax agreements entered into by South Africa with other countries. Thus, in resolving tax conflicts, treaties often use the source of income as the basis for the provisions contained in the treaty. The application of the provisions of a double tax agreement therefore often requires the identification of the source of income.³

The objective of this part of the research is to study selected actual and deemed source provisions that are still applicable to non-residents. In doing so, it is important to compare the application of source rules in South African income tax law with jurisdictions based exclusively on a source system such as Hong Kong, where the case law development in either of the countries generates a great deal of interest in the other.

A) The source principle

Definition

The source principle of taxation is an enigmatic concept. There is no universal definition or understanding of the meaning of source. This is mostly due to the fact that different jurisdictions provide different criteria in their tax laws for determining domestic source income. It has even been argued in some jurisdictions that the source principle is not a legal concept, but something which a practical man would regard as a real source of income.⁴

Different court jurisdictions have been approached with the issue of finding a proper meaning for source of income. In South Africa, for example, the difficulty in ascertaining a clear definition of source was exemplified in the leading case of *CIR v*

² See para (ii) of the gross income definition in section 1 of the Act.

³ See Huxham, K & Haupt, P, *Notes on South African Income Tax*, 2002, 21ed, p. 13.

⁴ See the judgment of Lord Atkin in *Rhodesia Metals Ltd (in liquidation) v COT*, (1940) AD 432, 11 SATC 244, where the learned judge laid down the authority applied in the South African context that the source of income is a practical hard matter of fact to be determined according to the circumstances of a particular case.

*Lever Brothers and Unilever Ltd.*⁵ In this case, a company was incorporated and carried on business in the United Kingdom. As a result of a series of transactions and agreements between Lever Brothers, another English company and a Dutch company (Mavibel), the latter owed Lever Brothers an amount of R 22 million. In pursuance of another agreement, Overseas Holdings, a subsidiary company which Lever Brothers had formed specially for this purpose in South Africa, was substituted for Mavibel as the debtor in respect of the debt.

The Commissioner sought to tax the interest paid to the taxpayer by the South African company. The contention on behalf of the Commissioner was that the source of interest paid on a loan is the debt, the debt is located where the debtor resides, and accordingly, where the debtor is a South African company, the debt is located in South Africa and the interest is received from a South African source.⁶

Although in this particular case the court was confronted with determining the source of interest, Watermeyer CJ, after analysing some English decisions, recognised in his judgment that it is probably an impossible task to formulate a definition that would furnish a universal test for determining when an amount is received from a source within the Republic. As he went on to say:

‘When the question has to be decided whether or not money received by a taxpayer is “gross income” within the meaning of the definition referred to above, two problems arise which have not always been differentiated from one another in decided cases. The first problem is to determine what is the source from which it has been received and when that has been determined the second problem is to locate it in order to decide whether it is or is not within the Union.

The word “source” has several possible meanings. In this section, it is used figuratively, and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipt of money, another possible meaning is the quarter from which it is received. A series of decisions of this court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Acts elsewhere have dealt with meaning of the word “source” and the inference, which, I think, should be drawn from those decisions is that the source of receipts, received as income, is not the quarter from whence they come, but the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, *the quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may

⁵ (1946) AD 441; 14 SATC 441.

⁶ It will be seen in analysing the South African source of interest that the position of the commissioner was practical and more realistic.

take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.’⁷

Schreiner JA, though giving a dissenting judgment in this case, broadly agreed with Watermeyer CJ on the meaning of ‘source’. He said that, with a few exceptions, a taxpayer obtains income from others ‘(a) because he renders them services, or (b) because they have the use of his property, or (c) because he carries on...profit-producing activities’.⁸ In regard to (b), he said that ‘the property itself, or...its use, is treated as the source of the income.’⁹

He continued:

‘Where we are dealing with income which the taxpayer gets because someone is using his property and is prepared to pay him for its use, the taxpayer’s activities, whether past or present, are in practice disregarded in describing the source of his income. We say simply...that he derives his income from land, shares or loans. If perchance we speak of his deriving his income from rent, dividends or interest we are obviously speaking loosely, for these things are his income itself and not its source. What is important is that no one would ordinarily speak of the taxpayer deriving his income from the contract by which he leased the land or bought the shares or loaned the money.’¹⁰

Because the *Lever Brothers* case was based on a complex set of facts dealing with interest payment within a group of companies with an element of source in various jurisdictions concerned, it was quite difficult to ascertain the final assertion in this court decision. It would be dangerous to extract the general legal principles to be applied in determining the source of income from this particular case. In adopting the pragmatic approach in the *Lever Brothers* case, Davis AJA best illustrated the problem of locating the *ratio decidendi*, when he stated that:

‘I have little doubt that the practical man would say that the source of Lever’s income was the provision...of assets in America and the giving of credit in England. He might have difficulty in deciding whether the source was located in England where, *inter alia*, the contracts were made, where the trustee was situated, where the credit was given and where all payments had to be made, or whether it was in America where the assets were situated and where those assets earned the money out of which the interest was paid. But the one place he would not choose would be South Africa. I cannot conceive of the practical man saying that, though the Treasury had only agreed to the transaction going through at all on the express condition that not one penny piece of capital or

⁷ At 449/450.

⁸ At SATC 16.

⁹ At SATC 17.

¹⁰ *Ibid.*

interest should be paid from any funds in South Africa, and though that condition had been fully carried out and not one penny piece had come from South Africa, yet the Treasury was right in now claiming that the whole of the interest had come from the source in South Africa, although the Treasury and the practical man both knew that as 'a practical hard matter of fact' none of it had done so, and that indeed the debtor possessed no assets in South Africa from which it possibly could have come.'¹¹

In other words, Davis AJA did not find it necessary to identify one legal test which could be applied in all situations involving the source of income. From the *Lever Brothers* case, it is difficult to reasonably conclude that there was a sufficient link between the business of the taxpayer and South Africa to allow the conclusion that the interest derived from a South African source.¹²

The lesson here is that although the *Lever brothers* case has authoritatively laid down the principle that the 'source of income' means the 'originating cause' of the income, conflicting arguments advanced by judges in this case, show that the court has struggled with this notion. Therefore, in defining the source of income, each case must be considered in the light of its particular facts.

In other jurisdictions such as Hong Kong, the source concept is still the exclusive basis of taxation although controversial decisions result from its application.

The source principle has also been used in a more formalistic manner in common law countries where the place of conclusion of the contract has been considered as an important factor in determining the source rules. However, in their application, these countries still revert to some combination of activity and presence. For example, though not unanimous on the common definition of this concept, jurisdictions such as the United States have introduced this concept into their legislation.¹³ The United Kingdom defines the source concept through the use of the terms 'trading with' and 'trading in' the United Kingdom, while Canada looks at the place of conclusion of the

¹¹ At 464/465.

¹² See Meyerowitz, D "Source or Residence As The Basis For Taxation" *The Taxpayer*, January 1999, p. 5.

¹³ In the US for example, the production and selling profits may be split on cross-border transactions involving manufactured goods. The passage of title rule in the US applies to traded inventory and certain depreciable personal property. In other cases, the sales income is deemed to arise in the seller's country of residence, unless either: (i) substantial sales activity is carried out in the country where the sale is made; or (ii) the goods are sold for the use, consumption or disposition in the other country and

contract as an important indicator of source. On the other hand, continental European systems such as France or Switzerland have explicitly adopted the concept of source into their legislation to refer to an activity linked with some form of permanent establishment when it comes to the taxation of their business profits.¹⁴

1. The South African position

1.1 Judicial analysis for determining the source of income

Introduction

Notwithstanding the fundamental change in the South African tax legislation, the source of income is still the primary connecting factor used to justify the imposition of income tax on non-residents. Even so, the concept of source is still an elusive one. Generally, the South African income tax system still faces several problems in the determination of the source of income.

As recommended by the Katz Commission, a detailed codification of general source rules is not desirable. Instead, consideration must be given to the introduction of international principles that can be interpreted according to the circumstances of a particular case.¹⁵ Consequently, not only that there is no statutory definition of the words 'source within the Republic' as included in section 1 of the Act¹⁶, but also the courts have experienced considerable difficulty in formulating a clear definition for determining when an amount is received by or accrued from a source within the Republic.

at least a significant amount of activity is carried out through a fixed place of business in that country. See Rohatgi, R, *Basic International Taxation*, 2002, p. 155.

¹⁴ France specifically applies the source concept in the taxation of its resident companies. See *The Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (The Katz Commission), Department of Finance, March 1997, chapter 5, p. 14. The source rules regarding the business profits of various jurisdictions over the world were also analysed by Vogel, K, ("Worldwide vs Source taxation of income – A review and re-evaluation of arguments", 1988, Part I, *Intertax*, vol 9, p. 226) who submitted that, there was a fundamental distinction between the countries allocating business profits according to a single and comprehensive rule (without distinguishing between different types of business profits) and those splitting business profits and allocating them according to their character (for example profits deriving from manufacturing, sales or loans).

¹⁵ See The Katz Commission, *op cit*, p. 14.

As mentioned above, though the legislature has left it to the courts to determine the source of specific income where necessary, the courts have been reluctant in some decisions to attempt to define 'source'. Thus, in *Rhodesia Metals Ltd v COT*¹⁷, Atkin LJ held that, the Privy Council members did not find it necessary to formulate a definition which would afford a universal test of when an amount is 'received from a source within the Republic'. In *CIR v Epstein*,¹⁸ Schreiner JA stated that the legislature 'was probably aware of the difficulty of defining the phrase "source within the Union", and therefore did not define the concept.'

Many court decisions have presented different arguments regarding the determination of the source of income. The *locus classicus* of the test of source was given by Watermeyer CJ, in the case of *Lever Brothers and another v CIR*,¹⁹ who pointed out that, the determination of source involves two problems. As the learned judge stated:

'When the question has to be decided whether or not money received by a taxpayer is gross income...two problems arise which have not always been differentiated from one another in decided cases. The first problem is to determine what is source from which it has been received and when that has been determined, the second problem is to locate it in order to decide whether it is or is not within the Union.'

The *Lever Brothers case* thus formulated the approach to be followed in determining the 'source of income' by the application of a two-tier test.

First, it is necessary to establish the source *qua* originating cause (the reason why the income accrued to the taxpayer) and thereafter the location of the originating cause must be determined.

Another argument may be the one supported by Danziger, who stated in the analysis of the *Rhodesia Metals case* that the determination of the source of income depended firstly on the choice of an appropriate test for locating the source of income, and secondly, on the selection of one dominant factor out of several factors related to the earning of the income and which would enable the source to be determined.²⁰

¹⁶ See The Income Tax Act no 52 of 1962.

¹⁷ (1940) AD 432, at 436.

¹⁸ (1954) 3 SA (AD) 689, at 698; (1954) Taxpayer 147; 19 SATC 221.

¹⁹ *Op cit*, p. 449.

²⁰ See Danziger, E, *International Income Tax, The South African Perspective*, July 1999, p. 17/18.

In the South African context, there are no hard and fast rules as far as the ascertainment of the actual source of a given income is concerned. Because the determination of the source is a practical matter of facts, the surrounding circumstances of each case are therefore vitally important. Each case ought to be decided on its merits, though broad guidelines have been laid down in the cases.²¹

The question that arises is how have the courts applied the dual inquiry test (of origin and location of income) in determining the source? In other words, what are the kinds of tests, considerations, and factors that should be used according to the circumstances when ascertaining the source of income?

Two approaches have been developed. This research considers both of them. Firstly, the courts have laid down some guidelines or 'tests' to ascertain the source of income. Secondly, a 'rule' approach is followed, in terms of which income is categorised and rules for the formulation of various categories of income have been set out.

1.2 Judicial tests

1.2.1 The place where the capital is employed

This test derives from the principle that the source of income is located where the taxpayer's capital was employed. As Murray CJ stated in *M Ltd v COT*,²² every profit making scheme involves two factors: firstly, the decision of the taxpayer to embark on the scheme; and secondly, the employment of capital in pursuance of the scheme, which embraces the carrying into effect of the decision implicit in the first factor.²³

This test has been given considerable support in many cases. In *COT v William Dunn and Co Ltd*,²⁴ the taxpayer acted as the London agent of certain South African traders. The issue before the court was to determine the source of the commission and the interest earned by the agent. Seale J held that, the income was 'earned directly by an

²¹ See *Nathan v FCT*, (1918) 25 CLR 183 at 189; also found in Williams, R. C., *Income Tax in South Africa: Law and Practice*, 1994, p. 28.

²² (1958), 3 SA 18 (FC).

²³ Also found in Danziger, *op cit*, p. 90.

²⁴ (1918) AD 607.

employment of English capital in an English business',²⁵ and that 'the source of the gain rests entirely on the fact that English capital is employed or credit obtained in England.'²⁶

In the appellate division, Innes CJ formulated the test as follows:

'In order to ascertain where the capital was employed to earn the profits sought to be taxed, we must have regard to the source from which they were derived. And that source, in the present case, was the company's English business. It employed its own capital in carrying on its own business in England, and by doing so it earned the interest...'²⁷

This principle was followed in *Overseas Trust Corporation Ltd v CIR*,²⁸ where Innes J held that dividends paid on and the proceeds of the sale of shares of companies incorporated outside South Africa were from a South African source, because the taxpayer who received these amounts had employed its capital in South Africa in acquiring the shares.

These views were confirmed in other cases. In *CIR v Black*,²⁹ the court held that the income earned by a South African stockbroker on share transaction effected in the United Kingdom were from a United Kingdom source, on the basis that the broker's capital (cash and credit) had been used in the United Kingdom in purchasing the shares there. Moreover, in *Rhodesia Metals Ltd (in liquidation) v COT*,³⁰ it was held that the source of the proceeds of the disposal of Zimbabwean mineral rights was Zimbabwe where the rights were situated, based on the reasoning that the employment of the seller's capital in acquiring the rights was in Zimbabwe.

However, because it is often a difficult matter to determine where the capital was employed in a particular situation, the 'employment of capital' test has been subject to criticism. In the *Rhodesia Metals case*, Lord Atkin expressed doubt whether 'the productive use of capital' is a useful test in an inquiry as to source. He asked whether in this case, capital is productively employed in the place where it is used to purchase

²⁵ *Ibid*, at 609.

²⁶ *Ibid*, at 610.

²⁷ At 615.

²⁸ (1926) AD 446.

²⁹ (1957) 3 SA 536 (A).

³⁰ (1938) AD 282.

stock, or in the place where the company directors take their decisions as to how to employ the capital.³¹

These remarks seem to suggest that, because capital might be productively employed in more than one place, the test may mean no more than carrying on business in a particular place. Thus, the 'employment of capital' test may be of little practical assistance in determining the source of income. Williams puts it in the following way: 'It seems that the place where the taxpayer's capital was employed is arguably just another way of saying the place where the taxpayer carried on business.'³²

Another critical aspect of the 'employment of capital' test lies in the fact that, as Danziger³³ argues, courts have failed in their decisions where they have applied this test to define the term 'capital'. 'Capital' in these two cases has taken the form of value of mineral rights (*Rhodesian Metals* case), the use of cash and credit (*Black's* case) or the place where the work is done or the service rendered (ITC 432³⁴). Thus, the attribution of different meanings to 'capital' gives rise to different results in the application of this test.

1.2.2 The place where the business is carried on

The locality of the business was used together with the 'employment of capital' test in *Williams Dunn* case. Innes CJ found in that case that the employment of capital test was dependent on the location of the business in which the capital was employed.³⁵

This test was rejected in *Rhodesia Metals* case, where Atkin LJ held that 'income can quite plainly be derived from more than one source even where the source is business.'³⁶

The locality of the business test was considered in three judgments.

In *Lever Brothers* case, this test was equated with the location of activity test, where the court held that:

³¹ At 436.

³² *Op cit*, p. 28.

³³ *Op cit*, p. 92/93.

³⁴ (1939) 10 SATC 537.

³⁵ At 615.

‘Generally it may be said that a source of income is either (a) some personal activity of the taxpayer, or (b) the property over which he has rights, or (c) a combination of both.’³⁷

Schreiner noted in this case that in situation where this test was applied through a combination of purchase and sale of movables with the conclusion of numerous contracts over a period of time, the taxpayer was said to carry on business. Therefore, the frequency of this type of activity as well as references by the courts to the United Kingdom tax statutes in which the term ‘business’ frequently appeared had resulted in a tendency on the part of the courts to seek the taxpayer’s business and to treat it as the source of any income earned by him in connection with it.³⁸

In *CIR v Epstein*,³⁹ the locality of the business test was recognised in the dissenting judgment of Schreiner J A, who softened his opposition to this test by stating that: ‘[W]hat is very relevant and may be crucial is where he [the taxpayer] carries on the business from which the income in question is derived.’⁴⁰

The same judge in *Black’s case*, maintained the decision of the Special Court that the United Kingdom was the source of income earned by a stockbroker on sharedealing transaction carried out in the United Kingdom through a United Kingdom agent, on the grounds that the United Kingdom transaction constituted a sharedealing business in that country, though the taxpayer exercised control of the transaction in South Africa. As Schreiner ACJ stated,⁴¹ the situation in this particular case was different from one in which assets bought in one country were sold in another, nor was it a case in which the place where contracts were concluded different from the place where the parties perform their contractual obligation. In this case, there was a distinct business carried on in the United Kingdom, and everything connected with the transaction except authorisation or confirmation had been effected in the United Kingdom.

³⁶ At 789.

³⁷ At 17.

³⁸ At 18.

³⁹ (1954) 51 SA (AD) 689 (A).

⁴⁰ At 700.

⁴¹ At 536.

The locality of the business test was followed by several Zimbabwean court decisions where the tendency was to look to the business of the taxpayer as the source of his income.⁴²

In *CW v COT*, for instance, the court held that the share dealing activities of the taxpayer on the Johannesburg Stock Exchange was located in Zimbabwe, where he carried on his investment-dealing activities.⁴³

Thus, as articulated by Williams, if a taxpayer carries on business in the Republic, then any income which he derives from transaction in the course of that business is from a source within the Republic, irrespective of whether the work was actually done within or outside the Republic. This means that the source of such income is the business itself, and the source is located where the business is carried on. In the same context, if two separate businesses are carried on, one within the Republic and the other outside the Republic, then, as decided in the *Black's* case, the source of income from the latter business is outside the Republic.⁴⁴

1.2.3 The location of activities test

This test was formulated in *Lever Brothers' case*, where Watermeyer stated in the definition of source that it could also mean an activity in which the taxpayer engages. This test was criticised by Schreiner JA in the dissenting judgment of the above case, where he held that:

‘Since in ordinary speech we ignore the taxpayer’s activities in describing the source of...income, there is, in my view, no good reason for treating such activities as the source of such income in contemplation of law.’

The location of activities test was applied in *CIR v Epstein*,⁴⁵ in relation to the source of income earned by a South African resident member of an international partnership from the sale of movables outside South Africa.

The same principle was also applied in *Millin v CIR*,⁴⁶ concerning the source of an author’s royalties.

⁴² See *M Ltd v COT*, 1958 3 SA 18 (FC); *T' Co Ltd v COT*, 1966, 2 SA 16 SR; *ITC 1395*, 1984, 47 SATC 123; *CW v COT*, 1990, 2 SA 245 (ZH).

⁴³ *Op cit* at 245.

⁴⁴ See Williams, *op cit*, p. 28.

⁴⁵ (1954) 2 SA 689, (A).

The principle followed by this test is that, if income is produced through activities performed in the Republic, the source of that income is the activities, and that source is located where the activities were carried out, namely in the Republic.

However, as argued by Williams following the *Epstein's case*, if income is produced through activities of the taxpayer which were performed outside the Republic, the source of the income will nevertheless be located within the Republic if those activities were performed in the course of a business carried on by the taxpayer in the Republic.⁴⁷ Thus, the location of activities test is subordinate to the place where the business is carried on.

1.2.4 The practical man test

This test originated in the High Court decision in Australia in *Nathan v COT*,⁴⁸ where Isaacs J, in interpreting a statutory provision levying tax on income 'derived directly or indirectly by every taxpayer from sources within Australia', held that:

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

In South Africa, the Privy Council in *Rhodesia Metals Ltd (in liquidation) v COT*⁴⁹ approved this test, where Atkin LJ held that:

'Their Lordships incline to the view quoted with approval from Mr Ingram's work on South African Income Tax Law by De Villiers J in his dissenting judgment: "Source means not a legal concept, but something which a practical man would regard as a real source of income. The ascertaining of the actual source is a practical hard matter of fact."'

This test was considered in *Lever Brothers' case* where Watermeyer said that he had 'some difficulty in differentiating the reasoning of a practical man from that of theoretical lawyer'.⁵⁰ While Schreiner JA in his dissenting judgment found that, the effect of the transaction in the instant case 'does not appear to me to be a matter on

⁴⁶ (1928) AD 207.

⁴⁷ See Williams, *op cit*, p. 28/29.

⁴⁸ *Op cit* at 189.

⁴⁹ *Op cit* p. 774.

⁵⁰ At 457.

which the opinion of the ordinary practical business man would provide much assistance.’⁵¹

1.2.5 The place of contracting test

This test is related to the place at which the taxpayer concludes the contract which gives rise to the income in issue in order to establish the source of that income. This test was formulated by Wilson J in *Lovell and Christmas Ltd v COT*,⁵² where he stated that:

‘One rule is easily deductible from the decided cases. The trade or business in question in such cases ordinarily consists in making certain classes of contract and in carrying those contracts into operation with a view to profit; and the rule seems to be that where such contracts, forming as they do the essence of the business or trade, are habitually made, there a trade or business is carried on within the meaning of the Income Tax Acts, so as to render the profits liable to income tax...But the decisions do not seem to furnish authority for going further back, for the purpose of taxation, than the business from which profits are directly derived, and the contracts which form the essence of that business.’

This test was recognised by Watermeyer CJ in *Lever Brothers’ case*,⁵³ where he held that the obligation which gave rise to the income had been assumed pursuant to contract made outside South Africa, and because the taxpayer had concluded no contract in South Africa, it was the contract entered into by the taxpayer and its performance under that contract that gave rise to its right to receive the income.

Searle J relied on the place of contracting test in *COT v Williams Dunn and Co Ltd*,⁵⁴ where interest and commission earned by a United Kingdom agent were held to derive from sources outside South Africa, by reason of the United Kingdom contract.

This test was also followed by De Villiers J A in *Rhodesia Metals’ case*, who in his dissenting judgment favoured the place of contracting test over the place of employment of capital test.

Murray CJ in *‘M’ Ltd v COT*⁵⁵ also held that the United Kingdom sharedealing profits made by a Zimbabwean company was sourced in the United Kingdom, in support of

⁵¹ At 464.

⁵² (1908) AC 46.

⁵³ *Op cit*, at 441.

⁵⁴ *Op cit*, p. 607.

the idea that the company had effected the actual contracts of purchase and resale in London.

1.2.6 The place of exercise of control test

This test regards the place from which the taxpayer exercises control over transactions or activities that give rise to the income as the source of the income.

In *Overseas Trust Corporation Ltd v CIR*,⁵⁶ the court held that South Africa was the source of the proceeds of share sales effected in Germany by a South African company, on the ground that the place of exercise of the control of the share transaction was in South Africa.

Schreiner ACJ rejected the above argument in *CIR v Black*,⁵⁷ on the basis that the source was in the United Kingdom because the taxpayer had a separate sharedealing business in that country, though the authorisation and confirmation of transaction were from South Africa.

This test was also rejected in *'M' Ltd case*,⁵⁸ where Murray CJ in the argument refused to accept that the investigation and deliberation were the source of income, because various contributory factors were involved in the earning of the income.

Thus, it may be submitted that, the place of the exercise of control test is important, depending on the facts of a particular case and the extent to which the taxpayer personally controlled the transaction or operation that gives rise to the income.

1.2.7 Conclusion

In conclusion, it may be said through the evaluation of judicial decisions concerning the determination of source of income in South Africa, that it is still difficult to give the concept of source, a simple, logically ascertainable meaning.

The meaning of 'source' remains unclear, and it is questionable whether the tests adopted by the courts are of practical value. As Danziger argues, this is due to judicial guidelines being vague, contradictory and difficult to apply to specific sets of factual

⁵⁵ (1958) 3 SA 18 (FC) at 23.

⁵⁶ (1926) AD 444.

⁵⁷ At 536.

⁵⁸ At 23.

situations.⁵⁹ For instance, the selection of tests to determine the source of income varies from case to case, and without sufficient indication why a particular test has been chosen.

Moreover, the application of these judicial tests is not always harmonious, and most of them are subordinated to others. For example, the employment of capital test is confused with the place of business test. In the same light, the activity test was questioned by Schreiner JA who demonstrated its inapplicability in relation to investment income, while the 'practical man' approach totally negated other criteria, and suggested the adoption of an *ad hoc* policy based approach to be determined on a case-by-case basis.⁶⁰

Therefore, it may be argued that while considering the facts and circumstances of a particular case in applying these tests, they must be approached with great circumspection. A small difference in the facts and circumstances of two almost identical cases can result in different judgments when determining the source of income.

Due to the fact that there is no statutory definition of the source of income, the determination of source is even more complicated, when the taxpayer's activities that produce income are performed partly in the Republic and partly outside it. This is because as stated in *ITC 1491*,⁶¹ even for a single business, there may be different sources for different categories of income. This calls on the issue of multiple sources of income.

1.3 The problem of multiple sources.

Introduction

This issue brings into light, the considerable difficulty in determining the originating cause of the income as well as the location of the source of that income.

⁵⁹ *Op cit*, p. 87.

⁶⁰ *Ibid*, p. 21.

⁶¹ (1991) 53 SATC 115 at 127.

In fact, it is common that a number of factors could contribute to the acquisition of income. Therefore, it is possible that income has more than one originating cause or the originating cause is located in more than one country, some of which are within and others outside the Republic.

In this particular situation of composite or multiple sources, the determination of the source of income can be extremely difficult. This problem is still unresolved because the South African Income Tax Act gave no clear guidance as to how to address the issue.⁶² As Watermeyer CJ pointed out in *Lever Brothers case*,⁶³ he was not aware of any decision that clearly lays down what principle is applied in such a situation. Therefore, the surrounding circumstances of a particular case must be given consideration.

The question to be asked is, what is the position adopted in different court judgments? Is it possible to apportion the income in case of multiple locations of the source?

1.3.1 Identification of the dominant cause.

In situations where various contributory factors and a number of originating causes were operative, possibly in different places before the income is earned, the courts have in many instances circumvented this problem, by considering it unnecessary to assign a separate source to 'incidental' or 'subsidiary' items of income as decided in *COT v Shein*.⁶⁴

Consequently, where there is more than one originating cause; for example, when income is generated partly by an identifiable trade conducted in the Republic and partly by another identifiable business conducted outside the Republic (like in *Epstein's case*), then it is the duty of the court to ascertain which of the causes is the main or dominant one, and recognition must be given only to that main or dominant cause.

⁶² See Williams, *op cit*, p. 29.

⁶³ (1946) AD 441.

⁶⁴ (1958) (3) SA 14 (FC).

Many court decisions support this principle. In *CIR v Black*,⁶⁵ the Special court held that Black, a broker who bought and sold shares in Johannesburg, had a similar independent business in London and that the profits from the latter business did not originate from a source within the Republic though the business in London was controlled from Johannesburg by Black. The Appellate Division held here that the main, dominant, substantial source of the income was the employment of capital in London.

The same argument was followed *M Co Ltd v COT*⁶⁶ where Murray CJ after analysing the facts of the case, found the dominant factor and stated that:

‘The essential facts in the present case are that, the company had an idle capital in London, employed it to purchase securities with the object of profit on resale, effected actual contracts of purchase and resale in London and received its profit on resale there. Thus, the cardinal facts lead to the conclusion that, the *causa causans* of the earning of the profits was located in London, where the activities there conducted were properly characterised as the source *qua* originating cause.’

The term ‘main or substantial or real and basic cause of the accrual of income’ was also used in the case of *Transvaal Associated Hide and Skin Merchants (Pty) Ltd v COT*, where the company which was registered in the Republic purchased hides in Lobatsi where they were prepared for sale in the Republic and elsewhere. The contracts were concluded in the Republic and payment took place here. The court held that the source of income was in Botswana because the dominant factor was the purchase and curing of the hides and not the sale. In this case, Schreiner JA made the distinction in the determination of source of income between the factual causation (*causa causans*) and the legal causation (*causa sine qua non*) in his application of the dominant causa or higher degree of essentiality in the following remarks:

‘No doubt selling the cured hides is necessary to bring an income to hand, so that it might be said of the sales, as much as of the curing, that they are a *causa sine qua non* of the accrual of the income. But the place where a *causa sine qua non* exists cannot be decisive of the place of origin of the income, for there may be a number of *causa sine qua non*. One must look for something more – something like the dominance or the basicity used in the above mentioned list of expressions; or like what I venture to call the highest, or higher, degree of essentiality.’⁶⁷

⁶⁵ At 536.

⁶⁶ (1958) 3 SA 18 (FC).

⁶⁷ *Op cit*, at 219; see also the case of *Essential Sterolin Products (Pty) Ltd v CIR*, (1993) (4) SA 859 (A), 55 SATC 357 where the principle of identification of the dominant cause of income was given preference.

Some academic writers such as Meyerowitz⁶⁸ also support the view that the source of incidental income may be ignored for the purpose of determining the source of income, and it is only when it is impossible to ascertain the main, basic, dominant, substantial or real source of the income that the profits from each source must be treated independently.

The above view is also expressed by Danziger, who in following the *de minimis* rule applied in *Shein's case*, noted that income should not be apportioned where that part of it which is derived from a source in one country is insignificant in relation to the balance of the income allocable to a source in another country.⁶⁹

In fact in *Shein's case*, the courts held that, the 'related, trivial and incidental source of income' must be ignored on ascertaining the source and the application of the *de minimis* rule was phrased in the following terms:

'[W]hen a man is engaged to perform a certain work in a given country but has minor duties, which are purely subsidiary and incidental, that fall to be performed in another country, then, I do not think it is a practical approach to suggest that portion of his income has its source in that other country. When he is not paid separately for these extraneous duties, it becomes particularly artificial to try to allot portion of his earnings to them.'

It must be taken into consideration that the cases discussed above do not lay down a conclusive and universal test for the determination of the main source of income. This is because those cases do not specify clear criteria to differentiate the 'main' source from other possible sources. This raises another problem because once the dominant or main originating cause has been identified, it is necessary to locate that cause geographically.⁷⁰

Then it may be found that the originating cause is located in more than one jurisdiction. In other words, it is common that the sole originating cause or the main or dominant originating cause is located both within and outside South Africa.

For instance, the main originating cause can be found to be the services rendered by the taxpayer, and those services were rendered partly in South Africa and partly outside the country.

In those situations, what should be the approach to be adopted by the courts?

⁶⁸ See Meyerowitz, D, *Meyerowitz on Income Tax*, 2001/2002 edition, para. 7-5/7-6.

⁶⁹ *Op cit*, note 21, p. 112.

⁷⁰ See Broomberg, EB, & Kruger, D, *Tax strategy*, 1998, 3rd Ed, Butterworths (Durban), p. 164.

1.3.2 The apportionment issue

This issue deals with the situation where a single amount has a multiplicity of sources both within and outside the Republic. This leads to the question whether it is possible for an amount to be split up so that part of it is to be regarded as arising from a Republic source and the other part not. In other words, as stated by Emslie and Jooste,⁷¹ the issue is whether an apportionment is competent under the South African income tax law.

The courts have discussed the application of the principle of apportionment of source of income. In the judgment of the *Lever Brothers' case*, Watermeyer CJ left open the question of apportionment in these following comments:

‘Turning now to the problem of locating a source of income, it is obvious that the taxpayer’s activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries, and consequently, after the activities which are the source of the particular “gross income” have been identified the problem of locating them may present considerable difficulties, and it may be necessary to come to the conclusion that the “source” of a particular receipt is located partly in one country and partly in another....Such a state of affairs may lead to the conclusion that the whole of a receipt, or part of it, or none of it, is taxable as income from a source within the Union, according to the particular circumstances of the case, but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case.’⁷²

In *CIR v Epstein*, Schreiner JA recognised that, theoretically, apportionment could be possible in certain circumstances as he held: ‘Where work has been done in producing or improving raw material which is sold elsewhere by the same person, it might be possible to apportion...’⁷³

However, it was categorically held in *CIR v Black*⁷⁴ that, the apportionment of amounts as between different sources is not possible in South African income tax law and preference must be given to the dominant factor.

⁷¹ See Emslie TS, and Jooste R, “Causation and the Concomitant Issue of Apportionment with Reference to Gross Income in South African Income Tax Law”, 1989, SALJ, p. 302.

⁷² *Op cit*, at 451.

⁷³ *Op cit*, at 689.

⁷⁴ *Op cit*, at 536.

The principle of apportionment of income was favourably considered in the case of *SIR v Kirsch*,⁷⁵ where the meaning of 'right to acquire' in terms of section 8A of the Act was in issue. A South African company taxpayer having wholly-owned subsidiaries in Israel resolved in pursuance to a recommendation contained in a resolution of the company's board of directors, that 5000 shares be offered to the respondent. The respondent was the executive service director of the company and he was authorised to allot the said shares to the extent that the offer was accepted.

The said shares of the company were allotted to the respondent and during the 1972 tax year, he made a gain thereon of R12400 which the Secretary for Inland Revenue included in his taxable income for that year.

The Special Court found that as 95% of the work motivating such authorisation was done in Israel, only 5% of the gain in issue was taxable in the Republic.

On appeal, Coetzee J found that on the facts of the case, the respondent had established that he received the shares, not qua director, but for his work as a 'Service Director' in Israel; and consequently, that the gain in issue was (save for the 5% thereof found by the Special Court to be taxable) not income 'from a source within or deemed to be within the Republic' as used in the definition of 'gross income' in section 1 of the Act.

The judicial consideration of the apportionment principle in South Africa was again highlighted in the case of *CIR v Tuck*,⁷⁶ though based on different grounds (this case was dealing with income from capital or revenue nature). In the case under consideration, the appellant was the managing director of a pharmaceutical company who had received certain shares in terms of a management-incentive plan.

Corbett JA applied the *quid pro quo* test formulated in the *Lever Brothers* case, and approved the principle of apportionment where a receipt of an amount, having regard to its *quid pro quo* contained both an income element and an element of a capital nature.

The learned judge in expressing doubt concerning the appropriateness of applying, in cases dealing with receipt for income tax purposes, the principles of causation (that is, the distinction between factual causation or *conditio sine qua non* and legal

⁷⁵ (1978), 3 SA 93; 40 SATC 95.

⁷⁶ (1988) (3) SA 819 (A).

causation), as developed in the law of delict and in criminal law, held that the receipt of the shares was attributed partly to a restraint-on-trade condition and partly to his services rendered, and that as the restraint element was of a capital nature, an apportionment was appropriate.

In delivering the unanimous decision of the court, Corbett JA held that:

‘There is, so far as I am aware, no authority for this proposition in our case law. Nevertheless, ..., it seems to me that in a proper case apportionment provides a sensible and practical solution to the problem which arises when a taxpayer receives a single receipt and the *quid pro quo* contains two or more separate elements, one or more of which would characterise it as capital. It could hardly have been the intention of the legislature that in such circumstances the receipt be regarded wholly as an income receipt to the disadvantage of the taxpayer, or wholly as a capital receipt, to the detriment of the fiscus.’⁷⁷

As decided by the court, the warning sent by the *Tuck*'s judgment is that the application of the apportionment principle in the context of capital or revenue income is in conflict with the income tax law recognition that all receipts or accruals to the taxpayer must fall into one category and be classified as being either exclusively of a capital nature or totally of a revenue nature. The point is that the concept of apportionment (and this could be as a matter of principle also extended to the area of source) will only take place where there are two or more distinct legal *causae* which give rise to a receipt or accrual or in the language of the *Lever Brothers* case, where there are two or more originating causes or when the originating cause is located in more than one country.

It is surprising to notice that specifically in the area of source, the judicial decision concerning the application of apportionment is still very rigid. In the case of *Essential Sterolin Products (Pty) v CIR*,⁷⁸ the taxpayer manufactured a product in South Africa and patented this by entering into an agreement in West Germany for the sale of rights for which consideration was received. He argued in court that the patent had no value in South Africa as it could only be sold for medicinal properties which were only available in Germany. The court held that the income earned was from a non-South African source because the business operations were all non-South African being

⁷⁷ At 834 G-J.

⁷⁸ (1993) (4) SA 859, 55 SATC 357, 1994 Taxpayer 15.

carried out and entered into in West Germany together with the fact that the patent itself had no value in South Africa.

As Corbett CJ found in applying the factual connection between the work carried out and the income arising therefrom in order to determine the source:

‘[O]ne must have regard to the factual matrix underlying and giving rise to the agreement in terms of which the income became payable and then apply the basic principles.’⁷⁹

As the court observed in the above case in locating the originating cause, there might be in individual cases, a number of causal factors relevant to the ascertainment of source. And in those instances, it will be appropriate to weigh these factors in order to determine the dominant or main or substantial or real and basic cause of the receipt.⁸⁰

The consideration of the total matrix of facts in a case was confirmed in the recent Supreme Court of Appeal decision of *First National Bank of South Africa v C: SARS*,⁸¹ where Smalberger ADP held in his judgment in applying the principles enunciated in *the Essential Sterolin* case to the determination of the source of interest that all the important factors which cause the interest income to arise and constituting the dominant cause of the receipt of the interest should be considered. Thus, in determining the source of income and the location of that source, there is a need to have regard to the essence of the whole transaction that generates the income.

Consequently, it can be stated through that the logic for refusing to apply the principle of apportionment to the source cases as indicated in other aspects of tax law is difficult to discern. It appears that the *Essential Sterolin* and the *First National Bank* cases confirmed that the approach adopted by the courts to this problem seems to be as follows: where there is more than one originating cause, then it is the duty of the court to establish in which is the main or dominant cause, and recognition must be given only to that main or dominant cause.

⁷⁹ At 859.

⁸⁰ At 870.

⁸¹ Reportable case no 343/2000, delivered on 7 March 2002.

1.3.3 Academic view

The issue of apportionment under the South African income tax law has given rise to academic analysis. In that light, writers have adopted different approaches.

Silke⁸² for example, is of the view that with reference to the *Transvaal Associated* case, there is no provision in the South African tax law for the apportionment of income, and considering the statements of Schreiner JA in *Epstein's case*, it might therefore as he sees it, be practically difficult for the application of apportionment in the absence of statutory guidelines.⁸³ Silke however goes further to recognise that the courts have in some instances authorised the apportionment of lumpsum income in the cases of services rendered.⁸⁴

This is actually the logic followed by Broomberg and Kruger who are of the view that if the main originating cause is located in different countries, then an apportionment must be made.⁸⁵ Their argument is supported by cases where apportionment received for services rendered partly within and partly outside the country was made.⁸⁶ In those specific situations, Tredgold J justified the correctness of apportionment in *Shein's case*,⁸⁷ when he observed that: 'It is not questioned that it is legally correct to apportion income if it is in fact clear that it is derived from more than one source...'. To substantiate this view, Danziger pointed out with reference to *ITC 97*⁸⁸ that, apportionment has most frequently been applied by the courts in relation to income from the rendering of dependent services, where the employment contract requires the employee to render services in more than one country.⁸⁹

In another approach to this matter, it is submitted that the question of apportionment of income for the determination of source is still unresolved because in most of the

⁸² See *Silke on Income Tax*, (1995 Service 7), para 5-4.

⁸³ This view is also supported by Williams (*op cit*, p. 29) who believes that the Income Tax Act does not authorise the apportionment between different sources of income, except in cases of specific provisions, such as income in relation to shipping, air transport, submarine cables, films and insurance, or income in relation to business that extends beyond the republic, as it was stated in section 30 before its repeal.

⁸⁴ *Op cit*, para 5-5.

⁸⁵ *Op cit*, p. 164.

⁸⁶ See *ITC 1104*, 29 SATC 46; *ITC 837*, 21 SATC 413; *ITC 396*, 10 SATC 87.

⁸⁷ 22 SATC 12.

⁸⁸ (1927), 3 SATC 245.

⁸⁹ *Op cit*, p. 108.

cases before the courts, the apportionment is not raised by either of the parties to the issue. This view is supported by Emslie and Jooste⁹⁰ who through the analysis of the particular cases (*Transvaal Hide, Epstein and Lever Brothers* cases) argued that, though the courts are still looking for the dominant or substantial cause in determining the source, the use of these terms does not amount to a rejection of the principle of apportionment. They went further to point out that a taxpayer who wants an amount to be apportioned as between different sources would simply have to raise this contention as a ground of objection in an objection to an income tax assessment.⁹¹

Therefore, as remarked by the same authors in their conclusion, because there is nothing in the Act or in the case law to prevent a court from applying the principle of apportionment as to source when dealing with the issue, the apportionment of income as between different sources must not only be competent but mandatory.⁹²

The above view is actually in line with the criticism laid down by the Katz Commission Report, which stipulated that the adherence to an uncodified system of dominant source has contributed to an all-or-nothing approach that is subject to abuse.⁹³

The necessity to find a dominant cause offers considerable tax planning opportunities. For instance, as noted by Holland, it is enough to prove that the dominant cause of a particular income is not South Africa, and then the taxpayer can easily avoid tax in South Africa. Consequently, this opens up avenues for creative tax planning to avoid sourcing income in South Africa, and instead sourcing it in a more tax efficient jurisdiction.⁹⁴

As the Katz Commission viewed it, the current all-or-nothing system of dominant source favoured by the South African courts should be replaced by a greater capacity in the system to apportion source.⁹⁵

⁹⁰ *Op cit*, p. 305/306.

⁹¹ *Ibid*, at 307. Danziger (*op cit*, p.107/113), also raises the argument that the courts will grant apportionment when it is claimed by the taxpayer. As he puts it, the taxpayer then bears the onus of showing that the apportionment is justified in a particular case.

⁹² *Ibid*, at 308.

⁹³ *Op cit*, at 15.

⁹⁴ See Holland, KJ, "The Viability of a Residence Based Tax System in South Africa", 1996, LLM thesis (UCT), p. 13/14.

⁹⁵ *Op cit* at 11.

Furthermore, as it was stated in the *Tuck* case, difficulties may arise in ascertaining an acceptable basis of apportionment. However, as Corbett JA pointed out in that case in considering a fair and reasonable apportionment on a 50:50 basis, this problem was not insurmountable, and not confined to source.

The learned judge went on to conclude that:

‘Having regard to the inherent nature of the receipt and its origin in the plan, it is not possible to find an arithmetical basis for apportionment ..., but I do not think that this should constitute an insuperable obstacle.’⁹⁶

Foreign courts have also been confronted with the issue of determining the proper method of apportioning income from different sources. In the interesting Zimbabwean case of *ITC 1104*,⁹⁷ the issue before the court was to decide whether section 9(1)(d) (as it then was in the South African context) which provided that amount received or accrued to a taxpayer by virtue of any service rendered or work done by him in carrying on in the country of any trade, irrespective of the status of the payer or the place of payment could apply, where a skindiver, as the facts revealed, had spent 323 hours and 34 minutes diving under the water on the Zambian side of the Kariba dam, and 310 hours and 6 minutes blowing bubbles on the Zimbabwean side of the dam wall.

The Commissioner argued that the whole of the remuneration that was paid to the diver was taxable in Zimbabwe, because, apparently, the diver kept his snorkel and flippers in a shack at the back of his girlfriend’s house in Bulawayo. The Commissioner stipulated that the diver’s trade was thus located in Zimbabwe.

The court rejected the Commissioner’s submission on the point that the diving on the Zambian side of the Kariba dam-wall was not linked to any Zimbabwean trade carried on by the taxpayer, and therefore the deeming provision of section 9(1)(d) was not applicable. However, the court considered the solomonic decision to split the income, insofar as the source was concerned, and it apportioned 48% as the element taxable in Zimbabwe.

Consequently, as applied in other aspects of tax, it is enough to say that once the taxpayer has established all the facts justifying the apportionment of income as

⁹⁶ At 834J-835A.

⁹⁷ (1967) 29 SATC 46.

between different sources, he may suggest his own apportionment and leave it to the court to make the apportionment that it deems fair and reasonable.

1.4 The source rules and the tax consequences

Introduction

Due to the complexity of the interpretation and application of judicial tests, another approach has been formulated as being more reliable for the determination of source of income. This approach which is known as the 'rule' approach, permits to determine the source of income through the nature of transaction that generates the income in question.⁹⁸ This rule is exercised by the formulation of the source of various categories of income.

The aim of the research here will be to analyse the tax consequences of different kinds of specific incomes that have their actual or deemed source within South Africa.

In that light, this section will first deal with the study of actual source of different kinds of income including among others the analysis of the selected source of active and passive income.

Judicial selections of appropriate tests to determine the actual source of income varies from case to case, and have proven at times to be contradictory and of limited practical value. Court principles for determining the true originating cause of income has in some cases tended to be vague and difficult to apply to specific factual situations.

In order to limit the scope for tax avoidance and to obviate uncertainty as to the source of income in borderline cases, the Income Tax Act, prior to the fundamental change of the tax system, included provisions mainly in section 9 which artificially in a number of instances, deemed certain amounts to be from a source within the Republic, irrespective of where the actual source was located.⁹⁹

⁹⁸ See Danziger, *op cit*, p. 87.

⁹⁹ With the introduction of the residence tax system in South Africa, most of the deeming source provisions have been repealed on the justification that they have become obsolete. The important subsections of section 9 dealing with the deeming source of income that have been repealed by section 7(a) of the Amendment Act 59 of 2000 are: section (1)(a) – contracts for the sale of goods concluded in

As previously mentioned, non-residents were taxed on South African source income in the past and would continue to be taxed on South African source income in the new tax system. Thus, this section will also focus on the analysis of specific deeming provisions that are relevant in the South African context as well as other crucial non-resident tax implications applicable in South Africa.¹⁰⁰

The study in this section will focus on the analysis of the above deeming provisions and their effect in particular kinds of income.

1.4.1 The actual source of income

1.4.1.1 The sale of goods

The analysis of the actual source of the sale of goods in the South African context will only cover the sale of movable property.

The analysis of the actual source of the sale of goods in the South African context will only cover the sale of movable property.

In this particular situation, the courts have never authoritatively laid down a general principle as to the source of income.¹⁰¹ However, important criteria can be considered including the place where the taxpayer's capital is employed and the carrying out of his trading activities. When these elements have occurred in the Republic, it has been held in many cases that the source of income was within the Republic.

For example, in *Transvaal Associated Hide and Skin Merchants v COT*,¹⁰² the taxpayer company had its head office in Johannesburg, where management and

South Africa; section (1)(b) – right to use in South Africa a patent, trademark, copyright, model pattern, plan, formula or process or property of a similar nature; section (1)(bA) – imparting of scientific, technical, industrial or commercial knowledge or information for use in South Africa; - section (1)(d) – services connected to a South African trade; section (1)(d)bis – services rendered during temporary absence of a South African ordinary resident on behalf of a South African employer.

¹⁰⁰ To limit the scope of this research, I will focus only on selected provisions dealing with the non-resident tax implications, though the Income Tax Act provides in some other instances that certain amounts are deemed to be from a source within the Republic, irrespective of whether such amounts are in fact received or accrued in the Republic. For example, recoupments of expenditure previously allowed as a deduction must be included in gross income, irrespective of the actual source, in terms of section 1, para (n) of the gross income definition. Other deeming source provisions that will not be analysed in this section includes sections 9(1)(cA), 9(1)(e), 9(1)(fA), and 9(1)(g).

¹⁰¹ See Williams, *op cit*, p. 37. Also analysed by Silke (*op cit*, 1997 service 12, para 5-15) referring to the remarks of Lord Atkin in *Rhodesia Metals Ltd (in Liquidation) v COT*, 1940 AD 432, 11 SATC 244.

¹⁰² 29 SATC 97.

control were exercised. It bought hides at abattoirs in Botswana, where the hides were salted and bound into bales, then dispatched from Botswana directly to customers in South Africa and overseas. It was found by Maisels JA that the dominant or main cause of the taxpayer's income in question was its activities (the curing process) in Botswana, and it was accordingly there that, the source of the income was located.

The elements of employment of capital and activity tests were considered in *Overseas Trust Corporation Ltd v CIR*,¹⁰³ where the taxpayer who carried on business in the Republic, made a profit on the sale of shares in Germany. Watermeyer J held that the source of income was the employment of the taxpayer's capital in the Republic because the shares were bought here (where the business was carried on) and the instruction to the taxpayer's agent in Germany to effect the sale had been sent from South Africa.

The 'activities' element was also found decisive in *CIR v Epstein*,¹⁰⁴ where Centlivres CJ held in the majority judgment that, in referring to the partnership existence between the taxpayer and the dealers in Argentina, it was nevertheless the taxpayer's activities in South Africa that gave rise to his share of the profits. And as all the activities of the taxpayer took place in South Africa, the profits were derived then from a source within South Africa.

It is also important to note that in determining the actual source of the sale of movable property, the other criteria of place of production, manufacture, or processing have also been taken into account in some cases. It is submitted that the source of such income will be located where the processes are carried on.¹⁰⁵

1.4.1.2 Sale of immovable property

The determination of source of income deriving from the sale of immovable property is also subject to controversy.¹⁰⁶

¹⁰³ *Op cit*, at 444.

¹⁰⁴ *Op cit*, p. 689. The facts of the case will be stated in the analysis of the actual source of partnership income.

¹⁰⁵ See Williams, *op cit*, p. 39.

¹⁰⁶ As analysed by Williams (*op cit*, p. 39), the decision in this context turns on the particular facts and it provides little illumination by way of general principles.

The source of income in this case is actually perceived to be the place where the capital that produces the income is employed. In other words, the source of such sale is the place where the property is situated.¹⁰⁷ Thus, by analogy, the source of income deriving from mining or farming is situated at the mine or farm respectively where the taxpayer's activities are exercised, including the productive employment of his capital.

The leading authority here is the *Rhodesia Metals case*,¹⁰⁸ where a company registered and resident in England had as its major asset certain immovable property situated in Rhodesia, namely certain registered tungsten mining claims. The sole business of the company was the purchase of these claims with a view to developing them and selling them at a profit. The company then profitably sold the whole of its undertaking, including these claims to another company also registered in England. The issue here was to decide whether the value of the claims in Rhodesia or the control of business in London was the source of income. In his judgment, Tindall JA held that, the dominant factor in the making of the profit was not the transaction in London but the value of the claims. Concurrently, Stratford CJ confirmed that:

‘On the facts, the profit was made not by the company’s organisation and connection in London but by the productive employment of its capital in Southern Rhodesia in acquiring and developing the claims situated there.’

1.4.1.3 The cross-border derivative transactions

In consideration of the significant number of derivative transactions such as interest rate swap or other interest rate options concluded between South African taxpayers and other foreign counterparties, it is of particular importance to determine the actual source of income of these transactions.

Though there is no decisive authority on the determination of source of income in this context, a number of court decisions have been held on the source of income derived from other cross-border transactions which are indicative of the approach likely to be

¹⁰⁷ See Danziger, *op cit*, p. 127.

¹⁰⁸ *Op cit*, at 282; see also *Davis v COT*, 1938, AD 301.

followed by the South African courts in dealing with the location of the source of payment of these transactions under consideration.¹⁰⁹

Thus, it emerges from the general principle that when a taxpayer enters into cross-border contracts in the course of his business, different factors may be considered in locating the source of income.

It is argued that the source of income may then either be the place where these cross-border derivative transactions were concluded,¹¹⁰ or it might also be the place where the taxpayer's activities in relation to those contracts are carried out, that is, the place where the contracts are negotiated, concluded and performed by the taxpayer. In other words, as Meyerowitz¹¹¹ put it:

'Where profits are derived from contracts, or the combination of contracts, which form the essence of the taxpayer's business, it may indeed be a workable test to look to the place where such contracts are "habitually" negotiated, namely to the ordinary place of business.'

The place of 'activity' test has been adopted in case law. So, in *ITC 36*,¹¹² the taxpayer company which carried on business in South Africa, received a payment from a Rhodesian mining company in consideration of the latter's use in Rhodesia of a patented process owned by the taxpayer. In determination of the source of income of the fee received by the taxpayer, the court held that it was from a South African source because it was derived from a contract entered into by the taxpayer in South Africa in connection with its South African business. The court based its judgment on the following point:

'It must be accepted as a principle clearly within the four corners of the Income Tax Act that the place where a company carried on its business and where it entered into contracts in connection with that business, where also it received the income resulting from those contracts, was the source of its income.'¹¹³

This decision was confirmed in the case of *ITC 313*,¹¹⁴ where the taxpayer in anticipation of the United Kingdom's departure from the gold standard, converted

¹⁰⁹ See Hutton, S, "The Taxation of Derivatives in South Africa", *The Taxpayer*, October 1998, vol 47, no 12, p. 188.

¹¹⁰ *Ibid*, p. 189.

¹¹¹ *Op cit*, para 7-15, referring to the dictum of the court in *Mount Morgan GM Co Ltd v C of I T*, 33 Commonwealth LR 76.

¹¹² 2 SATC 64.

¹¹³ At 65.

¹¹⁴ 8 SATC 157; see also *The Taxpayer*, *op cit*, p. 188.

some of his capital into gold coin. After the United Kingdom abandoned the gold standard, the taxpayer entered into forty-three transactions in terms of which he dispatched gold to England, sold it for sterling, transmitted the sterling to South Africa, reconverted it into gold and reshipped the gold to England, and made a substantial profit on these transactions due to profitable foreign exchange fluctuations. The court held that, as the taxpayer was resident in South Africa, the transactions were originated in each case in South Africa and the ultimate profit was derived by the taxpayer in South Africa, and therefore the taxpayer's profits were sourced in South Africa.

It appears from the above case law that the approach of the courts in determining the source of income derived from cross-border derivative transactions that form part of the taxpayer's business will ordinarily be the place where the taxpayer carries on its business. It thus follows that from these particular transactions, the place of conclusion of contract will not normally be the decisive factor. Consequently, it can be said that, if income is derived by a foreign counterparty from derivative transactions entered into with a South African taxpayer, the source of income from this transaction will not be South Africa. In the same light, income derived by a South African taxpayer from derivative transactions with foreign counterparties will invariably be sourced in South Africa.

1.4.1.4 Insurance transactions

In general, the important factor in determining the source of income derived by a taxpayer from an indemnity received under an insurance policy is the place where the contract of insurance was concluded, irrespective of the place of destruction or the loss of goods.¹¹⁵

This principle derived from the decision given in the leading cases. Thus, in *ITC 3*,¹¹⁶ the taxpayers were general merchants who had in the course of their business in South Africa insured certain goods in transit from Europe to Delagoa Bay. The goods were

¹¹⁵ See Meyerowitz, *op cit*, para 7-80; also analysed in *The Taxpayer, op cit*, p. 189.

¹¹⁶ 1 SATC 50.

destroyed by fire outside South Africa, and one of the issues to be decided by the court was the source of the insurance proceeds.

The court held that as the money was earned from a contract of insurance concluded in South Africa, and that money received by the taxpayer in South Africa, it was thus from a South African source. However, the courts also recognised in this case that the place where the taxpayer carries on his business might also be an important factor, though not decisive. The court actually noted that the taxpayer's insurance of the goods formed a necessary part of their business in South Africa and this could well have influenced it in locating the source of the proceeds.¹¹⁷

The place of 'conclusion of contract' test was followed in *ITC 81*,¹¹⁸ where the taxpayer which conducted its business operation offshore had insured certain of its produce in transit from its place of production outside South Africa to Europe in terms of a contract of insurance concluded in South Africa. The cargo was lost at sea and the issue was to determine the source of the proceeds from the insurance policy. The court held that the insurance of trading stock constituted a necessary part of the taxpayer's business and that, as the contract was concluded in the Union, the insurance proceeds then were from a South African source.

The reliance by the courts on the place of conclusion of an insurance contract as the source of the income has been subject to criticism. Thus, referring to the above case, it was argued that, the source of insurance proceeds might not necessarily be in South Africa where the contract was concluded, because it was entered into in the course of the taxpayer's business offshore, and thus, it would have been logical that, the insurance proceeds should have been sourced in the place where the taxpayer's business is conducted.¹¹⁹

In the same context, Meyerowitz argued that, the place of conclusion of the insurance contract is not a satisfactory test. And the better test would appear to be either the

¹¹⁷ At 51.

¹¹⁸ 3 SATC 136.

¹¹⁹ See *The Taxpayer*, *op cit*, p. 189.

place where the business of the insured is carried on or the supply of the money buying the policy.¹²⁰

1.4.1.5 Sale of securities

The rule applies in determining the real source of the sale of goods transaction also applies *mutatis mutandis* to the sale of securities (shares) transaction.

It is submitted that the determination of the source of income from the sale of shares is a question of facts to be decided according to the circumstances of a particular case. However, the general principle in this case is that where the taxpayer carries a distinct and separate business of dealing in shares outside the Republic, the source of such income is located outside the Republic, though the taxpayer may be carrying on a similar business in the Republic. This rule is subject to the proviso that the transaction carried out in the foreign country must not be so linked up with similar transaction in the Republic as to be an inherent part of it thereof.

The general rule is derived from different case judgments. In *Overseas Trust Corporation Ltd v CIR*,¹²¹ the taxpayer, a financial and investment company carrying on business in the Republic by purchasing and selling shares and other securities, sold certain shares through brokers in Germany. The brokers were instructed from Cape Town to find buyers at a certain price and the scrip being forwarded from Cape Town in fulfilment of the sales effected. The court held that the taxpayer had acquired the shares in the Republic where its capital was employed, that it did not carry on business in Germany, and that the transaction was controlled throughout from the Republic. So, the broker employed in Germany was merely its agent executing its instruction and the source of the profit was therefore in the Republic.

Solomon JA in giving his judgment held that:

‘Here again applying the test of where the capital was employed which earned the profit, it is clear that none was employed in Germany. The capital employed was that which the shares were bought which were afterwards sold in Germany. Had the company carried on part of its business in Germany by buying and selling shares there, the position would have been different. But it

¹²⁰ *Op cit*, para 7-80.

¹²¹ *Op cit*, p. 444.

carried on no business in Germany; it merely sent shares there to brokers to realize in accordance with instruction...¹²²

By contrast, in *CIR v Black*,¹²³ the taxpayer, a Johannesburg stockbroker, was associated in an arbitrage business with a London firm, which in addition, by arrangement, dealt in shares on the taxpayer's behalf in London. Though the transaction in London in many cases were effected only after discussion with the taxpayer, the London firm was however by arrangement entitled to deal in shares on the taxpayer's account without his authorization. The issue to be decided by the court was whether the profit derived by the taxpayer from the sharedealings in London was from a South African source. The court held that since 'the main, real dominant, substantial source of income' was the use of the taxpayer's capital in London and the making and executing of the contract there, the source of the profit was not in South Africa. The court based its judgment on the fact that since there was a distinct business of buying and selling shares in London, it was impossible to hold that the cause of the accrual of the profit was the control exercised by the taxpayer in Johannesburg.

In conclusion, it can be submitted through the analysis of the above cases that the source of profit on a particular transaction of a sharedealing business is the business carried on, provided that the transaction is part and parcel of that business. Where a taxpayer has idle capital in a foreign country which he employs there to purchase shares with a view to making a profit, the ultimate profit should be from a source outside the Republic if the activities constitute a separate business there.¹²⁴

1.4.1.6 Dividends

Although most of the South African source dividends are no longer subject to normal tax, the analysis of the source of dividends is still material. The significance of the source of dividends is related first, to the determination of the source of this form of income in terms of the taxation of foreign dividends; that is, dividends deriving from

¹²² At 458.

¹²³ *Op cit*, at 536; see also *M Ltd v COT*, 1958 (SR) (3) SA 18 (SA), 22 SATC 27.

¹²⁴ See *T' Co Ltd v COT* (1966) (2) SA 16, 28 SATC 67; and most recent cases of *ITC 1395* (1984) 47 SATC 123; *CW v COT* (1990) (2) SA (ZH), 50 SATC 137 at 144.

distributions to South African resident shareholders by non-resident companies.¹²⁵ Secondly, the source of dividends is also of consequence in respect of secondary tax on companies (STC).¹²⁶

With regard to the determination of source, the general principle as originated from cases in *Boyd v CIR*¹²⁷ and *Lamb v CIR*,¹²⁸ is that, the actual source of income from dividends is the share giving rise to the dividends and the shares are situated where they are registered, which means where they can be effectively dealt with, irrespective of the source from which the company derives its profits.

As analysed by Williams,¹²⁹ the rationale for the adoption of this principle is twofold: Firstly, dividends are income that derives from property in the form of shares, and because the share register is evidence of title to shares, the property is located where the register is located.

Secondly, once the dividends are declared, they become a debt owed by a company resident in the Republic.

The leading case in this connection is *Boyd v CIR*,¹³⁰ where the taxpayer received dividends on shares in the Consolidated Diamond Mines of South West Africa Ltd, which was a public company within the meaning of the Income Tax Act. The company was incorporated in South Africa and had its registered office and Head Office in Kimberley where its kept its share register, the central management and control of company was exercised and all the dividends were declared by the directors of the company. The company derived its income mainly from its diamond mining operation in South West Africa, but a portion of its income was derived from

¹²⁵ Dividends fall into gross income definition in terms of para (k) of section 1 of the Income Tax Act, as amended by the Taxation Laws Amendment Act, 30 of 2000, effective from 23 February 2000, and by section 2(e) of the Act 59 of 2000. While section 10(1)(k) (i) generally exempts (except in the case of certain unit trust arrangements) domestic source dividends, foreign dividends are still taxed in South Africa in terms of section 9E of the Act. Previously, foreign dividends were essentially dividends paid by a company out of profits derived from a source outside South Africa. However, in respect of dividends declared on or after 1 January 2001, the definition of foreign dividends changed to refer to dividends received by or accrued to a South African resident from a company which is a foreign entity. See the analysis of foreign dividends tax implications in Part III, p. ...

¹²⁶ See sections 64B and 64C read together with section 9E of the Act.

¹²⁷ (1951) (3) SA 525 (A), 17 SATC 366.

¹²⁸ (1955) (1) SA 270 (A), 20 SATC 1.

¹²⁹ *Op cit*, p. 36.

¹³⁰ *Op cit*, p. 525.

investments in South Africa. The court held that the source of the whole of the dividend income was South Africa.

Thus, it follows from this judgment that the source of dividend accruing to a shareholder is not necessarily the same as the source of the income of the company out of which the dividend was declared. By virtue of the South African Company law legislation,¹³¹ all companies are compelled to keep their register of shareholders in the Republic, and consequently, the shares of all such companies would be regarded legally as being registered in the Republic.

Another issue is to determine the source of dividend received from a company whose principal register is kept in the Republic, but the shares in question are registered in a branch register in a foreign country.

This matter was considered in the *Lamb's case*, where it was held that, a dividend received from Nchanga Consolidated Copper Mines Ltd, a company incorporated in England, with its central management and control in Northern Rhodesia, was from a source in England, notwithstanding the registration of the taxpayer's shares on which the dividend was received in the Johannesburg branch register of the company and not in the principal register in England.

The principle laid down from this case is that the location of the source of dividend is not where the shares of the company are registered at any particular date, but where the shares of the company are generally registrable. In other words, where there is more than one share register, the location of the principal share register of the company will prevail.¹³²

Thus, in South Africa, section 108(1) of the Companies Act provides that a branch register is deemed to be part of the principal register.

¹³¹ Act 61 of 1973

¹³² See notes by Emslie, TS, Davis, D, and Hutton, SJ, *Income Tax, cases and materials*, 1995, 2 ed, p. 147.

1.4.1.7 Partnership activities

In South Africa, a partnership does not possess a legal personality and therefore is not taxable as such in its own right. This means that the partnership income is taxed in the hands of the partners in accordance with their respective share in such income determined by the terms of the partnership agreement.¹³³ Yet, the question remains as to how to determine the source of that share.

As a general rule, the partner share of income may derive from the employment of capital, as in the case of a dormant partner, or the profit may be the result of work done or service rendered.¹³⁴

The source of the partner's income was considered in the landmark case of *CIR v Epstein*,¹³⁵ where the taxpayer resident and carrying on business in South Africa, entered into a partnership agreement with an Argentinian company in terms of which the former would purchase asbestos from a supplier in South Africa and ship it to the latter, who would sell it in Argentina. Any profit then so derived, was divided equally between the partners. The issue before the court was to decide about the location the source of income of the South African partner.

Centlivres CJ in giving the majority judgment laid down the principle that income derived from carrying on of a partnership business has its source in the respective business activities of the partners. In other words, where the partnership members carry on their business activities in different countries, the income of the partnership is derived from different sources and the partner carrying on his business activities in the Republic has the source of his income from partnership within the Republic, received or accrued as the *quid pro quo* for the services rendered to the partnership in the Republic. At the mean time, the other partners carrying out their activities outside the Republic have the source of their income in their foreign countries. Thus, the court in this case disregarded entirely the whole trading operation and looked only into Epstein's share of profits of the partnership and held that, the source of Epstein's income was in South Africa.

¹³³ See Williams, *op cit*, p. 42.

¹³⁴ See Meyerowitz, *op cit*, para 7-62.

¹³⁵ *Op cit*, p. 689.

The logic of the above principle is dubious. It offers the taxpayers scope for tax planning with regard to the question of source and it is difficult to reconcile with the fundamental principles of the partnership law.

The above proposition ignores, as Williams puts it,¹³⁶ the fact that in the partnership, partners carry on business for their joint benefit and each partner has the right to a share in all partnership profits. Then, the partnership income that has its source outside the Republic retains its character as such when it is distributed to the individual partners. If Epstein's half-share of the profits were to be considered as being derived directly from the entire trading operation, or if the court has approached the source in this case by looking at the taxpayer's overall business rather than at a particular profit producing transaction, it would have been possible that different result might have occurred.¹³⁷ The source of this income would have been found to be either in South Africa or in Argentina, depending on the argument about the identification of the dominant originating cause.

The better view in order to determine the source of the partnership income is the one considered by Schreiner JA who held in the minority judgement that:

‘Since a business may be carried on through partners or other agents, the place where the taxpayer's income originates is not where he personally exerts himself, assuming that he does so, but where the business profits are realised.’

Income accrues to all partners jointly, based on the concept that partners are one another's agents and that they take responsibility or risk in all territories where the partnership does business. Therefore, each partner shares in multiple source income of the partnership in the ratio of his or her profit shares to one another.

This approach has been given legal approval in view of section 24H(2) of the Income Tax Act¹³⁸ which states that:

‘Where any trade or business is carried on in a partnership, each member of such partnership shall... be deemed for the purposes of this Act to be carrying on such trade or business.’

¹³⁶ *Op cit*, p. 43.

¹³⁷ See Broomberg and Kruger, *op cit*, p. 20; see also *The Taxpayer, op cit*, p. 7.

¹³⁸ Inserted by section 21 of the Act 90 of 1988.

This provision has in some way given legal personality recognition to the partnership for income tax purposes by stipulating as noted by Emslie¹³⁹ that the business activities of a partnership must be viewed as if the partnership was a separate entity, and each partner will be then considered to be carrying on the business that is carried on by the partnership.

This unorthodox legal recognition accorded to the partnership by section 24H(2) tends to reject the argument that the choice of the parties to the contract can substantially affect the source of income to be derived from the contract. In other words, the implementation of section 24H(2) tends to confirm that it would indeed be anomalous for the source of business projects to vary according to whether that business was carried on by a partnership or by for instance a company.

If it is assumed however that these trading activities (in *Epstein's* case) had been conducted through the medium of a company, it is most likely that the company (taking into account its entire trading operation) would not have been taxed on its profits in the Republic, because the source of the trading income would almost certainly have been in Argentina.¹⁴⁰

1.4.1.8 Employment and services rendered

The general principle in the South African context with regard to the actual source of income from employment and other services rendered¹⁴¹ is that the service rendered itself constitutes the source of the income, irrespective of the place where the contract is concluded or the remuneration paid, and regardless of whether such service is mental or physical, or whether it is rendered or performed in person or through the agency of another. Thus, the source of income of these services is located at the place where the services are rendered.

¹³⁹ See Emslie, Davis, and Hutton, *op cit*, p. 137.

¹⁴⁰ Considering the principles set out in the *Transvaal Hide and Skin Merchants* case, as regards income from buying and selling of commodities, it is clear that by the application of section 24H(2) on the facts of the *Epstein's* case, there was only one source of income in any event, that is, the sale of asbestos in Argentina. Thus, the services rendered by Epstein were irrelevant.

¹⁴¹ It is understood that these terms deal with labour and services as they include the exercise and exploitation of a person's skill, wit, intellect, personality, and connection as well as manual labour.

This general rule for the determination of source of income of this nature was given consideration in the correct summary of Herbstein J in *ITC 837*,¹⁴² when he stated that:

‘...in the case of personal services the originating cause, i.e the source of the income resulting therefrom is the work which the taxpayer does to earn it...and the location of the source is the place where the services are rendered.’

However, the application of the above rule depends on the circumstances of a particular case and mostly on the type of service or work done.

a) The director’s fees

A director of company acting in his capacity as such is deemed to render the services at the head office of the company where the board of directors ordinarily meets to transact the business of the company. Thus, if the head office is situated in the Republic, the fees are derived from a South African source irrespective of the place where the director resides or where he performs the services.¹⁴³

So, a director who is resident outside the Republic would therefore be liable to South African tax on his fees if the board of directors meets in the Republic. If he shares his fees with an alternate director in the Republic, he will be subject to tax only on that portion accruing to him. Similarly, if a director is resident in the Republic and receives a fee from a company with its head office, where the board ordinarily transacts its business outside the Republic, the income is from a non-South African source.¹⁴⁴

However, it is sometimes common that the same person may hold different positions resulting in him acting as the director and employee of the same company at the same time.¹⁴⁵ In this case, a clear distinction must be made between the director’s fees and the income for services rendered in a capacity other than that of a director. For

¹⁴² 21 SATC 413.

¹⁴³ See *ITC 77* (1927) 3 SATC 72; *ITC 106* (1927) 3 SATC 336; *ITC 235* (1932) 6 SATC 262; *ITC 250* (1932) 7 SATC 46.

¹⁴⁴ See Silke, *op cit*, para 5-8.

¹⁴⁵ Amendments to the Fourth Schedule to the Income Tax Act with the inclusion of the new paragraph 11C have been enacted in order to cast the pay-as-you-earn (PAYE) net over private companies’ directors. Thus, with effect from 1 March 2002, the definition of employees now includes directors of a private company. They are currently subject to PAYE on their ‘deemed remuneration’ calculated in terms of formula as well as any actual remuneration paid or payable to them.

example, besides sitting on the board, a director may also be appointed to manage the day-to-day affairs of a company or involved in specific duties on a full-time basis (like assisting in buying or selling operations of the company). In the latter capacity, where the director holds a salaried appointment, the source of such income is located in the Republic if those services were rendered in the Republic.

This rule was considered in *ITC 235*,¹⁴⁶ where a managing director of a company located in the Republic performed his duties outside the Republic and was held liable to tax on both his director's fees and salary. It was held by the court with regard to the fees that the director's fees were derived as a result of being a director, and therefore had to be presumed to have been earned at the head office of the company located within the Republic. As regards his salary, the court decided that the director did not discharge the onus resting on him to prove that he was permanently transferred from the Republic and that the work done by him outside the Republic was independent of the operation of the company in the Republic.

Consequently, where a director establishes as a fact that he is employed not merely as director, but by virtue of his special skills or knowledge of the conditions prevailing in an overseas country, and he earns a fee specifically for such services rendered outside the Republic, such fee will thus be sourced outside the country.¹⁴⁷

b) Employees

As a general rule, the actual source of remuneration from employment is located at the place where the services are rendered.¹⁴⁸ It follows that the salary of an employee who is stationed outside the Republic to render services there on behalf of a South African employer is not taxable in the Republic, being from a source outside the

¹⁴⁶ *Op cit*, p. 262.

¹⁴⁷ See *ITC 266* (1932) 7 SATC 151. This rule also applies subject to the source of gains under section 8A of the Income Tax Act, which includes in a taxpayer's income the amount of any 'gain' made by him on the exercise, cession or release of a right to acquire a marketable security obtained by him as a director or ex-director of a company or in respect of services rendered or to be rendered by him as an employee to an employer.

¹⁴⁸ See *ITC 1104* (1967) 29 SATC 46.

Republic even if the contract of employment was concluded or the sale was payable in the Republic.¹⁴⁹

On the other hand, if a foreign employer sends his employee to the Republic to buy trading goods and the employee is stationed here for that purpose, the salary he receives is from a South African source by virtue of the services being rendered in South Africa, irrespective of the fact that, the employee is abroad or to whether or not the employee's salary is remitted to the Republic.¹⁵⁰

The principles in respect of actual source of income from employment were well illustrated by GJ Maritz in *ITC 77*¹⁵¹ by way of the following examples:

- An attorney whom practised in the Free State employed a clerk at a salary of £ 500. The source of that clerk's income will be the Union (South Africa), for his services were located there.
- An attorney who practised both in the Free State and in Basutoland employed a clerk to work in both businesses at a salary of £ 500; the locality of the services which earned the £ 500 would be partly in the Free State and partly in Basutoland. An allocation would have to be made probably on a time basis, of the £ 500, partly to a Union source and partly to a Basutoland source...
- An attorney who practised in the Free State near the Basutoland border employed a clerk at £ 500 per annum to serve him in his Free State business. The clerk, however, occasionally crossed the border to perform casual work for his employer in Basutoland. The locality of the services which earned the £ 500 would be Free State. The acts of service performed by the clerk in Basutoland were casual and accidental in their nature, and were not remunerated as such. If, however, the attorney remunerated him especially for the acts of service he performed in Basutoland, then the locality of the service which produced that

¹⁴⁹ See *ITC 182* (1930) 5 SATC 260. With the application of the residence tax system in South Africa, this is subject to whether or not the employee is a South African resident. See the analysis of the tax implications of South African residents' foreign employment income.

¹⁵⁰ See Silke, *op cit*, para 5-11. This rule is subject where applicable, to the double taxation agreements between South Africa and its trading partners, which may, provided that certain requirements are met, render income that has its source in the Republic in terms of this rule, exempt from tax.

¹⁵¹ (1927) 3 SATC 72.

special remuneration would be Basutoland, and the source of special remuneration would be Basutoland.

The conditions of the agreement in terms of which the employee performs his services is the most important factor in determining the place where the service was rendered or labour done. Thus, in *COT v Shein*,¹⁵² the taxpayer assumed the management of a store in the territory then known as Bechuanaland Protectorate. At first, the taxpayer resided at the store, but long before the year of assessment in issue, he moved to and lived permanently in Bulawayo, and employed a full-time storekeeper at his own expense to manage the shop in Bechuanaland.

The court held in considering the nature of the employment that a man may render services by accepting responsibility just as much as by manual or other work, and when he does so, he accepts responsibility at the place at which the business for which he accepts responsibility is being carried on, i.e, Bechuanaland. Therefore, as the court found it, the taxpayer was not liable for tax in Rhodesia.

In conclusion, in determining the actual source of income from employment, an apportionment is permissible where services are rendered partly within and partly outside the Republic, unless it can be proved that, the work done in a country other than that where the work is ordinarily done, or the services are ordinarily rendered, are merely subsidiary, incidental, casual or trivial and are not paid separately.¹⁵³

c) Professions

The determination of the actual source of professional services deals with independent personal services; that is, services that are rendered otherwise than in an employer-employee relationship. In this case particularly, the 'activity' test also applies in identifying the source of this kind of remuneration, which is submitted to be the place where the services are rendered. This was decided in *ITC 432*,¹⁵⁴ where the income earned by a United Kingdom company from the sale and installation of a lift in Zimbabwe was held not to be from a South African source, though the company had a

¹⁵² 22 SATC 12; see also *ITC 929* (1961) 24 SATC 331.

¹⁵³ See *ITC 266* (1932) 7 SATC 151.

¹⁵⁴ (1939) 10 SATC 437.

place of business in South Africa, was represented in South Africa by an agent for the sale of its products and had tendered for the installation in issue in South Africa.¹⁵⁵

In *ITC 134*,¹⁵⁶ a South African resident quantity surveyor contracted to prepare bills of quantities for a building in Kenya. He worked in Kenya for approximately six months investigating the requirements of the proposed building and thereafter, returned to South Africa to prepare the final bills of quantities. It was held that the source of the fees was South Africa where the taxpayer carried on his profession and drafted the final bills of quantities, and the investigation in Kenya held to be merely preparatory work. The fact that the fees earned were paid in Kenya was immaterial.¹⁵⁷

The above case can be compared with *CIR v Nell*,¹⁵⁸ where a South African consulting engineer who practised his profession in Johannesburg, went to Southern Rhodesia on different occasions to render certain services pertaining to his profession. He spent considerable time there in order to ascertain the requirements of the clients and to be able to advise them. Thereafter, he returned to the Republic and caused the draft plans to be prepared in his office at Johannesburg from the notes made in Rhodesia. It was found by the Appellate Division that it was impossible to interfere with the finding of the court *aquo* that the work of establishing the clients' requirements was an essential and basic part of the work which requires skill and experience and was usually attended to by the engineer himself, whereas the formulation of the draft plans from the engineer's notes was routine work entrusted to a relatively junior assistant.

Thus the income attributed to the services rendered outside South Africa was accordingly held to be a non-South African source.¹⁵⁹

¹⁵⁵ See also *ITC 1102* (1967) 29 SATC 28.

¹⁵⁶ (1928) 4 SATC 200

¹⁵⁷ See also *ITC 1104* (1967) 29 SATC 46.

¹⁵⁸ *Op cit*, at 774.

¹⁵⁹ The decision of the court was based on the absence of close link between the work done in Southern Rhodesia and the carrying on of trade by the engineer in South Africa in terms of the repealed section 9(1)(d) of the Act.

1.4.1.9 Interest

In determining the source of interest, the type of transaction that gives rise to the interest should be considered.

The 'employment of capital' test is used as a decisive factor in determining the originating cause of interest. This principle was followed in the early case of *COT v William Dunn & Co*,¹⁶⁰ where the taxpayer, a United Kingdom company, had purchased goods in the United Kingdom on behalf of South African companies. The taxpayer, which purchased the goods in its own name and paid for them itself and was reimbursed later by the South African companies, charged the companies interest on the balances owing by them from time to time. The court held that the interest resulted from 'an employment of English capital in an English business' because the funds used to purchase and shipped the goods to South Africa had neither been employed nor invested in South Africa.¹⁶¹ Consequently, the source of interest in this case was outside South Africa.¹⁶²

The determination of the source of interest was further considered in the landmark case of *CIR v Lever Brothers and another*.¹⁶³ A majority judgment of the Appellate Division held that, the interest paid by Overseas Holdings to Lever Brothers was not derived from a source within South Africa. Watermeyer CJ in his judgment laid down the principle that the originating cause of interest payable on a loan of money was not the debt but the services that the lender performs to the borrower, that is, the supply of credit in return for which the borrower pays him interest. He proposed the rule as follows:

'In the case of a loan of money the lender gives the money to the borrower, who in return incurs an obligation to repay the same amount of money at some future time and if the loan is one which bears interest, he also incurs an obligation to pay that interest. Though I use the words 'gives the money' this must not be taken literally as the usual way of making a loan. As a rule the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and this supply

¹⁶⁰ *Op cit*, at 607.

¹⁶¹ At 609.

¹⁶² This rule was also followed in *ITC 82 (1927 3 SATC 141)* where it was held in accordance with *Dunn's case* that, if capital were employed in the Republic by South African merchants for the payment of the purchase price of goods ordered by foreign principals, any interest so received would be from a South African source.

¹⁶³ (1946), *Op cit*, at 441; the facts of the case have been extensively analysed above (note 5).

of credit is the service which the lender performs to the borrower, in return for which the borrower pays him interest. Consequently, this provision of credit is the originating cause or source of the interest received by the lender. Although, colloquially, one speaks of a debt carrying interest, or interest on a debt, as though interest were a sort of growth sprouting from the debt, the language used means no more than that the borrower pays interest, if that is the agreement between borrower and lender, as consideration for the benefits allowed to him by the lender.¹⁶⁴

Consequently, the *Lever Brothers* case laid down the judicial authority that the source of interest on a loan of money is located neither where the agreement of loan is concluded, the borrower productively employs the funds, the interest is payable nor the debt is payable. Instead, the true source of interest is to be found where the funds are 'physically' made available to the debtor.

The *Lever Brothers* principle was again highlighted in the recent case of *First National Bank of South Africa Ltd v C: SARS*,¹⁶⁵ where the Supreme Court of Appeal found the issue to be a case of a 'source' of income within South Africa, as contemplated in the Act.¹⁶⁶

The issue revolved around the appellant's (taxpayer) international financing transaction, and the interest income it derived from it, by providing credit to its South African client who required the facility to finance its exports, imports and its working capital. In terms of its offshore business, the taxpayer had a facility to borrow funds from foreign banks interested in lending money to a South African bank. The international financing transactions in this case were triggered by a client's request for a foreign facility, after which the taxpayer would raise the facility by way of a loan from a foreign bank. The taxpayer would then make the facility available to the client by paying the amount into a foreign banking account operated by the client, or, if the amount was to be paid to the client in South Africa, by crediting the amount to its treasury account in the United States, which it frequently used for transactions of this kind. The Taxpayer would debit the client's account in South Africa in local currency. The client was debited with the interest the taxpayer was charged by the foreign bank, plus an added margin on the interest comprising the taxpayer's remuneration, plus a

¹⁶⁴ At 451.

¹⁶⁵ Reportable case no 343/2000, delivered on 7 March 2002.

¹⁶⁶ This refers to the Income Tax Act as it then before the amendment by Act 59 of 2000.

premium for the forward exchange rate to protect the client from adverse currency fluctuations.

The taxpayer's transactions were affected when the South African government declared a debt standstill in 1985, which prohibited banks from repaying obligations to foreign creditors. The taxpayer chose the option of continuing to use the foreign currency received pursuant to repayment by its clients of their debts and continue to lend such funds on the established basis.

The taxpayer's argument (upheld by the Special Court and disallowed by the Transvaal Provincial Division) on appeal by the Commissioner, was that the funds were always advanced and made payable offshore, usually in New York. All loans were repayable offshore both with regard to the principal and interest. The proceeds of such loan transactions were maintained offshore and utilised by the taxpayer for future transactions on the same basis as outlined.

On appeal by the First National Bank, the Supreme Court of Appeal confirmed the Transvaal Provincial Division's decision that apart from the fact that contractually the foreign currency was made available to the borrowing client in New York and had to be repaid there, all the other important factors which caused the interest income to arise (and which constituted the dominant cause of the receipt of the interest) had their origin in South Africa and flowed from the appellant's business activities and operations in the Republic. The narrow view taken by the appellant focuses only on where the funds were made available and had to be repaid. Thus, it overlooks the need to have regard to the essence of the whole transaction which generated the interest with a view to determining the location of its source. It was conceded on behalf of the appellant that had it borrowed foreign currency in New York, transferred it to South Africa and lent out the rand equivalent here, the source of the interest income generated by the loan would have been South Africa. There is no logical reason why the position should be any different because of the expedient of making the foreign currency available in New York to the client before transferring it to South Africa (and later back to New York) essentially using the same method. The substance of the

underlying income-generating transaction remains the same, even though the means used to achieve the same result may differ.¹⁶⁷

Thus, Smalberger ADP (with Harms, Streicher, Farlam and Brand JJA concurring) went on to conclude that in consideration of the totality of facts of the case, the appellant's reliance on the *Lever Brothers* decision was misplaced. The latter case did not provide authority for the narrow proposition advanced by the appellant. Accordingly, the facts of the *Lever Brothers* case differed materially from the *First National Bank* case. In any event, Smalberger's decision has the result of overriding the view that the *Lever Brothers* rule was the absolute authority for the proposition that the source of interest in the sense of originating cause is the loan or credit given and that its location is determined as being the place where the loan or credit is made available.

1.4.1.10 Rent

The determination of the source of rental income depends on the surrounding circumstances of a particular case. Some factors, though not conclusive have to be considered such as the place where the taxpayer's capital was employed in purchasing the leased property, the place where the taxpayer's business is carried on, the nature of the leased property whether movable or immovable and the duration of the lease.

These factors were laid down in the landmark case of *COT v British United Shoe Machinery (SA) (Pty) Ltd.*¹⁶⁸ The taxpayer was a company registered, managed and controlled in South Africa. It carried on business as a manufacturer and dealer in all kinds of machinery, appliances and tools used in the footwear industry. A large part of its business consisted in leasing machines in South Africa and Rhodesia. Once signed by the prospective lessees, the leases were all completed by the signature of the company in South Africa. The company had no branch office in Rhodesia and no canvassing for lease business was carried on in that territory. The issue to be decided was the location of the source of the Rhodesians rentals. The court held that it was the

¹⁶⁷ See the comments on the case in the April 2002, *The Taxpayer*, p. 72.

¹⁶⁸ *Op cit*, at 193.

use of the machines that produced the income and not the capital which was used to buy them.

The application of the above principle depends on the nature of the property let, the nature of the lessor's business and the duration of the lease. As the court stated in its *obiter*, different results as to the determination of the source of rental income may arise in the case of letting of smaller items of a relatively insignificant value for a more limited period, such as motor vehicles, typewriters and dictating machines. In this case, the source of rent would probably be the business of the lessor, rather the property let and the occasional use of property in another country would be ignored.

1.4.1.11 Royalties

Under South African income tax law, the true source of income derived from the exploitation of intangible property (in the form of patent rights, formulae, secret processes or similar items accruing to investors excluding the registration of patent rights) is in South Africa if the intangible property was created or developed in South Africa, irrespective of where the asset is used to generate royalties.

This principle was laid down in *Millin v CIR*,¹⁶⁹ where the author, Gertrude Millin, had derived royalties from a book which she had written in South Africa but which was published in England. The court held that she had exercised her wits, labour and intellect in South Africa in writing the book and in dealing with the publishers and consequently, the source of the royalties was located in South Africa.

However, the above principle does not apply when the royalties are derived by a person who is not the original author or inventor, but who had acquired the relevant rights from the author. The source of such income would then be derived not from the creative talent of the author, but depending on the circumstances of a particular case, either from the contract whereby such rights were acquired, or the business used to exploit such rights, or the capital employed in doing so, or the use of such rights,

¹⁶⁹ (1928) AD 207, 3 SATC 170.

following the analogy of the decision in *British United Shoe Machinery (SA) (Pty) Ltd case*.¹⁷⁰

As matter of principle, there is no difference between the letting of movable assets and the granting of right to use a trade mark and secret processes as decided in *ITC 1491*,¹⁷¹ where it was held that the exploitation in the United Kingdom of a patented process and know-how for resurfacing bathtubs gave rise to non-South African source income. The development of the process in South Africa was irrelevant because the property and the activities constituting the dominant cause that earned the income were situated in the United Kingdom.

1.4.1.12 Annuities

Conflicting court decisions lead to some uncertainty regarding the determination of the actual source of annuities. The general rule is that a contractual annuity, where a person agrees to pay another an annuity will be sourced in South Africa if the contract, which is the originating cause, is made in the Republic.

This principle was laid down in *obiter* by Centlivres CJ in *Boyd v CIR*,¹⁷² to the effect that:

‘If a resident of the Union whose sole source of income is South West Africa pays in terms of a contract made in the Union an annuity to another person, it seems to me that the source of that other person’s income is in the Union... It might be said that the ultimate source of the annuity is in South West Africa but I do not think that on a proper interpretation of the word “source” in the definition of “gross income” one is required to go back to the remote source...’

The leading authority in this case is *ITC 826*.¹⁷³ A widow taxpayer was entitled to an annuity payable out of the income of a trust created under the will of her late husband, or if the income of the trust proved insufficient, out of the capital of the trust. The assets of the trust comprised South African, Swaziland and Rhodesian assets, and during the year of assessment, income was derived from all three countries. The taxpayer was resident in the Republic, as also was her late husband during his

¹⁷⁰ (1964) (3) SA 193 (FC), 26 SATC 141; See also *ITC 1491* (1990) 53 SATC 115 at 123/124.

¹⁷¹ (1990) 53 SATC 115.

¹⁷² *Op cit*, at 377.

¹⁷³ (1956) 21 SATC 189.

lifetime. The last will of the deceased was executed in the Republic, the administrators of his estate and trustees of the trust were resident in the Republic and the general administration of the trust was carried out in the Republic. The issue was to decide whether the full amount of annuity included by the commissioner in the taxpayer's taxable income was from a source within the Republic. The court held that, the source of an annuity flowing from the terms of a contract is the place where the contract is made.¹⁷⁴

Another consideration is to ascertain the source of a purchased annuity, i.e, an annuity bought for instance, from an insurance company. In practice, as submitted by Silke,¹⁷⁵ The Inland Revenue regards the location of the source of purchased annuity to be the place where the contract in terms of which the company undertook to pay the annuity was entered into. This therefore means, the place where the capital is employed is irrelevant, but consideration must be given to the place where the insurance company accepts the proposal.

Then, by further implications, all annuities payable under a contract taken out with the South African branch of a foreign company are not taxable in the Republic if it is a requirement that the proposal be accepted at the foreign head office.

1.4.2 The deemed source application

1.4.2.1 Deemed source of interest: section 9(6)

It is argued that the unclear *ratio* of the *Lever Brothers* case fails to provide an acceptable definition of source of interest. The reason being that, that case was based on a complex set of facts and the majority judgment was able to dispose of the matter without showing a critical distinction between the submission that the source of interest is the provision of credit as opposed to the location of the debt.¹⁷⁶

¹⁷⁴ This rule was reaffirmed by the Appeal Court in *ITC 1069* (27 SATC 145) to the point that, an annuity paid out of the income of the trust created by a will has its real and immediate source in the debt imposed upon the trustees by the former testamentary Act. The originating cause of the annuity was the trust.

¹⁷⁵ *Op cit*, para 5-8.

¹⁷⁶ See *The Taxpayer, op cit*, p. 5.

Consequently, it is correctly submitted that the simplification of the source rule of interest has led to a damaging formalism, and in practice, this artificial test allows the source of interest to be changed through legal subtleties.¹⁷⁷

In order to avoid the distorted results that could happen in application of the 'provision of credit' test in determining the actual source of interest, the Katz Commission¹⁷⁸ proposed that the arguments stated by Schreiner JA in his minority judgment in *Lever Brothers* case were more relevant in the practical and theoretical sense. The learned judge was of the view that the source of interest on a loan should be considered to be where the capital is used and therefore where the debtor is located.¹⁷⁹

In line with Schreiner JA's view and to bring some certainty as to the source of interest, some statutory amendment was brought to the Act by the implementation of section 9(6),¹⁸⁰ which deems interest (as defined for the purposes of section 24J) to be from a source within South Africa where it is derived from the utilisation or application of funds or credit in the Republic.

The funds or credit are deemed to be utilised (unless proven otherwise) where the debtor is resident as it applies to individuals (through the ordinary residence test) and legal entities (through the place of effective management test) by virtue of section 9(7) of the Act.

Consequently, the place of residence of the debtor is the determining factor for the application of sections 9(6) and 9(7). Factors such as the place where the agreement between the parties is concluded and the performance by the creditor of his obligation under the agreement are of no relevance in determining the deemed source of interest.

For instance, if a debtor resident of the Republic borrows money or acquires an asset outside the country from a creditor, the interest payable to the creditor will be deemed to have a South African source, unless it is proved that the debtor utilised the funds or the asset outside the country. At the same time, the interest received by the creditor

¹⁷⁷ See Katz Commission, *op cit*, chapter 6, p. 22.

¹⁷⁸ *Ibid*, at 23.

¹⁷⁹ See 14 SATC 1 at 17.

¹⁸⁰ See The Taxation Laws Amendment Act no 30, 1998, Government Gazette, 29 June 1998, effective from 1 July 1998; also cited in Silke, *op cit*, p. 5/49.

will be exempt from tax, if he is not resident and does not spend more than 183 days in the Republic or a company resident outside the Republic provided that the interest is not effectively connected with the business carried on in the Republic by virtue of section 10(1)(hA) of the Act.

In the same manner, if the debtor happens to be a non-resident and borrows funds or acquires assets in South Africa and uses the funds or the assets outside the Republic, then the source of the interest is not deemed to be in South Africa. But if the creditor was a resident of the country, he would be taxable on the interest accrued or received by him in the country, subject to the *de minimis* exemption.¹⁸¹

It can be said that the onus of proof rests on the taxpayer who wants to escape the provision of sections 9(6) and 9(7) to prove that the funds or credit obtained or borrowed were used outside the Republic, though he is resident in South Africa.

The decision of the *Lever Brothers* case has now been overturned by the *First National Bank*¹⁸² case on the determination of the natural source of income, which emphasise the consideration of the relevant factual matrix of each case. However the provisions of sections 9(6) and 9(7) do not override the normal or actual source of interest rule, but complement it by deeming interest to be from a South African source. The commissioner can thus address the determination of the source of interest from two perspectives:

- He can either apply the normal source rules as laid down in the *First National Bank* case, by considering the essence of the whole transaction which generated the interest with the view to determining the location of its source ('totality of facts' test) or;
- If the normal source rule fails, he can recourse to the deeming source provision of sections 9(6) and (7).¹⁸³

¹⁸¹ The application of sections 9(6) and 9(7) of the Act is subject to the statutory rule (applying in this instance to the South African source interest) that the first R6000 and R10000 for persons aged 65 and over, of not otherwise exempt interest derived by a taxpayer who is a natural person is free from tax. See section 10(1)(i)(xv) of the Act as amended in clause 13(1)(a) of the Taxation Laws Amendment Bill (B 26-2002) following the Republic of South Africa Budget Review of 20 February 2002.

¹⁸² Case discussed under the actual source of interest.

¹⁸³ See Huxham, K & Haupt, P, *op cit*, p. 20.

1.4.2.2 Other statutory non-resident tax implications

a) Non-resident tax on interest: section 10(1)(hA)

Although interest earned from a South African source is taxed in the Republic, the legislation has provided some kind of relief in the form of exemption available to non-residents meeting certain requirements.¹⁸⁴

For the general application of section 10(1)(hA), South African source interest is exempt if received or accrued to any person who is not a resident.

In the case of natural persons,¹⁸⁵ the exemption will only apply in the following circumstances:

- The individual must be a non-resident;
- He must be physically absent from the Republic for at least 183 days (in aggregate) during the year of assessment in which the interest is received or accrued;
- The interest must not be derived from a business carried on by him in the Republic during the year of assessment.

With regard to a company, the South African source interest is exempt in terms of section 10(1)(hA)(v)¹⁸⁶ of the Act if:

- The company is a non-resident;
- And the interest is not effectively connected with the business carried on by that company in the Republic.

For the purposes of section 10(1)(hA), the term 'Republic' includes countries forming part of the common monetary area (CMA).¹⁸⁷ It follows that a person who is a

¹⁸⁴ In this section, I will focus only on interest exemption applicable to non-residents in general, without specifically analysing the tax provision in terms of section 10(1)(h) dealing with exemption on interest paid to non-residents on government stocks and similar investment.

¹⁸⁵ See para (iv) of the proviso to section 10(1)(hA) of the Act applying to interest received or accrued on or after 1 April 1995. It is considered that only a full day can be counted as a day of absence from the Republic in accordance with the 'physical presence' test in terms of the meaning of residence for individuals in section 1 definition of gross income. See also Silke, service 2001, para 9.19A-20.

¹⁸⁶ This provision applies to interest accrues on or after 1 April 1996 and was substituted by section 13(1)(i) of the Act 59 of 2000. The term 'carrying on business' in the Republic refers for instance to transactions carried on through a branch of a foreign company in South Africa.

resident, let say of Lesotho is deemed to be a resident of South Africa for the purposes of section 10(1)(hA). It is also provided in the application of section 10(1)(hA) that the interest portion of a dividend distributed by a unit portfolio in equities other than property shares to a resident outside the Republic is deemed to be interest, therefore falls within the ambit of the exemption.¹⁸⁸

b) South African branches of foreign companies

Foreign companies may decide to carry on business in the Republic through a minimum presence in the form of a branch. The term 'branch' is used in double tax agreements to confer a taxable presence in a source jurisdiction to a foreign resident company carrying on activities partly or wholly through a fixed place of business. Thus, the word 'branch' is included in the permanent establishment definition provided in article 5 of the OECD Model Tax Convention.¹⁸⁹

From the South African tax perspective, a branch of a foreign company is treated as a separate company. The term 'external company'¹⁹⁰ is used to designate a company incorporated outside the Republic which establishes a place of business in the Republic and is required to register its memorandum with the registrar of companies.¹⁹¹ It follows that the registration of the memorandum of an 'external company' does not result in the incorporation of the company in the Republic and it will therefore not consider to be resident, unless it is effectively managed in the Republic.¹⁹² Thus, an external company that carries on business in South Africa through a branch will be liable on its source or deemed source income, but not on its non-Republic source income.¹⁹³ Because a branch is not a resident company, there is no secondary tax on companies (STC) consequences when a foreign company declares dividends out of its South African branch profits.¹⁹⁴ However, the rate of tax

¹⁸⁷ See section 9 of the Currency & Exchange Act, 9 of 1933. The CMA includes South Africa, Namibia, Lesotho and Swaziland.

¹⁸⁸ See para (iii) of section 10(1)(hA) effective from 23 February 2000.

¹⁸⁹ See the OECD Model Tax Convention on Income and Capital as it is read on 29 April 2000.

¹⁹⁰ As defined in section 1 of the Companies' Act 61 of 1973.

¹⁹¹ See section 322 of the Companies Act 1973.

¹⁹² See De Koker, A et al, *Silke Tax Yearbook*, 2001-2002, p. A12.

¹⁹³ See para (ii) of the gross income definition in section 1 of the Act.

¹⁹⁴ See section 64B(5) of the Act.

for branches is at 35% and is currently higher than the normal company rate of 30%.¹⁹⁵

The analysis of the tax consequences of South African branches is relevant in the context for instance, of exemption provided to non-residents, not carrying on business in the Republic in terms of sections 10(1)(h) and (hA).¹⁹⁶

The meaning of 'carrying on business' in the Republic must therefore be ascertained in view of the above tax exemptions.¹⁹⁷

c) Meaning of 'carrying on business' in South Africa

The Act has not specifically defined the term 'carrying on business'.¹⁹⁸ However, in section 1, the Act does give a definition of 'trade' which includes: profession, trade, business, employment, calling, occupation, venture, letting of property, use or granting of permission to use certain assets. In the South African context, 'carrying on

¹⁹⁵ However, from an exchange control perspective, both a branch and a subsidiary are considered to be South African residents. Branch profits tax are freely remittable to the head office, subject to obtaining an auditor's certificate in respect of the profits being distributed. In South Africa, a branch has the advantage of not being subject to thin capitalisation legislation in terms of section 31(3) of the Act, enabling it to borrow as much as it needs from its head office. However, unless the head office has borrowed the funds itself, the branch will be denied a tax deduction for any interest on the head office loan. A branch has also the advantage that South Africa's transfer pricing does not apply to head office-branch transactions. Such legislation would however apply to transactions between the branch and other foreign group companies. Further, such legislation might also be used to restrict a tax deduction for interest paid by the branch to a foreign related party (not its head office) if such interest is considered excessive.

¹⁹⁶ The Katz Commission (5th Report, *op cit*, chap 7, p. 30) suggested (found also in its Second Interim Report) that the provision of section 10(1)(hA) of the Act should be amended to deny the tax exemption on interest received by non-residents where the non-resident carried on business in South Africa through a branch. The intention of the recommendation was to prevent foreign banks carrying on normal lending operations in South Africa through a branch and thus obtaining an unfair advantage over the domestic competition. When this recommendation was legislated however, the exemption was denied in all cases where the interest was effectively connected with the business carried on by that non-resident in South Africa.

¹⁹⁷ The establishment of a branch in South Africa does not automatically mean that the foreign company is carrying on business in the Republic. In some cases, the branch might be merely serving as a marketing and representative presence for the non-resident company within South Africa. The onus is therefore on the taxpayer to prove that it is not carrying on business in South Africa to benefit from the exemptions provided in section 10(1)(hA).

¹⁹⁸ The Katz Commission (*op cit*, p. 30) contended that the concept of 'carrying on business' in South Africa was much wider than the concept of doing so through a local branch, and this has created some uncertainty in situations not intended to have been affected. It recommended that the restriction should refer rather to more specifically to a non-resident carrying on business through a permanent place of business suitably equipped for carrying on such a business. Thus, in terms of section 10(1)(hA) application, interest which is attributable to such a business should then not qualify for the exemption.

business' is not the same as carrying on trade. Business has a narrower meaning than trade and it is only one of its components.¹⁹⁹

In *ITC 1179*,²⁰⁰ the court held that the term 'carrying on business' must be given their ordinary meaning in the commercial sense. In *Platt v CIR*,²⁰¹ Juta JA referred to the English case of *Smith v Anderson*²⁰² in which business was defined as anything which occupies the time, attention and labour of a man for the purpose of profit.

In *Estate G v COT*,²⁰³ Beadle CJ gave a list of activities which in commercial life could be regarded as carrying on business. In order to determine whether a business is being carried on, the nature, scope and magnitude of the taxpayer's activities, the object (whether to make a profit or not) and the continuity of the activities concerned would have to be taken into account. The list of these activities are regarded as elements determining the carrying on of business in the Republic and do not purport to be exhaustive, nor are they decisive, but each case must depend on its own particular circumstances.

i) The profit element in carrying on business

The general definition of business was provided in the *Smith's*²⁰⁴ case where the court held that business is related to anything which occupies the time, attention and labour of a man for a profit. A different view was expressed in *Modderfontein Deep Level Ltd v Feinstein*,²⁰⁵ in which a mining company bought clothing articles and re-sold them to its employees without making a profit. The court held that though the factor of profit was absent, the transaction could still be regarded as business. There is an argument that by selling at cost to its employees, the company could still benefit through for instance, greater staff retention and loyalty. That was the basis of the decision in *De Beers Holdings (Pty) Ltd v CIR*,²⁰⁶ where the court held that:

¹⁹⁹ See Williams, R.C., "The Distinction for Income Tax Purposes between 'Trading' and 'Carrying on Business'", 1999, 11 *SA Merc LJ*, p. 574. The distinction between 'trade' and 'business' has played a crucial role in the court decision governing the tax deductibility of losses arising from irrecoverable loans and from standing surety for loans. See the judgment of *CIR v Hilewitz* (1998, 60 SATC 86 T).

²⁰⁰ 35 SATC 38; 1974 Taxpayer 33.

²⁰¹ 1922 AD 42; 32 SATC 142.

²⁰² 1880, 15 CH D 247.

²⁰³ 1964, SR, 26 SATC 168.

²⁰⁴ (1888), *op cit*, at 247.

²⁰⁵ 1920 TPD 288.

²⁰⁶ 1986, 1 SA 8 (A); 47 SATC 229; 1986 Taxpayer 8.

‘Where a trader normally carries on business by buying its goods and selling them at a profit as a general rule, a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must in order to satisfy s 23(g), be shown to have been so connected with the pursuit of the taxpayer’s trade, e.g., on ground of commercial expediency or indirect facilitation of trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the purposes of trade.’²⁰⁷

In the case of *Platt v CIR*,²⁰⁸ the court stated that while accepting the objective of profit as a test, remarked that in certain circumstances there may be a carrying on of a business without the contemplation of procuring a gain. For instance, allowing business premises to be used as an outpatient branch of a hospital. The objective of making a profit is therefore not an essential feature in every instance where the carrying on of business is in issue.

ii) The continuity factor in ‘carrying on business’

The continuity element seems to be one of the important factors for the carrying on of a business. As a general rule, the expression ‘carrying on business’ usually involves a series of actions on the part of the person. Accordingly, one or two isolated transactions cannot be regarded, particularly in the case of individuals, as the carrying on of a business.²⁰⁹ However, a single undertaking may be of such a nature that it can be correctly described as a business. Thus, in *Stephan v CIR*,²¹⁰ the salvaging of a single ship’s cargo was considered a business because it involves a number of ordinary business acts. In *CIR v Lynderburg Platinum Ltd*,²¹¹ Stratford JA made the point that continuity is a necessary element in the carrying on of a business in the case of an individual but not of a company.²¹²

In the *Platt’s* case, the taxpayer guaranteed certain advances made by a bank to a company in the profits of which he was interested and was called on to make payment in terms of his guarantee. He sought to deduct the payment from his income as a sugar

²⁰⁷ It could be argued that the court’s ruling applicable to trade may equally apply to business transactions. The words ‘trade’ and ‘business’ seem to be used interchangeably by the court.

²⁰⁸ 1922 AD 42; 32 SATC 142 at 147.

²⁰⁹ See *Stott v CIR*, 1928 AD 252 at 262.

²¹⁰ 1919 WLD 1; 32 SATC 54.

²¹¹ 1929 AD 137 at 147.

²¹² See also *SIR v The Trust Bank of Africa Ltd*, 1975 (3) SA 652 (A); 37 SATC 87.

manufacturer. His right to do so depended on whether in the making of such advances he was carrying on trade. Juta JA held that:

'In the case of a company formed for certain purposes, the question of the continuity of the acts, which is another factor to be considered in deciding whether a business is being carried on, is not of the same importance as in the case of an individual. As was stated by Jessel MR in *Smith v Anderson*..., in the case of a company formed for a certain purpose, it would be said at once that it was carrying on business, because it was formed for that purpose, and for nothing else, and from the very nature of the association the idea of continuity is inferred.'²¹³

iii) Examples of carrying on business

- **Shares, investments, directorships**

It could be argued that the investment of surplus fund in shares in companies, as long as it does not form part of a general scheme of profit-making, cannot be regarded as the carrying on of a business.²¹⁴ It was held in *ITC 425*²¹⁵ that the investment of money on mortgage loans, loans on fixed deposits, as long as it is not part of a general financial or financier's business, does not amount to carrying on of a business.

In *Overseas Trust Corp Ltd v CIR*,²¹⁶ where the taxpayer made certain shares and other investments in South West Africa, the court held that the mere possession of shares and investments in a country does not amount to the carrying on of a business in that country. In *ITC 1501*,²¹⁷ the taxpayer was an 85% shareholder and director of a private company. He lived in the USA but returned to South Africa to attend directors' meetings. The issue before the court was whether in his capacity as director, he was carrying on business in South Africa. The court held that the mere fact that a taxpayer was a director and majority shareholder of a company conducting an extensive business did not make the company's business his. Nor was he required to be regarded as carrying on his own business simply because he was involved in the carrying on of the company's business. His investment in the company's shares as a shareholder did not amount to him carrying on business, neither did his directorship.

²¹³ At SATC 148.

²¹⁴ See *Silke, op cit*, 1997 Service 11, p. 14-38.

²¹⁵ 1938, 10 SATC 340.

²¹⁶ 1926 AD 444; 2 SATC 71.

²¹⁷ 1989, 53 SATC 314.

Nor did he earn his living by being a director of several companies. It could not be said that by carrying on the company's business, he himself was carrying on business.

The above view was confirmed in the recent case of *Tiger Oats Ltd v CIR*.²¹⁸ The appellant, a listed investment holding company held long term equity investments in subsidiaries and associated companies, and it made loans to them. It derived its income from dividends, interest on loans and management fees. It paid a monthly amount as regional service council (RSC) levies. It maintained that it was not liable to the council for the payment of levy on income derived from dividends, and accordingly claimed the refund of these levies back on the ground that it was not carrying on an enterprise as defined in section 1 of the Act 109 of 1985.

Judge Speolstra J (with Van der Westhuizen J and De Vos J concurring) held that the mere purchasing and holding of an asset does not constitute the carrying on of a business. It is the activities of the person in relation to that asset which determine whether or not the person is carrying on a business. Whether or not the activities of the person take that person from the category of simply holding an investment into the category of carrying on a business is obviously a matter of degree. The mere holding of share investments does not constitute an activity of a continuing nature within the ordinary meaning of that phrase and it also clearly cannot constitute the carrying on of business as money investor. Accordingly, the court found that the appellant's investments in the shares did not constitute the carrying on of a business as an investor of money within the meaning of the definition of financial enterprise in the regulations.

- **The Letting of property**

It is not possible to define with any degree of precision when the activities of a person in letting property will constitute 'carrying on of business'. The general principle is that a mere investment in fixed property must be distinguished from an intention to carry on business as a lessor of property. Each case must depend on its own circumstances, and it is important to consider the extent of the taxpayer's letting

²¹⁸ 8 August 2001, 63 SATC 473.

activities in order to determine whether they show that degree of continuity or regularity one would expect if the taxpayer were 'carrying on business' as a professional landlord.²¹⁹

Current Revenue practice treats the letting of a single property as not carrying on business, since there is no regular or systematic letting of property in the course of a business of letting of a single property. The temporary letting of a property in the Republic by a non-resident while waiting for an opportunity to sell cannot, it is argued, be regarded as the carrying on of a business, provided that the intention to sell can be clearly established.

In *ITC 883*,²²⁰ the taxpayer, a non-resident, inherited a property in South Africa. He gave his brother a power of attorney to enable the latter to let the property and to effect repairs and renovations as become necessary. It was held that the taxpayer was carrying on business but was merely receiving the benefit of his inheritance. In *ITC 1529*,²²¹ a non-resident taxpayer owned two stands in South Africa. His income consisted of rentals from the stands, interest on investments and dividends on shares. He made no decision in regard to the administration of the property as all his affairs were being handled by a firm of accountants. In finding that the circumstances and activities did not fall within the parameters of the considerations propounded for carrying on business, Melamet J referred to the following *dicta* of Beadle CJ in *Estate G v COT*,²²² as setting out the approach to be adopted:

'The sensible approach, I think, is to look at the activities concerned as a whole, and then to ask the question: Are these the sort of activities which, in commercial life, would be regarded as "carrying on business"? The principal feature of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, the intention with which the property was acquired. This list of features does not purport to be exhaustive, nor are any one of these features necessarily decisive, nor is it possible to generalise and state which feature should carry most weight in determining the problem. Each case must depend on its own particular circumstances.'

²¹⁹ See Silke, *op cit*, service 11, p. 14-39.

²²⁰ 1959, 23 SATC 328.

²²¹ 54 SATC 252; 1992 Taxpayer 213.

²²² 1964 SR, 26 SATC 168.

- **The Place where the business is carried on**

The place where the taxpayer carries on business may be important for income tax purposes. As a general rule, a business is carried on where the business activities are performed, though it may happen that a business is carried on in more than one country. In *Joel & Joel v CIR*,²²³ the issue was whether the taxpayers, members of a partnership and South African non-residents were not carrying on business in the Republic as financiers, floaters of companies in which they controlled by becoming directors thereof and shareholders. The court stated that about the taxpayers in London that:

- *They were represented in South Africa by servants and not agents;
- *They had an office under their business name;
- *They took the fees of some of their servants who served on the boards for them;
- *They entered into contracts to float companies in which they described themselves as carrying on business in Johannesburg and;
- *They dealt in shares through the local office.

In its decision, the court held that the taxpayers were carrying on business in two places at the same time being at their head office in London and their South African office in Johannesburg.

The place where the taxpayer resides is not generally conclusive as to where he carries on business. For instance, a person may be resident in one country and carries on business in another. A person may also carry on business through an agent, though in many instances, something more may be required to establish that he is carrying on business in a country.²²⁴

²²³ 1922 WLD 29; 33 SATC 106.

²²⁴ See *Lovell & Christmas Ltd v COT*, 1908, AC 46. Refer also to article 5 of the OECD in terms of permanent establishment definition in relation to carrying on business in a country through an agent. In terms of this provision, a person can be said to be carrying on business in a country through an agent, if the latter is dependent and normally enters into contract on behalf of the principal.

d) Non-resident tax on royalty income and similar payments: section 35

Certain amounts received by or accrued to non-residents from the use²²⁵ or right to use of patents, designs, trademarks, copyright, models, plans, motion picture films, video tapes and discs, know-how and similar property in the Republic and services connected therewith, whether payable as a lump sum or periodically, are referred in terms of section 35(1) of the Act as royalties.

In terms of the above provision, these amounts are subject to a final withholding tax of 12%.²²⁶ The introduction of the residence tax system in South Africa has offered the opportunity to vary the application of the withholding tax and its relationship with the normal corporate tax due by the non-resident recipient of the royalties. Thus, previously, section 35 provided for a 12% withholding tax on certain royalty payments to non-residents. In the case of corporate taxpayers, the withholding tax exceeds the actual tax payable, as the section provided that 30% of the royalty income is taxable. This means that the rate was 9% (30% of the royalty income taxable at a 30% of the company tax rate). Non-residents were entitled to submit a tax return and claim the excess back.²²⁷

Accordingly, royalties accruing to a recipient in a year of assessment commencing in 2001, is subject to a withholding tax and there is no liability for normal corporate tax.²²⁸ It is expressly provided that a person having an address outside the Republic will, until the contrary is proved, be deemed not to be a resident of the Republic.²²⁹ The payer of the amount or the recipient of the amount on behalf of the non-resident

²²⁵ The Commentary of the OECD Model Convention (updated as of 29 April 2000) clarifies in article 12 definition of royalties that the word 'use' implies that the rights must not amount to an outright assignment or sale of the intellectual property itself.

²²⁶ See section 35(1) of the Act, as substituted by section 39(a) of the Act no 59 of 2000. The rate of 12% is in most cases reduced in terms of double tax agreements entered into by South Africa with its trading partners. As the treaty definition is comprehensive, the use of the royalty definition under the South African domestic law may not be appropriate in its double tax agreements adopting the OECD Model. Unlike the South African provisions in section 35 (1)(b), The OECD Model was amended in 1992 to exclude technical service and assistance fees (show-how payments) from the royalty provision. They are treated under the OECD Model as active business income. See Article 12, para 11 of the OECD Commentary.

²²⁷ The imposition of the withholding tax on royalties in terms of section 35 of the Act constitutes an exception to the source rules because the royalty in this case is received from a non-South African source (with the deletion of the deeming source provisions of sections 9(1)(b) & (bA) of the Act) by a non-resident, but it is still taxed in South Africa.

²²⁸ In practice, the year of assessment referred to would be the financial year of the payer of royalties.

is obliged to declare the amount to the commissioner within the 14 days period and to pay the tax due calculated at the rate of 12% of the gross amount of the royalty.²³⁰

The non-resident remains obliged to render a return of income for the year of assessment and to pay any tax for which he is liable and the tax deducted from the amount concerned will be set off against the total tax payable for the year; any underpayment being recoverable from him and any overpayment being refunded to him. In particular, he can claim any tax overpaid in terms of section 102 of the Act.²³¹

i) Exemptions

- Any amount accruing to a non-resident company is exempt from the withholding tax if it is earned by that company in a trade carried on through a branch or agency in the Republic and is subject to normal corporate tax.²³² In other words, because section 35 subjects royalty income to tax, it is necessary to remove such royalty income from the non-resident normal tax.²³³
- Section 35 does not also apply to any amount accrued to a person (be it individual or company) other than one resident in a neighbouring country in respect of any copyright in a printed publication. This exemption does not however apply to copyright in advertising material for motion picture films (whether advertising or not) or for any printed publication relating to television.²³⁴

²²⁹ Proviso (ii) of section 35(2).

²³⁰ Section 35(2)(a).

²³¹ See section 35(2)(f). For exchange control purposes, approval is required for the payment of royalties. Manufacturing agreements are referred to the Department of Trade and Industry. This Department together with the South African Reserve Bank have jointly issued guidelines with regard to the maximum level of royalty that will be approved, namely 4% in respect of retail products and 6% in respect of intermediate and capital goods. The basis on which the royalties may be calculated would be restricted to 'net ex-factory sales' excluding the in-factory landed cost of imported components and raw materials directly or indirectly from the licensor, as well as VAT. License agreements relating to the use of intellectual property and agreements not involving local manufacture or production require the consent of the South African Reserve Bank.

²³² See section 35(1)(i).

²³³ This is achieved by means of section 10(1)(l) inserted by section 13(1)(o) of the Amendment Act 59 of 2000.

2. The concept of source in Hong Kong tax system

Introduction:

After the return of the region of Hong Kong to Mainland China²³⁵, it was decided that Hong Kong was to retain its own legal system, where the Judiciary would remain independent from the Executive, and therefore existing tax decisions by the Judiciary would remain binding. In that sense, the legal dimension of the Hong Kong tax system was to be maintained.²³⁶

Hong Kong is one of the jurisdictions where the principle of source is a critical aspect of the tax system.²³⁷ Taxation on income in Hong Kong is imposed by the Inland Revenue Ordinance (IRO, promulgated in 1947).²³⁸

Hong Kong has adopted a schedular system of tax in which only specified types of income, namely profits, salaries and property rental incomes are taxable. There is no 'general or total income' concept in Hong Kong. The income-type taxes that operate are separate. They operate without regard to other income that may be subject to tax under separate headings. For instance, a taxpayer operating a business will (subject to some exceptions) pay profits tax on any profits made in that business that are taxable in Hong Kong, and if he is also working in a salaried job, he will pay salaries tax on that salary according to Hong Kong tax law, but the two calculations operate

²³⁴ See section 35(1)(ii).

²³⁵ In July 1997 where Hong Kong became a Special Administrative Region (HKSAR) of the People's Republic of China (PRC).

²³⁶ See www.nan.shh.fi/onet/lists/aintacc-1/0126.html. As it was decided as such in the agreement between Britain and the People's Republic of China (PRC), Hong Kong was to maintain its legal and tax systems separate from those of the PRC for at least 50 years.

In the Basic Law (effective new constitution passed by the PRC in 1990) of the Hong Kong Special Administrative Region (HKSAR), it is provided in article 108 that the HKSAR 'shall, taking the low tax policy previously pursued in Hong Kong as a reference, enact laws on its own concerning the types of taxes, tax rates, tax reductions, allowances and exemptions and other matters of taxation'. See VanderWolk, JP, & Brook, P, "Hong Kong Source Rules: Another Twist in a Long-running Tale", *Info Tax, SA Tax Review*, September 1997.

²³⁷ See "Hong Kong Source of Profits – Again: Inland Revenue issues Statement of Practice" (Official Release by CIR, HK), 1993, 6 *SA Tax Review* 54.

²³⁸ Originally Cap. 20, 1947 (Cap. 112, 1950) Laws of Hong Kong. The IRO is based on the United Kingdom's tax legislation, particularly as it was exported to other Commonwealth countries. Because of these linkages, the tax law, of not only the United Kingdom but also Australia and New Zealand, continue to have a significant impact on the interpretation of the IRO. See *Tax Notes International*, November 1, 1993, p. 1122.

separately. The Hong Kong tax system is territorial in nature; tax is only levied on income arising in or derived from a source in Hong Kong.²³⁹

While the territorial principle itself appears to be clear, its application in particular cases has been proven at times to be a contentious issue between the Inland Revenue Department (IRD) and practitioners, with numerous disputes being referred to the Board of Review and the courts.²⁴⁰

The aim of the research in this section is to analyse in comparison with the South African position, the judicial tests and the specific statutory rules for determining the source of particular incomes in Hong Kong.

2.1 Taxation of profits

2.1.1 Determination of the source of profits

Profits tax is the major tax in Hong Kong.²⁴¹ In line with its territorial concept of taxation, the charge to profits tax in Hong Kong is only extended to persons (including *inter alia* corporations, partnerships, trustees and other legal entities) carrying on trade, profession or business there. Profits tax is charged on all profits (excluding profits arising from the sale of capital assets) arising in or derived from Hong Kong from such trade, profession or business.

²³⁹ Because of the pure territorial system of taxation applied in Hong Kong, the concept of residence is of little importance there, and there is little difference in the taxation of Hong Kong and foreign entities. In the simple example, a resident of Hong Kong may derive income from abroad without suffering tax, even if that earning is remitted to Hong Kong, and conversely, a non-resident may suffer tax on profits arising in Hong Kong.

²⁴⁰ The court system after July 1997 has also undergone some amendments in Hong Kong. Thus, the Court of Final Appeal has since then replaced the Privy Council as the most senior Court, and is composed of 5 members being the Chief Justice of the Court of Final Appeal, together with 3 permanent judges and 1 non-permanent Hong Kong judge or 1 judge invited from another Common Law jurisdiction. Underneath the Court of Final Appeal is the High Court consisting of the Court of Appeal of the High Court and the Court of First Instance of the High Court. Then follows the District Court jurisdiction and the Magistrate Court. In addition, the Hong Kong court system also includes the Small Claims tribunal, Labour tribunal, Lands tribunal, Obscene Articles tribunal and the Coroners Court, each with its own responsibilities and functions. See www.hk.org/guide-hk.html.

²⁴¹ The present rates for profits tax are 16% for companies and 15% for unincorporated companies such as partnerships and sole traders. In the case of corporations, no distinction is made between public and private companies or between distributed and undistributed profits. In the same context, branches of overseas companies are taxed at the same rate. See www.chinazone.nl/news/business/asia/hongkong/tax.html. See also Rohatgi, *op cit*, p. 261.

The main applicable provision to profits tax is contained in section 14(1) of the Inland Revenue Ordinance (IRO) which provides as follows:

‘Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part...’²⁴²

As stated in section 14, pre-conditions must be satisfied before liability to profits tax may arise. A person is only chargeable to profits tax in Hong Kong if:

- He carries on a trade, profession or business in Hong Kong;
- The trade, profession or business derives profits; and
- The profits arise in or are derived from Hong Kong.

It remains a contentious issue what constitutes the carrying on of a trade, profession, or business for Hong Kong tax purposes. Although the concepts of ‘trade’ and ‘business’ are fairly well defined, in general ‘business’ has been seen to have a very broad meaning whereas ‘trade’ is probably narrower.²⁴³

Vanderwolk contends that the term ‘business’ has been defined to cover virtually any activity, no matter how insubstantial or infrequent that is done with a view toward profit making. Contrary to the layman’s understanding of the terms, the concepts of trade and business are much wider in the context of taxation. Thus the element of repetition or ‘habit’ (used in the form of ‘habitual trading’) is not essential for tax liability to exist, with the result that profits or gains derived from a single transaction having a profit making purpose can be assessable profits of trade or business.²⁴⁴

²⁴² See Toh, D, “Source of Profits: Hong Kong Revisits Legal Tests”, 1992, 5 *SA Tax Review* 102; also indicated in www.hg.org/guide-hongkong.html. The legislative provision to tax profits in Hong Kong clearly makes a distinction between capital and revenue income by excluding gains or earnings derived from the realisation or disposal of capital assets which gives rise in the South African context for instance to capital gains implication effective from 1 October 2001. See www.info.gov.hk/ird/brief-pf.htm.

²⁴³ See Willoughby, P. G, *Hong Kong Revenue Law: Vol 2 and Vol 3*, 1981, section 1.04. It is said that much of the discussions on the issue of business refer to the broader definition as contained in the Business Registration Ordinance.

²⁴⁴ See Vanderwolk, JP, “Hong Kong Inland Revenue Board of Review Offers new view of ‘Carrying on Business’ in Hong Kong”, *Tax Notes International*, May 9, 1994, p. 1241. Also discussed by Willoughby, *ibid*. While in the Hong Kong tax law, the definition of business is extremely broad as including any activity in a form of trade, a different position is adopted in the South African context, where a transaction which falls within the broad category of a ‘trade’ may not fall within the narrower category of a ‘business’.

Whether a taxpayer is carrying on a business is largely a matter of fact and will depend upon the circumstances of a particular case. Thus as was decided by the Inland Revenue Board of Review in *D 27/93*²⁴⁵ on the meaning of ‘carrying on business’ in Hong Kong, it is necessary to find a significant degree of organised activity by the taxpayer in order to hold that a business is being carried on for Hong Kong tax purposes. Corporate taxpayers that have infrequent transactions in Hong Kong or that are engaged only in investment-type activity in Hong Kong that requires little active management will be able to argue that they are not carrying on a business in Hong Kong for tax purposes.

In general, a continuous commercial activity being carried on or performed in Hong Kong will be regarded as the carrying on of a business in Hong Kong.²⁴⁶ While the term ‘trade’ is defined as including ‘every trade and manufacture and every adventure and nature in the concern of a trade’ and is designed to bring into charge for profits tax purposes a single transaction which may have the characteristics of a trade or business.²⁴⁷

As the third condition provides, liability to profits tax will only arise if a person’s profits arise in or are derived from Hong Kong.

Section 2(1) of the IRO provides that:

‘[P]rofits arising in or derived from Hong Kong for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong whether directly or through an agent...’

²⁴⁵ (1993) 1 HKRC, para. 80-260.

²⁴⁶ See the *Bartica Investment Ltd* case (cited in the *Departmental Interpretation & Practice Notes No. 13: The Taxation of interest received and the deductibility of interest paid*) dealing with the issue of ‘carrying on business’ by an investment company that habitually places deposits and furnishing securities.

²⁴⁷ According to the *Departmental Interpretation and Practice Notes No. 30*, where a non-resident carried on business with a resident and the business is so arranged that it produces to the resident either no profits or less than the ordinary profits that might be expected to arise to an independent concern, the business may be treated as carried on in Hong Kong by the non-resident through the resident as his agent. This follows the Board of Review decision in *D 17/93* (1993, 1 HKRC, para. 80-250), involving a tax-avoidance structure designed to shift income to a tax-haven company that allegedly did not carry on business in Hong Kong. The Board of Review held in that matter that the fact that a company has not appointed an agent in Hong Kong will not necessarily ensure that the company is not carrying on business in Hong Kong. Thus, if an individual or company in Hong Kong negotiates and informally concludes agreements in Hong Kong on the offshore company, the offshore company may be held to be carrying on business in Hong Kong despite disclaimers to the contrary. See “Hong Kong Board of Review Decision Highlights Risks Involved in using Offshore Companies” (News Digest) *Tax notes International*, January 31, 1994, p. 278.

This element of territorial limitation (whether profits arise or derive from Hong Kong) is more difficult to analyse. As VanderWolk argues, at first glance, the provision appears susceptible to an extremely broad reading. As he sees it, section 2(1) does not assist in finding the answer to the question of how one determines whether a particular profit is 'from' one part of an overall business transaction as opposed to another part. For instance, if a contract of sale is made in Hong Kong but the property to which the contract relates is manufactured and delivered by the seller outside Hong Kong, is the seller's profit from business transacted in Hong Kong?²⁴⁸ Section 2(1) raises, but leaves open the question of the economic source of a given profit.

Because the IRO contains very few source rules, the ascertainment of the locality of profits for profits tax purposes has been subject to arguments.

It has been left to the commissioner and the courts to articulate guidelines for determining the source of such controversial profits.

2.1.2 Judicial tests

The courts in Hong Kong have over the years considered the subject of the source of profits. Because the law surrounding the source of profits in this jurisdiction is still unclear, it has been difficult in many court decisions to employ a simple legal test by which the locality of profits for profits tax purposes could be determined.

No universal rule will cover every case. Predictably, the guidelines that have been articulated in particular cases are difficult to apply in other cases.²⁴⁹

Certain tests have been devised through case law to ascertain the source of profits as analysed below.

a) 'Matter of fact or practical man' test

The general principle is that the source of profits or the question of locality of profits is a hard, practical matter of fact. Consequently, whether profits arise in or are derived from Hong Kong depends on the nature of the profits and of the transaction which gives rise to such profits.

²⁴⁸ See VanderWolk, JP, *The source of income: Tax Law and Practice in Hong Kong*, 1998, 2 ed, p. 8.

²⁴⁹ See VanderWolk and Brook, *op cit*, note 233.

This test originated from the case of *CIR v The Hong Kong & Whampoa Dock Co Ltd*,²⁵⁰ where Reece J in applying the ‘practical man’ test did not agree with Gregg J that the hypothetical ‘practical man’ would regard Hong Kong as the real source of the Dock company’s fee for salvaging the ship in the parcels due to the location of the Dock company’s entire organisation in Hong Kong. In considering various *dicta* from Australian tax cases²⁵¹ involving the question of source of income, Reece J went on to conclude that:

‘These cases all confirm that the source of income is a question of fact depending entirely upon the facts of each particular case and that no principle can be formulated which is universally applicable to every taxation system for the reason that each system differs from country to country. Furthermore, they indicate that the place where the business is carried on need not necessarily be the source of the profit, for profits may arise from more than one source, and finally, they demonstrate the importance of the contract element, that it is not to be treated as “as having no significance”.’²⁵²

The guiding principle was confirmed by Lord Bridge delivering the decision of the Privy Council (as it then was) in *CIR v Hang Seng Bank Ltd*,²⁵³ where he stated that:

‘But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined...’²⁵⁴

However, the ‘hard, practical matter of fact’ test is not very helpful in deciding cases, and therefore not of practical value because they deal with legal and accounting concepts that do not exist in nature.²⁵⁵ As analysed by VanderWolk, at face value, the notion that the source of profits is purely a factual matter seems absurd, for ‘profits’ are not observable natural phenomena like rivers, beams of light, odorous fumes, or anything else that is perceived to have emanated from some source.²⁵⁶

²⁵⁰ (1960) 1 HKTC 85.

²⁵¹ The cases referred to include *Federal Commissioner of Taxation v United Aircraft Corporation* (1944) 68 CLR 525; and *Tariff Reinsurances Ltd v Commissioner of Taxes* (1938) 59 CLR 205.

²⁵² At 109.

²⁵³ (1991) (1) AC 306 (FC), at 322/323.

²⁵⁴ It should be pointed out the Hong Kong Department of Inland Revenue through Interpretation and Practice Notes (for example, the note 21, revised 1998 on the locality of profits) has stated that, the *Hang Seng Bank case* has clarified the general principles to be followed in determining the locality of profits. Therefore, the Department intends to look closely at any particular circumstances where there is an apparent artificial attempt to turn profits which arise in or derived from Hong Kong (Hong Kong profits) into profits which arise in or derived from outside Hong Kong (offshore profits).

²⁵⁵ See Vanderwolk and Brook, *op cit*, note 233.

b) The 'operations' test

Accordingly, a more appropriate test favoured by the IRO is the 'operations' test of source whereby an examination of the operations or activity of the business giving rise to the profits is conducted. The broad guiding principle here is that, one looks to see what the taxpayer has done to earn the profits in question and where he has done it. This means that the proper approach will be to identify the operations which produced the relevant profits and then ascertain where those operations took place.²⁵⁷

The place where the activities are carried out is the important indicator of the source of profits. If the main business is carried on outside Hong Kong, basic administrative activities in Hong Kong such as the preparation of invoices, the negotiation of letters of credit through Hong Kong banks and the preparation of accounts would be regarded as being of an ancillary nature and therefore not resulting in a tax liability in Hong Kong.²⁵⁸

The judicial principles in determining the source of profits by the application of the 'operations' test have emerged from authoritative court decisions.

i) Case law

In *Sinolink Overseas Ltd v CIR*,²⁵⁹ the taxpayer was a Hong Kong company that bought plywood and paper from manufacturers in Hong Kong and overseas for sale to customers in Hong Kong and China. Sinolink acknowledged that the income from sales to Hong Kong customers was subject to Hong Kong tax but said that the majority (75%) of the sales were made to Chinese customers, and claimed an exemption on the income from those Chinese sales. Sinolink's sales personnel

²⁵⁶ *Ibid*, p. 46.

²⁵⁷ This principle originated from the *Dock case*, *op cit*, note 247. It involved service fees received by a Hong Kong-based taxpayer for services rendered on the high seas, namely, salvaging a ship and towing it back to Hong Kong. The Court held that, the services were substantially performed outside Hong Kong and so the service fees had their source outside Hong Kong. Thus, the court considered that income would be sourced where 'the operations take place from which the profits in substance arise.' The principle was also highlighted in *FL Smith & Co v F Greenwood* (1921, 3 KB 583 at 593).

²⁵⁸ See Horak, W, & Davis, D.M, "United Kingdom: Non-resident Companies," 1988, 1 *Juta's Foreign Tax Review* 57. In consideration of the guidelines now adopted by the Department of Inland Revenue in ascertaining the locality of profits, the distinction between Hong Kong profits and offshore profits is made by reference to the gross profits arising from individual transactions. Thus, only those business activities which directly produced the gross profits are taken into account in determining the source of profits. Activities such as general administration are normally not relevant. See www.info.gov.hk/ird/brief-sg.htm.

travelled to China to solicit orders, and contracts for the sale of plywood were negotiated and concluded in China. While the orders from China were fulfilled by the purchase of plywood from manufacturers in Hong Kong or more frequently, from suppliers in Singapore and Europe.

The court found that as the taxpayer's administrative office which controlled the Chinese sales was located in Hong Kong, the source of the proceeds of the sale was in Hong Kong. In rejection of the principle adopted in the *Dock* case (which focused on the particular profits from particular transaction), Hunter J expanded the 'operations' test to include all of Sinolink's operations, not just the operations relating to the particular transactions under which the profits in question arose.

As the learned judge stated, Sinolink's profits from China sales 'could never have been earned unless some mechanisms for the pre-contract management of the terms discussed with both buyers and sellers existed' and that 'this vital function could only be controlled and conducted from and through the company's administrative centre in Hong Kong.'²⁶⁰

In contrast, in Hong Kong Board of Review case *no D 15/82*,²⁶¹ a Hong Kong purchasing company was not subjected to tax on its income from sales, since the source of the income was regarded as being located outside Hong Kong, notwithstanding the fact that the Hong Kong company had an administrative centre in Hong Kong and the sales contracts were concluded in Hong Kong.

The agent of the Hong Kong company negotiated the contracts with manufacturers outside Hong Kong. The order would then be placed by the United States customer with the Hong Kong company, which would place the order with the manufacturer through the agent. The agent would inspect the goods on completion and ensure that they were delivered on time to the customer. The Hong Kong company invoiced the United States customer, and payment was made to the company by the letter of credit negotiated through Hong Kong bankers.

²⁵⁹ (1985) (2) HKTC 127.

²⁶⁰ At 133.

²⁶¹ (1982) 2 HKTC 27; also cited by Horak and Davis, *op cit*, p. 57, and analysed by Edwards, P "The Locality of Profits for Hong Kong Profits Tax Purposes", *International Tax Strategy* 224.

The Board of Review held that the source of the income was the operation of the agent outside Hong Kong in the country in which the manufacturer was located. This decision was in line with the *Dock* case in that it placed more weight on the operations required to carry out the relevant contracts than on the making of the contracts themselves.

The confusion relating to the application of the 'operations' test was highlighted in the landmark case of *CIR v Hang Seng Bank Ltd*,²⁶² where the taxpayer was a bank based in Hong Kong. Its internal investment department bought and sold securities in overseas markets such as Singapore and London through independent brokers. The decision-making as well as the provision of instructions occurred in Hong Kong and funds which were located in Hong Kong were utilised for the relevant purchases.

The Commissioner determined that the bank's profits from buying and selling securities in these overseas markets arose in Hong Kong. The Commissioner supported his argument by advancing two submissions:

- The business of the bank was indivisible since all the profit earning operations were conducted from Hong Kong by staff employed there, no overseas branch of the bank was involved and the funds employed in the purchase of the certificates of deposits arose from the carrying on of the business in Hong Kong.
- In any event, even if the sale and purchase of certificates of deposit failed to be treated as separate operations, the profits from these operations arose in Hong Kong. Investment decisions were taken in Hong Kong and the funds used in the purchase would have been derived from Hong Kong depositors.

In delivering the judgment on behalf of the Privy Council, Lord Bridge of Harwich rejected the Commissioner's submission on the basis that in line with section 14 of the IRO, the carrying on of the business element should be separated from the source of profits requirement. As the learned judge argued in illustrating the possibility of apportionment in ascertaining the location of profits, the structure of section 14

²⁶² (1991) (1) AC 306 (PC), 3HKTC 351; also extensively analysed in *The Taxpayer*, note 12, January 1999, p. 6. Prior to the *Hang Seng Bank* case, the Hong Kong courts have to settle the dispute between the *Bank of India v CIR* (1988) 2 HKTC 503, where the source of profits was in issue. Nazareth J in applying the 'overall business framework' approach concluded that 'the operations test as applying to Hong Kong in the light of the *Dock* case is that conveniently set out by Hunter J in the *Sinolink* case.'

presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong and others overseas. The former are taxable, and the latter are not. Therefore to accept the construction which underlies the Commissioner's primary submission would reduce the effect of the third condition of section 14 to negligible significance.²⁶³

Lord Bridge also rejected the Commissioner's second submission on the ground that the source of the profits from individual transactions must be located only by reference to the gross profit accruing from those transactions. The court held that the place where the funds were obtained was not an important factor as well as the place where the investment decisions were made. Thus, as Lord Bridge went on to state in this guiding principle:

'... One looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.'²⁶⁴

The court consequently found that, in this case, the taxpayer's activities were located outside Hong Kong. The decision was based on the point that the dominant cause giving rise to the taxpayer's income, which was the buying and selling of certificates of deposit was outside Hong Kong. The Privy Council therefore rejected the analysis adopted by the Board of Review, which looked at both property and activity as sources of the bank's profits. In the same manner, the Council indicated that the operations involved in performing a contract are generally the operations that, in substance, produce the profits receivable under the contract.

By doing so, the Privy Council reaffirmed the specific-operations approach taken by Reece J in the *Dock* case, and it rejected the compelling all-operations or business-framework approach reflected in the decisions of Gregg J in the *Dock* case and Hunter J in *Sinolink*.

²⁶³ At 318.

²⁶⁴ At 322/323.

The pragmatism of the judgment in the above issue is of relevance in the South African context because of its similarity to the decision in *CIR v Black*.²⁶⁵

In the re-invoicing related case of *Exxon Chemical v CIR*,²⁶⁶ the uncertainty regarding the issue of the source of profits in Hong Kong was again highlighted in the confusing High Court decision.

Exxon Chemical, the Hong Kong branch of a company organised in Panama, bought Petroleum Products from offshore affiliates and sold them to other offshore affiliates. Upon receiving a purchase order from an overseas affiliate, Exxon Chemical's Hong Kong office would transmit the order to a United States affiliate, which would identify a source of supply, purchase the goods on Exxon Chemical's behalf and arrange for direct shipment to the buyer. The United States affiliate received a fee from Exxon Chemical for these services. Exxon Chemical conceded that it was carrying on business in Hong Kong by accepting orders and placing orders from its Hong Kong office. It argued that it was not taxable because its profits had their source outside Hong Kong. Virtually, all operations relating to the performance of the contracts of sale took place outside Hong Kong; thus, it was argued that the profits must be treated as arising from offshore operations.

The court decided that Exxon Chemical's profits had their source in Hong Kong and were subject to Hong Kong profits tax. In Godfrey J's view, Exxon Chemical's profits arose from a sales mark-up that was effected by Exxon Chemical's acceptance of purchase orders and placing of corresponding orders with suppliers at a lower price.

Both of these activities technically took place in Hong Kong. The activities of Exxon Chemical's United States affiliate and other contractors were not viewed as giving rise to Exxon Chemical's profits. Rather, the offshore activities were seen as giving rise only to the profits earned by the contractors from their fees.

The court's decision was probably influenced by a wrong interpretation of the statutory provision that states that profits 'from the business transacted in Hong Kong' have their source in Hong Kong for tax purposes.

²⁶⁵ (1957), 3 SA 536 (A), 1957 *Taxpayer* 172.

²⁶⁶ (1989) 3 HKTC 57 (High Court).

In considering the fact that the sales contracts producing all of Exxon Chemical's income were entered into by Exxon Chemical in Hong Kong, the court had no difficulty in concluding that all of Exxon Chemical's business was transacted in Hong Kong and that its business profits had their source in Hong Kong.

The decision of the court in this case was very much criticised for overlooking the real substance of the action that gives rise to the profits. As it was argued, the court here defies the common sense approach that looks at where 'the real action took place, where the money was put at work.'²⁶⁷

Just one year after the *Hang Seng Bank* case, the Privy Council confirmed the application of the guiding principle stated in that case in *CIR v HK-TVB International Ltd*,²⁶⁸ by illustrating the appropriateness of the 'operations' test.

In this case, the taxpayer was based in Hong Kong but sent employees overseas to negotiate, and in some instances to conclude licensing agreements with independent film distributors and television station regarding the showing of films in which the taxpayer owned the copyright. The taxpayer acquired the copyright in the films in terms of an agreement made in Hong Kong with the parent company which had produced the films in Hong Kong.

The commissioner appealed against the decision of the Court of Appeal which had held that, as copyright royalties received from overseas licensees were from outside Hong Kong, they were not taxable.

In the Privy Council, it was decided in favour of the Commissioner. Lord Jauncey of Tullichettle, in considering what was done to earn the sub-licence fees, rejected the argument presented by the taxpayer that the sub-licencing services provided by TVBI generated the fees. The learned judge held that:

'Where a resident in country A grants in that country the right in country B to exercise intellectual property rights which he has therein acquired by registration or application, he does not render a service in country B by the grant. Nor does he render a service in country B or anywhere else by refraining in consequence of the grant from taking preventive action against

²⁶⁷ See VanderWolk, JP, "Hong Kong: Taxation of profits from international business: Recent cases," July 1990, *International Bureau of Fiscal Documentation*, p. 340. Following the *Exxon Chemical* case, an identical decision was adopted by the court in *CIR v Euro Tech (Far East) Ltd* (1995, 1 HKRC, para 90-074) involving the facts similar to *Exxon Chemical*.

²⁶⁸ (1992), STC 723, 3 HKTC 468; also cited by *The Taxpayer*, January 1999, p. 7.

the grantee. Rendering a service connotes some positive action on the part of the renderer and not a state of passivity.²⁶⁹

The court further carried on in giving the proper approach by stating:

‘The profit-making activity of the sub-licensees was carried on outside Hong Kong but the grant of the sub-licences took place in Hong Kong where the taxpayer company operated. Furthermore, the court’s alternative conclusion that the profit arose in or derived from the places where these assets were licensed erroneously presupposes that the rights in question had a fixed *situs* outside Hong Kong whence profits accrued no to the sub-licences but to the taxpayer company.’²⁷⁰

A detailed analysis of this case suggests that although the decision reaffirmed the fundamental principle in determining the source of profits, the *HB-TVBI International case* appears to have departed from the approach followed in the *Hang Seng Bank case*, in examining the taxpayer’s overall business rather than the particular profit-producing transaction.²⁷¹

Thus, the *TVBI* decision had the effect of reviving the business-framework approach exemplified in the *Sinolink* case.

This was confirmed in the *Wardley case*,²⁷² where the three-judge panel held, by a two-to-one majority that commission income received by a Hong Kong based portfolio management company from overseas stockbrokers arose in Hong Kong.

The commissions were essentially a share of the overseas brokers’ commissions on purchases and sales of securities held in portfolios managed by the taxpayer. The management agreement between the taxpayer and its customers permitted the taxpayer to keep any such commissions that the taxpayer was able to negotiate with stockbrokers. The taxpayer’s operations were all in Hong Kong, and it apparently held the customers’ funds, from which the commissions were paid, in Hong Kong bank accounts.

The two-to-one majority of the Court of Appeal in Hong Kong held that these commissions were taxable in Hong Kong. And as Fuad V-P stated in delivering the

²⁶⁹ At 728j / 729a.

²⁷⁰ At 730j / 731a.

²⁷¹ See *The Taxpayer*, note 12, January 1999, p. 7.

principal judgment, the Privy Council decisions in *Hang Seng Bank* and *HK-TVBI* require the court to look at what the taxpayer did to earn the profit and where it did it. Since the taxpayer did nothing outside Hong Kong, its profits must have arisen from what it was doing in Hong Kong. Moreover, it was pointed out that the taxpayer's income was earned under a management contract made in Hong Kong.

However, the dissenting judgment presented by Cons V-P offers a better view, where the judge stated that the commissions arose outside Hong Kong because the transactions that gave rise to the commissions were purchases and sales that were effected overseas. The management contract was not the source of these particular commissions because these commissions came from the overseas brokers rather than from the Hong Kong customers.²⁷³

In conclusion, the *Wardley* decision appears to be in line with *Sinolink* and *TVBI* cases rather than with *Hang Seng Bank*. The Court of Appeal failed to recognise that the overseas brokers were acting on Wardley's behalf as its agent and dealing with property held by Wardley outside Hong Kong. Instead the majority looked at Wardley's operations at its Hong Kong base. Immediately after the *Wardley* case, the court took an important step forward in the development of the law, by confirming the decision of the Board of Review under which the acts of agents were treated as acts of the taxpayer, in the trading profits dispute of *CIR v Magna Industrial Co Ltd*²⁷⁴ where the 'totality of facts' test was considered.

The consideration of the taxpayer's overall business as the proper approach in application of the 'operations' test was reinforced in the source case of *CIR v Orion Caribbean Limited*,²⁷⁵ where the Privy Council has further confused the already uncertain law in this area, by looking at the taxpayer's business as a whole (business-framework approach) rather than particular transaction giving rise to the profit in determining the source of interest.

²⁷² See *CIR v Wardley Investment Services (Hong Kong) Limited* (1992) 1 HKRC para 90-068; also commented by VanderWolk, JP, "The Structure of Revenue Law in Hong Kong", *Tax Notes International*, November 1, 1993, p. 1126.

²⁷³ See VanderWolk, JP, "Hong Kong Taxation: Where Do Profits Arise?" *Tax Planning International Review*, 1993, p. 12.

²⁷⁴ (1996), 1 HKRC, para 90-082.

²⁷⁵ (1997) 1 HKRC, para 90-089 (PC); also cited by VanderWolk and Brook, *op cit*, note 233; This case is also analysed in www.info.gov.hk/ird/ipn21.htm.

In this case, Orion Caribbean Limited (the company taxpayer), earned interest income by lending to unrelated parties as a participant in syndicated loans. It was not a financial institution as designed in the Ordinance. It was wholly owned by a Hong Kong financial institution, Orion Royal Pacific Limited (ORPL), which provided various services to the taxpayer in Hong Kong for a fee. ORPL also entered into syndicated loan agreements in Hong Kong on behalf of the taxpayer from time to time. About 40 per cent of the taxpayer's loan agreements were concluded in Hong Kong in this way.

The taxpayer's directors met in the Cayman Islands and approved all of its loans there. In all cases, the taxpayer, acting through ORPL, made the loan funds available to the borrower outside Hong Kong. The taxpayer relied on ORPL and another related bank in Singapore to lend it the funds with which it made its loans. ORPL handled virtually all aspects of the taxpayer's business except for the decision making by the directors.

The Commissioner's assessment at profits tax was upheld by the Inland Revenue Board of Review on the ground that the taxpayer was a financial institution carrying on business in Hong Kong and so its interest income was sourced in Hong Kong under the expansive source test of section 15(1)(I) of the Ordinance.

On appeal, the Court of Appeal (the case did not pass through the High Court) reversed the Board's decision holding that the taxpayer did not take deposits in Hong Kong and therefore was not a financial institution within the meaning of the statutory definition. Thus, the expansive source test of section 15(1)(I) was not applicable; rather the 'provision of credit' test was applicable. Since the taxpayer had provided the credit to the borrowers outside Hong Kong, its interest did not arise in Hong Kong and was not taxable.

In an appeal by the Commissioner to the Privy Council, the latter held, without considering whether or not the taxpayer was a financial institution, that the taxpayer was simply a vehicle or mechanism by which ORPL had avoided Hong Kong tax on interest from syndicated loans to borrowers outside Hong Kong.

In delivering the judgment, Lord Nolan listed three reasons why the taxpayer's interest was sourced in Hong Kong under the 'operations' test rather than outside Hong Kong under the 'provision of credit test':

- A distinction must be drawn between the situation where the taxpayer lends out its own funds and where the taxpayer must borrow before it may lend. In the first situation the source of the interest will be the place the money was lent. However, the latter case is more akin to a trading transaction involving commodities and both the place of lending and the place of borrowing should be looked at.
- The established authorities, including Lord Bridge's dictum in the *Hang Seng* case, do not stand for "the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of loan of money, the source of income was always located in the place that the money was lent." There is no simple single legal test – it is a practical hard matter of fact.
- The present case was far removed from the simple type of loan transaction contemplated by Lord Bridge. The business of the taxpayer was the borrowing and on-lending of money with a view to profit. The taxpayer allowed itself to be interposed between its Hong Kong parent and the ultimate borrowers as a channel for the loans. In all ways the parent acted as an agent for the taxpayer. The loan agreements were negotiated, concluded (in some cases at least) and serviced by the parent from funds raised or provided by the parent in Hong Kong.

Consequently, the implication of this case for the source of profits tax in Hong Kong is that the *Hang Seng Bank* case principle of determining the source of particular profits from particular transactions has been rejected in favour of the approach adopted in the *TVBI case*, which laid emphasis on the taxpayer's business as a whole in ascertaining the source of the taxpayer's profits.

The Privy Council did not distinguish between the loans that were concluded outside Hong Kong and those concluded in Hong Kong. As Lord Nolan seems to establish as a principle in the *Orion* case, the place of borrowing and the place of lending (that is the main operations) should be taken into consideration as important factors in

ascertaining the source of interest. Unfortunately, this decision contributed to the ongoing uncertainty in the law.

When comparing the *TVB International* and the *Orion* case to the *Epstein's case*²⁷⁶ in South Africa, It is observed that the courts in Hong Kong have rejected the majority judgment approach adopted in South Africa. Further, by looking at the entire business as one entity (the 'activities test', as known in the South African context), the Hong Kong courts seemed to agree with the dissenting judgment of Schreiner JA in the *Epstein's case*, which is now implemented in section 24H(2) of the South African Income Tax Act dealing with partnership income.

c) The 'business presence overseas' test

In the judgment of the *HB-TVBI case*, the court made an interesting remark on the relationship between the carrying on of a business and the source of profits.²⁷⁷ As their lordships went on to say:

'It can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Ordinance.'²⁷⁸

Under the Hong Kong tax system, a business may maintain a presence overseas which earns profits outside Hong Kong, but the absence of a business presence overseas does not, of itself, mean that all the profits of a Hong Kong business invariably arise in or are derived from Hong Kong.

However, as considered in the *HB-TVBI case*,²⁷⁹ in the vast majority of cases where the principal place of business is located in Hong Kong and there is no business presence overseas, profits earned by that business are likely to be chargeable to profits tax in Hong Kong.

There have been over the years some decisive court decisions to illustrate the exceptional circumstances as analysed below:

²⁷⁶ (1954) *Taxpayer* 147. See also Hollingsworth, R, "The Source of Income from Maritime Operations: A Comparison between South Africa and Namibian Legislations", 30 April 1994, vol. 1, Bcom Technical Reports (UCT).

²⁷⁷ See Toh, *op cit*, p. 105.

²⁷⁸ At 730a.

²⁷⁹ See the *Taxpayer*, note 12, *Op cit*.

For instance, in the *Hang Seng Bank case*,²⁸⁰ the buying and selling of certificates of deposits by agents outside Hong Kong was not subject to profits tax in Hong Kong because the court emphasised on the particular transaction giving rise to the income.

The similar situation was decided in some early cases where the circumstances were comparable to those in the *Hang Seng bank case*.

In *CIT, Bombay Presidency and Aden v Chunlilal B Mehta of Bombay*,²⁸¹ a broker in Bombay entered into future delivery contracts for the purchase and sale of commodities in various foreign markets with parties outside British India, in which no delivery was ever given or taken, and the profits flowing from such contracts were not received in British India. The Privy Council held that in the particular circumstances (the contracts having been neither framed nor carried out in British India), the profits derived from the contracts did not accrue or arise there. As the Court stated:

‘They are not saying that the place of formation of the contract prevails against everything else. In some circumstances it may be so, but other matters – acts done under the contract, for example – cannot be ruled out a priori. In the case before the Board the contracts were neither framed nor carried out in British India; the High Court’s conclusion that the profits accrued or arose outside British India is well-founded.’²⁸²

In *CIR v The Hong Kong & Whampoa Dock Co Ltd*,²⁸³ the appellants, in response to a request from the owners, sent a tug to salvage a vessel stranded on a foreign island. The tug refloated the vessel, towed her to a sheltered anchorage where she was made fit for the tow to Hong Kong, and thereafter towed her for four days to docks in Hong Kong.

The Supreme Court held that, the profits from the salvage operation were not ‘profits arising in or derived from the Colony’ within the meaning of section 14(1) of the Inland Revenue Ordinance. As Reece J stated:

‘Here the contract of salvage was entered into in the Paracels and all the work of refloating and putting the vessel into a condition to be towed to Hong Kong and nearly all the two, except for the last three miles, were completed beyond

²⁸⁰ *Op cit*, note 250.

²⁸¹ (1938) 6 ITR 521; also analysed by Toh, D, “Source Principles: Recent Hong Kong Cases”, (1990) 3 *Juta’s Tax Review* 52.

²⁸² At 533.

²⁸³ (1960) 1 HKTC 85.

the territorial limits of Hong Kong and consequently I take the view that the profits must be said to arise outside of Hong Kong rather than inside.²⁸⁴

The principle adopted in the *Whampoa Dock case* was followed in the *International Wood Products case*,²⁸⁵ where the facts are quite analogous to those in *TVBI case*. In this case, the Hong Kong based taxpayer had entered into an agency agreement and then sub-contracted all of its duties to offshore sub-agents. The taxpayer's profits consisted of the spread between commissions received and commissions paid to the sub-agents. Similarly, TVB International's profits equalled the spread between royalties received and royalties paid. In both cases, the taxpayers were not actively involved in earning the money on a day-to-day basis.

The Court in *International Wood Products* took the approach that, the 'real action' producing the profits was occurring outside Hong Kong. The fact that the taxpayer had no operation of its own outside Hong Kong was not thought to be relevant, though the Inland Revenue Department had argued otherwise.

In conclusion, as stated in the various court decisions, the judicial tests in ascertaining the source of profits tax do not lay down a rule of law that will cover all cases where the locality of profits was in issue.

In order to minimise the confusion and to provide certainty in the operation of the territorial source principle, the Inland Revenue Department (IRD) has established basic guiding principles²⁸⁶ to assist in locating the source of profits that can be summarised as follows:

- The question of locality of profits is a hard, practical matter of fact. No universal rule will cover every case. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transaction giving rise to them.
- The broad guiding principle is that, one looks to see what the taxpayer has done to earn the profits in question and where he has done it. In other words, the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.

²⁸⁴ At 116.

²⁸⁵ *CIR v International Wood Products* (1971) 1 KHTC 551.

- The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.
- In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.
- The place where the day-to-day investment business decisions are taken does not generally determine the locality of profits.
- The absence of an overseas permanent establishment of a Hong Kong business does not, of itself, mean all of the profits of that business arise in or are derived from Hong Kong.

Because each case has to be considered in the light of its own particular circumstances and facts, it is easy to apply the above guidelines in cases where, for instance, everyone can agree which operations produced the profits and those operations all occurred in the same place. Due to the fact that it is difficult to set out a hard and fast rule in tax disputes concerning source, another approach in determining the source of profits will be to look at straightforward scenarios that give rise to particular types of income.

2.2 Source of particular kinds of income.

As the above analysis demonstrates, conflicting court decisions suggest that it may not always be easy to determine with clarity the source of the profits of a business. Thus, in order to provide taxpayers with a higher degree of certainty in their taxation affairs, the Hong Kong's Inland Revenue Department (for a better interpretation and understanding of cases) has established Practice Notes and provides Advance Rulings (from 1 April 1998) of how the general rules for determining where profits arise apply to particular types of income.

²⁸⁶ The guiding principles in the form of Practice Notes and Advance Ruling are not laws, but rather the view of the IRD as to how the law presently operates. See *The Departmental Interpretation & Practice Notes No 21 (Revised 1998) on the Locality of profits*.

2.2.1 Trading profits

Determining the locality of profits derived from trading in commodities or goods has given rise to a lot of controversy. Generally, the determining factor as stated in the Privy Council decisions (the *Hang Seng Bank* and *TVBI cases*) is the place where the contracts for purchase and sale are effected.

The Department's approach derives from the fact that, because the locality of profits is a hard, practical matter of fact, 'effected' cannot merely mean legally executed (as this would depend on formal legal rules of offer and acceptance) and thus must contemplate the actual steps leading to the existence of the contracts including the negotiation, an in substance, conclusion and execution of the contracts.²⁸⁷

The Department's view here seems to contradict previous court decisions. For instance, as stated by Lord Bridge in the *Hang Seng Bank* case to the effect that contracts for the purchase and sale of goods are effected, at least in part, where the taxpayer's contractual obligations are performed. In contrast, the department seems to indicate that a trading profit is earned in its entirety, when the taxpayer enters into a contract of sale for a price in excess of that paid or payable by the taxpayer for the goods being sold. This is inconsistent with the principle that as a matter of law and as a matter of fact, the seller does not have the right to receive payment under the contract until he/she has performed his or her obligations under the contract. Therefore, the reality is that trading profits are not earned merely through the making of contracts.

Furthermore, the department's inclusion of negotiations as operations to be taken into account in determining where profits are earned is not in line with the principle that profits arise not from decision-making but from transactions. It is submitted that negotiations, *per se*, are mere preliminary activities and that the place where negotiations occurred could only be relevant in determining the locality of a profit (other than a fee for negotiation services) if the negotiations resulted in the making of a contract at that place.

²⁸⁷ Contained in www.info.gov.hk/ird/brief-sg.htm.

2.2.1.1 'Totality of facts' test

However, following the recent Court of Appeal decision in *CIR v Magna Industrial Co Ltd*,²⁸⁸ it is now clear that a wider approach is necessary. The proper approach is to look at the totality of facts in determining what the taxpayer did to earn the trading profits. All the relevant facts must be considered, not simply the purchase and sale of goods.

The taxpayer, Magna, was a Hong Kong company whose sole office was located in Hong Kong. The company derived profits from selling goods in foreign markets through independent sale agents based overseas. It purchased the goods in Hong Kong from a wholly owned subsidiary, Company A. Company A purchased the goods on its own account from independent suppliers and stored them in Hong Kong warehouse pending the receipt of orders from Magna. Magna paid Company A a cost-plus price for the goods in addition to a service fee for its assistance in carrying out Company A's obligations under the contract with the buyer.

The Board of Review held that Magna's profits for overseas sales had arisen outside of Hong Kong, on the grounds that the overseas agents had concluded the sales on Magna's behalf outside Hong Kong.

The Commissioner appealed the board decision to the High Court arguing that the board had reached the wrong conclusion as to where the profits arose. The High Court surprisingly agreed with this, holding that 'the true and only reasonable conclusion would have been that the profit arose and was derived from Magna's activities in Hong Kong'.²⁸⁹

The Court of Appeal overturned the High court judgment stating that the judge 'was not entitled' to make such a finding. Litton V-P went on to confirm the principle that, only in 'rare cases' will no tax be due on the profits of Hong Kong-based taxpayers, noting that Magna's wide network of overseas agents and distributors was 'rare'. He also noted that the question of whether particular profits arose in Hong Kong or overseas is one in which reasonable people might differ.

²⁸⁸ (1996) 1 HKRC para 90-082.

²⁸⁹ *Ibid*, para 90-078.

As the Court of Appeal pointed out:

‘Obviously the question where the goods were purchased and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?’²⁹⁰

This actually reflected the statement by the High Court in relation to how the relevant facts are considered:

‘More often than not, it would not be the quantity of activities but the nature and quality of them that matters more. The cause and effect of such activities on the profits is the determining factor. It is what role such activities played and the relative importance of them in the making of profits that would usually tilt the scale and not the number of activities carried out at a particular place.’²⁹¹

As stated in the headnote to *Case No D9/89* that:

‘Generally, the employment of staff and the maintenance of an office in Hong Kong, with all necessary services and facilities including telephone and telex, are the essence of a trading company’s activities. Where these are all in Hong Kong, it could be concluded that the resultant profits have a Hong Kong source. The fact that goods are located and delivered outside Hong Kong is not material for this purpose.’²⁹²

The development of the source of trading profits through cases has not helped to clarify this sensitive aspect of the source income. As correctly submitted by VanderWolk, confusion continues to reign as to where trading profits arise for tax purposes. As the cases reveal, we are told to look at where contracts are effected. Then we are told to look also at the totality of facts relevant to the earning of the profits. After that, we are told that merely having an office in Hong Kong with a working telephone is somehow the ‘essence’ of the business and will suffice for the profits to be properly treated as arising in Hong Kong.²⁹³

2.2.1.2 The Inland Revenue Department’s views

On the basis of the opinions expressed above and in the light of the various court decisions, the department’s views which are contained in its assessing practice on the

²⁹⁰ At 773.

²⁹¹ At 732.

²⁹² (1989) 4 IRBRD 207.

locality of profits derived from trading in commodities or goods by a business carried on in Hong Kong can be summarised as follows²⁹⁴:

- Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.
- Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits is taxable.
- Where either the contract of purchase and contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. However, the totality of facts will have to be examined to determine the source of profits.
- Where the sale is made to a Hong Kong customer, the sale contract will usually be taken as having been effected in Hong Kong.
- Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.
- Where the effecting of the purchase and sale contracts does not require travelling outside Hong Kong but is carried out in Hong Kong by use of telephone, fax or other electronic means including the internet, the contracts will be considered as having been effected in Hong Kong.
- The purchase and sale contracts are important factors, but the totality of facts must be looked at to determine the locality of the profits.

i) Irrelevant facts

Facts not directly related to the trading activities are considered irrelevant in ascertaining the locality of profits. There may be cases where the activities of a Hong Kong trading business are limited to the following:

- Issuing or accepting an invoice (not order) to or from an ex-Hong Kong customer or supplier (whether related or not) on the basis of contracts of sale or purchase already effected by an ex-Hong Kong associates;
- arranging letters of credit;

²⁹³ See VanderWolk, *op cit*, note 233, p. 102.

²⁹⁴ See *Departmental Interpretation and Practice Notes*, no 21 (Revised 1998) in www.A/taxhk4.htm

- operating a bank account, making and receiving payments, and
- maintaining accounting records.

This situation commonly arises when a Hong Kong business, as a member of a group and pursuant to group directives, carries out the above activities and 'books' the profits in Hong Kong. Provided the activities of the Hong Kong business do not include the acceptance or issue of sale or purchase orders in or from Hong Kong, the profits would not be taxable.

Another situation that may arise is that a trading company, carrying on business outside Hong Kong, may set up a branch in Hong Kong to act as a buying office. The activities of the branch are confined to the purchase of goods in Hong Kong and it is not involved in their sale, either in Hong Kong or elsewhere. In such a case, a liability to Hong Kong profits tax would not arise. The function of buying office may also be carried by a subsidiary company or by an accredited agent (either related or unrelated). However, as for a branch, the subsidiary company or accredited agent must not be involved in the sale of goods. On the other hand, any commission or other remuneration earned by the subsidiary company or accredited agent for performing its services in Hong Kong will be fully taxable.²⁹⁵

Cases may also arise where it is claimed that contracts of purchase and of sale have been effected outside Hong Kong by employees of the Hong Kong business travelling abroad or by fully accredited overseas agent. In this context, an agent is regarded as fully accredited if it has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal. Normally, the activities of a fully accredited agent and an employee are accorded the same weight if it can be shown that the employee has fully authority to conclude contracts without reference to the business in Hong Kong. In considering claims that contracts have been effected outside Hong Kong by employees, assessors will require details of travelling, hotel and subsistence expenses in respect of each individual transaction. Where it is claimed that contracts are effected by overseas agents, it will be necessary to provide agency agreements or other documentary evidence to support the claim.

The department also states in its guiding principle that ‘the question of apportionment does not arise in relation to trading profits’, which will either wholly taxable or wholly non-taxable. No rationale is given in support of this position. This approach is difficult to reconcile with the fact that the department at the same time stresses the need to look at the totality of facts in determining the source of trading profits; it seems then strange that the commissioner is not willing to consider the possibility of apportionment of such profits in cases where the relevant activities occurred both inside and outside Hong Kong.

2.2.1.3 Profits of manufacturing businesses.

2.2.1.3.1 ‘The place of manufacture’ test

The Inland Revenue Department considers that the source of profits for a manufacturing business is the place where the goods are manufactured. The profits arising from the sale of goods manufactured in Hong Kong are fully taxable there.

In the situation where goods are manufactured partly in Hong Kong and partly outside Hong Kong (say in the Mainland China), that part of the profits which relates to the manufacture of goods outside Hong Kong will not be regarded as arising in Hong Kong.

The Department’s views are illustrated through the following examples:

i) **Manufacturing under a processing or assembling arrangement with an entity in the Mainland China.**

It is common for a Hong Kong business, which may well have previously carried out all of its manufacturing operations in Hong Kong and does not have a licence to carry on a business in the Mainland, to enter into a co-operative agreement, sometimes referred to as a processing or assembling arrangement with an entity in China.

Under this arrangement, the Hong Kong manufacturer normally provides the raw materials, technical know-how, management, production skills, design, skilled labour,

²⁹⁵ Vanderwolk, JP, “Source Based Taxation: Hong Kong Inland Revenue Department Issues Long awaited Practice Note on Locality of Profits”, December 1992, *Tax Notes International*, p. 1308.

training and supervision for the locally recruited labour and the manufacturing plant and machinery.

The Mainland entity is responsible for processing, manufacturing or assembling the goods by providing factory premises, land and labour that are required to be exported to places outside the Mainland. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business.

In this type of case, strictly speaking as a matter of law, the Mainland entity is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment in respect of the latter's profits should not arise.

However, recognising that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply of raw materials, training and supervision of the local labour), the Department is prepared to concede in cases of this nature to allow the profits on the sale of goods in question to be apportioned which is based generally on a 50:50 basis. In other words, only 50% of the profits are assessed as sourced in Hong Kong.²⁹⁶

ii) **Manufacturing by an independent sub-contractor in the Mainland of China.**

It is recognised by the Department that in cases where the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business in the manufacturing work, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits. Its profits will be calculated by deducting from its sale the cost of goods sold, including any sub-contracting charges paid to the sub-contractor in the Mainland. Therefore, taxability of such profits will be determined on the same basis as for commodities trading business.

The Department's views on the subject can be summarised as follows:

²⁹⁶ Contained in www.info.gov.hk/ird/brief-sg.htm

- A Hong Kong company manufactures goods in Hong Kong and sells them to an overseas customer. The fact that the company has sales staff overseas does not give a part the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax. On the other hand, where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profits tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, the profits attributable to the retailing activities are fully taxable.
- A Hong Kong garment manufacturer has a factory in the Mainland where sweater panels are knitted. These panels are then transported to the manufacturer's factory in Hong Kong where there are sewn together into finished garments for sale. This would be a case where the manufacturing profit could be apportioned.

2.2.1.4 Sale or purchase commission

2.2.1.4.1 The place where service is performed

This refers to situations where the commission income is earned both by securing buyers for a manufacturer's products and by securing suppliers to make products required by customers.²⁹⁷ In such cases, the Department considers that the activity which gives rise to the commission income is the arrangement of the business to be transacted between principals. The source of the income is the place where the activities of the commission agent are performed. Thus, if such activities are performed in Hong Kong, the income has a source in Hong Kong.

Factors such as the place where the principals are located, how they are identified by the commission agent, and the place where incidental activities are performed prior or subsequent to the earning of the commission are not generally relevant in determining the source of the commission income.

²⁹⁷ It should be noted that typically, the commission income is a percentage of the invoiced value of goods.

The Inland Revenue Practice was tested in court in the recent case of *CIR v Indosuez W.I Carr Securities Ltd (Carr)*.²⁹⁸ Carr was organised as a Hong Kong securities hub company with clients all over the world. The issue was whether brokerage commission income earned by Carr from transactions consummated for clients on various stock exchanges outside Hong Kong, such as Thailand, Singapore, Indonesia, India, Korea and Taiwan, was derived outside Hong Kong and therefore not taxable in Hong Kong.

In the first instance, the Board of Review concluded that the answer depended on where Carr's clients were located. Commissions from clients not based in Hong Kong were offshore in nature and thus not taxable, while commissions from Hong Kong-based clients were onshore and taxable. In the case of clients not based in Hong Kong, the rationale adopted by the board was that the source of the commissions was the activity undertaken by the subsidiaries or office of Carr located outside Hong Kong in places like New York, London, and Singapore (collectively referred to as affiliates). The board reasoned that although Carr had not furnished any evidence that the affiliates were agents of Carr, it was reasonable for the board to infer that they acted as Carr's agents when they undertook activities such as company research, maintaining client relationships, and processing orders. Because the acts of an agent are attributed to the principal, the board concluded that Carr had performed the activities outside Hong Kong and the related commission was therefore offshore in nature. Curiously, the board ignored the acts of the brokers who actually consummated the trades, because they were considered to be independent contractors providing services to Carr.

In the case of Hong Kong clients, the board concluded that activities performed by Carr both in and out of Hong Kong generated the commission income. The onshore and offshore activities carried a weighting of roughly 60 to 40. Although the board was tempted to apportion the income on a 60-40 basis, it concluded that the commission from Hong Kong clients was wholly onshore and therefore fully taxable because apportionment was not permissible, according to previously decided cases.

²⁹⁸ Inland Revenue Appeal No 5 of 2001.

In the appeal to the Court of First Instance, Deputy High Court Judge Longley concluded that the board erred in its conclusions on the agency of both the affiliates and brokers. Because the onus was on Carr to provide evidence that the affiliates were acting as its agents in law and Carr had not furnished the relevant evidence, the board erred in concluding that the affiliates were agents of Carr. On the other hand, even the counsel for the commissioner accepted that brokers who were responsible for executing orders were acting as agents; however, in the commissioner's view, they were agents of Carr's clients, not Carr. That was firmly rejected by the judge, who accepted that the brokers were acting on behalf of Carr.

On the question of apportionment, the court concluded that the observation made by the Privy Council in the *Hang Seng Bank* case (namely the lack of statutory provision for apportionment did not preclude apportionment) was the right legal position in Hong Kong.

Having arrived at the above conclusions, the judge remitted the case back to the board with the following instructions:

- In the case of commissions from clients based outside Hong Kong, the board should reconsider the position on the basis that the acts of affiliates could not be attributed to Carr. The board also needed to consider whether non-Hong Kong clients could properly be considered clients of Carr or its affiliates.
- In the case of commissions from clients in Hong Kong, it would be appropriate for the board to apportion the income. In arriving at the offshore portion, it will now be necessary for the board to ignore the activities of the affiliates but take into account the acts of the non- Hong Kong brokers.

2.2.1.5 Interest

2.2.1.5.1 Persons other than financial institutions

Considering its policies of being an attractive financial center, Hong Kong repealed interest tax with effect from the year of assessment commencing on the 1 April 1989. Now in Hong Kong, the only interest chargeable to tax under the profits tax is the one

accrued or received by persons carrying on a business, trade, profession in Hong Kong.²⁹⁹

In Hong Kong, the source of interest income has been determined in practice by the Commissioner of Inland Revenue and in law by the courts.

Before studying the test generally applied for determining whether interest accrued or received by a business carried on in Hong Kong is assessable, it is important to analyse the extent to which the receipt of interest income can constitute a trade or business.

a) Receipt of interest as trading activity

The question whether the passive receipt of interest income by a company constitutes the carrying on of a business has arisen occasionally under the Hong Kong income tax law. The Department's view on this matter has derived from the court decisions in *IRC v Korean Syndicate Ltd*,³⁰⁰ *CIR v The South Behar Railway Co Ltd*,³⁰¹ and *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue*,³⁰² where the current position was formulated as follows:

- The mere receipt of interest by a company does not constitute the carrying on of a business;
- actions that go beyond 'mere passive acquiescence' may constitute the carrying on of a business;
- a period of inactivity does not rebut the fact that a company is still carrying on business.

The application of the above principle was highlighted in the Supreme Court case of *CIR v Bartica Investment Ltd*,³⁰³ where a company placed deposits with financial institutions as security for back-to-back loans, and also held investments and purchased shares in a listed Hong Kong company.

²⁹⁹ For instance, interest on bank deposits placed in Hong Kong's authorised banking institutions is exempt from profits tax. See www.deloitte.com/asia/hk/0698-2.htm

³⁰⁰ 12 TC 181.

³⁰¹ 12 TC 657.

³⁰² (1978) STC 581.

³⁰³ Case cited in the *Inland Revenue Department Interpretation and Practice Notes No 13 (Revised October 1996, July 1997)*.

Cheung J decided in favour of the Commissioner that, without having to rely on its investment holding and share purchasing activities, the company's principal on-going activity of placing deposits and furnishing securities was sufficient to constitute carrying on a business. As the court found it, the company's activities had gone beyond 'mere passive acquiescence', and therefore, considering the case on its own facts, it can be distinguished from situations involving the mere passive receipt of interest.

Section 15(1)(g) of the Inland Revenue Ordinance, deems interest received in respect of the funds of a business carried on in Hong Kong by a person, other than a corporation, to be receipts arising in Hong Kong from a business carried on in Hong Kong and chargeable to profits tax. Interest is thus subject to profits tax on the same basis as all other income received by a business.

Moreover, as decided in *CIR v Lau, Wong & Chan*,³⁰⁴ interest received in respect of monies held on trust, for instance, interest bearing clients' trust accounts which by agreement with the clients is retained by a business, trade or profession is also subject to profits tax. As it was stated in that case, such income is received as consideration for services rendered and consequently arises in or is derived from that business in Hong Kong.

b) Test for interest tax liability

i) The 'provision of credit' test

In the case of interest income from loans made in the course of business (other than financial institution), the Inland Revenue Ordinance has over the years relied on a provision of credit test which holds that interest arises in the place where the credit was first made available to the borrower.³⁰⁵

³⁰⁴ 2 HKTC 470.

³⁰⁵ See www.hk.org/guide.hk.html; also cited by Swanepoel, E, *op cit*, p. 50.

The Department's view on the provision of credit test derives from the court decisions in *CIR (NZ) v N V Philips Gloeilampenfabrieken*,³⁰⁶ and *CIR v Lever Brothers & Unilever Ltd*,³⁰⁷ where the courts held that for the purpose of determining the place where interest arises or is derived from, it is the location of the originating cause that almost invariably determines the source.

In essence, the place of derivation of interest is the place where the funds from which the interest is derived were provided to the borrower.

The correctness of the provision of credit test as a general matter was re-affirmed by a dictum of Lord Bridge in the Privy Council's decision in *CIR v Hang Seng Bank Ltd*,³⁰⁸ where it was stated that, profits from lending money would arise where the money was lent.

Consequently, if the originating cause of the income is situated in Hong Kong, the source of interest is in Hong Kong, irrespective of the currency in which the loan is denominated, the place of residence of the debtor or the place where the debtor employs the capital.

As it was decided in *IRBRD 20/75*,³⁰⁹ and in *Studebaker Corporation of Australasia Ltd v C of T*,³¹⁰ while the emphasis is generally placed on the provision of credit, in some instances, such as mortgages, the originating cause may well be the mortgage itself. In addition, interest has a Hong Kong source where it forms an integral part of a trading transaction carried out in Hong Kong, i.e, where a Hong Kong manufacturer sells his goods to an overseas buyer on extended credit terms. In such situations, the interest is just as much a part of the profit as the trading profit itself and also arises in Hong Kong.

³⁰⁶ (1954) 10 ATD 435.

³⁰⁷ (1946) 14 SATC 1.

³⁰⁸ *Op cit*, note 250.

³⁰⁹ At 184.

³¹⁰ (1921) 29 CLR 225.

ii) Departure from the ‘provision of credit’ test: The *Orion* case

In the case of *CIR v Orion Caribbean Ltd*, the issue was whether the interest earned from lending money outside Hong Kong has its source in Hong Kong.³¹¹

The Privy Council refused to apply the provision of credit test in determining the source of interest, and thus departed from the principle that was thought to be settled.

Lord Nolan in his judgment reiterated the Board of Review’s finding that the taxpayer served as a vehicle for a tax avoidance scheme and established this as the foundation for the decision, without finding that the taxpayer was not a genuine company or that the arrangements could be disregarded under either general principles or anti-avoidance legislation.

In applying the ‘operations’ test to the case rather than the ‘provision of credit’ test, it was argued that the learned judge has altered the test to determine the source of interest for an entity which is not a financial institution as defined in the Ordinance. He consequently gave the impression that the ‘provision of credit’ test is limited to the situation where the money lent is the entity’s own money and that if the taxpayer has had to borrow funds in order to lend, it appears that both the place where the borrowing took place and the place of lending should be looked at in determining the source of the interest.³¹²

This case has come to lay down the principle that the ‘provision of credit’ test is no longer the conclusive factor in ascertaining the source of interest. Even if the funds was provided outside Hong Kong and the relevant activity or operation leading to the earning of that interest was carried on in Hong Kong, it would thus be possible to apply the basic charging provision of section 14 of the Ordinance

Accordingly, though the *Orion case* has set a precedent that has rendered the source of interest test in Hong Kong to be more problematic, this has not in practice changed the way the Department interprets and applies the law relating to the source of interest income accruing to a business (other than a financial institution).

³¹¹ (1997) 1 HKRC para 90-089.

³¹² See VanderWolk and Brook, *op cit*, note 233.

Thus, as a general rule, the source of interest is only considered to be in Hong Kong if the lender provides the funds there to the borrower.³¹³

2.2.1.5.2 Interest earned by financial institutions

The 'provision of credit' test was apparently abused by Hong Kong financial institutions. In response, the Ordinance was amended in 1978 by the addition of section 15(1)(I) which deems interest income received by financial institutions from their businesses in Hong Kong to arise in or be derived from a trade, profession or business carried on in Hong Kong, notwithstanding that the provision of credit may have been outside of Hong Kong.³¹⁴

In other words, all sums accrued or received by a financial institution by way of interest or profits or the sale or the redemption of certificates of deposits, notwithstanding that the money in respect of which the interest is received or certificates acquired was made available outside Hong Kong, will be assessable to profits tax if such sums arise through or from the carrying on of the business of the financial institution in Hong Kong.

The issue has been raised as to what extent interest can be said to have arisen from the carrying on of a business in Hong Kong by a financial institution. It is argued that this is a question of fact to be determined by the totality of circumstances in each case. Modern international banking is a highly complex business and circumstances will vary between different financial institutions.

³¹³ See the Department's guide on territorial source principle of taxation, February 1998, from www.info.gov.hk/ird/brief-sg.htm.

³¹⁴ The term 'financial institution' is defined as :
-an authorised institution within the meaning of section 2 of the Banking Ordinance (Cap 155); and
-an associated corporation of an authorised institution which would have been liable to be authorised as such an institution under the Banking Ordinance had it not been exempt under the relevant provisions (such as the deposit taking companies) under section 3(2) of the Banking Ordinance.

Section 15(1)(I) only applies to interest income not otherwise chargeable to profits tax. Thus, the Board of Review has also held that, notwithstanding that the provision of credit was outside Hong Kong, interest derived by a financial institution may still be chargeable under section 14 if the interest arose from a financial institution's operations in Hong Kong. See 2 IRBRD 59.

If financial institutions carrying on business solely in Hong Kong accepted deposits there but use part of the proceeds to purchase foreign interest-bearing securities or advance loans to overseas borrowers, the whole of its profits will arise from its Hong Kong business.

On the other hand, we may also have situations where the operations carried out in Hong Kong are confined merely to entering a transaction in the books of account, and it would be difficult to claim that the profits on such transactions arise from the carrying on of business in Hong Kong. Conversely, if the operation of substance relating to a transaction are carried out in Hong Kong, the profits tax liability cannot be escaped merely by entering the transaction in the books of an overseas branch of the Hong Kong financial institution.³¹⁵

The complexity of finance operations shows that it is not possible to lay down one comprehensive formula to cover all situations. Thus, cases falling between the two extremes will arise where it can be said that the profits derived from business carried on in Hong Kong and partly from business carried on elsewhere. This will probably give rise to some difficult apportionment problems.

In recognising the practical difficulty associated with determining the assessable profits of financial institutions, the Department has reached agreements (like in 1986),³¹⁶ with practitioners and their financial institution clients on the taxation treatment of certain interest and related fee income in order to reduce a large number of disputes resulting from the 1978 amendment to section 15(1)(I) of the Ordinance. Accordingly, depending on the types of income, their tax treatment is settled as follows:

i) interest from loans

- Where the offshore loans are initiated, negotiated, approved and documented by an associated party outside Hong Kong and funded outside Hong Kong, or where the funds are raised and loaned directly to the borrower by a non-resident (such as

³¹⁵ See Mintz, JM & Richardson, SR, "Taxation of Financial Intermediation Activities in Hong Kong", February 2002, 25 *Tax Notes International*, p. 771.

³¹⁶ Cited in the 1993, 6 *SA Tax Review* 57.

a subsidiary) albeit through or in the name of the Hong Kong institution, the transaction is 100% non-taxable.

- Where offshore loans are initiated for example, by the Hong Kong institution and funded by it in or from Hong Kong, the transaction is 100% taxable.
- Where offshore loans are initiated, for instance, by an associated party outside Hong Kong, but funded by the Hong Kong institution, the transaction is 50% taxable.
- Where offshore loans are initiated for example, by a Hong Kong institution but funded by offshore associates (particularly applying to start up position where the Hong Kong institution has yet to establish a market presence), the transaction is 50% taxable.

ii) Interest on certificates of deposit (CDs)

The acquisition of CDs is treated in the same way as deposit placements (as distinguished from loans). The treatment is predicated on the fact that the Hong Kong institution operates within previously approved parameters as to credit limits and prime banks with whom it may operate. Such transaction is 100% taxable.

iii) Interest from securities other than CDs

The tax treatment in this case follows the same approach as adopted in the case of interest from loans. If there is to be any attribution of interest to offshore intervention, the role of the Hong Kong institution must be that of a mere intermediary in the purchase and sale of securities with no discretion in the matter. It is unlikely that any claim for exemption will be entertained in instance where the Hong Kong institution possesses its own security dealing capability and is active in this capacity.

iv) Guarantee/underwriting fees

In this case, a principal consideration of source is related to whether or not the risk under the guarantee or underwriting commitment is evaluated and is to be borne by the Hong Kong institution. In instance, where the Hong Kong institution has no

discretion on the acceptance or rejection of offshore instruction, and undertakes no risk, such fees will be accepted as merely 'booked' and not assessable.

2.2.1.6 Royalties

The tax treatment of royalties falls under provisions for ascertaining liability to profits tax in Hong Kong. Thus, as stated in section 15(1)(a) of the Ordinance, income received from the exhibition or use in Hong Kong of cinematography or TV film or tape, any sound recording or any advertising materials connected with such film, tape, or recording, is deemed to be from a Hong Kong source.

In the same manner, section 15(1)(b) of the same Ordinance states that sums received for the use or right to use in Hong Kong, a patent, design, trademark, copyright material or secret process or formula or other of a similar nature will also be from a Hong Kong source.

As a general principle, the source of royalties in Hong Kong is determined by where the relevant intellectual property rights are located. This is the result of the first decision of the courts of the Hong Kong Special Administrative Region on the source of profits in *Emerson Radio Corporation v CIR*.³¹⁷ In this case, the court recognised the territorial limitation in section 15(1)(b) which turns on the exploitation in Hong Kong of intangible property as being the originating cause of the royalty income.

The taxpayer, Emerson US, had granted a license to its wholly owned Hong Kong subsidiary, Emerson HK, to use the 'Emerson' trademark in the manufacture and sale of goods to US customers. In exchange for the right to use the trademark, Emerson HK agreed to pay Emerson US a percentage of its income from sales to US customers. Emerson HK engaged contract manufacturers both in and outside Hong Kong to produce goods bearing the 'Emerson' brand, and sold such goods to customers located outside Hong Kong. The activities of Emerson HK in Hong Kong consisted only of paperwork relating to the manufacturing, sale, shipment of and payment for the goods, all of which were done elsewhere (apart from some of the manufacturing and shipping).

³¹⁷ (1998) Inland Revenue Appeal No. 2, 1997, Court of First Instance, 30 June 1998.

The Commissioner assessed tax on Emerson US under section 15(1)(b) and therefore all of the royalties paid to Emerson US were included as taxable amounts.

Emerson US objected arguing that, first, the trademark was used only in the US where the relevant sales were made, and second that if the trademark was also used where the manufacturing occurred, then only a portion of the royalties could be said to be within the scope of section 15(1)(b).

The Board of Review held in favour of the Commissioner, saying that the trademark was used both in and outside Hong Kong but for the purposes of section 15(1)(b), the royalty was an indivisible sum that arose from a business carried on in Hong Kong by Emerson HK which produced Hong Kong-sourced profits. Thus, the royalty was subject to tax in Hong Kong in its entirety.

In the Court of First Instance, Ribeiro R agreed with the Board of Review that the trademark was used both in the place where sales were made and the place where the manufacturing of the branded goods occurred, but he disagreed with the notion that the royalty was an indivisible sum that had to be either wholly within or wholly outside the scope of section 15(1)(b). As he went on to say:

‘The foreign proprietor [of the trademark] is taxed only in respect of royalties earned from use of the trademark in Hong Kong in a manner essential to the generation of that royalty. It is the Hong Kong profit-generating activity that triggers the charge....[The] taxpayer’s royalty receipts in respect of goods which were manufactured, marketed and sold wholly outside Hong Kong, do not activate section 15(1)(b)....I cannot accept the suggestion that each royalty payment was “a single indivisible sum”. Under the Royalty Agreement, royalty payments represented a percentage of US sales achieved. It seems clear that such payments are in principle divisible, and that it is possible to relate particular sums of royalty to the sale of particular goods deriving from the use of the trademark in Hong Kong.’³¹⁸

However, the general rule on the source of royalties is subject to certain qualifications:

First, when the royalties on intellectual property used in Hong Kong are paid to a non-resident (like an overseas company not carrying on business in Hong Kong), only 10% of the gross payments (sum receivable) is taxable, and therefore, the effective

³¹⁸ At 28, 32, 34.

rate of tax is 1.65% of the total sums due, as a deemed Hong Kong sourced business receipt.

The Hong Kong party must withhold such taxable amount at the time of payment, which the foreign party is statutorily obliged to indemnify.

This first qualification is the result of the amendment of section 21A of the Ordinance which by virtue of section 21(A)(3) expressly prevents the exploitation of the royalties provision by Hong Kong companies which enter into arrangements with overseas associates. The usual approach in order to circumvent section 21A was for the Hong Kong company to enter into sale and licence back arrangement with a subsidiary incorporated offshore. By such agreement, the Hong Kong company would transfer ownership of property of a kind referred to in section 15(1)(a) or (b) to the offshore subsidiary which would then grant back to the Hong Kong company.

The objective for tax purposes was for the Hong Kong business to obtain a deduction under section 16(1) of the Ordinance, for the full amount of the royalty or fee paid while the offshore subsidiary was taxed under section 21A on only 10% of the sums it received. Funds remained within the group but a 90% deduction was created in respect of the royalties or fees involved.

With the new provision following the amendment to section 21A, if the patent or know-how was utilised in a trade, profession or business in Hong Kong and the royalties are received from an associate, then the royalty payments are determined on the same basis as trading profits.

This leads to the second qualification as to the source of royalty in Hong Kong, by which royalties received by a business are taxable in Hong Kong if the relevant activities (operations test) are carried out in Hong Kong, though the intellectual property might have been used outside Hong Kong.

This rule was reaffirmed from the leading case of *CIR v TVB International Ltd*,³¹⁹ where it was held that the royalties received by the taxpayer was from a source in Hong Kong. In this case, the taxpayer exercised rights to grant sub-licences for the exhibition outside Hong Kong of Chinese dialect films made or acquired by its parent

³¹⁹ This principle was early adopted in *D 9/88* (1988, 3 IRBRD 166); and confirmed in *D 39/89* (1989, 1 HKRC para 80-004).

company, and the court based its decision on the point that because the main activity giving rise to the royalties were exercised in Hong Kong, the profits had a Hong Kong source.

This decision was highly criticised for failing to appreciate that such income arises from property rather than from activities of the licensor. It is argued that this approach was not satisfactory, and not supported by any reasoning because it was inconsistent with general principle that royalties arise where the licensed intellectual property rights are registered or otherwise located.³²⁰

The above case reconciles with the determination of actual source of royalties as decided in the South African case of *Millin v CIR*,³²¹ to the effect that the source of royalties is the place where the royalty producing activities of the taxpayer takes place. This results in a similar decision to that arrived at by the Hong Kong court in the *TVBI* case.

2.2.1.7 Source of other profits

In dealing with the locality of other types of profits which have generally not given rise to disputes in the past, the Department considers their tax liability to be as follows³²²:

i) Rental income

Rental receipt from real property is taxable in Hong Kong if the property is located in Hong Kong.

It is important in the Hong Kong context to draw the inter-relation between profits tax based on rent and property tax. Though property tax in Hong Kong is levied on the consideration (in the form of rent) received by the taxpayer for the use of his land, buildings, or other structures in Hong Kong, any person who sublets premises is considered to be carrying on business, and the corresponding rental income is chargeable to profits tax rather than property tax.

³²⁰ See VanderWolk, *op cit*, note 233, p. 119.

³²¹ (1928) AD 207.

³²² See 1993, 6 *SA Tax Review* 56.

Consequently, any company which carries on trade, profession or business in Hong Kong can on agreement with the Commissioner be exempt from property tax provided that any income earned in respect of any property is brought into charge for profits tax purposes or the corporation occupies the property for the purpose of producing profits assessable to profits tax.

- ii) Profits from the sale of real property are taxable in Hong Kong if the property is located in Hong Kong.
- iii) Profits from the purchase and sale of listed shares are taxable if the stock exchange where the shares are bought and sold is located in Hong Kong.
- iv) Profits accruing to a business from the sale of securities issued outside Hong Kong and not listed on an exchange are taxable if the contracts of purchase and sale are effected in Hong Kong (except financial institutions in instances where section 15 (1)(I) applies).
- v) Service fee
This type of income is taxable if the services which give rise to the payment of the fees are performed in Hong Kong. In the case of an investment adviser whose organisation and operations are located only in Hong Kong, profits derived in respect of the management of the clients' funds are considered to have a Hong Kong source. Included in chargeable sums are not only management fees and performance fees but also rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or elsewhere in respect of securities transactions executed on behalf of clients.
- vi) Cross-border land transportation income
It is normally taxable if the place of uplift of the passengers or goods is in Hong Kong. However, where the contract of carriage does not distinguish between outward and inward transportation, apportionment will not be permissible.

2.3 Apportionment of profits

The courts in various decisions have enunciated the issue of apportionment of profits under the Hong Kong tax law.

Early in the *Whampoa Dock case*,³²³ Reece J analysed the treatment of profits arising or derived from different sources by recognising that one must make a judgment concerning the relative importance of the different parts of the source of an indivisible profit, and then concludes that the profit arose in the jurisdiction where the most important part or parts of the source of the profits were located.³²⁴

Later in the *Hang Seng Bank case*,³²⁵ Lord Bridge favourably considered the possibility of apportioning profits arising from different sources when he held that:

‘... [T]he structure of the section [14] presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not...’³²⁶

The effect of the above cases is that if it is determined that a given profit arose partly in Hong Kong and partly elsewhere, a determination of how much of the profit arose in Hong Kong must be made if it is possible to do so on a rational basis in light of all of the facts and circumstances of the case.

This principle was highlighted in the landmark case of *CIR v Emerson Radio Corporation*,³²⁷ where the court made it clear that, the profits in issue must be apportioned into those arising in Hong Kong and those arising elsewhere.

As Ribeiro R went on to say in applying the doctrine of apportionment:

‘[I]n my view, an apportionment of the taxpayer’s receipt is required... [T]he royalties received or accrued in relation to the sale of goods manufactured in Hong Kong must be segregated from other royalties. Only the former class of royalties attracts the charge to profits tax.’³²⁸

The concept of apportionment has been clearly endorsed in the *Carr Securities*³²⁹ case where the court concluded that source is not necessarily an ‘all or nothing’ question, and thus in appropriate cases, income may have to be apportioned between onshore and offshore components.

³²³ *Op cit*, note 247.

³²⁴ *Op cit*, at 116.

³²⁵ *Op cit*, note 250.

³²⁶ At 318.

³²⁷ 23 June 1998; final appeal no 3 of 1999 (Civil). Case analysed under the source of royalty’s section.

³²⁸ At 35.

³²⁹ Inland Revenue Appeal no 5 of 2001.

The Department now accepts that notwithstanding the absence of a specific provision for apportioning profits in the Ordinance, there are certain situations in which an apportionment of the chargeable profits is appropriate, though it does not consider it will have a wide application.³³⁰

The Department believes that where apportionment is appropriate, a pragmatic arrangement with apportionment on a 50:50 basis will be generally adopted across-the-board, unless compelling reasons dictate otherwise.

For instances, it has been recognised that for manufacturing profits or service fee income involving substantial activities, both inside and outside Hong Kong, apportionment of profits is appropriate.

Moreover, when apportionment is applied, it may lead to the question of how indirect expenses are to be allocated. It will be necessary to scale down claims for general expenses of the business, which contribute indirectly to earning both the Hong Kong and offshore profits.

3. Concluding remarks

The analysis of the application of source rules in the South African context has revealed that the concept of source although very crucial for the taxation of non-residents is still subject to inconsistent judicial decisions.

With the application of a fully-fledged residence tax system, the deletion of most of the deeming source provisions in section 9 that were criticised for being formalistic, unclear, rigid in their application and did not give substance to the real cause of income, is welcome because they became obsolete and were easily manipulated.

A major issue in the South African source rules is that although the courts have in many occasions recognised the possibility that a given commercial event giving rise to the income may have multiple sources, they have continued to follow an 'all-or-

³³⁰ In Hong Kong, it is only in the specific situation of profits resulting from commodities trading transaction that the Department expressly considers that no question of apportionment can arise. Thus, as the Department views it, such profits will either be wholly taxable or wholly non-taxable. See Departmental Interpretation and Practice Notes No 21 (revised 1998) at www.info.gov.hk/ird/ipn21.htm

nothing' approach to the determination of the dominant source.³³¹ Following the Katz Commission recommendations, the principle of apportionment with respect to the source of income should be incorporated into the tax law in such a manner that the South African courts would be obliged to apportion income between its various sources.

The rigid structure and lack of clarity in the application of source rules might pose a serious concern to offshore investors. For instance, South Africa has repealed the application of deemed source of royalties (in which royalties were considered sourced in the country where the intellectual property was used), but is still imposed a withholding tax on royalty payment made to non-residents based on the repealed deemed source rules. Further, the South African definition of royalties is much broader than the OECD Model definition, by including the show-how payments which normally should be taxed under active business income.

In addition, the term 'carrying on business' for the purposes of interest exemption in section 10(1)(hA) should refer mainly to situations where the non-resident company carries on business through a permanent place of business suitably equipped for carrying on such a business (the permanent establishment concept), rather than merely for instance setting up a local branch. This would establish a true taxable presence for the non-resident in South Africa and avoid confusion as to the determination of 'carrying on business' as applicable to companies. Thus, as the Katz Commission recommended, in terms of section 10(1)(hA) application, interest which is attributable to such permanent establishment should then not qualify for the exemption.

The imposition of a higher rate of tax (35%) on non-resident companies carrying on business in South Africa through a branch, as compared to the 30% imposed on South African companies (assuming they do not distribute dividends), might be seen as

³³¹ It is somehow surprising that the concept of apportionment as indicated in the *Lever Brothers* case, has been given a favourable treatment for other fiscal purposes. For instance, in *Tuck v CIR* (1988, 3 SA 819, 50 SATC 98), dealing with capital and revenue income issues in which there were two or more originating causes of a lumpsum receipt by a taxpayer and the court applied an apportionment. The apportionment has also been applied in the capital and revenue expenditure situations such as the recent case of *CIR v VRD Investments (Pty) Ltd* (1993, 4 SA 330, 55 SATC 368, 1993 Taxpayer 231).

discriminatory and might jeopardise South African relationship with its trading partners, particularly in the negotiation of double tax agreements.³³²

Hong Kong's taxation system on the other hand, works on the territorial source principle whereby only earnings derived in Hong Kong are taxable.

Yet, for years, international businesses have had to accept that there is an element of uncertainty about Hong Kong taxation. As far as the determination of source of profits is concerned, Hong Kong tax law has been attacked as being in a state of confusion, because the courts have not analysed the question of 'source' and interpreted the 'operations' test with any consistency. The Inland Revenue Department has also failed to adopt a practice that is clear or acceptable.³³³

It has been argued that because there is no legislation on the issue of source, this has given rise to a string of ambiguous court decisions. For instance, on the source of trading profits following the *Magna Industrial case*, it has been difficult for a potential taxpayer to know when he is conducting a business in Hong Kong and whether the related profits are Hong Kong source, and therefore taxable. Furthermore, the court decision in the *Orion Caribbean case* has rendered the test for determining the source of interest income to be more problematic.

Following the international practice, it is suggested that as applied in the South African context on source of profits, rather than giving a general definition, it may be more helpful to ascertain the source of income by considering particular types of income on a case-by-case basis.

In order to render the tax law more predictable when determining the source of profits, the Department in Hong Kong is much more active in reducing the possibility and the areas of disputes with the taxpayers, by consistently providing Advance Rulings and Practice Notes on the locality of profits to businesses. For instance, unlike in South African, the Department in Hong Kong in most cases where profits

³³² See Harrison, P, "Non-discrimination of Tax Treaties", Accountancy SA, February 2002, p. 8-11.

³³³ See *The Taxpayer*, January 1999, p. 8. It was stipulated by VanderWolk, *op cit*, *Tax Notes International*, 7 December 1992, p. 1307, that the department's practice note has raised more questions than it answered. It suffers from both internal inconsistencies and from departures from authoritative

are earned from different sources has recognised that apportionment is permissible under the Ordinance, and is in favour of a pragmatic arrangement with apportionment of profits on a 50:50 basis.

Finally, the comparison of the source of particular incomes in Hong Kong and South Africa as adopted by the Inland Revenue practice in both countries can be summarised as follows:

Types of income	Hong Kong	South Africa
Rental income from real property	Taxable if the property is located in Hong Kong	Taxable if the property is located in South Africa.
Profits from the sale of real property	Taxable if the property is located in Hong Kong	Taxable if the capital is employed or the taxpayer's activities exercised in South Africa.
Profits from the sale of goods	Taxable in principle, if the contract is effected in Hong Kong, but following the <i>Magna Industrial</i> case, consideration also of the totality of facts.	Taxable if the capital is employed or the activities carried out in South Africa.
Profits from the purchase and sale of listed shares	Taxable if the stock exchange where the shares are bought and sold is located in Hong Kong. However, profits accruing to a business (other than financial institution) from the sale of securities issued outside Hong Kong and not listed on an exchange are taxable if the contract of purchase and sale is effected in Hong Kong.	Taxable depending on the facts, if the independent share dealing business is carried on in South Africa.
Service fees	Taxable if the services are performed in the Republic. However, employment income is taxable if it is located in Hong Kong.	Taxable if the service is performed in South Africa.
Royalties on Intellectual property	Taxable if the intellectual property is used in Hong Kong (when received by	Sourced in South Africa if intellectual property is created or developed in the

legal sources such as the Hang Seng Bank decision. Moreover, certain areas where the law is currently uncertain are simply not addressed.

	a non-resident). Otherwise, if received by a business, taxable on the same basis as trading profits.	Republic irrespective of where the asset is used to generate royalties. However, it is subject to a withholding tax on payment to non-residents for the use of intellectual property in South Africa.
Interest accruing to a business (other than financial institution)	Taxable in principle, if the lender provides the funds in Hong Kong to the borrower. However, following the Orion case, can be subject to tax in Hong Kong if the main business of the lender which gave rise to the interest is located there. In the case of financial institution, taxable if the business is carried on in Hong Kong irrespective of the location of the provision of credit.	All types of interest income taxable in South Africa if either the provision of credit was made in the Republic or if the debtor uses the money in South Africa.

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Part V: General conclusion and recommendations

This research analyses the concept of fiscal jurisdiction using a comparative approach. In doing so, it attempts to show that it is still difficult, irrespective of the jurisdiction considered, to find a comprehensive and uniform test for determining the factors for tax liability.

In analysing the concept of fiscal jurisdiction in the countries considered, one of the main findings is that one of the problems of international taxation today concerns the divergent interpretation of similar or identical issues by the tax authorities and the courts in different countries. Even for countries adopting the same system of taxation, it is common that a single criterion could be interpreted differently. The main solution suggested is for countries to enter into agreements in order to counter the problem of multiple taxation of the same income and to facilitate international trade.

However, the issue remains in relation to the harmonisation and proper understanding of rules on how to decide which one of the contracting states shall have the right to tax. Tax treaty language can sometimes be quite vague, and necessarily so, given that it is designed to operate in what may be two very different revenue systems. The legal effect of treaties may be different in the two treaty countries, and the manner in which a treaty is interpreted may vary in different court systems without necessarily harmonious results.¹

From the fiscal analysis of the jurisdictions considered (South Africa and Hong Kong), the concept of source has appeared to be an enigmatic principle in terms of its definition and application. The first argument that has been raised in this study is that there is no statutory definition of 'source' principle in South Africa and Hong Kong and the courts have not analysed the issue of ascertaining the source of particular incomes in these two

¹ See Sandler, Part III, *op cit*, p. 39.

countries with any consistency.² Moreover, in the application of the source concept, the South African tax system, in taxing according to a dominant cause of income, could learn from the Hong Kong system where the principle of apportionment of income is expressly implemented in the tax legislation.

In addition, it has been argued that apart from the similarity of approach adopted by the courts in these two countries, taking into consideration that the case law development in one generates a great deal of interest in the other, every jurisdiction still provides in its tax law different criteria for the determination of their domestic source of income.

Given the level of cross-border activities undertaken, it remains important to clarify and harmonise the rules relating to the determination of the source of income in any jurisdiction. It is also necessary to explain the taxation of particular types of income in order to provide certainty to taxpayers and to minimise the effect of international double taxation. It is to this effect that in the implementation of the residence tax system in South Africa from 01 January 2001, most of the deeming source provisions, criticised for being formalistic and subject to abuse, have been repealed in the legislation.

In the complex world of international trade, no single tax principle can be applied in a pure form. Various principles have been modified in the direction of some common middle ground. As a result, jurisdictions exclusively based on source (Hong Kong) have also imported an element of a residence basis, while others like South Africa have shifted their tax system from a hybrid source based to a pre-dominantly residence tax system.

In the jurisdictions considered, that is, South Africa, the United Kingdom and the United States, various factors are adopted to ascertain the meaning of 'residence'. This determination varies from the 'physical presence' test to the factual approach in the case of individuals. With regard to legal entities, the main tests are the place of incorporation

² The Hong Kong source system has been criticized for being in a state of confusion, while South African tax legislator has reacted in the past by the adoption of various deeming provisions to circumvent this problem.

and the subjective factor of central management and control or the place of effective management.

In the United Kingdom, for instance, the scope of residence in tax law applicable to individuals is extremely wide, and as a result, the different forms of residence create their own problems by relying, to a considerable extent, on calculation of length of stay and the taxpayer's intent. The tax legislation in South Africa appears to be more comprehensive in comparison although it still contains a number of uncertain areas. For example, the interpretation in the legislation of the term 'ordinarily resident' is still vague, although guidelines have now been provided on its interpretation by SARS.³ Furthermore, the United States rules on individual residence, based on the green card and substantial presence tests, differ from those of both South Africa and the United Kingdom in some interesting respects.

With regard to legal entities, South Africa has implemented in its tax law, in addition to the 'place of incorporation' test, the OECD tie-breaker rule of 'place of effective management' in its tests of residence. In terms of SARS' Interpretation Note,⁴ the place of effective management is viewed as the place where the highest level of day-to-day management is located, which is very distinct from the 'central management and control' applicable in the United Kingdom. The United Kingdom Revenue authorities considered the place of central management and control to be where the board of directors meets to make the key decisions.

In contrast, the United States tax law is based only on the 'place of incorporation' as the unique test for determining the residence of corporations. With the globalisation of the world's economies and the desire to attract foreign direct investment in most countries, the registration of a company has become easy and inexpensive and it is therefore surprising that such a formality should have such significant tax consequences. The effect

³ See *SARS' Interpretation Note* no 3, 4 February 2002.

⁴ No 6, dated 26 March 2002.

is that adopting the place of incorporation as the sole factor for determining the corporate residence may reach a result that is purely formal and devoid of any substance.

Furthermore, even countries which adhere strictly in their bilateral treaties to the OECD Model Tax Convention do not adopt the same interpretation of the definitional provision of this Convention, although the Commentary⁵ of the Model now provides an interpretation of the 'place of effective management', which is very similar to the United Kingdom application. Thus, for the purposes of fiscal jurisdiction, this could explain why OECD measures have had limited success in resolving the more serious problems of international tax avoidance. One of the ideal solutions for a more homogeneous interpretation of the provisions of the treaty is for different jurisdictions to co-operate by agreeing to a common tax base.

1. The evaluation of the reasons for the radical change to the residence basis of taxation in South Africa

For major net capital exporting countries, the residence tax system is preferred. It is argued that with the international economic integration, where capital has become highly mobile and businesses increasingly becoming transnational, adopting a residence tax system would protect the tax base from possible erosion when exchange controls are lifted.

South Africa's main reasons for shifting from a source system to a residence tax system were as follows:

- To place the income tax system on a sounder footing thereby protecting the South African tax base from exploitation;
- To bring the South African tax system more in line with international practice;
- To relax exchange control regulations and facilitate greater involvement of South African companies offshore;

⁵ See The OECD Commentary updated as of 29 April 2000, on the definition of 'place of effective management', in article 4, para 24.

- To more effectively cater for the taxation of e-commerce.

From the perspective of a developing country like South Africa, the more important tax problem in respect of the residence principle concerns the gradual relaxation of exchange controls and the resultant capital flight. With the application of the residence tax system, many residents, especially those with the greatest wealth, will seek to send their wealth abroad and those sophisticated may wish to ensure that no tax liability arises in respect of the wealth, by using various stratagems. The main problem is one of detection and tax administration.

South Africa has tried to protect its tax system from this kind of exploitation by widening its tax base. Thus, under the current 'residence-minus' system, South Africa imposes taxes on a worldwide basis. South Africa has therefore followed the international practice (as applicable in the United Kingdom and the United States), by implementing legislation in the forms of controlled foreign entity and foreign dividend application rules, which provide for South African taxation either of certain foreign sourced income generated by South African controlled foreign entities, or when the foreign income is finally repatriated in South Africa in the form of foreign dividend.

For instance, in relation to South African controlled foreign entity (CFE) rules, South Africa tax applies where failure to tax foreign controlled entity income will likely lead to an artificial flow of funds offshore, not where taxation will likely damage South Africa international competitiveness. In addition, countries studied in this research attribute income of a CFE only to resident taxpayers that have a minimum interest (which may be variable) in the CFE. The rationale for a minimum ownership requirement is fairness. Although all shareholders of a CFE benefit from the deferral of residence country tax on the income of the CFE, shareholders with small interests in CFEs, may not have any influence over the affairs of the CFE and may not even be able to obtain the necessary information to report their share of the CFE's undistributed income.

Similarly, for the purposes of encouraging investment in South Africa, the legislation introducing the residence based system of taxation in South Africa has provided some specific concessions, including incentives and exemptions to motivate the establishment in the country of foreign international company's headquarters,⁶ the exemption of foreign employment income of contract workers, and the temporary exemption on foreign pensions received by South African residents. In addition, the legislation provides in section 9E(8A), a kind of ministerial exemption by which the Minister of Finance may grant, if the taxpayer meets certain requirements, exemption from the application of foreign dividend rules of section 9E. The effect of this tax sparing concession is that the taxpayer will be able to repatriate the benefits of the tax incentives enjoyed in the foreign country. Previously, such benefits would have been lost when the dividends were brought in South Africa.

However, it can be argued that the previous tax regime (source system) helped to attract and retain companies in South Africa. Thus, the shift in tax policy (with the implementation of the residence tax system) has made it less attractive to run businesses from South Africa, not only because companies have to pay South African taxes on local and foreign earnings, but mainly because the tax system has become enormously complex, contrary to the intention of the Katz Commission in its 5th Report, which advocated a system that is as simple as possible. Judge Davis⁷ contended on this matter that there is an information overload in the new tax system, and because the tax system through its foreign income taxation rules is ever changing, this has left tax advisers at a loss as to how to advise their clients.

It is known that CFE and foreign dividend application rules are legitimate actions against tax avoidance. This is because under a worldwide system of taxation, it is unacceptable that the mere incorporation of a subsidiary in a tax haven would lead to an exemption or deferral of tax. Thus, for countries using a residence tax system, the decision to introduce

⁶ This is the main concession in the South African tax law whereby headquarter companies are practically out of the tax system, though certain items of income generated by them will still be taxed in South Africa, probably because they represent South African source income. See section 1(b) of the Act.

for example, CFE legislation is based on the consideration of capital export neutrality. This requires that all residents of a country should face the same effective rate whether they invest in that country or abroad. The fairness issue is magnified when the domestic market is important and taxpayers with foreign activities would be favoured over domestic operations.

Although the implementation of the CFE legislation in South Africa reflects strong adherence to this doctrine, it has been proven in its application to be notoriously complex and difficult to administer. Thus, generally, a strong dissent has been expressed by the proponents of deferral against the implementation of CFE rules by countries on the following grounds:

- They infringe upon tax sovereignty;
- They destroy capital import neutrality;
- They prevent fair tax competition; and
- They confuse deferral of tax and abuse.

With regard to whether the South African residence tax system is more suitable for the taxation of e-commerce, it may be argued that in the digital economy, the jurisdictional rules of residence may be more dependable and less subject to manipulation than those governing source-based taxation, although this does not mean that they are without difficulty. Thus, there seems to be a trend that residence-based tax systems assume greater importance and are more suited and effective in an e-commerce environment. On the other hand, to the extent that reliance is still placed on the physical presence or location in a particular territory in determining the residence tests, the communication technology will also affect the test for residence.

2. Summary of recommendations

For the purposes of analysing the concept of fiscal jurisdiction, the following emerges:

⁷ See Davis, D, "Tax Reform Not Complete, But Pause Needed", January 2002, no 11, *Tax Update*, *Deneys Reitz Attorneys Publication*.

- (i) The justification for the imposition of tax depends on the theory of fiscal jurisdiction chosen. There are a variety of models, and this research has considered two essential concepts: source and residence. It is appropriate for a jurisdiction to consider a connecting factor for tax liability that is suitable for the circumstances of its economy. A country should adopt the basis for tax liability that prevents the abuse of the tax system, while taking into consideration its administrative efficacy in enforcing the legislation.
- ii) Developing countries with policies to attract foreign direct investment and strict exchange control regulations which result in insignificant outward investment should tend more to adopt the source principle of taxation, while developed countries which are more capital exporters would in many cases apply the residence tax system. It might seem surprising in the case of South Africa that as a developing country, it has decided to adopt the residence principle of taxation. However, the South African shift to a mainly dominant residence system is justifiable in consideration of the continuous relaxation of its exchange control regulations which has triggered a large volume of outbound investment as well as the compatibility of the residence system with the practice of its trading partners. In addition, the residence tax system is considered to be suitable in an e-commerce environment.
- iii) The main challenge for any country is to be able to develop certainty in domestic rules of fiscal jurisdiction. This is not easy in the South African context because of the necessity for the tax system to borrow extensively rules from other countries which are initially alien to South African application. Thus, it is important to harmonise the key tax concepts in the application of double tax treaties. With regard to the source system for instance, the rule relating to the determination of the source of income should be more consistent or the taxation of particular types of income should be explained to provide certainty to taxpayers. On the other hand, with regard to the residence concept, though it is the favourable tax system in international practice, it remains important for a

jurisdiction to adopt in its national tax laws, residence criteria that are not extremely wide and fragmented into classes and application. Although the combination of various residence rules may minimise the abuse of the tax system, it follows that they may nevertheless become impractical, especially in light of growth of multinational companies and cross-border movement.

- iv) As already mentioned, the decision for a residence country to introduce specific anti-avoidance measures such as CFE and foreign dividend application rules is based on the policy consideration of capital export neutrality. Many technical issues are involved in determining the appropriate portion of the income of a CFE or foreign dividend to be attributed to resident shareholders. Countries limit the application of CFE rules to foreign entities that are controlled by residents or in which residents own a substantial interest. For South African tax purposes, the tax system is very complex and several factors have contributed to this state of affairs, such as: the increasing complexity of modern business; the greater sophistication of tax planning techniques; the effect of globalisation with taxpayers investing and doing more business offshore. It is recommended that SARS should provide detailed interpretation notes on the understanding of the relevant legislation, and should avoid constant change of the legislation in order to allow the taxpayers to digest and absorb the implications.

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