

***“THE TAXATION OF INTELLECTUAL PROPERTY:
A SOUTH AFRICAN EXPORTING PERSPECTIVE”***

A RESEARCH REPORT
BY

JOHANNES NICOLAAS VERMEULEN

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1. Introduction

Intellectual property is an asset; it has economic value; it can be commercialised, licensed or sold.

The role and importance of intellectual property assets in a business's activities, value and financing has increased dramatically in recent years. Businesses today are increasingly pursuing their key goals and objectives through intellectual property transactions or business activities involving intellectual property assets. Successful implementation of a business transaction involving intellectual property assets depends not only on the translation of the 'deal' into the agreement between the parties, but also on the tax consequences of a particular form of the agreement, transaction or business activities relating to intellectual property assets.

Given the move toward the internationalisation of business, and the need for businesses to compete globally, there is a requirement for businesses to extend their reach offshore. In addition, with the growing of the Internet on business, businesses will be forced to ensure the strength of their intellectual property internationally. Businesses should begin to consider ways to legally, effectively and efficiently move their intellectual property offshore into a suitable jurisdiction.

The transferring of a trademark, or any other intellectual property asset, offshore into a strong global jurisdiction enables a business to gear off the growth of the asset in that jurisdiction. This process achieves the many objectives of South African businesses to expand internationally. In addition, international commercialisation of intellectual property through licensing has the potential to provide many South African businesses, large and small, with the opportunity to unlock recurring and accrual type revenues from their technologies.

It is therefore important that a South African exporter of intellectual property conducting a business, be it an individual, company, trust or other juristic person, has a clear strategy for managing the South African tax implications relating to agreements concluded with foreign parties. The objective of this paper is, therefore, to identify and analyse the various tax issues that should be considered to facilitate planning for possible tax consequences in order to obtain optimum tax results.

2. Research Question

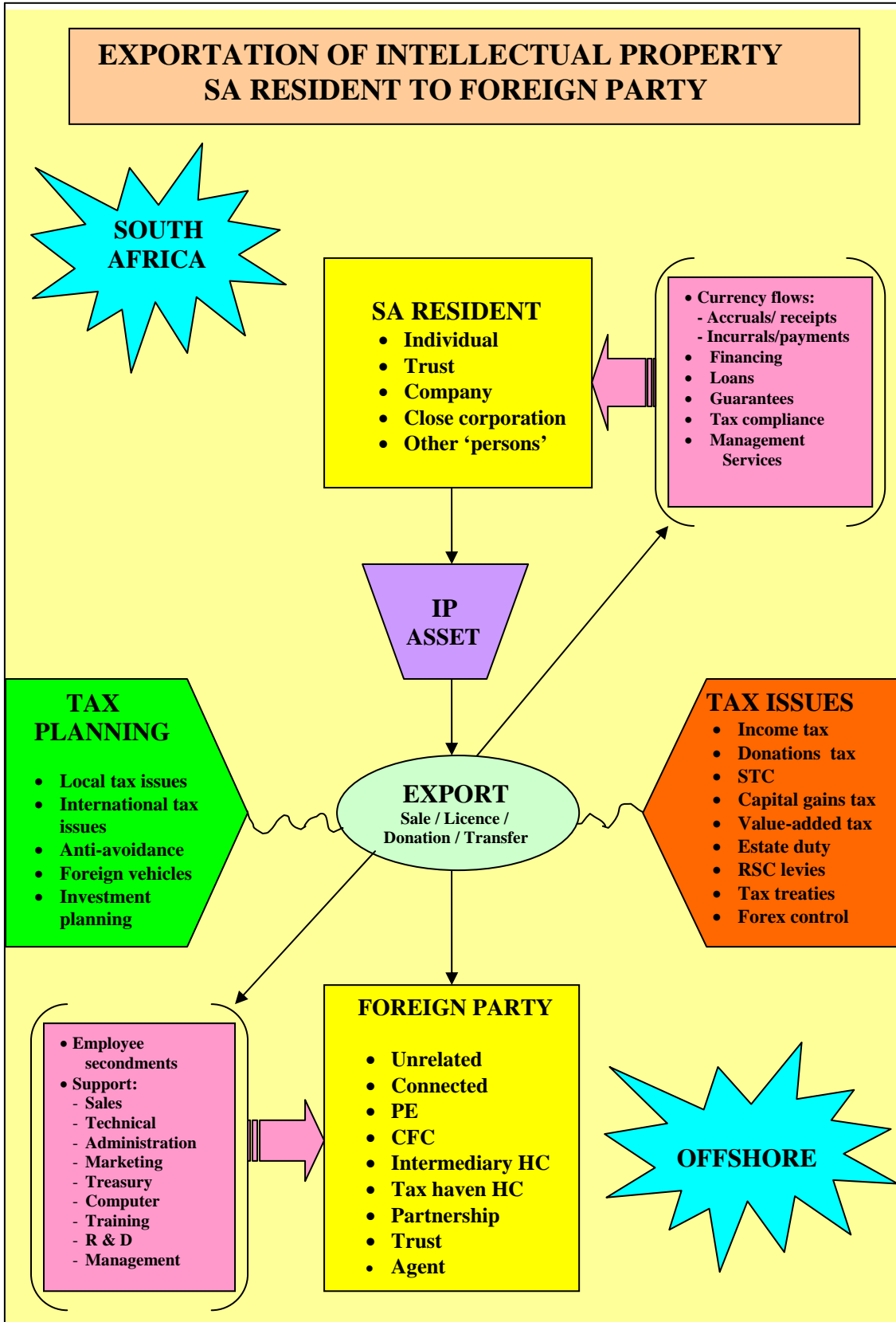
This research report explores the following key question:

“What are the tax implications for a South African resident intellectual property exporter, in respect of the sale, licensing, transfer or donation of intellectual property rights to a foreign contracting party?”

The tax implications for a South African intellectual property (“IP”) exporter spans over a number of tax regimes, *inter alia*:

- ***Income tax (“IT”)*** - with reference to the Income Tax Act, No 58 of 1962 (“the IT Act”), relevant case law as decided in the Courts, Practice Notes and Interpretation Notes as prepared by the SA Revenue Service;
- ***Secondary tax on companies (“STC”)*** – with reference to sections 64B and 64C of the IT Act;
- ***Donations tax (“DT”)*** – with reference to sections 54 to 64 of the IT Act;
- ***Capital Gains Tax (“CGT”)*** – with reference to the Eight Schedule to the IT Act;
- ***Value Added Tax (“VAT”)*** – with reference to the Value-Added Tax Act, No 38 of 1996 (“the VAT Act”);
- ***Regional Services Levy (“RSC”)*** – with reference to the Regional Services Councils Act, No 109 of 1985 (the “RSC Act”) and promulgated regulations;
- ***Estate Duty (“ED”)*** – with reference to the Estate Duty Act, No 45 of 1955;
- ***Foreign exchange control (“Forex Control”)***;
- ***Double taxation agreements (“DTAs”)***.

The issues inherent to the research question are schematically depicted in the diagram on the next page. In exploring the research question, each of the tax regimes will be analyzed in order to identify the *‘international’* aspects of the SA tax legislation impacting on a resident exporting IP rights by way of sale, licensing, transfer or donation. The relevant tax law authority will be discussed, where after it will be evaluated in the context of international tax planning before coming to a conclusion.



3. Key Concepts and Definitions

The following abbreviations, key concepts and definitions are relevant with reference to the research question:

3.1 Abbreviations

'CFC' – Controlled foreign company

'CMA' – Common Monetary Area

'DTA' – Double taxation agreement or tax treaty

'IHC' – Intermediary holding company

'IP' – Intellectual property

'OECD' – Organisation for Economic Co-operation and Development

'PE' – Permanent establishment

'SA' – South Africa or South African

'SARS' – South African Revenue Service, headed by the Commissioner

3.2 'The taxpayer'

In the context of this paper, this is the legal owner holding the title, rights and interest in the IP asset of whatever nature. This is the SA resident taxpayer, conducting his trade in whatever form or entity, be it as an individual, a company, a close corporation, a trust or any other *'person'* that is resident. As the beneficial owner of the IP asset, he is free to exploit his rights via any avenue; be it by sale, licensing, donation or transfer.

3.3 'Intellectual property'

IP is an intangible asset which is defined as *'an identifiable, non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.'*¹ From a tax standpoint this comprises patents, designs, trademarks, copyrights and trade secrets/know-how.²

Patents³

A patent protects an invention, which could be a process or method, an article or device, a chemical compound or composition. It protects the principle on which the invention is performed or constructed or operates. An invention has a technical content, and to be patentable it must be new, involve an inventive step and be capable of being used in trade, industry or agriculture. Patents include the design of the exterior of a useful article. *Examples:* the 'look' of a motor car, computer, sport shoes,

¹ See GAAP AC 129, *Intangible Assets*

² For a detailed overview refer to the 2002 *Business Blue Book of SA*, National Publishing (Pty) Ltd, Cape Town, pages 613 to 646

³ Regulated by the Patents Act, No 57 of 1978

fridges, etc. Plant patents protect plants which have been reproduced to have desirable characteristics and possibly beauty. *Examples:* varieties of orchids, roses, flowers, and other agricultural plants. The main type of patent is the utility patent. Utility patents are for inventions relating to machines, processes, compositions of matter. *Examples:* circuits, machines, chemicals, processes – in short: protection for things and the way they work.

Designs⁴

A design covers both aesthetic and functional features. An aesthetic design means any design applied to an article which appeal to the eye and are not necessitated by the function of the article. *Example:* Articles which have optional patterns, shapes, ornamentation or configuration such as furniture, textiles, moulded articles, bottle shapes, lamp shades, door handles, clothes hangers and so on. Functional designs cover those features of an article which are necessitated by the function which the article is to perform. *Example:* integrated circuit topography, mask works, cogs, cams, levers, rolled metal sections and the like.

Trademarks⁵

A 'trademark' means a mark to be used or proposed to be used by a person in relation to goods or services for the purposes of distinguishing the goods or services in relation to which the mark is used or proposed to be used from the same kind of goods or services connected in the course of trade with any other person. A 'mark' is defined as any sign capable of being represented graphically, including a device, name, signature, word, letter, numeral, shape, configuration, pattern, ornamentation, color or container for goods or any combination of the aforementioned.

A trade mark distinguishes the goods or services of the trade mark owner from those of others; a strong mark gives a competitive advantage. *Examples* of South African trademarks: MTN, Investec, Castle Lager, Old Mutual, Peppadew, Sasol, ProNutro, Capespan, etc.

Copyrights⁶

The copyright Act sets out a list of 'works' that are eligible for protection under copyright, including: literary works; musical works; artistic works; cinematograph films; sound recordings; broadcasts; program-carrying signals; published editions and computer programs.

Rights vested in the copyright owner to reproduce the work: to compose derivative works; to perform the work publicly; to distribute the work (sale, lease, rental, etc) and to display the work.

Trade secrets / know-how⁷

This includes scientific, technical, industrial or commercial knowledge, know-how, trade secrets or other information.

⁴ Regulated by the Designs Act, No 195 of 1993

⁵ Regulated by the Trade Marks Act, No 194 of 1993

⁶ Regulated by the Copyright Act, No 98 of 1978

⁷ Curtis L. Harrington, Intellectual Property Tax, www.patentlawyer.com/library/biziptax.html

3.4 ‘Exported’

This means the sale, licensing, transfer or donation of IP rights to parties in an export country, which is any country other than SA and includes any place which is not situated in SA.

3.5 ‘Sale’

This means a transaction where the risks and rewards of ownership pass, i.e. when legal title or possession to the IP rights passes from seller to buyer.⁸

3.6 ‘Licensing’

Licensing is an arrangement between two or more parties in terms of which one party grants certain rights inherent to its technology or IP to the other party in return for some remuneration, usually in the nature of royalties, franchise fees, licensing fees, rentals or of a similar nature. The relationship is set out in a license agreement that stipulates the scope of the relationship and sets out issues such as the extent of the rights to be licensed, the way in which one party (licensee) will reward the other party (licensor) for the use of such rights, and the manner in which the relationship will be maintained.⁹

3.7 ‘Transfer’

This refers to cross border dealings between connected parties which are, in terms of section 31 of the IT Act, not regarded at an arms’ length price for the IP rights so transferred.

3.8 ‘Donation’

This means any gratuitous disposal of property including any gratuitous waiver or renunciation of a right in terms of s 55 of the IT Act.

3.9 ‘Foreign contracting party’

This means a contracting party resident outside the Republic, to include: (1) unrelated party; (2) connected party¹⁰; (3) permanent establishment¹¹; (4) intermediary holding company¹²; (5) tax haven holding company; (6) partnership or joint venture; (7) foreign trust; (8) agent or representative.

⁸ See GAAP AC 111, *Revenue Recognition*

⁹ Stephan J Lamprecht: *Licensing can unlock commercial value*. Business Day, 28 February 2005

¹⁰ With reference to the definition of ‘connected person’ in sections 1 of the IT Act and the VAT Act

¹¹ Refer to Article 5 of the *Model Tax Convention on Income and on Capital* of the Organisation for Economic Co-operation and Development

¹² Olivier L, Brincker E, Honiball M. *International Tax: A South African Perspective*, 2nd Edition, Siber Ink, Cape Town, 2004

4. Tax Implications

This chapter explores the various potential SA tax implications that an IP exporter is faced with in contracting with a foreign party with a view of exploiting its IP assets. The applicability of the tax rules under each tax regime will, to a large extent, also depend on the status of the taxpayer in question, that is, whether it is an individual, company, trust or 'other' person recognized for tax purposes. With this in view, the tax exposures are henceforth analyzed.

4.1 INCOME TAX

4.1.1 Introduction

The exportation of IP rights by a resident triggers an income tax incidence in the event of sale, licensing, transfer or donation. This flows from the fact that SA residents are taxed on a residence or worldwide basis, regardless from what source or territory the taxable income originates.

The starting point in the calculation of income tax is '*gross income*'. From this is deducted any amounts exempt from income tax, giving '*income*'. From the latter is deducted all the amounts allowed, i.e. deductions, allowances and set-offs, giving '*taxable income*'.¹³ Normal tax is derived by applying the tax rate applicable to the person in question. From this is deducted any '*rebates*'¹⁴ to arrive at the amount of '*tax payable*'.

The SA tax regime pillars on the concepts of '*gross income*' and '*residence*' by configuring:

- Whether the amounts so derived are of a '*capital*' or '*revenue*' nature?
- Whether the '*persons*' who derived these amounts are '*resident*' or not?
- Once this is established, a decision can be made whether the amounts will be included in '*gross income*' or not.

The various income tax issues impacting on the taxpayer are henceforth considered.

¹³ The terms '*gross income*', '*income*', '*taxable income*' and '*resident*' and '*person*' are defined in section 1 of the IT Act

¹⁴ Per sections 6 and 6quat

4.1.2 Residence

Natural persons

Two tests apply to determine whether a natural person is a resident or not. The first is the '*ordinarily resident test*', i.e. normally the place to which a person will naturally and as a matter of course return to from his wanderings.¹⁵ The second is the '*physical presence test*' which is based on the number of days during which a natural person is physically present in SA.¹⁶

Persons other than natural persons

Any person, other than a natural person, which is incorporated, established, formed or has its place of effective management in SA is regarded as being resident in SA. In a SA context '*place of effective management*' means the place where the company is managed on a regular day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised or where the board of directors meets.¹⁷ It therefore refers to the place where policy and strategy decisions made by the board of directors are *implemented* and not where they are *taken*.

4.1.3 Gross income

Definition of gross income

This is probably the most important concept in the IT Act. '*Gross income*'¹⁸ means:

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

Accordingly, the definition makes it clear that residents are taxed on a worldwide basis and non-residents are taxed in SA on income they derive from SA sources.

The principle was confirmed in **People's Stores**¹⁹ that '*accrued*' means '*has become entitled to*'. In **Ochberg**²⁰ it was stated that an accrual must be '*unconditional*'; if there is a condition imposed, there can be no accrual until such event has taken place.

¹⁵ Cohen v CIR [1946 AD 174, 13 SATC 362]

¹⁶ Section 1 definition of '*resident*'

¹⁷ SARS' Interpretation Note (6 of 2002)

¹⁸ Section 1 definition of '*gross income*'

¹⁹ CIR v People's Stores (Walvis Bay) (Pty) Ltd [1990(2) SA 353 (A), 52 SATC 9]

²⁰ Ochberg v CIR [1933 CPD 256, 6 SATC 1]

Apart from the general rule, the definition of gross income specifically includes the following items relevant to IP revenue streams: par (a) – annuities; par (g)(iii) – amounts derived from use/right of use of IP; par (g)(A) – amounts derived from imparting IP knowledge or information and par (n) – amounts recovered or recouped on IP allowances granted.

Exploitation of IP rights

Gross income represents the fruits of man's wits, intellect and labour, i.e. working his capital. It was stated in **Visser**²¹: '*... income is what capital produces...it is the fruit...as opposed to... [the] tree.*' In the same way as any other income, income from the use or exploitation of IP anywhere in the world will be included in gross income and taxable in SA as long as it was derived by a 'resident'. **Silke**²² remarks that there is no reason why assets of an IP nature should be treated any differently for purposes of taxation from assets such as land or shares. The same tests should be applied to determine whether IP assets are of an income or a capital nature as are applied to any other asset.

Capital or revenue?

This is an all important question. All receipts or accruals must be categorized as being either of an income or of a capital nature – there is no 'half-way house'.²³ Where there is a transfer of ownership of an IP asset, difficulties could arise - what is a receipt of a capital nature in the hands of one taxpayer may be of an income nature in the hands of another. There is no definition in the IT Act of '*receipts and accruals of a capital nature*'. Despite a wealth of established case law, there is no single infallible test for settling the question whether a particular receipt or accrual is income or capital. The consistently applied test is the enquiry whether a taxpayer was engaged in a '*scheme of profit making*'. The test, referred to in **Californian Copper Syndicate**²⁴, was quoted in **Overseas Trust Corporation**²⁵ as follows:

'Where an asset was realised at a profit as a mere change of investment there was no difference in character between the amount of enhancement and the balance of proceeds. But where the profit was ... a gain made by an operation of business in carrying out a scheme for profit making, then it was revenue derived from capital productively employed, and must be income.'

Silke²⁶ states that the most important '*test*' employed by the Courts in deciding whether the proceeds arising upon the disposal of an asset are in the nature of income or capital is the test of '*intention*': with what intention did the taxpayer acquire and hold the asset? The intention of a taxpayer is a very important factor in determining the taxability or not of a transaction; the intention of a taxpayer can throw some light on whether he has embarked on a scheme of profit-making or not.

Accordingly, the key question to be answered in the decision whether amounts derived by a person constitutes gross income: *was the intellectual property rights sold in a*

²¹ CIR v Visser [1937 TPD 77, 8 SATC 271]

²² De Koker A, *Silke on South African Income Tax*, Memorial Edition, Butterworth's, Durban, par 3.22

²³ Pyott Ltd v CIR [1945 AD 128, 13 SATC 121]

²⁴ Californian Copper Syndicate v CIR [1904 41 Scar 691]

²⁵ Overseas Trust Corporation Ltd v CIR [1926 AD 444, 2 SATC 71]

²⁶ De Coker A, *Silken on South African Income Tax*, Memorial Edition, Butterworths, Durban, par 3.2

scheme of profit-making? If the answer is *yes* then it is taxable proceeds; if the answer is *no*, then the proceeds are not taxable - capital nature. In the context of IP, see also **ITC 1542**²⁷, **Evans Medical Supplies**²⁸ and **Rolls Royce**²⁹

Annuities

It should be noted, however, that the proceeds from selling IP, which would otherwise have been of a capital nature and therefore not subject to income tax, may well become taxable if those proceeds are determined as a percentage of future profits. Cognisance must, therefore, be taken of the rulings in **Hogan**³⁰ and **ITC 713**³¹: beware of the annuity trap in par (a) of the definition of 'gross income' – avoid linking IP consideration to profits.

Sale

The outcome of an outright *sale* of IP rights is to discard or divest, with ownership transferred with a cession and assignment. Where the IP asset is held as stock-in-trade, the proceeds will be gross income and taxable. In **Lategan**³² the principle was established that gross income accrues to a taxpayer in the year of assessment in which he acquires the right to claim payment in the future and not in the year of assessment in which he eventually is entitled to claim payment. The value of the right (sum of future instalments) constitutes gross income.

IP can be sold, not for a lump sum, but for a consideration measured by the annual income or net profit derived from the use of intellectual property or depending on the number of articles produced or sold - the periodical payments then assumes the nature of income. When the consideration is expressed as a lump sum plus a periodical payment, the lump sum is a capital receipt while periodical payment is in the nature of income.

Licensing

Where the use or right to use of the intellectual property is granted to another the royalty receipts represents '*gross income*' for the IP rights holder. Royalty receipts are in the nature of rent or lease payments, which are inherently gross income.

Significance of the Millin case

The question for decision in **Millin**³³ was whether the amount received by way of royalties was from a source within SA. It was held that where a taxpayer carries on the trade of a novelist, the source of her income from royalties is her wits, labour and intellect in writing the book and in dealing with the publishers. The source of the

²⁷ ITC 1542 [54 SATC 417]

²⁸ Evans Medical Supplies Ltd v Moriarty [1958 1 WLR 66, 37 TC 540]

²⁹ Rolls Royce v Jeffrey [1962 40 TC 443]

³⁰ KBI v Hogan [1993 (4) SA 150 (A), 55 SATC 329]

³¹ ITC 713 [1950 - 17 SATC 337]

³² Lategan v CIR [1926 CPD 203, 2 SATC 16]

³³ Millin v CIR [1928 AD 207, 3 SATC 170]

royalties is located where these faculties are employed. The place where the contract with the publishers was entered into is irrelevant. The contention that the copyright was a capital asset was rejected. **Emslie et al**³⁴ criticized this decision stating:

'If a third party purchased the copyright and licensed its use in return for royalties the copyright would be a capital asset. Why then should it make a difference if the copyright is acquired not by cession but by the exercise of the owner's wits and labour? The distinction between the retention of a copyright by an author who licenses its use in return for royalties and an outright disposal of the copyright for consideration is that in the former case the copyright is used as a source of future profits (royalties) as part of the author's income-earning structure, whereas in the latter case it is not. The fact that the author's wits and labour constitute his or her capital does not in our view preclude the resultant copyright, when retained and used to produce income, from also constituting a capital asset'

It is submitted that the facts of the case might not be applicable to different facts in another case involving other forms of IP. However, the case may have implications in the granting of foreign tax credits per s 6quat. The foreign income which qualifies for the rebate must be derived by the resident from a 'source outside the Republic' (see paragraph 4.1.4 below). If the Millin principle is applied to IP originated in SA and subsequently exploited in foreign countries, any foreign taxes paid or proved to be payable on income derived, will not qualify for credit as it is regarded as originating from a SA source! No case law has, as yet, given guidance on this matter.

Transfer

Refer paragraph 4.1.15: international agreements – s 31.

Donation

Refer paragraph 4.1.5: diverted income – s 7.

4.1.4 Rebate for foreign income taxes

As a result of SA 'residents' being taxed on a worldwide basis, international double taxation is a reality. This concept refers to the imposition of comparable income taxes by two or more sovereign countries on the same item of income of the same taxable person for the same tax period.³⁵ Section 6quat provides a unilateral tax relief gesture whereby foreign taxes paid by 'residents' are allowed as a rebate (credit) against their SA tax liability. The ability to claim a rebate is limited to residents and only applies to income derived from a source outside SA and not deemed to be derived from a source within SA. It is therefore important to note that the section operates on the basis that a resident only qualifies for a rebate to the extent that SA tax is payable on the income in question. *Example:* if withholding tax was paid on a foreign dividend, which in turn is exempt from tax in SA, no credit will be granted.

For a resident, deriving foreign IP income which was subjected to qualifying foreign taxes, the following aspects of the section is relevant:

³⁴ Emslie TS, Davis DM & Hutton SJ. *Income Tax Cases and Materials*. The Taxpayer, Cape Town, p 132

³⁵ Olivier L, Brincker E, Honiball M. *International Tax A South African Perspective*, 2nd Edition, Siber Ink, Cape Town, 2004, p 263

Qualifying inclusions in taxable income from a source outside SA

Section 6quat(1): A rebate is claimable on the following are categories of 'income': (1) royalties, franchise fees, rentals, fees or income of a similar nature; (2) income attributed via the CFC rules per s 9D; (3) income diverted per s 7 and (4) income originating from a foreign trust per s 25B. 'Income' in this context assumes the normal meaning as defined, i.e. the remainder of gross income less exempt income.

Qualifying payments of foreign taxes

Section 6quat(1A): The rebate available for consideration is the amount equal to the sum of all 'taxes on income' (as defined) 'proved to be payable' on income to any sphere of government of a foreign country. The taxes must be payable without any right of recovery by a person. In order to qualify for the rebate, the relevant 'income' (as listed above) must be included in the resident's taxable income. The words 'proved to be payable' refers to an existing foreign tax liability – the rebate is not only granted in respect of taxes paid but also in respect of which an legal obligation to pay exists. Olivier et al ³⁶ refers in this regard to the case of **Texas Petroleum Corporation v Critchley, 1988 STC 691**.

Apportionment for partnerships and trusts

Section 6quat(1A)(proviso): Where the resident is a member of any partnership or a beneficiary of any trust and the partnership or trust is liable for tax as a separate legal entity in a foreign country, a proportional amount of any tax payable by such entity, which is attributable to the interest of the resident in the partnership or trust, is deemed to have been payable by the trust. This treatment stems from the fact that partnerships and/or trusts are not always treated as see-through (conduit) entities in foreign jurisdictions, but as separate legal entities.

Maximum rebate

Section 6quat(1B): The maximum rebate is based on the 'pro rata' method, where the amount of attributable tax is determined by apportioning the total normal SA tax payable in the ratio which the relevant foreign taxable amount bears to the total taxable income.³⁷ In other words:

Maximum rebate = Total income tax payable x Foreign taxable amounts ÷ Total taxable income

The result is that, in a particular tax year, the resident is limited to claiming no more than his average rate of SA tax on his total foreign income.

Treatment of excess amount

Section 6quat(1B): The excess of the sum of the taxes proved to be payable over the rebate determined is known as the 'excess amount'. The excess amount may be carried forward to the succeeding tax year, and will be deemed to be a tax on income

³⁶ Olivier L, Brincker E, Honiball M. *International Tax: A South African Perspective*, 2nd Edition, Siber Ink, Cape Town, 2004, p 284

³⁷ Practice Note No 9 (26 June 1989)

paid to the government of a foreign country in that year. It is possible to carry forward the excess amount for a maximum of seven years.

Rebate under double taxation agreements

Section 6quat(2): The section provides that a rebate may be granted in substitution for, but not in addition to, any relief to which a SA resident is entitled under a DTA concluded with a foreign country. In this context a potential conflict exists between DTAs that provide on their own for a tax relief over and above the provisions of s 6quat. SARS' view in this regard is that a taxpayer may elect not to claim a rebate in terms of the section, but rather the relief provided for by a DTA.³⁸ In such a case, none of the other provisions will be relevant, e.g. the carry forward period of seven years.

Conversion of foreign taxes to Rands

Section 6quat(4): The taxable income derived by a resident from a source outside SA must be determined in a foreign currency and then be converted in the manner as envisaged in s 25B. In order to determine the amount in SA Rands which is claimable as a rebate, the foreign tax proved to be payable is to be converted to SA Rands on the last day of the year of assessment by applying the 'average exchange rate' for the year of assessment.

Foreign taxes more or less than allowed for

Section 6quat(5): Where it is subsequently shown that the actual foreign tax paid is more or less than proved to be payable to the government of a foreign country for purposes allowing a rebate in terms of this section, SARS has the power to issue reduced or additional assessments. Such assessments may not be issued after the expiry of six years from the date of assessment in terms of which the rebate was allowed.

4.1.5 Diversion of income

Section 7 targets specific instances of tax avoidance: it attributes certain diverted income back to the person in whose hands the income accrued, thereby preventing taxpayers from exploiting the marginal tax rate by 'taxable income shifting' from a high to a low marginal taxpayer.

The provisions of the section is of importance to an IP rights holder disposing the rights by way of a 'donation' (a disposal of property for no consideration), 'settlement' (a gratuitous disposal of property subject to specific terms and conditions) or 'disposition' (any disposal of property made wholly out of generosity of the disposer). The provisions will only apply where an asset was gratuitously disposed of by a donor, resulting in income being accrued to a beneficiary.³⁹ The section deems income to be that of the donor and effectively restores the *status quo* before the assets were donated to the beneficiary or trust for the benefit of the beneficiary, in the following circumstances: s 7(2) - donations between spouses; s 7(3) - donations to a minor child;

³⁸ Interpretation Note No 18 (31 March 2003)

³⁹ *Ovenstone v SIR* [1980 (2) SA 721 (A), 42 SATC 55]

s 7(4) - reciprocal donations; s 7(5) - conditional donations; s 7(6) - revocable donations; s 7(7) - cession of income; s 7(8) - donation by resident to a non-resident whereby income is derived by a non-resident. Furthermore, s 7(9) - indicates that the disposal of an asset for less than the market value will result in a donation being made for the difference between the market value and the actual consideration.

4.1.6 Recovery / recoupment of allowances

Section 8(4) and subparagraph (n) of the definition of 'gross income' provides that amounts previously allowed as deductions from income that is recovered or recouped in any way must be included in income, even if they are recovered or recouped abroad. This is in particular the case where an IP rights holder disposes of an item in respect of which a deduction has been allowed under ss 11(gA), 11(gC) and 11B. Recoupments are taxed only to the extent that it was previously allowed as a deduction for tax purposes – amounts received in excess of the original cost of the asset are of a capital nature and not taxed. A deemed recoupment also kicks in when the IP rights are (1) donated; (2) transferred in any manner or form to a shareholder of a company, being the holder of the IP rights; or (3) disposed of to a connected person.

4.1.7 Non-residents deriving IP income from SA sources

Where the taxpayer employs a foreign entity, e.g. an intermediary holding company, deriving income from the exploitation or use of IP in SA, the income so derived by the non-resident is deemed to have accrued from a SA source and taxed in SA by virtue of s 9(1)(b) (IP rights) and s 9(1)(bA) (IP knowledge or information).

However, s 35 provides for the taxation of royalties and similar payments on a withholding tax basis which applies to non-resident individuals, companies and other artificial persons. The applicable rate is 12% and represents a final tax paid to SARS by the person incurring a liability to pay such an amount to a non-resident. The withholding tax does not apply to a non-resident company that derives such an amount from a trade carried on through a branch or agency in SA when that amount is subject to tax in SA.

4.1.8 Controlled foreign company

In exporting IP to the international arena, a foreign entity is often employed to administer intra-group IP agreements or as a central IP licensing vehicle to various jurisdictions.

Recognising that under the residence based taxing system SA residents are subject to tax on their worldwide income, s 9D provides an extremely powerful mechanism of bringing into the tax net income earned by SA owned 'foreign companies'. If this form of income goes untaxed, SA residents can avoid tax simply by shifting their income to foreign entities. Section 9D is designed to prevent deferral through SA owned foreign entities. However, international law only allows SA to tax foreign residents on their SA source income. International law does not allow SA to directly tax foreign entities on

their foreign source income, even if those entities are completely owned by SA residents. In order to remedy the problem of deferral while complying with international law, s 9D taxes SA owners on the foreign income earned by their foreign entities when derived, and not the foreign company itself.⁴⁰

The following aspects of s 9D must be considered by a SA resident IP exporter, making use of a '*controlled foreign company*' ('CFC') vehicle:

Attribution of indirect foreign income of residents

SA residents holding '*participation rights*' in a CFC, must include a proportional ownership percentage of the '*net income*' earned by the CFC in their income.

Definitions

The following elements are critical to an understanding of the workings of the section:

- '*Foreign company*': it must be a '*company*' as defined in s 1, which is not a resident. **Brincker et al**⁴¹ takes the view that the validity of a foreign company should be determined with reference to foreign law.
- '*Controlled foreign company*': a foreign company in which one or more SA residents directly or indirectly, together with their connected persons, hold more than 50% of the total participation rights in a foreign company.
- '*Participation rights*': the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of a company. This will also include non-participating preference shares.
- '*Business establishment*': the definition is similar to OECD definition of '*permanent establishment*' but includes additional criteria in the form of an 'economic substance' and 'business purpose' tests.

Net income of a CFC

'*Net income*' is equal to taxable income and all the provisions of the IT Act are applicable in determining this. Disallowed as a deduction in the hands of a CFC are: (1) interest, royalties, rental or income of a similar nature paid or payable by the CFC to another CFC of the SA resident; (2) adjusted amounts for transfer pricing purposes per s 31; and (3) foreign exchange differences determined per s 24I. Deductions, allowances or set-offs against the CFC's income is limited to its income. Any excess is ring-fenced and may be set-off against its income in a succeeding year. Net income of the CFC is calculated at the end of the foreign tax year of the country in which the CFC is resident and is included in the resident's income at the end of the SA tax year. The percentage holding at the end of the foreign tax year is used as a basis for attribution, irrespective of changes in shareholding during the year.

Non-attribution

The attribution rules do not apply when a resident, together with his connected persons, hold at the end of the last day of the CFC's foreign tax year *less than 10%* of its participation rights.

⁴⁰ National Treasury's Detailed Explanation to Section 9D of the Income Tax Act, issued June 2002

⁴¹ Olivier L, Brincker E, Honiball M. *International Tax: A South African Perspective*, 2nd Edition, Siber Ink, Cape Town, 2004, p 204

Exemptions

The application of the section is excluded in a number of instances. Notably, there will be no inclusion in the resident's income (i.e. he will be exempt from tax) to the extent that the CFC's net income is attributable to –

- *Business establishment*: That is, a CFC's *bona fide* business establishment in a foreign country. In granting this exemption a distinction must be made between income derived from legitimate business activities and that derived from illusory undertakings, i.e. mobile business income, diversionary business income and mobile passive income. '*Mobile business income*' is income that cannot be attributed to a business establishment and, therefore, does not qualify for exemption. '*Diversionary business income*' attributable to the CFC is also not exempt from tax, that is: (1) income arising from transactions between a CFC and a SA connected person subject to the s 31 transfer pricing provisions; and (2) those that are not subject to transfer pricing but the possibility of price manipulation exists. '*Mobile passive income*' does not qualify for exemption from attribution, because no active business activities are involved. It includes: dividends, interest, royalties, rental, annuities, income of a similar nature and foreign currency gains per s 24I.
- *South African taxable income*: Income derived from an actual or deemed SA source, which is subject to SA tax. In addition, the net income must not be exempted or taxed at a reduced rate as a result of a DTA being applicable.
- *Dividends*: A foreign dividend declared to the CFC by another CFC in relation to the resident.
- *Interest, royalties, rental or income of a similar nature*: Amounts paid or payable to a CFC by another CFC in relation to the SA resident, adjusted amounts for transfer pricing purposes per s 31 and foreign exchange differences determined per s 24I. Note that the amounts in question will also not be allowed as a deduction in the determination of the other CFC's net income.
- *Designated country*: With effect from 1 June 2004, this is no longer available.

Elections by a taxpayer

Residents holding between 10% and 25% of a CFC's participation rights, may elect in any particular foreign tax year that:

- *None of the 'exemptions' will apply* to the CFC's net income: thereby having the whole of the CFC's net income included in his gross income.
- *A foreign company is a CFC*: a proportional amount of the interest will then be attributed to the SA resident.

By exercising these elections, residents will be entitled to the s 6quat rebate, but no excess foreign tax credits may be carried forward to the next year of assessment.

Foreign currency conversion rules

The net income has to be converted in the currency which the CFC uses for purposes of financial reporting. That amount is then converted, in accordance with s 25D, at the end of the year of assessment for the SA resident at the average exchange rate to Rands. It must be noted that although the amount is determined at the end of the foreign tax year, it is only converted at the average exchange rate (and included) at the end of the SA year of assessment.

Double taxation and foreign tax credit

Attributed foreign CFC net income is taxed in the hands of the SA resident when it accrues, irrespective of when it is repatriated. The jurisdiction in which the foreign entity is resident will in all probability also tax the income, resulting in double taxation. This problem is solved by providing a foreign tax credit as envisaged in s 6quat. When the income is eventually distributed in the form of dividends, it will be exempt from tax per s 10(1)(k)(ii).

Transfer pricing rules applicable to a CFC

Both the transfer pricing and thin-capitalisation rules contained in s 31 apply to a CFC. For transfer pricing purposes transactions, operations and schemes entered into between a CFC and a person connected to a CFC are deemed to be an '*international agreement*'.

The interaction between section 9D and double taxation agreements

The purpose of tax treaties is to avoid double taxation and determine the taxing rights between treaty parties. The purpose of tax treaties is not to prevent treaty partners from protecting their tax base. The CFC legislation taxes the resident shareholders of the CFC and not the CFC itself. As the same resident is not being taxed twice on the same amount, no double taxation arises. It therefore cannot be said that the CFC legislation overrides any double taxation agreements. Where the resident shareholder is taxed on foreign amounts that are calculated according to proportional holdings in the CFC, this would amount to economic double taxation in the absence of the granting of appropriate foreign tax credits via s 6quat. In this regard, cognisance must be taken of UK landmark case of **Bricom**,⁴² dealing with the compatibility of tax treaties and domestic law where CFC legislation is involved.

The CFC rules are extremely complex and in practice many unresolved issues exist. It is noted that SARS has not issued an Interpretation Note in this regard.

4.1.9 Exemptions

Exempt income is free or immune from tax. By its very nature, it is included in the 'gross income' of a taxpayer but does not form part of its '*income*'. An IP exporter must take note of the following exemptions:

Authors and copyright holders

Section 10(1)(m) exempts proceeds derived by an author and copyright-holder for the assignment or granting of an interest in a copyright, if such amounts are chargeable with income tax in a foreign country. This exemption applies to all persons, but excludes a company or a person who is not the first owner of the copyright.

⁴² Bricom Holdings Ltd v IRC [UK, 1996 STC (SCD) 228]

Foreign dividends

Foreign dividend accruals are included in 'gross income' by way of par (k) of the latter definition. However, s 10(1)(k)(ii) exempt foreign dividends to the extent : (1) that the profits to which foreign dividend relate to, has been or will subject to SA tax; (2) it relates to dividends declared by a dual listed company; (3) it relates to dividends comprising CFC attributed amounts; (4) it relates to a 25% plus shareholding. Accordingly, the effect is that SA residents have to account for tax on foreign dividends to the extent that the shareholding constitutes a so-called '*portfolio*' holding, but excludes substantial '*direct*' holdings.

Foreign assignments

'Remuneration' from services rendered outside SA is exempt from tax under s 10(1)(o)(ii). To be able to qualify for the exemption a taxpayer must prove that: (1) he was working for or on behalf of an employer (SA or foreign) outside SA for a total of more than 183 full days in aggregate during any 12-month period beginning or ending in a tax year; and (2) a continuous or uninterrupted period of more than 60 full days during the 12-month period. This dispensation is particularly relevant for an IP exporter seconding employees to foreign destinations. It must be noted this provision only applies to '*remuneration*' derived by an employee and not other types of income, e.g. interest, rent, royalties, annuities, etc

Relocation benefits

Section 10(1)(nB) provides that where an employee is appointed, transferred or dismissed, and moves at the insistence of his employer and the employer bears the cost (as specified) thereof, the amount expended will not be taxed in the employee's hands.

4.1.10 Deductions

An exporter of IP will during the course of his trade incur a myriad of expenses linked with the exploitation of IP in a foreign jurisdiction. To name just a few: cost of search, applying, registering, restoring, renewing and extending the term of registration of IP; marketing research; consulting fees; foreign travel and accommodation; costs for due diligence investigations; legal fees; agent or intermediary fees; sales commissions; staff secondment and reallocation costs; advertising and promotions; expenses for running a foreign office; accounting and audit fees, etc Just as the worldwide income of an IP exporter will be included in his gross income, he will be entitled to worldwide deductions – provided that the deductions claimed satisfies the criteria established by general principles of tax law.

The relevant deduction provisions impacting on the IP exporter are explored below:

The general deduction formula

Section 11(a) read with s 23(g) contains the general deduction formula. Section 11(a) provides for the deduction of expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.

Furthermore, s 23(g) prohibits a deduction of moneys not expended for the purpose of trade.

The preamble to s 11 requires that, before a deduction may be claimed from income in terms of s 11(a), the taxpayer must be *'carrying on any trade'*. A trade is widely defined in s 1 and include the letting of any property and the use of or the grant of permission to use any patent, design, trade mark, copyright or any other property of a similar nature.

The words *'incurred'* means either *'paid'* or *'becoming liable for'*.⁴³ It refers to the coming into existence of an absolute and unconditional legal liability to pay, irrespective of the fact that payment may only be made in the future. Refer to the cases of **Port Elizabeth Electric Tramway**⁴⁴, **Caltex Oil**⁴⁵ and **Edgars Stores**⁴⁶.

To rank as a deduction from income, expenditure and losses must actually have been incurred *'in the production of income'*. In **Port Elizabeth Electric Tramway**⁴⁷ it was established that this requires a link between the act giving rise to the expenditure and the earning of income.

The words *'expended for the purposes of trade'* in s 23(g) mean: *'for the purpose of enabling a person to carry on and earn profits in trade'* or *'for the purpose of earning profits'*.⁴⁸

Furthermore, expenses must not be of a *'capital nature'*. Various other tests have been used by the Courts in considering whether or not expenditure is of a capital nature, i.e. fixed or floating capital⁴⁹, once and for all expenditure⁵⁰, enduring benefit⁵¹, etc. But, the pre-eminent and principal test for the distinction between capital and revenue expenditure was stated in **VRD Investments**⁵² as follows:

'Generally speaking, expenditure is of a revenue nature if it can properly be regarded as part of the cost of performing the income-earning operations of the business, and of a capital nature it can properly be regarded as part of the cost of establishing or enhancing or adding to the income-earning structure of the business...'

[emphasis added]

To summarise: In order for the IP exporter to claim a deduction under the general deduction formula, it must be laid out for the purposes of trade; incurred in the production of income; or be so closely connected with the income earning operations that it can be regarded as part of their cost; that is: it must be a necessary concomitant of the carrying on of a particular business; Expenditure need not, however, give rise to income to be deductible. In addition, it must not be of a capital nature.

⁴³ ITC 542 [1942 – 13 SATC 116]

⁴⁴ Port Elizabeth Electric Tramway Company v CIR [1936 CPD 241, 8 SATC 13]

⁴⁵ Caltex Oil (SA) Ltd v SIR [1975 (1) SA 665 (A), 37 SATC 1]

⁴⁶ Edgars Stores Ltd v CIR [1988 (3) SA 876 (A), 50 SATC 81]

⁴⁷ Port Elizabeth Electric Tramway Company v CIR [1936 CPD 241, 8 SATC 13]

⁴⁸ Strong & Co of Romsey Ltd v Woodfield (Surveyor of Taxes) [1906 AC 448, 5 TC 215]

⁴⁹ CIR v George Forest Timber Co Ltd [1924 AD 516, 1 SATC 20]; SBI v Aveling [1978 (1) SA 862 (A), 40 SATC 1]

⁵⁰ Vallambrosa Rubber Company v Farmer [1910 SC 519 at 524]

⁵¹ New State Areas v CIR [1946 AD 610, 14 SATC 155]

⁵² CIR v VRD Investments (Pty) Ltd [1993 (4) SA 330 (C), 55 SATC 368]

Deduction of expenses in respect of foreign branches

To the extent that a foreign *'permanent establishment'* (e.g. a branch or foreign office) exists all income associated with the activities of the PE must be accounted for, and all expenses actually incurred in the production of income will be allowed as a deduction in the determination of taxable income. This includes, for example, the salaries and relocation costs of SA resident employees seconded to foreign branches, travel expenses, support services, etc

Deduction of expenses in respect of subsidiaries

Expenses incurred in respect of a foreign subsidiary are not allowed as a deduction in the hands of the SA holding company per ss 11(a) and 23(g).

Capital expenditure on intellectual property

Due to the perceived abuse by taxpayers, e.g. overstatement of the value of IP such as trademarks for purposes of obtaining the allowance under this section, the legislature has made dramatic amendments in this area over the last couple of years. Section 11(gC) contains the rules effective for tax years commencing on or after 1 January 2004, while the replaced s 11(gA) operated prior to that. Section 11(gC) provides for an allowance on expenditure incurred by the taxpayer to *'acquire'* (but not by way of devising, developing or creation – which could be allowed as a deduction under s 11B) IP listed as: inventions or patents; designs; copyrights; other property of a similar nature (but excluding trademarks) and knowledge connected with the use of the above or the right to have such knowledge imparted. The deduction is allowed in the year in which the IP is brought into use for the purposes of trade.⁵³ The deduction is taxable if it is recovered or recouped.

Research and development

The old section s 11(p) and s 11(q) rules for respectively *'scientific research expenditure'* and *'scientific research capital allowance'* were replaced with effect from 1 January 2004 with s 11B dealing with allowable deductions in respect of *'research and development'* (R&D). Qualifying R&D must be undertaken for purposes of devising, developing or creating any invention, patent, design, copyright or other property of a similar nature (but excluding a trademark). Deductions are available for R&D costs directly incurred; expenditure in respect of R&D undertaken on the taxpayer's behalf; registration and extension costs and capital R&D costs. As regards to the latter, the deduction amounts to 40% of the cost on any building, machinery, plant, implement, utensil or article of a capital nature (acquired exclusively for

⁵³ If the cost does not exceed R5 000, it is deductible full. For IP acquisitions in excess of R5 000, the allowance is spread over a number of years, i.e. –

- 5% on the cost of inventions, patents, copyrights, other property of a similar nature or knowledge connected with the use of this or the right to have such knowledge imparted.
- 10% on the cost of designs or other property of a similar nature or knowledge connected with the use of this or the right to have such knowledge imparted.

Where the IP was acquired from a connected person, the allowance is limited to the lesser of:

- the cost of the asset to the connected person; or
- the market value of the asset on the date it is obtained or acquired from the connected person.

qualifying R&D) in the first year brought into use, thereafter 20% in each of the next three tax years.

Legal expenses

Section 11(c) provides for the deduction of legal expenses actually incurred, during the year of assessment in respect of any claim, dispute or action at law arising in the course of the ordinary operations undertaken by the taxpayer in the carrying on of his trade. In applying s 11(c) regard must be taken of s 11(a), and *vice versa*; if legal expenses are not deductible under s 11(a), they may nevertheless still be deductible under s 11(c).

4.1.11 Foreign assessed losses

In accordance with s 20, an assessed loss or balance of assessed loss originating from a foreign trade (e.g. a foreign branch) can not be set off against amounts derived from carrying on a trade in SA. These losses are effectively ring-fenced. The impact of this is that a resident will pay tax on his worldwide taxable income, undiminished by foreign assessed losses.

4.1.12 Trading stock

IP could be held by a *'technology trader'* as *'trading stock'* on hand available for resale. In such instances s 22 deals with the relevant income tax aspects. Expenditure incurred for the purchase of trading stock is expenditure incurred in the production of income and is deductible in full in terms of s 11(a) – even if some trading stock remains unsold at the end of the year of assessment. The value of trading stock in the beginning and end of the year must be taken into account at its *'cost price'* (as defined) in determining taxable income – the value of closing stock is taxable, while the value of opening stock is deductible.

4.1.13 Foreign currency transactions

Due to the international nature of the IP contract concluded with a foreign contracting party, it is probable that the SA resident will derive revenue, incur expenses and record assets and liabilities denominated in a foreign currency. The term *'foreign currency'* means any currency other than SA Rands. A number of sections in the IT Act deals with the foreign currency conversion rules and are appropriately discussed below.

Unremittable foreign income

Section 9A provides for a so-called blocked funds deferral of tax in instances where funds may not be remitted to the SA resident due to *'currency or other restrictions or limitations imposed in terms of the laws of the country where the amount arose.'* The section applies in instances where a person derived: (1) direct amounts that is required to be included in his gross income or taxable income; or (2) indirect amounts to be included in income via a CFC attribution (s 9D). If these circumstances are

established, there is no inclusion in income during the tax year in which it accrues – the relevant amount will only be included in gross income or taxable income during the tax year in which it may be remitted ex the foreign jurisdiction.

Foreign exchange gains and losses on exchange items

Section 24I aims to bring within the tax net exchange differences arising from an exchange item. It is an extremely complex piece of legislation and provides that certain categories of gains or losses as a result of exchange differences, arising from the holding by a qualifying taxpayer of any foreign currency loans, advances or debts owing by/to the taxpayer, incurred in the course of carrying on a trade in SA, be included in or deducted from the taxpayer's taxable income: (1) when the gain or loss is realized, during the current year of assessment; (2) by translation at the end of the year of assessment when the gain or loss is unrealized; (3) regardless of whether it is of a revenue or capital nature.

Lastly, s 24(l)(10) states that no unrealised exchange differences must be included in or deducted from the income of a resident, where the resident and a company are parties to an exchange item, and the company is a CFC in relation to the resident or which forms part of the same group of companies as the resident. Also, no inclusion or deduction is allowed for the CFC. For tax purposes, exchange differences are only taken into account on realisation date. Therefore, no interim unrealised translation gains or losses are permitted for tax purposes, but only those that arose on date of actual realisation.

Currency conversion rules

The general conversion rule is contained in s 25D. The conversion process is twofold:

- Firstly, a determination of the foreign currency amounts derived (receipts/accruals) or incurred (expenditure) by a person;
- Secondly, the amounts so determined, in any foreign currency, are then converted at the average exchange rate for the SA tax year.

The term '*average exchange*' rate is defined in s 1, and the taxpayer has a choice between using the '*actual average rate*' or the '*weighted average rate*'.

4.1.14 Partnerships

A partnership or joint venture arrangement could be an effective and flexible vehicle for exporting IP in conjunction with foreign partners, for the purpose of licensing IP and know-how outside SA, technical service agreements, franchise agreements and performing technological services.

In SA law a partnership is not a legal '*persona*' separate from the partners; at the same time, it is not recognised as a taxable entity and not assessed as a taxpayer – the partners are treated as separate taxpayers in their own right. Income derived by a partnership is therefore subject to tax in the hands of the partners, pro rata to their share of profits in terms of the partnership agreement. Where the partner is a SA resident, he will be taxed in SA on his income derived from the foreign partnership. In

terms of s 20, foreign partnership losses are ring-fenced and may not be set-off against the partners' SA derived income.

The SA tax principles relating to partnership arrangements, will also apply to foreign partnerships in which the taxpayer is a partner. Section 24H regulates the incidence of income derived via a partnership.

Partners are not restricted to natural persons, it can also be companies, trusts, etc For taxation purposes, the '*conduit principle*' applies: e.g. dividend received by a partnership remains a dividend in the hands of the partner per profit sharing ratio.

Finally, as there is no statutory framework on which to rely, the control and administration of the business of the partnership, and the rights and liabilities of the parties *inter se*, depend to a large degree on the terms and conditions of the partnership agreement. Special care is needed in drafting partnership agreements.

4.1.15 Trusts

The trading trust has been criticized in some quarters as being a legal absurdity, since a trust, unlike a company, should not be a vehicle for the taking of risk but rather one for the holding of assets in trust for the benefit of beneficiaries. Despite this, evidence suggests that the corporate use of trusts, especially offshore trusts, is a very popular vehicle to '*park*' IP assets to be exploited in the international market.⁵⁴ From this point of view an IP exporter must take note of the income tax issues facing him by virtue of a sale, transfer or donation of an IP asset to a foreign trust.

Legal status of trusts

A trust is not a legal entity and cannot incur rights and obligations – but, it is treated as a '*person*' for income tax purposes.

Trust residence

The tax status of an offshore trust will depend largely upon the place where it is resident and the place where it conducts its activities. With reference to the definition of '*resident*' in s 1 of the IT Act, the trust will be a resident if it is formed in SA, no matter where it is effectively managed. But it will be a resident if it is not formed in SA only if it is effectively managed here. It is therefore crucial to establish where a trust was formed and, if it was formed abroad, whether it is effectively managed here. If the trust is a non-resident it will be liable for tax only on taxable income derived from a source within or deemed to be within SA. On the other hand, if the trust is an offshore trust, in the sense that it is formed outside SA but effectively managed here and is therefore a resident as defined, it will be liable to SA income tax on its worldwide taxable income.

The conduit principle

The '*conduit principle*' is critical to an understanding of the tax status of a trust. The conduit principle holds that income flows through a trust to the beneficiaries who have

⁵⁴ Divaris, C & Stein, M: *Trust Deeds & Trustees: Still Serving You Well?*, BSP Seminars Workshop, 26 March 2003

a right to it. The income accordingly retains its identity (e.g. dividends, interest, rentals, royalties) in the hands of the beneficiaries who are liable to tax on it.⁵⁵ It follows that any exemption applicable to the income will be available to the beneficiary to whom it accrues. For example, if exempt dividends derived by a trust accrue to a beneficiary, they will remain exempt from tax in his hands. The conduit principle applies to current income of a trust distributed or otherwise accruing to a beneficiary. But, in **Rosen's**⁵⁶ case the view was expressed that trust income loses its identity if it is retained by and taxed in the trust in the year in which it arises and is then distributed only in a later year. In that year it will be regarded as a distribution of 'capital' to the beneficiary and therefore not taxed in his hands.

The section 25B attribution rule

Section 25B deal with the taxation of income derived by a trust and is summarized as follows: (1) 'vesting' income is treated as being derived by the beneficiary, not the trust; (2) 'non-vesting' income is treated as being derived by the trust, not the beneficiary; (3) the exercise of their discretionary powers by the trustees in favor of a beneficiary is equivalent to vesting of the income in that beneficiary; (4) deductions and allowances follow the income stream to which they relate; and (5) trust losses are 'ring-fenced' and retained in the trust and, therefore, cannot be set-off against any other income derived by the beneficiaries.

Section 25B is made subject to s 7 (diversion of income rules), which means that, where s 7 applies, it overrides the provisions of s 25B and result in the income not being taxed in the hands of the trustees or beneficiaries, but in the hands of the founder/planner.

Capital distributions by foreign trusts

Section 25B(2A) was inserted to counter the use of offshore trusts for tax planning. It applies in the case where a SA resident beneficiary acquires a vested right to capital of a non-SA resident trust, and the capital arose from 'income' derived by the trust in a previous year of assessment in which the beneficiary had a contingent right to the income, the beneficiary will be taxed on the capital so distributed. It applies not only where the capital arose from income, but also from receipts and accruals that would have constituted income had the trust been a SA resident. Income in this context is 'income' as defined in s 1 (gross income less exempt income) derived from a source within or deemed to be within SA.

Interest-free loans to trusts

The principle established in the **Woulidge**⁵⁷ case must be noted: the amount of the income earned by a trust from an asset disposed of to a trust in consideration for an interest-free or low-interest loan that may be attributed to the lender is the amount by which interest charged at a fair market-related rate exceeded the interest, if any, actually charged by the lender. Naturally, if this amount exceeds the income actually earned from the asset, the amount to be attributed to the lender would be limited to the income actually earned. An interest-free loan to an offshore trust resulting from the sale of an income-producing IP asset to it, will bring in the income tax net via the s 7(8)

⁵⁵ *Armstrong v CIR* [1938 AD 343, 10 SATC 1]

⁵⁶ *SIR v Rosen* [1971 (1) SA 173 (A), 32 SATC 249]

⁵⁷ *CSARS v Woulidge* [2001 (A), 63 SATC 483]

diversion of income rules the trust's income from the transferred asset to the resident. Where the trust is funded via a low or no-interest loan, the s 31 transfer pricing provisions may be invoked whereby SARS may adjust the interest rate to a market-related interest rate and levy tax on this increased rate in the hands of the 'connected' lender.

Distributions by a foreign trust

Unless the diversion of income rules in s 7, especially s 7(8) (resident to non-resident donations, settlements or other dispositions), apply to deem its income to accrue to the donor, the income of an offshore trust that is distributed to a SA resident during the year of assessment in which it is derived by the trust, will be taxed in the hands of the beneficiary to whom it is awarded. The 'conduit principle' will apply so that income will flow through the trust to the beneficiaries retaining its nature as, for example, royalties, interest, foreign dividends or rent. If the income is not so distributed to a beneficiary in the current year, but only in a subsequent year, s 25B(2A) applies to characterise the capital distributions as 'income'.

Income retained by a foreign trust

While the trust itself, as a non-resident, would be liable to tax in SA only on amounts that it derives from a source in SA, the source of the amounts will be irrelevant to the liability to tax of a resident beneficiary to whom it is distributed. This is because residents are liable to tax on their worldwide income. For this reason, SA tax may be saved or at least postponed on foreign income that is retained by an offshore trust and not distributed to the SA beneficiary. In doing this, the trust's liability for tax in the foreign jurisdiction must also be considered.

4.1.16 International agreements

Intellectual property rights can in general be transferred from one entity to another 'connected' entity in four ways: by sale, by granting a right of use, by donation or a *de iure* transfer.

Relations between associated entities will invariably result in transfer pricing distortions. When connected parties deal with another, external market forces may be absent and commercial and financial relationships may dictate a price that could differ from those in the open market. By artificially determining prices, taxable profits could be shifted from high tax jurisdictions, as in the case of SA, to low tax jurisdictions, as in the case of Mauritius.

Section 31 aims to counter transfer pricing practices which may have adverse tax implications for the SA *fiscus*. What follows, is a summary of the SA transfer pricing rules as it finds application in the context of cross-border IP transactions between related parties:

Transfer pricing

Transfer pricing has been defined by **Malan**⁵⁸ as: '*...the price put on a transaction between parts of a single organisation or members of a group of companies. The term*

⁵⁸ Deloitte & Touche. *Guideline: Transfer Pricing and Thin Capitalisation in South Africa*. Deloitte & Touche, Johannesburg, 1996

is a way of indicating that it is a price arranged within a group, and not arrived at in the open market. The term is often used in condemnation because of a suspicion that prices within an organisation are readily manipulated to avoid tax or to achieve some other ulterior motive.’

Tax adjustment

Where goods or services are supplied in terms of an international agreement, the supplier and acquirer are connected persons, and the price they set is greater or less than the arm’s length price, SARS has the power in terms of s 31(2) to exercise a discretion to adjust the consideration (for purposes of the calculation of taxable income) to reflect an arm’s length price. The terms ‘goods’, ‘services’ and ‘international agreement’ are defined in s 31(1).

The arm’s length principle

The OECD Guide⁵⁹ suggests that prices charged to related parties must be determined with reference to the ‘arm’s length principle’, approximating the price which would be made between independent and unrelated parties in open market conditions. When applying the arm’s length principle in general, SARS would expect an arm’s length price to result a return for the South African operations, commensurate with its economic contribution and risks assumed.⁶⁰

SARS’ Practice Note

A detailed practice note⁶¹, based on the globally accepted OECD Guide, provide taxpayers with guidelines about the procedures to be followed in the determination of arm’s length prices, taking into account the SA business environment. The practice note states that ‘comparability’ is fundamental to the application of the arm’s length principle. The price charged must be comparable with transactions between independent third parties, taking into account the characteristics of the goods or services; the relative importance of functions performed; the terms and conditions of relevant agreements; the risks assumed; the capital and assets employed; economic/market conditions; and business strategies.

OECD Guidelines

Chapter VI of the OECD Guidelines deals specifically with intangible property. SARS considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm’s length conditions in international agreements with connected persons involving intangible property.

Applying the arm’s length principle

An arm’s length pricing for intellectual property must take into account, for the purposes of comparability, the perspectives of both the transferor of the property and the transferee. The arm’s length principle for the transferor would examine the pricing at which the comparable enterprise would be willing to license the property. A

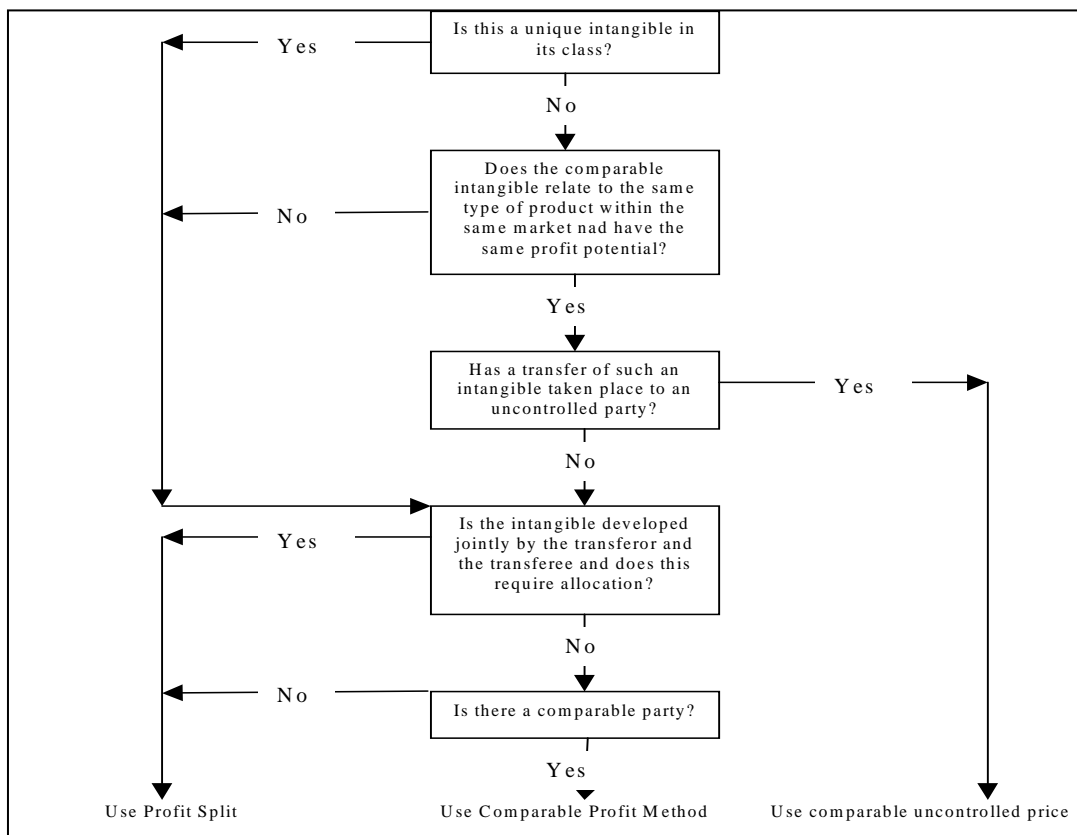
⁵⁹ The Organisation for Economic Co-operation and Development (OECD) Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published in July 1995 (‘OECD Guide’)

⁶⁰ Refer to paragraph 12.5.3 of Practice note 7.

⁶¹ SARS Practice Note No. 7 (6 August 1999)

comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property in its business. The transferee will generally be prepared to pay this license if the benefit it reasonably expects to secure from the use of the intangible is satisfactory with regard to other realistic options available. The analysis must recognize that the licensee will have to undertake investments or incur expenses to use the license. It must be established whether an independent enterprise would be prepared to pay a license fee of the given amount considering the expected benefits from the additional investments and other expenditure incurred. Furthermore, intangible property may have a special character complicating the search for comparables. It is imperative to test the arm's length consideration by reference to what independent enterprises would have done in comparable circumstances, taking uncertainty into account.

Practice Note 7 as well as the OECD Guidelines is not specific regarding which methodologies are best suited for the determining of an arm's length consideration for IP. However, the application of three accepted methodologies (i.e. profit split, comparable profit method, comparable uncontrolled price) and their application to IP are depicted in the following diagram of **Alers**.⁶²



Interest free or low interest outbound loans

The granting of financial assistance to a foreign connected person is included in the definition of 'services'. According to OECD Guidelines the term 'loan' is used in the

⁶² Johan Alers. *Transfer Pricing: A look at intangible assets with specific reference to 'brand names'*, Thesis for Masters in Tax, University of Cape Town, August 2003

broad sense and applies to all forms of indebtedness and includes: loans, advances, money or other consideration irrespective of whether there is a written agreement. The OECD Guidelines indicate that a loan entered into between related parties should bear interest if interest would have been charged in a comparable transaction between unrelated parties. It also recognises that it is normal for tax authorities to impute interest on inter-company indebtedness arising from the non-payment of accounts for periods in excess of that allowed third parties under normal trade practice.

But, there might be valid commercial reasons for the provision of a zero-rated loan, for example: country restrictions on having a 100% equity holding in a local entity and the remaining investment being provided via a zero rated loan; initial start-up funding and the new business unable to bear an interest charge on the funding and reverse thin capitalisation adjustment resulting in a decision not to levy interest charges on a loan to a subsidiary.

However, in terms of paragraph 11.8 of SARS Practice Note 7: *'...in exercising his discretion in terms of s 31(2) to adjust the consideration in respect of the granting of the financial assistance, the Commissioner will take into account the amount of income of the non-resident which is taxed in the Republic in terms of the provisions of section 9D, the impact of the transaction on the tax base of any of the taxes imposed under any of the Acts administered by the Commissioner, the business activities of the non-resident and the ruling interest rates in the Republic as well as the country of the resident who/which borrowed the funds.'*

Application to branches

In terms of s 31 an international agreement can only arise in respect of a transaction, operation or scheme which takes place between two separate legal entities. Therefore, on strict reading of s 31 transactions between the head office and a branch of a single entity are not subject to the SA transfer pricing provisions. However, SARS Practice Note 7 at paragraph 6.4 states that transactions entered into between the head office and the branch of a single entity will be subject to SA transfer pricing provisions where the branch, or the head office, is located in a jurisdiction with which SA has concluded a tax treaty.

4.1.17 Burden of proof

The burden of proof is on the taxpayer claiming, in respect of any amount, that he is exempt from or not liable to tax or entitled to a deduction, abatement or set-off under the IT Act.

Essentially, the main justification for placing the onus of proof on the taxpayer in tax appeals, is that matters concerning the tax position taken by a taxpayer are normally primarily within the knowledge and power of the taxpayer and originate with him or her. What is required from the taxpayer is to discharge this onus, in firm evidence that satisfies a Court, upon a balance of probability, that the taxpayer is entitled to the exemption, non-liability, etc of any amount claimed by the taxpayer in his or her appeal. The decision of SARS will not be reversed or altered on appeal by the Tax Court, unless the taxpayer succeeds in showing that such a decision is wrong.

In several instances⁶³, however, it has been held in case law that SARS bears a rebuttal onus. This essentially means evidence to prove that the evidence submitted on behalf of the taxpayer is wrong. The onus is on SARS to prove an amount. In doing this, SARS must apply its mind in arriving at such amount. Once determined, the onus falls back on the taxpayer, in terms of s 82, to prove otherwise.

4.1.18 Tax avoidance

'Tax avoidance' denotes the actions of a taxpayer of arranging his affairs within the law in order to minimise the amount of tax payable.⁶⁴ 'Tax evasion', on the other hand, refers to all those activities deliberately undertaken by a taxpayer outside the law to free him of tax. There may be a thin line between the two, but in one sense it is a solid one, as Denis Healey (a former British chancellor), once put it: '*The difference between tax avoidance and tax evasion is the thickness of a prison wall.*'

The SA income tax contains several provisions to combat specific forms of tax avoidance, for example the diversion of income rules in s 7, the CFC attribution rules in s 9D, the transfer pricing rules in s 31, to name a few. In addition, section 103 contains the general provisions to counter schemes for the avoidance of tax. The following aspects are of relevance to an IP rights holder in the context of the section:

General anti-tax avoidance provision

Tax avoidance could be seen as aggressive tax planning which stretches the law to its extreme limits and normally involves elements of abnormality and the lack of a commercial or business purpose to an extent which could result in a successful application by the Commissioner of s 103(1), the general anti-tax avoidance measure in the SA IT Act. Specifically, the Commissioner can apply the provisions of the section to set aside transaction or act in a manner to prevent the avoidance of tax, if he is '*satisfied*' that all the following four requirements⁶⁵ are present:

- There must be a transaction, operation or scheme ('scheme'); and
- It must have effect of avoiding or postponing or reducing the liability for tax; and
- Abnormal features exist: the manner in which the scheme is entered into must be one which normally would not be employed for *bona fide* business purposes; and
- Its sole or main purpose must have been to obtain a tax benefit.

Before any onus rests upon the taxpayer in terms of s 82, the Commissioner has to establish a *prima facie* case of tax avoidance. Consequently, the section will not apply unless tax avoidance is the dominant purpose. It was remarked in **R Ltd and K Ltd**⁶⁶: '*when a genuine commercial transaction is considered and there are two ways of carrying it out, one that involves paying more tax than the other, it is quite wrong to*

⁶³ See for example ITC 1654 [61 SATC 131]

⁶⁴ Duke of Westminster v IRC [51 TLR 467, 19 TC 490]; Levene v IRC [1928 AC 217, 13 TC 486]; Ayrshire Pullman Motor Services and D M Ritchie v IRC [14 TC 754]

⁶⁵ SIR v Geustyn, Forsyth, and Joubert [1971 (3) SA 567 (A), 33 SATC 113]

⁶⁶ R Ltd and K Ltd v COT [High Court of Zimbabwe March 1983, 45 SATC 148]

draw the inference, as a necessary consequence, that in adopting the course which involves paying less tax, one of the main objects is to avoid tax.'

Substance versus form

A taxpayer's liability for tax must be determined with reference to his legal rights and having regard to substance rather than form, and not on the parties' perceptions thereof.⁶⁷ The 'label' given to a transaction is therefore irrelevant; what is relevant is the true nature of the transaction, together with the rights and obligations created between the parties, and not what the parties 'label' the agreement. In exploring the real or true nature of an transaction, the Court will: evaluate all facts and circumstances leading to the agreement; inconsistencies or conflicting facts; simulated agreement; disguised facts (including dishonesty and fraud); flaws in an agreement to nullify form to substance; honesty of witnesses; window dressing or dressed up transaction; actual implementation in line with theory/facts; terms commercially justifiable (market related prices/consideration); arms' length and businesslike approach; tell-tale signs (inconsistencies).

Disguised and artificial transactions

Clegg⁶⁸ stressed that an examination of the substance of a transaction is quite different from a consideration whether it is a sham. Sham transactions are simply ignored for tax purposes – not because the substance overrides the form but because the actual agreement of the parties takes a different form from that which is apparent on the face of it. The SA Courts do not lightly disregard what the parties say – the traditional approach is that only where the Court is satisfied that the agreement is a sham or is a dishonest transaction, will the words in the agreement be discarded, as was expressed in **Randles, Bros and Hudson**⁶⁹: '*... a disguised transaction is a dishonest transaction and is dishonest inasmuch as the parties to it do not really intend it to have, inter parties, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties.*'

In such instances the whole '*artificial edifice*' which has been erected by the taxpayer for the purpose of avoiding tax may be pulled down⁷⁰ and under appropriate instances successfully piercing the '*corporate veil*'.⁷¹ The effect is that the transaction remains valid and enforceable between the parties to it, but for tax purposes the Commissioner may ignore it or counteract its tax effect in any appropriate manner.

Approach to tax avoidance

The **Furniss v Dawson**⁷² case confirmed a new approach to anti-avoidance measures in the United Kingdom: the practical effect of the judgment is to determine the tax consequences according to results achieved – in defiance of the substance of a transaction; in other words, it is permissible, in analysing the tax consequences of the transactions involved, to have regard only to the beginning and end without paying too much attention to what happens in the middle; in this case it was held that the

⁶⁷ ITC 1654 [61 SATC 131]

⁶⁸ Clegg, DJM. Tax Law through the Cases. First Edition 1991, Juta & Co, Ltd, p605

⁶⁹ Commissioner of Customs and Excise v Randles, Bros and Hudson Ltd [1941 AD 369, 33 SATC 48]

⁷⁰ H v COT [1972 (2) SA 719 (RAD)];

⁷¹ CIR v Gilleam Matthys van Zyl & Bay Security CC [High Court, case no. 2654/98]

⁷² Furniss v Dawson [1984, 153 STC 161]

intermediate company should be ignored for tax purposes as its existence served no purpose other than the avoidance of tax – it never played any real or beneficial part in the transaction. The SA Courts, however, are compelled to limit their law making – they cannot simply ignore the substance of a transaction in order to determine the tax consequences according to the results achieved.

Lastly, it must be remembered that even if any part of s 103 is applied against the taxpayer, the transaction remains valid and enforceable between the parties to it, but for tax purposes the Commissioner may ignore it or counteract its tax effect in any appropriate manner.

4.1.19 Foreign contracting parties

The choice of foreign parties to the contract of sale, licensing, donation or transfer of IP may have a crucial bearing on the income tax implications for the taxpayer, as regards to the quality, timing and incidence of tax. Special attention must therefore be devoted to the tax status of each party to the contract.

The fact that the contract is concluded with a foreign party and sourced from a foreign territory, do not alleviate the SA tax incidence. As a resident, gross income derived from the carrying on of a trade anywhere in the world is taxable, unless the deferral of taxation on blocked foreign income applies. This applies in whatever form or entity the taxpayer operates its business.

The various alternatives for a possible '*foreign contracting parties*' and the possible tax implications for the SA resident IP exporter are explored below:

Unrelated party

In a truly arm's length transaction, dealings with an unconnected or unrelated party will, as a normal rule, not culminate in any special or abnormal income tax consequences.

Connected party

The question whether parties are '*connected parties*' to each other is a significant factor in deciding how to structure the purchase arrangement. From a tax perspective, dealings between connected parties are treated with suspicion, because of a perception that transactions are readily manipulated to avoid tax or to achieve some ulterior motive. The definition of '*connected person*' in s 1 must always be considered for possible tax consequences between related parties. A number of anti-avoidance provisions are incorporated in the IT Act and dealt with in this analysis, in particular, diversion of income rules (s 7), deemed recoupments (s 8(4)), CFC attribution rules (s 9D), foreign exchange gains and losses (s 24I) and international transactions (s 31). In this context, special care is required in drafting the agreement in order to determine the nature and extent of the transaction on each contracting party.

Permanent establishment

The taxpayer could use a foreign PE as a base to exploit its IP asset, e.g. a foreign office. From a legal perspective, the foreign PE is not an independent legal entity

distinct from the SA resident – it is exactly one and the same legal *persona*. The net income attributable to the foreign PE will, therefore, be included in the SA resident's taxable income via the foreign currency conversion rules. From a tax perspective, a PE is regarded as a '*connected party*'. This is particularly so in the context of international agreements involving the s 31 transfer-pricing aspects, and with reference to Practice Note 7.

Tax haven intellectual property holding company

Generally, a tax haven is generally a country or state which has a lower rate of taxation than elsewhere. This is also referred to a '*low tax jurisdictions*' or '*offshore finance centres*'. A 1998 OECD report⁷³ identify a tax haven as follows: no or nominal taxes on income; lack of effective exchange of information about taxpayers benefiting from the low tax regime; lack of transparency in the operation of legislation, legal or administrative provisions; and the absence of a requirement that an activity needs to be substantiated.

Despite the international onslaught against the use of tax havens, international transfer of IP technology with the use of tax havens offers many advantages for the taxpayer. Apart from the direct tax benefits which may flow from earning foreign income in the name of a separate taxpayer situated in a tax haven, other non-tax or commercial reasons for utilising tax havens also prevail. Some of these are: platform for globalisation; attractiveness for asset protection; strict secrecy laws; reputation for confidentiality and dependability; political sensitivity; the elimination of exchange controls; leading edge communications and technology; flexible commercial regimes; the offering of different corporate entity forms, to name just a few.

However, as a disadvantage, tax havens seldom enter into tax treaties with other countries, and the '*aura of concealment*' that surrounds them may cause the domestic tax authorities to monitor their taxpayers more closely.

Unlike countries such as the United States, United Kingdom, Canada, Australia and New Zealand, SA does not have specific anti-tax haven legislation as part of its domestic legislation which specifically identifies or 'blacklists' tax havens. Instead, it relies heavily on the CFC attribution rules (s 9D), transfer-pricing rules (s 31) and the general anti-avoidance rule contained in s 103(1) to retain or bring the income home.

Intermediary holding company

An IHC is a holding company situated in any foreign jurisdiction, whether or not in a tax haven, that is interposed between the foreign subsidiary and the resident shareholder (investor) of a multinational group of companies.⁷⁴ The use of an IHC is a very important tax planning tool for a multinational group of companies. The purpose of an IHC would normally be to acquire, manage or sell investments in domestic or foreign companies. In this regard, an IHC is often used as an IP holding company. There are both tax and non-tax benefits to using an IHC.⁷⁵ The tax benefits will generally

⁷³ Organisation of Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue*, 1998, para 52

⁷⁴ Olivier L, Brincker E, Honiball M. *International Tax: A South African Perspective*, 2nd Edition, Siber Ink, Cape Town, 2004, p 145

⁷⁵ Other tax reasons for establishing an IHC:

- Reducing withholding taxes: the country of residence of the IHC may have negotiated a more favourable network of DTAs than the investor country;

materialise only when the IHC is located in a jurisdiction with a lower tax rate than that of the ultimate holding company. Tax havens are generally not suitable for IHC purposes because they seldom have tax treaty networks. A tax haven is therefore often combined with another low tax jurisdiction to obtain a withholding tax or other tax benefit for IHC purposes. Alternatively, high tax countries with special holding company tax regimes, like the Netherlands, can be used to obtain withholding tax and other benefits.

Setting up an IHC to avoid investor country taxes is often extremely complicated and may not be possible at all. The SA CFC attribution rules and transfer pricing rules act as an anti-avoidance counter in this regard.

Partnership or joint venture

Where a SA resident has an interest in a foreign partnership or engages in a joint venture arrangement with a foreign party, he will be taxed in SA on his share of partnership income. Under s 24H the income will be taxed in the hands of the individual partners at the time it is derived by the partnership/joint venture. It must be noted that CFC rules are not applicable to foreign partnerships as it is not an incorporated body in some or other form.

Foreign trust

The income derived by a foreign trust will not be attributed to SA resident beneficiaries. A foreign trust is not a 'foreign company' as envisaged in s 9D, as it is not a body corporate in other form, but a flow-through entity. The income will fall within the SA tax net only once it is distributed to the beneficiaries.

Agent or representative

Agents are categorised as '*dependent agents*' and '*independent agents*'. These agents may either be individuals or companies and they do not need to be residents of, nor have a place of business of business in, the state in which they act for the enterprise concerned. In this context, the IP exporter must be aware that utilising an agent or representative could in certain circumstances create a tax presence and draw

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- Deferring tax on operating income: defer tax by not remitting dividends to the investor – act as a vehicle to accumulate dividends and to reinvest income ('dividend trap');
 - Optimising credits for foreign taxes;
 - Obtain tax benefits from or reduce negative tax consequences of foreign exchange gains and losses;
 - Re-characterisation of income: an IHC could act as a vehicle which effectively changes the nature of income from, say, royalties to dividends.

Non-tax reasons for establishing an IHC:

- Raising external finance: reduce country risk;
- Exchange controls: facilitate reinvestment, prevent repatriation of profits or the trapping of profits within the exchange control area;
- Structural consolidation: centralised legal control for a geographic region or consolidation of investments under one legal entity;
- Asset protection: reduced risk of expropriation;
- Combination of IHC with headquarters activities to provide services to include accounting, legal, computer, marketing and IP support services.

him squarely into the tax net of the foreign jurisdiction, with reference to the OECD definition of the term '*permanent establishment*'.⁷⁶

4.2 DONATIONS TAX

4.2.1 Introduction

Sections 54 to 64 deals with the aspects of donations tax (DT). DT is not a tax on income but rather a tax on the transfer of assets. DT is payable by the donor at the rate of 20% on '*the value of any property disposed of (whether directly or indirectly and whether in trust or not) under any donation by any resident*'. An IP rights holder donating the asset to a foreign contracting party must consider the DT implications of such an arrangement.

4.2.2 Donation of property

Donation

In terms of s 55 a '*donation*' means any gratuitous disposal of property including any gratuitous waiver or renunciation of right. The common law meaning of a donation refers to pure liberality at the expense of the donor, an act whereby the donee is enriched and the donor correspondingly impoverished; it must be inspired solely by a disinterested benevolence.⁷⁷

Property

'*Property*' means any right in or to property, movable or immovable, corporeal or incorporeal, within or outside SA. The donation of IP rights are therefore trapped in this wide definition.

When a donation takes effect

A donation takes effect upon the date which all the legal formalities for a valid donation have been complied with.⁷⁸ A donation which is subject to a '*suspensive*' condition, even if it is accepted by the donee, only comes into effect when the suspensive

⁷⁶ Article 5 of the *OECD Model Tax Convention*, dealing with the definition of a '*permanent establishment*', states that if a non-resident carries on a business through an agent in a foreign jurisdiction, the non-resident is deemed to have a PE only if the agent habitually exercises an authority to conclude contracts in the name of the non-resident. Dependent agents, therefore, will deem to constitute PE when they act on behalf of the enterprise and have the authority to conclude contracts that will bind the principal. On the other hand, a broker, commission agent, or other agent of independent status who acts in the normal course of its business will not be considered to create a PE of that non-resident. Independent agents, therefore, must both be legally and economically independent of the enterprise and the agent must be acting in the ordinary course of its business in carrying out the activities on behalf of the enterprise.

⁷⁷ Estate Sale v CIR [1945 AD]; Avis v Erupt [1943 AD]; CIR v Estate Hewlett [1990(2) SA 786(A), 52 SATC 109]

⁷⁸ See General Law Amendment Act 50 of 1956 for conditions under an executory contract of donation.

condition has been fulfilled. A donation which is subject to a 'resolutive' condition will normally become effective immediately. The fulfillment of a resolutive condition nullifies the donation from the beginning. A donation is a contract and the normal Roman Dutch Law of contract applies e.g. offer and acceptance, delivery, etc. A valid donation will not take effect until there is an offer by the donor and acceptance by the donee – even though the donor has signed a document embodying the terms of the contract.⁷⁹ If a donation is made illegally, i.e. the legal formalities for a valid donation have not been complied with; the donation does not take effect for this purpose, even if the property has been transferred from donor to donee.

4.2.3 Exemptions

Section 56 contains a number of exemptions, i.e. items on which no DT is payable. Noteworthy are donations between spouses; under and in pursuance of any trust; by public companies; between the same group of companies; casual gifts by not non-natural persons (R10,000 in aggregate per annum) and an annual threshold for natural person (R30,000).

4.2.4 Deemed donation

Section 58 deals with deemed donations in situations where property is disposed of for an inadequate consideration. What is important is the question of whether there is a quantified mismatch between property disposed of and consideration received in return. **Meyerowitz**⁸⁰ suggests that the section can apply to any disposal of property under any transaction and for any motive, if SARS is of the opinion that the consideration given is not adequate. It is his opinion which is decisive and it is not subject to appeal. **Silke**⁸¹ is of the view that SARS may be entitled to apply the section whenever consideration is inadequate, irrespective whether there is an intention to donate. This is an anti-avoidance provision. The section brings into the DT net disguised donations, where a donor donates property for a ridiculously low consideration in order to nullify the 'gratuitous' element of a donation as defined in s 55. The value of the donation will be the value of the property reduced by the consideration given.

4.2.5 Valuation of donations

In terms of s 62(1)(d) the value of a donation is the fair market value of the property - ignoring any conditions imposed.⁸²

⁷⁹ Van Reenen's Trustee v Versfeld 9 SC 161; Slabber's Trustee v Neezor's Executor [12 SC 163].

⁸⁰ Meyerowitz D. *Meyerowitz on Income Tax 2002 – 2003*, The Taxpayer, Cape Town

⁸¹ De Koker A. *Silke on South African Income Tax*, Butterworths, Durban, par 23.5

⁸² Ogus v SIR [18 SATC 336].

4.3 SECONDARY TAX ON COMPANIES

4.3.1 Introduction

SA resident companies are liable for secondary tax on companies (STC) at the rate of 12.5% on the net amount (i.e. excess of outgoing dividends over incoming dividends) of dividends declared or treated as having been declared during a dividend cycle. The tax is payable by and borne by the company declaring the dividend – it is not deductible from the amount of the dividend declared and is thus not a tax payable by the shareholder.

4.3.2 Deemed dividend – transfer pricing adjustments

When an exporter of IP engages in transactions with a foreign connected party it could materialize that SARS could invoke adjustments or disallowances in accordance with the transfer pricing provisions in s 31. In accordance with s 64C(3)(e) the amount so adjusted or disallowed, is deemed to have been distributed to a shareholder or his connected person. The impact of this is in effect an indirect penalty, in addition to any tax which may be due as a result of the adjustment or disallowance.

4.4 CAPITAL GAINS TAX

4.4.1 Introduction

SA residents are subject to CGT on all asset disposals on a worldwide basis, i.e. capital gains and losses will be taken into account from whatever source. CGT is calculated in accordance with the Eight Schedule and forms part of the income tax whereby it is included in '*taxable income*' as envisaged per s 26A.

An IP rights holder disposing of his asset, held on capital account, to a foreign contracting party could incur a CGT liability as a result of the transaction. It is therefore important for the taxpayer to identify and recognise his exposure in this area by exploring the mechanics of the CGT regime via the notions of '*asset*', '*disposal*', '*base cost*' and '*proceeds*'.

4.4.2 Asset

The definition of 'asset' is of importance, as CGT is not triggered until an asset is disposed of. An 'asset' is widely defined as: '(a) *property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency...*, and (b) *any right or interest of whatever nature to or in such property*'. The definition, therefore, includes all types of IP assets.

4.4.3 Disposal

Disposal or deemed disposal

The concept of disposal is dealt with in paras 11 and 12 and covers any event which constitute the alienation or transfer of ownership of an asset, e.g. the sale or donation of IP; the scrapping, loss or destruction of IP; the distribution of IP rights by a company to its shareholder; the vesting in a beneficiary of an interest in an IP asset of a trust.

Time of disposal

The dates (time rules) on which disposals are treated as having taken place are set out in par 13 and are of importance as it determines in which year of assessment the disposal of an asset takes place in order to fall within the CGT net. The general timing rule, when a change in ownership takes place, is that the time of disposal is the date of change of ownership. In the case of an agreement subject to a suspensive condition, it is the date on which the condition is fulfilled; agreements not subject to a suspensive condition, it is the date on which the agreement is concluded, etc

4.4.4 Base cost

Paragraph 20 to 34 deals with the 'base cost' aspects in the CGT computation. The most complicated and detailed aspect of CGT is the determination of the deductible base cost of an asset. This is a result of the inclusion within the CGT net of assets acquired before, and not disposed of still held on the '*valuation date*' (1 October 2001), coupled with the objective to exclude pre-valuation date appreciation and depreciation in the value of these assets.

Different rules apply for '*pre-valuation date assets*' (i.e. assets acquired before the valuation date and not disposed of and still held on valuation date) and '*post-valuation date assets*' (i.e. assets acquired on or after the valuation date).

4.4.5 Proceeds

The basic rule, in terms of par 35, is that the proceeds from the disposal of an asset by a person are actual or deemed amounts received by or accrued to the person in respect of the disposal. As the Eight Schedule is part of the IT Act, income tax rules and principles apply to determine when proceeds are received or accrued, e.g. '*accrued*' means '*entitled to*' per Lategan principle.

A specific rule provides that an amount to which the taxpayer becomes entitled during a tax year, but which is only received in a subsequent tax year, is treated as having accrued in the first tax year. This means that once the disposor of the asset has an unconditional entitlement to payment, all of the proceeds are immediately trapped in the CGT net, regardless when it is received.

4.4.6 Foreign currency

Paragraph 43 contains the different permutations for determining the capital gain or loss where: (1) both proceeds and expenditure is in the same foreign currency; (2) the currency of disposal does not match currency of expenditure.

4.4.7 Trusts

As trusts act as a conduit, a capital gain arising from the disposal of a trust asset must in the first instance be taxed in the hands of a beneficiary. If an asset does not vest in a determined beneficiary, then CGT liability will be determined in the hands of the trust. In certain circumstances a donor, i.e. the person who made a donation, settlement or other disposition to the trust, could also incur a liability in terms of the attribution rules incorporated in paragraph 68 to 73. As is the case of income tax where *'expenses follow income'* in income distributions to beneficiaries, the same is true in CGT where *'base costs follows proceeds'* in asset distributions to beneficiaries.

Special note must be taken of the specific rules set out in par 80 with regard to the vesting of a trust asset in a beneficiary; vesting of capital gain in a beneficiary; where beneficiary already has a vested right and the disposal of discretionary interest. Where a trust is not a resident and a resident acquires a vested right to the capital of a non-resident trust and the capital arose from: (1) a capital gain of the trust in any prior tax year during which the resident had a contingent right to that capital; or (2) any amount that would have constituted a capital gain had the trust been a SA resident, and the capital gain has not been subject to tax in SA, then the amount of the capital gain is deemed to be that of the SA resident beneficiary and subject to CGT in the hands of such beneficiary.

Capital losses are trapped in the trust and special rules apply, in terms of par 39, to capital losses determined in respect of a disposal of trust assets to connected persons.

4.4.8 Partnerships

A partnership is not a separate legal entity and is not a taxpayer - it is therefore the individual partners who must bear the consequences of CGT. In terms of par 36 the proceeds from the disposal of a partner's interest in a partnership asset is treated as having accrued to the partner at the time of the disposal. In the absence of a specific asset-surplus-sharing ratio, the proceeds will normally be allocated according to the profit-sharing ratio.⁸³

⁸³ ITC 1721 [1999, 64 SATC 93]

4.4.9 Anti-avoidance provisions

The Eight Schedule contains a number of anti-avoidance provisions relevant to IP: (1) intangible assets acquired prior to valuation date - par 16; (2) donations and transactions between connected persons not at arm's length price - par 38; (3) disposals to connected persons - par 39; (4) attribution of capital gains - paras 68 to 73 and (5) the general anti-avoidance provisions - s 103(1).

4.5 VALUE ADDED TAX

4.5.1 Introduction

Value-added tax (VAT) is a broad-based indirect tax based on the 'supply' of 'goods' or 'services' by 'vendors' in the course or furtherance of their 'enterprise'. VAT is, therefore, a transaction tax because it is charged when a transaction takes place. It does not matter whether the supply is of a capital good or of trading stock – VAT must be levied if the vendor uses the goods in his enterprise.

It is, therefore, important for an IP rights holder engaging in international transactions to appreciate the VAT implications of the cross-border flow of goods and services, covering both exports and imports in the course or furtherance of his enterprise.

4.5.2 Supply of goods and services

VAT is triggered by the 'supply' of 'goods' and 'services' at a 'consideration'. The Act does not refer to the selling of goods or the rendering of services, instead the action which gives rise to VAT is a 'supply'. It includes performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law. It includes any transfer of ownership, possession or use. Goods are corporeal (tangible) movable things, fixed property and any real right in any such thing or fixed property. IP rights are therefore not classified as goods because they are intangible assets. Services, on the other hand, means 'anything done or to be done', including the granting, assignment, cessions, or surrender of any right; or the making available of any facility or advantage. The definition of 'services' is very wide – it basically traps everything that is not goods as defined. The definition, therefore, includes, for example: royalty agreements, sale of IP and the 'supply' of professional and other personal type services, etc 'Consideration' is the VAT inclusive amount of any payment made or to be made, whether or not in money, for the supply of any goods or services.

4.5.3 Cross-border supplies

Services supplied to a non-resident

Section 11(2)(l) provides that services rendered to a non-resident are zero rated, i.e. sale of IP rights, granting of licences, franchises, etc. However, the following services to non residents are not zero rated (i.e. standard rated): (1) services supplied in connection with IP rights inside SA at the time the services are rendered; (2) services rendered to a non-resident who is in SA at the time the services are rendered; (3) services comprising the acceptance of an obligation to refrain from conducting an enterprise in SA (restraint of trade).

Services in respect of IP rights in an export country

Section 11(2)(g)(i) provides that services rendered directly in respect IP rights located in an export country are zero rated, e.g. rendering of assistance or service in connection with the application or utilization of IP. It must be noted that the IP must be in an export country at the time the services are rendered.

Services outside SA

Section 11(2)(k) provides that services physically rendered outside SA are zero rated. This section does not identify the person to whom the service is supplied – it can be supplied to residents and non-residents. What is important is the place where the service is physically rendered.

IP used outside SA

To the extent that IP rights are for use outside SA, services in respect of those rights are zero rated – s 11(2)(m).

Branch situated outside SA

The definition of 'enterprise' is limited by the exclusion of a number of activities, one which refers to a branch of a vendor situated outside SA. Supplies made by such branch are not subject to VAT (do not form part of the SA activity), if: (1) it is permanently located at premises outside SA; (2) it can be separately identified, and (3) an independent system of accounting is maintained by the concern in respect of the branch. Supplies made by the SA vendor to such an independent branch outside SA would attract VAT unless the transfer is specifically zero rated. Ordinarily, inter-branch transfers do not constitute a 'supply' and is therefore not an 'export' as envisaged – one cannot supply to oneself because the foreign branch and the SA main business is one legal entity. But, transfers to independent foreign branches are deemed to be supplies in terms of s 8(9). However, s 11(2)(o) provides that services supplied by a vendor to or for the purposes of a branch in an export country are zero rated if certain conditions are met. For example, no zero rating apply (i.e. standard rated) if the services were rendered in connection with IP located inside SA at the time the services are rendered. Supplies made to dependent branches in export countries are zero rated, and the transfer to the branch is ignored. This provision maintains neutrality

between a SA company that has a foreign subsidiary on the one hand and a SA company that has a foreign branch.

The value of a supply to a foreign independent branch is the lesser of: (1) cost to the SA vendor; or (2) open market value (s 10(5)). The time of transfer is the actual date the services are performed, not when the tax invoice is issued or payment is received (s 9(2)(e)).

Foreigners granting the use of IP in SA

It could materialise that the SA IP rights holder, for various reasons, uses a foreign IHC or a subsidiary to administrate and licence the IP rights to various countries, including SA licensees. If this is the case, the foreign entity will be regarded by SARS as carrying on an '*enterprise*' in SA for VAT purposes and will be obliged to register as a '*vendor*'. The flows from the definition of enterprise referring to an ongoing activity conducted in or partly in SA. SARS' view is that the foreign entity is '*in*' SA at the time the services are rendered.

4.6 REGIONAL SERVICES LEVY

4.6.1 Introduction

The aim of these levies is to provide development infrastructure around the country, e.g. to provide essential services, assist in financing large projects and to provide bulk services to urban areas. RSC levies consist of two components, i.e. services levy (payroll tax) and an establishment levy (gross turnover tax) and is payable on a monthly basis by a 'person' to the 'council' within the 'region' in which he carries on his 'enterprise' .

Of direct relevance to an IP exporter, in the context of exploiting his IP rights, is the regional establishment levy (REL). Each possible transaction will be considered, including the receipt of interest on loans to foreign subsidiaries and dividends.

4.6.2 Calculation of levy and definitions

The REL levy is calculated at a rate of 0,228% (including VAT) on the '*leviable amount*', which represents the '*consideration*' received from '*leviable transactions*' originating from a non-financial enterprise and/or a financial enterprise.

4.6.3 Exploitation of IP rights

Sale

Critical to the determination of whether a sale of IP rights fall within the net of leviable transactions is the determination of whether the taxpayer had been trading with the IP rights or whether it was held as a long-term asset. The **Sanlam**⁸⁴ case provides some guidance in this regard where it was held that a transaction falling outside of the normal range of activities of an enterprise, such as a 'once-off' selling of its infrastructure or long-term assets, is not of a continuous nature and does not fall within the ambit of the levy. Therefore, the RSC levy is only leviable on the proceeds of the transaction if the taxpayer was trading with the IP rights in the ordinary course of its enterprise.

Licensing

The licensing of IP rights fall within the purview of RSC leviable transactions.

Donation

Distinguish between IP rights held as a '*long-term asset*' and a '*trading asset*'. If the donation relates to the former category, it submitted that it will be altogether excluded from the RSC calculation. If it relates to the latter category, then, whatever consideration received, even if it is an inadequate consideration, will be included in the RSC calculation. RSC does not concern itself with imposing a '*market value*' for determining the consideration.

Transfer

As with donations above, the transfer of an IP trading asset will be brought into the RSC net at whatever consideration is received in return.

4.6.4 Dividends and interest from foreign subsidiaries

The decision whether dividends and interest received from foreign subsidiaries falls within the REL net, rests on the question whether the taxpayer was carrying on a financial enterprise as an investor of money of a continuing nature. In this regard the findings in the **Tiger Oats**⁸⁵ case are important. In that case the taxpayer carried on the business of an investment holding company, acted as banker for the group and made interest bearing loans to its subsidiary and associated companies. It was held that the taxpayer was not a mere passive investor but it was actively involved in the business of its subsidiaries. It was in the making of investments in those companies which enabled it to be actively involved. The taxpayer conducted a business and was carrying on an enterprise as an investor of money, which is classified as a financial enterprise. Accordingly, the dividends received from subsidiaries constituted leviable REL transactions. The interest received was not in issue in the appeal, therefore, conceded to be subjected to REL by the taxpayer.

⁸⁴ Commissioner for South African Revenue Service v Sanlam [Cape Provincial Division – 9 February 2000]

⁸⁵ Commissioner for South African Revenue Service v Tiger Oats Ltd [2003, 2 All SA 604 (SCA)]

4.7 ESTATE DUTY

4.7.1 Introduction

The ED Act regulates the payment of estate duty (ED) in respect of the estate of every natural person who dies and was ordinarily resident in SA at the date of death. All assets of such resident, no matter where in the world such assets are situated, fall into his estate. Broadly speaking ED is payable on the following assets: SA residents – worldwide assets and non-SA residents – SA assets only. For an individual IP rights holder, understanding the ED implications associated with this asset is important in order to facilitate estate planning.

4.7.2 Property in an estate

What constitute an estate

In accordance with s 3(1), the estate of any person consists of all property and deemed property as at the date of his death. The property must have belonged to or have been vested in the deceased at the date of his death for it to form part of his estate for ED purposes. Rights vesting after the date of death are not property in the estate. For example: royalties accruing to the estate after death are income after death. If a deceased had contractually bound him to deliver property to another, and on his death the property has not as such been delivered, that property is still his property at the date of his death.⁸⁶

Property

Section 3(2) defines property as: *'any right in or to property, movable or immovable, corporeal or incorporeal'*. *'Any right'* refers to *personal* and *real* rights. The definition, therefore, includes IP assets and any right therein. Vested rights are included but not contingent rights. Also, specifically included as property is a *'fiduciary, usufructuary or other like interest'* (including a personal right to income held by a deceased under a trust, which ceased upon death) and a *'right to an annuity'* enjoyed by the deceased immediately prior to his death and which accrues to someone else on his death.

Deemed property

Section 3(3), read with sections 3(4) and 3(5), bring into the estate of a deceased person certain deemed property, i.e. property which did not exist at the time of the death of the deceased but treated for ED purposes as property. Amongst others, and of particular interest, is s 3(3)(d) which includes any property which the deceased was competent to dispose for his own benefit, or for the benefit of the estate, immediately prior to his death. *To illustrate*: an IP asset donated to a trust of which the donor

⁸⁶ CIR v Estate Kirch [1951 (3) SA 496 AD]; Estate Robottom CIR [1961 (1) SA 33 C]

retains the right to revoke the donation or change the beneficiaries in such a way as to benefit himself or his estate.

4.7.3 Deductions

Section 4 lists the deductions which may be made from the 'gross estate' in order to arrive at the 'net value' of the estate. The following deductions, amongst others, are of interest: debts due; administration charges; foreign debts; charitable and other bequests and accruals to a surviving spouse.

4.7.4 Valuations in an estate

The valuation rules for ED purposes are contained in s 5 and cater for both property values per s 3 and deductions per s 4. The valuation must be determined on the date of death of the deceased. Property disposed by a *bona fide* purchase and sale in the course of liquidation of an estate, is valued at the price realized by the sale. Whenever the deceased has in his lifetime contracted to sell or dispose of property for a consideration, but has not at the date of death transferred the property, the transaction cannot be regarded as a sale by the executor in the course of liquidation and the property must be valued at its fair market value and not the sale price.⁸⁷ The value of property realized is the gross price received, but expenses connected with the sale, e.g. auctioneer's commission, advertising costs, brokerage, etc are allowable deductions as part of the administration expenses. Any other property not sold is valued at fair market value at the date of death.

4.8 DOUBLE TAX AGREEMENTS

4.8.1 Introduction

A South African resident exploiting his IP rights in cross-border transactions may be taxable here and abroad, resulting in effective double taxation.

International tax agreements are important for encouraging investment and trade flows between countries. Section 108 sets up the mechanism for the SA Government to enter into agreements with governments of other countries for the purpose of preventing the imposition of comparable taxes in two or more jurisdictions on the same taxpayer in respect of the same transaction or income for identical periods. The main purpose of a '*Double Taxation Agreement*' (DTA) is to avoid the imposition of international juridical taxation and the prevention of fiscal evasion. It clarifies the taxing rights of each state, which in turn can decide whether to tax the item in question or not.

⁸⁷ CIR v Estate Kirch [1951(3) SA 496 (A), 17 SATC 412]

A DTA does not impose a tax burden; it can only provide relief from taxation. Also, a DTA does not provide the basis for a higher tax charge, unless the application of the domestic legislation results in the imposition of a higher tax burden. In terms of s 108 read with s 232 of the Constitution⁸⁸ a DTA becomes part of SA tax law. A DTA may override domestic tax law to the extent that it conflicts with such law. Various categories of income, profits and gains are dealt with in a DTA, as will be highlighted in the discussion below.

SA has an extensive network of tax treaties concluded with the majority of its trading partners: 56 comprehensive treaties and 33 at various stages of signature, ratification or negotiation.⁸⁹ The OECD's '*Model Tax Treaty*' (the Treaty)⁹⁰ is internationally regarded as the accepted norm for tax treaties. SA has endorsed the contents of the model.

Being an international 'player', the IP exporter must take cognisance of any relevant articles of the Treaty, not only from the view of exploiting the IP rights in a foreign country, but also with regards to the possible impact on employees facing possible secondment, the earning of directors fees, rendering of professional services, treaty shopping, etc

4.8.2 Scope and objectives of a DTA

The scope of a DTA is limited to taxes covered by the IT Act, including donations tax, CGT and STC. Estate duty, RSC levies and VAT is not covered. Apart from its primary objective to eliminate double taxation on income, profits and gains, **Brincker et al**⁹¹ lists the following additional objectives: (1) the facilitation of international trade and investment by the removal of tax barriers; (2) provision of certainty to taxpayers; (3) the sharing of tax revenues; (4) the allocation of income and expenditure between business activities conducted in the countries concerned (e.g. branches); (5) establishment of the '*arm's length principle*' for the adjustment of transfer prices; (6) the curtailment of possible abuse of treaties and prevention of international tax evasion.

4.8.3 Persons covered by a DTA

A DTA only applies to '*persons*' who are '*residents*'. A PE does not constitute a person and they cannot therefore rely on treaty protection. A PE will qualify for treaty protection only if the owner of the PE is a resident. It should be noted that a partnership and a trust is not always included as a person. This depends on whether the foreign state regards them as separate legal entities. In SA a partnership is not regarded as a person, whereas a trust is.

⁸⁸ Constitution of the Republic of South Africa, Act 108 of 1996

⁸⁹ As at 28 February 2005

⁹⁰ Organisation for Economic Co-operation and Development (OECD). *Model Tax Convention on Income and on Capital*

⁹¹ Olivier L, Brincker E, Honiball M. *International Tax: A South African Perspective*, 2nd Edition, Siber Ink, Cape Town, 2004, pp 329 - 330

4.8.4 Business profits

Article 7 of the Treaty deals with *business profits* generated by a PE as defined in Article 5. Extensive reliance is placed on the concept of PE as a threshold for allocating taxation rights between States under a DTA. In most treaties, the source territory, that is the territory in which the non-resident is trading, may only exercise its taxing right in respect of profits that arise through a PE.

The following criteria need to be met for a PE: (1) a place of business (physical presence); (2) the place of business must be fixed (established at a distinct place with a certain degree of permanence); and (3) the business must be carried on through the fixed place of business.

It must be noted that making use of *'dependent agents'* in a foreign state will constitute a PE for the SA resident. Agents of independent status will not create such a PE.

Tax treaties further provide that the PE's State of residence must relieve any double taxation on profits imposed in the State of source. In SA the tax credit mechanism is contained in s 6quat. In the absence of a PE, only the State of residence of the enterprise will be able to tax business profits arising in a foreign jurisdiction. In such a case, an unilateral tax credit for foreign taxes paid will be granted, regardless whether a Treaty has been concluded with the relevant foreign jurisdiction or not.

Another pertinent issue is the question of what profits are properly attributed to the PE, over which the country in which it exists will have primary taxing rights. A DTA generally provide that transactions between associated enterprises must be at arm's length. It, therefore, follows that branch profits, in the allocation of income and expenditure, must also be determined in accordance with this principle, notwithstanding the fact that a branch is not a separate legal person from its head office.

4.8.5 Associated enterprises

Article 9 of the OECD Model Treaty mandates an adjustment of profit if there is a special relationship between *'associated enterprises'* (e.g. a CFC). In this regard, it is generally accepted that the arm's length principle be followed in determining the profits of an enterprise.

4.8.6 Distributive rules

Articles 10 to 12 of the Treaty contain the so-called *'distributive provisions'* as follows:

- *Dividends*: normally, the State in which the dividends are declared may impose a withholding tax and the state in which they are received may impose full tax;
- *Interest*: normally, the State of source is entitled to tax interest at a maximum rate of 10%;
- *Royalties*: in most of the DTAs concluded by SA, royalties are only taxed in the State of residence as opposed to the State of source.

The existence of withholding taxes on dividends, interest and royalties is often the subject of much treaty planning and/or treaty shopping. For instance, to make use of the lower withholding tax rates in DTAs, the parties must be residents of the relevant contracting states.

4.8.7 Capital gains

Paragraph 13 deals with capital gains. Gains derived by a resident from the alienation of immovable property situated in the State of source, is taxed in the State of source. Gains derived from the alienation of movable property forming part of a PE, including gains from the alienation of such PE, may be taxed in the State of source. Gains arising from the alienation of any other property are taxable only in the State of which the alienator is resident.

4.8.8 Services

Independent personal services

Article 14 encompasses the rendering of '*professional services*' and other activities of an independent character e.g. scientific, literary, lawyers, engineers, architects, etc. Income in respect of these activities is only taxable in the State of residence, unless: (1) the professional has a fixed base regularly available to him in the State of source for purposes of performing his activities; or (2) if the stay of the professional in the State of source is for a period or periods exceeding 183 days in aggregate in the fiscal year concerned.

Income from employment

Article 15 states that remuneration or similar income derived by a resident from employment is only taxable in the State of residence if the following three conditions are met: (1) the recipient is present in the State of source (where employment is exercised) for a period or periods not exceeding 183 days in aggregate in the fiscal year concerned; and (2) the remuneration is paid by, or on behalf of an employer who is not a resident of the State of source; and (3) the remuneration is not borne by a PE (or fixed base) which the employer has in the State of source.

Director's fees

Article 16 provide that director's fees or similar payments received by a resident, in his capacity as a director of a company resident in the State of source, may only be taxed in the State of source.

Exchange of information

Article 26 provides for controlled information exchange between the tax administrations of the two contracting states. It is one of the most important anti-avoidance weapons available and it is starting to happen more frequently.

4.8.9 Improper use of a DTA

'Treaty shopping' involves the use of the protection offered under a particular treaty by interposing a person who can claim treaty protection, which would have otherwise been unavailable. This normally occurs where a resident of country A establishes an entity in country B which has a favourable tax treaty with country C in circumstances where no favourable tax treaty exists between country A and country C. This is, therefore, done for the purpose of exploiting the benefits of a specific DTA. In order to stamp out this abuse, these entities are excluded in the OECD Model from the definition of 'resident' and will be taxed on the income sourced in a country. *For example*, the United States applies a stringent 'qualified resident' test and Germany applies a threefold test for denying treaty benefits to foreign countries which (a) do not engage in a business activity of their own; (b) their imposition has no commercial or non-tax validity, and (c) their shareholders would not be entitled to treaty benefits if the income were received direct. In addition, the distributive rules (see above) indicate that the ability of a state will not be denied in circumstances where the recipient is not the beneficial owner of the relevant income.

4.8.10 Credit for foreign taxes

Section 6quat of the IT Act provides for a rebate (credit) on foreign taxes paid or proved to be payable, to the extent that SA tax is payable on the income in question.

4.9 FOREIGN EXCHANGE CONTROL

4.9.1 Introduction

Despite the gradual relaxation of exchange control barriers in SA over the last couple of years, the free flow of funds in cross-border transactions are still not permitted.

In SA various cross-border IP transactions occur daily and include the sale or licensing of IP to non-residents. A resident IP exporter needs to take the following exchange control restrictions into account:

4.9.2 Disposal / licensing rules

Any agreement involving the disposal of any IP right to a non-resident, and any licence agreement requires the prior approval from the authorities (depending on the circumstances either the Department of Trade and Industry or Exchange Control). Exchange control will not approve a transaction unless satisfied that a disposal is for fair value. Exchange Control does not generally approve minimum payments where

the calculated royalty payable does not reach a certain amount during a specific period – the royalty payable by the non-resident should be directly related to sales.

4.9.3 Foreign investment rules

Investment allowance

Exchange control residents who are natural persons over the age of 18 years may transfer overseas a once-off R750 000 in the form of an investment allowance, provided their tax affairs are in order. Non-resident individuals, emigrants, trusts and companies do not qualify for this allowance. Once the allowance has been approved, any investment acquired with the allowance may be disposed of and the proceeds reinvested overseas.

Foreign subsidiaries

No approval is required to acquire or establish subsidiary companies within the CMA. Approval must be obtained for investments outside the CMA, within the limits allowed for – R2 billion for new and approved African investments and R1 billion outside Africa. On application, a further 20% of a new investment may be funded by local cash holdings if the maximum investment allowance has been utilised. The ‘investments’ envisaged here represents fund flows ex SA in the form of: (1) capitalising foreign subsidiaries with equity shares; (2) loans; (3) transfer of an asset in specie; or (4) guarantees with a view of obtaining credit anywhere in the world. Normal trade credit items are managed within the ‘*foreign currency accruals*’ system.

Intermediary holding companies

An intermediary holding company (IHC) may also be established, with approval, to hold such overseas investments (e.g. to take advantage of non-CMA DTA networks). However, such IHC located outside the CMA is not permitted to hold an investment within the CMA

Loans to branches and foreign subsidiaries

A foreign branch is treated as a separate person, even though it forms part of the same legal entity as the SA head office. Where loans are made to a foreign branch or subsidiary by a SA resident, prior approval must be obtained as envisaged above.

5. International Tax Planning

5.1 Overview

Eskinazi⁹² states: *'The term 'international tax' is a misleading one – international tax law is nothing more than the international aspects of the domestic tax system of a particular country. International tax planning, therefore, is firmly ensconced in the details of one or more domestic tax systems.'*

International tax planning is concerned with finding ways to legally reduce tax burdens (called *'tax avoidance'*) as oppose to deliberately undertaking actions to free a taxpayer in an illegal manner from tax burdens to which he would otherwise have been subjected to (called *'tax evasion'*) . Successful tax planning revolves around the following aspects: (1) cognisance of all tax legislation; (2) the transactions which constitute the plan must be legal; (3) the plan must be cost effective; and (4) commercial and other objectives, not the saving of tax, must be the primary considerations. International tax planning requires an in-depth knowledge of tax treaty provisions. In addition, continual monitoring of developments in international tax laws is essential to keep the original tax plan in step with changes.

With the above as background, and reflecting on the various issues highlighted under each tax discipline in **Chapter 4**, the IP exporter must focus in particular on the following opportunities and challenges in drafting its tax plan:

5.2 Income tax

Residence: place of effective management

The question whether a resident, as it applies to a company or trust, has its *'place of effective management'* in SA is not only important against the background of the numerous double tax agreements concluded by SA with its foreign counterparts, but also in order to determine whether they are regarded to be a resident of SA for purposes of the IT Act. The term is not defined in the Act and SARS view this as the place where the day-to-day management is carried out, rather than the location where central management and control is exercised, i.e. where the 'shots are called'. The international use of the term indicates lack of uniformity on its meaning. Therefore, care should be exercised in relying on the meaning of the term in other countries, as the term does not have a universal meaning.

Foreign tax relief

The SA tax system attempts to avoid subjecting a SA resident to double taxation where its foreign income has already been subjected to foreign taxes that are substantially similar to those imposed in SA. SA residents in receipt of foreign income

⁹² Ray Eskinazi. *International Tax: Relevant considerations from a South African perspective*. Accountancy SA, September 2002

may seek relief under s 6quat, in respect of SA tax payable, via a rebate for foreign taxes already paid on the foreign income.

It is important to note that a resident only qualifies for a rebate to the extent that SA tax is payable on the income in question. Furthermore, it must be foreign sourced income and not deemed to be from a SA source. The rebate structure is subject to a number of complicated and technical qualifications and there are provisos for the limitation of the amount of the rebate granted, with the carrying-over of excess foreign tax credits into the following year.

Diversion of income rules

A planner must take careful cognisance of the series of income tax diversion rules contained in s 7 by virtue of a donation, settlement or other disposition. In particular, s 7(8) deals with donations of income-producing assets by a resident to a non-resident, including an offshore trust. It must be noted that the provision does not apply when the income is received by or accrues to the resident donor's CFC.

Controlled foreign companies

The power of s 9D as an anti-avoidance provision cannot be underestimated. It will attribute the CFC net income to the SA participation holder, in whatever jurisdiction this is generated. In order for an entity to qualify as a CFC in terms of s 9D, it must be a 'foreign company'. Any juristic entity (other than a trust) that is not a resident of SA is a foreign company for purposes of the Act. The first issue is to determine where the foreign company is effectively managed. If it is effectively managed in SA it will not be a CFC but a SA resident and taxable in SA, on the same basis as any other SA resident company. If this is the case, it is submitted that past unutilized and ring-fenced tax losses would not be available for offset against the taxable income of the company after it becomes SA resident.

Foreign currency

The foreign currency rules for both income tax and capital gains tax are extremely complex, because of the difficult language it is cast into. These rules are particularly relevant in the light of the extreme volatility of the Rand over the past few months or so. The planner needs to consider this for purposes of: (1) foreign currency conversions; (2) treatment of foreign currency gains and losses; (3) deferral due to remittance restrictions; (4) CFC's, in particular the restrictions on unrealised gains or losses resulting from inter-group transactions; (5) foreign permanent establishments; and (6) foreign tax credits.

Transfer pricing

Taxpayers engaging in international transactions with connected persons, as envisaged in s 31, must take their transfer prices seriously in order to avoid the possibility of an adjustment being made to their taxable income. SARS is now targeting enforcement in this area. As indicated on the 2004 income tax return (IT14), it is now compulsory for all companies that enter into international transactions with related companies and persons, to attach a transfer pricing policy document to the IT14 form that has to be submitted to SARS. It is submitted that transfer pricing is a pure economic exercise. It is therefore advisable to employ the services of an economist to

draft or at least review the transfer pricing policy document before submission to SARS.

Tax avoidance

Tax avoidance could be seen as aggressive tax planning which stretches the law to its extreme limits and normally involves elements of abnormality and the lack of a commercial or business purpose. While there is a need for tax awareness, a sense of proportion must be retained. Care must be taken not let the '*tax tail wag the commercial dog*': structure the transaction to achieve commercial objectives. At the same time, do not ignore the tax implications, but don't let the structure be tax driven, thereby losing sight of commercial objectives and risking a tax substance versus form attack under s103.

Nature of the contract

The nature of the IP exploitation contract may be decisive in determining the capital or income nature of a transaction. The case of ***Vacu-Lug***⁹³ illustrates that, when a contract approaches the borderline between a sale and a lease, ever greater care must be taken by the draftsman, as every feature of the contract will be scrutinized by the Court for tell-tale signs. When drafting a contract, the draftsman should always keep the tax consequences in mind; the nature of a contract, or even the choice of the expression of the rights and obligations of the parties, can bring significant changes in the tax consequences.

Tax advice

A tax adviser must seek to confine the results of his advice to those which are broadly acceptable to SARS; failure to comply may entice the authorities to question a perfectly legal, but aggressively planned, transaction on moral grounds; in this sense, moral grounds may be regarded as an extra limitation on tax planning.

Partnerships

For SA income tax purposes, a partnership is not a separate legal entity distinct from its partners and is treated as fiscally transparent per s 24H. The amount of tax payable on the partnership income is, therefore, determined by the particulars of the partners comprising the partnership. It is therefore possible to vary the accrual of partnership income by varying the partner's profit sharing ratios. Because of this fiscal transparency, the partnership itself is not regarded as a SA resident for DTA purposes. The SA resident partners, in their individual capacity, would be entitled to the benefit of a DTA to the extent that the partnership income is allocated to them.⁹⁴

Foreign trusts

- *Capital distributions by a foreign trust:* Capital distributions from an offshore trust out of past income and capital gains are taxed in the hands of the SA beneficiary. The SA beneficiary has an opportunity to disprove the characterisation of capital distributions as 'income'. In order to do this, the

⁹³ *Vacu-Lug (Pvt) Ltd v COT* [1963 (2) SA 694 (SR), 25 SATC 201]

⁹⁴ Principles established in the report on The Application of the OECD Model Tax Convention to Partnerships, as discussed by Brinker, *et al* on p 377

trustees must keep good records to determine the nature of accruals of an 'income' and 'capital' nature.

- *Income retained by a foreign trust.* Unless the foreign trust distributes income (and capital gains) in real time, they will be taxed in the hands of the trust rather than in the hands of the beneficiaries. The decision to distribute or to retain might be influenced by equivalent taxes payable in the foreign jurisdiction. In SA these rates are higher for trusts as compared to individuals, and therefore, from a tax savings point of view, favours a distribution to a beneficiary.
- *Interest free loans:* Income from an asset sold to a foreign trust in exchange for a loan, is not taxed in the hands of the lender, except to the extent of the interest not charged on the loan at a fair rate and included per s 7 and s 31.
- *Interposing a second foreign trust.* From a tax planning point of view, one possible avenue to overcome the workings of s 25B(2A), is to interpose a second non-resident trust between the original trust and the resident beneficiary. Distributions will then be made from the original foreign trust to the second (interposed) foreign trust to the beneficiary. In this way the distributions to the SA resident beneficiary will then be capital distributions with no direct SA link. As a possible counter SARS could rule this as a 'scheme', in terms of s 103(1), to avoid tax. Therefore, the interposing of the second foreign trust must be supported by valid commercial reasons.

Spitz⁹⁵ warns that recent international judgements, in particular the US and UK, have ruled that for a trust to be 'valid', there must be a genuine transfer of legal ownership of the assets in the trust to the trustee by the settlor. Where the settlor seeks to protect his assets against creditors, spouses or tax authorities, in a discretionary offshore trust, but has used devices, such as letters of wishes or protectors, to keep control of the assets, the Courts are now seeing right through the trust and declaring the assets to be still vested in the hands of the settlor. Papers before the House of Lords indicate that perhaps 90% of all offshore trusts are invalid on the grounds that the settlor is calling the shots. As a result, SA investors are encountering serious difficulties in the use of offshore trusts. In addition, trusts are expensive to manage. As a consequence of these developments, establishing an asset protection trust that minimises these risks and difficulties, while remaining effective, has become more and more difficult and expensive for SA settlors.

5.3 Secondary tax on companies

Where SARS makes a transfer pricing adjustment in terms of s 31, the amount so adjusted will be treated as a deemed dividend. The subsequent application of s 64C(3)(e) means a double penalty. None of the exclusions in s 64C(4) apply and STC must be calculated on this amount.

⁹⁵ Barry Spitz. *Why offshore trusts have lost their appeal*, Personal Finance, IOL, July 26, 2003

5.4 Donations tax

Donations to a trust

Any transfer of an IP asset by a SA resident into a trust is liable to donations tax – irrespective of whether this is local or overseas assets. Care must be taken not to donate an income producing asset to a trust, since the donor will pay donations tax on the donation and will then pay income tax on its entire income from the asset under the s 7 diversion of income rules. Rather sell the asset in return for a loan, because there will be no donations tax to pay and the taxpayer (lender) will pay income tax only on an amount of its annual income equal to the interest not charged on the loan.

Deemed donations

The deemed donation rule in s 58 applies to any donation for whatever reason, where there is a quantified ‘*mismatch*’ between property disposed of and consideration received in return. The applicable test for the levying of donations tax in terms of the section is the determination of the reasonable market value of the property and the reasonable market value of the counter performance.⁹⁶

Donations to a spouse

A donation to or for the benefit of a spouse is not subject to donations tax in terms of s 56(1)(a), because any amount left to a surviving spouse is not subject to estate duty per s 4 (q) of the Estate Duty Act. This is even so if the spouse is a non-SA resident. No income tax advantage can be obtained from donations between spouses in view of s 7(2) which provides that all income of a spouse (the donee spouse) which is received by or accrues to that spouse as a result of a donation, settlement or other disposition by the other spouse (the donor spouse) is deemed to be that of the donor spouse.

Donations between companies within the same group

An exemption applies in terms of s 56(1)(r) to donations between resident companies within the same group. However, donations between a SA resident company and its foreign holding company or CFC are, therefore, fully subjected to donations tax.

5.5 Capital gains tax

Determination of base costs and proceeds

From a CGT perspective, the identification of each IP asset and the attendant determination of base costs and proceeds must be conducted with care. Failure to do so, might face the following consequences: (1) valuations – and valuation date values – that do not distinguish between distinct assets will not hold good; (2) where proceeds are not allocated in keeping with the relative values of the IP assets, the parties will (in particular if they are connected persons) lay themselves open to an adjustment of ‘the terms of trade’ by SARS.

⁹⁶ ITC 1599 [58 SATC 88]

The buyer and the seller: intangibles and capital loss limitations

Losses incurred by the seller on IP assets will not necessarily be available to shelter gains on other assets. The major hazard lies in the area of IP acquired by the seller before valuation date. Paragraph 16 of the Eight Schedule to the IT Act will deny the availability of capital losses on IP acquired prior to valuation date if the taxpayer: (1) acquired the IP from a connected person; or (2) acquired the IP in the course of taking over a business.

Defer the time of disposal: pinpoint the time of receipt or accrual of proceeds

If a taxpayer can delay the time of disposal, the CGT liability may be postponed to a later year. If this is not possible, but he can delay the receipt/accrual of proceeds under par 35 until an ensuing year, the CGT exposure will likewise be deferred until the ensuing year. If there are no proceeds to be recognized in the year of disposal, and the asset has a base cost, what you will have in the current year is not a capital gain, but a capital loss in terms of par 4(a). The capital loss may, in the form of an assessed capital loss, be carried forward to shelter gains in the ensuing year. Par 13 prescribes that if there are no suspensive conditions attached to a disposal, the time of disposal shall be the time of entry into the agreement governing the disposal. If there are suspensive condition(s), the time of disposal shall be the time of fulfillment. An obvious response might be that if the seller wished to postpone the incidence of CGT until the ensuing year, it should import a suspensive condition into the agreement. The obvious response may not only be impracticable (because of the commercial uncertainty created by suspensive conditions), but unnecessary because where payment is to be made to the seller against transfer in the ensuing year, the proceeds will only have to be recognized in the ensuing year. The analysis turns around the *exceptio non adimpleti contractus* – the defense which a buyer has available to it, against the claim for payment by a seller, where the contract calls for payment against or after transfer, and transfer has not yet been affected or tendered against payment. This analysis suggests that there may be no need to attempt to shift the time of disposal into the ensuing year. By delaying the transfer of the assets until the ensuing year, with payment to be made on or after transfer, the taxpayer may be able to ensure that: (1) while there is a disposal in the current year, there are no proceeds; (2) accordingly, the current year disposal triggers a capital loss. In the ensuing year, par 3(b)(1) will operate to treat the entire amount then received/accrued as a capital gain, to be offset against the capital loss carried forward in an amount equivalent to the base cost of the asset.

Earn-outs

An earn-out (a contingent payment to be made on the satisfaction of agreed criteria, i.e. minimum gross turnover level) is often a component of the total purchase price in an IP sale. If the contingency is (as is usually the case) only satisfied in a year following the disposal of assets, the consequences of the receipt or accrual of the 'earn-out amount' are governed by par 3(b)(i) – the entire amount accrued or received will be a capital gain, with no provision for any offset of base costs. When the assets are sold (in the prior year) you do not 'reserve' any part of their base costs for offset against the receipt or accrual of the earn-out amount in a future period. What may be available for offset against the capital gain caught under par 3(b)(i) would be any

assessed capital loss carried forward from the year in which the business assets were disposed off.

Resolutive and suspensive conditions

The distinction between a '*suspensive*' and a '*resolutive*' condition plays a vital role in determining the time of disposal of assets pursuant to a contract. In terms of par 13(1)(a)(i) the treatment of a suspensive condition is clear enough – the time of disposal will incur on satisfaction of the suspensive condition. The treatment of a resolutive condition is less satisfactory – in terms of par 13(1)(a)(ii) the disposal would occur at the outset on entry into the agreement – notwithstanding that the obligation to effect transfer may be extinguished prior to transfer on satisfaction of the resolutive condition. In relation to the time of accrual of proceeds, it is better to couch conditions in a suspensive rather than a resolutive form. A suspensive condition can be utilized to defer an accrual until its fulfilment; a resolutive condition leaves you open to the construction that because you have a '*present right*' to payment you have a '*present accrual*', notwithstanding that the present right might be extinguished before the time of payment.

Effective dates

It is common for contracts to provide that the 'effective date' of the agreement is some day other than the day of entry into the agreement. 'Effective date' clauses are unlikely to be 'effective' in determining the time of disposal of a contract - par 13 look at the time of conclusion of the agreement or the time of fulfillment of suspensive conditions, in determining the time of disposal.

Deferred consideration

Vendors need to be wary of the CGT consequences where ownership of the IP assets is transferred at the outset, with payment or payments to follow in an ensuing financial year(s). The need for caution arises from two considerations: (1) where payments yet to follow in a later year are caught up as 'proceeds' in the year of disposal per par 35(4), the vendor will have an immediate 'unfunded' CGT exposure; (2) the application of par 4(b) in relation to previously accrued (but unpaid) amounts should they prove to be irrecoverable in years following the disposal. The paragraph offer the vendor the illusory consolation of a capital loss which cannot be carried back to reduce the previously derived capital gain. Strategy: if payment must be effected in installments over a year or years following upon handing over of the assets, the only (and not always satisfactory) answer appears to be to delay the passing of ownership (and the time of disposal) by means of a suspensive condition, so that ownership shall pass only on the payment of the last installment. CGT liability kicks in the year the liability is met.

5.6 Value-added tax

The VAT legislation attaches great importance to the place of consumption of goods or services, the concept of supply and the carrying on of an enterprise. In particular, cross-border supplies as it relates to IP, must take cognisance of the rules relating to:

(1) services supplied to a non-resident; (2) services in respect of IP rights in an export country; (3) services physically rendered outside SA; (4) IP used outside SA; (5) branches situated outside SA; (6), foreigners granting the use of IP in SA; and (7) connected party transactions.

5.7 Regional services levy

The decision in the *Tiger Oats*⁹⁷ as regards to the liability for the regional establishment levy (REL) on its dividend income will cause company groups to reconsider their corporate structures. For example, if there is a holding company and, under it, an intermediate holding company, and dividends flow through the latter, there may be a danger that the same dividends will be subject to REL in both companies. Also, in appropriate cases, consideration may be given to having a single holding company, holding only shares in subsidiaries and associates, with group loans and other traditional holding company activities housed in another group company. The case appears to broaden the situations in which a taxpayer may be regarded as carrying on business or trade or conducting an enterprise. In particular, the tax effectiveness of compartmentalisation or segregation of business and non-business assets and operations within the same entity is now more questionable.

5.8 Estate duty

Estate duty is calculated on the value attributed to property (actual or deemed): if a person owns 'growth orientated' assets all growth in the value of the assets held will be reflected in this formula. In order to avoid paying estate duty on the future growth in the value of assets, estate planning is used to 'freeze' the value of 'growth' assets at present values. The following techniques are used: (1) selling or donating assets to a trust, a company, or an intended beneficiary; (2) donating assets to a spouse. The former technique creates a donations tax problem: donations tax is levied at a flat rate of 20% - which is the same rate as estate duty. Section s 4(q) of the ED Act permits a deduction from the gross value of an estate any property which accrues to the surviving spouse of the deceased. Donations made to a spouse are also exempt from donations tax per s 56(1)(a) of the IT Act. The advantage of transferring assets to the surviving spouse lies not in reducing estate duty but deferring it – the estate duty which would be payable when the first spouse dies can be deferred until the death of the second spouse. In disposing of his 'growth' assets, the planner will ensure that, for estate duty purposes, those assets will be reflected in his estate at present values.

5.9 Double tax agreements

Tax treaties lie at the heart of international tax planning. They are of tremendous importance to businesses with an international dimension, because they allow business to transact with a degree of certainty both on the part of the individuals, partnerships and corporate entities and the government of the state in which that business entity operates.

⁹⁷ Werkmans Attorneys. *Tax Werks: News Release*, Vol 13, 11 August 2003

Understanding treaties

It is because of this that treaties often assume huge importance when developing tax strategies. It is, therefore, not only necessary to understand how they operate but also how they are interpreted. Although the Model Convention and its Commentaries are an invaluable starting point, they are only guidelines and the provisions of the individual treaties as they are implemented in local law are the only relevant determining factors.

Treaty shopping and anti-avoidance

The introduction of anti-treaty shopping articles in treaties and the exchange of information between member states are forcing substance into structure where perhaps a decade ago this would not have been an issue. **Saunders**⁹⁸ is of the opinion that much is likely to change in the field of double tax agreements, both in terms of interpretation and anti-avoidance; however, it is the exchange of information which is seen as the key to preventing tax evasion.

Permanent establishment

The concept of 'permanent establishment' is important as the country of source has taxing rights to business profits derived from business activities carried on in that country on a reasonably substantial scale. It is therefore necessary to appreciate what exactly creates the required physical nexus (and a permanent establishment) so as to render the proceeds of transactions in a foreign state subject to tax in that jurisdiction. In this context, the distinction between 'dependent' and 'independent' agents is important. Care must be displayed in using a foreign subsidiary as an '*agent*'. This could be construed as establishing a PE in the foreign jurisdiction for the SA holding company.

5.10 Foreign exchange control

In a real sense, exchange control is not compatible with a modern open economy as it deters investment and encourages the flight of capital. Although SA has seen some relaxation over the last decade, exchange control is here to stay for some time in the foreseeable future. International tax planning, therefore, needs to be done within the exchange control parameters imposed. Although the foreign sale of IP assets is subject to exchange control, the establishment of a foreign CFC, without any transfer of assets ex SA into the company, does not require exchange control permission. It must also be borne in mind that the allowance to establish a foreign subsidiary is only granted to companies, not to individuals (including partnerships) and trusts. Individuals must utilize the foreign investment allowance in this regard.

⁹⁸ Roy Saunders. *Understanding Double Tax Treaties*, International Tax Planning Association Library, <http://www.itpa.org>

5.11 Foreign operating vehicles

By utilising an offshore company, it may be possible for an IP exporter to secure a number of advantages. The tax and other benefits which can be obtained by the use of offshore entities usually depend upon the country of residence of the beneficial owner and its anti-avoidance legislation. In addition, regard must also be taken of the requirements of any other country with which the offshore entity might carry on its business. The use of these foreign operating vehicles will effectively result in the CFC attribution rules being invoked, resulting in the taxation of the entity's 'net income' in the hands of the SA resident shareholders. However, non-tax reasons for the use of foreign operating vehicles might prevail.

Alternative structures or typical uses to which an offshore company might be put: ⁹⁹

International business companies (IBC)

The successful IBC, most commonly found in the British Virgin Islands, has effectively created a new type of company, with minimal administrative and reporting requirements.

Limited liability companies (LLC)

Another useful and practical offshore vehicle is the LLC, which can be used either independently or in conjunction with a trust, which may be either onshore or offshore. The LLC is able to provide what an IP exporter needs in an offshore structure: corporate personality; limited liability; minimal administrative requirements with no directors; a manager with such powers only as the members choose to give him; asset protection; safety in that there are no shares, bearer or otherwise, to be lost or alienated; no loss of control; and minimal disclosure. A LLC comes from the companies acts internationally modelled on English Law, and is being used as the Anglo-Saxon version of the foundation, which is used in Europe.

Investment companies (IC)

Funds accumulated through an IC set up in offshore areas can be invested or deposited throughout the world. While the interest returns will be subject to taxation in the resident jurisdiction, there are a number of offshore areas in which funds may be placed either in tax free bonds or as bank deposits where interest is paid gross. Similarly, in many offshore areas no CGT is applicable. Use of an offshore company incorporated in a suitable country allows the possibility of investing tax efficiently in a high tax country where there is a concessionary tax treaty in respect of investments made by companies incorporated in the offshore country.

Holding companies (HC)

Use may be made of an offshore HC which would fund the operation of subsidiaries in various countries so that the subsidiaries obtain the benefit of tax deductions on interest paid. If the HC is situated in an offshore area where there are no income or corporation taxes and no requirement that dividends must be paid, then the profits

⁹⁹ Summarised from: 'Why Choose an Offshore Company' at www.companylink.co.za

which are accumulated in the tax free climate can be used to fund the requirements of subsidiaries or reinvested as business convenience suggests.

Personal holding company (PHC)

A high net worth individual with assets in a number of countries may wish to hold these through the medium of a PHC so that upon his demise probate would be applied for in the country in which his company was incorporated rather than in each of the countries in which he might hold assets. This saves legal fees and avoids publicity. Again, not everybody wishes to advertise wealth and an individual may wish to hold assets through an offshore entity simply because of the privacy the offshore arrangement gives.

Patent, copyright and royalty companies

An offshore company can purchase or be assigned the right to use a copyright, patent, trademark or know-how by its original holders with a power to sublicense. Upon acquisition of the IP right the offshore company can then enter into agreement with licensees around the world who would be able to exploit the IP right in various countries. It is thought preferable to acquire, for example, a patent at the patent pending stage before it becomes very valuable so that the capital payment for the acquisition of the patent can be set at a lower amount. Often royalties paid out of a high tax area attract withholding tax at source. In many cases an interposing holding company may allow a reduction in the rate of tax withheld at source.

5.12 Investment planning

The maze of international tax laws and treaties is complicated by the economic and political systems of the international marketplace. In addition, foreign investment can be extremely risky if not done properly. Factors adding to the risk of offshore investment: political and economic stability; legal and administration systems; professional, commercial and banking facilities; business climate; accounting laws; procedure, customs and language barriers.

5.13 Exposure to international tax

The tax plan must, as far as possible, explore all alternatives to minimise the taxpayer's international tax liability as a result of the exploitation of the IP asset. The elimination of double taxation must be the ultimate objective, and if it does occur, to ensure that the taxpayer avail himself to possible relief measures.

6. Conclusion

Intellectual property assets play an increasingly important role in the modern economy and this importance is reflected in various domestic and international taxing acts. It is therefore important that a taxpayer has a clear strategy for managing the tax issues and consequences relating to intellectual property assets.

This analysis sought to address the relevant tax consequences, from a SA perspective, a taxpayer will be confronted with in exploiting the asset to his advantage by contracting to a foreign party.

The relevant SA taxing regimes were first considered, namely: income tax, secondary tax on companies, donations tax, capital gains tax, value-added tax, estate duty and regional establishment levies. Each tax discipline was scrutinized with a view of identifying the relevant international aspects of the domestic legislation. The choice of foreign parties to the contract is important, and has been examined in relation to the effect such choice may have on the incidence of tax. The tax status of each possible foreign party were explored, i.e. an unrelated party, a connected party, a permanent establishment, a controlled foreign company (including a tax haven entity or an intermediary holding company), a partnership, a trust and an agent or representative. As exchange control is still very much alive and well in SA, this aspect could also not be ignored with regards to the *'internationalization'* of IP. Lastly, the importance of tax treaties were also considered, as domestic taxing provisions may also be significantly restricted by a tax treaty concluded between the treaty partners.

This report does not claim to be an exhaustive summary on the subject, because the issues involved are too vast and too complex and must be considered on a case-by-case basis. It merely attempts to provide a good understanding of the many issues regarding the exportation of IP rights.

As highlighted, the taxpayer faces a myriad of tax issues. Some of the aspects are extremely complicated, for example, the transfer pricing provisions, the CFC attribution rules, the diversion of income rules, foreign currency rules, capital gains tax, etc. Planning is even made more complex by the fact that such provisions must be interpreted in the light of any tax treaty that may exist between SA and the country in question. The particular articles of each individual treaty must always be examined to ascertain whether it contains its own anti-avoidance provisions, for example, to prevent 'treaty shopping' by restricting the benefits afforded by the treaty to bona-fide residents of the treaty countries. In addition, the current SA foreign exchange control limitation 'barriers' must always be considered in the expansion of IP rights internationally.

From the perspective of the South African IP exporter, an understanding is required of how the SA tax systems will interact with that of a foreign country, either when cross-border exploitation occurs or when there is a flow of funds between the two countries. The cross-border exploitation of IP could take place without any form of presence in the foreign jurisdiction (especially with this day and age of the Internet and e-commerce), for example, the sale of IP, the franchising of a concept, the licensing of IP, etc Alternatively, the exploitation of IP may require some form of foreign presence,

for example, a branch, subsidiary, trust, agent or partnership. This more active form of investment usually also necessitates the cross-border transfer of individuals who will work and earn remuneration outside SA, their usual country of residence, with potential tax consequences, as well as planning opportunities, in both SA and the 'host' country. Therefore, the interaction of the SA tax regime with that of a foreign country requires a thorough understanding by the taxpayer or his advisor of the SA provisions for taxing foreign income.

But, there are both sides to a coin. In order to identify the appropriate IP exploitation structure for investment into a foreign country, the taxpayer or his advisor cannot be expected to have a perfect knowledge of the tax system of the foreign jurisdiction in question, but he needs to be in a position to raise the questions which will enable him to identify the foreign tax issues which may impact on the cross-border transaction in question. Once the optimum structure for IP exploitation has been identified from a foreign perspective, this needs to be coordinated with the most appropriate structure from the SA perspective for outward investment.

Finally, international tax planning, similar to tax planning in the domestic context, presents opportunities for legitimate tax avoidance for the taxpayer. However, there has recently been an increase in the anti-avoidance legislation enacted by countries to deal with certain form of tax avoidance, which is also manifested in tax treaties. As highlighted, South Africa's general anti-avoidance provisions, supported by the concepts of '*substance over form*' and '*sham*' transactions, could allow SARS to reclassify a transaction so as to deny the intended tax benefits.

In conclusion, it can be said that the tax structures impacting on IP offers a minefield of opportunities and vulnerabilities. The opportunities are there for the taking. It is definitely not the case of finding a gaping loophole in tax legislation (including treaties) and exploiting it vigorously to save enormous amounts of tax. Unfortunately, in the words of Dale ¹⁰⁰: '*...a loophole in tax which is too readily and obviously usable becomes not a loophole but a noose. It will be closed and the taxpayer will be unable to extricate himself.*'

The road to success in the exportation of IP, from a tax perspective is, therefore, built on the bricks of clear objectives, correct planning, ethical business practices, expert advice and cognizance of all relevant international aspects of domestic tax practice and legislation.

¹⁰⁰ Dale, H. *Tax Havens*, 1979, De Rebus, South Africa

“THE TAXATION OF COLLECTIVE INVESTMENT”

A RESEARCH REPORT

BY

JOHANNES NICOLAAS VERMEULEN

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1. Introduction

Over the last decade or so, collective investment schemes have become increasingly popular investment vehicles for South African investors, whether it is individuals or institutions.

Since 1998, total South African collective investment assets trebled. To illustrate, at end March 2005 total assets topped the R319 billion mark, of which 77% can be attributed to individual investors and 23% to institutional investors (i.e. pension funds, provident funds, retirement funds, companies and group money, endowment policies and structured funds). A total of 551 funds were registered with the Financial Services Board. These funds administer a total of 2,317,719 accounts. In addition, foreign funds registered for business in South Africa totalled 322 with assets of R53 billion.¹

Due to the low costs, transparency and high governance standards, these collective investment vehicles are becoming the first choice for investors. Two additional factors embrace this choice, i.e.:

- Firstly, collective investment schemes are a simple means of access to a wide range of investments running across equity options, fixed property, participation bonds and foreign funds;
- Secondly, by their very nature collective investment schemes offer less risk as they invest in a spread of underlying investments in a chosen portfolio. This means that investors benefit from a diversified portfolio.

The basic premise of collective investment schemes makes sense for all kinds of investors – collectively putting their money together to buy a spread of underlying investments not only increases their collective buying and bargaining power, but also allows a large reduction in risk. This is manifested through accessing the expert skills of a professional asset manager who hopefully is going to be better at selecting individual stocks than the average investor. It allows for sufficient capital to buy a range of investments. It has been suggested that collective investment schemes should be the backbone of any South African investment portfolio.²

The new Collective Investment Schemes Control Act became effective on 3 March 2003, replacing the Unit Trusts Control Act and the Participation Bonds Act and provides for a greater variety of investment schemes. Currently, most investment vehicles are confined to the trust model, but the Act now allows the creation of an open-ended investment company, which is a brand new concept in South Africa but not unfamiliar in European countries.

From a taxation point of view, these new developments have implications for both the investment vehicles and investors (residents and non-residents). The investment or participatory interest of an investor in a CIS may take the form of a unit in a trust or a share in an open-ended investment company.

¹ Association of Collective Investments (ACI). *R11 billion flows into unit trusts as investors remain bullish.* News release, 14 April 2005

² Association of Collective Investments. *A record breaking year for the unit trust industry.* News release, 5 January 2005

After having acquired a participatory interest in a CIS, an investor may realise it by disposing of it to a third party, or having it repurchased or cancelled (*'repo'*) by the trust or open-ended investment company, as the case may be. The investor may receive distributions of income or capital accruals on its units (in the case of a CIS constituted a trust) or dividends (in the case of a CIS constituted as an open-ended investment company). Alternatively, these accruals may be retained by the CIS.

Furthermore, investors are able to invest *directly* (via the use of Reserve Bank approved direct currency transfers) and *indirectly* (via foreign funds registered in South Africa) in a multitude of foreign investment vehicles. These vehicles are open-ended or closed-ended mutual funds structured as investment companies, trusts, partnerships, or other transparent entities (most of which would fall outside the South African *'controlled foreign company'* provisions). In some cases 'income' is paid either by way of dividends or other forms of distribution such as the redemption of preference shares (via share capital or share premium) or the repurchase of such shares. In some cases income is *'rolled-up'*, while in other cases income is *'wrapped'* in an investment product which yields a capital return. All these products have tax consequences for the South African investor, which will be further complicated where, for example, the investment has been routed via an offshore trust.

2. Research Question

This research report explores the following key question:

“What are the tax implications of collective investment, from the perspective of:

- i. Collective investment vehicles registered under the Collective Investment Schemes Control Act –***
 - in securities;***
 - in property;***
 - in participation bonds;***
 - in declared funds;***
 - in foreign funds;***
- ii. Resident and non-resident investors through local collective investment vehicles;***
- iii. Resident investors through foreign collective investment vehicles?”***

The tax implications of collective investment encompass a number of tax regimes, *inter alia*:

- Income tax (“IT”)*** – with reference to the Income Tax Act, No 58 of 1962 (“the IT Act”), relevant case law as decided in the Courts, Practice Notes and Interpretation Notes as prepared by the SA Revenue Service;
- Capital Gains Tax (“CGT”)*** – with reference to the Eight Schedule to the IT Act;
- Retirement Funds Tax (“RFT”)*** – with reference to the Tax on Retirement Funds Act No. 38 of 1996 (the ‘RFT Act’).

In exploring the research question, each of the tax regimes will be analyzed in order to identify the aspects of the SA tax legislation impacting on collective investment as envisaged in the Collective Investment Schemes Control Act, No 45 of 2002 (the “CIS Act”). The relevant tax law authority will be discussed, where after it will be evaluated in the context of tax planning before coming to a conclusion.

The objective of this paper is, therefore, to identify and analyse the various tax issues for both collective investment vehicles and investors that should be considered to facilitate planning for possible tax consequences in order to obtain optimum tax results.

3. Key Concepts and Definitions

The following abbreviations, definitions and key concepts are relevant with reference to the research question:

3.1 Abbreviations

- 'CIS' – collective investment scheme
- 'CISS' – collective investment scheme in securities
- 'CISP' – collective investment scheme in property
- 'CISPB' – collective investment scheme in participation bonds
- 'DCIS' – collective investment scheme so declared
- 'FCIS' – foreign collective investment scheme
- 'FPC' – a fixed property company
- 'OEIC' – open-ended investment company
- 'PH' – a participating holder (unit-holder)
- 'SA' – South Africa or South African
- 'SARS' – South African Revenue Service, headed by the Commissioner

3.2 Definitions

A *'collective investment scheme'* is defined in s 1 of the CIS Act as:

a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which –

- (a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of a scheme through shares, units or any other form of participatory interest; and
- (b) the investors share the risk and benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed,

A number of other important definitions are also contained in section 1 of the same Act, amongst others:

- *'Administration'* means any function performed in connection with a CIS, including (1) the management and control of a CIS; (2) the receipt, payment or investment of money or other assets, including income accruals, in respect of a CIS; (3) the sale, repurchase, issue or cancellation of a participatory interest in a CIS and the giving of advice or disclosure of information on any of those matters to investors or potential investors; and (4) the buying and selling of assets or handing over thereof to a trustee or custodian for safe custody;
- *'Assets'* is defined as the investments comprising or constituting a portfolio of a CIS and includes income accruals, derived from the investments in the portfolio, held or that are due to the investors in that portfolio;
- *'Deed'* is the document of incorporation whereby a CIS is established and in terms of which it is administered;

- *'Income accruals'* means any dividends or interest or any other income received by the trustee, custodian or manager on behalf of investors in a portfolio;
- *'Investor'* is the holder of a participatory interest in a portfolio;
- *'Open-ended investment company'* ('OEIC') is a company with an authorized share capital, which is structured in such a manner that it provides for the issuing of different classes of shares to investors, each class of share representing a separate portfolio with a distinct investment policy;
- *'Participatory interest'* is an interest, undivided share or share whether called a participatory interest, unit or by any other name, and whether the value of such interest, unit, undivided share or share remains constant or varies from time to time, which may be acquired by an investor in a portfolio;
- *'Portfolio'* is a group of assets, including cash, in which members of the public are invited or permitted by a manager to acquire (pursuant to a CIS) a participatory interest or a participatory interest of a specific class that, as a result of its specific characteristics, differs from any other class of participatory interest;
- *'Manager'* is a person who is authorized in terms of the Act to administer a CIS;
- *'Trustee'* is the custodian of the assets in the portfolio.

3.3 Open-ended versus closed-ended schemes

This paper is specifically meant to apply to *open-ended* CISs that are marketed to the general public. In general, investors may buy and sell units in an *open-ended* CIS within the bounds of the constitution or deed of the CIS, at the net asset value (NAV), which is the market value of all assets in the CIS net of expenses divided by the number of units in the CIS. By way of contrast, in *closed-ended* funds, which are traded on exchanges, the operator has no responsibility to redeem the positions.

3.4 Types of collective investment schemes

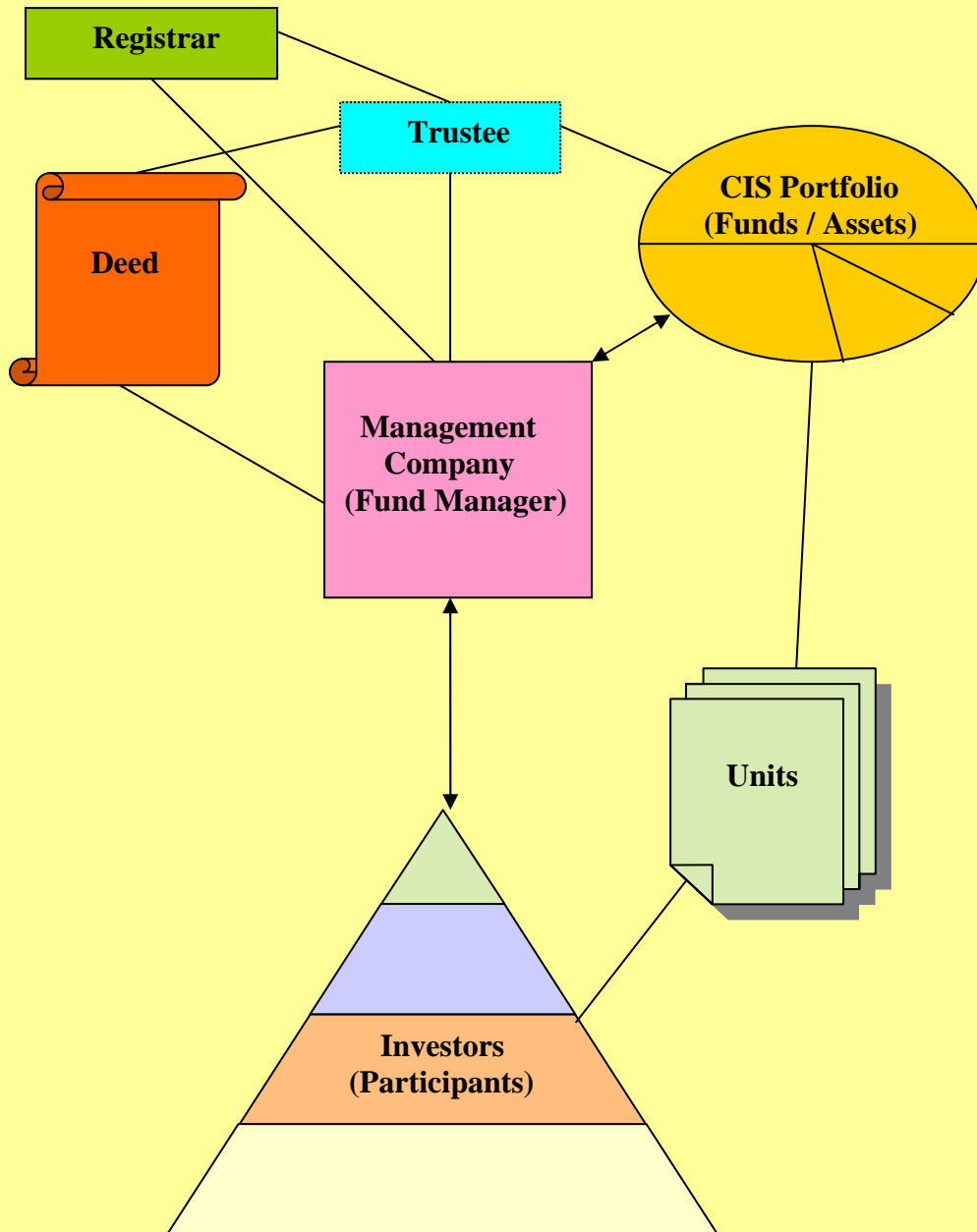
The CIS Act provides for the SA registration of five types of collective investment schemes, that is:

- in securities ('CISS')
- in property ('CISP')
- in participation bonds ('CISPB')
- so declared ('DCIS')
- a foreign scheme ('FCIS')

3.5 Structure of collective investment

The structure of collective investment schemes and inter-party relationships are schematically depicted in the diagram on the next page.

THE STRUCTURE OF COLLECTIVE INVESTMENT SCHEMES



4. The Law

4.1 Statutory tax provisions

4.1.1 Income tax

The IT Act follows an intricate web of provisions relating to collective investment schemes. Some of the provisions are cast in extremely difficult language and at times provide for confusing reading, i.e. cross-referencing between the provisions making use of a process of deduction or elimination. This all makes the interpretation of the law as it relates to CIS's a complex task. The focus of the IT Act is on a CISS, FCIS and CISP. A CISPB and DCIS are not mentioned at all. What follows is a synopsis of the relevant provisions contained in the IT Act.

Overview of tax regime

SA residents are taxed on a residence or worldwide basis, regardless from what source or territory the taxable income originates. Non-residents are only taxed on income derived from a SA source.

The liability to pay tax falls onto natural and artificial '*persons*', e.g. individuals, companies, close corporations and any other legal entity which has taxable income, either because they are legal '*persons*' or are defined as such for tax purposes.

The starting point in the calculation of income tax is '*gross income*'. From this is deducted any amounts exempt from income tax, giving '*income*'. From the latter is deducted all the amounts allowed, i.e. deductions, allowances and set-offs, giving '*taxable income*'.³ Normal tax is derived by applying the tax rate applicable to the person in question. From this is deducted any '*rebates*'⁴ to arrive at the amount of '*tax payable*'.

The SA tax regime pillars on the concepts of '*gross income*' and '*residence*' by configuring:

- Whether amounts derived are of a '*capital*' or '*revenue*' nature?
- Whether the '*persons*' who derived these amounts are '*resident*' or not?
- Once this is established, a decision can be made whether the amounts will be included in '*gross income*' or not.

³ The terms '*gross income*', '*income*', '*taxable income*' and '*resident*' and '*person*' are defined in section 1 of the IT Act

⁴ Per sections 6 and 6quat

Residence of a CIS – s 1 def. ‘resident’

The tax status of a CIS will depend largely upon the place where it is resident and the place where it conducts its activities (i.e. the making of investment decisions). With reference to the definition of ‘resident’ in s 1 of the IT Act, a CIS will be a resident if it is established or formed in SA, no matter where it is effectively managed. But it will be a resident if it is not incorporated, established or formed in SA, but is effectively managed here. It is therefore crucial to establish where CIS was incorporated, established or formed and, if it was formed abroad, whether it is effectively managed here. If the CIS is a non-resident it will be liable for tax only on income derived from a source within or deemed to be within SA. On the other hand, if it is a foreign CIS, in the sense that it is established or formed outside SA but effectively managed in SA, it is therefore a resident as defined, it will be liable to SA income tax on its worldwide taxable income.

A CISS and FCIS afforded company status – s 1 def. ‘company’ par (e)

A CISS and FCIS are afforded the status of ‘company’ for income tax purposes. This stems from par (e) of the definition of ‘company’ in s 1 which specifically includes a CISS and any FCIS. This is even so, regardless of its juridical form, i.e. trust or OEIC.

Participating holder of a CISS and FCIS deemed a shareholder – s 1 def. ‘shareholder’

Paragraph (b) of the definition of ‘shareholder’ deems the registered holder of any participatory interest in a CISS and FCIS portfolio as a shareholder.

Distributions by a CISS and FCIS treated as a dividend – s 1 def. ‘dividend’

As both a CISS and a FCIS is classified as a ‘company’ for income tax purposes, it follows that distributions via these vehicles is treated as a ‘dividend’. This is mandated in the definition of ‘dividend’ in s1, which regards PHs as ‘shareholders’ in relation to such CISS and FCIS.

Form of CIS: tax status

The definition of a ‘collective investment scheme’ in s 1 of the CIS Act provides that a scheme can be constituted in whatever form, i.e. either a ‘trust’ or an ‘open-ended investment company’. The OEIC is a new form of investment vehicle introduced by the CIS Act and is not specifically mentioned in the IT Act. An OEIC is structured and incorporated in terms of the Companies Act and is, therefore, a ‘company’ as envisaged s 1 of the IT Act and taxed as such.

Where the CIS is constituted as a trust, the tax status for the various CIS categories is tabled as follows:

CISS	CISP	CISPB	DCIS	FCIS
Taxed as a ‘company’ [def. ‘company’ par (e)(i)]	Taxed as trust [s 25B]	Taxed as trust [s 25B]	Taxed as trust [s 25B]	Taxed as a ‘company’ [def. ‘company’ par (e)(ii)]

Form of CIS: distributions

Distributions made by an OEIC to its shareholders are a 'dividend' as defined in s 1 of the IT Act. Where the CIS is constituted as a trust, the distributions made to participating holders by the various CIS categories are treated for tax purposes as follows:

CISS	CISP	CISPB	DCIS	FCIS
Treated as a 'dividend' [def. 'dividend']	Distribution by trust [s 25B - conduit principle]	Distribution by trust [s 25B - conduit principle]	Distribution by trust [s 25B - conduit principle]	Treated as a 'dividend' [def. 'dividend']

Repurchase or cancellation of shares by a company – s 1 def. 'dividend' par (c)

Paragraph (c) of the definition of 'dividend' in s 1 determines that where a company repurchases its shares at a value greater than its issue (nominal) value, the difference will be deemed to be a dividend. Accordingly, depending on the residence status of the OEIC this difference is either treated as a 'local' or a 'foreign' dividend.

Gross income: general definition – s 1 def. 'gross income'

This is the starting point for the determination of taxability in SA. Gross income is defined in s 1 to mean:

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

Accordingly, residents are taxed on a worldwide basis and non-residents on a source basis.

The principle was confirmed in *People's Stores*⁵ that 'accrued' means 'has become entitled to'. In *Ochberg*⁶ it was stated that an accrual must be 'unconditional' – there is no accrual unless the taxpayer's right to the amount is unconditional; if there is a condition imposed, there can be no accrual until such event has taken place.

Capital or revenue?

This is an all important question. All receipts or accruals must be categorized as being either of an income or of a capital nature – there is no 'half-way house'.⁷ Where there is a transfer of ownership of participation rights (units) in a CIS, difficulties could arise - what is a receipt of a capital nature in the hands of one taxpayer may be of an income nature in the hands of another.

⁵ CIR v People's Stores (Walvis Bay) (Pty) Ltd [1990(2) SA 353 (A), 52 SATC 9]

⁶ Ochberg v CIR [1933 CPD 256, 6 SATC 1]

⁷ Pyott Ltd v CIR [1945 AD 128, 13 SATC 121]

There is no definition in the IT Act of ‘*receipts and accruals of a capital nature*’. Over the years a number of ‘tests or norms’ have been formulated by the Courts for distinguishing between capital and revenue: the consistently applied test is the enquiry whether a taxpayer was engaged in a ‘*scheme of profit making*’.⁸ It was remarked in **Trust Bank**.⁹

‘The question whether the profits realised on the sale of shares constituted a revenue or capital accrual depended ... upon whether the purchase, holding and sale of shares were steps in a scheme of profit-making, i.e. to make a profit by the resale of the shares at an enhanced price; or whether the sale constituted the realisation of a capital asset acquired and held for purposes other than such profit-making scheme.’

Silke¹⁰ states that the most important ‘test’ employed by the Courts in deciding whether the proceeds arising upon the disposal of an asset are in the nature of income or capital is the test of ‘*intention*’: with what intention did the taxpayer acquire and hold the asset? The intention of a taxpayer is a very important factor in determining the taxability or not of a transaction; the intention of a taxpayer can throw some light on whether he has embarked on a scheme of profit-making or not.¹¹ Therefore, the key question to be answered in the decision whether amounts derived by a person constitutes gross income: *was the participation rights (units) in the CIS sold in a scheme of profit-making?* If the answer is yes then it is taxable proceeds; if the answer is *no*, then the proceeds are not taxable - capital nature.

Gross income: dividend inclusion – s 1 def. ‘gross income’ par (k)

The definition of ‘*gross income*’ in s1 includes by way of par (k) *any* amount received or accrued by way of a dividend. Accordingly, the definition includes both local and foreign dividends.

The *proviso* to par (k) states that where a foreign dividend is declared by a foreign company and is received by or accrues to a CISS, and that foreign dividend is fully or partially distributed by that CISS by way of a dividend to any PH in that CISS, then that foreign dividend is treated, to the extent that it is declared to a PH, to have been declared by that foreign company directly to the PH and to be a foreign dividend so derived by the PH. This is effectively a *conduit* foreign dividend.

Foreign dividend

This means any dividend derived by any person from a foreign company as defined in s 9D. All distributions ex a FCIS are therefore treated as a ‘*foreign dividend*’.

Rebate for foreign taxes paid – s 6quat

Section 6quat provides a unilateral tax relief whereby foreign taxes paid or proved to be payable by ‘*residents*’ are allowed as a rebate (credit) against their SA tax liability. The ability to claim a rebate is limited to residents and the ability to claim a rebate only

⁸ Overseas Trust Corporation Ltd v CIR [1926 AD 444, 2 SATC 71]

⁹ SIR v Trust Bank of Africa Limited [1975 (3) SA 652 (A), 37 SATC 87]

¹⁰ De Koker A, *Silk on South African Income Tax*, Memorial Edition, Butterworths, Durban, par 3.2

¹¹ Elandsheuwel Farming (Edms) Bpk v SBI [1978 (1) SA 101 (1), 39 SATC 163]

applies to income derived from a source outside SA and not deemed to be derived from a source within SA. It is therefore important to note that the section operates on the basis that a resident only qualifies for a rebate to the extent that SA tax is payable on the income in question. If, for example, withholding tax was paid on a foreign dividend, which in turn is exempt from tax in SA, no credit will be granted.

Income invested, accumulated or capitalised – s 7(1)

A taxpayer is liable for tax on: (1) income that has been invested, accumulated or capitalized by him; (2) income that is due and payable to him, even though the income has not actually been paid over to him; and (3) income that has been credited in an account or reinvested or accumulated or capitalized or otherwise dealt with in his name or on his behalf.

Unremittable foreign income – s 9A

Section 9A provides for a so-called blocked funds deferral of tax in instances where funds may not be remitted to the SA resident due to *'currency or other restrictions or limitations imposed in terms of the laws of the country where the amount arose.'* The section applies in instances where a taxpayer derived: (1) direct amounts that is required to be included in his gross income or taxable income; or (2) indirect amounts to be included in income via a CFC attribution per s 9D. If these circumstances are established, there is no inclusion in income during the tax year in which it accrues – the relevant amount will only be included in gross income or taxable income during the tax year in which it may be remitted ex the foreign jurisdiction (i.e. when the cash flows).

Attribution of indirect foreign income of residents – s 9D

Section 9D provides that SA residents holding *'participation rights'* in a *'controlled foreign company'* (CFC), must include a proportional ownership percentage of the *'net income'* earned by the CFC in their income. A CFC is a foreign company in which one or more SA residents directly or indirectly, together with their connected persons, hold more than 50% of the total participation rights in a foreign company. The attribution rules do not apply when a resident, together with his connected persons, hold at the end of the last day of the CFC's foreign tax year less than 10% of its participation rights. Residents holding between 10% and 25% of a CFC's participation rights, may elect in any particular foreign tax year that a foreign company be treated as a CFC, in which case a proportional amount will then be attributed to the SA resident. By exercising this election, residents will be entitled to the s 6*quat* rebate, but no excess foreign tax credits may be carried forward to the next year of assessment.

Attributed foreign CFC net income is, therefore, taxed in the hands of the SA resident when it accrues, irrespective of when it is repatriated. The jurisdiction in which the foreign entity is resident will in all probability also tax the income, resulting in effective double taxation. This problem is solved by providing a foreign tax credit as envisaged in s 6*quat*. When the income is eventually distributed in the form of dividends, it will be exempt from tax per s 10(1)(k)(ii).

Interest derived by a non-resident is exempt – s 10(1)(h)

Section 10(1)(h) provides that interest derived by a non-resident is exempt from tax. No exemption is granted in the following instances:

- *Physical presence:* in the case of a natural person who was physically present in SA for a period exceeding 183 days in aggregate during the tax year in which he derived the interest; or
- *Permanent establishment:* in the case of natural and any other person who carried on a business in SA via a permanent establishment.

For purposes of this section, a dividend distributed by a CISS out of its *'income'*, which is exempt from tax in the hands of the CISS per s 10(1)(iA), is treated as interest.

Basic interest and dividend exemption – s10(1)(i)(xv)

Section 10(1)(xv) provides that natural persons qualify for an exemption on the first R15,000 of dividends and interest, not otherwise exempt, derived by a taxpayer in any tax year. For persons 65 years and over the exemption is R22,000. Where a taxpayer derived any taxable foreign dividends and interest, the first R2,000 of this exemption is first applied to: (1) foreign dividends; and (2) any excess up to R2,000 in respect of foreign interest.

The following non-exempt or *'taxable dividends'* specifically qualifies for this basic exemption:

- *Dividends distributed by a CISP from amounts derived from a FPC* [s 10(1)(k)(i)(aa)];
- *Dividends distributed by a CISS out of its income* [s 10(1)(k)(i)(bb)(A)];
- *Dividends distributed by a CISS from amounts derived from a FPC* [s 10(1)(k)(i)(bb)(B)].

Exemption of income distributed by a CISS – s 10(1)(iA)

Section 10(1)(iA) exempt from tax so much of the *'income'* derived by a CISS that has been distributed, or will be distributed, by way of a dividend or a portion of a dividend, to entitled PHs. *'Income'* is not defined for purposes of the section, but it comprises amounts such as interest on investments, dividends from a fixed property company, taxable foreign dividends, and CFC attributed net income in terms of s 9D. Local dividends qualifying for exemption under s 10(1)(k)(i), i.e. *'exempt dividends'*, is not income for purposes of s 10(1)(iA).

The PHs, on the other hand, derive a dividend which is *'taxable dividend'* in accordance with s 10(1)(k)(i)(bb)(B), s 10(1)(k)(i)(bb)(c) and the *proviso* to par (k) of the definition of *'gross income'* in s 1.

Exemption of local dividends – s 10(1)(k)(i)

Local dividends derived by a taxpayer are included in 'gross income' by way of par (k) of the latter definition. But, s 10(1)(k)(i) is designed to exempt, subject to certain exclusions (below), all local dividends derived by a taxpayer from tax. This will also be the case where a CISS and a FCIS distribute dividends out of dividends derived from their shares in local companies included in their respective portfolios. Therefore, local dividends *per se* on-distributed as a 'dividend' to PHs remain an 'exempt dividend'. However, excluded from this exemption are the following local dividends, or portions of dividend, which is specifically taxable, i.e. representing a 'taxable dividend':

- *Dividends distributed by a CISP from amounts derived from a FPC:* a dividend distributed by a CISP out of dividends derived from a FPC whose shares are included in the CISP portfolio [s 10(1)(k)(i)(aa)].

The effect of this exclusion is that a distribution consisting of revenue profits arising from an underlying FPC is taxable in full in the hands of its PHs, in the same way as if the distribution was derived directly from the underlying FPC. Instead it comes to them via a conduit represented by the CISP. The FPC itself qualifies for a deduction of this dividend in terms of s 11(s). It must be noted that this rule does not apply to persons who is neither a resident nor carry on business in SA. Dividends received from this source by persons qualifying as such a non-resident, will be exempt and therefore tax free. The rule also does not apply in respect of dividends distributed by the underlying FPC out of profits of a capital nature, which will be a dividend exempt from income tax, but it could be liable to capital gains tax.

- *Dividends distributed by a CISS out of its income:* a dividend distributed by a CISS out of income derived by it, which is exempt from tax in the hands of the CISS under s 10(1)(iA) [s 10(1)(k)(i)(bb)(A)].

Being distributed out of income (gross income less exempt income) this represents a taxable dividend by a CISS for its PHs. Therefore, to the extent that a distribution consists, for example, a taxable foreign dividend, interest income or any other taxable income derived by the CISS, it will be wholly taxable in the hands of its PHs, in the same way as if they had derived the foreign dividend, interest income or other income directly. Instead it comes to them via a conduit represented by the CISS.

- *Dividends distributed by a CISS from amounts derived from a FPC:* a dividend distributed by a CISS out of dividends derived from a FPC whose shares are included in the CISS portfolio [s 10(1)(k)(i)(bb)(B)].

This will also be the case where a PH in a CISS derives revenue profits from a FPC derived by the CISS as a result of its interest in a CISP. In this way, via the two conduits represented by the CISS and CISP, the PH derives a taxable dividend consisting of interest income and rental profits. Dividends distributed by a CISS out of capital profits derived by it from a FPC remain exempt from income tax, but could be liable to capital gains tax. The dividend distributed by the FPC is allowed as a deduction per s 11(s) in the hands of the FPC.

- *Dividends on share buy-back*: any dividend derived by a taxpayer as part of consideration paid or payable on the disposal of shares, which were held as trading stock by the taxpayer, on the buy-back of shares by a company.¹²

Certain foreign dividends received is exempt – s 10(1)(k)(ii)

Foreign dividend accruals are included in ‘*gross income*’ by way of par (k) of the latter definition. However, s 10(1)(k)(ii) exempt foreign dividends to the extent : (1) that the profits to which foreign dividend relate to, has been or will subject to SA tax; (2) it relates to dividends declared by a dual listed company; (3) it relates to dividends comprising CFC attributed amounts; (4) it relates to a 25% plus shareholding.

Generally, therefore, the effect is that SA residents have to account for tax on foreign dividends to the extent that the shareholding constitutes a so-called ‘*portfolio*’ holding (less than 10%), but excludes substantial ‘*direct*’ holdings (10% or more).

A distribution by a CISS out of a ‘*taxable foreign dividends*’ derived by it will be taxable in the hands of its PHs – see the *proviso* to par (k) of the definition of ‘*gross income*’ relating to *conduit* foreign dividends. It must be noted that this only applies to residents; if the PH is non-resident the foreign dividend portion will not be subject to tax in SA. Similarly, a distribution of ‘*exempt foreign dividends*’ would remain exempt in the hands of its PHs.

Deduction for dividends distributed by a CISP – s 11(s)

For purposes of determining the taxable income of a FPC, the company is in terms of s 11(s) allowed to deduct the dividends distributed by it to a CISP, as a result of its shares included in the CISP portfolio. The deduction is not available when a distribution is made by the FPC out of profits of a capital nature. The wording of the section envisages distributions to ‘*any collective investment scheme in property*’. It is interpreted that the word *any* incorporates both a CISP *and* a CISS by inference to the wording of s 10(1)(k)(i)(bb)(B).

Deductions in respect of foreign dividends – s 11C

Section 11C provides for the deduction of interest expenditure incurred in the production of foreign dividends. The deduction is limited foreign dividends taxable in SA and any excess must be carried forward to the next tax year.

On election by the taxpayer, a deduction is also allowed for foreign withholding taxes paid or proved to be paid on the foreign dividend from the foreign company. It is submitted that if the taxpayer does not opt for this election, he can always fall back on the provisions of s 6*quat* claiming a rebate on taxes.

¹² In terms of section 85 of the Companies Act, 1973 (Act No. 61 of 1973)

Units held as trading stock – s 22

Participating rights (units) could be held by an investor as *'trading stock'* on hand available for resale. In such instances s 22 deals with the relevant income tax aspects. *'Trading stock'* is defined in s 1 to include: *'...anything purchased ...or acquired by the taxpayer for purposes of... sale or exchange ... the proceeds from the disposal of which form or will form part of his gross income...'* Expenditure incurred for the purchase of trading stock is expenditure incurred in the production of income and is deductible in full in terms of s 11(a) – even if some trading stock remains unsold at the end of the year of assessment. The value of trading stock in the beginning and end of the year must be taken into account at its *'cost price'* in determining taxable income – the value of closing stock is taxable, while the value of opening stock is deductible.

Taxation of income derived by a trust – s 25B

Section 25B deals with the taxation of income derived by a trust and is summarized as follows: (1) *'vesting'* income is treated as being derived by the beneficiary, not the trust; (2) *'non-vesting'* income is treated as being derived by the trust, not the beneficiary; (3) the exercise of their discretionary powers by the trustees in favor of a beneficiary is equivalent to vesting of the income in that beneficiary; (4) deductions and allowances follow the income stream to which they relate; and (5) trust losses are *'ring-fenced'* and retained in the trust and, therefore, cannot be set-off against any other income derived by the beneficiaries.

Currency conversion rules – s 25D

The general conversion rule is contained in s 25D. The conversion process is twofold:

- *Firstly*, a determination of the foreign currency amounts derived (receipts/accruals) or incurred (expenditure) by a person;
- *Secondly*, the amounts so determined, in any foreign currency, are then converted at the average exchange rate for the SA tax year.

The term *'average exchange'* rate is defined in s 1, and the taxpayer has a choice between using the *'actual average rate'* or the *'weighted average rate'*.

Exemption from secondary tax on companies – s 64B(5)(j) & 64B(5)(j)

Dividends distributed by a CISS are exempt from the STC per s 64B(5)(j). This applies regardless of whether the CISS is constituted as an OEIC or a trust (deemed to be a *'company'* for income tax purposes). In the determination of dividends which accrued to a company in a dividend cycle, s 64B(3A)(b) excludes the local *'taxable dividend'* envisaged in s10(1)(k)(i)(bb), i.e. dividends distributed by a CISS out of its income and dividends distributed by a CISS from amounts derived from a FPC. Accordingly, the dividend accruals in a cycle will only take account of local *'exempt dividends'* but not the local *'taxable dividends'* received ex CISS.

Section 64B(5)(j) also exempts the dividend a FPC distributes out of its *'revenue profits'* in terms of s 11(s). Accordingly, dividends distributed out of *'capital profits'* is not exempt from STC.

An FCIS is not liable for STC as it is not a resident company.

4.1.2 Capital gains tax

Overview of tax regime

SA residents are subject to CGT on all asset disposals on a worldwide basis, i.e. capital gains and losses will be taken into account from whatever source. Non-residents are only liable for CGT to the extent that it relates to the disposal of: (1) immovable property or rights therein situated in SA; and (2) any asset attributable to a permanent establishment of the non-resident in SA.

CGT forms part of the income tax system. Although the definition of *'gross income'* per s 1 of the IT Act excludes receipts and accruals of a capital nature, CGT as calculated per the Eight Schedule is specifically included in *'taxable income'* as envisaged per s 26A.

A CGT event is triggered by the *'disposal'* or deemed disposal of an *'asset'* – unless such a disposal occurs, no gain or loss arises. A *'capital gain'* arises when the *'proceeds'* upon the disposal of an asset exceed the *'base cost'* of that asset. A *'capital loss'* occurs when an asset is disposed of and the base cost of that asset exceeds the proceeds on disposal. CGT applies to all assets of a person disposed of on or after 1 October 2001 (*'valuation date'*), whether or not the asset was acquired by the person before, on or after that date. However, only the gain accruing from 1 October 2001 will be subject to tax.

For natural persons 25% of the *'net capital gain'*, after deducting the annual exclusion described below, is included when calculating the tax payable. For any other person, the inclusion rate is 50%. Natural persons are entitled to an annual exclusion, which is the amount of an individual's net capital gain or loss that is disregarded for CGT purposes. The annual exclusion is R10 000 but is increased to R50 000 where an individual dies during a year of assessment.

It is therefore important for the taxpayer to identify and recognise his exposure in this area by exploring the mechanics of the CGT regime via the notions of *'asset'*, *'disposal'*, *'base cost'* and *'proceeds'*.

Disregarding of capital gain or loss by a CISS – par 61 of Eight Schedule

A CISS vehicle is not subject to CGT on the disposal of shares in its investment portfolio. Par 61 of the Eight Schedule provides that a CISS must disregard any capital gain or loss in this regard. When a portfolio manager restructures a unit trust portfolio, that is, sells an underlying share or bond in adherence to its mandate, CGT will not be incurred. Certain other investment products, in comparison, will not be as tax effective.

It should be stressed, however, that this exclusion extends only to the CISS vehicle, the PHs in a CISS will be subject to CGT on the disposal of their individual interests. Unit trust investors will only bear a CGT cost once – when they sell their units.

The par 61 exemption is only afforded to a CISS. The exclusion of a FCIS does not mean that the exemption afforded under par 61 will not be extended to a local CISS which invests in foreign equities, provided that the investment decisions are made by the SA registered manager. It is where investment decisions are made which will determine where an arrangement or scheme is 'carried on'. This approach draws on the principles of establishing the 'place of effective management' – it is situated where the day-to-day decisions are made.¹³

Capital gains or losses in respect of interests in a CISP – par 67A of Eight Schedule

Par 67A provides that a PH in a CISP must determine a capital gain or loss in respect of a participatory interest only upon disposal of that interest. Par 67A further provides that:

- On disposal of the interest, the capital gain is to be determined by reference to the base cost of that interest, and the proceeds on disposal.
- The proceeds on disposal are to include distributions prior to disposal, whether in cash or otherwise, which were not included in the gross income of the PH of the interest. In the case of *in specie* distributions, the amount to be included in proceeds will be the market value of the asset when distributed.
- The market value of an asset distributed to the PH of an interest (prior to a disposal of the interest) determines the base cost of the asset to the PH.

Par 67A is silent regarding the incidence of CGT at the level of the CISP. Silence is not always ominous. A CISP will invariably be set up as a 'vesting trust', with the holder having fixed (or 'vested') interests in the trust property. On this basis, the trust/CISP will not itself be exposed to CGT. Par 11(2)(e) provides that there is no disposal of an asset by a trustee in respect of the distribution of an asset of the trust to a beneficiary to the extent that the beneficiary has a vested interest in that asset. The CGT exposures are, therefore, confined to the beneficiaries/holders, where they are deferred until interests

Disposal events by an investor – par 11 of Eight Schedule

Par 11 provides for the following possible disposal 'events' for a PH giving rise to a CGT liability:

- Sale of units;
- Switches out of a fund;
- Repurchase or cancellation ('repo') of units by the trust or OEIC;
- Transfer of units, where beneficial ownership of the units change (e.g. donation to a trust);
- The death, sequestration or emigration of a unit holder;
- The divorce of a unit holder married in community of property.

¹³ SARS' Interpretation Note (6 of 2002)

However, no CGT event is triggered where a unit holder transfers units from a personal account with a management company to a bulk account of a Linked Investment Service Provider (LISP) or vice versa, or where a unit holder donates units to a spouse (see below).

The issue of a participatory interest by a CIS – par 11(2)(c) of Eight Schedule

Par 11(2)(c) determines that there is no disposal of an asset by a portfolio of a CIS in respect of the issue of a participatory interest in that portfolio, or the granting of an option to acquire such participatory interest.

Base cost for pre-valuation date investments – par 25 of Eight Schedule

The base cost of pre-valuation investments consists of two elements: (1) the valuation date value of an asset, plus (2) specified allowable expenditure (*'par 20 expenditure'*) incurred on or after the valuation date. Depending on circumstances, the valuation date value of an asset may be determined by reference to: (1) its market value on valuation date; (2) an amount equal to 20% of its disposal proceeds; or (3) its time-based apportionment cost. To prevent possible manipulation of base cost, specific rules apply to its determination in certain circumstances.

The market value on valuation date – par 29 of Eight Schedule

Par 29 establishes the market value on *'valuation date'*, constituting a right of a PH in a:

- CISS and CISP: the price published by the Commissioner in the Gazette, which is the average of the price at which a unit could be sold to the management company of the scheme for the last five trading days before valuation date; or
- FCIS: the last price published before valuation date at which a unit could be sold to the management company of the scheme or where there is no management company, the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market.

Base cost for post-valuation date investments – par 20 of Eight Schedule

The base cost of a post-valuation date asset is represented by the *'par 20 expenditure'*. This is represented by the actual cost that a PH pays for the units, including any initial charges.

Base cost of identical assets – par 32 of Eight Schedule

Special rules exist to determine the base cost of assets that are so-called *'identical assets'*. These rules are set out in par 32. Identical assets are defined as a group of similar assets which (a) if any one of them were disposed of, would realise the same amount regardless of which of them was so disposed of; and (b) are not able to be

individually distinguished apart from identifying numbers which they may bear. Generally speaking, the base cost of identical assets must be determined by using either the *'specific identification method'* or the *'first-in-first-out method'*. However, the use of the *'weighted average method'* is also permitted, but only in respect of listed financial instruments (e.g. shares), unit trusts, investor coins (e.g. Kruger Rand) and interest-bearing instruments (e.g. Government bonds).

In practice, each time an investor buys units the management company will recalculate the weighted average base cost by multiplying the existing number of units by the existing base cost of the units. The total cost, calculated at the buy price, of the new units bought is added to obtain a new monetary value. This is then divided by the sum of existing units and new units to arrive at the new weighted average base cost of all units in the account.

Preference for a base cost establishment method

A PH is entitled to use any of the methods provided for in the Eighth Schedule when computing gains or losses and reporting these to SARS. Section 30 of the Schedule provides for the time-apportionment method and section 32 deals with the base cost of identical assets and provides for using any one of the specific identification, first-in/first-out or weighted average methods. A unit holder wishing to use any method other than the weighted average must ensure that all records are available to be furnished with the annual income tax return.

Proceeds

Proceeds derived on disposal of an asset are determined per par 35 in accordance with normal income tax principles, and consists of all amounts which the taxpayer has become entitled to.

Transfer of assets between spouses – par 67(1) of Eight Schedule

No capital gain or loss arises when any disposal of an asset is made by one spouse to another per par 67(1). The spouse receiving the asset takes over all aspects of the history of the asset from the donor spouse, the dates of acquisition and improvement, the expenditure incurred and the usage. This is effectively a *'roll-over'* provision. The practical effect is that where a unit holder donates units to a spouse, no CGT event is triggered. The original base cost has to be transferred to the new account. To facilitate this, management companies will issue valuation certificates to enable the base cost to be carried forward.

Where the asset is disposed to a spouse who is not a resident, this is treated as a CGT event in a similar vein as assets bequeathed to a non-resident surviving spouse [par 40(1) read with par 67(3)]. An exception is an asset that remains in the CGT net for non-residents, e.g. local immovable property [par 67(3) and 2(1)(b)].

Disposal of assets in a foreign currency – par 43 of Eight Schedule

Paragraph 43 contains the different permutations for determining the capital gain or loss where foreign currency is involved. Par 43(4) states that where a person disposes a *'foreign equity instrument'* during a tax year, which was acquired and disposed of in a foreign currency, the foreign currency amounts, for purposes of determining the capital gain or loss on disposal of the assets, must be translated as follows:

- *Proceeds*: translate into SA Rand at average exchange rate for year of assessment; and
- *Expenditure*: translate expenditure into SA Rand at average exchange rate for year of assessment during which expenditure was incurred.

4.1.3 Retirement Funds Tax

Overview of tax regime

The RFT Act provides for the taxation of interest, net rental income and foreign dividends (but *not* local dividends) derived by a *'retirement fund'* (that is, pension, provident and retirement annuity funds) as well as the *'untaxed policyholder fund'* (UPF) of an insurer (that is, business carried on by the insurer with pension funds, provident funds, retirement annuity funds, benefit funds, institutions exempt from tax per s 10 of the IT Act and annuity contracts of which annuities are being paid). The receipts and accruals of these funds are exempt from *income tax* via ss 10(1)(d) and 29A(4)(a) of the IT Act. RFT was instituted on the principle that a retirement fund and a UPF's income should be taxed as it arises rather than when paid out. The rate of tax is currently pinned at 18% on a six monthly self-assessment basis.

Interdependency of the RFT Act and the IT Act – s 1 'definitions'

Section 1 of the RFT Act states, as a preamble to the *'definitions'*, that for the purposes of the RFT Act, any word or expression to which a meaning has been assigned in the IT Act, bears the meaning so assigned, unless the context within which such word or expression is used indicates otherwise.

Interest – s 1 def. 'interest'

'Interest' as defined in the RFT Act refers to the ordinary, common law, non-defined meaning of interest including, amongst others, any amount contemplated in the definition of *'interest'* in section 24J(1) of the IT Act.

Rental income – s1 def ‘rental income’

‘Rental income’ is defined in the RFT Act as including, amongst others, any *dividend* (other than those distributed out of profits of a capital nature) distributed by a *fixed property company* as defined in section 1 of the Unit Trusts Control Act.¹⁴ The term fixed property company was replaced with ‘*property shares*’ when the Collective Investment Schemes Control Act, 2002 replaced the Unit Trusts Control Act.

Foreign dividend – s 3

The term ‘foreign dividend’ is not defined under the definition section, but is described in the formula for the determination of income of a fund in s 3 of the RFT Act (under the symbol ‘D’) as any foreign dividend derived by a fund during a tax period which is not exempt from tax in terms of s 10(1)(k)(ii) of the IT Act.

4.2 Common law principles

Legal status of a trust

Collective investment schemes are a *genus* of trust, so the ‘normal’ trust principles apply to amounts distributed to unit holders in the scheme, irrespective of the type of securities held by the CIS portfolio. In a legal context, trusts do not have separate juristic personality. Any amounts which accrue to a trust, accrue to the trustees in their capacity as trustees for the benefit of those named in the trust deed as beneficiaries. In the context of a CIS the beneficiaries have a ‘*vested*’ right as opposed to a ‘*contingent*’ right.

Tax status of CIS’s

Despite being defined as a ‘*company*’ in the IT Act, a CISS and a FCIS is in fact in the nature of a trust.¹⁵ It follows that, were it not for their being defined as dividends, its distributions would have retained their character in the hands of PHs. As a resident, it would derive, for example, taxable foreign dividends, taxable interest and exempt local dividends. But for tax purposes, its distributions would retain their artificial legal character as ‘*dividends*’.

The other CISs, e.g. CISP, CISPb and DCIS, are not defined as a company, but are treated as a trust for income tax purposes thereby falling within the ambit of s 25B. The tax status of CISs are not specifically mentioned in the RFT Act, except that income derived from a CISP is treated as ‘rental income’.

¹⁴ Unit Trusts Control Act (Act No. 54 of 1981), now replaced by the Collective Investment Schemes Control Act, No 45 of 2002

¹⁵ Divaris, C and Stein, ML. *South African Income Tax Guide 2003/2004*. LexisNexis, Durban, 2004

The conduit principle

The '*conduit principle*' is critical to an understanding of the tax status of a trust. The conduit principle holds that income flows through a trust to the beneficiaries who have a right to it. In the ***Armstrong*** case ¹⁶ it was held that income retains its identity (e.g. local dividends, foreign dividends, interest, rentals, etc) in the hands of the beneficiaries who are liable to tax on it. It follows that any exemption applicable to the income will be available to the beneficiary to whom it accrues. For example, if exempt local dividends derived by a trust accrue to a beneficiary, they will remain exempt from tax in his hands. The conduit principle applies to current income of a trust distributed or otherwise accruing to a beneficiary. But, in ***Rosen's*** ¹⁷ case the view was expressed that trust income loses its identity if it is retained by and taxed in the trust in the year in which it arises and is then distributed only in a later year. In that year it will be regarded as a distribution of '*capital*' to the beneficiary and therefore not taxed in his hands.

¹⁶ *Armstrong v CIR* [1938 AD 343, 10 SATC 1]

¹⁷ *SIR v Rosen* [1971 (1) SA 173 (A), 32 SATC 249]

5. CIS in Securities

5.1 Investment focus

A CISS¹⁸ is a scheme where the investment portfolio consists of specified equity securities or a class of specified equity securities. It can also consist of participatory interests in another CISS, foreign equity and non-equity securities approved by the Registrar.

Of all the CISs on offer, this is by far the most popular vehicle from an investor point of view. CISSs are suitable for a wide range of risk profiles and can be combined in different ways to suit differing investment needs. Equity based CISSs offer capital growth, asset allocation unit trusts offer a mixture of growth and income, and fixed interest unit trusts offer income. Investors also have the option of rotating the sectors of their investments or opting for general equity or index funds.

Income streams in a CISS are represented by interest; local dividends; foreign dividend; fixed property company dividends via a CISP or on grounds of a direct investment in a FPC; distributions ex another CISS; CFC attributed net income; and capital gains on realisation of investments. Deductions from a portfolio are restricted¹⁹ and includes: charges payable on the buying or selling of assets for the portfolio (e.g. brokerage, marketable securities tax, value added tax or stamp duties); auditor's fees, bank charges, trustee/custodian fees and other levies or taxes; share creation fees payable to the registrar of companies; the agreed service fees of the manager; and stock exchange listing fees. The resulting net amount is available for distribution/dividend to unit holders in accordance with the deed.

5.2 Tax implications

The various income tax, CGT and STC implications of a CISS from the perspective of the investment vehicle, resident investors and non-resident investors are tabulated below:

CISS: VEHICLE

Income Tax		
#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none">A CISS is resident if it is incorporated, established or formed in SA, no matter where it is effectively managed [s 1 – def. 'residence'].

¹⁸ See Part IV (sections 39 to 46) of the Collective Investment Schemes Control Act, No 45 of 2002

¹⁹ Refer to section 93 of the Collective Investment Schemes Control Act, No 45 of 2002

2	Tax status	<ul style="list-style-type: none"> • If constituted as a 'trust' (trust/CISS), it is treated as a 'company' and taxed as a company [s 1 – def. 'company' par (e)(i)]; • If constituted as an 'OEIC' (OEIC/CISS), it is a company <i>per se</i> and taxed as a company [s 1 – def. 'company' par (a)].
3	Tax rate	<ul style="list-style-type: none"> • Company tax rate of 29% with effect from 1 April 2005
4	Distributions	<ul style="list-style-type: none"> • If a 'trust', the distribution to PHs is treated as a 'dividend' [s 1 – def. 'dividend']; • If an 'OEIC', the distribution to PHs is a dividend [s 1 – def. 'dividend'].
5	'Income' accruals in a CISS	<ul style="list-style-type: none"> • 'Income' accruals in a CISS include: interest; foreign taxable dividend; FPC revenue-dividend via a CISP or on grounds of a direct investment in a FPC; 'taxable dividend' on its participatory interest in another CISS; and CFC attributed net income; • To the extent that these amounts are subsequently distributed to PHs, it is exempt from tax [s 10(1)(iA)]; • A distribution by the CISS out of 'income' results in a local 'taxable dividend' in the hands of its PHs; • The tax treatment of the individual items is expanded below.
6	'Exempt' accruals in a CISS	<ul style="list-style-type: none"> • 'Exempt' accruals in a CISS include: local dividends; foreign exempt dividends; capital gains on realisation of investments; 'exempt dividends' on its participatory interest in another CISS; and FPC capital-dividends via a CISP or on grounds of a direct investment in a FPC; • A distribution by the CISS out of exempt accruals results in a local 'exempt dividend' in the hands of its PHs; • The tax treatment of the individual items is expanded below.
7	Interest derived	<ul style="list-style-type: none"> • Interest accruals is taxable [s 1 – def. 'gross income']; • If distributed to PHs, it is exempt from tax [s 10(1)(iA)].
8	Foreign dividends derived	<ul style="list-style-type: none"> • Foreign dividend accruals is included in gross income [s 1 – def. 'gross income' par (k)]; • Certain foreign dividends accruals qualify for an exemption (foreign exempt dividend) [s 10(1)(k)(ii)]; • If foreign taxable dividend accruals are distributed to PHs, it is exempt from tax [s 10(1)(iA)].
9	FPC dividends derived	<ul style="list-style-type: none"> • FPC revenue-dividend accruals via a CISP or on grounds of a direct investment in a FPC are a taxable [s 10(1)(k)(i)(aa) & s 10(1)(k)(i)(bb)(B)]; • FPC capital-dividend accruals via a CISP or on grounds of a direct investment in a FPC are exempt [s 10(1)(k)(i)].
10	Dividends ex another CISS	<ul style="list-style-type: none"> • Dividends ex another CISS is included in gross income [s 1 – def. 'gross income' par (k)]; • If 'taxable dividends' accruals are distributed to PHs, it is exempt from tax [s 10(1)(iA)]; • If 'exempt dividends' accruals are distributed to PHs, it is exempt from tax [s 10(1)(k)(i)].
11	CFC net income attributed	<ul style="list-style-type: none"> • CFC net income attributed is taxable [s 9D]; • If these amounts are distributed to PHs, it is exempt from tax [s 10(1)(iA)].
12	Dividends ex another CISS	<ul style="list-style-type: none"> • Dividend accruals ex a CISS is included in gross income [s 1 – def. 'gross income' par (k)]; • However, local dividends derived are exempt from tax [s 10(1)(k)(i)].

13	Local dividends derived	<ul style="list-style-type: none"> Local dividend accruals is included in gross income [s 1 – def. ‘gross income’ par (k)]; However, local dividends derived are exempt from tax [s 10(1)(k)(i)].
14	Foreign taxes paid	<ul style="list-style-type: none"> A rebate is permitted in respect of taxes paid on foreign sourced income, included in taxable income [s 6<i>quat</i>].
15	Blocked funds	<ul style="list-style-type: none"> Taxation of foreign income is deferred in cases where the remittance of foreign funds is restricted [s 9A].
16	Deduction for foreign dividends	<ul style="list-style-type: none"> A deduction is allowed for interest incurred in the production of foreign dividends [s 11C].
17	Foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [s 25D].

Secondary Tax on Companies

18	Dividends distributed by a CISS	<ul style="list-style-type: none"> Distributions by a CISS, whether constituted as a trust or an OEIC, is not subject to STC [s 64B(5)(j)].
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Capital Gains Tax

19	Issue of units	<ul style="list-style-type: none"> There is no disposal of an asset in respect of the issue of a participation interest in a portfolio [par 11(2)(c) of Eight Schedule].
20	Disregarding of capital gains/losses	<ul style="list-style-type: none"> Capital gains and losses originating from investment activities are disregarded and it is not attributable to PHs [par 61 of Eight Schedule].

CISS: RESIDENT INVESTORS

Income Tax

#	<u>Issues</u>	<u>Tax Implications</u>
1	Tax basis	<ul style="list-style-type: none"> SA residents are taxed on a worldwide basis, regardless from what source the taxable income originates [s 1 – def. ‘gross income’].
2	Repurchase or cancellation of units	<ul style="list-style-type: none"> The gain/(loss) made by a PH on the repurchase or cancellation of units (repo) by a CISS constituted as a trust is either on ‘income’ account if the units were held as trading stock or on ‘capital’ account if it were not so held [s 1 – def. ‘gross income’]; Where a PH realises its share investment in an OEIC by way of repo, and the repo payment exceeds the amount of the share capital and share premium of the OEIC appropriated for the repo, the excess will be a dividend for tax [s 1 – def. ‘dividend’ par (c)]; However, the dividend so derived is exempt [s 10(1)(k)(i)].
3	‘Taxable dividend’ ex CISS	<ul style="list-style-type: none"> ‘Taxable dividends’ derived ex CISS is included in gross income [s 1 – def. ‘gross income’ par (k)]; A ‘taxable dividend’ is not exempt from tax in the hands of PHs [s 10(1)(k)(i)(bb)(A)] and [s 10(1)(k)(i)(bb)(B)].
4	‘Exempt dividend’ ex CISS	<ul style="list-style-type: none"> ‘Exempt dividends’ derived ex CISS is included in gross income [s 1 – def. ‘gross income’ par (k)];

		<ul style="list-style-type: none"> • However, these amounts will remain exempt from tax [s 10(1)(k)(i)].
5	Basic exemption	<ul style="list-style-type: none"> • Natural persons qualify for the basic R15,000/R22,000 interest and dividend exemption where the first R2,000 is applied to foreign interest and dividends [s 10(1)(i)(xv)].
6	Foreign taxes paid	<ul style="list-style-type: none"> • A rebate is permitted in respect of taxes paid on foreign sourced income, included in taxable income [s 6<i>quat</i>].
7	Blocked funds	<ul style="list-style-type: none"> • Taxation of foreign income is deferred in cases where the remittance of foreign funds is restricted [s 9A].
8	Deduction for foreign dividends	<ul style="list-style-type: none"> • A deduction is allowed for interest incurred in the production of foreign dividends [s 11C].
9	Trading stock	<ul style="list-style-type: none"> • Where participating rights (units) are held as trading stock available for resale, the proceeds on disposal will form part of gross income [s 1 – def. '<i>gross income</i>']; • Expenditure incurred for the purchase of trading stock is deductible in full [s 11(a)]; • The value of trading stock in the beginning and end of year must be taken into account at its cost price in determining taxable income [s 22].
10	Foreign currency	<ul style="list-style-type: none"> • Where relevant, apply foreign currency conversion rules [s 25D].
Secondary Tax on Companies		
11	Dividends ex CISS	<ul style="list-style-type: none"> • Where the PH is a SA resident company, the determination of incoming dividend accruals in a dividend cycle for STC purposes must exclude '<i>taxable dividends</i>' derived [s 64B(3A)(b)]; • Accordingly, a CISS '<i>exempt dividend</i>' is included in the STC credit.
Capital Gains Tax		
12	Tax basis	<ul style="list-style-type: none"> • SA residents are subject to CGT on all asset disposals on a worldwide basis, regardless from what source the capital gains and losses originate [par 2 of Eight Schedule].
13	Disposal events	<ul style="list-style-type: none"> • Disposal events giving rise to a CGT liability include: sale of units; switches out of fund; repurchase or cancellation of units; transfers where beneficial ownership change; death; sequestration; emigration; and divorce (if married in community of property) [par 11(1) of Eight Schedule].
14	Post-valuation date investments	<ul style="list-style-type: none"> • The base cost of post-valuation date investments is represented by the 'par 20 expenditure' [par 20 of Eight Schedule].
15	Pre-valuation date investments	<ul style="list-style-type: none"> • Base cost equals valuation date value plus specified expenditure incurred after valuation date [par 25 of Eight Schedule].
16	Market value	<ul style="list-style-type: none"> • The market value of a unit on valuation date is a published price [par 29 of Eight Schedule].
17	Identical assets	<ul style="list-style-type: none"> • The use of the 'weighted average method' is permitted to determine the base cost of units [par 32 of Eight Schedule].
18	Proceeds	<ul style="list-style-type: none"> • Consists of all amounts to which the PH has become entitled to [par 35 of Eight Schedule].

19	Disposals in foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [par 43 of Eight Schedule].
20	Transfer of units between spouses	<ul style="list-style-type: none"> Capital gains and losses are disregarded in the case of transfers between spouses – this is a roll-over provision [par 67(1) of Eight Schedule].

CISS: NON-RESIDENT INVESTORS

Income Tax

#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none"> Non-residents are taxed on a source basis, i.e. income originating from a source or deemed SA source [s 1 – def. ‘gross income’].
2	‘Repo’ of units	<ul style="list-style-type: none"> Same as residents – see above.
3	‘Taxable dividend’ ex CISS	<ul style="list-style-type: none"> Same as residents, but excluding: <ul style="list-style-type: none"> A foreign taxable dividend ex CISS is not subject to tax in SA for a non-resident as the amounts are deemed to be derived directly from the foreign company [s 1 – proviso to def. ‘gross income’ par (k)]; Interest ex CISS is not subject to tax in SA for a non-resident as the amounts are exempt [s 10(1)(h)]; CFC attributed net income ex CISS is not subject to tax in SA as the amounts are derived from a foreign source and the PH is a non-resident [conduit principle].
4	‘Exempt dividend’ ex CISS	<ul style="list-style-type: none"> Same as residents – see above.
5	Basic exemption	<ul style="list-style-type: none"> Non-resident natural persons qualify for the basic R15,000/R22,000 exemption for SA sourced interest and dividends [s 10(1)(i)(xv)].
6	Trading stock	<ul style="list-style-type: none"> Same as residents – see above.
7	Foreign currency	<ul style="list-style-type: none"> Not applicable to non-residents.

Secondary Tax on Companies

8	Dividends ex CISS	<ul style="list-style-type: none"> Not applicable to non-resident companies.
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Capital Gains Tax

9	Tax basis	<ul style="list-style-type: none"> Non-residents are only liable for CGT if the participating interest forms part of the assets of a permanent establishment (PE) that the non-resident has in SA [par 2 of Eight Schedule]; If this is the case, the same rules applicable to residents apply – see above.
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6. CIS in Property

6.1 Investment focus

A CISP²⁰ is a scheme where the investment portfolio consists of property shares, immovable property, participatory interests in another CISP, related foreign investments and other investments approved by the Registrar.

'Property shares' means shares in and of a *'fixed property company'* (FPC), which could be structured as a holding company which has no subsidiaries other than FPCs which are wholly owned subsidiaries. A FPC is a company whose shares are property shares, and: (1) all of its issued shares are included in a CISP portfolio; (2) its principal business consists of the acquisition and holding of urban or other approved immovable property, or any undivided share or interest therein or leasehold in respect thereof. An FPC is either a company incorporated and registered under the Companies Act or it can be a foreign company registered as an external company under the Companies Act.

Income derived in a CISP is represented by rental, interest, FPC dividends; foreign taxable dividends; attributable CFC net profits; and income accruals on its participatory interests in another CISP. Permissible expenses are regulated – see items listed under CISS. The resulting net amount is available for distribution/dividend to unit holders in accordance with the deed.

Investors in a CISP get a share of the portfolio's rental income in the short term, while the value of the units themselves increase in the longer term, mainly because of the rising value of the properties in the portfolio. While equity provides for capital growth and cash reduces risk, property offers investors the best of both worlds. It's a secure, stable investment with a predictable future income stream, as well as the prospects of capital growth. The easiest, quickest, and safest way of investing in property is through CISPs, which are considered to have one of the lowest risk profiles of property investment vehicles.

6.2 Tax implications

The various income tax, CGT and STC implications of a CISP from the perspective of the investment vehicle, resident investors and non-resident investors are tabulated below:

²⁰ See Part V (sections 47 to 51) of the Collective Investment Schemes Control Act, No 45 of 2002

CISP: VEHICLE

Income Tax

#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none"> Resident if incorporated, established or formed in SA, no matter where effectively managed [s 1 – def. ‘residence’].
2	Tax status	<ul style="list-style-type: none"> If constituted as a ‘trust’ (trust/CISP) it will be taxed as a trust [s 25B]; If constituted as an ‘OEIC’ (OEIC/CISP) it is a company <i>per se</i> and taxed as a company [s 1 – def. ‘company’ par (a)].
3	Tax rate	<ul style="list-style-type: none"> Trusts are taxed at a 40% rate; companies are taxed at a 29% rate with effect from 1 April 2005.
4	Distributions	<ul style="list-style-type: none"> Trust/CISP: the CISP act as a conduit and ‘income’ accruals may be distributed tax-free to its PHs [<i>conduit principle</i>]. OEIC/CISP: the distribution is a dividend [s 1 – def. ‘dividend’].
5	‘Income’ accruals in a CISP	<ul style="list-style-type: none"> ‘Income’ accruals in a CISP are represented by: rental; interest; FPC revenue-dividend; foreign taxable dividends; attributable CFC net profits; and income accruals on its participatory interests in another CISP.
6	‘Capital’ accruals in a CISP	<ul style="list-style-type: none"> ‘Capital’ accruals in a CISP include: gains on disposal of investments and FPC capital-dividends derived.
7	Interest derived	<ul style="list-style-type: none"> Interest accruals is taxable [s 1 – def. ‘gross income’]; Trust/CISP: when it distributes the interest to its PHs, the interest is not be subject to tax in the CISP [<i>conduit principle</i>]; OEIC/CISP: interest is taxed and the after tax portion of the interest will be distributed to its PHs by way of a dividend.
8	Rental derived	<ul style="list-style-type: none"> Rental accruals is taxable [s 1 – def. ‘gross income’]; Trust/OEIC: where it distributes the rentals to its PHs, the rentals will not be subject to tax in the CISP [<i>conduit principle</i>]; OEIC/CISP: the rentals are taxed and the after tax portion of the rentals will be distributed to its PHs by way of a dividend.
9	Dividends ex FPC from ‘revenue profits’	<ul style="list-style-type: none"> A FPC (whose shares are held by either or both a CISS or CISP) will derive ‘revenue profits’ in the form of rental and interest which is taxable in the hands of the FPC [s 1 – def. ‘gross income’]; However, the FPC gets a deduction to the extent that it distributes this ‘revenue profits’ in the form of a ‘FPC revenue-dividend’ to a CISS or CISP [s 11(s)]; The ‘FPC revenue-dividend’ is not exempt from tax in CISP, being of an income nature [s 1 – def. ‘gross income’]; Trust/CISP: where it distributes the ‘FPC revenue-dividend’ to its PHs, the amount so distributed is not be subject to tax in the CISP [<i>conduit principle</i>]; OEIC/CISP: the ‘FPC revenue-dividend’ is included in gross income and taxed as such. The after tax portion of the ‘FPC revenue-dividend’ will be distributed to its PHs by way of a dividend.
10	Dividends ex FPC from ‘capital profits’	<ul style="list-style-type: none"> ‘Capital profits’ derived by a FPC are not subject to income tax [s 1 – def. ‘gross income’]; No deduction is available for the FPC when it distributes this ‘capital profits’ in the form of a ‘FPC capital-dividend’ to a CISP [s 11(s)]; The ‘FPC capital-dividend’ derived is exempt from tax in the hands of a CISP, whether it is constituted as a trust or as an OEIC.

11	Foreign dividends derived	<ul style="list-style-type: none"> Foreign dividend accruals is included in gross income [s 1 – def. ‘gross income’ par (k)]; Certain foreign dividends accruals qualify for an exemption (foreign exempt dividend) [s 10(1)(k)(ii)]; Trust/CISP: when it distributes the foreign taxable dividend to its PHs, the amount so distributed is be subject to tax in the CISP [<i>conduit principle</i>]; OEIC/CISP: the foreign taxable dividend is taxed and the after tax portion is distributed to its PHs by way of a dividend.
12	CFC net income attributed	<ul style="list-style-type: none"> CFC net income attributed is taxable [s 9D]; Trust/OEIC: when it distributes the attributed CFC net income to its PHs, the amount so distributed is not subject to tax in the CISP[<i>conduit principle</i>]; OEIC: the attributed CFC net income is taxed and the after tax portion of the attributed CFC net income will be distributed to PHs by way of a dividend.
13	Distributions ex another CISP	<ul style="list-style-type: none"> The taxability of distributions derived by a CISP ex another CISP is dependent on how the declaring CISP and the receiving CISP is constituted; Where the declaring’ CISP is a trust and it makes a distribution out of its ‘income’ accruals and ‘capital’ accruals to a ‘receiving’ CISP constituted as a: <ul style="list-style-type: none"> - Trust/CISP: the amount derived out of ‘income’ is taxed to the extent that it is not distributed to its PHs [<i>conduit principle</i>]. The amount derived out of ‘capital’ is exempt from tax. - OEIC/CISP: the amount derived out of ‘income’ is taxed and the after tax portion is distributed to PHs by way of a dividend declared by the OEIC. The amount derived out of ‘capital’ is exempt from tax. Where the ‘declaring’ CISP is an OEIC and it makes a dividend distribution to a ‘receiving’ CISP, whether constituted as a trust or an OEIC, the dividend derived is included in gross income, but it is exempt from tax [s 1 – def. ‘gross income’ par (k) & s 10(1)(k)(i)]. The dividend distribution out of after tax profits does not distinguish between ‘income’ and ‘capital’.
14	Foreign taxes paid	<ul style="list-style-type: none"> A rebate is permitted in respect of taxes paid on foreign sourced income, included in taxable income [s 6<i>quat</i>].
15	Blocked funds	<ul style="list-style-type: none"> Taxation of foreign income is deferred in cases where the remittance of foreign funds is restricted [s 9A].
16	Deduction for foreign dividends	<ul style="list-style-type: none"> A deduction is allowed for interest incurred in the production of foreign dividends [s 11C].
17	Foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [s 25D].
Secondary Tax on Companies		
18	Dividends by FPC	<ul style="list-style-type: none"> Dividends distributed by a FPC out of ‘revenue profits’ are not subject to STC [s 64B(5)(b)]. Accordingly, any dividends distributed by a FPC out of ‘capital profits’ are subject to STC.
19	Dividends by an OEIC/CISP	<ul style="list-style-type: none"> The dividend declaration by an OEIC/CISP to its PHs is subject to STC. The OEIC/CISP will have a STC credit for the incoming FPC dividends (revenue and capital) and dividends derived from it participating interest in another OEIC/CISP.
20	Distributions by a trust/CISP	<ul style="list-style-type: none"> As a trust/CISP is not regarded a company, its distributions are not dividends, hence no STC liability.

Capital Gains Tax

21	FPC	<ul style="list-style-type: none"> The capital gains/losses of a FPC are subject to normal CGT rules.
22	OEIC/CISP	<ul style="list-style-type: none"> The capital gains/losses of an OEIC/CISP are subject to normal CGT rules; The issue and subsequent repo of participatory interests is not regarded a disposal for CGT purposes [par 11(2)(b) of Eight Schedule].
23	Trust/CISP	<ul style="list-style-type: none"> A trust/CISP is set up as a 'vesting trust', with the PHs having fixed (or 'vested') interests in the trust property. On this basis, the trust/CISP will not itself be exposed to CGT [par 11(2)(e) of Eight Schedule]; The issue and subsequent repo of participatory interests is not regarded a disposal for CGT purposes [par 11(2)(c) of Eight Schedule].

CISP: RESIDENT INVESTORS

Income Tax

#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none"> SA residents are taxed on a worldwide basis, regardless from what source the taxable income originates [s 1 – def. 'gross income'].
2	Repurchase or cancellation of units	<ul style="list-style-type: none"> The gain/(loss) made by a PH on the repurchase or cancellation of units (repo) by a trust/CISP is either on 'income' account if the units were held as trading stock or on 'capital' account if it were not so held [s 1 – def. 'gross income']; Where a PH realises its share investment in an OEIC/CISP by way of repo, and the repo payment exceeds the amount of the share capital and share premium of the OEIC/CISP appropriated for the repo, the excess will be a dividend for tax [s 1 – def. 'dividend' par (c)]; However, the dividend so derived is exempt [s 10(1)(k)(i)].
3	'Income' accruals ex trust/CISP	<ul style="list-style-type: none"> 'Income' accruals ex a trust/CISP are derived via a conduit, represented by the trust/CISP, and is taxable in the hands of PHs [conduit principle; s 1 – def. 'gross income']; A 'FPC revenue-dividend' distributed by a CISP is specifically not exempt from tax [s 10(1)(k)(i)].
4	'Capital' accruals ex trust/CISP	<ul style="list-style-type: none"> 'Capital' accruals ex a trust/CISP are derived via a conduit, represented by the trust/CISP, and are tax free in the hands of PHs [conduit principle; s 1 – def. 'gross income'].
5	Dividends ex OEIC/CISP	<ul style="list-style-type: none"> Dividend accruals ex OEIC/CISP is included in gross income [s 1 – def. 'gross income' par (k)]; However, these amounts are exempt from tax [s 10(1)(k)(i)].
6	Basic exemption	<ul style="list-style-type: none"> Natural persons qualify for the basic R15,000/R22,000 interest and dividend exemption where the first R1,000 is applied to foreign interest and dividends [s 10(1)(i)(xv)].
7	Foreign taxes paid	<ul style="list-style-type: none"> A rebate is permitted in respect of taxes paid on foreign sourced income, included in taxable income [s 6quat].
8	Blocked funds	<ul style="list-style-type: none"> Taxation of foreign income is deferred in cases where the remittance of foreign funds is restricted [s 9A].

9	Deduction for foreign dividends	<ul style="list-style-type: none"> A deduction is allowed for interest incurred in the production of foreign dividends [s 11C].
10	Trading stock	<ul style="list-style-type: none"> Where participating rights (units) are held as trading stock available for resale, the proceeds on disposal will form part of gross income [s 1 – def. ‘gross income’]; Expenditure incurred for the purchase of trading stock is deductible in full [s 11(a)]; The value of trading stock in the beginning and end of year must be taken into account at its cost price in determining taxable income [s 22].
11	Foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [s 25D].
Secondary Tax on Companies		
12	Dividends ex OEIC/CISP	<ul style="list-style-type: none"> PHs that is resident companies will have a STC credit for the incoming CISP dividends.
13	Distributions ex trust/CISP	<ul style="list-style-type: none"> As the CISP is a trust (and not treated as a company for income tax purposes), its distributions are not dividends as defined, hence no STC liability.
Capital Gains Tax		
14	Tax basis	<ul style="list-style-type: none"> SA residents are subject to CGT on all asset disposals on a worldwide basis, regardless from what source the capital gains and losses originate [par 2 of Eight Schedule].
15	Disposal events	<ul style="list-style-type: none"> Disposal events giving rise to a CGT liability include: sale of units; switches out of fund; repurchase or cancellation of units; transfers where beneficial ownership change; death; sequestration; emigration; and divorce (if married in community of property) [par 11(1) of Eight Schedule].
16	Post-valuation date investments	<ul style="list-style-type: none"> The base cost of post-valuation date investments is represented by the ‘par 20 expenditure’ [par 20 of Eight Schedule].
17	Pre-valuation date investments	<ul style="list-style-type: none"> Base cost equals valuation date value plus specified expenditure incurred after valuation date [par 25 of Eight Schedule].
18	Market value	<ul style="list-style-type: none"> The market value of a unit on valuation date is a published price [par 29 of Eight Schedule].
19	Identical assets	<ul style="list-style-type: none"> The use of the ‘weighted average method’ is permitted to determine the base cost of units [par 32 of Eight Schedule].
20	Proceeds	<ul style="list-style-type: none"> Consists of all amounts to which the PH has become entitled to [par 35 of Eight Schedule].
21	Disposals in foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [par 43 of Eight Schedule].
22	Transfer of units between spouses	<ul style="list-style-type: none"> Capital gains and losses are disregarded in the case of transfers between spouses – this is a roll-over provision [par 67(1) of Eight Schedule].

CISP: NON-RESIDENT INVESTORS

Income Tax		
#	<u>Issues</u>	<u>Tax Implications</u>
1	Tax basis	<ul style="list-style-type: none"> • Non-residents are taxed on a source basis, i.e. income originating from a source or deemed SA source [s 1 – def. ‘gross income’].
2	‘Repo’ of units	<ul style="list-style-type: none"> • Same as residents – see above.
3	‘Income’ accruals ex trust/CISP	<ul style="list-style-type: none"> • ‘Income’ accruals ex trust/CISP are derived via a conduit, represented by the trust/CISP, and is taxable in the hands of non-resident PHs [<i>conduit principle</i>; s 1 – def. ‘gross income’], except in the case of: <ul style="list-style-type: none"> - A foreign dividend ex trust/CISS is not subject to tax in SA for a non-resident as the amounts are deemed to be derived directly from the foreign company [s 1 – proviso to def. ‘gross income’ par (k)]; - CFC attributed net income ex trust/CISP is not subject to tax in SA as the amounts are derived from a foreign source and the PH is a non-resident [<i>conduit principle</i>]; - Interest ex trust/CISP is exempt from tax in the hands of a non-resident [s 10(1)(h)].
4	‘Capital’ accruals ex trust/CISP	<ul style="list-style-type: none"> • ‘Capital’ accruals ex trust/CISP are derived via a conduit, represented by the trust/CISP, and are tax free in the hands of non-resident PHs [<i>conduit principle</i>; s 1 – def. ‘gross income’].
5	Dividends ex OEIC/CISP	<ul style="list-style-type: none"> • Same as residents – see above.
6	Basic exemption	<ul style="list-style-type: none"> • Non-resident natural persons qualify for the basic R15,000/R22,000 exemption for SA sourced interest and dividends [s 10(1)(i)(xv)].
7	Trading stock	<ul style="list-style-type: none"> • Same as residents – see above.
8	Foreign currency	<ul style="list-style-type: none"> • Not applicable to non-residents.
Secondary Tax on Companies		
9	STC	<ul style="list-style-type: none"> • Not applicable to non-resident companies.
Capital Gains Tax		
10	Tax basis	<ul style="list-style-type: none"> • Non-residents are only liable for CGT of the participating interest forms part of the assets of a permanent establishment that the non-resident has in SA; or the non-resident (alone or together with any connected person in relation to the non-resident) holds 20% or more of the total participatory interests in the CISP (trust or OEIC) [par 2 of Eight Schedule]; • If this is the case, the same principles applicable to residents apply – see above.

7. CIS in Participation Bonds

7.1 Investment focus

A CISP²¹ is a scheme where the investment portfolio consists mainly of assets in the form of participation bonds and members of the public are invited or permitted to acquire a participating interest in all the participation bonds included in the scheme.

The participant's money is pooled, and the scheme then lends the money to individuals or companies that want to buy or develop properties – mainly commercial, industrial and retail property. The interest paid on these loans is passed on the participants in regular payments. The scheme lends the money to more than one borrower to reduce the risk to the participants. The minimum investment period in a participation bond by an investor is five years. Participation bonds are regarded as low-risk investments and are mainly used to generate income, which is why they are attractive to pensioners.

Essentially, a '*participation bond*' is a mortgage bond over immovable property: (1) which is described as a participation bond and is registered in the deeds office as such in the name of a nominee company and is included in a CISP portfolio; and (2) which is a first mortgage bond or which ranks equally with another first participation bond and has the same mortgagor.

A '*nominee company*' is a nominee or representative acting for the investors in whose name the bonds will be registered.

7.2 Tax implications

The various income tax, CGT and STC implications of a CISP from the perspective of the investment vehicle, resident investors and non-resident investors are tabulated below:

²¹ See Part VI (sections 52 to 61) of the Collective Investment Schemes Control Act, No 45 of 2002

CISPB: VEHICLE

Income Tax		
#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none"> Resident if incorporated, established or formed in SA, no matter where effectively managed [s 1 – def. ‘residence’].
2	Tax status	<ul style="list-style-type: none"> If constituted as a ‘trust’ (trust/CISPB) it will be taxed as a trust [s 25B]; If constituted as an ‘OEIC’ (OEIC/CISPB) it is a company <i>per se</i> and taxed as a company [s 1 – def. ‘company’ par (a)].
3	Tax rate	<ul style="list-style-type: none"> Trusts are taxed at a 40% rate; companies are taxed at a 29% rate with effect from 1 April 2005.
4	Distributions	<ul style="list-style-type: none"> Trust/CISP: act as a conduit and ‘income’ accruals may be distributed tax-free to its PHs [<i>conduit principle</i>]. OEIC/CISPB: the distribution is a dividend [s 1 – def. ‘dividend’].
5	‘Income’ accruals in a CISP	<ul style="list-style-type: none"> ‘Income’ accruals take the form of mortgage interest.
6	‘Capital’ accruals in a CISP	<ul style="list-style-type: none"> Unlikely.
7	Interest derived	<ul style="list-style-type: none"> Interest accruals is taxable [s 1 – def. ‘gross income’]; Trust/CISPB: when it distributes the interest to its PHs, the interest is not be subject to tax in the CISPB [<i>conduit principle</i>]; OEIC/CISP: interest is taxed and the after tax portion of the interest is distributed to its PHs by way of a dividend.
Secondary Tax on Companies		
8	Dividends by an OEIC/CISPB	<ul style="list-style-type: none"> The dividend declaration by an OEIC/CISPB to its PHs is subject to STC.
9	Distributions by a trust/CISPB	<ul style="list-style-type: none"> As a trust/CISP is not regarded a company, its distributions are not dividends, hence no STC liability.
Capital Gains Tax		
10	General	<ul style="list-style-type: none"> A CISPB is unlikely to make gains from the disposal of mortgage bonds. However, it may make losses through, for example, default. However, it will not be able to use these losses as it will not make capital gains and cannot distribute losses to investors.
11	OEIC/CISPB	<ul style="list-style-type: none"> The capital gains/losses of an OEIC/CISPB are subject to normal CGT rules; The issue and subsequent repo of participatory interests is not regarded a disposal for CGT purposes [par 11(2)(b) of Eight Schedule].
12	Trust/CISPB	<ul style="list-style-type: none"> A trust/CISPB is set up as a ‘vesting trust’, with the PHs having fixed (or ‘vested’) interests in the trust property. On this basis, the trust/CISPB will not itself be exposed to CGT [par 11(2)(e) of Eight Schedule]; The issue and subsequent repo of participatory interests is not regarded a disposal for CGT purposes [par 11(2)(c) of Eight Schedule].

CISPB: RESIDENT INVESTORS

Income Tax		
#	<u>Issues</u>	<u>Tax Implications</u>
1	Tax basis	<ul style="list-style-type: none"> SA residents are taxed on a worldwide basis, regardless from what source the taxable income originates [s 1 – def. <i>'gross income'</i>].
2	Repurchase or cancellation of units	<ul style="list-style-type: none"> The gain/(loss) made by a PH on the repurchase or cancellation of units (repo) by a trust/CISP is either on 'income' account if the units were held as trading stock or on 'capital' account if it were not so held [s 1 – def. <i>'gross income'</i>]; Where a PH realises its share investment in an OEIC/CISPB by way of repo, and the repo payment exceeds the amount of the share capital and share premium of the OEIC/CISPB appropriated for the repo, the excess will be a dividend for tax [s 1 – def. <i>'dividend'</i> par (c)]; However, the dividend so derived is exempt [s 10(1)(k)(i)].
3	Interest ex trust/CISPB	<ul style="list-style-type: none"> Interest ex a trust/CISPB is derived via a conduit, represented by the trust/CISPB, and is taxable in the hands of PHs [<i>conduit principle</i>; s 1 – def. <i>'gross income'</i>].
4	Dividends ex OEIC/CISP	<ul style="list-style-type: none"> Dividends ex OEIC/CISPB is included in gross income [s 1 – def. <i>'gross income'</i> par (k)]; However, these amounts are exempt from tax [s 10(1)(k)(i)].
5	Basic exemption	<ul style="list-style-type: none"> Natural persons qualify for the basic R15,000/R22,000 interest and dividend exemption where the first R1,000 is applied to foreign interest and dividends [s 10(1)(i)(xv)].
6	Trading stock	<ul style="list-style-type: none"> Where participating rights (units) are held as trading stock available for resale, the proceeds on disposal will form part of gross income [s 1 – def. <i>'gross income'</i>]; Expenditure incurred for the purchase of trading stock is deductible in full [s 11(a)]; The value of trading stock in the beginning and end of year must be taken into account at its cost price in determining taxable income [s 22].
Secondary Tax on Companies		
7	Dividends ex OEIC/CISP	<ul style="list-style-type: none"> PHs that is resident companies will have a STC credit for the incoming CISPB dividends.
8	Distributions ex trust/CISP	<ul style="list-style-type: none"> As the CISPB is a trust (and not treated as a company for income tax purposes), its distributions are not dividends as defined, hence no STC liability.
Capital Gains Tax		
9	Tax basis	<ul style="list-style-type: none"> SA residents are subject to CGT on all asset disposals on a worldwide basis, regardless from what source the capital gains and losses originate [par 2 of Eight Schedule].
10	Disposal events	<ul style="list-style-type: none"> Disposal events giving rise to a CGT liability include: sale of units; switches out of fund; repurchase or cancellation of units; transfers where beneficial ownership change; death; sequestration; emigration; and divorce (if married in community of property) [par 11(1) of Eight Schedule].

11	Post-valuation date investments	<ul style="list-style-type: none"> The base cost of post-valuation date investments is represented by the 'par 20 expenditure' [par 20 of Eight Schedule].
12	Pre-valuation date investments	<ul style="list-style-type: none"> Base cost equals valuation date value plus specified expenditure incurred after valuation date [par 25 of Eight Schedule].
13	Market value	<ul style="list-style-type: none"> The market value of a unit on valuation date is a published price [par 29 of Eight Schedule].
14	Identical assets	<ul style="list-style-type: none"> The use of the 'weighted average method' is permitted to determine the base cost of units [par 32 of Eight Schedule].
15	Proceeds	<ul style="list-style-type: none"> Consists of all amounts to which the PH has become entitled to [par 35 of Eight Schedule].
16	Disposals in foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [par 43 of Eight Schedule].
17	Transfer of units between spouses	<ul style="list-style-type: none"> Capital gains and losses are disregarded in the case of transfers between spouses – this is a roll-over provision [par 67(1) of Eight Schedule].

CISPB: NON-RESIDENT INVESTORS

Income Tax

#	<u>Issues</u>	<u>Tax Implications</u>
1	Tax basis	<ul style="list-style-type: none"> Non-residents are taxed on a source basis, i.e. income originating from a source or deemed SA source [s 1 – def. 'gross income'].
2	Repurchase or cancellation of units	<ul style="list-style-type: none"> Same as residents – see above.
3	Interest ex trust/CISPB	<ul style="list-style-type: none"> Interest ex trust/CISP is exempt from tax in the hands of a non-resident [s 10(1)(h)].
4	Dividends ex OEIC/CISPB	<ul style="list-style-type: none"> Same as residents – see above.
5	Trading stock	<ul style="list-style-type: none"> Same as residents – see above.

Secondary Tax on Companies

6	STC	<ul style="list-style-type: none"> Not applicable to non-resident companies.
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Capital Gains Tax

7	Tax basis	<ul style="list-style-type: none"> Non-residents are only liable for CGT of the participating interest forms part of the assets of a permanent establishment that the non-resident has in SA; or the non-resident (alone or together with any connected person in relation to the non resident) holds 20% or more of the total participatory interests in the CISPB (trust or OEIC) [par 2 of Eight Schedule].
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8. Declared CIS

8.1 Investment focus

A DCIS²² is any scheme (other than a CISS, CISP or CISPB) that has been declared to be a collective investment scheme by the Minister of Finance, who will define its business activity. This could, for instance, include a 'Stokvel' which pools money to earn interest for its investors.

8.2 Tax implications

DCIS: Vehicle

There are no special or specific provisions in the Act or the SA tax legislation that will apply to a DCIS. Generally, what is said above in relation to the taxation of a CISPB will also apply for the taxation of a DCIS.

DCIS: resident and non-resident investors

Here, too, what is said above in relation to the taxation of investors in a CISPB will apply to investors in a DCIS.

²² See Part VII (sections 62 to 64) of the Collective Investment Schemes Control Act, No 45 of 2002

9. Foreign CIS

9.1 Investment focus

A FCIS²³ is any arrangement or scheme carried on outside SA in pursuance of which members of the public are invited or permitted to invest in a portfolio of a FCIS, where two or more investors contribute to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest.

A FCIS is prohibited to carry on business in SA without the necessary approval of the Registrar of Collective Investment Schemes. Once approved a FCIS may solicit investments from members of the public in SA.

FCISs can take many forms, from trust structures to OEICs. The juridical form of these vehicles is dependent on the foreign jurisdiction's regulatory requirements. The FCIS usually offers various investment portfolios with different investment strategies, by creating a sub-fund or share class for each portfolio in which shares or units are issued to investors. An investor's participation right in a FCIS sub-fund is evidenced by a share or unit issued to him by the FCIS. The value of the participation right is derived from the underlying investments of the particular fund.

A SA investor can follow one of two routes in investing in a FCIS: (1) he can invest *indirectly* in a locally registered unit trust fund with international exposure; or (2) he can invest *directly* in foreign markets by using his R750 000 once-off foreign investment allowance. In the case of the latter option, the natural person must be at least 18 years of age and the investment can not be made through a trust, close corporation or company. Application must be made to SARS for a tax clearance certificate and this will be sent directly to an authorized dealer handling the actual transfer/investment of the funds. Obviously, in the case of institutional investors, for example local insurance companies, Reserve Bank approval must be obtained for investment in any FCIS.

Income distributions by a FCIS are mainly in the form of dividends (if an equity or property fund) or interest (if a money market fund). Regardless of its nature or form, for SA tax purposes it is classified as a '*foreign dividend*'. The same applies to income being '*rolled-up*' (see later) or '*wrapped*' in an investment product which yields a capital return. Quite often investors instruct fund managers to reinvest distributions and not remit the funds to SA. This is clearly a tax event as envisaged in s 7(1) – the decision to reinvest is made after accrual to the taxpayer.

The cost of investing in a FCIS scheme varies depending on the type of fund you invest. For example, a money market fund may have no initial fees and an annual fee of 0.5%, while an equity fund may have a 5% initial fee and an annual fee of between 1-2%.

²³ See Part VIII (sections 65 to 67) of the Collective Investment Schemes Control Act, No 45 of 2002

Generally, FCISs do not usually accept investments of less than US\$ 5 000 – and most expect minimum investments of US\$ 10 000. Very few accept regular monthly investments via debit order.

9.2 Tax implications

The various income tax, CGT and STC implications of a FCIS from the perspective of the investment vehicle, resident investors and non-resident investors are tabulated below:

FCIS: VEHICLE

Income Tax		
#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none"> Resident if incorporated, established or formed in SA, no matter where effectively managed. It will also be resident if it was incorporated, established or formed outside SA but it is effectively managed in SA [s 1 – def. <i>'residence'</i>]. Non-residents are taxed on a source basis, i.e. income originating from a source or deemed SA source [s 1 – def. <i>'gross income'</i>].
2	Tax status	<ul style="list-style-type: none"> Regardless of how it is constituted, a FCIS is treated as a company for income tax [s 1 – def. <i>'company'</i> par (e)(ii)]; The special or specific SA tax rules applicable to a CISS or CISP do not apply to a FCIS, even if it meets the requirements of a CISS or CISP.
3	Tax rate	<ul style="list-style-type: none"> Companies are taxed at a 29% rate with effect from 1 April 2005.
4	Distributions	<ul style="list-style-type: none"> FCIS distributions are treated as a foreign dividend [s 1 – def. <i>'dividend'</i>].
5	'Income' accruals in a FCIS	<ul style="list-style-type: none"> SA sourced <i>'income'</i> accruals can take a myriad of forms, i.e. rentals, local <i>'taxable dividends'</i> or distribution ex SA CIS's as a result of its participating interest in those CIS's (in particular those originating from CISSs, CISP, CISPBs constituted as either a trust or OEIC); Each source of income needs to be carefully analysed in order to determine its SA tax liability.
6	'Capital' accruals in a FCIS	<ul style="list-style-type: none"> <i>'Capital'</i> accruals are not liable to tax.
7	'Exempt' accruals in a FCIS	<ul style="list-style-type: none"> This would include, for instance, local <i>'exempt dividends'</i> [s 10(1) (k) (i) and interest s 10(1) (h)].
Secondary Tax on Companies		
8	Dividends by an FCIS	<ul style="list-style-type: none"> The dividend declaration by an FCIS is not subject to STC as it is a non-resident <i>'company'</i>.

Capital Gains Tax

9	General	<ul style="list-style-type: none"> A FCIS is only liable for CGT if the participating interest forms part of the assets of a permanent establishment that the FCIS has in SA; or the non-resident (alone or together with any connected person in relation to the non resident) holds 20% or more of the total participatory interests in a CISP or CISPB (trust or OEIC) [par 2 of Eight Schedule].
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FCIS: RESIDENT INVESTORS

Income Tax

#	<u>Issues</u>	<u>Tax Implications</u>
1	Tax basis	<ul style="list-style-type: none"> SA residents are taxed on a worldwide basis, regardless from what source the taxable income originates [s 1 – def. ‘gross income’].
2	Repurchase or cancellation of units	<ul style="list-style-type: none"> The gain/(loss) made by a PH on the repurchase or cancellation of units (repo) by a trust/CISP is either on ‘income’ account if the units were held as trading stock or on ‘capital’ account if it were not so held [s 1 – def. ‘gross income’]; Where a PH realises its share investment in an FCIS by way of repo, and the repo payment exceeds the amount of the share capital and share premium of the FCIS appropriated for the repo, the excess will be a dividend for tax [s 1 – def. ‘dividend’ par (c)]; The above dividend does not qualify for any of the foreign dividend exemptions [s 10(1)(k)(ii)].
3	Dividends ex FCIS	<ul style="list-style-type: none"> Dividends ex FCIS is included in gross income [s 1 – def. ‘gross income’ par (k)]; Certain foreign dividends qualify for exemption [s 10(1)(k)(ii)]; Generally, ‘portfolio’ holdings are taxed and substantial ‘direct’ investments are exempt.
4	CFC attribution	<ul style="list-style-type: none"> Where the FCIS qualify as a controlled foreign company, some or all of its net profits could be attributed to SA resident PHs [s 9D].
5	Basic exemption	<ul style="list-style-type: none"> Natural persons qualify for the basic R15,000/R22,000 interest and dividend exemption where the first R1,000 is applied to foreign interest and dividends [s 10(1)(i)(xv)].
6	Foreign taxes paid	<ul style="list-style-type: none"> A rebate is permitted in respect of taxes paid on foreign sourced income, included in taxable income [s 6<i>quat</i>].
7	Blocked funds	<ul style="list-style-type: none"> Taxation of foreign income is deferred in cases where the remittance of foreign funds is restricted [s 9A].
8	Deduction for foreign dividends	<ul style="list-style-type: none"> A deduction is allowed for interest incurred in the production of foreign dividends [s 11C].
9	Trading stock	<ul style="list-style-type: none"> Where participating rights (units) are held as trading stock available for resale, the proceeds on disposal will form part of gross income [s 1 – def. ‘gross income’]; Expenditure incurred for the purchase of trading stock is deductible in full [s 11(a)]; The value of trading stock in the beginning and end of year must be taken into account at its cost price in determining taxable income [s 22].

Secondary Tax on Companies		
10	General	<ul style="list-style-type: none"> The receipt of a foreign dividend will qualify as an STC credit.
Capital Gains Tax		
11	Tax basis	<ul style="list-style-type: none"> SA residents are subject to CGT on all asset disposals on a worldwide basis, regardless from what source the capital gains and losses originate [par 2 of Eight Schedule].
12	Disposal events	<ul style="list-style-type: none"> Disposal events giving rise to a CGT liability include: sale of units; switches out of fund; repurchase or cancellation of units; transfers where beneficial ownership change; death; sequestration; emigration; and divorce (if married in community of property) [par 11(1) of Eight Schedule].
13	Post-valuation date investments	<ul style="list-style-type: none"> The base cost of post-valuation date investments is represented by the '<i>par 20 expenditure</i>' [par 20 of Eight Schedule].
14	Pre-valuation date investments	<ul style="list-style-type: none"> Base cost equals valuation date value plus specified expenditure incurred after valuation date [par 25 of Eight Schedule].
15	Market value	<ul style="list-style-type: none"> The market value of a unit on valuation date is the last published price before valuation date or open market value [par 29 of Eight Schedule].
16	Identical assets	<ul style="list-style-type: none"> The use of the 'weighted average method' is permitted to determine the base cost of units [par 32 of Eight Schedule].
17	Proceeds	<ul style="list-style-type: none"> Consists of all amounts to which the PH has become entitled to [par 35 of Eight Schedule].
18	Disposals in foreign currency	<ul style="list-style-type: none"> Where relevant, apply foreign currency conversion rules [par 43 of Eight Schedule].
19	Transfer of units between spouses	<ul style="list-style-type: none"> Capital gains and losses are disregarded in the case of transfers between spouses – this is a roll-over provision [par 67(1) of Eight Schedule].

FCIS: NON-RESIDENT INVESTORS

Income Tax		
#	Issues	Tax Implications
1	Tax basis	<ul style="list-style-type: none"> Non-residents are taxed on a source basis, i.e. income originating from a source or deemed SA source [s 1 – def. '<i>gross income</i>'].
2	Distributions ex FCIS	<ul style="list-style-type: none"> No SA tax impact where the FCIS is a non-resident and makes distributions to non-resident PHs.
Secondary Tax on Companies		
3	STC	<ul style="list-style-type: none"> Not applicable to non-resident companies.

Capital Gains Tax

4	Tax basis	<ul style="list-style-type: none">• Non-residents are only liable for CGT if the participating interest forms part of the assets of a permanent establishment that the non-resident has in SA [par 2 of Eight Schedule].
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9.3 Foreign 'roll-up' investments

The tax consequences for South Africans with investments in foreign 'roll-up' funds were recently discussed by **Coetzee**.²⁴

A foreign roll-up fund is a FCIS, usually in the form of an OEIC, which offers various investment portfolios with different investment strategies, by creating a sub-fund or share class for each portfolio in which shares or units are issued to investors. An investor's participation right in an FCIS sub fund is evidenced by a share or unit issued to him by the FCIS. The shares do not pay any dividends. When an investor redeems his shares he is paid an amount equal to the net asset value of the fund, divided by the number of shares in issue, multiplied by the number of shares redeemed by the investor.

A FCIS is defined as a company in terms of the definition of a 'company' in s 1 of the IT Act. In terms of the dividend definition in s 1 of the same Act, where a company repurchases its shares at a value greater than its issue (nominal) value, the difference will be deemed to be a dividend. This means that every time an investor realizes investments directly from the FCIS at more than the original purchase price, a foreign dividend tax implication will arise. This will be the case in most instances where the roll-up fund's prospectus provides that the only method for redemption is for the fund to repurchase the investor's shares. For funds that make use of a management company to facilitate the redemptions, only a capital gains tax consequence will arise.

Therefore, any growth on investments redeemed by an investor directly from the FCIS will result in a taxable foreign dividend, unless the exemption criteria in section 10(1)(k)(ii) applies. In addition to the foreign dividend being taxable, the investor will also be subject to CGT on currency movement to the extent that the Rand depreciates against a foreign currency.

The following example illustrates the consequences of an investment realized:

Illustration

Assume an investment is made for USD 100 on 1 March 2002 when the average exchange rate is 5 ZAR = 1 USD. Assume the same investment is redeemed on 28 February 2004 directly from the FCIS when the market value has grown to USD 110 and the average exchange rate is 10 ZAR = 1 USD.

²⁴ Leon Coetzee. *Taxing foreign roll-up investments*. Accountancy SA, February 2005

Solution

1. Determine the foreign dividend

Foreign Dividend: 110 less 100 = USD 10

2. Convert the foreign dividend at the average exchange rate at 28 February 2004

Taxable foreign dividend: USD 10 x 10 = R100

3. Determine the amount subject to CGT

In terms of par 43(4) of the Eight Schedule, the capital gain or loss is determined by translating proceeds into Rand using the average exchange rate for the year of disposal and by translating base cost to Rand using the average exchange rate of the year of acquisition:

Proceeds	(110 x 10)	R 1 100
Less: taxable foreign dividend		100
Less: base cost	(100 x 5)	500
Amount subject to CGT		<u>R 500</u>

Comments

An investment in a roll-up fund is subject to income tax, albeit on realization of the investment. Also, depending on the investment vehicle and method of redemption, the growth may or may not be subject to income tax in the form of a taxable foreign dividend. The current situation is similar to a SA CISS where the scheme is not subject to tax, but the investor is subject to CGT when he realizes his investment. The major difference, however, is that the FCIS does not distribute income whereas the SA CISS does distribute income, which may or may not be taxable in the investor's hands, depending on the nature thereof.

9.4 Foreign trusts

There is evidence that SA residents are increasingly investing in FCISs by utilising a foreign trust as the participating unit holder. The result of this is that income and/or capital streams ex a FCIS is channelled via a foreign trust who in turn makes distributions (if any) to the resident beneficiary in the trust. A number of tax implications are apparent from arrangement.

Unless the income attribution rules in s 7, especially s 7(8) (resident to non-resident donations, settlements or other dispositions) apply to deem its income to accrue to the 'donor', the income of an offshore trust that is distributed to a resident of SA during the year of assessment in which it is derived by the foreign trust, will be taxed in the hands of the beneficiary to whom it is awarded. The '*conduit principle*' will apply so that the income will flow through the trust to the beneficiaries retaining its nature as, for example, interest, foreign dividends or rent. As SA residents are tax on their

worldwide income, SA tax may be saved – or at least postponed – on foreign dividends from a FCIS that is retained by an offshore trust. But, the trust's liability for tax in the foreign jurisdiction must also be considered.

Another important consideration is that of s 25B(2A) which was inserted to counter the use of offshore trusts for tax planning. It applies where a SA resident beneficiary acquires a vested right to capital of a non-SA resident trust, and the capital arose from *'income'* derived by the trust in a previous year of assessment in which the beneficiary had a contingent right to the income, the beneficiary will be taxed on the capital so distributed. It applies not only where the capital arose from income, but also from receipts and accruals that would have constituted income had the trust been a SA resident.

10. The Management Company

10.1 Introduction

The management company ('the manager') administers the fund. Only a '*company*' duly registered under the Companies Act is permitted to act as a manager.

To ensure that the manager has a vested interest in the performance of assets under management, all management companies are obliged to hold an investment of at least 10% of the total amount of units in each portfolio. This can be limited to R1 million, subject to the approval of the Financial Services Board.

Management companies charge unit holders two types of fees for the management of their money – an '*initial creation fee*' and an '*annual management fee*' (both subjected to VAT). The management company may deduct fees only from accrued income, and not capital invested in the fund. The assets of the CIS remain unaffected, despite the financial position of the management company.

10.2 Tax implications

The management company is a taxpaying entity in its own right, completely divorced from the CIS itself. All the normal tax principles applies as regards to fees derived and expenses incurred in the production of its income.

11. Case Study

11.1 Introduction

The *'untaxed policyholder fund'* of an insurer and a *'retirement fund'* (both referred to as a 'fund' or 'funds') is exempt from *income tax* per sections 29A(4)(a) and 10(1)(d) of the IT Act. But, these funds are taxed in accordance with the RFT Act on interest, rentals and foreign dividend accruals.

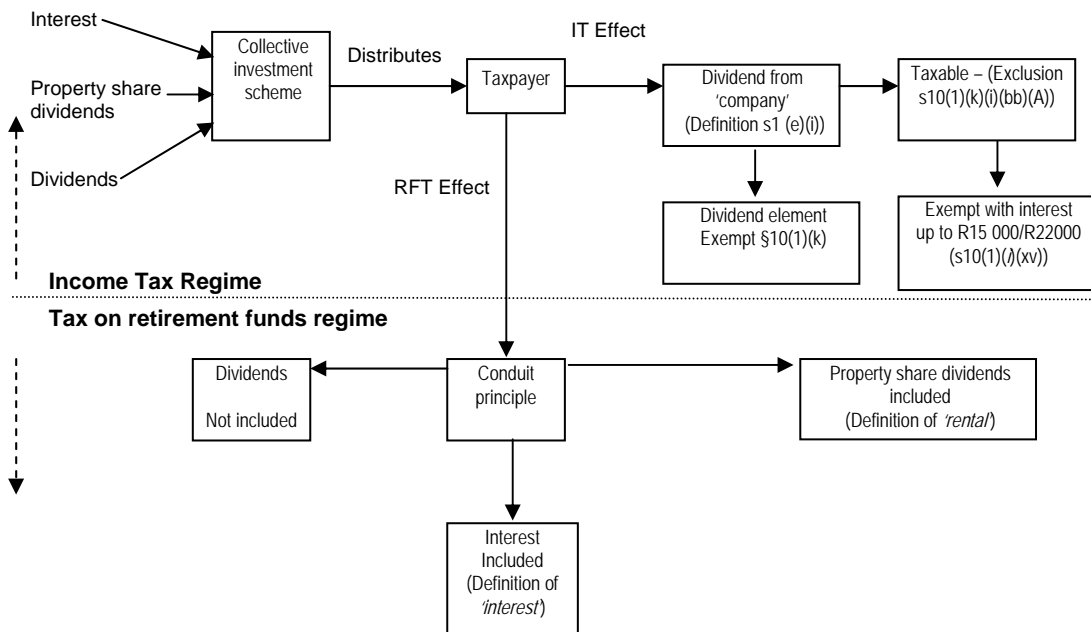
It is common practice for these funds to utilise CIS vehicles (mainly CISSs, CIPs and FCISs) as part of their investment strategies. The taxation of accruals ex CIPs and FCISs are clear and established in the RFT Act – the former is included as rentals derived and the latter as foreign dividends derived. However, the position as regards to distributions ex a CISS in the context of the RFT Act is not clear at all, in particular where the CISS is constituted as a trust (which is currently the case with most, if not all, CISSs in SA). The trust/CISS make distributions to participating holders out of its *'income'* (e.g. interest derived) and *'exempt income'* (e.g. local dividends derived).

SARS clarified the position of distributions ex a CISS in an ***Information Brochure on the Tax on Retirement Funds Act***, released via Government Gazette at the inception of the Act in 1996, as follows:

As the Tax on Retirement Funds is dealt with in a separate Act, the normal trust principles will apply to interest distributed to unit holders by any unit trust scheme, irrespective of the type of securities held by the unit portfolio. Funds as unit holders in a unit trust scheme will, therefore, only be taxable on the interest received by or which accrued to them from the unit trust scheme.

Basically, what is envisaged is an application of the common law trust *'conduit principle'* depicted as follows:²⁵

²⁵ Designed by Peter Maspero, Tax Consultant, SARS Enforcement Centre, Cape Town



It must be noted that, where the CISS is constituted an OEIC there is no uncertainty in the RFT Act: the OEIC is a company *per se* and its distributions are *local* dividends which is excluded in the formula for determination of income of the fund

The following case illustrates the difficulty in applying the concepts in practice.

11.2 Case study

Background

The position is that interest has been received by a CISS, constituted as a trust, which in turn has made distributions to the taxpayer, an insurer, which was allocated to its untaxed policyholder fund (UPF). The taxpayer did not include this interest in its calculation of income for RFT purposes. The taxpayer's contention is that the distributions in question constitute dividends for purposes of the RFT Act, and that it is accordingly not liable for RFT in respect thereof. SARS assessed the taxpayer on the interest amounts in question on grounds that the distributions in question constitute interest for purposes of the RFT Act, and that they are accordingly subject to RFT. This view is in line with the Information Brochure issued in relation to the RFT Act.

Taxpayer's case

The taxpayer objected to this inclusion arguing as follows:

1. It is stated in the preamble to the definitions contained in s 1 of the RFT Act that, for purposes of the RFT Act, any word or expression to which a meaning has been assigned in the Income Tax Act, bears the meaning so assigned, unless the context indicates otherwise. It follows that, even though the IT Act and the RFT Act are different acts, they are clearly interdependent and inter-related as is stated by the preamble;
2. As a CISS is not defined in the RFT Act, one must fall back on the IT Act, which defines a CISS as a '*company*' and distributions from a CISS are included in the definition of '*dividend*'. There is no indication in the RFT Act that a CISS should bear a different meaning than that afforded in the IT Act;
3. The conduit principle only finds application in regard to ordinary trusts. Where a CISS is also for the purposes of the RFT Act regarded as a company, it is not possible to apply the conduit principle to such CISS;
4. The way in which a CISS is arranged and operates could be distinguished from an ordinary trust;
5. The Explanatory Memorandum published with the Bill does not refer to this issue at all and the Information Brochure, issued three months after enactment, does not have any force of law.

SARS' case

SARS disallowed the objection and provided reasons to the taxpayer along the following lines:

"We note that the crux of your grounds as to why the amounts in question should not be subjected to tax is founded on the notion that the definition of '*company*' and, in consequence, '*dividend*' in the IT Act should be adopted for the purposes of the RFT Act. You suggest that the inclusion of those definitions in the RFT Act is under the authority of the following words, which comprise the preamble to the definition section, §1, of the RFT Act –

For the purposes of this Act any word or expression to which a meaning has been assigned in the Income Tax Act, 1962 (Act No. 58 of 1962), hereinafter referred to as the Income Tax Act, bears the meaning so assigned, unless the context within which such word or expression is used otherwise indicates...

[Emphasis added]

It needs to be understood that an 'artificial' scenario is created for *income tax purposes*, whereby a CISS, which is in fact a trust, is treated as a company, and its distribution as a dividend. We refer to this as the 'income tax regimen'.

In the IT Act, dividends are *in the main* exempt from *further* income tax in terms of section 10(1)(k)(i). We say 'in the main' because, *inter alia*, a dividend from a CISS is excluded from the general dividend exemption, if distributed out of '*income*' that is exempt in terms of section 10(1)(iA) – see the *proviso* (bb)A in §10(1)(k)(i). The income that is exempt in terms of s 10(1)(iA) is that portion of the '*income*' that has

been distributed to participatory holders; in the present context then, this *'income'* comprises interest.

The point is that, in this way the interest income, which would have been subjected to income tax under the conduit principle, shall we say 'the conduit scenario', but is transformed into a dividend under the income tax regimen, is still taxed. In other words, the legislature, in recognizing the distinction in the treatment of distributions from trusts and companies, has mirrored the conduit scenario in relation to interest from CISS.

We say 'further' because the underlying profits, from which dividends have been distributed, will have been subject to taxation in the normal course under the general body of the IT Act.

It should be noted that if the income tax regimen were to overlay the RFT Act, the interest from a CISS, which should be subject to RFT, would escape tax altogether. In fact, it would mean that, of all the income that accrues to a fund, only interest from CISS would be exempt; that is excluding dividend income, which, having been paid out of after-tax income is purposefully left out of the RFT taxable amount formula.

The intended result is to subject fund income, which would normally be subject to income tax, to RFT; applying the income tax regimen defeats this intention. On the other hand, applying the conduit scenario matches the common law reality, and aligns itself with the treatment under the IT Act where interest from a CISS is still taxable.

All in all, SARS believe that the context does *'indicate the contrary'*, so it would be inappropriate to ascribe the term 'dividend' *per* the IT Act to distributions from a CISS. It was with this interpretation of the law in mind, that SARS gazetted the *'Information Brochure on the Tax on Retirement Funds Act'* in 1996, which specifically addresses the inclusion."

Comment

The case revolves around the question whether distributions made out of interest by a trust/CISS constituted dividends or interest in the hands of the taxpayer for purposes of the RFT Act.

SARS argument is based on the premise that the RFT Act and the IT Act are two separate taxing acts of Parliament. In the context of the RFT Act, the normal trust principles apply to interest distributed by a trust/CISS to its PHs. Its view is supported by an Information Brochure which specifically addresses the inclusion.

However, the taxpayer disputes this inclusion, arguing that under the IT Act a CIS is for all intents and purposes classified as a *'company'* and resultant distributions to unit holders is regarded as a *'dividend'*. Once this is determined, the further income tax treatment of this dividend for purposes of the RFT Act must be ignored.

If this case goes to Court, what needs to be considered, in my opinion, is the following:

- The exact status of a trust/CISS in the context of the RFT Act. Does it assume its common law status of a trust, in which case the conduit principle applies to its distributions to participating holders or does it assume an artificial legal character of a ‘*company*’ as envisaged in the IT Act, in which case the distributions are classified as a ‘*dividend*’ in the hands of its ‘*shareholders*’;
- The acceptability of interpreting words or expressions in more than one piece of legislation with specific reference to the extent to which one can draw definitions from the IT Act when interpreting the RFT Act. Also what does “... *unless the context within which such word or expression is used otherwise indicates ...*” mean, bearing in mind that both the IT Act and the VAT Act commence with a similar expression;
- The *contra fiscum* rule of interpretation. This rule is applied in favor of the taxpayer when there is ambiguity in the legislation. If there is indeed an ambiguity in the sense that the legislation can reasonably be interpreted as meaning that the distributions are either interest or dividends, there is in my opinion no doubt that a Court would then be bound to construe the legislation *contra fiscum*.²⁶ However, the application of rule is not a matter for judicial choice; it is a binding rule of law based on the presumption that the least possible burden should be imposed upon persons affected by a statutory provision.

²⁶ Hulett & Sons Ltd v Resident Magistrate, Lower Tugela [1912 AD 760]; Israelsohn v Commissioner for Inland Revenue [1952 (3) SA 529 (A)]; Commissioner for Inland Revenue v Whitfield [1993 (2) SA 326 (E)]

11. Tax Planning

12.1 Introduction

A good definition of tax planning was offered by **Gavin Urquhart**²⁷ as follows:

'...tax planning can be described as ... the management and arrangement of the affairs of a [taxpayer], so as to legally minimise as far as possible and as cost effectively as possible, all taxes payable, within the constraints imposed by the commercial and other objectives of the associated taxpayers'

Tax planning is, therefore, concerned with finding ways to legally reduce tax burdens (called *'tax avoidance'*) as oppose to deliberately undertaking actions to free a taxpayer in an illegal manner from tax burdens to which he would otherwise have been subjected to (called *'tax evasion'*) . Successful tax planning revolves around the following aspects: (1) cognisance of all tax legislation; (2) the transactions which constitute the plan must be legal; (3) the plan must be cost effective; and (4) commercial and other objectives, not the saving of tax, must be the primary considerations.

With the above as background, and reflecting on the various tax implications highlighted under each type of collective investment scheme (refer Chapters 5 to 9) the taxpayer (from the perspective of both the investor and the scheme itself) must in particular focus on the following opportunities and challenges in drafting its tax plan:

12.2 Tax planning aspects

Taxes

The influence of tax on a portfolio, in particular income tax and capital gains tax, must be analyzed and optimized. The basic objective must be to choose strategies that will optimize after-tax returns.

Basis of taxation

The overriding tax principle applicable to all investments is that SA residents are taxed on their worldwide income and assets, irrespective of where the income is earned or the assets are based. Non-residents, on the other hand, are only taxed on their SA sourced income and capital gains pertaining to fixed property in SA.

²⁷ EM Stack, M Cronje & EH Hamel. *The Taxation of Individuals & Companies*. 2003 edition, Lexis Nexis, Durban, p 496

Buying and selling of units

One of the essential characteristics of an *open-ended* CIS is that investors can buy and sell units in the CIS at net asset value (NAV) at times of their own choosing.

From the view of the CIS vehicle (trust and OEIC) the buying and selling of units has no income tax or capital gains tax implications.

From the perspective of an investor the buying of units can either be on '*income*' account (e.g. purchase of trading stock with a view of profitable resale) or '*capital*' account (e.g. purchase of units as an investment with a view of generating income). If the former is the intention of the taxpayer, the profit on sale of the units is liable to income tax in full. If the latter is the intention of the taxpayer, the disposal of the units will give rise to CGT, i.e. the 'profit' represented by proceeds less base cost. All income derived on the units during the holding period will, in both instances, be subject to tax.

It is, therefore, of great importance that a taxpayer carefully document its intentions and dealings both at the time of buying and selling the units, which could be tabled as vital evidence in its onus of proof. From a tax planning point of view cognisance must be taken the judgement in the case of **Nussbaum**²⁸.

Distribution of income by CIS

Income not distributed by a local trust/CIS is taxed at a rate of 40%, but excluding a CISS which is taxed at the company rate of 29%. Distributions subsequent to being taxed are of a capital nature when distributed to investors. It must be emphasized that this is hardly ever the case, as trust deeds generally provide for a full distribution (net of expenses) to investors on or before the trust year-end. This distribution makes a distinction between a 'taxable' dividend (e.g. interest) and 'exempt' dividend (e.g. *prima facie* local dividends). The intention of a trust is to have the income portion taxed in the hands of investors, while the exempt portion remains exempt in their hands.

An OEIC, on the other hand, is liable to tax on all income derived at company tax rates and makes distributions of after-tax income to investors which in turn is exempt in the hands of investors. In addition, the OEIC is liable to STC on dividends distributed to its investor 'shareholders'. From a tax perspective, this places the OEIC vehicle at a considerable disadvantage as compared to a trust.

Income derived by investors

The liability for SA tax on investment income earned from local and foreign CIS's depend on a number of factors, *inter alia*: (1) residence status of the investor; (2) nature of the income; (3) source of income; and (4) form of CIS vehicle making the distribution. Each factor needs to be carefully considered in the context of the unique circumstances of the investor in order to determine on what basis income derived are to be included in gross income, the extent of available exemptions, and deductions/allowances for purposes of determining the SA tax liability.

²⁸ *CIR v Nussbaum*²⁸ [1996 (4) SA 1156 (A), 58 SATC 283]

Trust versus open-ended investment company structure

What will determine whether OEICs take of in SA is their tax position. As companies, they are paying companies tax at the rate of 29% on profits and 12.5% on dividends declared to shareholders. As yet, no ruling has been issued by SARS that would put them on the same footing as trust structures.

A CIS management company pays company tax on its own profits but not on the profits of the CIS and, as an OEIC/CIS is also an umbrella structure with underlying funds, it ought to be taxed in the same way. This would require lobbying from local companies that are interested in pushing OEICs.

From a tax planning point, the form of a CIS is an important factor for the investor: when the vehicle is constituted as a trust/CIS investors have a lot more control over the implications of their investments on their likely tax bill leading to more efficient financial planning; when the vehicle is constituted as a OEIC/CIS the investor, in a sense, sacrifices this control. In addition, foreign investment schemes have different structures which an investor must understand before investing, e.g. ranging from trust structures to corporate structures (OEICs, SICAVs and mutual funds), each having its own unique tax implications.

Roll-up funds

Many foreign CISs are structured as '*roll-up funds*' meaning that any investment income earned by the portfolio is reinvested in the foreign CIS for future capital growth. So, there would be no investment income earned or distributed on such portfolios. However, when the investment is liquidated, the difference between the amount paid and proceeds will be a taxable foreign dividend.

This roll-up concept must be distinguished from the stipulations envisaged in s 7(1), which subject to tax any income that has been credited in an account or reinvested or accumulated or capitalized or otherwise dealt with in the taxpayer's name or on his behalf. Accordingly, once there is a '*distribution*' by the CIS it will be subjected to tax. The fate of income after it has accrued or been received is therefore of no consequence to the tax-gatherer. The ultimate destination of the income cannot affect its nature as income.²⁹

Foreign exchange

Where the foreign funds may not be remitted, a deferral of the tax liability is possible in terms of s 9A. If this was not the case, the taxpayer will be sitting with an unfunded tax liability.

²⁹ *Van Rhyn Deep Ltd v CIR* [1922 WLD 22, 33 SATC 101]

Rebate for foreign taxes paid

If you invest in a foreign FCIS, the onus is on the taxpayer to pay the taxes owing.

Where the investment is in a *'true offshore fund'*, i.e. offshore finance centre or tax haven where taxes are low or non-existent, you may not be liable to tax in the jurisdiction in which the fund is domiciled. But, as a SA resident you must declare any income and/or foreign dividends earned, and/or capital gains realised from an investment in a FCIS to SARS. True offshore funds are domiciled in places such as Jersey, Guernsey, the Isle of Man, Luxembourg, the Republic of Ireland, Bermuda, Cyprus and Mauritius. There are also funds in tax havens such as Cayman Islands, the British Virgin Islands and countries in the Caribbean, but the regulation of investments in these places is often lax.³⁰

Where the investment is in an *'onshore fund'*, e.g. funds in UK, US, Australia, Canada, France, Germany, etc you may have to pay tax in the country in which the scheme is domiciled. As a SA resident, you must still declare any income and foreign dividends you have earned from your investment for tax purposes in SA. However, s 6quat allows a deduction against the taxpayer's SA income tax charge for foreign taxes on foreign investment income.

Routing FCIS income via a foreign trust

Foreign trusts can be used as an effective vehicle to 'park' investments in a FCIS. However the trust's own tax status in the foreign jurisdiction must be carefully considered in the case where income is retained and not distributed to the SA beneficiary. Where the trust is resident in a *'tax haven'* or *'financial centre'* jurisdiction, this can prove to be useful from a tax planning perspective. The implications of s 7, in particular s 7(8) dealing with resident to non-resident donations, and s 25B(2A) in respect of the taxability of capital distributions by a foreign trust to a resident beneficiary, must also be carefully considered.

Conduit principle

As CISs in SA are predominantly constituted in a trust form, the taxpayer must take cognisance of the so-called *'conduit principle'* as its find application in common law. This holds that income flows through a trust to the beneficiaries who have a right to it. The income accordingly retains its identity (e.g. dividends, interest, rentals, etc) in the hands of the beneficiaries who are liable to tax on it. It follows that any exemption applicable to the income will be available to the beneficiary to whom it accrues. For example, if exempt dividends derived by a trust accrue to a beneficiary, they will remain exempt from tax in his hands.

³⁰ Laura du Preez. *How to directly access foreign investments*. Personal Finance, www.persfin.co.za

Exemptions

All local *prima facie* dividends are tax free for both residents and non-residents per s 10(1)(k)(i). In addition, qualifying non-residents deriving local interest ex a CIS are also exempt from tax per s 10(1)(h). Annual interest exemptions are R15 000 and R22 000 for individuals respectively under 65 years of age and 65 years and older. Foreign interest and foreign dividends will only be exempt up to R2 000 of the total exemption.

Onus of disclosure

The onus of disclosing the amount of income from local and foreign income and capital gains rests on the investor. In terms of s 78, dealing with estimated assessments, SARS has the discretion to impose a deemed amount as foreign investment income where a taxpayer has not fully disclosed its investment income. General SARS practice is for an amount equal to the official interest rate, currently 10.5%, to be raised as investment income in the hands of the offending taxpayer.

A taxpayer is always advised to make full disclosure on his or her tax return of all investments that he or she holds. The tax consequences of redemptions should be disclosed based on the views expressed in this paper. To the extent that the investment remains unrealized, only the cost of the investment needs to be disclosed.

Tax on retirement funds

From the perspective of long-term insurers there is currently a great deal of uncertainty whether the interest element of distributions from a trust/CISS must be included in 'income' for purposes of determining the taxable amount of retirement funds for purposes of the RFT Act. SARS' argument for inclusion of such interest relies heavily on the common law conduit principle as applicable to trusts and an information brochure it circulated in this regard. Unlike the IT Act, the RFT Act does not specifically contain a statutory provision for inclusion of interest derived from a CISS. It is anticipated that this aspect will be referred to the Court for decision.

FCIS regarded as a 'company'

A FCIS is classified a company in terms of par (e)(ii) of the definition of 'company' in s 1 of the Act. However, most of these FCISs are structured as so-called 'umbrella funds', i.e. these funds have sub-funds in which an investor may invest. Investors are generally also allowed to 'switch' their investments in the various sub-funds should they wish to change their investment strategy. It is unclear from par (e)(ii) if the Act regards each sub-fund (separate portfolio) in the FCIS as a separate company or if it refers to the FCIS as a whole (i.e. all the portfolios combined). The classification is important as it affects the application of s 9D and s 10(1)(k)(ii).

Controlled foreign company

Section 9D defines a CFC as *inter alia*, a foreign company where more than 50% of the total participation rights in that foreign company are held by one or more residents. It is apparent that the interpretation of par (e)(ii) of the company definition could have far-reaching implications. If the definition were to be interpreted that the entire FCIS (with its sub-funds) should be regarded as the foreign company, the presence of foreign participants could dilute the percentage participation rights that SA residents hold, resulting in the FCIS not being regarded as a CFC. However, if the various sub-funds of the FCIS were to be regarded as companies in their own right, some of the sub-funds could clearly be regarded as a CFC. In addition, the regular movement in an investor's participation rights as a result of sales and purchases makes it extremely difficult to monitor whether the FCIS is a CFC or not. It may move from being a CFC to not being a CFC on many occasions during the year. Clearly this creates many difficult tax compliance issues for the SA investors.

Repurchase of shares: dividend or capital gain?

A CIS, in particular a CISS and a FCIS which is treated a company regardless of its form of constitution, may repurchase an investor's participation right directly from the investor on exit, i.e. with no management company intervention. Any repurchase directly by the CIS will be regarded a redemption of share capital and would give rise to dividends in so far as the repurchase price exceeds the purchase price at the date the investment was made (per the dividend definition in s 1).

This is contrary to the expectation that the sale of shares would ordinarily be of a capital nature as the proceeds are now regarded as a dividend on the difference between the proceeds and the nominal value of the shares. As local dividends has tax exempt status, this is not the case for a foreign dividend ex an FCIS

It must be noted that in situations where a management company facilitates the repurchase of participation rights from investors who want to realize their investments, the transaction is covered by the capital gains tax provisions of the Eighth Schedule. This will be the case for all local CIS's, where a management company deals with all repurchases. However, in the context of a FCIS the 'direct' versus 'indirect' distinction is important because it will dictate whether resulting gains will be taxed under normal tax or capital gains tax.

Exempt foreign dividends

Section 10(1)(k)(ii)(dd), effective from 1 June 2004, requires that a person must hold more than 25% of the equity share capital in the foreign company declaring the dividend to qualify for the dividend to be a tax free foreign dividend in the hands of the SA resident. SA investors could find it very difficult to establish whether the share capital of the FCIS would be regarded as '*equity share capital*' as defined in s 1 of the Act. There is therefore uncertainty as to whether SA investors holding more than 25% of the share capital of the FCIS would qualify for the section 10(1)(k)(ii)(d) exemption.

Capital gains tax

Having CGT paid outside of the unit CIS vehicle that unit trust portfolio managers can focus on their core business of managing an investment portfolio according to a mandate, rather than being distracted by tax issues. This could result in more focused and better investment performance. The CGT rate applicable to individual CIS investors could be as low as 4,5% depending on the investor's marginal tax rate or as high as 10,5%. Investors are empowered to decide when to become liable for CGT, allowing them to defer tax and to plan their investments appropriately. Relief measures such as the R10 000 exemption and the offsetting of losses against gains, can also be used.

Accordingly, CGT policy is in line with the objective of a CIS as a medium- to long-term savings and investment vehicle and should encourage CIS investors to treat them as such. You could, for example, not pay CGT for as long as 20 years, if you hold onto your investment. Unit trust investors should, however, not become obsessed with not paying CGT, thereby losing sight of their overall investment objectives. All local and foreign unit trusts will be subject to CGT, except for money market funds, which have a fixed price and which generate income rather than capital gains or losses.

It is recommended that the unit holder consults a tax expert or financial adviser prior to using the alternative base cost methods.

Non-tax factors

It must be pointed out that investors should not base their investment decisions entirely on the tax consequences – there are several other objectives which must also be borne in mind. For example, risk tolerance, return requirements, liquidity, inflation and time horizon.

Diversification by way of globalisation of portfolio

Diversification is the key to successful investing. Being exposed to only one country or one market is risky and is not a prudent investment strategy. With globalisation an investor is spreading its risk across different countries, currencies, economic sectors, industries and companies. Furthermore, there is a vast array of leading international companies which are not available in SA. CIS vehicles are, therefore, a simple and effective way of accessing foreign markets to broaden the base of an investment portfolio while reducing risk over the long term.

Flexibility

In selecting an investment, one will obviously look at crucial areas such as risk and return after costs, but flexibility is a key area for any investor. CIS's are flexible as they have no minimum investment term and are easy to buy and sell. Unit trusts are an ideal way to achieve capital growth with minimal taxable income. The investor has the freedom to switch between funds and even stop investing for a while without being penalised.

Laws and regulations

The taxpayer must take any legal constraints, such as trust deed provisions, CIS Act, etc, into account when compiling its portfolio. The domicile of a FCIS is important because the way a scheme is regulated differs from one jurisdiction to another.

Investment prudence

Investors should balance their investment exposure across a spread of equity, property and cash investments. It is always a prudent strategy that one third of a portfolio should be invested in the property market (for security), one third in the equity market (for capital growth), and one third in fixed interest investments (for low risk).

Direct versus indirect investment

Investors must weigh-up the merits of participation in a CISS against direct investment in a portfolio of shares. The disadvantage (for the skilled investor) of participation in a CISS is loss of control over portfolio selection. The advantage to skilled and unskilled investors alike is a deferral of CGT until participatory interests are sold.

13. Conclusion

Collective Investment Schemes have been one of the most significant developments in financial intermediation during the past few decades. OECD³¹ data indicates that CIS assets have been rising sharply as a share of national income and a share of financial assets in most member countries. In addition to functioning as an effective vehicle for individuals to implement their preferred investment strategies, CIS already play a major role in providing for retirement income. This role is likely to grow in coming years, as increased responsibility is placed on the average citizen, as opposed to governments or companies, in meeting critical needs such as education, retirement and health care. In this context, CIS can be used, either alone or in combination with other forms of institutional savings, such as pension funds and insurance products, to enable individuals to meet their financial planning goals.

The concept underlying CIS is simple. Whatever its legal form, a CIS is a form of institutional investment through which individuals pool their funds and hire professionals to manage their investments, with each investor entitled to a proportional share of the net benefits of ownership of the underlying assets. The operation of a CIS manifests itself inside an established legal, regulatory and market framework. In SA this control is exercised via the CIS Act.

A CIS as an investment vehicle is not exclusively used by small investors, sophisticated individual investors and institutional investors also use CISs. It is therefore important for both investors and CIS vehicles alike to have a clear understanding of the SA tax issues and consequences relating to collective investment. This analysis sought to put this in perspective.

The relevant SA domestic legislation was first considered, namely: income tax, capital gains tax and tax on retirement funds. Each tax discipline was scrutinized with a view of identifying the relevant collective investment aspects of the domestic legislation, followed by a brief discussion and or comments on the aspect in question. Some common law principles were also visited, specifically those in relation to trusts. The analysis segregated the various collective investment scheme forms (i.e. in securities, in property, in participation bonds, a scheme so declared and foreign schemes) and looked at the impact of tax law on each, specifically in relation to the vehicle itself, resident and non-resident investors. Current law interpretation difficulties as to the classification of income generated via collective investment schemes in securities in the context of the RFT Act were discussed in a case study.

As highlighted, the taxpayers face a myriad of tax issues. Some of the aspects are extremely complex, for example, the conduit principle, dividend rules, gross income, exemptions, the CFC attribution rules, foreign currency rules, capital gains tax, etc. Planning is even made more complex by the fact that the form of investment vehicle has different tax consequences, i.e. trust versus an open ended investment company. Where a foreign CIS is employed it represents additional implications, for example the tax treatment of 'roll-up' funds. The analysis concluded by highlighting certain planning aspects for taxpayer in the collective investment arena.

³¹ OECD. *White Paper on Governance of Collective Investment Schemes (CIS)*. OECD 2005

This report does not claim to be an exhaustive summary on the subject, because the issues involved are too vast and too complex and must be considered on a case-by-case basis. It merely attempts to provide a good understanding of the many issues regarding collective investment.

The new CIS Act came a long way in regulating the SA collective investment industry on a world-class basis and by promoting new investment vehicles. At the same time it is also recognized in industry circles that current tax law does not complement these revolutionary changes, as there is a clear lack of an adequate regulatory tax framework to deal with the implications of the CIS Act³². As with most South African tax rules, the tax rules for collective investment schemes are complicated and quite often inconsistent or anomalous. As it stands, the SA tax rules are not conducive to have a CIS in the form of an OEIC. The tax treatment, both for income tax and CGT, will be unfavourable, if not discriminatory, when compared to a trust form. The fundamental tax difference is that the tax burden will be borne mainly by the investors if the CIS is constituted as a trust, and by the CIS if it is constituted as an OEIC. Surely, the latter is not the intention of a CIS – the intention is to have the underlying income of the CIS taxed in the hands of investors where it retains its nature and character. By allowing the creation of open-ended investment companies, the CIS will help attract foreign investments because most offshore investors are familiar with how the OEIC works, particularly those in the European market. In the UK, for instance, a reduced rate of corporation tax applies to OEICs making the tax treatment of OEICs and authorized unit trusts (AUTs) virtually in all aspects the same.³³

In a letter³⁴ to National Treasury, the South African Institute of Chartered Accountants (SAICA) recommends certain changes to legislation in view of problems that the insurance and fund management industry experiences with foreign collective investment schemes: (1) the amendment of par (e)(ii) of the definition of 'company' in s 1 of the Act to clarify its application to a collective investment scheme; (2) the amendment of the definition of 'equity share capital' to clarify its application in the context of a FCIS; and (3) the amendment of par 43(4) of the Eighth Schedule to allow translation at the spot rate. The investor's tax position will then be matched by the cash flows of the investment and it will reduce the administrative burden of a management company to keep track of many different average rates for the various investors.

In conclusion, it can be said that the tax structures impacting on collective investment offers a minefield of opportunities and vulnerabilities. The opportunities are there for the taking. It is definitely not the case of finding a gaping loophole in tax legislation and exploiting it vigorously to save enormous amounts of tax. Unfortunately, in the words of Dale³⁵: *'...a loophole in tax which is too readily and obviously usable becomes not a loophole but a noose. It will be closed and the taxpayer will be unable to extricate himself.'*

The road to success in collective investment, from a tax perspective is, therefore, built on the bricks of clear objectives, correct planning, ethical business practices, expert advice and cognizance of all relevant international aspects of domestic tax practice and legislation.

³² Paul Ferreira. *Tax and collective investment schemes*. Tax Werks, Werksmans Attorneys, November 2002

³³ HM Revenue and Customs. Explanatory Note to the Finance Bill 2005: Clause 16: Open-Ended Investment Companies

³⁴ SAICA. letter to National Treasury dated 18 January 2005 headed '*Investments in Foreign Collective Investment Schemes*'

³⁵ Dale, H. *Tax Havens*, 1979, De Rebus, South Africa