5th Report - BASING THE SOUTH AFRICAN INCOME TAX SYSTEM ON THE SOURCE OR RESIDENCE PRINCIPLE - OPTIONS AND RECOMMENDATIONS

Chapter 1 - INTRODUCTION TO THE TAXATION OF INTERNATIONAL INCOME BY USING THE SOURCE AND RESIDENCE PRINCIPLES OF TAXATION

When a country's own citizens or residents transact business or invest abroad, or foreigners trade or invest within its domestic jurisdiction, the tax system as it affects these activities needs to balance carefully domestic and international economic objectives. On a global basis, countries need to maintain orderly tax regimes to promote international trade, and there is a need for accepted rules and conventions limiting any one country's rights to tax its own citizens or residents operating or investing abroad, or the citizens or residents of other countries doing so in its own jurisdiction. Two mainstream principles or bases which have developed for this kind of "international" taxation are respectively the *source* and the *residence* bases. On the international level, these are then amplified by a network of bilateral Double Tax Agreements which seek to remove any remaining potential conflicts and to eliminate the danger of taxing the same income twice.

1.1 DEFINITION OF THE RESIDENCE PRINCIPLE

1.1.1 Under a residence system income which accrues to a resident of a country should be subject to the taxes of that country. In the case of the United States, all citizens, even if not resident, may be so subject on their worldwide income; this is an exceptional position, and the possibility of basing tax on citizenship is not considered further in this report.

1.1.2 The basic rationale of a residence basis of taxation has been contrasted to that of a source based system in the following terms by the Appellate Division (*Kerguelen Sealing & Whaling Co., Ltd v CIR,* 1939 AD 487, 10 SATC: 363):

> "*In some countries residence (or domicile) is made the test of liability for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is 'source of income'; again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. In both systems there is, of course, the assumption that the country adopting the one or the other has effective means to enforce the levy.*"

1.1.3 A less convincing argument is that resident taxpayers should all be subject to the same tax system since they live in the same country. The latter argument ignores the fact that the income in question is generated under substantially different circumstances in other jurisdictions. The differing tax treatment in the foreign country is usually related to the particular circumstances pertaining to the taxpayers operating in that system, for example low tax rates often compensate for poor infra-structure or other deficiencies in order to attract investment.

1.2 DEFINITION OF THE SOURCE PRINCIPLE

1.2.1 Under a pure source system income is taxed in the country where that income originates, regardless of the physical or legal residence of the recipient of the income.

1.2.2 In addition to the motivation emphasising enjoyment of the source country's resources as noted by the Appellate Division in the Kerguelen case, a source system is also motivated by the degree to which it ensures fair competition between taxpayers in the particular jurisdiction and taxpayers (competitors) from other jurisdictions.

1.2.3 The primary right of the "source" country to tax "active" business income is widely recognized internationally and soundly anchored in the principles underlying double taxation agreements - even where the taxing country has a residence system.

1.3 APPLICATION OF THE RESIDENCE AND SOURCE SYSTEMS – INTERNATIONAL TRENDS

1.3.1 Nowhere in the world are either of these systems applied with any degree of purity.

1.3.2 In terms of double tax treaties, and in many instances under the national regimes of residence based countries, these countries are generally required to exempt income generated in the other contracting state or to provide a credit for the tax imposed in the source state. Accordingly, all residence based systems still tax non-residents on income sourced within their jurisdictions.

1.3.3 Countries with a source system have gradually extended the scope of their taxes by statutorily deeming certain types of income (especially of a passive nature) to be sourced within their jurisdictions, and therefore to be subject to tax there. (They then, too, grant relief to their taxpayers for taxes suffered in the source jurisdiction.) The arguments in favour of taxing passive income generated abroad are more pragmatic than convincing. Essentially, it is argued that the state of residence of the taxpayer has enabled him to accumulate capital (to lend offshore), to develop intangible property (to license offshore), or to acquire a capital asset (to lease offshore), and that the taxpayer does not actively use the infra-structure of the other state where another taxpayer uses the capital or asset.

1.3.4 Both these systems, albeit in hybrid form, are strongly represented amongst the tax systems of the world. In Latin America there is still a strong territorial sentiment, although fairly recently both Brazil and Argentina changed over to a residence based system. In the case of Argentina, the Commission had evidence from various sources that the change, introduced by way of a few cryptic lines of legislation in 1992, is as yet unsupported by any form of regulation or detail resulting in serious problems. Malaysia also experimented with both systems. From 1948 to 1967 the country's tax system was territorial, with a remittance basis. In 1968 it changed to a worldwide system, but this lasted only until 1973 whereafter it reverted to the territorial basis.

1.3.5 International bodies are also pointing towards territoriality or source as a favoured system. In 1955 the International Chamber of Commerce changed their earlier support for a word-wide basis of international taxation to suggest that the source country should have 'the sole right' to tax international income. At its 1984 Buenos Aires conference the International Fiscal Association pointed out the economic disadvantages of worldwide taxation. The Association went on to recommend 'a system of territorial taxation or exemption', and appealed to governments who had adopted the worldwide basis to reconsider their positions.

1.3.6 While the academic debate continues, the ultimate result of the two systems is not that different once all the exceptions and compromises are recognised. The system appropriate to a given country often is dictated more by other factors such as economic strategies, net cross-border capital flows, the relative sizes of the national and domestic economies, relative tax rates, history, and administrative capacity.

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CHAPTER 2 - SOUTH AFRICAN HISTORY AND BACKGROUND

2.1 HISTORY OF INVESTIGATIONS

2.1.1 The first income tax laws in South Africa were based on the principle that tax would be levied only on income sourced in the Union. Since then, several investigations into the advisability of this system have been made. In 1951 the Steyn Committee[1] recommended that the source basis of taxation be retained. Its reasoning was based mainly on the perceived complexity of changing to a residence system, and the fact that it did not foresee a material impact on revenue.

2.1.2 The Franzsen Commission[2], on the other hand, recommended the opposite in 1970. Its main arguments were that more income was beginning to flow into South Africa without being taxed, South Africa's major trading partners were on a worldwide basis, the worldwide basis enhanced the individual's ability to pay, and the Income Tax Act had already deviated from a pure source basis through the introduction of various deeming provisions. The Government in a subsequent White Paper accepted these recommendations, subject to further study on various aspects. This intention to change to a worldwide system was never pursued.

2.1.3 The Margo Commission[3], which reported in 1986/87 also reviewed the whole issue comprehensively. It recommended that, subject to the possibility of extending some of the then existing source deeming provisions, the source basis should be retained. It highlighted two reasons which would militate towards a residence basis:

(i) If exchange controls were lifted, a worldwide basis might be instrumental in curbing consequential tax avoidance; and

(ii) The "independent national states" that then existed (and to some extent the existence of other countries in the rand monetary area) exposed the system to schemes of avoidance, and a worldwide system would help counter this.

2.1.4 At the same time, the Margo Commission noted some considerations in favour of retaining the source basis:

(i) It considered that legislation for and the administration of a worldwide system would be considerably more complex than the system then pertaining;

(ii) While income inflow from off-shore was increasing, the failure of a source system to tax such income made relatively little difference to the yield as in terms of international convention, South Africa would have to grant credit for the foreign taxes already paid; and

(iii) The fiscal benefits that might be derived from a worldwide basis would be reduced as and when the South African tax rates were reduced.

2.1.5 In conclusion, the Margo Commission advised that the disruption caused by a change would not be justified by the possible benefits. The Government White Paper following the report accepted the recommendation. In consequence, the current position is that South Africa still bases its tax system on the source principle, although over the years the hybrid nature of the system has grown through deeming provisions as to source, especially in the passive income arena.

2.2 SOUTH AFRICAN BACKGROUND FACTORS

Various factors have a bearing on what may be an appropriate system for South Africa.

2.2.1 An Open Economy

In 1987 the Margo Commission reported (in para. 26.2):

"*The Republic has an open economy and seeks to create an environment that will attract investment and facilitate trade. A hospitable fiscal environment is seen as an integral part of such endeavours. Transnational corporations are making valuable contributions to the growth of developing countries through their inputs of expertise and capital, and they should be encouraged.*"

Since then, the democratisation of South Africa has triggered a dramatic increase in the reintegration of the South African economy with the global economy, and this process should continue.

2.2.2 Protection of Financial Capital and Human Skills

While foreign investment in South Africa and South African trade with and investment in other economies remain a vital part of any growth strategy, outward investment must not become a long-term export of South African financial capital and skills. Instead, it should form another platform for South African economic growth, centered around an influential, locally based multi-national sector.

2.2.3 Exchange Controls

South Africa still has exchange controls over residents. Government policy is that the controls should go, but this is likely to happen by gradual process rather than as one dramatic measure. Certainly, as the controls are lifted, South African residents are increasing the off-shore element of their investment or operations. The Commission heard contradictory evidence as to the likely investment patterns that would emerge when controls were lifted, but the differences seemed to be more of degree than of kind. Most agreed that there would be some net capital outflow, especially immediately after major relaxations. Although factors like the rate of exchange, the real return on investments, and the gradualism in relaxing controls would influence the suddenness of movement, it seems likely that the flow of income to South Africa will increase. Approval for operational or real investment by South African businesses off-shore is already being granted more readily by the exchange control authorities, and the Commission received little evidence of a likely major outflow of direct investment capital.

2.2.4 Capital Flows

Disregarding any short term capital flows immediately after exchange control relaxation, South Africa, as a developing country, is likely to remain a net capital importer for a considerable period. Nevertheless, it will be fully subject to the international phenomenon of both financial and human capital having become much more mobile than ever before.

2.2.5 Regional Headquarters Base

South Africa's current source based tax system positions it well as a head office, finance or management company location for investment into Africa north of its borders. With the expectation of an important South African role in regional or even continental economic revival, this will impact on South African investment into Africa, and non-African investment into the continent via this country with its relatively developed financial structure and other infrastructural advantages.

2.2.6 Treaty Network

Since 1987, South Africa has dramatically increased its network of double taxation treaties. With the exception of the United States and Japan, the country now has treaties with most of its major trading partners (the treaty with the USA has been signed and negotiations with Japan and Australia have commenced).

[1] *First Report of the Committee of Enquiry into the Income Tax Act* (The Steyn Committee Report), UG No. 75-1951 (Pretoria: The Government Printer), para. 68, p. 19.
[2] Commission of Enquiry into Fiscal and Monetary Policy in South Africa (The Franzsen Commission Report). *Taxation in South Africa: Second Report.* RP 86/1970 (Pretoria: The Government Printer 1970), para. 20.
[3] *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (The Margo Commission Report), RP34/1987 (Pretoria: The Government Printer 1987), para. 26-3.

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CHAPTER 3 - POLICY OPTIONS - OBJECTIVES AND AN OVERALL APPROACH

3.1 CONSIDERATIONS RELEVANT TO BASING THE TAXATION OF INCOME ON EITHER THE RESIDENCE OR THE SOURCE PRINCIPLE

Several objectives for a new system were advanced in evidence by various parties. Conflicts amongst these are inevitable, but a balanced system would seek to find the optimal compromises. The Commission believes that the following objectives should be accommodated to where feasible.

3.1.1 Generation of tax revenue

3.1.1.1 The primary function of the tax system is to raise revenue for the state. With the mobility of capital in the modern world, the evidence is that once relevant exchange controls are lifted, South African residents, including the institutions, will make considerable passive investments off-shore. From a purely revenue viewpoint, a worldwide system will therefore be more effective in securing the tax revenue on income from such investments.

3.1.1.2 Direct investment which relates to active business is dictated more by real commercial factors and is therefore less mobile. It is difficult to project the potential yield of a worldwide income tax system on active or business income. Unlike passive income, direct investment income cannot be switched in and out of South Africa or between foreign jurisdictions. While it is difficult after many years of foreign investment restrictions, both through exchange controls and through political factors, to predict the potential revenue loss on income from such direct investment, the lesser mobility will tend to slow down any tax-opportunistic export of capital. Most foreign countries tax the profits that derive from investments in their jurisdictions. Even if South Africa were to grant a credit for those foreign taxes (as opposed to exempting income already taxed), the gain to the fiscus would be restricted to the excess of South African tax over the source country tax. It was with this in mind that the Margo Commission commented in their report (para. 26.19):

"The fiscal benefits resulting from the introduction of a world-wide basis of taxation would be reduced if there were a reduction in South Africa of the individual and/or company rates of tax, as has been recommended by the Commission ..."

3.1.1.3 On an overall basis it is to be noted that, even if the residence/source options were fairly consistently applied, the revenue difference for South Africa would be small in view of the fact that the South African Gross National and Gross Domestic Products vary by only one or two percentage points.

3.1.1.4 The Commission concludes that, from the perspective of collecting revenue, adopting a residence or source basis will make little if any difference as regards direct investment (referring to active income), but that as regards passive investment, a residence or worldwide system will bring a revenue advantage.

3.1.2 Neutrality

3.1.2.1 Neutrality is a sound tax principle, but in the international context also has a particular competitive dimension which is important to South Africa.

3.1.2.2 An important criterion for an ideal tax system is that it should not influence business behaviour. In the international context, the literature sometimes distinguishes between "capital export" and "capital import" neutrality[1]. Export neutrality is seen as ensuring that the investor pays the same total income tax (domestic plus foreign), whether he receives given investment income from foreign or from domestic sources. Import neutrality is seen as ensuring that capital funds originating in various countries should compete on equal terms in the capital market of any country. According to these definitions, then, export neutrality would imply a word-wide system of taxation with foreign tax credit, and import neutrality a source based system, or one exempting foreign income.

3.1.2.3 Professor Klaus Vogel suggests that the differentiation is not that simple. He points out that export neutrality does not, in fact, achieve neutrality of competition in the country of the foreign investment[2]:

"*We cannot exclude, therefore, that to an investor the prospect of being taxed more heavily than his competitors in a low tax country may influence his decision (made in his country of residence) whether to invest at all in the foreign country. If so, even capital export neutrality is disturbed.*"

3.1.2.4 The main claim to neutrality (namely, capital export neutrality) of the worldwide system relies on keeping all domestic businesses on an equal competitive basis tax-wise, no matter where they operate internationally. Vogel develops the theme of non-neutrality of the word-wide system further by pointing out that, apart from tax, a variety of state-induced circumstances and administrative and other infrastructural variables operate to make such neutrality a myth.

3.1.2.5 In the South African context, where our tax rates are still higher than those of many of our trading partners, it means that South African business trying to compete abroad would, under a worldwide system, do so at a material tax disadvantage. This applies both to some of our traditional trading and investment partners like the United Kingdom (with a current corporate tax rate of 33%), and to the economically dynamic region of the Pacific Basin where several countries have substantially lower tax rates than South Africa. A residence based system would therefore put South African business at a competitive disadvantage in these and similar jurisdictions through a total corporate and/or individual tax rate well in excess of their levels.

3.1.2.6 Vogel concludes as follows on this matter:

"*Whether the distinction between capital export neutrality and capital import neutrality is accepted or rejected, taxation of direct investment in foreign countries is economically efficient only if the investor pays no more tax than is imposed on domestic enterprises in the same country in which the enterprise* *was established. This is consistent with a source-based taxation if 'source' is defined to be the place where the enterprise - or partial enterprise - established by direct investment is located. It is not consistent with a worldwide taxation of income, even if mitigated by a foreign tax credit*" (supra, 1988).

3.1.2.7 The Commission has noted the need for South African business to become reintegrated with the world economy. Such outward direct investment would not only result in the longer term inward flow of both technology and the income deriving from that investment, but it also often forms the channel through which the multinational's operations located in this country find access to international trade and technology. The competitive tax neutrality of South African direct foreign investment is therefore accepted as an objective of any new system, and is seen by the Commission as an important indicator in favour of a source based system as far as direct investment is concerned.

3.1.2.8 As concerns foreign direct investment into South Africa, the Commission also accepts tax neutrality as an objective. In its First Interim Report the Commission recorded its view that foreign investors should not be discriminated against, nor should they be favoured over domestic investors. As pointed out by Vogel (supra 1988), this is indeed one of the advantages of taxing foreign investors on a source basis.

3.1.2.9 The Commission therefore interprets the objective of neutrality as meaning that South African business competing off-shore, and off-shore business competing domestically, should in each case do so on the basis that the tax burden is neutral in the jurisdiction of direct investment. An important corollary is that such a neutrality favours developing economies. That is why Vogel states unqualifiedly that the source based system:

"*...benefits capital importing countries, which normally are poorer countries*" (supra, 1994).

3.1.2.10 This theme is supported by Leif Muten of the IMF, who argues that a worldwide system is economically detrimental, in particular to developing countries. Norman Ture argues the same and concludes that only the source system leaves the international flow of commerce and capital unaffected (see Vogel, supra, 1994).

3.1.2.11 The Commission concludes that the South African international tax regime should promote neutrality of competitive advantage for South African direct investment abroad, and equally for foreign direct investment in South Africa, as against domestic business. It concludes that a source basis is more likely to achieve these objectives.

3.1.3 Protection of South African Capital Base

3.1.3.1 South African multi-nationals trading in the world economy will only contribute to the wealth of this country for as long as they remain South African based. In a post-exchange control era, and in a world of mobile capital, a relatively higher South African tax rate may have a real potential to become a contributing factor to an emigration of financial capital and human skills through relocation of the ultimate holding location. The Commission received evidence from a broad range of South African businesses, both individually and through organised business structures, that such an emigration of resources would be a likely result of a residence based system for as long as our rates exceeded those in alternative jurisdictions.

3.1.3.2 The Commission concludes that, while our tax rates exceed those of material trading and investment partners, a residence based system will carry a real danger of promoting the export of South African financial and human capital, and contribute towards an under-developed South African multi-national sector.

3.1.4 Enhancing South Africa's role as an attractive base for regional investment

3.1.4.1 The current South African source based system makes it an ideal location from a tax viewpoint for the location of headquarter companies, finance companies, or with minor concessions even management companies, for investment into Africa north of our borders. Already there is evidence of this occurring. Protecting this advantage will not only benefit South Africa itself, but the entire region.

3.1.4.2 The Commission concludes that a source based system is favourable to the objective of establishing South Africa as a base for headquarter, finance and regional management companies.

3.1.5 International compatibility

3.1.5.1 It is accepted that South Africa's re-entry into full international trade is a major national economic objective. While the tax system should primarily be geared to raise revenue, it should do so in a manner that poses a minimum obstacle to the normal flow of cross-border commercial activity. The Commission accepts international compatibility of the system as a vital objective of any tax reform as regards the source/residence issue.

3.1.5.2 There are three possible dimensions to the international compatibility of a source system:

(i) *Exceptionality:*

It is sometimes suggested that a source based system puts South Africa out of step with the world, thus inhibiting its commercial efficacy. The Commission does not accept this notion. Most systems, the South African one amongst them, are in fact hybrids which come to much the same result in practical terms. Evidence presented to the Commission indicates that investors or trading partners are less concerned with the label given to the system than that the system should be clear and predictable in its effect on the taxpayer.

(ii) *Treaty Negotiations:*

It is sometimes claimed that a source basis of taxation compromises a country's position in double tax treaty negotiations. It is argued that the basic OECD Model Convention requires the source country to make substantial tax sacrifices and thus allows the residence country to tax the particular item of income. A country which does not impose tax on a residence basis is then said to have sacrificed its right to tax source income, without a corresponding ability to tax income which the treaty may allocate to the residence country.

This argument, however, ignores the fact that all countries which tax on a residence basis, also tax non-residents on a source basis. Furthermore, it ignores the fact that most of the countries which tax on a residence basis either provide a credit for foreign taxes paid or actually exempt income generated abroad.

It is also sometimes argued that a source system would, under typical treaty provisions, lead to an exemption from tax in both countries. This situation may occur in the following cases:

(a) In accordance with treaty rules relating to the taxation of business profits, such profits may only be taxed in the source country if the taxpayer carries on business through a permanent establishment in the source country. Usually, a permanent establishment is established through a presence in the source country of a fixed base which is used regularly. Under the current source system, it is theoretically possible that a South African taxpayer operates in the other country without creating a permanent establishment, i.e. qualifying for the exemption in the source country. Owing to our source based system, the taxpayer may also be exempt from tax in South Africa. However, such cases would be rare since it is unlikely that the dominant or even a material contributing cause of the income would be located outside South Africa if the taxpayer had such a limited presence or activity abroad. Under the proposed new system (see below), the ‘active’ income generated abroad would escape South African tax only if the taxpayer generated such income through the equivalent of a substantial presence abroad.

(b) The source country is required to reduce its withholding taxes on income (usually 'passive') paid to a resident of the other country: if South Africa is not entitled to tax such income in the hands of the resident recipient, the recipient would again enjoy either total exemption or very low taxation. While this may be true in a pure source system, the proposed taxation of passive income on a worldwide basis (see below) would remove such a problem. In extremely rare cases where such passive income is not subject to tax, there may still not result an actual loss of yield since expenditure incurred to generate the income would not be tax deductible.

Apart from the fact that South Africa today has negotiated treaties successfully with most of its major trade or investment partners, the Commission believes that any concerns as to a competitive disadvantage in double tax treaty negotiations are unfounded or would be addressed even further by the new system proposed in this report.

(iii) *Internationalisation of concepts and terminology:*

The third, and possibly most important dimension of international compatibility relates to the clarity of a country's tax laws as they affect foreign trade partners or investors, or South African business investing or trading abroad. The Commission therefore accepts such clarity as an important objective of tax reform. In the international tax context, an important aspect of that clarity is the use of internationally recognisable tax concepts and terms. In a world where the two concepts of residence and source based systems are so close in their practical impact, using internationally familiar concepts and terminology contributes more to the required international integration than the label carried by the system. This integration with international concepts will also enable the system to benefit with a minimum disruption from the continuing evolution of international tax, caused for example by the increasing impact of electronic communication (see Section 7.7 below).

3.1.6 Administrative effectiveness and feasibility

3.1.6.1 A system that cannot be administered effectively, no matter how effective in theory, can only bring about poor collection and ultimately a self-defeating disrespect for the law. In the international context such a system breeds uncertainty as to the tax outcome of business actions, and in itself becomes a deterrent to international investment and trade. In the international area as much as elsewhere, therefore, the Commission sets as one of the objectives of tax reform that the system can and will be administered effectively by the South African Revenue Service (SARS). The Commission also takes cognisance of the strain it would put on the administration especially as regards active income to change over now from a source based system to a residence based one.

3.1.6.2 As regards passive income, it is noted that such income is already the subject of quite wide-ranging deeming provisions as to source, as well as of various foreign tax credit provisions. Any refinements or extensions in this regard will therefore not impose a major additional complexity or administrative burden.

3.1.7 Uncoupling the tax and exchange control regimes

3.1.7.1 The possibility of a short - or long term outflow, particularly of passive investment, when exchange controls are lifted, has been referred to above. The Commission has commented on previous occasions that it believed exchange control policy should be determined independently of its tax implications, that is, the tax system should be able to protect itself against erosion of its base without reliance on an exchange control system. To the extent that complete freedom to make passive investments offshore may result in an outflow of such investments and may negatively impact on the South African tax base, the tax system should carry its own counter measures. Tax neutrality would indicate that investment decisions should preferably not be made with reference to tax considerations. With the mobility of passive investment that will come in a post-exchange control era, an ability to escape the relatively higher South African tax rates through simple off-shore passive investment would represent just such a lack of tax neutrality.

3.1.7.2 The Commission has considered whether the current deemed source provisions could be extended to provide for all cases where residents derive passive income offshore. However, this course of action in the past has created several problems and loopholes and the Commission believes that a worldwide system of taxation in respect of passive income would provide more effective protection to the tax system. It would bring the neutrality that would result in the required uncoupling of the tax and exchange control systems.

3.2 Basic characteristics of tax reforms proposed

In response to the factors analysed above and towards achievement of an appropriate balance between the objectives as stated, the Commission has developed an overall approach to tax reform in the international area. Several more detailed aspects are analysed in further sections of this Report. The basic characteristics of the system recommended by the Commission are summarised below.

3.2.1 The system should recognise a difference between "active" income (income deriving from direct, operational activity), and "passive" income (income which is derived from passive forms of investment, such as interest or royalties). This division is well recognised in modern international tax law.

3.2.2 "Active" income should continue to be taxed on a source basis. This will secure the objective of neutrality and equal competition for both inward and outward investment, protect South Africa's capital and skills, facilitate the headquarter company function, and take realistic cognisance of current administrative limitations. Combined with an effective worldwide system on passive income, an active income source basis will be internationally compatible, and can be made even more compatible through some of the measures suggested below. Revenue loss will be limited to that caused by tax rate differentials (which, as a matter of general policy, should not be allowed to go too far anyway), as well as through the lesser mobility of direct or active business as opposed to passive investment. Through facilitating South Africa's competitive participation in the global economy, the national goal of economic growth should be enhanced, and the overall result should be an improved tax yield.

3.2.3 "Passive" income should effectively be taxed on a worldwide basis. This will protect revenue insofar as investment which gives rise to passive income is highly mobile and may otherwise be exported or manipulated purely for tax reasons. It will also promote the required independence between the tax and exchange control systems.

3.2.4 In defining what "active" income is, international norms should be used, plus some degree of specific definition. Passive income will be all income which is not active income.

3.2.5 Appropriate anti-avoidance measures, with reference to international precedent, are necessary to prevent avoidance through re-characterisation of taxable income into non-taxable dividends or the deferral of taxation by accumulating passive income abroad. The Commission proposes that anti-avoidance measures should strike a common-sense balance between effectively curbing material abuse, and not burdening the system with complexity which will lead to failure.

3.2.6 No attempt at a detailed set of rules to determine the source location of active income should be attempted. Instead, guidelines which are generally used internationally, and especially in the treaty context, should be incorporated into our law. This will greatly enhance clarity and therefore international compatibility. Most deeming source provisions will become unnecessary and should be scrapped.

3.2.7 The current all-or-nothing approach of dominant source favoured by our courts should be replaced by a greater capacity in the system to allocate source. This should be accompanied by rules of allocation of related expenditure. Again, for the sake of international recognisability, the well-tried allocation methodologies of international tax law and tax treaty law should form the basis of these rules.

[1] Musgrave RA and Musgrave PB. 1972. " International Equity" in Bird RM and Head (Eds) *Modern Fiscal Issues,* page 63.

[2] See "World-wide vs. Source Taxation on Income - A Review and Re-evaluation of Arguments", first published in *Intertax* 1988 Nos. 8-11. Reference must also be had to his subsequent article, *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Community Law,* published by Kluwer: Erasmus University, 1994, Vol 2, Foundation for European Fiscal Studies.

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CHAPTER 4 - DEFINITION OF ACTIVE AND PASSIVE INCOME

4.1 GENERAL

4.1.1 The specific distinction between "active" and "passive" income has not been recognised explicitly in South African tax law. In circumscribing these basic concepts for a new tax system, it would be advisable to use concepts and interpretations which are applied internationally. This should promote certainty, in particular for foreign investors, but also for South African residents.

4.1.2 The tax concepts which are used in double taxation agreements have been developed by the international fiscal community over many decades. A substantial body of international commentaries has also been produced. The most relevant in the international tax arena is the Commentary by the OECD Committee for Fiscal Affairs on the OECD Model Double Taxation Convention on Income and Capital. In *Downing v SIR*, 1975 (4) SA 518 (AD), the Appellate Division acknowledged this Commentary as an important guide in interpreting concepts used in South African double taxation agreements.

4.1.3 The OECD Model Convention uses the concept "business income" in conjunction with the concept of a "permanent establishment" to describe the circumstances under which the "source" country may tax the income generated from economic activities within its borders. Such items of income could generally be regarded as "active" income as opposed to other items not generated through business operations carried on through a permanent establishment in the source country (such as dividends, interest and royalties). The latter items of income, as defined in the OECD Model Convention, could be regarded as "passive income".

4.1.4 Several other types of income are also separately dealt with in the OECD Model Convention such as pensions, income from shipping, income from immovable property, etc. However, the basic distinction as suggested above could be regarded as the overriding guide to determine whether an item of income should be regarded as "active" or "passive". This would require some legislative recognition of the OECD Model Convention concepts and definitions. The OECD Commentary on the meaning of "business profits" should also be given formal recognition as a guideline for interpretation.

4.2 ACTIVE INCOME

4.2.1 To provide more certainty, it would be advisable to list certain specific items of income which would be included in the concept of "active" income. The examples used in certain selected countries (mainly in their Controlled Foreign Corporation or CFC rules) have been analysed and the following provides an illustrative, but *non-exhaustive*, list:

(i) Income from agriculture and forestry;

(ii) Income from the buying and selling of goods;

(iii) Income from manufacturing, processing, assembling or installing goods/assets;

(iv) Income from construction activity;

(v) Income from the rendering of services;

(vi) Income from the mining or exploration of natural resources;

(vii) Income from a banking, broking or insurance business;

(viii) Income from the effective management of ships or aircraft; and

(ix) Income from the generation of energy.

4.3 PASSIVE INCOME

4.3.1 The Commission has considered whether any attempt should be made to define "passive" income separately and specifically, or to suggest instead that, once active income has been defined, anything outside that definition will automatically be "passive" income.

4.3.2 Discussions were held with Professor Vogel about the need to define "passive" income. Professor Vogel pointed out that the definition was introduced into the German Foreign Tax Act *(Aussensteuergesetz)* to counter abuse. Prior to the introduction, many taxpayers disguised "passive" income as "active" income by means of window dressing, for example by setting up a finance company in a tax haven with a basic office and personnel. It was generally very difficult for the tax authorities to prove that the finance company was not actually carrying on a bona fide "banking" or "active financing" business. Therefore, it was decided specifically to exclude such types of income (i.e. income with a so-called "capital investment" character) if the finance company was situated in a low tax jurisdiction. However, Vogel suggested that such anti-avoidance measures should not have been introduced under the circumscription of the "active" income exceptions, but should rather have been set up as separate anti-avoidance measures. (See further discussion of the German anti-avoidance rules in the Annexure).

4.3.3 It may well be advisable, therefore, for anti-avoidance provisions to list certain income items which would be regarded as passive income unless the taxpayer can show that such income was derived off-shore through permanent business premises, suitably equipped for the generation of such income. For example, if the taxpayer can prove that he is carrying on a genuine financing business (in line with the United Kingdom test outlined in the Annexure), the income derived from such activities would still be "active". There will thus be a rebuttable presumption that a related finance company derives "passive" income unless the taxpayer can satisfy the SARS that the finance company carries on genuine finance activities through a permanent establishment abroad, which constitute an active finance business.

4.3.4 The Commission has also considered whether "passive" income extracted by a South African parent company from an active foreign subsidiary should be regarded as "active" income as being merely a mechanism to repatriate the underlying active income of the subsidiary. Such an argument would however ignore the fact that such income flows can only be generated if the parent company actually makes either capital or fixed assets/intangible property available to the subsidiary so that the income is compensation for such use. The fact that the capital or assets are used by a related party as opposed to an independent third party should not change the basic characteristic of the income. Furthermore, the existence of independent legal entities should be recognised. An opposite view results in severe distortion of the basic distinction between "active" and "passive" income, and also creates serious inequity between taxpayers. It would also result in a bias in favour of investment offshore and thus distort commercial considerations for such decisions.

4.3.5 However, the Commission concluded that this case should be distinguished from the case where the offshore subsidiary develops an intangible asset or accumulates capital and subsequently licenses such intangibles or lends such funds to other entities offshore. Such income would be linked to an offshore active business and should thus also be treated as active. A potential mechanism to counter abuse is to provide that this "concession" would lapse if the active business which generated the intangible or capital is substantially downsized or terminated.

4.3.6 It would of course be important to introduce rules to ensure, for example, that taxable passive income is not routed via an off-shore company to create exempt dividends, or to avoid the accumulation of passive income abroad aimed at deferring tax. This and other anti-avoidance aspects are explored further in the Annexure to this report as regards the so-called Controlled Foreign Corporation and Foreign Investment Fund rules.

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CHAPTER 5 - DETERMINING THE SOURCE OF ACTIVE INCOME

Once it is accepted that active income will be taxed on a source basis, it becomes necessary to consider how source should be determined or located. Indeed, the Commission's instructions were cognisant of the confusion that often arises around the concept of source, and charged it with considering whether a statutory definition of source and its location would be advisable.

5.1 INTERNATIONAL EXPERIENCE

5.1.1 The Commission is not in favour of attempting a detailed definition of a phenomenon that can have as many variables as international commerce and investment in the hands of endlessly creative entrepreneurs. Even in the United States, with arguably the most detailed legislation in this regard, the attempt at codification has often run into trouble. A good example was the rule that sales income would be sourced where title of the goods passes. The passing of title, being a legal concept, was easily manipulated contractually so as to suit the tax needs of the contracting parties. The reaction of the American Law Institute on International Aspects of United States Income Taxation was interesting. The Institute suggested that the seller's country of residence should be regarded as the country of source (this position could have been justified on the basis that the US is a major exporter), but the aforesaid suggestion was qualified by stating that sales income should be considered to be sourced in the purchaser's country in any situation where "either a substantial sales activity is carried on in that country through a fixed place of business situated there, or, if the property in question is sold for use, consumption or disposition in the other country, ... at least a significant amount of activity is carried on through a fixed place of business in that country" (see Vogel, supra, 1988). This line of thinking has since found its way into American tax law in terms of the 1986 Tax Reform Act.

5.1.2 The Commission recommends against a detailed codification of general source rules, but suggests that consideration be given instead to introducing internationally intelligible principles which can then be interpreted according to the circumstances of each case.

5.1.3 Vogel points out that there is no universal definition or even understanding of the meaning of source. Yet, even in residence based systems, source remains a crucial concept where taxes are levied on non-residents, as well as where there are rules for granting exemption or foreign tax credit relief on foreign income on which their residents have been taxed.

5.1.4 In Common Law countries there tends to be a more formalistic approach, often elevating the place where a contract is concluded to being an important factor in determining source. Yet many of these systems, in their application, revert to some combination of activity and presence. As mentioned, the United States has even introduced these concepts into its legislation. The United Kingdom refers to the concepts of trading 'with' or trading 'within' the United Kingdom. Canada refers to the place of contract, but then looks at whether contracts are habitually concluded in the country.

5.1.5 Many countries explicitly incorporate the concepts of an activity linked with some form of permanent establishment into their law when it comes to what is often termed 'business profits'. Switzerland, France and Australia are examples. The French refer to the concept of an industrial or commercial activity which 'is exercised habitually' in a certain country. Many European countries attribute income to permanent establishments by treating them as if they were independent enterprises, using either separate accounting methods or formulae.

5.1.6 Finally, the entire international tax treaty convention on business profits tends heavily towards the concept of the right to tax relating to the degree to which business profits can be attributed or allocated to some or other permanent establishment within the taxing country. As such, the relevant terminology and methods of allocation have become an international language with an established meaning.

5.2 SOUTH AFRICAN ISSUES

5.2.1 Currently, South Africa's income tax system experiences several problems in the determination of source for active or business income. It is submitted that these problems inhibit the smooth flow of trade and investment across our borders. Some of the difficulties are listed below:

(i) There is no clear guideline as to the source of income generally, and particularly not of active or business income;

(ii) In our Income Tax Act (the Act hereafter) there are several deeming provisions on source with respect to active income, and not all of these enhance definition and understanding, or any sense of underlying logic. Some examples are as follows:

- Section 9(1)(a) - This highly formalistic provision which deems the proceeds of a sales contract to be sourced where the contract was 'made', was the subject of criticism by the Margo Commission. Subsequent governments have not reacted to the criticism. The Commission is of the opinion that the provision is an example of lack of clarity, and futility - very similar to the United States' 'passing of title'. It is easily and formalistically circumvented, and has little to do with any real substance as to where the real cause of the proceeds may have been located;

- Section 9(1)(d) - This provision seeks to extend the source of active or business income and has become all but unused in view of restrictive court interpretations of its terms. As will appear, it also runs counter to the notion proposed in this report;

- and Section 9(1)(d)bis - This provision extends the source of proceeds from the rendering of personal services and is another example of a formalistic measure which is easily avoided.

(iii) In theory, a non-resident who derives any income from a South African source, even if only in the course of one day, is subject to tax thereon. This is mostly unenforceable and a whole regime of non-enforcement on short-duration income has come into existence; this undermines compliance enforcement generally, and encourages non-compliance even beyond the de minimis situations; and

(iv) Although our courts have more than once recognised the possibility that a given stream of income may have multiple sources, in every instance they have then continued to find a dominant source. This adherence to an uncodified system of dominant source has contributed to an all-or-nothing approach which can be abused, which poses a serious concern to off-shore investors, which creates uncertainty to South Africans trading off-shore, and which often results in a tax consequence not in line with the realities of international trade.

5.3 RELATING INCOME TO A 'PERMANENT ESTABLISHMENT'

5.3.1 The Commission recommends that the international trend, both in various national legal systems and in international tax treaty law, of liability to tax arising from identification of a permanent establishment should be formally introduced into South African tax law. Taxability of cross-border active income will therefore be determined by the interaction between two basic concepts - presence (through a permanent establishment), and activity. When, and to the extent that, active income generated by the activity can be attributed to the permanent establishment, it should be taxed in the jurisdiction where that permanent establishment is located. This should be applied both as regards inward and outward trade. The OECD Model Convention would provide the basic concepts and terminology for the legislation but the Commission recommends that the scope be extended to cover situations described in the United Nations Model Double Tax Convention. Essentially, the latter Model allows the source country more latitude to impose tax on the residents of the other State.

5.3.2 A resident who has a permanent establishment outside South Africa will not be taxed on any active income attributable to that permanent establishment. At the same time, a non-resident will not be taxed in South Africa on active income if that active income is not attributable to a permanent establishment in this country.

5.3.3 This approach will have the following advantages:

(i) It recognises the fact that there is a distinction between trading with a country and trading in a country, and that the former does not necessarily give South Africa the right to tax income;

(ii) It creates certainty in that non-residents will easily recognise a familiar terminology which is supported by an extensive body of international law;

(iii) It recognises the fact that it is difficult to tax a non-resident who is in this country for a short period;

(iv) It facilitates the decision as to the source of the income for South African residents carrying on business abroad;

(v) Since the permanent establishment rules will be drafted in accordance with the United Nations Model Convention, that is, in such a manner that the requirements for a permanent establishment are easily met, South Africa would be in a position to relax these requirements when it negotiates treaties with foreign jurisdictions; and

(vi) It is an equitable basis of levying tax.

5.4 DEFINITION OF 'PERMANENT ESTABLISHMENT'

It is recommended that the definition of 'permanent establishment' contained in the United Nations Model Double Tax Convention should be used as basis for the definition in our law. This definition is preferred above that contained in the OECD Model Tax Convention as it allows the source country a wider scope to impose tax on the non-resident. It also enables our treaty negotiators to be in a position to negotiate concessions with other countries, or allows them to offer some benefits to residents of countries which have concluded treaties with South Africa. The definition as proposed would need to be qualified in a number of minor respects. Two may be highlighted:

(i) The degree of 'fixedness' implicit in the treaty definition is no longer appropriate in the light of modern trade practices; and

(ii) Some initial 'time cut-off' is desirable before the existence of a permanent establishment would result in taxability, so as to prevent unenforceable short periods from perverting the system as a whole.

5.4.1 A "place"

5.4.1.1 While the concept of some relevant presence needs to be retained, the Commission feels that the degree of 'fixedness' required by the treaty definition does not recognise the technological advances which have made possible facilities such as the 'mobile office'. It therefore recommends that the definition be adjusted by removing the requirement that there be a 'fixed' place of business, and that in its place be put the requirement of a business facility 'suitably equipped' for the particular business.

5.4.1.2 This concept, again, is not new in international tax law. Germany and the United Kingdom offer useful precedents.

5.4.2 A "period"

5.4.2.1 All systems that have incorporated a time dimension to indicate when income may become taxable have in mind some degree of permanency: a period beyond a mere incidental or very brief presence. The same applies to international tax treaties. This concept of some period of presence being required coincides with one of the philosophical platforms of a source based system, namely that the person deriving income from a source within the taxing country's jurisdiction is enjoying the legal, physical or economic infrastructure of the host country.

5.4.2.2 The Commission recommends that a place of business be regarded as a 'permanent establishment' only once the facility has existed in the relevant jurisdiction for a minimum of, say, 3 months (or 92 days). Such a limitation should be determined per fiscal year. For South African residents operating off-shore, the requirement should also be overall as opposed to being subjected to a by-country test. The period should not need to be continuous. The overall test should be the use of a suitable business facility through a more-than-temporary presence off-shore.

5.4.2.3 More detailed rules will have to be developed around the definition. For example, if it was envisaged at the outset that a taxpayer would not have a permanent establishment, but he is found subsequently in fact to have established one, he would be deemed to have had such an establishment from the outset. Rental of facilities should also give rise to a permanent establishment if the rental period exceeds a certain period, for example 3 months. Any activities connected to this activity should be subject to tax in South Africa (as source or host country), e.g. the supply of maintenance services.

5.4.2.4 The reason for this cut-off period is two-fold. First, it is simply a pragmatic measure that brings the law in line with the reality that very short periods cannot be policed - in effect it recognises a kind of de minimis principle. Secondly, such a cut-off period can be justified with reference to the argument that income earned during such short periods is unlikely to have utilised to any material extent the capital and infrastructure of the temporary location - it is therefore in line with the basic philosophical justification for taxation on the basis of source.

5.4.2.5 Normally, the definition of a permanent establishment in international tax treaties includes the following:

(i) Place of management;

(ii) A branch;

(iii) An office;

(iv) A factory;

(v) A workshop;

(vi) A mine, an oil or gas well, a quarry, or any other place of extraction of natural resources (including the exploration of such resources whether on or offshore);

(vii) A building site, a construction, assembly or installation project or a supervisory or planning activity connected therewith if it lasts more than three months. (It might be advisable to deal specifically with associated services to ensure that they are also taxed if the contract extends beyond the specified term. This may include the rental of substantial equipment or machinery where this is being used for more than a specified period.); and

(ix) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if the activities of that nature continue (for the same or a connected project) for a period aggregating more than three months within any one fiscal period.

5.4.2.3 The treaty definition of a 'permanent establishment' specifically excludes a list of activities such as:

(i) The use of facilities solely for the purpose of storage or the display of goods or merchandise. It is noted that the UN Model Convention does not include the delivery of goods in this section whereas the OECD Model Convention does;

(ii) The maintenance of a stock of goods or merchandise solely for the purpose of storage or display;

(iii) The maintenance of a stock of goods or merchandise solely for the purpose of processing by another (unrelated) enterprise;

(iv) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information;

(v) The maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise any other activity of a preparatory or auxiliary character; and

(vi) The maintenance of a fixed place of business solely for any combination of activities mentioned provided that the overall activity resulting from the combination remains preparatory or auxiliary in nature.

5.4.2.4 These activities are exempt to the extent that the activity itself does not form an essential and significant part of the activity of the enterprise as a whole. For example, an after-sale service would not fall to be excluded as it would be regarded as an essential and significant part of the business. This exemption typically does not apply to an entity which has a place which engages in sales as opposed to merely delivery.

5.4.2.5 It is recommended that these or similar exemptions be listed in the Income Tax Act to enhance certainty in these typical cases.

5.4.2.6 A taxpayer will not normally be regarded as having a 'permanent establishment' if he carries on business through a broker, general commission agent or any other agent of independent status (i.e. independent both legally and economically) provided that other person is acting in the ordinary course of his business. However when the activities of such an agent are devoted wholly or almost wholly to servicing that enterprise, i.e. if he is legally or economically dependent, he will be considered a dependent agent.

5.4.2.7 Where a person other than an agent of independent status is acting on behalf of another person and habitually exercises an authority to conclude (negotiate) contracts in the name of the other enterprise, that person will be deemed to constitute a 'permanent establishment'. Where that person does not have the authority to conclude an agreement but habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, he will be deemed to be a 'permanent establishment' of the latter.

5.5 ATTRIBUTION - MULTIPLICITY OF SOURCES AND THE APPORTIONMENT OF INCOME

5.5.1 A tax regime where taxability arises by virtue of an activity carried on through a presence in the taxing jurisdiction carries with it the inevitable notion of allocation of income to that presence. Only income allocable to the permanent establishment should therefore be drawn into the tax net.

5.5.2 Furthermore, the Commission believes that the tendency in South African law to find a dominant source should be replaced by a system of allocation between two or more contributory sources. The practical result of the current tendency of taxing according to a dominant source results in an "all-or-nothing" type gamble which is not in accordance with typical reality and poses a major concern to foreign investors. The concept of apportionment has been recognised by our Courts (see CIR v Tuck - 1988(3)SA 819(A) - which decision was justified with reference to CIR v Lever Brothers & An - 1946 AD 441). The principle of apportionment as raised in the Lever Brothers case may thus be regarded as authority for the apportionment in determining source issues, notwithstanding the fact that Tuck's case dealt with the distinction between the capital and revenue nature of income. However, to achieve more certainty in determining the source of income, the Commission recommends that the principle of apportionment with respect to the source of income be enshrined in our law in such a manner that our Courts will be obliged to apportion income between its various sources.

5.5.3 The Commission recommends that the well-known example of international tax treaties be followed:

(i) There shall be attributed to each activity the taxable income which it may have been expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the other parts of its business;

(ii) In determining the taxable income the local operation will be allowed to claim as a deduction expenses which are incurred for the purposes of the local operation including executive and general administrative expenses so incurred; and

(iii) The taxable income will be determined by the same method year on year unless there is good and sufficient reason to vary the basis.

5.5.4 Where a non-resident has a 'permanent establishment' in South Africa, but derives other profits that are not attributable to it, the question arises whether those profits should also be taxed by virtue of the permanent establishment. An argument in favour of such a proposition is that the requirement of a permanent establishment is something of a concession, and not one required by the non-resident who already has some more established presence here. On the other hand, this would conflict with the notion that income should not attract tax in a jurisdiction where there is no real reliance on the host country's infrastructure towards the earning of that income. The Commission believes that there is little real income that turns on this question, and that non-taxability of income not allocable to the permanent establishment is the preferred route. However, it should be clear that the onus is on the taxpayer to prove that any given item of income cannot so be allocated to the existing permanent establishment, and full disclosure of all income should be legally required so that a proper determination can be made.

5.5.5 The UN Model Tax Convention specifically stipulates that no deduction shall be allowed in respect of amounts, if any, "paid" by the permanent establishment to the head office or any of its other offices (in law, within the same legal entity) by way of royalties, fees or other payments in return for the use of patents or other rights, or by way of commission for specific services, or for management, or by way of interest on moneys lent to the permanent establishment. Likewise no account shall be taken of amounts charged (other than the allocation of actual expenses) by the permanent establishment to the head office or other offices by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services, or for management, or by way of interest on moneys lent to head office or any other offices. In denying a deduction for such notional expenses, these rules are in compliance with our present law, and it is recommended that they should be retained. This does not, of course, contradict the procedure, as contemplated in the Model Treaties, that in determining the profits to be allocated to a permanent establishment, these notional expenditures should be considered as if the branch and head office were separate entities. Furthermore, it does not prevent the allocation of any third party expenditure, incurred by one of the offices for the benefit of the other office, to that other office.

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CHAPTER 6 - IMPORTANT CONSIDERATIONS WITH REGARD TO THE TAXATION OF PASSIVE INCOME

6.1 RESIDENCE STATUS

Despite the recommendation that the South African income tax system should continue to tax active income on the source basis, the taxing of passive income effectively on a worldwide basis would still require a definition in South African law as to the meaning of 'residence', both for individuals and for juridical persons.

6.1.1 Natural persons

6.1.1.1 The Commission believes that the concept currently used in our law of 'ordinarily resident' is well understood and, subject to the qualification in the next paragraph, should be retained.

6.1.1.2 Where, under current rules, it is not possible to establish any one single place of residence for a natural person, it is recommended that his or her residence status be determined in accordance with the tie-break provisions as contained in the OECD Model Tax Convention. This presents a solution for an otherwise difficult problem which is both practical and internationally familiar.

6.1.2 Persons other than natural persons

6.1.2.1 The current definition of a domestic (read "resident") company is a company incorporated in South Africa, or a company "managed and controlled" in South Africa. The main criticism of this definition is that it has proven subject to relatively simple, formalistic manipulation. This concept is also out of line with the commonly used, and much more substantial, tax treaty expression of "effective management". The Commission recommends that the concept of effective management as referred to in Article 4(3) of the OECD Model Tax Convention be used consistently to designate the tax residence of persons other than natural persons. This may perhaps be best achieved through an appropriate definition in Section 1 of the Income Tax Act. Again, the change will have the benefit of employing international and, therefore, commonly understood terminology.

6.2 INTEREST

6.2.1 Interest flowing into South Africa

6.2.1.1 Investment capital is highly mobile and can be moved easily in and out of jurisdictions not only with reference to commercial investment criteria, but also according to tax advantages. That is why most tax systems tend to tax interest on a worldwide basis. Due to exchange controls, South Africa has so far not been exposed to any material tax driven outflow of domestic capital. Consequently, only a limited degree of protection against movement of capital from the South African tax jurisdiction has been required. The essential provision is section 9(3) of the Act which deems certain bank and similar deposits off-shore to give rise to South African source income.

6.2.1.2 To counter the avoidance of this and other deemed source provisions, South Africa introduced its own so-called "Controlled Foreign Corporation"(CFC) rules under section 9A of the Act. These provisions deal with the situation where deemed source income is routed through a company in a neighbouring country (including Botswana, Lesotho, Namibia and Swaziland) so as to convert the income to tax free dividends. Because most of these territories (except Botswana) fall within the Rand Monetary Area, the combination of no exchange controls and, in some cases, favourable tax regimes, combined towards a capital outflow to these jurisdictions; therefore, effectively a "region-wide" system was imposed. The same kind of avoidance can be expected should South Africa now lift controls over South African residents investing off-shore. Again the only proper answer is to expand the anti-avoidance provisions to ensure that all forms of passive income are taxed on a worldwide tax basis.

6.2.1.3 The Commission commented in its Second Interim Report that the tax system should protect the tax base independently of any exchange control measures. Failure to ensure this would make exchange controls hostage to deficiencies in the tax system. The Commission therefore recommends that, subject to any other applicable exemptions or provisions of the Income Tax Act, all interest received or accrued by South African ordinary residents or resident companies should be subject to tax.

6.2.1.4 To counter the avoidance of such taxes by routing income through offshore entities, the CFC rules embodied in section 9A of the Income Tax Act need to be expanded to cover all offshore entities. As in the case of a permanent establishment, interest received or accrued by an off-shore permanent establishment which is not effectively connected with the business and operations of that permanent establishment will be subject to taxation in the hands of the South African resident; i.e. it should not be possible to escape taxation by merely flowing funds through a permanent establishment.

6.2.1.5 The Commission also recommends that for purposes of any provisions pertaining to cross-border interest, whether pertaining to an inflow or an outflow, the concept "interest" should carry the meaning ascribed to it in section 24J of the Income Tax Act as different meanings could result in random discrimination between local and cross-border funding situations.

6.2.1.6 If these recommendations are accepted, the existing deeming provisions regarding the source of interest can be scrapped. Obviously, where interest derived from other jurisdictions is subjected to tax in South Africa, it may also have been taxed in another jurisdiction. Apart from the protection against double taxation afforded by the tax treaties, most systems contain measures against this double taxation in their national law. In this regard, the Commission recommends that the current foreign tax credit provisions be reviewed and be replaced by more appropriate measures (see further discussion in 6.4 below where foreign tax credits are considered generally).

6.2.2 Interest flowing from South Africa

6.2.2.1 Most worldwide or residence based systems of taxation subject non-residents to taxation on income derived from a source within their jurisdiction, and, in principle, there should be no objection against doing the same as regards interest accruing to or being received by a non-resident from a South African source. However, in this instance, the high mobility of capital militates against the adoption of a pure approach. Most countries refrain from so taxing interest, at least as regards interest on debts with unrelated parties (so-called portfolio interest). At the same time, most of those systems tax interest flowing between related parties. The reason is that in the latter situations interest merely represents another form of extracting profits from the jurisdiction where they were earned, and of course would enjoy a deduction in appropriate circumstances. In following these tendencies South Africa will ensure that it remains competitive in international capital markets, while still, like most other countries, protecting the tax base on income arising from South African operations.

6.2.2.2 The application of this system requires some definition of the source of interest. Currently there is no statutory definition of the primary source of interest and both Revenue practice and our courts have been relying for many years on the unclear ratio from the decision in the Lever Brothers case (supra). Essentially, it was held that the source of interest was the making available of the credit. However, to determine the location of the source, the court considered various factors particular to that case. Over the years, the application of the test applied in the Lever Brothers case has become highly over-simplified, and the credit was generally held to be sourced where the agreement was concluded and the funds "physically" made available to the debtor. This simplification not only fails to consider the many other circumstances the majority of the court relied on for their decision, but has led to a damaging formalism in the sourcing of interest. It has become very simple to locate the source of interest tax advantageously, without affecting the economic substance in any way.

6.2.2.3 The Commission is of the view that the arguments stated by Schreiner JA in his minority judgment in the

Lever Brothers case have both practical and theoretical merit. He commented first on the common sense which needs to be brought to bear on matters like this:

"*In common parlance, by which it is a sound rule to judge definitions, the property itself, or, which for present purposes amounts to the same thing, its use, is treated as the source of the income*" (14 SATC 1 at page 17).

Pursuing this approach, he said:

"*Essentially¼the interest is the fruit of the money and comes from where the money is, irrespective of where the contract was made or the interest is payable*."

Judge Schreiner concluded that the source of interest on a loan should be considered to be where the capital is used and therefore where the debtor is located.

6.2.2.4 To obtain certainty as to the source of interest, the Commission recommends that the source of interest should be statutorily defined as the location where the credit or funds are being applied - which in most cases would be where the debtor is located.

6.2.2.5 The proposed change of the source of interest would have the result that most interest payments to non-residents would technically be subject to normal tax in South Africa. However, the exemptions currently available under particularly sections 10(1)(h) and 10(1)(hA) of the Act should function to exempt such interest from normal tax.

6.2.2.6 The Commission recommends that the current exemptions be retained for unrelated (i.e. not connected parties) non-resident lenders, and indeed be expanded to include the wider definition of "interest" as per section 24J of the Act in order to ensure that South Africa is in a position to attract foreign loan capital.

6.2.2.7 However, where interest is paid to a non-resident who is a connected party, such payments actually function to reduce the South African tax burden of the non-resident in favour of the fiscus of the non-resident, as the income would usually be taxed in the other jurisdiction. The non-resident will normally be entitled to a foreign tax credit for South African taxes imposed which means that the only benefit to the non-resident under the current system is that the lender may benefit from a lower tax burden abroad. The Commission thus recommends the reintroduction of non-residents tax on interest (NRTI) in respect of such connected party interest.

6.2.2.8 When interest received by non-residents was still taxable, it was subject to both normal South African tax and NRTI. The NRTI was then creditable against the normal tax. The Commission is aware that in the past, when both these taxes applied, in practice most taxpayers simply paid the NRTI without ever filing a return to be assessed for normal tax. It recommends that this practice be given legal validity by making the NRTI, which will apply only in connected party situations, as a final withholding tax. This will bring the South African NRTI in line with similar taxes in other jurisdictions. The rate at which this NRTI should apply is the prerogative of the government, but the Commission does not envisage something materially different from the previous rate of 10%.

6.2.2.9 In summary then, where interest flowing from a primary South African source to a non-resident constitutes a portfolio investment (i.e. payment to an unconnected lender), it should continue to be exempt from both normal tax and NRTI. In the case where it flows between connected parties, only the exemption from normal tax should apply. The exemption from withholding tax (NRTI) would therefore not apply between connected parties, in consequence whereof the NRTI will become a final withholding tax.

6.3 ROYALTIES

Before considering the taxation of royalties, the definition of the term itself requires comment. The Commission recommends that, for ease of understanding and international compatibility, the OECD Model Convention definition of royalties should be utilised. This is contained in Article 12(2) of the model and reads as follows:

"The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

Following this route also reduces the possibility which currently exists that elements of royalty payments may be classified as such under national law, but not be covered by our typical tax treaties. The recommendation contemplates that this definition should replace the current implied definitions contained in sections 9(1)(b) and 9(1)(bA) of the Act. It is nevertheless emphasised that, even if the existing definitions were to be retained they would require amendment, *viz.* -

(i) The Commission believes that physical plant and equipment have no place in the concept of intellectual property. In this regard the wording of the current sections 9(1)(b) and 9(1)(bA) is acceptable; and

(ii) It should also be noted that the OECD definition makes no reference to services. The omission of services would be an improvement on the present wording in section 9(1)(bA) of the Act which includes in the ambit of the deeming provision, services related to the utilisation of intellectual property. The Commission does not believe that the concept of royalties should extend to payments for services (as distinct from the conveyance of knowledge or experience). This would be inconsistent with the basic distinction between active and passive income that has been recommended. It has also led to great uncertainty in practice. To the extent that international royalty agreements often contain service elements, the recommendations in the OECD commentary that contracts should allocate the contract payments as between royalty elements and service elements should be the departure point; obviously, any attribution by the taxpayer, whether contractually or by way of declaration in tax returns, will be subject to anti-avoidance provisions, including the new transfer pricing rules in the Income Tax Act. In this manner current uncertainties will be reduced, but the system will find a functional resonance with international norms and practices.

From a tax technical viewpoint, in a system which seeks neutrality as far as possible, there seems to be no justification for excluding royalties for the use in South Africa of printed publications - i.e. books or magazines. The Commission recommends that this exclusion should be removed from the ambit of section 9(1)(b) of the Act.

6.3.1 Royalties flowing into South Africa

6.3.1.1 Under South African tax law, income derived from the exploitation of intangible property is regarded as sourced in South Africa if the intangible property was developed in South Africa, irrespective of where the asset is used to generate royalties (see the basic principles as to source of royalties as expounded in *Millin v CIR* 1928 AD 207). Therefore, royalty income generated by a South African resident is largely taxed on a worldwide basis under the current system.

6.3.1.2 Royalties would usually be regarded as passive income and would thus be taxable on a worldwide basis under the proposed system. Since most royalties are currently effectively subject to tax on a worldwide basis, the proposed system would not materially change the status quo.

6.3.1.3 An appropriate foreign tax credit mechanism should apply. Section 6(*bis*) currently provides such credit relief in respect of royalty income. It should be noted here that this provision is more appropriate as a credit mechanism than the provisions of section 6(*quat*) (which applies generally) in that it does not require the foreign tax to be exacted on income which is foreign source according to South African source principles. Instead, it requires that the foreign income tax be properly payable, without a right of recovery.

6.3.1.4 As in the case of interest, the CFC regime recommended elsewhere in this report will serve to curb practices whereby the taxation of royalties are avoided through their transmutation into dividends via facilitating off-shore structures. Furthermore, royalties routed through an off-shore permanent establishment (as referred to in this chapter) and not effectively connected with that permanent establishment, will continue to be subject to taxation. In line with the proposals as to the taxation of passive income, where the royalties are effectively connected with such a permanent establishment in that they are generated through the substantive business activity of that establishment, they will not be taxable in South Africa in accordance with the basic principle that active income generated offshore will not be considered as sourced in South Africa.

6.3.2 Royalties flowing from South Africa

6.3.2.1 As stated with regard to the source of royalties, such payments to non-residents would usually not be sourced in South Africa. However, most residence systems impose some form of withholding tax on such payments. Currently, South Africa also imposes a withholding tax on such payments in accordance with deemed source provisions. It is proposed that the following would apply:

(i) Where a non-resident receives or accrues royalties from South Africa which are not of a South African source, but which relate to the use in South Africa of the relevant intangible, the deemed source provisions and a withholding tax mechanism should continue to apply; and

(ii) Where a non-resident derives South African source royalties, normal tax principles shall apply to determine whether the income is attributable to a permanent establishment. If it is not attributable to a permanent establishment, the income should only be subject to the withholding tax.

6.3.2.2 If the recommendation is accepted that royalties should be defined with reference to the OECD Model Tax Convention, sections 9(1)(b) and 9(1)(bA) of the Act should be replaced with a provision that incorporates the new definition. The source deeming element should be retained. That is, the withholding tax will apply to royalties as then defined, derived from the use or right of use of the relevant intangible in South Africa.

6.3.2.3 The Commission sees little benefit in the complicated manner in which the royalty withholding tax rate is computed, and recommends that a flat rate be introduced. If this rate should vary too much from some reasonable approximation to the normal tax rate, it should be adjusted together with other rates in the system. To fix the rate is the prerogative of Government, but the Commission would not envisage anything that materially increases or decreases the current effective rate.

6.3.2.4 The Commission understands that the provision in terms of section 35(2)(f), whereby a subsequent return can be filed in respect of the royalty, is both narrow in scope and very rare in application. The royalty withholding tax, for all practical purposes, has been a final withholding tax and the Commission recommends that this be formalised by removing this provision.

6.4 RELIEF FROM DOUBLE TAXATION THROUGH GRANTING FOREIGN TAX CREDITS

6.4.1 General

6.4.1.1 When a home country, i.e. one in which the taxpayer resides, seeks to tax foreign-source income of residents or the domestic-source income of nonresidents, the possibility of double taxation becomes real. As noted elsewhere, typically the source country will be favoured and the residence country will be expected to grant relief. A jurisdiction that follows the residence principle has therefore only one practical solution at its disposal if it wishes to adhere to the neutrality canon in its income tax system. It must grant tax relief, either unilaterally or through the negotiation of bilateral double tax agreements.

6.4.1.2 South Africa has for many years taxed some passive income effectively on a worldwide basis and has therefore built such relief into its system, mainly through credits against its own taxes on taxes paid in foreign jurisdictions, the so-called foreign tax credit or FTC. The Commission believes this mechanism is entirely appropriate, and therefore deals only with adjustments to this system that would flow from its proposed expansion to a worldwide basis.

6.4.1.3 It has been mentioned that section 6(*quat*) of the Act is too limited and that the current section 6(*bis*) may be an appropriate starting point for a full foreign tax credit system. Such a system will, however, have to be extended to all income subject to tax in South Africa rather than be limited only to intellectual property income. With South Africa increasing its participation in international trade and investment, however, its provisions need to be amplified in some respects to comply with international norms.

6.4.2 Foreign tax credit pools

6.4.2.1 The foreign tax credit should be limited to a credit for foreign income or withholding taxes imposed on the income which is also subject to tax in the hands of the South African resident. Therefore, foreign taxes on active income or dividend income would not be creditable taxes. A primary consideration is whether there should be only one comprehensive foreign tax credit pool or several according to type of income and/or country of origin of the income. Obviously, although foreign income (subject to tax in South Africa) may be divided into various pools, there will be an overall restriction placed upon foreign tax credits in that the overall credit granted will not exceed the South African tax on the foreign income.

6.4.2.2 A single pool would greatly enhance simplicity, especially in a system where there is provision for carry-forwards of unutilised credits as recommended below. The argument against a single pool is that it allows taxpayers to manipulate their foreign tax burdens as between high and low tax jurisdictions so as to maximise the credit against the home taxes. Another problem is that it allows them to mix highly "mobile" forms of income with the less mobile forms, which leads to the manipulation of different kinds of income merely to maximise the foreign tax credit from one type of income against another. The most obvious example of this latter phenomenon is where interest bearing off-shore investments are located in particular jurisdictions with the sole purpose of exploiting the taxpayer's overall foreign tax credit profile.

6.4.2.3 The Commission considers, in the first place, that providing for separate pools by country will introduce disproportionate complexity without materially enhancing revenue collection. Due to the high mobility of capital, the Commission gave consideration to the possibility of recommending that foreign tax credits on interest income should be accounted for separately from those on other income. In this, other systems were considered, these ranging from the Australian multiple pool system to the German system, where effectively only one pool is used. The Commission considers that, even in the case of interest, the likely manipulation of foreign tax credits will not be large enough to justify the additional complexity in the foreign tax system that separate pools will bring about. It therefore recommends that a general foreign tax credit system should provide for only one pool of foreign income, regardless of geographic origin or nature. The situation can be monitored and, if it appears that there is an unacceptable degree of foreign tax credit manipulation as South African off-shore investment increases, a separate pool for interest income may be introduced at a later stage.

6.4.3 Carry-forward and carry-back rules

6.4.3.1 There is little consistency around the world on the carry-forward or carry-back of unutilised foreign tax credits. At the one extreme the United States and Canada, for example, allow a 7 year carry-forward plus a 3 year carry-back. The United Kingdom and New Zealand, on the other hand, allow no carry-forward or carry-back. Japan allows a 3 year carry-forward, and Australia one of 5 years.

6.4.3.2 Failure to allow at least some degree of carry-forward could result in inequity, inhibition of international trade and the expenditure of much unproductive effort in artificially managing credits so that they may not be lost. For these reasons the Commission recommends that a carry-forward of unutilised foreign tax credits be allowed.

6.4.3.3 The Commission considered whether any carry-back should be allowed, and whether there should be any restriction imposed as to the number of years for which the foreign tax credit could be carried forward. It concluded that, in line with the current treatment of tax losses in the South African system, foreign tax credits should not be allowed to be carried back, but should be allowed to be carried forward indefinitely.

6.4.4 Tax losses

6.4.4.1 In order to have a smoothly functioning system of foreign tax credit it is necessary that there be a convention regarding the ordering of the utilisation of foreign tax credits versus the utilisation of current or carried forward South African tax losses. Assuming there is a combination of South African assessed loss, foreign source taxable income and foreign tax credit, a convention is required to establish which takes precedence. Is the assessed loss first set off against the foreign source income, or is the foreign tax credit first set off against the South African tax applicable to the foreign source income?

6.4.4.2 The Commission would opt for the system of first utilising the foreign tax credit against the foreign source income. To do otherwise would be to the detriment of the taxpayer in that it could create a loss of foreign tax credit. However, the more substantial reason for opting for the convention is that the Commission does not wish to discourage South African resident companies or individuals from establishing activities and performing services abroad.

6.4.4.3 It should be pointed out that this issue of ordering only becomes critical in a situation such as that in the United Kingdom where foreign tax credit cannot be carried forward at all. The UK has in fact reversed their convention regarding this ordering, so as not to discourage the utilisation of the UK as a base for foreign investment, and has adopted a convention most favourable to the taxpayer.

6.4.5 Computation of profits

6.4.5.1 The Commission notes that, in order to determine the amount of applicable South African tax with reference to the foreign source income, the foreign income which is taxable in South Africa needs to be reconstituted according to South African tax principles. Such a computation is necessary to determine the maximum creditability in respect of foreign tax for the given year. When he South African taxable income has been computed - with reference to the foreign source income - foreign tax credit will then be available to the extent of the South African tax on that foreign source income as recomputed.

6.4.6 Secondary Tax on Companies (STC) and the offsetting of foreign tax credits

6.4.6.1 The extension of the deemed source provisions automatically raises the issue as to whether passive income would be subject to STC. Currently, foreign source income is excluded from the ambit of STC. It is the Commission's view that such passive income should not be excluded in the computation of STC, especially since South Africa has deliberately styled STC as a tax on the company, and not on the shareholder. The affected income would therefore be subject, not only to normal tax at 35%, but also to STC at 12,5%. The necessary corollary of that would then be that our foreign tax credit system must allow foreign taxes to be set off against both normal tax and STC. The Commission recommends accordingly.

6.4.6.2 It is suggested that the simplest procedure is to allow the relevant foreign tax to be offset against the attributable normal tax. Then, to the extent that there is an excess, this should be allowed against the attributable STC. Any remaining credit would be carried forward to the following year if the recommendations as to the carry-forward of credits are accepted.

6.4.6.3 Little additional administrative effort would be required, since section 64B(6) already requires taxpayers to calculate an apportionment between local source and foreign source net annual profits. The tax return could be modified to allow companies to split the local source section into normal source and deemed source portions. The foreign tax credit would then only be deductible against the STC attributable to dividends declared out of the latter.

6.4.6.4 The only administrative complexity would relate to the order of set off. This follows because the company will only be able to set off against STC an excess remaining after the normal tax set off, and this excess is only properly determinable once the company's annual tax return is assessed. Since such returns are assessed only annually, and are frequently subject to considerable delay, and since dividends may be declared at frequent intervals, the potential for inequitable treatment (and confusion) is considerable unless a reasonable estimate is accepted.

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CHAPTER 7 - OTHER RELATED MATTERS

7.1 CORPORATE HEADQUARTERS AND HOLDING COMPANIES

7.1.1 Encouraging the formation of international corporate headquarters and holding companies located in South Africa will be advantageous to the economy in two ways:

(i) It will encourage local investors to expand offshore without sending scarce human resources abroad; and

(ii) It will encourage foreign investors to expand into Africa via South Africa.

Both of these factors would lead to the retention and importation of skills, and a subsequent contribution to overall economic activity in the country.

7.1.2 As stated before, a residence tax system would not encourage such companies to locate in South Africa. The current system, on the other hand, has been less than successful because:

(i) The investment climate was hostile prior to the country's democratisation;

(ii) There is concern that a residence (worldwide) tax system will be introduced;

(iii) The existence of exchange controls is a deterrent; and

(iv) Certain items of income generated by headquarter companies are taxed in South Africa, either because they represent South African source income like head office management services, or by virtue of section 9(1)(d) of the Act.

7.1.3 The first consideration has disappeared, and the third falls outside the scope of this Commission's responsibilities. The Commission's recommendations in this chapter, however should favourably impact upon the second factor. The fourth consideration requires a legislative solution. If South Africa is to encourage the formation of new international headquarter and holding companies, and prevent the migration of those already established, it is essential that their tax status be certain and unassailable.

7.1.4 The key fiscal attributes of a regime conducive to the formation of international holding companies are:

(i) A reasonable double tax agreement (DTA) network;

(ii) The exemption of offshore corporate dividend income from local income tax;

(iii) The exemption of other defined offshore corporate income from local income tax;

(iv) The absence of local corporate capital gains tax;

(v) Low or no local withholding tax on dividends paid to shareholders; and

(vi) An efficient local tax rulings system.

7.1.5 In contrast, and in addition to the above, the key fiscal attributes of a regime conducive to the formation of international headquarter and service companies are:

(vii) No tax on head office services rendered at the head office to the multi-national group; and

(viii) The exemption of offshore personal remuneration from local income tax, where the employee works exclusively offshore for a certain minimum period.

7.1.6 By way of comparison, and to define the environment in which South Africa is competing, the conditions conducive to international holding companies prevailing in fifteen countries in Europe and Asia have been considered. In addition to these, there are of course numerous tax havens, each of which is also a potential competitor. When, however, South Africa's geographic proximity, regional superiority as regards infrastructure, and common cause with Africa are considered in addition to fiscal factors, it could become a highly attractive location for these types of companies at least for operations in Africa (and especially Sub-Saharan Africa).

7.1.7 It is also significant that, while for a long time there has been little or no initiative by other African countries to establish their status in this regard, the Commission understands that Botswana is considering a regime in terms of which fees etc. earned by headquarter companies would be tax exempt. Australia is another jurisdiction in the larger region which already provides this kind of exemption. The Commission recommends that similar exemptions be introduced for South African headquarter companies.

7.1.8 The tax regime as it currently exists, or as further recommended in this report, to a large extent satisfies the preferred criteria listed above. The Commission recommends, however, that consideration be given to a statutory commitment that headquarter and holding companies established at the time of any change in legislation that affects this favourable status will be protected by a delayed implementation, or would be given a phase-in period in which to adjust.

7.2 DEEMING PROVISIONS AND EXEMPTIONS

7.2.1 There are several deeming provisions as to source currently in the Act which, under a new dispensation, would have to be removed. Some of these have been indicated, but a proper inventory of them should be made and judgment exercised in each case as to their retention. It is certainly not so that all will disappear, but those remaining should be compatible with the new system.

7.2.2 Some of the existing exemptions of cross-border income would have to be reviewed to harmonise these with the new system. For example, in its Second Interim Report, the Commission recommended that the provisions of section 10(1)(hA) of the Act should be amended to deny the tax exemption on interest received by non-residents where the non-resident carried on business in South Africa through a branch. The intention with this recommendation was to prevent foreign banks carrying on normal lending operations in South Africa through a branch and thus obtaining an unfair advantage over their domestic competition. When this recommendation was legislated, however, the exemption was denied in all cases where the interest was effectively connected with the business carried on by that non-resident in the Republic. The concept of carrying on of a business in South Africa is much wider than the concept of doing so though a local branch, and this has created some uncertainty in situations not intended to have been affected. It is recommended that the restriction should refer rather to the existence of a branch, and then more specifically, in the context of these recommendations elsewhere in this report, to a non-resident carrying on the business through a permanent place of business suitably equipped for carrying on such a business. Interest which is attributable to such a business should then not qualify for the exemption.

7.3 REMUNERATION OF EMPLOYEES WITH REGARD TO CONTRACT WORK PERFORMED IN SOUTH AFRICA

7.3.1 Contractors and sub-contractors who participate in projects in South Africa, but who often fail to make their presence known to the tax authorities, have long been a problem to the system. The 1986 Margo Report recommended that a form of withholding tax should be investigated. It recommended further that details of foreign contractors and individual job seekers and employees entering the country should be made available by the Department of Home Affairs to enable Revenue to register them as taxpayers and, in the case of independent contractors, as employees for PAYE purposes. The subsequent Government White Paper agreed that this possibility should be investigated, and stated that arrangements had been made to get the suggested information from the Department of Home Affairs. Neither of these has achieved the desired result.

7.3.2 The issue involves several practical and administrative problems, but the Commission agrees with the suggestions of the Margo Commission and urges that appropriate action be taken.

7.4 THE ELECTRONIC FUTURE

7.4.1 The Commission received much evidence regarding a not too distant future where international trade investment will increasingly become a function of global electronic communication such as through the Internet. There is no doubt that these developments will greatly impact some of the basic tenets of international taxation as they exist today. Examples include the irrelevance of physical presence in order to trade (impacting on "permanent establishment" concepts), the ease with which current residence notions can be manipulated through hyper-mobility of an entire office and trading or management capacity, and the manner in which goods or services can be contracted for, advertised and even delivered via electronic means.

7.4.2 The Commission has found no precedents around the world, nor even proposals, which purport to deal with these likely developments. This is a matter that will affect all economies, and no doubt measures will be developed as the impact increases. The Commission is of the view that it would be premature now to introduce an entirely new regime of international taxation which seeks to cope with these developments; indeed, to seek a pioneering role here would be both arrogant and dangerous. On the other hand, by the major thrust of integrating South Africa's international tax arrangements as closely as proposed with international tax conventions and concepts, the South African system should be better placed than most to absorb technical tax changes as they develop between trading nations. For example, it can be reasonably assumed that much of this tax evolution will take place through treaty negotiations around concepts like permanent establishment definitions, attribution rules, or exemptions or credits affecting passive income. By incorporating many of these international concepts into our national law, successful developments internationally will make our options clear and facilitate their implementation where it is felt they have sufficient merit.

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CHAPTER 8 - ANTI-AVOIDANCE MEASURES

8.1 GENERAL

8.1.1 It would be easy for a taxpayer to change "passive" income into exempt dividends by re-routing the income through an offshore company. Furthermore, taxation can be deferred by accumulating income in offshore entities. Such schemes have to be countered by specific anti-avoidance rules, since the general anti-tax avoidance provisions of section 103(1) of the Act would often not apply, for example, such an offshore company may also function to avoid or reduce foreign taxes.

8.1.2 It is also important to recognise that more extensive anti-avoidance rules will become necessary in the South African system not as a result of the proposals in this report, but simply because, once exchange controls are relaxed, cross-border investment will increase in quantum, sophistication and variety to a level where current measures will be wholly inadequate. To the extent that additional measures introduce greater complexity, this is the inevitable price to pay for the final step towards full integration with the global economy.

8.1.3 The Commission's review of international systems, including discussions of their effectiveness and practical application with those more conversant with their actual implementation, convinced it that anti-avoidance measures must strike a balance between perfection and pragmatism. Measures which seek to address every possible eventuality become highly complex with two results: firstly, they inhibit legitimate trade, which is a sure sign of a bad international tax system; and secondly they more often than not lead to an ineffective anti-avoidance regime because their complexity prevents proper administrative implementation.

8.1.4 The specific anti-avoidance provisions of Australia, the UK and Germany are furnished in some detail in the Annexure, as these indicate representative examples of anti-avoidance systems ranging from a highly complex anti-avoidance regime to a less ambitious one that is from an administrative perspective perhaps more realistic and efficacious.

8.2 SELECTED COUNTRY ANALYSIS

8.2.1 The problems which necessitate anti-avoidance measures are also experienced by countries which base their tax systems on the residence principle. South Africa has not so far had to develop detailed rules of this nature due to the exchange control and other inhibitions on making off-shore investments. Elsewhere offshore intermediary entities can be used to change the character of income to dividend (exempt) income, or simply to defer home country taxation by accumulating income in the offshore entities. Deferral may also be achieved by the use of offshore trusts, which may be utilised by either companies or individuals.

8.2.2 Most countries which tax on a residence basis have introduced specific measures to counter such practices. The measures applicable in the United Kingdom, Germany, the United States of America, Australia and New Zealand have been considered as guidelines for suggesting suitable rules for South Africa. The rules applicable in Australia, Germany and the United Kingdom could be regarded as representative of the basic options available.

8.2.3 The rules applicable in the systems analysed all distinguish between "active" and "passive" income albeit that different concepts are used. New Zealand rejected the distinction as being too uncertain with regard to their "Controlled Foreign Corporation" (CFC) rules, but applied similar concepts in their "Foreign Income Fund" (FIF) rules.

8.2.4 The rules applicable in the USA, Australia and New Zealand are very complex and comprehensive. The Australian rules are possibly the most comprehensive and they seem to attempt to cover every conceivable case. The rules applicable in the UK and Germany appear far more simple and general, i.e. they do not attempt to be exhaustive, and may rather be seen as guidelines, with more discretion left to the tax authorities. The latter approach appears to be the more practical in the light of the tremendous administrative effort required under the former and since both authorities and taxpayers will have a large body of international guidance on which to rely.

8.2.5 The rules analysed relate essentially to the attribution of income to the local shareholders/participants/controllers of a controlled offshore intermediary entity. However, some countries have also introduced specific rules to counter the accumulation of income in foreign investment funds which are not necessarily controlled by local residents or beneficiaries (the Foreign Investment Fund rules). Such funds enable investors to escape or defer all tax, i.e. both foreign and local, and these rules should also be considered, particularly since local retirement funds are now subject to tax.

8.3 RECOMMENDATIONS

8.3.1 CFC Rules

8.3.1.1 To counter the re-routing of taxable passive income through offshore intermediate entities to convert the income to tax exempt dividend income or capital distributions, or to achieve a deferral of taxation by accumulating funds in such offshore entities, Controlled Foreign Corporation (CFC) rules should be introduced. Essentially, the income derived by the intermediate entity should be attributed proportionately to the controlling resident in South Africa. This implies an extension of the existing provisions under section 9A of the Income Tax to cover all foreign jurisdictions and all foreign taxable entities.

8.3.1.2 A CFC should be defined to include all foreign entities which would be regarded as taxable entities under South African income tax law, i.e. tax transparent entities should not be included as the income would not accrue to such entities for tax purposes.

8.3.1.3 The definition of "control" should be wide to avoid manipulation, particularly through the use of "straw persons" as directors as well as the use of offshore discretionary trusts as holding entities. This also implies an extension of the current definition of a controlled company under section 9A of the Income Tax Act. In this regard, the tests applicable under the German CFC rules could be considered. Their definition of "control" includes any form of indirect control through a person holding shares or voting rights/participation where such a person has to follow the instructions of a local resident in such a way that he/she does not have real freedom to make his or her own decision.

8.3.1.4 Under the German CFC rules, income of a foreign intermediate entity controlled by a German resident will be attributed proportionately to the resident if such income was subject to low taxation abroad, even if the income was so-called active income. Before such attribution will apply, a shareholding or voting right/participation of 50% is required. The German attribution rules in respect of income with a "capital investment character" apply where a German resident owns at least 10% of the shares of a CFC. This application of the rules to a situation where in fact there is no control is out of step with the notion of controlled foreign corporation rules. It is also uncommon, and the Commission recommends that this approach should not be followed. The attribution should only apply in cases where South African residents control 50% or more of the shareholding/voting right/participation of the CFC.

8.3.1.5 The CFC rules would not apply if the CFC derived the income through the carrying on of an active business. In this regard, the examples of tests for genuine business activities as outlined in the description of "exempt activities" in Part II of Schedule 25 of the UK Income and Corporations Taxes Act could be a useful guideline.

8.3.1.6 The condition for exemption of active income under both the UK and German rules, that such income may not be subject to tax at a rate below a minimum level, should not be introduced under the new rules as that would contradict the basic premise that active income would only be taxed on the source basis.

8.3.1.7 This condition could be included in the new rules in respect of passive income i.e. if such income is subject to an effective tax burden equivalent to the South African tax burden on such income. There would be no loss to the fiscus in the latter case as a foreign tax credit would be available in respect of such foreign taxes.

8.3.1.8 The exception provided under the UK rules in respect of "acceptable" distributions should not apply as the dividends would not be taxed anyway.

Dividends are taxable in the UK, hence the exception.

8.3.1.9 The restriction under the UK rules that a CFC must carry on an active business in the country of its incorporation is not recommended. In terms of the basic tests for active income outlined above, any offshore presence (qualifying as a permanent establishment) should suffice to classify the attributable income as active income.

8.3.1.10 The restriction applicable under both the UK and the German rules that a CFC may not derive the income through transactions with connected persons should not be introduced as transfer pricing rules should be sufficient to counter any related abuse.

8.3.1.11 The UK guidelines refer to a motive test in terms of which the rules would not apply if the taxpayer can show that the motive for establishing the offshore CFC was not only to divert profits from the UK, and that there was a bona fide business purpose. Such a test is not recommended as it would make it very easy to avoid the application of the rules. It is suggested that the rules should apply in all cases where passive income was re-routed through an offshore CFC irrespective of the motive.

8.3.1.12 The UK has introduced special rules in connection with offshore banking and insurance companies. In the light of the potential manipulation in this area, specific rules for such activities should be considered. The UK rules should be considered in formulating such rules.

8.3.1.13 The German rules deal specifically with renting or leasing of moveable property. It is required that the CFC carries on a commercial renting or leasing business and participates in business dealings and performs all activities typical of such a business. It is submitted that the latter conditions are akin to the test outlined above for active income and would therefore not add to the specific anti-avoidance rules. However, this test could be useful in formulating the test for "active" income.

8.3.1.14 The special exception under the UK rules of excluding offshore listed companies should be introduced under the new rules. The *de minimis* exception under UK rules should also be introduced.

8.3.1.15 The German system specifically excludes the application of its rules in cases where an offshore holding company extracts passive income from a foreign active subsidiary. As pointed out above, the Commission is not in favour of such an exception. On the other hand, where the offshore CFC generates the passive income as incidental to its active income, e.g. where cash is generated which is on-lent to a foreign subsidiary or where an intangible was developed and leased to a foreign subsidiary, such income should not be attributed under the CFC rules.

8.3.1.16 As in the UK, the final rules should be clarified by means of a Revenue Practice Note which could be expanded to cover practical problems encountered in their application.

8.3.2 FIF Rules

8.3.2.1 To counter the avoidance of South African income tax and, in particular, the new tax dispensation for retirement funds, in cases where residents invest abroad into entities or funds which they do not control, Foreign Income Fund (FIF) rules should be introduced. The Australian FIF rules provide a useful example.

8.3.2.2 Essentially, investments by South African residents in offshore entities or funds should not provide an opportunity to defer or avoid tax on investment returns. The FIF rules should apply to attribute the underlying income of the foreign entity or the investment fund to the South African investor in proportion to his or her investment. To determine the actual return on such a participating investment will be virtually impossible in most cases and therefore a deemed return based on the original capital amount invested should be assumed. The Australian precedent is useful in this regard.

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CHAPTER 9 - SUMMARY OF RECOMMENDATIONS

GENERAL PROPOSITIONS

9.1 The system should recognise a difference between "active" income (income deriving from direct, operational activity), and "passive" income (income which is derived from passive forms of investment).

9.2 Active" income should continue to be taxed on a source basis.

9.3 No detailed definition of source should be attempted, and instead the general concept used internationally of taxing business profits with reference to a combination of "activity" linked to a "permanent establishment" should form the basis of taxability.

9.4 "Passive" income should be taxed on a worldwide basis.

9.5 South African tax law, insofar as it relates to investment and trade across borders, should seek generally to incorporate concepts and terminology widely used and recognised internationally.

9.6 Suitable anti-avoidance measures should be introduced both to make current provisions which are being retained, as well as new provisions proposed, effective. Such measures must strike a balance between being sufficiently detailed to be effective, but not so elaborate as to be counter-productive and unduly inhibiting of international trade and investment.

CHAPTER 4: DEFINITION OF ACTIVE AND PASSIVE INCOME

Active Income

9.7 In defining active income, reference should be made to the international treaty terminology of business income, together with an illustrative, but non-exhaustive list of activities which shall be regarded as active income [paras. 4.1 and 4.2].

Passive Income

9.8 Passive income should not be separately defined, and should include all income which is not active income.

9.9 For purposes of anti-avoidance, certain income should be deemed to be passive income unless the taxpayer can show that such income was derived off-shore through a permanent establishment suitably equipped for the generation of such income.

9.10 Passive income extracted by a South African company from an active foreign subsidiary should not be regarded as active merely by virtue of the connected party relationship [para. 4.3].

CHAPTER 5: DETERMINING THE SOURCE OF ACTIVE INCOME

9.11 The Commission recommends against a detailed codification of general source rules, and suggests the introduction instead of internationally understood source principles, which can then be interpreted against an internationally available base of analysis and expertise [para. 5.1].

9.12 The Commission recommends that the international trend, both in various national legal systems and in international tax treaty law, of tax liability arising through a permanent establishment should be formally introduced into South African tax law. Taxability of cross-border active income will therefore be determined by the interaction between two basic concepts - presence (through a permanent establishment), and activity. When, and to the extent that, active income generated by the activity can be attributed to the permanent establishment, it should be taxed in the jurisdiction where that permanent establishment is located [para. 5.3].

9.13 With certain qualifications [see paras. 5.4.1 and 5.4.2], a permanent establishment should be defined with reference to the typical treaty definition, preferably that contained in the United Nations Draft Model Convention [para. 5.4].

9.14 International treaty concepts of attribution of profits to a permanent establishment should be introduced into our law, and there should be a less emphasis on a dominant source [para. 5.3].

CHAPTER 6: IMPORTANT CONSIDERATIONS WITH REGARD TO THE TAXATION OF PASSIVE INCOME

Residence status

9.15 The definition of residence status for both natural persons and others should in several respects be aligned with international norms [para. 6.1].

Interest

9.16 Subject to any applicable exemptions or provisions of the Income Tax Act, all interest received or accrued by South African ordinary residents or resident companies should be subjected to tax [para. 6.2].

9.17 To counter avoidance, the Controlled Foreign Corporation (CFC) Rules currently embodied in section 9A of the Income Tax Act need to be expanded to cover all offshore entities.

9.18 Whether affecting interest flowing into or from South Africa, for purposes of any provisions relating to interest flowing cross-border, the concept of "interest" should carry the extended meaning ascribed to it in section 24J of the Income Tax Act.

9.19 Existing deeming provisions as to interest should be scrapped.

9.20 Current foreign tax credit provisions should be reviewed and be replaced by measures appropriate for the expanded scope of taxation of off-shore interest [para. 6.4].

9.21 Where interest flows from a South African source to a non-resident who is a connected party, such interest should attract a withholding tax, namely a non-residents tax on interest (NRTI). The exemption from normal tax should stay, thereby making the NRTI a final withholding tax.

9.22 The source of interest should be statutorily defined as the location where the credit or funds are being applied - which in most cases would be where the debtor is located [para.6.2].

Royalties

9.23 The definition of "royalties" should be aligned with the international treaty definition [para. 6.3].

9.24 Royalties should be taxable in South Africa if received or accrued to a South African ordinarily resident individual or resident company, regardless of the source from which they originate.

9.25 As with interest, anti-avoidance measures, including CFC rules, should be expanded, and suitable foreign tax credits provided for.

9.26 The withholding tax on royalties received or accrued by non-residents should be fixed at a flat rate, and should be made a final withholding tax (the Commission's recommendations are not intended to bring about a material change in the actual rate used).

Foreign Tax Credits

9.27 The current principle of granting a credit in respect of foreign taxes paid against income taxed also in South Africa is sound and should, subject to suitable adjustments, be retained [para. 6.4.1].

9.28 A general foreign tax credit system should provide for only one pool of foreign income, regardless of geographic origin or nature. The situation must be monitored and, if it appears that there is an unacceptable degree of foreign tax credit manipulation as South African off-shore investment increases, a separate pool for interest income may be introduced at a later stage [para. 6.4.2].

9.29 In line with the current treatment of tax losses in the South African system, foreign tax credits should not be allowed to be carried back, but should be allowed to be carried forward indefinitely [para. 6.4.3].

9.30 The foreign tax credit system should allow foreign taxes to be set off against both normal tax and STC where these taxes were levied on the foreign income.

9.31 It is recommended that taxpayers should be allowed first to set off the relevant foreign tax against the attributable normal tax. Then, to the extent that there is an excess, this should be allowed against the STC attributable to the passive income taxed in terms of these recommendations. Any remaining credit would be carried forward to the following year if the recommendations as to carry-forward are accepted [para. 6.4].

CHAPTER 7: RELATED MATTERS

Corporate Headquarters and Holding Companies

9.32 The current favourable regime for corporate headquarter and holding companies (which will be retained by the Commission's recommendations as to source), should be further enhanced:

· through appropriate exemptions regarding fee income to such companies, and

· through a statutory commitment that headquarter and holding companies established at the time of any change in legislation that affects the favourable status, will be protected by delayed implementation, or would be given a phase-in period in which to adjust [para. 7.1].

Deeming Provisions and Exemptions

9.33 All deeming provisions as to source currently in the Income Tax Act should be reviewed as to their retention in view of the recommendations in this report.

9.34 The exemption on interest received by or accrued to non-residents is currently restricted with reference to interest effectively connected with a business carried on in the Republic by such a non-resident. This restriction should be amended to refer to interest relating to a permanent establishment as recommended in this report [para. 7.2].

Contract Work

9.35 The Margo Commission's recommendations towards increasing the effectiveness of tax collection from foreign contracting parties in South Africa, accepted at the time by a Government White Paper for further investigation, should be pursued urgently [para. 7.3].

The Electronic future

9.36 It is not recommended that South Africa should seek to pioneer a whole new tax regime to cope with the major changes coming about through modern electronic communications. However, the recommendations in this Report towards the internationalisation of South African tax law affecting international trade and investment will be a major factor in the country's capacity to deal with these changes [para. 7.4].

CHAPTER 8: ANTI-AVOIDANCE

General

9.37 Current rules in South African tax law to inhibit the recharacterisation of taxable passive income into exempt dividend income, or the deferral of taxable passive income, should be extended.

9.38 These anti-avoidance rules should be sufficiently detailed to be effective, but should not become so complex as to become counter-productive and inhibiting of international trade and investment. In this regard the rules contained in the German and United Kingdom systems appear of particular instruction [para. 8.1].

Controlled Foreign Corporation (CFC) Rules

9.39 The existing provision under section 9A of the Income Tax Act should be extended to cover all foreign jurisdictions and all foreign entities which would be regarded as taxable entities under South African tax law [para.

8.3.1 of the report contains several more detailed recommendations in this regard].

Foreign Income Fund (FIF) Rules

9.40 To counter the avoidance of South African income tax and, in particular, the new tax dispensation for retirement funds in cases where residents invest abroad into entities or funds which they do not control, Foreign Income Fund (FIF) rules should be introduced. The Australian FIF rules provide useful examples of such rules [para. 8.3.2].

5th Report - BASING THE SOUTH AFRICAN INCOME TAX SYSTEM ON THE SOURCE OR RESIDENCE PRINCIPLE - OPTIONS AND RECOMMENDATIONS

ANNEXURE 1 - CFC RULES APPLICABLE IN AUSTRALIA, THE UK AND GERMANY

1. The analysis below is not intended to be exhaustive or a complete summary of the systems in question but merely to provide examples of the essential provisions of the rules applicable in the particular countries.

Rules Applicable In Australia

Basic Tax System

2. Australia imposes tax on a residence basis.

3. A company resident in Australia is essentially taxed on its worldwide income. However, there is an exemption for foreign branch profits of Australian resident companies derived from carrying on business in a listed country, provided the profits are not "designated concessioned income", i.e. income taxed at concessionary rates. Basically, "listed" countries are countries imposing taxes comparable to Australian taxes on such income.

4. There is also an exemption for "non-portfolio" dividends (where the shareholder holds an interest of at least 10% in the company paying the dividend) paid by the non resident company to a company resident in Australia, provided the dividend is derived from profits which were not "designated concession income".

5. The exemption in respect of foreign branch profits requires:

(a) the carrying on of a business through a permanent establishment in that foreign country;

(b) that the country must be a listed country; and

(c) that the income may not be "designated concession income.

6. The carrying on of a business through a "permanent establishment" is defined with reference to the concept in an applicable double taxation agreement or a similar concept embodied in the Australian Income Tax Assessment Act (ITAA).

7. The listed countries impose taxes which are comparable to corporate taxes in Australia (with a minimum rate of 25%).

8. "Designated concession income" is income which enjoys special tax incentives in the listed country which result in a substantial reduction of the effective tax burden on such income.

CFC Rules

9. Where income is routed through an intermediate offshore entity controlled by Australian residents, the income of that offshore entity may be attributed to the Australian residents, subject to certain conditions.

10. Essentially, if the CFC is resident in a listed country, its income will not be attributed to the Australian participants provided the income is not designated concession income. If the income is designated concession income, it will be so attributed except if it qualifies under the "active" income exemption or the *de minimis* exemption.

11. If the CFC is resident in an unlisted country the income will be attributed unless it qualifies under the active income exemption or the *de minimis* exemption.

12. "Active income" is not specifically defined. However, certain specific conditions are stipulated in the Act. The essential conditions are:

(a) the CFC must carry on business in the country of residence through a permanent establishment in that country; and

(b) the CFC may not receive "tainted" income equal to or exceeding 5% of total income.

13. "Tainted income" consists of:

(a) passive income;

(b) tainted sales income; or

(c) tainted service income.

14. "Passive income" includes:

(a) dividends;

(b) unit trust dividends;

(c) tainted interest income;

(d) annuities;

(e) tainted rental income;

(f) tainted royalty income;

(g) consideration for the assignment of any copyright, patent, design, trademark or similar property;

(h) income derived from trading with or disposal of tainted assets;

(i) tainted commodity gains; and

(j) tainted currency gains.

15. "<u>Tainted sales income</u>" is broadly speaking gross income from sales of goods purchased or sold from/to a related party either resident or carrying on business through a permanent establishment in Australia.

16. "<u>Tainted services income</u>" is income from the provision of services to a related party resident or carrying on business through a permanent establishment in Australia.

17. "<u>Tainted interest income</u>" means interest or other payments that would be assessable under the Australian discounted and deferred interest security provisions, and factoring income.

18. "<u>Tainted commodity gains</u>" include gains from a forward contract or a future contract in respect of a commodity or any right in respect of such a contract, except if the CFC carries on a business of producing or processing the commodity or if the hedging contract was entered into to reduce risk relating to another commodity transaction.

19. "<u>Tainted currency exchange gains and losses</u>" will include all such gains/losses except where they relate to an active income transaction.

20. "<u>Tainted rental income</u>" includes income from leases to related parties and real estate; also including income from loaning of ships, aircraft, cargo containers, and plant for use on ships.

21. "<u>Tainted royalty income</u>" includes all but certain specified royalties. Royalties will be excluded if the CFC receives royalties from non related parties and the CFC produced or substantially developed or improved the intangible property involved.

22. "<u>Tainted assets</u>" include loans and other financial instruments, shares, interest in a trust or partnership, futures and other derivatives, life insurance policies, rights or options relating to such assets, assets held solely or principally to

derive tainted rental income and asset's other than assets used solely in carrying on a business. Special rules apply to determine the tainted income of financial institutions and insurance companies.

23. In accordance with the *de minimis* exemption, if the designated concession and untaxed income exceed the lesser of $50 000 or 5% of gross turnover of the CFC, the income will not be attributed.

FIF Rules

24. The FIF Rules were introduced to counter tax avoidance opportunities which remained after the introduction of CFC and Foreign Trust Estates Rules.

25. They address the accumulation of income in foreign companies not controlled by Australian residents and in foreign trusts in which the Australian resident has an interest but no present entitlement to income. The FIF measures also extend to certain foreign life assurance policies that have an investment component.

26. The FIF rules do not apply if the foreign company is principally engaged in certain active businesses. This exception does not apply to foreign trusts but if the trust invests in a foreign company carrying on "eligible activities" (i.e. active business), such income will be excluded.

27. Specific exemptions are available for investments in foreign listed (approved) companies, banks, certain life insurance businesses, listed foreign insurance companies, listed real estate (commercial) investment companies and certain approved foreign trusts.

28. Three methods may be used to determine the amount of FIF income which is attributed to the Australian resident, namely:

(a) the market value method;

(b) the deemed rate of return method; and

(c) the calculation method.

29. The interest in a Foreign Life Policy may be calculated on:

(a) the deemed rate of return method; or

(b) the cash surrender value method.

30. The market value method essentially applies objective market values (quoted values on approved stock exchanges) and deducts any prior year losses not used earlier.

31. The deemed rate of return method essentially applies indicative factors to determine the value. Several methods may be used. The first method refers to recent quoted values (on approved stock exchanges). The second method uses an independent valuation. The third method applies a deemed rate of return for each year with reference to the capital originally invested.

32. Adjustments are made for fluctuations subsequent to a valuation date.

The Rules Applicable in the UK

Basic tax system

33. The UK imposes tax on a residence basis. In some cases income earned abroad is only taxed when remitted to the UK (essentially for individuals not domiciled in the UK).

34. Double taxation of foreign source income is avoided by granting tax credits for foreign taxes payable. Companies may also qualify for tax credits in respect of certain underlying foreign taxes paid by subsidiaries and affiliates abroad.

Statutory CFC provisions

35. The statutory provisions applicable in the UK are very simple and clear in comparison to the Australian rules.

36. In terms of section 747 of the UK Income and Corporation Taxes Act, 1988 as amended (ICTA), the UK Revenue may apply the CFC rules if they have reason to believe that the company:

(a) is resident outside the UK;

(b) is controlled by persons resident in the UK; and

(c) is subject to a lower level of taxation in the territory in which it is resident.

The "company" in question is defined to include any body corporate or unincorporated association.

37. The Revenue may then apportion the chargeable profits and attributable creditable tax among the UK residents who had an interest in the CFC at any time during the fiscal years.

38. There are several restrictions on Revenue's discretion to apply the CFC rules. In the first place, the rules will only apply to apportion income to a UK resident company if at least 10% of the CFC's income could be attributed to the UK company (including amounts apportioned to persons who are connected or associated with the UK company). Secondly, "lower level of taxation" may only be assumed if the tax paid by the CFC in its country of residence is less than ¾ of the corresponding UK tax on the offshore profits of the CFC. References to profits exclude capital gains.

39. In this regard, the UK Revenue has published a list of countries in which residence and the carrying on of business will not trigger the CFC rules. Part II of the list contains countries where the CFC will qualify only if it does not enjoy certain tax concessions.

40. Furthermore, the following specific exceptions are stipulated in the ICTA:

(a) where the CFC follows "acceptable" distribution policy;

(b) where the CFC is engaged in exempt activities;

(c) where the CFC complies with the approved public quotation condition;

(d) where the *de minimis* limitation applies; and

(e) where the reduction of UK tax is not the main reason for the existence of the CFC.

"Acceptable" Distribution Policy

41. Essentially, an acceptable distribution policy for a foreign trading CFC requires a 50% distribution of profit. A non-trading company must distribute at least 90% of its profits. The dividends must be paid not more than 18 months after the end of the relative accounting period of the CFC.

42. Profits are the "chargeable" profits less the "creditable" tax. "Chargeable" profits are the profits, excluding chargeable gains, on which the CFC would be liable to UK tax if it were resident in the UK.

43. A "<u>trading company</u>" for purposes of the CFC rules is defined in section 756(1) of the ITCA as " a company whose business consists wholly or mainly of the carrying on of a trade or trades."

44. "Trade" is defined in section 832(1) as "every trade, manufacture, adventure or concern in the nature of trade."

45. "Exempt activities" are outlined in Part II of Schedule 25 of the ICTA. Essentially, the CFC must carry on a business in the territory of its residence wholly or mainly through reasonably permanent premises, i.e. a concept similar to the permanent establishment concept used in double taxation agreements. Furthermore, the company's business affairs must be effectively managed there. This requires that the CFC must employ sufficient people in that territory and any services that the CFC provides for persons resident outside the territory must not be performed in the UK (subject to certain other conditions).

46 Certain activities are specifically exempt or "permissible". Two tests must be satisfied to qualify:

(a) The main business of the CFC must not consist of "investment business" or dealing in goods for delivery to or from the UK or to or from connected persons, unless the goods are actually delivered into the CFC's country of residence. "Investment business" includes holding or dealing in securities, holding intellectual property and leasing business; and

(b) If the CFC is engaged in wholesale, distributive or financial business, less than 50% of its gross trading receipts must be derived from connected persons.

There are special rules for banks and insurance companies. Holding companies which are CFS's may also qualify under these exemptions if their subsidiaries carry on exempt activities;

Motive Tests

47. Even if the exclusions and exemptions do not apply, the rules may not be applied if two motive test are satisfied. In the first place, if any of the CFS's transactions achieved a reduction in UK tax but the reduction was either minimal or was not the main purpose for the transactions, the rules may not apply. Secondly, the rules will not apply if the reduction in UK tax through the diversion of profits from the UK, was not the main reason for the existence of the CFC.

48. "Public quotation" condition. A CFC will satisfy this condition when:

(a) shares (except preference shares) conferring at least 35% of the voting power in the CFC, are publicly held throughout the fiscal year;

(b) within the fiscal year, any such shares have been dealt in on a recognised stock exchange in the territory of residence of the CFC;

(c) within the fiscal year, the shares have been quoted in the official list if such stock exchange;

(d) the CFC's principal members possess no more than 85% of the voting power in the company; and

(e) a "principal member" means someone who possesses (directly or via others) more than 5% of the voting power, unless there are more than 5 such members in which case only the member with the greatest percentage would be a principal member.

49. "*De minimis* exemption". If the changeable profits in the fiscal year do not exceed £20 000, the rules may not be applied.

The Rules Applicable in Germany

Basic tax system

50. Germany imposes tax on a residence basis. However, foreign source income eg income generated through a foreign branch, which is effectively a permanent establishment under treaty law, is often exempt from German tax. Furthermore, dividends derived from foreign companies are usually tax exempt in the hands of a corporate taxpayer, provided they are not "portfolio investments".

Statutory CFC rules

51. The German CFC rules are embodied in section 7 - 14 of the Foreign Tax Act (*Aussensteuergesetz*, 1972). The rules are also rather simple compared to the Australian rules.

52. Section 7 determines that the income of a non resident corporation, association or asset fund may be attributed to German residents if they hold a participation in the foreign entity equivalent to more than 50%.

53. German residents are considered to participate in more than 50% of such a foreign entity if shares/voting rights in the CFC are held by a person who has to follow or actually follows the instructions of a German resident, in such a way that the person has no real freedom to make his own decisions. Such shares/voting rights shall be attributed to the German resident.

54. An important extension of the basic rule is that where a foreign company functions as an intermediary in respect of income with a "capital investment character" (essentially passive income), and a German resident owns at least 10% of the shares of such a company, then the proportionate share of the income shall be taxable in the hands of the German resident regardless of whether the other preconditions mentioned have been met.

55. This extension shall not apply if the gross passive income does not exceed 10% of the total gross income of the foreign company and the *de minimis* limitation of DM120 000 is not exceeded.

56. Section 8 stipulates that the income of a CFC may be attributed to German shareholders if the income is subject to low taxation and which is not derived from:

(a) agriculture and forestry;

(b) the manufacture, processing, treatment or assembly of assets, generation of energy, or the search for and the exploitation of minerals;

(c) the operation of a banking business or an insurance business if a business establishment is maintained which is commercially equipped for this business, unless the business transactions are predominantly made with German residents who have a participation in the foreign corporation according to section 7, or with persons being related within the meaning of section 1(2) with the aforesaid persons;

(d) trading, unless -

(i) an individual or corporate resident who participates in the foreign corporation in accordance with section 7 or a person related with the said resident within the meaning of section 1(2) delivers the commodities or goods so traded from Germany to the foreign corporation; or

(ii) the commodities or goods are delivered by the foreign corporation into Germany to such a resident as defined above or to such a related person, except if the resident (as defined) can prove that the foreign corporation maintains a business establishment suitably equipped for such commercial transactions participating in general business dealings and that the foreign corporation performs the activities relative to the preparation, the conclusion and the fulfilment of those transactions without the assistance of the resident or of the related person as defined above.

(e) services, except -

(i) if the CFC uses the services of a German resident who participates in the CFC as defined above or of a related person who is taxable in Germany on such services income;

(ii) if the CFC renders services to a German resident or related person, unless the taxpayer can prove that the CFC maintains a suitably equipped business establishment to enable it to perform such services without the assistance of the German resident taxpayer or connected person:

(a) renting and leasing, except for -

(i) the granting of the right to use rights, plans, designs, processes, know-how and knowledge, unless the taxpayer can prove that the foreign corporation exploits the results of its own research and development undertaken without the assistance of a taxpayer who holds a participation in the foreign corporation in accordance with section 7 or of a person related to such taxpayer within the meaning of section 1(2);

(ii) the renting and leasing of real estate, unless the taxpayer proves that the income resulting therefrom would be tax exempt in terms of a Double Taxation Convention if received directly by the residents who hold participations in the foreign corporation as defined in section 7; and

(iii) the renting and leasing of movables, unless the taxpayer can prove that the foreign corporation operates a commercial renting or leasing business and participates in general business dealings and performs all the activities typical of such a commercial rental or leasing business without assistance of a resident holding a participation in it in accordance with section 7 or a person related with such a resident with the meaning of section 1(2):

(a) the borrowing and the granting of loans if the taxpayer can prove that the capital was raised exclusively on foreign capital markets and not from related persons and further, that the funds were applied in businesses or permanent establishments abroad which carry on exempt activities, or applied in a business or permanent establishment in Germany.

57. A foreign holding company will not be regarded as an intermediary CFC if the holding company holds at least 25% of the shares in another foreign company for a period of at least 12 months prior to the calculation date and the taxpayer can prove that:

(a) the principal place of management and the corporate seat of this corporation is located in the same country as the foreign corporation and that it derives its gross income exclusively or almost exclusively from the exempt activities mentioned above; or

(b) the foreign company’s holding is commercially linked to activities of its own falling under the exempt activities mentioned above and if the company in which the foreign corporation so participates derives its gross income exclusively or almost exclusively from such activities.

58. "Low taxation" within the meaning of sub-section (1) exists if the income is, neither in the country of the principal place of management, nor in the country of the corporate seat of the foreign corporation, subject to a total tax burden on income of 30% or more, provided this is not the result of a mixing with income from other sources, or if the taxes thus to be taken into consideration are - by operation of law of the country in question- reduced by taxes which have to be borne by the company from which the income originates. Income which is to be excluded from the amount of attributions in accordance with Section 13 and tax relative thereto shall not be taken into account.

59. "Income with a capital investment character" includes income of the foreign company derived from the holding and management of investments. The "holding" of investments includes passive ownership of the investments but also the realisation of such investments, i.e. gains from such disposals would be attributable income. The "management" of investments implies the management of the investments held by the holding entity and not of the investments of others. "Investments" include instruments of payment (cheques, promissory notes, cash, etc.), claims (including loans, debentures, etc.), shares, bonds, profit participation certificates, interest in a partnership (passive), options, advances, etc.

60. Income from the holding of investments includes gains from the realisation/liquidation of the investments. Income from the holding of financial instruments also includes currency gains. However, if the taxpayer can prove that the income is linked to its own exempt activities (stipulated above), the income will not be treated as income with a capital investment character. Furthermore, 60% of the income will also be excluded if the taxpayer can show that the CFC earned the income in funding foreign related companies or branches which mainly carry on exempt activities.

5th Report - BASING THE SOUTH AFRICAN INCOME TAX SYSTEM ON THE SOURCE OR RESIDENCE PRINCIPLE - OPTIONS AND RECOMMENDATIONS

ANNEXURE 2 - WRITTEN SUBMISSIONS RECEIVED

Name	**Company**
Gering,	
Pretorius	
Lategan, T	AHI
Ball, M	MBorden Foods (Pty) Ltd
Botes, AJ	Mine Officials Pension Fund
Botes, AJ	Mine Employees Pension Fund
Ngalwana	
Botha, A	Assoc. of Law Societies of RSA
Lermer, D	Coopers and Lybrand
Ross, RB	SAICA
Tudhope, R	Nedcor Bank
Howes, HG	First National Bank

5th Report - BASING THE SOUTH AFRICAN INCOME TAX SYSTEM ON THE SOURCE OR RESIDENCE PRINCIPLE - OPTIONS AND RECOMMENDATIONS

EXECUTIVE SUMMARY

Since the democratic elections in 1994, South Africa has rapidly rejoined the global economy. This development now requires a careful analysis of the international dimensions of its tax system in general and, more particularly, whether that system should be based on the so-called residence or source principle. This report seeks to provide this analysis. Given the complexity of the subject, an executive summary is provided as an overview of the underlying themes and the main proposals. For a complete understanding of all relevant issues, the full report needs to be studied.

The Basic Options - Source or Residence

As trade and investment developed an international character, nations started making a choice between two basic principles by which to levy tax on income generated by international economic activity - namely, the residence or the source principle.

According to the residence principle, a country seeks to tax all the income derived by its residents, regardless of the source of such income. This approach is usually justified by the argument that residents enjoy the protection of the state, and should therefore contribute to the cost of the government of the country in which they reside, even with tax on income earned outside that state. The source principle also expects residents to contribute towards such costs of the state, but it is premised on the basis that, irrespective of residence, any person who derives income within a state's jurisdiction, should contribute to the cost of that state.

In the complex world of international trade, no simple principle can be applied in a pure form. Both basic principles have typically been modified in the direction of some common middle ground. Residence based systems, usually adopted by developed and net capital exporting countries, have compromised by taxing the residents of other countries if they derive their income from within the domestic economy; that is, they have "imported" an element of the source principle. Source based systems, usually adopted by developing and net capital importing countries, have extended their tax nets by deeming a whole range of income (in particular passive type income) received by its residents to be from a domestic source and thus taxable, irrespective of where the income actually originates. ("Passive" income is typically investment income such as interest or royalties, while "active" income derives from active trade or commerce.)

The compromise has gone even further. As international trade expanded, countries started concluding double tax treaties with each other to prevent the same income being taxed twice between the two jurisdictions. In addition, many provided for relief against such double taxation in their national law. Double taxation would have radically reduced international trade and investment. In developing these measures against double taxation, the country of source has more or less universally been given preference; that is, whether provided for in national law or treaties, where both the country of residence and the country of source sought to tax the same income, the country of residence would typically be expected to grant relief against its own tax, whether through an exemption of the income, a deduction of the foreign tax, or a credit for the source country's tax against its own tax.

South African Options

The South African system has developed on the source basis, and, in accordance with the experience of other countries applying the source principle, has been extended by a number of deeming provisions that bring passive income derived from sources outside South Africa into the tax net.

The Commission's recommendations have a few main themes, briefly summarised below and analysed further in the report itself.

Active income - Maintain Source

South Africa should continue to tax active income on a source basis. The following considerations are analysed further in the report.

Direct revenue should not be very different from that yielded by a residence system since South Africa would have to provide relief for foreign taxes under a residence system. Furthermore, if the recommendations regarding passive income are implemented, the major risks of revenue losses would be avoided.

South Africa's re-integration into the world economy will be enhanced by the proposals, which should materially contribute to the entire economy and therefore, indirectly, to revenue collection. So long as South African tax rates are effectively higher than those of most of its trading and investment partners, taxing on a residence basis would mean that South African businesses would have to compete in foreign countries at a major competitive disadvantage - they would pay more tax on income earned in those countries than the host and often third country competitors. Furthermore, by continuing to use a source basis for active income, foreigners operating in the South African economy will generally pay tax on the income they derive here from such activities at the same rate as domestic businesses. In the South African context, therefore, maintaining the source principle on active income provides the kind of tax neutrality that is good in principle and facilitates our participation in the global economy.

It is vital for economic growth that the national financial and human/skills capital be maintained. This means that we must avoid policies that encourage their emigration. If South Africa were to tax all foreign income of South African multi-nationals, including income from their active operations abroad, and do so at the present relatively high rates, South Africa may lose many of these multi-nationals through emigration to more beneficial tax environments. The Commission has received much evidence that holding companies, headquarters companies and finance companies are likely to relocate from South Africa if a residence basis of taxation were now to be introduced. This emigration of capital will become much easier in a post-exchange control environment. Tax should not become an artificial contributor towards such a development.

The current source system facilitates the development of South Africa as a major location for domestic or foreign businesses to base holding companies, headquarters companies and finance companies for investment and trade into Africa, and in particular Southern Africa. Preserving and even extending that state of affairs will benefit the South African economy directly and help the country to acquit itself of its regional developmental responsibilities.

The administrative complexity of changing the system from source to residence for active income militates against the introduction of such a system.

Passive Income - Go Worldwide

The Commission recommends that passive income should effectively be taxed on a worldwide basis. In a broad sense, this is the same as extending the current deeming provisions as to source to include all forms of passive income. That means that South African residents, corporate or individual, should pay South African tax on their passive income, irrespective of the source of such income.

This measure would protect the tax base from possible erosion when exchange controls are lifted. Capital has become highly mobile and passive income can be relocated with little inhibition in pursuit of tax objectives rather than financial or commercial ones. Protecting the tax base without relying on exchange controls would uncouple the tax and exchange control regimes so that policy decisions on controls could then be made without concern for their effects on the tax base.

In adopting this approach, South Africa will effectively follow comparative precedent; therefore, there should not be any negative international impact.

Since South Africa already applies a fair measure of "worldwide" taxation of passive income, as well as commensurate anti-avoidance measures in that context, some administrative and legal infrastructure already exists. Therefore, expanding it need not add materially to complexity.

As with all other residence based systems, South Africa will have to continue to allow relief against its own taxes for tax paid on that passive income in the country of source to avoid double taxation. However, since passive income is frequently exempt from tax in the source country, the tax relief to be granted in South Africa in respect of such income should be substantially lower than in the case of active income. Therefore, the commensurate increase in revenue collection would further justify extending the tax net on passive income.

International Compatibility

In making its recommendations, the Commission considers that the implementation thereof will provide a unique opportunity to ensure that our law is compatible with international conventions and terminology. Those conventions and terminology are contained both in the international treaty network and in the international dimensions of national tax laws. In this way, foreign investors will have a much quicker understanding of our tax regime, it will equip domestic business to plan in a more familiar environment, and both taxpayers and authorities will have a mass of international expertise available in interpreting and implementing the tax law fairly and effectively.

Several recommendations pursue this internationalisation of our tax laws. The advantage of this reform is most evident in the proposed rules to determine the source of income. The Commission recommends that the taxation of active income should be based on the notion of business *activity* through a minimum *presence* within the taxing jurisdiction. If a foreign resident derives active income from a presence in South Africa that has sufficient substance, it should be taxed here. Conversely, where a South African resident derives active income through such a presence in another jurisdiction, it should not be taxed by South Africa. In applying these tests, the Commission recommends that well-developed and internationally accepted concepts should be applied. For example, the concepts of a "permanent establishment" would be used to determine whether the taxpayer has a substantive presence in a particular jurisdiction, and only income "attributable" to that establishment, according to widely accepted international norms, would be taxed in that jurisdiction. In the same way as income, expenditure will also be attributable to that income according to international norms.

In pursuing this approach, the South African system will be based on tested international principles, compatible with international tax conventions and terminology. Moreover, as international trade practices, technology, computerisation and electronic communication impact the development of international tax law in the future, the South African system should be better equipped to absorb the changes effected internationally.

Anti-Avoidance

Several recommendations are made regarding the development of South Africa's anti-avoidance measures in our international tax law. Some of these are complex. However, the Commission emphasises that the need for these measures, and the complexity that comes with them, is not the result of its recommendations as such, but of South Africa's growing re-entry into the global economy, especially once exchange controls are relaxed. As South Africans participate increasingly in the global economy, the country will require measures similar to every other control-free system, irrespective of whether it is primarily residence or source based.

The Commission has emphasised that anti-avoidance measures should remain simple enough to be capable of effective implementation. On a broad basis, two approaches can be identified internationally in this context - that which seeks to address every possible eventuality regardless of complexity, and that which addresses the main areas of avoidance but seeks to do so through a manageable balance between scope and pragmatism. The United States and Australia may be seen as examples of the former, Germany and the United Kingdom of the latter. The Commission strongly recommends that this latter balance be sought as over-elaborate anti-avoidance measures are often less effective than administratively feasible ones; furthermore, such measures can seriously inhibit international trade and investment.

The Commission is aware that many of these measures would need to be refined and elaborated in legislative drafting, but it recommends that the above comments be borne in mind.

Concluding remarks

These comments merely provide a frame-work for the many more detailed issues raised in the body of the report. As such they constitute an aid to reading the report itself, but are also dependent for their full content on a careful reading of the report.

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