Office
Commissioner

Enquiries
J J Louw

Telephone
012 422 5155

Facsimile
012 422 5254

Room

Reference

Date
24 October 2000

THE CHAIRPERSON
PORTFOLIO COMMITTEE ON FINANCE
(PCOF)
NATIONAL ASSEMBLY

South African Revenue Service
299 Bronkhorst Street,
Nieuw Muckleneuk, Pretoria
P O Box 402, Pretoria, 0001
SOUTH AFRICA
E-mail jdelarey@sars.gov.za

COMMENTS ON REPRESENTATIONS TO THE PCOF ON THE REVENUE LAWS AMENDMENT BILL, 2000

1 Introduction

As indicated to you during the hearings on the above Bill, SARS and the National Treasury wish to respond as follows to the various points raised by presenters on their submissions on the Bill. It needs to be noted that this submission is in addition to the National Treasury's response to the representations made during the hearings on the 6th and 10th October 2000.

2 Consultation

Within the timeframe available, SARS and the National Treasury tried to consult as widely and extensively as possible. What must be kept in mind is that the policy decision to introduce a residence basis of taxation was already announced by the Minister of Finance in his Budget speech on 23 February 2000. A broad outline of the framework to be followed was also published in the Budget Review released on the same day.

- The first draft of the legislation was released on 31 July 2000 to the Association of Black Accountants of South Africa; the AHI; the Association of

Law Societies; the Association of Unit Trusts of SA; the Banking Council; the Commercial and Financial Accountants; COSATU; the Financial and Fiscal Commission; the FSB; the Institute of Retirement Funds; TAC members; the JSE; the Life Offices Association; NAFCOC; NEDLAC; SACOB; SAICA; the SA Association of Mining Contractors (3 August 2000) and some individuals.

- A second draft was released on 8 August 2000.
- A meeting was held on 14 August 2000 with interested parties, i.e. E Mazansky (Grant Thornton Kessel Feinstein); A Bennet (Deloitte & Touche); D Lermer (PricewaterhouseCoopers); E Lai King (SACOB); B Lacey (SACOB); B Croome (SAICA); A Chait (Brait Advisory Services) and W Cronje (SACOB) to discuss the draft Bill. The following persons were also invited but could not attend the meeting: D Kruger (Deloitte and Touche); M Van Blerck (FFC/Anglo); W Horak (Arthur Andersen) and D Clegg (Ernst and Young).
- A third draft was released on 23 August 2000.
- A meeting was held with the same interested parties on 28 August 2000 to discuss the legislation.
- A meeting was held on 1 September 2000 with the SA Federation of Civil Engineering Contractors and the SA Company of Mining Contractors to discuss the taxation of income of SA residents working outside SA as contractors.
- A fourth draft was released on 6 September 2000.
- An extended meeting was held on 7 September 2000 with some members of the Tax Advisory Committee, certain academics and representatives of institutions to which the drafts were circulated.
- The draft legislation was placed on the websites of SARS and the National Treasury on 22 September 2000.
- A revised draft was placed on the websites on 24 October 2000.

The point was made that taxpayers in the wider sense of the word were not exposed to the draft legislation to fully assess and evaluate the economic implications thereof. In response to that it should be borne in mind that-

- as already mentioned the principle was announced as far back as 23 February 2000;
- the interested parties to whom it was circulated are the professionals who are in the best position to evaluate the implications of the proposals;
- although the legislation was only made available to these interested parties, it is quite clear that there was wide access to it;
- as will be noticed from what follows, the proposal in its entirety is relatively mild if it is compared internationally;
- the legislation was available on both the SARS and National Treasury websites as from 22 September 2000.

Despite this no major issues other than those which were pointed out during the consultation process were raised.

The point was also made that quite a number of drafts with significant changes were made available which made it difficult to follow the process. This, however, could certainly not be used as a point to delay the process as the very reason therefor was to accommodate valid concerns raised throughout the process and should demonstrate the willingness to make the process a meaningful one.

3 Bigger picture

3.1 Reasons for changing to residence basis of taxation

- the move to a residence system is part of the government's overall effort to lower tax rates to be more internationally competitive;
- it offers better protection to the SA tax base by dealing more effectively with diversionary transactions in the form of transfer pricing and round-tripping schemes relating to for example interest, rentals and royalties;
- the residence basis of taxation is an internationally accepted system introduced by virtually all our trading partners, developed and developing countries;
- it places the SA tax system on a better footing in the sense that exclusions from the tax base are targeted. The tax base need not be refined on a continuous basis as deficiencies in the system are discovered;
- the source basis of taxation originates from the time of colonialism and has not since then kept up with international developments;
- over the last number of years direct investment (outbound and inbound) resulted in a net outflow of funds from SA. The proposed legislation recognises that SA is exporting capital. SA, therefore, requires tax legislation which is consistent with other capital exporting countries around the globe;
- the relaxation of exchange controls and increased international trade lead to increased savings and active economic activities outside SA; and
- it is internationally accepted that a residence basis of taxation deals more effectively with e-commerce.

3.2 Criteria applied for designing the residence-minus system

As is by now a well known fact no country in the world has really introduced a pure residence basis of taxation. All countries that tax on the basis of residence have a system which is commonly referred to as a residence-minus system. The trick, therefore, is to determine what that minus should be.

In designing the move from a source-plus basis of taxation to a residence-minus basis of taxation for South Africa, it was important to take cognisance of a number of internal and external factors. Some of the factors that were evaluated were the following:

- Potential revenue that may flow from the proposal;
- The extent of economic disruption;
- Domestic neutrality;
- SA's international competitiveness;
- SARS's administrative capacity;
- The international legitimacy of the proposed system if compared to the tax regimes of other countries.

The resulting trade-off between competing policy priorities was informed by concerns regarding the effect on South Africa's international competitiveness, complexity from a tax administration and compliance point of view and possible economic disruptions.

Based on a cross country analysis it is government's considered view that the proposed residence system, viewed holistically, is more than reasonable given the number of options available.

In view of the above it is important to note the following key facets of the new proposal.

Controlled Foreign Entity (CFE)

From a CFE point of view (which really encompasses the major portion of the proposal) the provisions of section 9D(2) have in the first instance been framed as widely as possible to attribute all the income of a CFE to the controlling residents.

It is, however, important to read this wide charging section together with the exclusions (the minus part relating to CFE's) contained in section 9D(9).

Firstly, section 9D(9)(a) excludes all the income of a CFE if the CFE operates in a country which-

- is a designated country with a tax system similar to SA; and
- taxes its profits at a statutory rate of at least 27 per cent.

The rationale therefore being that taxing CFEs of such a nature would not really make sense from an administrative and economic point of view, as SA would have to allow the tax paid to the foreign jurisdiction as a credit against the SA tax. An exclusion of this nature is internationally accepted practice.

This means that CFE's operating in countries such as Algeria, Australia, Austria, Belgium, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, Republic of Korea, Lesotho, Malawi, Namibia, Netherlands, Norway, Poland, Romania, Slovakia, Swaziland, Sweden, Thailand, Tunisia, United Kingdom, United States of America, Zambia and Zimbabwe will generally be out of the system. The above countries are all countries designated by the Minister of Finance for purposes of the foreign dividend legislation (section 9E).

The list of designated countries will be extended, taking even more CFE's out of the proposed system. This will significantly reduce the administrative and compliance costs of the system with a minimal loss in revenue. It will also allow simplification of the foreign tax credit system and reduce the need to carry forward foreign losses.

Secondly, section 9D(9)(b) provides that if a CFE is operating in a country which is a low or zero tax country and does not fall within exclusion 9D(9)(a), SA will tax the income of the CFE on a deferred basis. In short, the income will remain exempt from SA tax until it is repatriated to SA.

This will, however, only be allowed if the CFE operates by way of a proper business establishment in that country. A business establishment is a place of business-

- with a reasonable degree of permanence;

- which is properly staffed with on-site operational management and employees;
- which is suitably equipped for purposes of conducting the business; and
- which has its place of business outside SA which is maintained for a *bona fide* business purpose.

The net result of these two wide exclusions is that the income of a CFE will only be imputed to and taxed in the hands of a SA resident where the:

- income of the CFE does not arise from a proper business establishment in the foreign country;
- income is diverted from SA at the cost of the SA tax base, i.e.
  - transfer pricing
  - round-tripping schemes making use of, for example, interest, rental or royalty deductions in SA
- income constitutes certain passive income.

Branches – section 9F read with section 10(1)(kA)

Companies operating offshore by way of a branch will be dealt with as follows. If the branch is situated in a designated country with a tax system similar to that of SA and the income will be subject to tax at a rate of at least 27 per cent, the income will be exempt. If not, the income will be included in the hands of the SA resident and a credit will be allowed for foreign tax paid.

Individuals

Individuals will mainly be affected as follows:

Business income

Business income will be included in their taxable income as it arises. Foreign tax paid will be allowed as a credit against SA tax liability. The reason for not following the acceptably taxed country principle is that the tax rates applicable to the income of individuals differ significantly from country to country in respect of the progression of the rate structures and the level where the maximum marginal tax rates are reached.

Passive income

Passive income has been included in their taxable income as it arises since 1997. The tax base was extended earlier this year to also include foreign dividends. Foreign tax paid is allowed as a credit against SA tax liability.

Foreign employment income

Foreign employment income of a resident will be taxed in SA, unless it is exempted in terms of section 10(1)*(o)*.

4 Responses to specific issues raised during the representations on the draft residence legislation – 6 and 10 October 2000

4.1 Definition of resident in section 1 of the Income Tax Act, 1962

a) Clarify meaning of the term ordinarily resident, the meaning of days in the definition of resident and the place of effective management.
(SAICA; PricewaterhouseCoopers)

The definition of resident covers both natural persons (individuals) and legal persons such as companies.

(i) Individuals

Residence in the case of an individual is determined in accordance with two rules, namely-

- Ordinary residence. This is a subjective test and the criteria in this regard have been laid down by case law over many decades. It generally means a person's permanent home or place of fixed abode to which he or she will normally return. This is an internationally accepted test and has as recent as 1992 been confirmed in SA by our High Court of Appeal in the case of CIR vs Kuttel 1992 (3) SA 242 (A).
- Time rule. This is an objective test which is measured over a period of 4 years. The wording of this rule has now also been simplified in the sense that-
  - the 91 day rule will apply during each of the 4 years; and
  - the 183 day rule has been collapsed into a 549 day in aggregate rule during the first 3 years of the 4 year period.

(ii) Companies

Residence in the case of a company is determined by the place of incorporation or the place of effective management. Effective management generally means the company's place of day to day management. International headquarter companies are excluded from the definition of resident (see paragraph 4.4 for more details of these companies).

It is agreed that these concepts can be expounded upon in the form of a practice note. Such a note can summarise the relevant criteria and will be issued for general information. Australia, New Zealand and the United Kingdom.also did not clarify the issues by way of legislation. A day will, however, include part of a day.

b) The days-based test of residence is retrospective as it is based on physical presence from March 1998. Apply residence test with reference to tax periods from 2001.
(PricewaterhouseCoopers)

The view is held that the definition does not operate on a retroactive basis as is suggested. Although the definition takes into account historic events, the **taxing event** occurs from a current date onwards. Income is not taxed retroactively.

If this argument is accepted then one also cannot take past facts into consideration in determining ordinarily residence, which cannot be the case. This will defeat the whole purpose of taxing on a residence basis.

c) **The new definition of resident should also be clarified in the context of SA's tax treaties**
(PricewaterhouseCoopers)

The new concept will be taken into account in negotiating new treaties and existing treaties may be changed by way of a protocol where necessary.

d) **Clarify in the Income Tax Act how the residence of dual residence companies is to be determined by amending the definition of resident**
(PricewaterhouseCoopers)

The provisions of the relevant treaty whose tie breaker rules are applicable will determine which country has the right to tax the profits of the company. The treaty will in any case override the provisions of the domestic provisions relating to income tax. In cases where tax treaties are not in place, SA should only determine residence on the basis of the definition contained in the Income Tax Act. No change is deemed necessary.

4.2 Foreign tax credit – section 6*quat*

a) **Provide for foreign tax credits where a resident together with connected persons owns 10% or more but not individually**
(SAICA)

This issue is raised in the context of section 9E, i.e. the taxation of foreign dividends. The underlying principle applied in allowing a credit of foreign tax paid in respect of foreign dividends taxed in SA was as follows:

- where the resident holds an interest of 10% or greater in the foreign company – foreign withholding tax and underlying corporate tax will be allowed as a credit.
- where the resident holds an interest of less than 10% - only foreign withholding tax will be allowed as a credit.

The reason for not allowing underlying tax as a credit to portfolio investors (<10% interest) is that these shareholders would find it administratively very difficult if not impossible to obtain the relevant information relating to foreign tax paid from the company declaring the dividend. Similarly it will also be difficult for SARS from an administrative point of view to check this. It is an internationally accepted principle that portfolio investors are not allowed a credit for foreign underlying tax.

b) **Allow excess tax credits against STC until list of designated countries has been sufficiently expanded, alternatively the new list should apply from 23 February 2000**
(Marius van Blerck)

Simplification played a major role in taking this decision as the calculations around the creditability of foreign tax against STC are extremely complex.

SAICA supports the proposal that foreign tax credits should not be allowed against STC in view of the extension of the period of carry forward of credits to 7 years.

The decision to do away with the credit of foreign tax against STC was a trade-off between the pure tax principle of creditability and-

- Extending the carry forward of excess credits from 3 to 7 years;
- Onshore mixing of foreign tax credits;
- The simplification of the system;
- The fact that it is unlikely that there will be many instances of excess tax credits. This is so by reason of the fact that CFE's operating in designated countries where they are taxed at 27% or more will be out of the system in any case. As mentioned above the only situation left where the income of a CFE will be imputed in the income of a resident is where-
  - income is diverted from SA;
  - no proper business establishment exists; or
  - the income is mainly passive.

Furthermore, not allowing the foreign tax as a credit against STC does not compromise our view that STC is a normal tax. This is so by reason of the fact that in those cases where a resident is exempt from the provisions of section 9D, the exemption applies in respect of both normal tax and the STC.

The new expanded list of designated countries will only apply from 1 January 2001. The foreign tax credit against STC will be available until the residence basis is introduced. Companies have the option to defer dividends until after promulgation of the Bill and publication of the revised list.

c) **A mechanism should be provided for taxpayers to reopen their assessments where the actual foreign tax credit was not known at the end of the year of assessment or as a result of subsequent changes in the foreign tax payable** (PricewaterhouseCoopers)

This proposal is accepted and specific provisions have been introduced to regulate the treatment of changes in foreign tax paid for a period of six years from the date the relevant assessment is issued.

4.3 Controlled foreign entities

a) **The election to convert the net income of a CFE at the year-end rate or average rate should be a permanent election** (PricewaterhouseCoopers)

This proposal is accepted and in exercising his discretion the Commissioner will have to specify that the relevant method of conversion be applied on a consistent basis.

b) **Withdraw 1-year lease period requirement for business establishments** (PricewaterhouseCoopers)

This requirement has been reworded to refer to a total period of use of at least 1 year. Lease agreements concluded for an aggregate period of one year will qualify. The 1-year requirement has been removed in the case of a mine, oil or gas well, or quarry.

c) **Section 9D is overly complex and will hinder international competitiveness, It goes beyond protecting the SA tax base and creates uncertainty. Developing countries do not have such strict CFC provisions and SA should not be compared to developed economies such as the US and the UK. Provisions can constrain commercial activity and potentially drive such activity away from SA. Too many aspects are left open to the Minister's and the Commissioner's discretion.**
(PricewaterhouseCoopers)

The provisions of section 9D have been simplified as far as possible compared to the previous draft by moving certain provisions relating to trusts to other sections of the Act, by rewording complex provisions and deleting some provisions.

The proviso to section 9D(9)(b) contains two rules around diversionary transactions.

- The first is mainly based on transfer pricing principles.
- The second set of rules amplifies the main rule and targets certain high risk areas which are more susceptible to diversionary transactions.

The view is held that the provisions of section 9D aimed at diversionary transactions, taking into account the authority of the Minister of Finance to grant an exemption from the application of the diversionary rules, will not impact on economic activity but will address diversionary transactions.

Since South Africa's re-emergence in the international market, there has been a marked expansion of international trade and commerce. An increasing proportion of this international activity is carried on between members of multinationals. As globalisation of business activity continues to accelerate, protecting the SA tax base is vital to SA's wealth and development. The rules aimed at diversionary transactions target structures that most likely contain artificial pricing of transactions and businesses activities which move offshore for tax reasons. The purpose of the discretionary powers given to the Minister are to address those circumstances where the second set of rules may impact negatively on *bona fide* commercial transactions. The intention behind these let out provisions is to make the system more flexible during the initial stage and to refine these rules over time to such an extent that the discretionary provisions can be dispensed with.

d) In the case of diversionary transactions the application of sections 9D and 31 will result in a doubling up of tax, interest and penalties
(PricewaterhouseCoopers)

The imputation of profits in the case of diversionary transactions not being at arm's length is effectively a penalty provision as the resident may also be subject to a transfer pricing adjustment. This measure will serve as an inhibiting factor limiting non-arm's length pricing for transactions with controlled foreign entities. However, in exercising his discretion in terms of section 31 in relation to the resident the Commissioner may take into consideration the amount of net income of the relevant CFE which has been or will be imputed.

e) Add further certainty by introducing a formal advance pricing agreement (APA) procedure in future
(PricewaterhouseCoopers)

This proposal is supported in the longer term and measures will be provided for as soon as SARS has the capacity to administer APA's.

f) Delete requirement in section to s 9D(9)(b)(ii)(bb)(C) that delivery of the product take place within country in which selling company is resident
(Marius van Blerck)

This requirement was inserted to specifically deal with transactions routed through low or zero tax jurisdictions. Taxpayers can address submissions to the Minister of Finance for his consideration whether to treat a number of countries which comprise a single economic market as one country for purposes of sections 9D.

g) The notices published by the Minister and Commissioner in terms of section 9D(9)(b)(ii) should be contained in the Act
(SAICA)

It is agreed that once these rules have been established and refined over time they should ultimately be incorporated into the main Income Tax Act.

h) Offshore holding companies – extend exemption for inter-CFE dividends to dividends from 25% or larger shareholdings
(Marius van Blerck)

The threshold of 25% is applied in tax treaties in order to determine what the percentage of withholding tax on dividends should be or to determine the extent to which an indirect tax credit should be allowed. This is a different aspect from the imputation of the income of CFEs and should not be applied to foreign dividends from group companies where an interest of less than 50% is held.

An unacceptable risk of the proposal is that passive income could be accumulated in the 25% to 50% held foreign company which would not be subject to SA controlled foreign corporation provisions.

A guiding principle in drafting section 9D was that passive income (including foreign dividends) from companies which are not CFE's should be taxed on an imputation basis as it arises. This proposal is, therefore, not supported.

i) **Extend relief for payments between CFE's to royalties and other income from administrative functions performed by an intermediate holding company** (PricewaterhouseCoopers)

The proposal is supported and the necessary amendments have been made. Relief already exists in the case of interest and dividends which are re-cycled between offshore CFE's. The main concern is in respect of income diverted from SA to another country and not about passive income diverted from one foreign jurisdiction to another. The deductibility of the royalty or rent incurred by the CFE will be limited where the recipient CFE is not taxed as a result of the inter-CFE exemption. Transactions of this nature will be monitored to determine whether the relief measures are being abused.

j) **Grant deferral benefit to intermediate holding companies responsible for cash management and other group management functions.** (SAICA)

This proposal is not supported. Deferral relief was granted to a certain extent for interest, foreign dividends, rental and royalties from other CFE's but not for passive income earned from outside the group. Business establishment rules are strict for the specific purpose of imputing all income not meeting that requirement and which is taxed at a statutory rate of less than 27%.

4.4 Headquarter companies

Introduce specific exemptions for South African regional/international headquarter companies of foreign multinationals in order to effect a tax neutral flow-through of foreign income.
(SAICA; PricewaterhouseCoopers; Marius van Blerck; SACOB)

An exemption has been incorporated in this Bill by excluding international headquarter companies from the definition of resident for purposes of the Income Tax Act. The companies which will qualify as international headquarter companies should-

- only have non-resident shareholders other than trusts;
- SA residents and trusts in aggregate should not have an indirect interest in the company of more than 5%;
- At least 90% of the value of assets should represent holdings in subsidiaries which are non-resident.

The effect of introducing this relief measure will be that an international headquarter company will-

- not be taxed on foreign dividends;
- not have to include an amount equal to the net income of its CFE's in its income; and
- STC will not be levied on dividends declared to its shareholders.

Income from local sources will be taxable as in the case of any other non-resident company. The OECD has reported that holding company regimes are preferential tax regimes which may constitute harmful tax competition. The OECD reached no conclusion concerning their status as potential harmful preferential practices but the aim is to reach firm proposals by early 2001. Any developments in this regard will be followed closely especially given that a number of OECD member countries have similar or more generous holding company regimes.

4.5 Tax sparing provisions

Introduce unilateral tax sparing provisions in legislation in order not to neutralise tax incentives granted, especially by developing countries in Africa. (SAICA; PricewaterhouseCoopers; Marius van Blerck)

The tax policy direction in SA over the last number of years has been to limit tax incentives granted in domestic legislation. The preferred choice in this regard is to limit tax sparing provisions to only a number of situations. Provisions have been incorporated in the Bill (section 9E(8A)) in order to enable the Minister of Finance in the national interests of the Republic and subject to such conditions as he may prescribe to approve specific economic development projects which meet certain criteria such as the-

- likely economic benefits for SA;
- extent to which goods and services will be provided from SA;
- potential effect on the SA tax base;
- other assistance granted by the State or an organ of State in respect of the project; and
- such other criteria which the Minister may prescribe by way of notice in the Gazette.

A clause will also be inserted to enable him to withdraw the tax sparing benefit where the project no longer complies with the criteria.

The effect of this approval will be that profits from these projects repatriated by way of dividends to SA residents will not be subject to tax. The on-declaration to its foreign shareholders will also not be subject to STC.

This approach will limit the rigid nature of general provisions in tax treaties which cannot be unilaterally withdrawn at short notice. Furthermore, the deferral option built into sections 9D and 9E will allow the company not to declare a dividend to a resident until the Minister has approved a specific project in terms of section 9E or indicated that a request for tax sparing in respect of a project has not been approved.

4.6 Foreign dividends

a) **Apply deemed dividend provisions only to the sale of shares in companies which are not CFE's; current proposal create unlevel playing fields in financial service industry**
(LOA)

No amendment is proposed to change the scope of the deemed dividend provisions. The treatment of the sale of an interest of 10 per cent or more and the sale of an interest in a CFE will be treated the same where none of the exemptions apply. The Commissioner can in both instances exercise his discretion in terms of subparagraph (vi) of the proviso to paragraph (b) of the definition of foreign dividend where there is no tax avoidance.

b) **The effective date of the new list of designated countries should be 23 February 2000**
(Marius van Blerck)

Where a dividend is received until 1 January 2001 from a company in a country where profits are taxed at a rate in excess of 30 percent and the country is not currently designated, the excess foreign credit will be set off against the liability for STC and the balance can be carried forward for 3 years. It is therefore unlikely that the foreign tax credit will be forfeited. A further aim of deciding on the effective date of 23 February 2000 was to counter tax avoidance schemes. The effective date for the new list will be 1 January 2001, the date from which the new residence provisions will come into effect.

c) **Provide for an exemption for foreign dividends declared from dividends which were declared by companies from profits subject to tax in SA**
(PricewaterhouseCoopers)

This proposal is accepted and the necessary exemption will be provided in order to avoid double taxation.

d) **Clarify the meaning of statutory rate in the case of sliding scale rates**
(PricewaterhouseCoopers)

The provisions of sections 9D, 9E and 9F relating to the statutory rate of tax are only applicable to the income of companies. The legislation will be clarified by providing that in the case of a progressive or dual tax rate schedule for companies the exemption will be granted with reference to the maximum statutory rate potentially applicable to the income of the company. An example dealing with a company whose income is subject to a dual rate of tax will be incorporated in the Explanatory Memorandum.

e) Amend existing law to repatriate reserves accumulated prior to 23 February 2000 without a tax charge
(Marius van Blerck)

This proposal is not accepted. The tax on foreign dividends is triggered by the declaration of dividends from 23 February 2000 which is a separate event from the generation of the profits offshore. The tax incidence also falls on a different taxpayer, i.e. the shareholder. This principle has been considered and debated earlier this year and has already been enacted in section 9E. The view is, therefore, held that the measure is not of a retro-active nature as the income (dividend) is taxed in the hands of a separate taxpayer.

f) Foreign dividends from reserves comprising capital gains should be taxed at the rate applied to domestic capital gains
(Marius van Blerck)

This proposal is not accepted. To make such a distinction for underlying capital gains is not international practice. Foreign dividends are income of a revenue nature and are taxable at normal tax rates irrespective of the capital or revenue nature of the profits out of which they are distributed. It is an accepted principle that any form of income loses its character once it becomes part of profits available for distribution. Dividends declared by a company in the normal course of its business are subject to STC irrespective of the revenue or capital nature of the underlying profits. This issue was also extensively debated at the time section 9E was introduced.

4.7 Exemptions

a) Change reference to resident in section 10(1)(c)(iii) back to ordinarily resident
(SAICA)

This proposal is accepted and the reference to ordinarily resident will be retained to be in line with the Vienna Convention and the provisions of the Diplomatic Immunities and Privileges Act, 1989.

b) Expand on the meaning of "social security system of any other country"
(SAICA)

The explanatory memorandum to the Bill will clarify this concept.

c) Issue guidelines on PAYE deductions in the case of the section 10(1)(o) exemption
(SAICA)

Guidelines will be issued in due course.

d) **Employment income exemption where an individual is outside SA for a continuous period of 183 days makes SA businesses and individuals uncompetitive and could lead to a loss of foreign contracts.**

- **Employment opportunities for South Africans will be reduced and it will negatively impact on the economy. 91 days test is more practical and transitional measures should be introduced.** (SAFCEC)

- **Reduce the requirement to a continuous absence of at least 90 days subject to incidental visits. Change the 183-day rule during a year of assessment to any 12 month period commencing or ending during the year of assessment.** (PricewaterhouseCoopers)

- **Detrimental effect on family life, period is unlikely to fit into one year of assessment, higher cost to employers and SA labour will become more expensive.** (AGC)

- **SA employees may resign or locate to more favourable tax jurisdictions** (SACOB)

- **Will result in the loss of SA skilled individuals working abroad** (SAAMC; SAACE)

- **Foreign companies may be disinclined to invest and locate in SA and African activities may be reconsidered** (SAACE)

In order to have only one test applicable to all industries the required period of presence will be changed from a 183 day continuous period to an aggregate period of 183 full days per tax year. The revised proposal should accommodate most of the concerns raised in this regard.

The current approach is already more generous than that of, say, the USA which requires an absence of 330 days out of 365 days and caps the exemption at $78 000. Other jurisdictions, such as Australia, require that the employees' income be taxed offshore before an exemption is granted in the jurisdiction of residence.

The effect of this relief measure will be monitored to determine whether certain categories of employees abuse this exemption to earn foreign employment income in double non-taxation situations.

e) **Introduce only one test for the exemption in section 10(1)(o) – 183 days in aggregate as is the case for crew members on certain ships**
(SAICA; Marius van Blerck; SAFCEC; SA Association of Mining Contracting Companies)

This concept will be introduced. See paragraph (d) above.

f) **Allow for incidental visits during the period of continuous foreign presence**

- **14 days in aggregate for report back, arrange procurements, hospitalisation or family bereavement.**
(Marius van Blerck)

- **for holidays, to attend to personal matters or incidental business needs such as management meetings**
(PricewaterhouseCoopers; SAACE)

As an aggregate 183 day rule is applied it is not necessary to grant relief for incidental visits to SA.

g) **The taxation of foreign fringe benefits without any form of relief does not address major cost variances between SA and other countries**
(SAFCEC; SA Association of Mining Contracting Companies)

Where an employee qualifies for a section 10(1)*(o)* exemption the employment income as well as foreign fringe benefits will be exempt

No deduction is allowed for expenses of a personal or private nature. Where an employer reimburses an employee for business expenditure incurred a fringe benefit may not arise. An allowance paid for accommodation while an employee is away from his or her usual place of residence is as a rule generally not subject to tax.

h) **Grant relief to individuals on the actual SA tax suffered on the foreign income**
(SAFCEC)

This proposal amounts to an exemption from tax on foreign income and cannot be accommodated. The basic principle is that residents are taxed on their world-wide income and a credit is allowed for foreign tax paid on the income.

i) **Transitional measures are required for tenders which have already been awarded or adjudicated on the basis of no tax on the income of contract workers. Exempt employment income for a period of three years** (SAFCEC; SA Association of Mining Contracting Companies)

The exemption proposed in its revised format should suffice to also deal with contractors working on existing projects.

The granting of transitional relief is not supported as employment income is earned on a current basis. The situation is similar to the adjustment of tax rates for individuals where no transitional relief is granted. In any event, the substantial relaxation of the requirement for qualification for section 10(1)*(o)* exemption, proposed in (d) above, should resolve the problem.

4.8 Grant tax relief to high net worth individuals who become SA residents, in order to attract foreign capital and skills, on the following basis:

- **Exempt foreign income from assets acquired prior to becoming resident;**
- **Apply a remittance basis of taxation as is done in the UK; or**
- **Impose a fixed tax charge on non-SA income**

(PricewaterhouseCoopers)

- **High net worth immigrants create substantial economic benefits, but the evidence is not yet conclusive. Continue to tax local source income and impose a minimum flat rate tax on foreign income.**

(Marius van Blerck)

This proposal is not accepted for the following reasons-

- Foreigners who became ordinarily resident in SA already benefited from a three year phase-in until 28 February 2000. Individuals who are residents as a result of the days test would in many cases qualify as ordinarily resident and were not taxed on foreign passive income since 1997. The view is held that no relief other than that proposed for foreign pensions be granted to immigrants.
- The principle behind taxing on a residence basis is that the resident uses the infrastructure of the country of residence and should therefore make a contribution by paying tax in the country of residence.
- The tax principle of horizontal equity advise against such measures. Persons who are SA residents from birth are taxed in full on their foreign income. The taxation on a remittance basis would act as a disincentive to bringing the income back to SA.
- Taxation is not the only reason why foreigners decide to retire or move to SA, i.e. the cost of living and the climate.
- The estimated loss to the fiscus is based on a limited sample of 9 selected clients of PWC. The figures of R11-19 billion are based on unsubstantiated assumptions as to the direct and indirect tax contribution by these individuals, nominal growth of 18% per annum, future value instead of present value and the percentage of these

individuals who may become non-resident.

- Evidence of the property market in the Western Cape indicates an increase in the number and value of transactions from 1999 to 2000.
- Lastly, if the individual is taxed in SA on the persons foreign income, the foreign tax paid will be allowed as a credit.

With regard to the argument that these high net worth individuals should be subject to only a fixed annual fee, it is not in line with normal tax principles of taxing a person on its taxable income and may set a dangerous precedent.

Relief is granted in respect of foreign pensions which will not be taxed for a period of three years until the tax treatment of the retirement industry has been resolved.

4.9 Scrapping of pipelines

Amend section 11(o) to provide for the scrappping of pipelines
(SAICA)

Section 11(o)(i) provides that no scrapping allowance will be allowed where structures of a permanent nature are scrapped within a period of ten years from the date of erection. As pipelines are written off over 10 years, it is not deemed necessary to allow for a scrapping allowance.

4.10 Losses

a) **Ring-fencing of assessed losses arising from a trade carried on outside South Africa is harsh and contrary to the fundamental basis of world-wide taxation. Allow foreign losses but introduce a claw back provision when the branch is converted in a profitable untaxed subsidiary.**
(Marius van Blerck; PricewaterhouseCoopers)

The principle behind ring-fencing the foreign losses is to protect the existing SA tax base.

Branches

In the case of a SA resident company operating via a number of offshore branches the foreign profits and losses will be set-off against each other. This is so by reason of the fact that it is the same legal entity trading only at different places. If the net result of such offshore activities is a loss, that loss will be ring-fenced and not available for set-off against the resident's SA source profits.

A number of countries do ring-fence foreign losses, e.g. Australia, Brazil, Lesotho and Peru. This limitation should also be seen in the context of foreign tax credits which are allowed to be carried forward for seven years.

CFE's

In the case of a SA resident with multiple CFE's operating offshore, each of such offshore operations represents a separate legal entity. By allowing such offshore entities to pool their profits and losses will be tantamount to group taxation which is not allowed locally. Again it is important to see this matter as part of the bigger picture:

- Profits and losses generated in designated countries will be out of the system.
- Where the CFE operates even in a low taxed country via a proper business establishment, it does not matter whether it generates a profit or a loss. All that will be taxed are dividends when they are finally declared to a South African resident.
- What is, therefore, left is again economic activities arising from diversionary transactions and CFEs with no proper business establishments (mobile operations).

b) Limit the deductibility of foreign costs to foreign income in CFE's only in the aggregate and not on a company-by-company basis.
(Marius van Blerck)

It is not possible to accede to this proposal. It is general practice internationally that losses of one CFE are not allowed to be set off against the profit of another CFE. To allow such a set-off would effectively mean that a group basis of taxation is applied to off-shore entities, where it is not even allowed for SA groups of companies. In addition, CFE income is only imputed to a resident where CFE's are engaged in unacceptable transfer pricing, diversionary transactions or earn passive income in excess of 5% of their gross receipts. It is questionable whether SA should assist taxpayers engaged in such practices by allowing an offset of losses.

4.11 Secondary tax on Companies

Provide a STC exemption for companies which are deemed to be incorporated in SA in terms of section 322 of the Companies Act but are only carrying on a trade in SA through a branch or agency
(PricewaterhouseCoopers)

Section 322 of the Companies Act, 1973 deems such a company to be registered in terms of that Act and not to be incorporated in SA. STC will, therefore, not be imposed on the basis of incorporation. STC is a tax on the income of a company. The provisions of the relevant treaty whose tie breaker rules are applied will determine which country has the right to tax the profits of the company. The treaty will in any case override the provisions of the domestic provisions relating to STC. No change is proposed.

4.12 General

a) Bring the wording of section 103 in line with the new definition of resident (SAICA)

These amendments will be effected.

b) **Extend new definition of spouse to donations tax and include heterosexual permanent relationships in the new definition of spouse.**
(SAICA)

These proposals cannot be agreed to. This would be too easy to manipulate for donations tax purposes. A key difference noted by the Constitutional Court is that people in heterosexual relationships have the option to get married. The constitutional implications of not including such relationships in the definition of spouse have been considered and the view is held that such exclusion will not be unconstitutional.

c) **Give serious consideration to grant a tax amnesty to citizens who have transferred funds abroad illegally**
(SAICA)

During 1996 the Final Relief on Tax, Interest, Penalty and Additional Tax Act, 1996 was enacted which had a cut-off date of 28 February 1997. That amnesty did not only grant relief to non-filers, but also to persons who under-declared their income. Granting an amnesty in this regard will open the door for further requests in respect of local income which has not been declared. Where a person voluntarily declares foreign assets which were generated from untaxed SA income the voluntary disclosure will be taken into account by the Commissioner in determining the interest and penalties to be imposed. If at all, an amnesty would only be considered when further relaxation of exchange control is granted.

Furthermore, this issue is not only a tax issue, but would also require an amnesty from the exchange control regulations.

Prepared by SARS and the National Treasury