



National
Treasury



Briefing Note

Residence Basis of Taxation

1 Existing basis of taxation

The South African income tax system is currently primarily based on what is commonly referred to as the source plus basis of taxation. All income which, therefore, originates in the Republic and certain types of income which are deemed to be from a source in South Africa are taxable in terms of the Income Tax Act.

2 Proposed basis of taxation

As was announced in the Budget Review, a “residence minus” system will be adopted with effect from years of assessment commencing from 1 January 2001. Residents will be taxed on their world-wide income, but certain categories of income and activities undertaken outside South Africa will be exempt from South African tax. Foreign taxes paid by these residents will, however, be allowed as a credit against the South African tax liability.

3 Reasons for change

The most important reasons for changing to the new basis of taxation are-

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

4 What are the most important changes?

4.1 Re-defining the tax base

To implement the new proposals it is necessary to re-define one of the most important building blocks on which the income tax system is based, namely what income is taxable. The gross income definition will therefore be amended to reflect the world-wide basis of taxation, whereby-

- all residents will be taxable on their South African and foreign income
- all non-residents will be taxable on their South African sourced income.

4.2 Defining a resident

As a world-wide tax system is based on residency, it is of crucial importance that there is certainty of what the term means.

Individuals

As far as individuals are concerned two rules will apply to define what a resident is.

The first rule is based on ordinary residence and will mean that a person is a resident of South Africa if his or her permanent home, to which he or she will return, is in South Africa.

The second rule is a time based and more objective rule. A person will become a resident if he or she-

- was physically present in South Africa for more than 91 days per tax year for four consecutive tax years; and
- was physically present for an average of 183 days per year during the first three years of the four years in South Africa.

In terms of this rule a person will therefore only become a resident of South Africa in the fourth tax year if he or she complies with the time rules as set out above.

Companies

A company is a resident if it is incorporated or effectively managed in South Africa.

4.3 Tax credits in respect of foreign tax paid

To avoid the impact of double taxation where foreign income was taxed in the hands of a resident, the foreign tax paid will be allowed as a credit against the South African tax liability.

4.4 Specific exclusions

Foreign pensions

It is proposed that foreign pensions should not be taxed at this stage. This is, however, only an interim measure. The whole issue of foreign pensions will be reviewed over the next three years when the final decision in this regard will be made.

Foreign employment income

In terms of the world-wide basis of taxation residents will now also become taxable on their remuneration earned outside South Africa, irrespective of whether they work for a local or foreign employer. To alleviate the impact of the proposed system on foreign employment income the following exemption is proposed. Where a resident has rendered services outside South Africa for a continuous period of 183 days or longer in a tax year, the income earned from the services so rendered will be exempt from tax.

4.4 How will the income from foreign branch operations be taxed?

The foreign income of any branch of a resident company will generally be subject to tax. However, branch income will be exempt if such income was subject to tax at a statutory rate of at least 27 per cent and the basis of taxation in that country is similar to that of South Africa and the country has been designated by the Minister of Finance. Any other income which was not taxed at that rate or which was taxed at a

similar or higher rate in a non-designated country will be taxable in the Republic and a credit will be granted in respect of any foreign taxes which are proved to be payable in respect of such income.

4.5 How will the income of a controlled foreign entity (CFE) be taxed?

A CFE in essence means a foreign entity which is controlled by South African residents. Control in this sense means where South African residents hold more than 50 percent of the participation rights or votes in the entity or control the entity.

Where such a situation applies, the income, whether active or passive, will be imputed under the new residence system and taxed in the hands of the residents controlling the CFE.

The following exceptions to the above rule will, however, apply-

(a) Income taxed at a statutory rate of 27 per cent or higher

Where the CFE is located in a country which has a tax system similar to that of South Africa and taxes the income of the CFE at a statutory rate of at least 27 per cent, the CFE's income will not be imputed. In addition dividends declared from these profits will not be taxed.

(b) Income taxed at a rate below 27 per cent

If the CFE's activities constitute those of a proper business establishment, the income will not be imputed. In these circumstances taxation in South Africa will be deferred until a dividend is distributed by the CFE. This is generally referred to as the deferral approach. A proper business establishment will generally be a place of business which is suitably equipped, properly staffed and which has its place of effective management in the country where the CFE is located.

If the business does not constitute such a proper business establishment, the income of the CFE will be imputed as it arises.

(c) Diversionary transactions

Circumstances may arise where, even though the CFE has a proper business establishment, the income of the CFE will be imputed as it arises. This will be so in the case of transactions which are generally referred to as diversionary transactions and which are aimed at exploiting the South African tax base. These transactions may include transactions in respect of both goods and services where the income which should otherwise have been taxable in South Africa is reduced or otherwise diverted to a low tax jurisdiction or a tax haven country. A transaction whereby an abnormally high or low price for a purchase or sale is used to divert profits from South Africa is an example in this regard.

(d) Passive income

Most passive income of a CFE will be immediately imputed.

4.6 How will foreign losses be treated?

Losses of foreign branches of a resident company will not be set off against the income of the South African resident. Foreign losses and foreign income of different

branches may, however, be pooled. The reason for not allowing the net loss to be set off against the South African income of the resident is to protect the South African tax base.

Foreign losses of a CFE will also be ring-fenced in the CFE and not taken into consideration in determining the tax liability of the South African resident controlling the CFE.

4.7 What are the reporting requirements for foreign income?

A number of reporting requirements have been introduced in order to enable SARS to monitor the foreign activities carried on by South African residents.

Where residents hold interests in a CFE the resident who holds the greatest percentage of participation rights in a CFE has to provide information such as:

- the name, address and country of the CFE;
- the classes of participation rights;
- participation rights held by residents holding more than 10%;
- the foreign income statement and balance sheet;
- the income imputed or exempt; and
- the foreign tax paid.