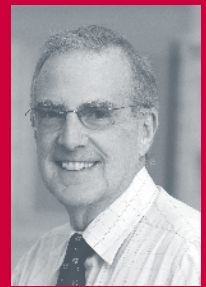


Section 10

Taxation and double taxation agreements

by Ian MacKenzie



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Various forms of taxation are levied in South Africa and the extensive and constantly changing taxation legislation can prove to be a minefield for the unsuspecting foreign investor.

Individuals are taxed on a progressive basis up to a maximum rate of 40% on taxable income exceeding R400 000 per year. A uniform rate of tax is applied to all individuals, irrespective of sex or marital status.

Domestic companies are taxed at a flat rate of 29%. They are also subject to secondary tax on companies ('STC') of 12,5% of the net amount of dividends declared (see discussion on page 75). Accordingly, if all of the company's after-tax profits are declared as a dividend, its combined effective tax rate will be 36,89%.

Non-resident companies, which trade in South Africa through a branch are subject to taxation at a rate of 34%, but are not subject to STC.

Trusts (other than special trusts) are taxed at a flat rate of 40% on income that does not vest in a beneficiary of the trust during the year in question. Income that vests in a trust beneficiary is taxed in the beneficiary's hands and does not lose its identity because it first passes through the trust.

A 'special trust' is a trust created solely for the benefit of a person who suffers from:

any 'mental illness' as defined in Section 1 of the Mental Health Act, 1973; or

any serious physical disability,

where the illness or disability incapacitates the person and prevents him from earning enough income to provide for his own needs.

Special trusts are taxed on the same progressive basis as individuals.

Partnerships are not recognised as entities for tax purposes. Instead, the individual partners are taxed separately on their share of the partnership profits.

Income tax

The principal source of direct taxation revenue in South Africa is income tax, the liability for which is determined and regulated by the Income Tax Act of 1962 ('the Income Tax Act').

Basis of taxation

South African residents are (subject to certain exemptions) taxed on their worldwide income, while non-residents are only taxed on South African sourced income (subject to the provisions of any relevant double tax agreement ('DTA')).

The meaning of a 'resident' is crucial to the current residence based system of taxation. In relation to a natural person, a 'resident' is defined in the Income Tax Act to mean a person:

- > who is ordinarily resident in South Africa (ie a person whose permanent abode is South Africa); or
- > who was physically present in South Africa for at least 91 days during the year of assessment and was during the five preceding years present for at least 91 days in each year, and for 915 days in aggregate over those five years. However, if a person is outside South Africa for a continuous period of 330 days, that person will be deemed to have ceased to be a resident as from the first day of that 330-day period.

A person, other than a natural person, is a 'resident' if it is 'incorporated, established, formed' or has 'its place of effective management in the Republic'. This has far-reaching implications as it means, for instance, that a trust that is established or formed in South Africa will constitute a 'resident' despite the fact that it may be managed offshore. Similarly, a company that is incorporated under the South African Companies Act will qualify as a 'resident' despite the fact that it is managed offshore, while a foreign-incorporated company will be a 'resident' if its place of effective management is in South Africa.

Controlled foreign companies

Section 9D includes in the taxable income of South African taxpayers income earned and capital gains realised by a controlled foreign company ('a CFC').

A CFC is defined, subject to certain provisos, as a 'foreign company' in which South African residents individually or collectively hold more than 50% of the rights to participate directly or indirectly in any of the share capital, share premium, current or accumulated profits or reserves of the foreign company, or the right to exercise any voting rights in such company ('participation rights'). A person is deemed not to be a resident for the purposes of determining whether South African residents hold more than 50% of the participation rights or voting rights in a foreign company if: (i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that

person holds less than 5% of the participation rights of that listed company; or (ii) in the case of a foreign collective investment scheme or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such foreign collective investment scheme, except in circumstances where connected persons hold more than 50% of the participation rights or voting rights in that foreign entity. (Foreign companies include any non-resident association, corporation, arrangement or scheme.)

Section 9D provides for the inclusion in the income of the resident shareholder in a CFC, a proportional amount of the 'net income' of the CFC, determined at the same ratio as such resident's participation rights in the CFC. Subject to certain exclusions and exceptions, the 'net income' of a CFC is an amount equivalent to its taxable income, determined in accordance with the Income Tax Act as if the CFC had been a South African resident.

There are a number of exclusions from the application of Section 9D. In particular, the proportionate share of the net income of a CFC will not be imputed, *inter alia*:

- > to a resident who (together with any connected person) holds less than 10% of the participation rights, and may not exercise at least 10% of the voting rights, in the CFC;
- > to the extent that the participation rights are held by a resident indirectly through any company that is a resident;
- > to the extent that it is attributable to interest, royalties, rental or income of a similar nature payable to that CFC by any other foreign company, where that CFC and that other foreign company form part of the same group of companies;
- > to the extent that it has already been subject to South African tax;
- > where it is attributable to any business establishment carried on outside South Africa (this exclusion is, however, subject to a number of provisos); or
- > where it is attributable to the disposal of an asset, as defined for capital gains tax purposes in the Eighth Schedule to the Income Tax Act (other than any financial instrument or intangible asset), where that asset was attributable to any business establishment of any other controlled foreign company, where the CFC and that other controlled foreign company form part of the same group of companies.

Foreign dividends

Foreign dividends are taxable in the hands of residents, subject to the exemption provision in Section 10(1)(k)(ii). A foreign dividend received by, or accrued to, any person will be exempt from income tax, *inter alia*, where:

- > the profits from which the foreign dividend is distributed relate to any amount which has been or will be subject to tax in South Africa, in terms of the Income Tax Act, unless those profits are exempt or taxed at a reduced rate because of a DTA; or arose directly or indirectly from any dividends declared by a resident company;
- > the foreign dividend relates to any amount which was declared by a company that is listed on both the Johannesburg Stock Exchange and any other recognised foreign stock exchange, if more than 10% of the equity share capital in that listed company is, at the time of the declaration of that foreign dividend, held collectively by residents; or
- > the shareholder (together with all other companies in the same group of companies) holds at least 20% of the total equity share capital and voting rights in the foreign company.

Calculation of 'taxable income'

The 'taxable income' of all taxpayers, including natural and juristic persons, is the basic point of departure for assessing income tax liability. A taxpayer's 'gross income' must initially be ascertained. 'Gross income' (subject to certain specific inclusions) is, in the case of a South African resident, the total amount, in cash or otherwise, received by, or accrued to, or in favour of, such resident during the relevant year, excluding receipts or accruals of a capital nature. In the case of a non-resident, 'gross income' is limited to such receipts or accruals which derive from a South African source or deemed South African source.

Certain exemptions may be claimed from a taxpayer's 'gross income' in respect of certain forms of receipts and accruals.

(In addition, certain entities are exempt from income tax on all their receipts and accruals). The result of 'gross income' less any exemptions is the taxpayer's 'income', as defined in the Income Tax Act. From this 'income', further

amounts may be deducted or allowances claimed in terms of the Income Tax Act, giving rise to the taxpayer's 'taxable income'. Any taxable capital gains derived by the taxpayer (and determined under the Eighth Schedule to the Income Tax Act) are then included in the taxpayer's 'taxable income'.

Exemptions

Dividends

In terms of Section 10(1)(k) of the Income Tax Act, dividends are exempt from income tax irrespective of the juristic nature of the taxpayer or the place of incorporation of the company paying the dividends.

The above exemption does not apply, *inter alia*, to:

- > foreign dividends (except as outlined on page 72);
- > dividends distributed by a company the shares of which are 'property shares' as defined in Section 47 of the Collective Investment Schemes Control Act, 2002.

Public benefit organisations

The exempt status of non-profit organisations is governed by Sections 10(1)(cN) and 30 of the Income Tax Act.

Section 10(1)(cN) provides that receipts and accruals of any 'public benefit organisation' which has been approved by the Commissioner in terms of Section 30(3) shall be exempt from tax to the extent that such receipts and accruals were derived otherwise than from any business undertaking or trading activity or from certain pre-determined business undertakings or trading activities. A 'public benefit organisation' (which is defined in Section 30 as a Section 21 company, trust or association whose sole object is the carrying on in South Africa of a public benefit activity in a non-profit manner) may apply to the Commissioner for exempt status. The Commissioner must approve the application if the public benefit organisation complies with the criteria set out in Section 30.

The Ninth Schedule to the Income Tax Act lists the public benefit activities that a public benefit organisation may carry on to become entitled to exempt status. The activities are categorised under the following headings:

- > welfare and humanitarian;
- > healthcare;
- > land and housing;
- > education and development;
- > religion, belief or philosophy;
- > cultural;
- > conservation, environment and animal welfare;

- > research and consumer rights;
- > providing funds, assets or other resources;
- > sport; and
- > general.

Section 18A of the Income Tax Act allows deductions to be claimed for bona fide donations to certain public benefit organisations approved by the Commissioner under Section 30. The deduction is limited to an amount not exceeding 5% of the taxable income of the taxpayer (before the deduction).

Deductions and allowances

Under the general deduction formula contained in Section 11(a), read together with Section 23(g) of the Income Tax Act, expenditure and losses actually incurred by the taxpayer in the production of the taxpayer's income are deductible, provided that they are not of a capital nature and only to the extent that they are laid out or expended for the purposes of trade. In addition, a number of specific deductions and capital allowances are provided for in the remainder of Section 11 and, *inter alia*, Sections 11A, 11B, 11C, 11D, 12C, 12D, 12E, 12F, 12H, 13, 13bis, 13ter, 18, 18A, 21, 24C, 24F and 24G.

Some of the capital allowances provided for in the Act include:

- > a wear-and-tear allowance under Section 11(e), calculated on the straight line basis on the cost of plant, machinery, equipment or articles, at prescribed rates;
- > an annual allowance under Section 12C, in the ratio of 40:20:20:20 in respect of new or unused machinery or plant which was or is brought into use by the taxpayer in the course of its business (other than banking, financial services, insurance or rental business) and is used by him directly in a process of manufacture (or any other similar process);
- > an allowance equal to the full cost of a qualifying asset brought into use for the first time by a 'small business corporation' (Section 12E);
- > an allowance in terms of Section 13*quat* in respect of the cost of the erection, extension, addition or improvement of any commercial or residential building or part of a building which is owned by the taxpayer and is to be used solely for the purposes of that taxpayer's trade if *inter alia* the building is situated in an 'urban development zone'; and
- > A deduction in terms of Section 11D equal to 150% of any expenditure actually incurred by a taxpayer in respect of activities undertaken in South Africa for the purposes of devising, developing or creating any

invention, patent, design, copyright in any computer programme or other similar property of a scientific or technological nature.

Group liability and tax losses

The Income Tax Act recognises the concept of an assessed loss. An assessed tax loss occurs where a taxpayer's total deductions exceed its total income. As provided in terms of Section 20 of the Income Tax Act, this assessed loss can be carried forward and set off against the taxpayer's taxable income in the following year. There is no provision for the carry back of an assessed loss to a previous year.

Since companies within a group are treated as separate entities for tax purposes, the losses suffered by one company within the group cannot be set off against another company's profits within the group. The principle underlying this is that an assessed loss is peculiar to the particular taxpayer suffering the loss and accordingly cannot be transferred to another taxpayer.

Tax losses carried forward may be utilised indefinitely, provided the company in question does not cease trading activities and become dormant.

A taxpayer is, in terms of Section 20 of the Income Tax Act, prohibited from setting off against any amount derived by it from the carrying on of a trade within South Africa, any assessed loss or balance of assessed loss incurred by it in carrying on a trade outside South Africa. Thus, the losses of foreign branches of a resident company cannot be set off against the South African income of the company. A loss of a foreign branch may, however, be set off against the income of another foreign branch and South African losses may be set off against foreign income.

Section 20A operates, in particular circumstances, to prevent a natural person from setting off his assessed losses arising out of certain trades (for example, the practise of a sport, the performing or creative arts, farming, gambling or betting) and against income derived otherwise than from carrying on those trades.

Mining Operations

Companies conducting mining operations (other than gold mining) are taxed in the same way as other companies, except that they are entitled to a special mining capital expenditure deduction in respect of expenditure on shaft sinking and mine equipment.

The capital expenditure deduction is 100% of the qualifying expenditure actually incurred during the year of assessment, limited in any one year to the taxable income from mining on the particular mine before allowing for this deduction. Any excess capital expenditure may be carried forward for deduction from mining taxable income in any future year.

Gold mining companies are entitled to the same mining capital expenditure deduction. The net taxable income from gold mining operations is taxed at a rate determined in accordance with one of two special formulae, instead of at the normal corporate rate of 29%.

Where the formula $y = 37 - 175/x$ is elected, the company will also be subject to STC on any dividends declared. Where the formula $y = 45 - 225/x$ is elected the company is exempt from STC.

In both cases, y is the determined tax rate and x is the ratio of taxable income from gold mining to the total income from gold mining, expressed as a percentage.

Special rules apply to the transfer of mining property and assets from one taxpayer to another.

Oil and Gas Companies

The Tenth Schedule provides for the tax treatment of oil and gas activities with effect from the commencement of years of assessment ending on or after 2 November 2006.

In terms of paragraph 2 of the Tenth Schedule the rate of tax on taxable income derived from oil and gas income of any 'oil and gas company' which is a resident will not exceed 29% and which is not a resident will not exceed 32%. In terms of paragraph 3, the rate of STC payable on dividends declared by a resident oil and gas company will not exceed 5%.

In terms of paragraph 5, 100% of all capital expenditure actually incurred in respect of exploration and 50% of capital expenditure actually incurred in respect of production may be deducted from oil and gas income. To the extent that any assessed losses remain after the deduction of all normal deductions and the capital expenditure deductions from oil and gas income, an amount of 10% of such assessed loss may be set off against other taxable income derived by the company.

For these purposes, an 'oil and gas' company is a company that holds any oil and gas right (as contemplated in schedule 1 of the Mineral and Petroleum Resources Development Act, 2002), engages in exploration or production in terms of any oil and gas right or engages in refining of gas derived in respect of such oil and gas right, and carries on no other trade.

Farming Operations

Taxpayers conducting farming operations are taxed in the same way as other taxpayers, except that they are entitled to a special deduction in respect of qualifying farming capital expenditure, and are subject to certain ring fencing provisions in relation to the cost and closing value of trading stock in the form of livestock.

The farming capital expenditure deduction is 100% of the qualifying expenditure actually incurred during the year of assessment, limited in any one year to the taxable income from farming before allowing for this deduction. Any excess capital expenditure may be carried forward for deduction from farming taxable income in any future year.

Special rules apply to plantation farmers, with particular reference to the acquisition and disposal of land and growing timber.

Capital Gains Tax

From 1 October 2001, any net capital gain, which arises from the disposal or deemed disposal of assets of a resident and from the disposal or deemed disposal of certain assets of a non-resident effected, are subject to tax in South Africa. Although this tax is colloquially referred to as 'capital gains tax' ('CGT'), the net capital gain is actually not taxed separately from normal income, but rather as an integral part of income tax.

The assets of a resident that are subject to CGT are all forms of property (movable or immovable, corporeal or incorporeal), or rights in such property, other than

currency or coins (unless made mainly from gold or platinum) and certain 'personal use assets', irrespective of where such assets are situated. In relation to non-residents, only disposals of immovable property, which is situated in South Africa (or rights or interests in such property, which includes certain indirect interests in immovable property held through companies or other legal entities) and disposals of assets of a permanent establishment of that non-resident through which trade is carried on in South Africa are subject to CGT.

'Disposals' are broadly defined to be 'any event, act, forbearance or operation of law that results in the creation, variation, transfer or extinction of an asset' and include, for example: the scrapping, loss or destruction of an asset; the forfeiture, release, waiver, renunciation, expiry or abandonment of an asset; distributions of assets by companies to their shareholders; the grant, renewal, extension or exercise of an option; and transactions that result in a shifting of value between holders of interests in companies, trusts or partnerships who are connected persons to one another (value shifting arrangements). Certain events are, however, expressly excluded from constituting disposals. These include transfers of assets as security; the issue or cancellation of shares by a company; the grant by a company of an option to acquire a share or debenture in that company; and the issue of bonds, debentures, notes, or other borrowing of money or obtaining of credit.

A number of events are further deemed to constitute disposals. These include where:

- > a person ceases to be a resident or a CFC;
- > an asset of a non-resident becomes part of its permanent establishment in South Africa, or ceases to be part thereof;
- > assets held as trading stock cease to be held as trading stock, and *vice versa*; and
- > a creditor reduces a debt without full consideration being paid therefor.

In broad terms and subject to various exceptions and special rules, the amount that is subject to CGT within the relevant tax year, is determined as follows:

- > each disposal of an asset to which the tax applies results in either a capital gain or a capital loss. This capital gain or loss is the positive or negative difference, as the case may be, between the 'base cost' of the asset and the 'proceeds' derived from the disposal.

Generally speaking, the base cost of an asset is the sum of expenditure actually incurred by the taxpayer in respect

of that asset, which falls within permitted categories of expenditure identified in the Act. Subject to certain exceptions, such allowable expenditures include the actual costs of acquisition or creation of the asset (e.g. the purchase price); all costs directly related to the acquisition or disposal of the asset (e.g. transfer costs, relocation costs); valuation costs; and expenditure incurred to improve or enhance the value of the asset to the extent still reflected in its value. With the exception of assets that are used wholly and exclusively for business purposes, listed shares and interests in a unit portfolio, borrowing costs, expenditure on repairs, maintenance, insurance, and the like are not permitted to be included in an asset's base cost. The base cost of an asset is also reduced by the amount of any expenditure that has already been accounted for as a deduction from gross income, or that is recovered or recouped.

The principles identified above are, however, subject to a number of exceptions and qualifications. In particular, special rules apply in determining the base cost of: (a) assets that were acquired prior to 1 October 2001; (b) financial instruments; (c) identical assets; and (d) assets which are the subject of a value-shifting arrangement;

- > the 'proceeds' of a disposal are all amounts received by or accrued to the person disposing of the asset. The proceeds are reduced to take into account any amounts that are included in the taxpayer's gross income, or that are repaid or become repayable, and any reductions of an accrued amount. In addition, in a number of instances, the Act deems the value of the proceeds to be certain amounts (usually the market value of the asset). These deeming provisions include gratuitous disposals, disposals for a consideration not measurable in money, and disposals between connected persons other than at an arm's length price;
- > once a capital gain or capital loss has been determined, it may in certain instances be attributed to a person other than the person who disposed of the asset. Accordingly, in certain instances, capital gains are attributed to spouses, to donors, to parents of a minor child and to residents in respect of gains vesting in non-residents. Generally speaking, however, these attribution rules are only triggered where the gain is directly or indirectly attributable to a donation, settlement or other gratuitous disposition by the person to whom the gain is attributed, or where the gain is derived from a tax avoidance scheme to which that person is a party;
- > at the end of every year of assessment, the capital gains and capital losses of a taxpayer are then aggregated and, in the case of natural persons, reduced by the annual exclusion (presently R12 500, or R60 000

in the year of the taxpayer's death). This determines the aggregate capital gain or aggregate capital loss for that year of assessment. Certain capital gains and capital losses are, however, excluded or limited in one manner or another. Excluded gains and losses include those derived from: (a) the disposal of assets of a natural person, which are used mainly for non-trade purposes (personal use assets); (b) the disposal by a natural person of the active business assets of a business (or such person's interest therein) of which the market value of all of its assets is less than R5 million (limited to a lifetime exclusion of R500 000); and (c) the disposal by a natural person of his or her 'primary residence' (limited to R1,5 million per disposal). Capital losses incurred on disposals between certain connected persons are excluded, as are capital losses that arise on the disposal by a creditor of a debt of a connected person (unless a corresponding amount is included in the debtor's capital gain or taxable income);

- > the assessed capital loss carried forward from the previous tax year (if any) is then deducted from the aggregate capital gain or added to the aggregate capital loss to derive the net capital gain or assessed capital loss, as the case may be, for that year;
- > if a net capital gain arises, the net capital gain is multiplied by the relevant inclusion rate and the amount thus determined is then added directly to the taxpayer's taxable income and subject to normal tax at the applicable rate. The inclusion rates are presently as follows:
 - for unit trusts and untaxed policy holder funds: 0%;
 - for natural persons, special trusts and individual policy holder funds: 25%;
 - for all other taxable entities, including permanent establishments: 50%;
 - if, however, an assessed capital loss arises in that year, such losses are carried forward to the next tax year and are not deducted from the taxpayer's taxable income. Capital losses are, in effect, therefore only deductible from capital gains.

Departing from the general principles outlined above, special rules exist in a number of instances that alter the amount, timing or incidence of CGT, including rules relating to: disposals between spouses; disposals to and from deceased estates; short-term disposals and re-acquisitions of identical financial instruments; certain involuntary disposals (roll-overs); certain re-investments in replacement assets; distributions by companies; and certain share-for-share

transactions; assets-for-shares transactions; intra-group transactions; unbundling transactions and disposals to a resident holding company that arise from the liquidation, winding up or de-registration of its subsidiary.

Where a person disposes of an interest in the equity share capital of a foreign company (other than a foreign financial instrument holding company), paragraph 64B of the Eighth Schedule to the Income Tax Act provides that any capital gain or loss determined in respect of such a disposal must be disregarded if that person immediately before that disposal held more than 20% of the equity share capital in that foreign company; and held that 20% interest for a period of at least 18 months prior to that disposal, unless that person is a company and that interest was acquired by that company from any other company that forms part of the same group of companies and that company and other company in aggregate held that interest for more than 18 months; and that interest is disposed of to a person who is not a resident or is disposed of when a person ceases to be a resident or a CFC. This 'participation exemption' is subject to specific anti-avoidance provisions.

The incidence of CGT is, of course, also subject to any contrary provisions which may exist under any applicable DTA. In this regard, the OECD Model Double Tax Treaty (on which many of South Africa's DTAs are modelled) provides that:

- > gains from the disposal by a non-resident of immovable property situated in South Africa may be taxed in South Africa;
- > gains from the disposal of movable property forming part of a permanent establishment of a non-resident may be taxed in South Africa (disposals of ships and aircraft are dealt with somewhat differently);
- > gains from the disposal of any other property of a non-resident are only taxable in the state in which the person is resident.

Secondary tax on companies

The secondary tax on companies ('STC') was introduced in South Africa in March 1993.

The introduction of this source of corporate tax

revenue coincided with the reduction of the rate of corporate income tax from 48% to 40%, which rate was reduced further in 1999 to 30% and to 29% in 2005,

in line with the international trend towards lower taxation, or increased tax exemption, levels for business income.

STC is currently levied on companies distributing dividends to shareholders at a flat rate of 12,5% of the 'net amount' of the dividends declared. Subject to certain provisos, the 'net amount' of the dividends declared is the amount by which the dividends declared by a company exceed the sum of any dividends that have accrued to the company during a stipulated period. STC is a tax on the company distributing the dividend and not on the dividend itself - as a result, it is not a withholding tax and is not relieved by the DTAs listed on page 81.

Although STC liability is determined by reference to the amount of dividends declared by a company, it is payable by the company declaring the dividends and is not deductible from the amount of the dividend declared. STC is, therefore, a corporate tax that targets distribution rather than income, ensuring that a company's distributed earnings are taxed at a higher rate than its undistributed earnings. STC thus provides an incentive for a company's shareholders to approve the productive re-investment of a greater proportion of the company's earnings, with the aim of encouraging corporate investment within the South African economy.

Subject to certain limited exclusions, STC also applies to distributions by a company to a shareholder, or to a connected person of such shareholder, which are deemed to constitute dividends under Section 64C. Such deemed dividends include all distributions of cash or assets of any nature (e.g. loans), the sale of assets to shareholders for less than their market value, the waiver of a debt,

the settlement of a shareholder's debt and certain amounts adjusted or disallowed under the transfer pricing provisions (Section 31).

Foreign companies

STC is only levied on dividends declared by companies that are resident in South Africa. Therefore, STC is not imposed on dividends declared by foreign companies out of profits generated by a South African branch although, as outlined above, the rate of income tax for external companies with branches in South Africa is currently 34%.

Exemption from STC

For a declared dividend to be subject to STC it must be a 'dividend' as defined for income tax purposes. Even if it is so defined, it will be exempt from STC if it falls within the scope of one of the exemptions set out in Section 64B(5). These exemptions include:

- > dividends distributed in the course of, or in anticipation of, the liquidation or winding-up of a company in so far as such represent either (i) a distribution of profits derived during any year of assessment which ended not later than 31 March 1993, (other than any such profits derived by way of the revaluation of trading stock held by such company); or (ii) a distribution of profits of a capital nature (other than capital profits attributable to the disposal of any asset on or after 1 October 2001 which capital profits must, in the case of an asset acquired before that date, be limited to the amount of profit determined as if that asset had been acquired on 1 October 2001 for a cost equal to the market value of that asset on that date);
- > certain dividends declared by a fixed property company, as defined in terms of the Collective Investment Schemes Control Act, 2002; and
- > dividends declared by a company, which accrue to a shareholder of that company if that shareholder is a company forming part of the same group of companies as the company declaring the dividend; to the extent that the dividend is derived out of profits earned by that company when it formed part of the same group of companies as the shareholder; that shareholder would be subject to STC should that shareholder declare a dividend from that dividend so declared by that company and not elect that paragraph 54B(5)(f) must apply in respect of the dividend; and the company declaring the dividend elects to have the exemption apply.

Share buy-backs and STC

Section 85 of the Companies Act of 1973, provides for the acquisition by a company of its own shares.

The definition of 'dividend' in Section 1 of the Income Tax Act provides that where a company acquires its own shares, that amount of the consideration paid to the shareholder that exceeds the nominal value of the shares acquired shall be a dividend. STC will, therefore, be payable on such amount.

Where a share buy-back is funded by way of a reduction of the company's share premium account, it is necessary to distinguish between 'true premium' and 'tainted premium'. While 'true premium' arises pursuant to a subscription of shares, 'tainted premium' arises pursuant to a transfer from the company's reserves to its share premium account. When 'true premium' is returned to shareholders, no STC is payable. Where, however, 'tainted premium' is returned, the return will constitute a dividend and STC will consequently be payable. Where the seller of the shares that are subject to the buy-back is a company, and where the consideration paid to the seller constitutes a dividend, the seller may claim a credit for STC purposes.

Corporate rules

Special rules relating to the tax consequences of corporate transactions qualifying as 'company formations', 'amalgamation transactions', 'share-for-share transactions', 'intragroup transactions', 'unbundlings' and 'liquidation distributions' are covered by Part III of the Income Tax Act. A qualifying corporate transaction is given tax concessions in the form of 'roll-over' relief from capital gains tax and income tax. In addition, in terms of Section 46 (which deals with unbundling transactions), a concession in the form of an exemption from secondary tax on companies is given. A number of further concessions are provided for in other parts of the Income Tax Act and in other taxing statutes in relation to qualifying corporate transactions. For instance, an intra-group transaction is exempt from donations tax and the acquisition of marketable securities by a company in terms of a qualifying corporate transaction is exempt from stamp duty and uncertificated securities tax. The acquisition of property by a company in terms of an intra-group transaction or any liquidation distribution is exempt from transfer duty.

A 'company formation transaction' is defined as a transaction in terms of which a person disposes of an asset (other than an asset which constitutes a restraint of trade or personal goodwill) to a resident company in exchange

for equity shares of that company where such person, after that transaction, holds a qualifying interest in the company concerned (ie equity shares that are listed or will be listed within 12 months after the transaction or that constitute an interest of at least 20% of the equity shares and voting rights of the company concerned) or is a natural person who will be engaged on a full-time basis in the business of that company of rendering any service.

A 'share-for-share transaction' is defined as a transaction in terms of which a person disposes of any equity share ('the target share') in a resident company ('the target company') to another resident company ('the acquiring company') in exchange for shares in the acquiring company. To qualify as a 'share-for-share transaction', the acquiring company must, after the transaction, hold a specified percentage of shares in the target company (where the target company is listed or will be listed within a specified period after the transaction) or hold a direct interest of more than 50% in the target company. In addition the person disposing of the target share must, after the transaction, hold shares in the acquiring company (at least 20% where the acquiring company was not listed on the date of the transaction and any percentage where it was listed).

An 'intra-group transaction' is defined as one in terms of which any asset is disposed of by a company to a resident company that is part of the same group of companies.

An 'unbundling transaction' is a transaction that is carried out to enable the shareholder of any listed 'unbundling company' or the holding company of any unlisted 'unbundling company' to acquire all the equity shares held by that unbundling company in the company which is to be unbundled, in accordance with the effective interest of such shareholders.

Anti-avoidance Provisions

Sections 80A to 80L of the Income Tax Act contain a general anti-avoidance rule that targets 'impermissible avoidance arrangements'. The enquiry focuses on a consideration of whether the transaction:

- > was entered into for the sole or main purpose of obtaining a tax benefit; and
- > was, in the case of a business activity, entered into or carried out in a manner not normally employed for *bona fide* business purposes, other than the obtaining of a tax benefit; or
- > was, in the case of other activities, entered into in an abnormal means or manner or has created rights or obligations not normally created between persons

dealing at arm's length.

- > lacks commercial substance, in that it results in a significant tax benefit for a party, but does not have a significant effect on either the business risks or net cash flows of that party, taking into account indicators such as the presence of round-trip financing, accommodating or tax indifferent parties and offsetting elements; or
- > has created rights or obligations that would not normally be created between persons dealing at arms length; or
- > would result directly or indirectly in the misuse or abuse of the provisions of the Income Tax Act.

If Section 80A applies, the Commissioner is entitled to determine the tax liability of the relevant party either as if the transaction had not been entered into 'or in such manner as in the circumstances of the case he deems appropriate'.

There are a number of other anti-avoidance provisions in various sections of the Income Tax Act, dealing with particular transactions.

Section 103(2) of the Income Tax Act is specifically aimed at arrangements that have been entered into or effected by any person solely or mainly for the purpose of utilising any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss incurred by a company or trust, in order to avoid liability on the part of that company or trust or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof. The Commissioner may, if he is satisfied that Section 103(2) applies, disallow the set-off of any such losses against income or capital gains, as appropriate.

Transfer pricing

Section 31 of the Income Tax Act deals with transfer pricing and provides that when goods or services (including loans) are supplied in terms of any 'international agreement', the Commissioner is entitled, for the purpose of assessing the taxable income of the supplier or acquirer, to adjust the consideration to reflect an arm's length price, if:

- > the acquirer is a 'connected person' in relation to a supplier; and
- > the goods or services are acquired at a price that is not at arm's length.

The amount by which the consideration is adjusted is further deemed to be a dividend, which is subject to STC.

Thin capitalisation restrictions

As outlined above, a company's interest payments are generally tax deductible while dividends are not,

which means that a company funded with loan capital has a taxation advantage over a company provided with equity capital.

In order to limit this advantage, thin capitalisation rules are contained in Section 31(3) of the Income Tax Act. These rules apply where a non-South African resident has granted 'financial assistance' to:

- > a South African resident 'connected person' (as defined in Section 1 of the Income Tax Act); or
- > any other resident entity in which he has an interest entitling him to participate in at least 25% of the dividends, profits or capital of that entity or to exercise at least 25% of the votes of that entity.

'Financial assistance' is widely defined and includes loans, advances, debts and the provision of any security or guarantee.

In terms of SARS Practice Note 2 (dated 14 May 1996), the thin capitalisation rules will generally be applied to disallow interest incurred on financial assistance that results in a debt-equity ratio of more than 3:1. Such disallowed interest is further deemed to be a dividend, which is subject to STC.

Foreign tax credits

Section 6quat of the Income Tax Act grants rebates in respect of foreign taxes on income. A South African resident is entitled to a rebate equal to the sum of any taxes on income payable to the government of another country, in respect of, *inter alia*, income received by such individual from a source outside South Africa which has been included in that individual's taxable income in South Africa and which is not deemed to be from a South African source. The foreign tax credit is limited to the attributable South African income tax (excluding STC) on the foreign income.

Offshore mixing of foreign tax credits is allowed under Section 6quat. In other words, the foreign tax credit against tax on income of one country may be used as a credit against tax on income from another country. Unutilised credits may be carried forward for seven years but may not be carried back to previous years.

A resident who is a beneficiary of a non-resident trust or a partner in a non-resident partnership may claim a credit for a proportionate amount of any foreign tax paid by the partnership or trust.

Taxation of a foreign company

The tax liability of a foreign company is contingent upon the nature of the income derived by it, as well as the existence of a DTA. Where it is established that the income is derived from a South African source, the enquiry then focuses on the existence or non-existence of a DTA with that other country. The number of DTAs entered into by the South African government in recent years has increased rapidly, encompassing most of Europe (including an increasing number of Eastern European countries), in addition to a number of African and Asian countries. Those countries with which South Africa has concluded a DTA are listed on page 81.

The relevant DTA will usually provide that the foreign company will be subject to South African tax on its 'business profits' only where it has a 'permanent establishment' or a 'fixed place of business' as defined in a DTA. Generally, these two phrases are defined according to the model definition proposed by the Organisation for Economic Co-operation and Development, and include a branch, office, place of management, factory, workshop, mine or construction site.

Payments to non-residents

Interest payments to non-residents

In terms of Section 10(1)(h) of the Income Tax Act, interest received by or accrued to a person who is not a resident of South Africa is exempt from income tax irrespective of its source, unless that person has, at any time during the relevant year of assessment, carried on business in South Africa through a permanent establishment, or is a natural person who was physically present in South Africa for a period exceeding 183 days during that year of assessment.

So much of any dividend distributed to a non-resident by a portfolio of a collective investment scheme out of

exempt income in the hands of that portfolio, is deemed to be interest in the hands of the non-resident.

Royalty payments made to non-residents

In terms of Section 35 of the Income Tax Act,

any person who becomes liable for the payment to a non-resident of an amount for the use in South Africa of intellectual property rights shall pay in advance, and on behalf of the non-resident concerned, a withholding tax amounting to 12% of the payment.

If the recipient of the payment is resident in a territory which is a party to a DTA with South Africa, the withholding tax may be reduced to 0% if so provided for in the DTA. The DTA may provide that taxation of the payment in the receiving state is a condition precedent to a reduction to 0%.

Payments made to non-resident entertainers and sportspersons

In terms of Sections 47A to 47K any non-resident entertainer or sportsperson is subject to a final tax of 15% on all amounts received or accrued in respect of any personal activity exercised in South Africa as an entertainer or sportsperson. This also applies to non-

resident companies that provide the services of such entertainers and sportspersons in South Africa.

Any resident who incurs a liability to make a payment referred to above is obliged to withhold the tax from the payment to the non-resident.

Donations tax

As provided by Section 64 of the Income Tax Act, donations tax is levied at a flat rate of 20% on the value of property donated by South African individuals and companies. Certain donations are exempt from donations tax, such as donations made by a public company, donations made between spouses and charitable donations. Donations tax is payable by the donor.

Donations to an offshore trust will be subject to donations tax, although non-residents are not liable for donations tax.

Value Added Tax

The principal source of indirect taxation revenue in South Africa is value added tax ('VAT'). VAT liability is assessed and regulated in terms of Section 7(1) of the Value Added Tax Act of 1991 ('the VAT Act'). At present, the standard rate of VAT is 14%, although South African exported goods and services are zero-rated.

A person who carries on an enterprise and provides 'taxable supplies' in excess of R300 000 per year is required, in terms of the VAT Act, to register as a vendor. A person may register voluntarily as a vendor if it can show that it is in the process of acquiring an enterprise or part of an enterprise as a going concern, of which the total value of taxable supplies in the preceding 12 months exceeded R20 000. Alternatively, the Commissioner must be satisfied that the applicant is already carrying on an enterprise and that the total value of taxable supplies made by it in the preceding 12 months exceeded R20 000.

The application of VAT extends over a substantial part of economic activity, and Section 7(1)(a) of the VAT Act provides that VAT will be imposed on the supply by any vendor of goods or services supplied by it in the course or furtherance of any enterprise carried on by it. It is apparent that the majority of transactions will fall within the scope of this particular provision, and will be subject to VAT. A number of supplies are exempt from VAT, including, the supply of 'financial services', which includes the exchange of currency, the issue and transfer of debt and equity

securities, the provision or transfer of a long-term insurance policy, the buying or selling of any derivative.

The VAT Act does not provide a clear definition of the term 'supply', which means that, theoretically at least, supplies of goods or services made outside South Africa could nevertheless attract South African VAT, provided that the person making the supply is registered as a vendor under the VAT Act and the supply is made in the course of an 'enterprise' (as defined) conducted by that vendor. Such an enterprise would, however, have to be at least partly based in South Africa. The effect of this unusual feature is largely nullified in practice, however, as supplies made outside South Africa are generally not subject to VAT, either because they are specifically classified as exempt transactions or because they are zero-rated.

The VAT system operates in practice as follows:

- > a vendor incurs VAT on taxable supplies made to it in the furtherance of his enterprise; and
- > the vendor charges VAT on the taxable supplies made by it in the course of or furtherance of its enterprise.

The VAT paid by a vendor is termed an 'input tax', whereas VAT charged by a vendor is termed an 'output tax'.

The 'input tax' is claimable by a vendor as a deduction from the 'output tax', which it is obliged to add to the cost of its supplies.

A vendor is obliged to submit VAT returns to the South African Revenue Service ('SARS') periodically, and to pay over to SARS the amount by which its 'output tax' exceeds its 'input tax' during the relevant period. Should a vendor's 'input tax' exceed its 'output tax', the vendor has a claim against SARS for the excess.

Any business registered as a VAT vendor in South Africa, and which invests in any assets, will effectively incur no VAT

liability, since any VAT payable is fully reclaimable.

The intention behind the introduction of VAT was not that the enterprise should incur the tax, but rather that the ultimate tax burden should rest on the consumer or final recipient of the taxable supplies.

Potential liability for VAT is a relevant tax issue for foreign investors, as the obligation to charge VAT is, in terms of Section 7(1) of the VAT Act, imposed on any person who qualifies as a vendor.

Estate duty

Estate duty liability is assessed and regulated by the Estate Duty Act of 1955. The duty is levied at a flat rate of 20% on the 'dutable amount' of the deceased's estate, after deducting an abatement of R2,5 million.

The determination of 'dutable' property will depend to an extent on the place where the individual was 'ordinarily resident' at the date of his death. If the taxpayer was 'ordinarily resident' in South Africa at the date of his death, all his assets, wherever situated in the world, form part of the total value of the estate for the purposes of determining liability for estate duty in South Africa.

If the taxpayer was ordinarily resident beyond the borders of South Africa, only those assets situated in South Africa will form part of the total value of the estate for the purposes of determining estate duty liability.

Transfer duty

Transfer duty is levied in terms of the Transfer Duty Act of 1949, which provides that the transfer of immovable property by an individual is subject to tax at a rate of 0% of the value of property up to R500 000, 5% of the value of property above R500 000, in the case of property with a value between R500 001 and R1 million, and R25 000 plus 8% of the value of property above R1 million, where the value of the property is R1 million and above, and by a company or a trust at a rate of 8% of the value of the property.

Stamp duty

In terms of the Stamp Duties Act of 1968, stamp duty is levied on the registration of transfer (but not the original

issue) of securities if uncertificated securities tax is not otherwise payable. The current rate of stamp duty is 0,25%. As provided in terms of Section 4 of the Stamp Duties Act, certain financial instruments are exempt from stamp duty. These include:

- > any instrument if the duty is payable by the South African Government or by the government of any other country;
- > any instrument executed by or on behalf of a public benefit organisation; and
- > debentures that constitute financial instruments as contemplated in Section 24J of the Income Tax Act.

Uncertificated securities tax

The Uncertificated Securities Tax Act of 1998, provides for the payment of uncertificated securities tax on transfer (but not the issue) of beneficial ownership of securities which are listed on the JSE Securities Exchange. The rate of tax is 0,25% of the selling price of the securities.

Uncertificated securities tax is not payable on the transfer of securities that constitute instruments as contemplated in Section 24J of the Income Tax Act.

Double Taxation Agreements

COUNTRY	EFFECTIVE DATE	COUNTRY	EFFECTIVE DATE	COUNTRY	EFFECTIVE DATE
Algeria	12 Jun 2000	Indonesia	23 Nov 1998	Poland	5 Dec 1995
Australia	21 Dec 1999	Iran	23 Nov 1998	Romania	21 Oct 1995
Austria	6 Feb 1997	Ireland	5 Dec 1997	Russian Federation	26 Jun 2000
Belarus	29 Dec 2003	Israel	27 May 1980	Seychelles	29 Jul 2002
Belgium	9 Oct 1998	Italy	2 Mar 1999	Singapore	5 Dec 1997
Botswana	20 Apr 2004	Japan	5 Nov 1997	Slovak Republic	30 Jun 1999
Bulgaria	27 Oct 2004	Korea	7 Jan 1996	Swaziland	23 Aug 1973
Canada	30 Apr 1997	Lesotho	9 Jan 1997	Sweden	25 Dec 1995
Croatia	7 Nov 1997	Luxembourg	8 Sep 2000	Switzerland	11 Jul 1968
Cyprus	8 Dec 1998	Malawi	2 Sep 1971	Taiwan	12 Sep 1996
Czech Republic	3 Dec 1997	Malta	12 Nov 1997	Thailand	27 Aug 1996
Denmark	21 Dec 1995	Mauritius	20 Jun 1997	Tunisia	10 Dec 1999
Egypt	16 Dec 1998	Namibia	11 Apr 1999	Turkey	6 Dec 2006
Finland	12 Dec 1995	Netherlands	20 Jan 1972	Uganda	9 Apr 2001
France	1 Nov 1995	New Zealand	23 Jul 2004	Ukraine	29 Dec 2004
Germany	28 Feb 1975	Norway	12 Sep 1996	United Kingdom	17 Dec 2002
Greece	14 Feb 2003	Oman	29 Dec 2003	USA	28 Dec 1997
Hungary	5 May 1996	Pakistan	9 Mar 1999	Zambia	31 Aug 1956
India	28 Nov 1997	People's Republic of China	2 Feb 2001	Zimbabwe	3 Sep 1965

Taxation on retirement funds

In terms of Section 10(1)(d) of the Income Tax Act, the receipts and accruals of any pension fund, provident fund or retirement annuity fund (as defined) are exempt from tax.

Retirement funds are, however, subject to the tax on retirement funds, which is levied in terms of the Taxation on Retirement Funds Act, 1996, at a rate of 9% of receipts and accruals in the form of interest and rental income.

Skills development levies

In terms of the Skills Development Levies Act of 1999, a skills development levy is imposed on employers. The amount of the levy is 1% of the remuneration paid or payable, or deemed to be paid or payable.

Employers paying annual remuneration of less than R500 000 are exempt from the payment of the skills development levy.

Unemployment insurance fund contributions

In terms of the Unemployment Insurance Contributions Act, 2002, each of the employer and employee are required to contribute 1% of the employee's remuneration to the Unemployment Insurance Fund. The employer is liable for the payment of both contributions to the Fund, but may recover the employee's contribution from the employee.

For this purpose, the remuneration on which the contribution is based is limited to a maximum of R11 662 per month. Any remuneration paid to an employee in excess of this limit is not subject to any contributions. **END**