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Income Tax in South Africa

THE FIRST 100 YEARS
1914–2014

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Ensuring a right balance in applying the residence and source bases of taxation

Annet Wanyana Oguttu

Abstract

For any country to have an effective tax system, it has to consider the right basis for taxing the income of residents and non-residents trading within its borders. Internationally, mainly a worldwide/residence or the territorial/source basis of taxation is applied. In that context one of the main tax policy issues that legislators have to grapple with is where a country ought to be on the broad spectrum that runs from a pure worldwide system to a pure territorial system. This paper shows that in the first 100 years of income tax in South Africa, legislation to advance each basis of taxation appears to have been enacted haphazardly. This is done against the background of the rationale for these bases of taxation, the principles of a good tax system, perceptions about these bases, and international developments. Tax policy in South Africa has swung from one extreme whereby the first income tax laws were predominately source based – resulting in numerous tax avoidance loopholes; to the other extreme whereby outward-bound income tax laws (to buttress the residence basis of taxation for residents) were more onerous than source rules that apply to non-residents – which impacted on the competiveness of domestic enterprises. In recent times, while South Africa was strengthening its outbound income tax laws, internationally many developed countries began to move towards largely territorial systems, to protect the competitiveness of domestic companies. Over the last few years, South Africa's policy makers seem to have moved to some middle ground, with the emphasis placed on both residence and source taxation. Relaying the lessons learnt from leaning heavily towards the extremes in the past, this paper makes a case for the basis of taxation South Africa should gravitate towards if it is to have an effective tax system that ensures competiveness of the economy in a globalised world.

Introduction

The acceleration in the globalisation of trade and investment, and the removal of barriers to the free movement of capital,[1] have resulted in increased competition among businesses in the global marketplace and encouraged individuals, entities and multinational enterprises to increasingly develop strategies to maximise profits and reduce their global tax exposure.[2] To protect their tax bases and remain competitive in a globalised world, many countries have been compelled to modernise their tax systems to reflect these global developments.[3] Since the primary function of any country's tax system is to raise revenue for the state,[4] governments are always looking for new, sustainable ways of raising revenue.[5] The need for an effective tax system often requires countries to consider the right basis for taxing the income of its residents

1 Organisation for Economic Co operation and Development (OECD) *Harmful Tax Competition: An Emerging Global Issue* (1998) 13–14 ('OECD 1998 Report').
2 M Grundy *The World of International Tax Planning* (1984) 1–2; A Ginsberg *International Tax Havens* 2 ed (1997) 5.
3 OECD 1998 Report (n 1) 13–14.
4 MM Katz (chairman) 'Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa: Basing the South African Income Tax System on the Source or Residence Principle – Options and Recommendations' (1997) para 3.1.1 ('Katz Commission Report').
5 WB Barker 'International tax reform should begin at home: Replace the corporate income tax with a territorial expenditure tax' (2010) 30 Issue 3 *Northwestern Journal of International Law & Business* 651.

and the non-residents trading within its borders.[6] For a country to levy tax on income derived nationally or internationally, a connection (basis), or 'tax nexus' must be established between the country and that income. Although there are other bases of taxation applied in the world today, for example: domicile[7] and citizenship;[8] the two main bases for taxing income that are applied internationally are the territorial (source) basis and the worldwide (residence) basis of taxation (both explained in paragraph 2 below).[9] Nowhere in the world are either of these bases applied with any degree of purity.[10] In many countries, both these bases are applied in a hybrid form; with some countries leaning more towards the territorial system and others leaning more towards the worldwide basis of taxation. The basis of taxation appropriate to a given country is often dictated by various factors, such as: economic strategies, net cross border flows, the size of the national economies, relative tax rates, historic developments and the administrative capacity of the country.[11] Depending on the factors at play in a given country, one of the main tax policy issues that the legislators have to grapple with is where the country ought to be on the broad spectrum that runs from a pure worldwide system to a pure territorial system. The answer to this question requires the legislators to consider whether the country's resources and administrative capacity should be used to cast the domestic tax net worldwide so as to tax its residents' foreign investments; or whether the country's resources should be used to effectively tax income that is within their borders and encourage the competiveness of domestic enterprises to invest offshore. Generally, countries do not adhere to one of these policy objectives at the complete expense of the other; rather, they gravitate towards one fiscal policy that combines elements of both objectives. The research problem analysed in this article is that South Africa does not appear to have a clearly stated fiscal policy on this matter. The Income Tax Act merely provides that residents are taxed on a worldwide basis and non-residents on a source basis.[12] Income tax legislative amendments over the years seem to indicate that developments in the country's income tax laws tend to swing from emphasising one basis of taxation over another, with no clear tax policy.[13] The aim of this paper is to provide a case for the basis of taxation South Africa should gravitate towards if it is to have an effective tax system.

The paper is structured as follows: Firstly, a description is given of the territorial and the worldwide bases of taxation and the rationale thereof. Then a discussion follows of the principles of a good tax system. Thereafter an analysis of the international fiscal background and the perceptions held about the different bases of taxation is provided. Next follows a discussion of how these bases of taxation have been applied in South Africa over the years. Thereafter a comparative study is presented of changes in tax bases that some of South Africa's trading partners have had to make as they strive to remain competitive in the global economy. Based on this analysis the paper provides the legislators some guidance as to which basis of taxation South Africa should gravitate towards if it is to effectively collect taxes and ensure the competiveness of the economy in a globalised world. It should be noted that the scope of this paper covers mainly the policy considerations behind the laws. The relevant sections of the Income Tax Act and the relevant court cases is not discussed, save in so far as is necessary to clarify a matter under discussion.

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6 Barker 'International tax reform' (n 5) 651.

7 Domicile as a basis of taxation is for instance applied in the UK. There are different rules to determine domicile in common law jurisdictions and civil law jurisdictions. See L Olivier & M Honiball *International Tax: A South African Perspective* 5 ed (2011) 46.

8 Citizenship or nationality as a basis of taxation is not often used. In countries where it is applied, for instance in the US, an individual's nationality or citizenship is used to tax his or her income irrespective of whether he or she permanently lives in his or her country of citizenship or in another country. In the USA case *Cook v Tait* 265 US 49 (1924), the Supreme Court of Appeal upheld the right to tax US citizens on their worldwide income irrespective of where they actually lived. The justification for this basis of taxation is that the US provides benefits to its citizens irrespective of where they live.

9 D Meyerowitz *Meyerowitz on Income Tax* (2008) para 7.1.

10 Katz Commission Report (n 4) para 1.3.1

11 Katz Commission Report (n 4) para 1.3.6.

12 The definition of 'gross income' in s 1 of the Income Tax Act 58 of 1962, as amended.

13 AW Oguttu 'Developing South Africa as a gateway for foreign investment in Africa: A critique of South Africa's headquarter company regime' (2011) 36 *South African Year Book of International Law* 92.

Territorial and Worldwide Bases of Taxation

Historians have traced the origins of residence and source taxation back many centuries. For example, traces of a source basis of taxation can be found as far back as the 13th century in England and in the context of an income tax, the source basis was clearly already in use in Pitt's income tax of 1799.[14] Modern day justifications for the residence and source basis of income taxation can be traced back to the period after World War 1 (1914–1919)[15] when the incidence of double taxation increased dramatically and industrialised countries became concerned about capital flight which proved an obstacle to the reconstruction efforts, as companies were increasingly trading in foreign markets due to the industrial revolution.[16] Before World War 1, there existed a small network of similarly worded bilateral tax treaties among mainly the German-speaking European countries, which would serve as a basic reference point for the conclusion of tax treaties and the effort to develop a model solution for the problem of double taxation after the War.[17] The existing tax treaty network was rudimentary and its theoretical underpinnings not well articulated. This necessitated industrialised countries to engage about the policy considerations in an attempt to reach a consensus position for an international legal framework for preventing double taxation of entities that transacted internationally and to also protect their domestic tax bases.[18] So at the 1920 Brussels International Financial conference, the industrialised nations appealed to the Financial Committee of the League of Nations to take action to eliminate double taxation.[19] In 1921, the League of Nations appointed a team of four economists[20] known as the 'Committee of technical experts on double taxation and evasion' who prepared a report in 1923 entitled 'Report on double taxation',[21] which dealt with the economic aspects of international double taxation. In this report, the four economists articulated the doctrine of 'economic allegiance' as underpinning the international competence or basis to tax income; noting that 'a part of the total sum paid according to the ability of a person, ought to reach the competing authorities according to his economic interest under each authority'. The economists posed four questions by reference to which they proposed economic allegiance should be determined:

a) Where is the yield physically or economically produced?
b) Where are the final results of complete process of production of wealth actually found?
c) Where can the rights to the handing-over of these results be enforced?
d) Where is the wealth spent or consumed or otherwise disposed of? [22]

The four economists noted that not every economic function could fall easily into these four questions since income is a complex concept and it is not easy to theoretically assign, in a quantitative sense, proportions of allegiance to the different countries interested.[23] From the above list of questions, the four economists concluded that the two most important factors that determine economic allegiance are,

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14 P Harris *Income Tax in Common Law Jurisdictions* (2006) 47, 58–60, 112, 415.
15 RS Avi-Yohan *Advanced Introduction to International Tax Law* (2015) 3.
16 MJ McIntyre *Developing Countries and International Cooperation on Income Tax Matters: A Historical View* (2015) 1.
17 J Hattingh 'On the origins of model tax conventions: 19th century German tax treaties and laws concerned with the avoidance of double taxation' in J Tiley (ed) *Studies in the History of Tax Law* vol 5 (2013) 31–79.
18 JA Becerra *Interpretation and Application of Tax Treaties in North America* 2 ed (2013) chap 2 para 2.1.
19 The League of Nations was formed to ensure world peace after World War 1 (1914–1919).
20 Consisting of Prof. Einaudi (Italy), Prof Bruins (Netherlands), Sir J Stamp (United Kingdom) and Prof Seligman (United States of America). See Avi-Yohan *Advanced Introduction to International Tax Law* (n 15) 3.
21 Economic and Financial Committee, League of Nations 'Report on Double Taxation' (5 April 1923, Geneva, League of Nations) E.F.S.73.F.19. at 25[4029]. Available at http://adc.library.usyd.edu.au/view?docId=law/xml-main-texts/brulegi.xml&chunk.id=d640e396&toc.id=d640e396&database=&collection=&brand=ozfed, accessed on 25 May 2015.
22 'Report on Double Taxation' (n 21) 25[4029].
23 'Report on Double Taxation' (n 21) 25[4029].

first, the place where the yield is physically or economically produced (the origin of wealth). This factor connotes the benefits principle which is able to underpin both the residence and source basis of taxation in that tax is levied based on the benefit (for example, services) received from the State.[24] The other factor is the place where wealth is spent, consumed or otherwise disposed of – that is, the place of residence of the person who consumes the wealth and this is what underpins the residence basis of taxation.[25] Residence and source are legal concepts and it is not always straightforward to reconcile them with the economic theories. The findings of the four economists proved to be controversial and they were not immediately adopted in actual tax treaties and unilateral measures dealing with double taxation; however, these ideas have endured and are considered as the 'intellectual base' from which subsequent model solutions for double taxation were developed.[26] Since then, residence and source as factors expressing ideas about economic allegiance continue to be the main jurisdictional bases of income taxation applied in the world today.[27]

Territorial basis of taxation

Under this system, persons are taxed on income that originates within the territorial or geographical confines of the country, irrespective of the taxpayer's home country.[28] It is based on the proposition that a country has the right to tax income that has 'arisen' in that country.[29] The territorial system is considered a direct method of assigning a tax base to a nation in that it links taxation with power over the subject matter of the tax. Practically, the territorial system draws lines between those transactions and economic events that occur in a country and those that do not. Taxpayers are generally not liable for tax on their income earned abroad that is not brought into the territory.[30] The justification for territorial taxation is that a taxpayer can be expected to share the costs of running the country that makes it possible for the taxpayer to produce income.[31] Countries that apply the territorial system of taxation typically provide exemptions for dividends received from foreign subsidiaries. They also apply the exemption system in their tax treaties to avoid double taxation of income[32] in that where a resident of a contracting state derives income or owns capital that may be taxed in the other state, the source state must exempt such income or capital from tax.[33] This system minimises compliance costs, it's relatively simple for the tax authorities.

Worldwide basis of taxation

This system is an indirect method of assigning a tax base to a nation.[34] Residents are taxed on their worldwide income regardless of the source of the income.[35] Generally, this basis of taxation applies a personal jurisdiction approach in that it ignores the focus of the activity or factors that give rise to the

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[24] DR Tillinghast *Tax Aspects of International Transactions* (1984) 3. See also OECD *Addressing the Tax Challenges of the Digital Economy* (2014) 38.

[25] 'Report on Double Taxation' (n 21) 25[4029].

[26] HJ Ault 'Corporate integration, tax treaties and the division of the international tax base: Principles and practice' (1992) 47 *Tax Law Review* 567.

[27] Meyerowitz *Income Tax* (n 9) para 7.1.

[28] BJ Arnold & MJ McIntyre *International Tax Primer* 2 ed (2000) 15.

[29] WB Barker 'Optimal international taxation and tax competition: Overcoming the contradictions' (2002) 22 Issue 2 *Northwestern Journal of International Law & Business* 181.

[30] Barker 'International tax reform' (n 5) 650.

[31] *Kergeulen Sealing & Whaling Co Ltd v CIR* 1939 AD 487 at 507.

[32] P Dittmer 'A global perspective on territorial taxation' (2012), available at http://taxfoundation.org/article/global-perspective-territorial-taxation, accessed on 10 September 2014.

[33] Article 23A of the OECD Model Tax Convention.

[34] Barker 'Optimal international taxation' (n 29) 181.

[35] Olivier & Honiball *International Tax* (n 7) 19; L Olivier 'Residence-based taxation' (2000) 1 *South African Law Journal* 20: Grundy *The World of International Tax Planning* (n 2) 3.

income and instead looks to the person or entity that earns the income. The personal relationship between the nation and a resident gives that nation the right and the power to tax that person on their worldwide income.[36] The justification for the residence basis of taxation is that as a resident enjoys the protection of the state, he should contribute towards the cost of the government of the country in which he resides, even if income is earned outside that country. It is also justified by the fact that residents know that they can always return to the country of residence whenever they want and they will have the protection of their government whenever they are abroad.[37] To prevent double taxation of income, worldwide systems grant tax credits for taxes paid to foreign countries.[38] The credit is essentially a deduction of an amount that the resident state allows from its own tax, which must equal (not exceed) the tax paid in the foreign country.[39] The credit for foreign taxes is limited to the amount of domestic tax on foreign source income. Thus the foreign tax paid by a resident taxpayer on foreign source income reduces domestic taxes payable by the amount of foreign tax.[40] Where the foreign tax paid is less than the domestic tax, the foreign taxes have to be topped up so that the combined domestic and foreign tax rate on foreign source income is equal to the domestic tax rate. If the foreign tax exceeds the domestic tax, no tax refund is granted.[41] Thus, residents are treated equally from the perspective of total domestic and foreign tax except if foreign taxes exceed domestic taxes.

Overview

Nowhere in the world, is either of these bases of taxation applied in their pure form. In practice, the two bases of taxation are at opposite ends of a spectrum and many countries' policies fall somewhere in the middle. Countries that apply the residence based system normally tax non-residents on a territorial basis. Countries that apply the territorial system often extend the scope of their domestic tax laws by deeming certain types of income (especially passive income such as dividends, interest and royalties) to be sourced within their jurisdiction.[42] Internationally, double tax treaties recognise the primary right of source countries to tax active income even where the taxing country has a residence based system.[43] In a treaty context, it is also recognised that in order to prevent double taxation of income of a person who is resident in one treaty country and carries on business in the other country (source country), the residence state of the taxpayer is required to grant a tax credit or exempt income that is taxed in the source state.[44]

Principles of a Good Tax System

For a basis of taxation to accomplish the goals of effective taxation, it has to comply with the principles of a good tax system, which are: equity, efficiency, certainty and simplicity.[45]

36 Barker 'International tax reform' (n 5) 650.
37 Meyerowitz *Income Tax* (n 9) para 7.1.
38 Article 23B of the OECD Model Tax Convention; Barker 'International tax reform' (n 5) 680.
39 Article 23B of the OECD Model Tax Convention.
40 Arnold & McIntyre *International Tax Primer* (n 28) 36.
41 Arnold & McIntyre (n 28) 36.
42 Katz Commission Report (n 4) para 1.3.3.
43 Katz Commission Report (n 4) para 1.2.2.
44 Article 23A and 23B of the OECD Model Tax Convention.
45 RM Sommerfeld, SA Madeo, KE Anderson & BR Jackson *Concepts of Taxation* (1993) 10; WA Raabe & JE Parker *Taxation Concepts for Decision Making* (1985) 14.

Equity

Adam Smith's first canon of taxation is that taxes should be equitable.[46] Equity requires that a coun should ensure that it gets its fair share of revenue from cross-border transactions. This entails protect a country's tax base by developing domestic laws that are fair and impartial. Equity also requ imposing equal tax burdens on taxpayers with equal income, without reference to the source of income, and by making those burdens commensurate with the ability of taxpayers to pay.[47] The cla economic view is that the allocation of the tax burden is fair where each person contributes accordance with the benefits he or she receives from government services.[48] Indeed, the 'ben principle' of taxation is considered the primary theory that underlies the territorial basis of taxatio that tax is justified on the basis of benefit received.[49] The resident basis of taxation subscribes to 'ability to pay' principle,[50] in that the tax obligation is based on the special relationship between taxpayer and a state. This status justifies worldwide taxation without regard to actual benefits receive the taxpayer.[51]

Efficiency

This element requires that tax should be imposed so as to minimise the social costs inherent in collection thereof. Taxes are considered to be efficient if resources are used in a way that maximises tl output.[52] An efficient tax should encourage neutrality of tax, in that the incidence of the tax should change the relative prices of goods and services in the public sector. A tax is inefficient when its incide distorts economic decision making.[53] In the international setting, tax rules are not neutral where t affect the location of an enterprise or investment especially when factors of production (for exam capital, technology, trademarks and labour) are mobile.[54] Traditionally the debate about the efficie and neutrality of a tax system has depended on whether the country adheres to the theories of 'cap export neutrality (CEN); or 'capital import neutrality' (CIN).[55] Both CEN and CIN acknowledge source countries' legitimate right to tax income and capital of non-residents. Both theories also recog that it is the investor's country of residence that can determine whether capital is efficiently alloca worldwide. However, the theories differ as to what the resident countries' response should be.[56] Cap import neutrality requires that country residents who invest abroad should be taxed at the same rat the residents of the country in which they invest.[57] It requires that a country should avoid tax laws t might cause its multinational companies to bear higher effective tax burdens in foreign markets than multinational companies of other countries. Capital import neutrality is violated if, for example, fore investors in a host country are taxed on their investment income at the home country rate, while the h

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46 A Smith *An Inquiry into the Nature and Causes of the Wealth of Nations* Vol 5 ch 2 (1776) 2.
47 For example, a group of related companies should be charged the same tax as a single company engaging in comparable activiti Use of the 'arm's length principle' to curtail transfer mispricing is an example of a provision that can ensure that related companies taxed at the same rates as single companies engaging in comparable activities. See s 31 of the Income Tax Act 58 of 1962 as amend
48 B Peeters *The Concept of Tax*: 2005 EATLP Congress Naples (Caserta) (2005) 24.
49 Tillinghast *Tax Aspects of International Transactions* (n 24) 3.
50 Barker 'Optimal international taxation' (n 29) 187.
51 Barker 'Optimal international taxation' (n 29) 187.
52 Barker 'International tax reform' (n 5) 655.
53 RA Musgrave & PB Musgrave *Public Finance in Theory and Practice* 5 ed (1994) 193.
54 A Easson *Taxation of Foreign Direct Investment: An Introduction* (1999) 17.
55 Arnold & McIntyre (n 28) 5; T Horst 'A note on the optimal taxation of international investment income' (1980) 94 The Quarterly Journal of Economics 793.
56 Barker 'International tax reform' (n 5) 656.
57 D Sandler *Tax Treaties and Controlled Foreign Company Legislation Tax: Pushing the Boundaries* 2 ed (1998) 14.

country does not levy income tax on investment income.[58] The territorial system is said to be consistent with CIN.[59]

Capital export neutrality requires that all residents of a country should face the same marginal effective tax rate, whether they invest in that country or abroad. In other words, the tax system should be neutral with regard to decisions to invest at home or abroad.[60] Capital export neutrality suggests that a country should design its international tax laws so as to neither encourage nor discourage outflows of capital. The worldwide system, with appropriate double taxation relief, is said to comply with CEN[61] in that it ensures that no matter where a company is located, its profits will always be subject to taxes. Indeed, the overarching purpose of worldwide taxation is to create equality among resident taxpayers, so as not to distort the investment decisions of domestic companies toward low-tax jurisdictions.[62] However, in today's global economy characterised by less barriers to the flow of goods and capital, enterprises can move to a different country with more competitive tax conditions as taxes form a major consideration in business strategy.[63] Capital export neutrality is violated if, for example, both the home and the host countries fail to tax income from investment in the host country, while an investment in the home country is taxed. This could happen when the home country allows tax deferral and the host country does not impose a tax on foreign investors. In that case, investors would prefer to invest in the host country rather than the home country even if the pre-tax yield on the domestic investment were higher.[64] This gives rise to many opportunities to defer the payment of tax on foreign profits, leaving them in the hands of the foreign subsidiary that earned them. This is a breach of the CEN,[65] since deferral reduces the present values of the tax burden substantially. Often countries enact controlled foreign company (CFC) legislation to guard against the erosion of the domestic tax base by the residents investing in non-resident companies as a means of addressing this concern.[66] However, some countries do not have CFC legislation possibly because they do not have a strong commitment to CEN (that resident taxpayers should pay the same tax on their domestic income and foreign-source investment income).[67] Other countries may not have CFC legislation because the extent of avoidance of domestic tax by the use of non-resident companies may not be such a significant problem in their particular circumstances that it justifies legislation of this nature.[68]

Since the source basis of taxation implies that all investors within a country face the same tax burden regardless of the country of residence, if the tax rates between countries vary, the source basis of taxation distorts investment allocation as there might be an incentive to move investments to other countries so as to profit from the different tax rates.[69] Consequently, the source basis of taxation is said not to adhere to CEN[70] since it is considered as a tax on investments.[71]

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58 RS Avi-Yonah 'Comment on Peroni, Fleming and Shay, 'Getting serious about curtailing deferral of US tax on foreign source income' (1999) 52 *Southern Methodist University School of Law Review* 533.
59 Barker 'International tax reform' (n 5) 656.
60 Sandler *Tax Treaties* (n 57) 14.
61 MA Desai 'New foundations for taxing multinational corporations' (2004) 82 *Taxes* 39; Barker 'International tax reform' (n 5) 656.
62 Barker 'International tax reform' (n 5) 680.
63 OECD 1998 Report (n 1) 13–14.
64 Avi-Yonah 'Comment on Peroni, Fleming and Shay' (n 58) 532.
65 J Tiley *Revenue Law* 5 ed (2005) 1139.
66 Tiley *Revenue Law* (n 65) 1139.
67 OECD *Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation* (2000) 11.
68 OECD *Studies in Taxation of Foreign Source Income* (n 67) 11.
69 MG Asher & RS Rajan 'Globalisation and tax systems: Implications for developing countries with particular reference to Southeast Asia' Discussion Paper 2, Adelaide University Australia, Centre for International Economic Studies (1999) 8.
70 Arnold & McIntyre (n 28) 5–6.
71 Asher & Rajan (n 69) 8.

Certainty

A good tax system must ensure certainty for foreign investors. Certainty goes hand in hand with administrative efficiency; that is, low compliance and administrative costs. Thus, in designing an effective basis of taxation, consideration needs to be given to the cost of compliance so as to ensure that the system does not place onerous documentation requirements on taxpayers. The territorial basis of taxation is considered to be easier to administer, and that is why it is employed by most African countries. Since the residence basis of taxation covers the worldwide taxation of a country's residents very few countries have the administrative capacity to cast their nets worldwide, so this basis of taxation is usually adopted by developed and net capital exporting countries.[72] Inevitably the residence basis of taxation has very high informational requirements and it presents high compliance costs.[73] The system requires that the authorities of the foreign country in which the resident taxpayer invests, provide the necessary information to the tax authorities of the taxpayer's country of residence; or that the taxpayer truthfully reports their foreign incomes, both of which are highly unlikely.[74] It is submitted that if system cannot be administered effectively, no matter how effective in theory, it will bring about poor ta collection and ultimately a self-defeating disrespect for the law.[75]

Simplicity

This principle of a good tax system requires that tax laws are not too complex. The legislation should b clear and unambiguous; easy to comply with and easy to administer.

International Fiscal Background

Historically most countries tax policies were generally territorial in nature in that they were developed deal mainly with domestic economic and social concerns. Although the domestic tax systems of mo countries also had an international dimension, since they had to deal with the foreign source income domestic residents, the interaction of domestic tax systems was relatively minimal, since there w limited mobility of capital.[76] With the globalisation of trade and the removal of barriers to the fr movement of capital, many developed countries shifted towards the worldwide system of taxation ensure the preservation of their taxes even when their residents invested offshore. Faced with high t rates in their countries of residence, taxpayers began to increasingly employ global tax avoidan strategies to maximise profits, lessen their global tax exposure; and so their links with any single coun with a favourable tax climate became more tenuous. Taxpayers would ensure that foreign assets a income were concealed and kept outside their domestic tax jurisdiction. In response, countries enact various anti-avoidance legislation (such as CFC legislation and transfer pricing provisions) to curt these tax avoidance strategies but taxpayers are generally a step ahead. The cycle of continu amendments to cover loopholes in the legislation made the provisions more complex and yet this did n prevent well-advised taxpayers from aggressively avoiding domestic taxes by keeping their income in lo tax jurisdictions. To remain competitive in a globalised world, reduce administrative costs and to ens the simplicity of their tax systems many developed countries (as explained in section 6 below) have the past decades been compelled to migrate to largely territorial systems.[77] Indeed, territorial taxat

72 Olivier & Honiball (n 7) 60.
73 Asher & Rajan (n 69) 8.
74 Asher & Rajan (n 69) 9.
75 Katz Commission Report (n 4) para 3.1.6.
76 OECD 1998 Report (n 1) 13–14.
77 P Rush & M Mincieli 'Are US taxes causing a global disadvantage?' (2010) 26 No 5 *Financial Executive* 34–39.

has been referred to as 'a pragmatic response to the practicalities in a world where competition is fast growing and truly global'.[78] It should however be noted that the basis of taxation appropriate to a given country is often dictated by various factors, such as: economic strategies, net cross border flows, the size of the national economies, relative tax rates, historic developments and the administrative capacity of the country.[79] Although the factors that influence fair and efficient taxation for domestic and foreign income vary in different countries, the primary focus of any tax system should be to raise revenue and protect the domestic tax base from erosion.[80] The domestic income tax base generally comprises three interrelated aspects: (i) the domestic source tax base for all taxable persons, both domestic and foreign; (ii) the foreign source income of residents; and (iii) the foreign source tax income of non-resident corporations owned by residents. The first aspect targets effective territorial taxation of taxable persons. The second and third aspects target effective extra-territorial (worldwide) taxation of residents' income. It is argued that while the second and third aspects may be appropriate objectives of policy in some situations, the primary goal of international tax rules and their reform must be the first concern (territorial taxation of the domestic tax base).[81]

Perceptions about the Bases of Taxation

The most common negative perception about the territorial system is that if foreign taxes are lower than domestic taxes, this would result in increased investment abroad and reduced domestic investment.[82] However, foreign investment does not necessarily imply reduced domestic investment. Often foreign and domestic investments complement rather than substitute each other, as both outbound and inbound investments are associated with economic growth.[83] Foreign investment can boost a company's productivity; provide access to new factors of production; and open up new markets. This promotes the health of companies and the economies in which they operate.[84] The territorial system is designed to equalise the tax costs between international competitors operating in the same jurisdiction, so that all companies can invest where they can achieve the greatest after-tax return on investment.[85] It is argued that this is good for domestic investors, as putting up barriers to growth abroad ultimately slows growth at home.[86] In Canada where the territorial system has been historically applied, the Federal Trade Commissioners have an explicit mandate to facilitate investment by Canadians abroad.[87] Similarly, The Netherlands (which has also historically applied the territorial system) recognises that its small domestic consumer base cannot self-sustain growth or support economies of scale, so it upholds the policy that international expansion that is good for companies is also good for the country; as it results in increased profits and employment for the Dutch.[88] This reasoning further dispels other perceptions that applying the territorial system leads to job losses at home as domestic capital would go to employ foreign rather

78 United States Congress 'How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market: Hearing Before the Committee on Ways and Means US House of Representatives' 112th Congress, First Session (24 May 2011) 3-4.
79 Katz Commission Report (n 4) para 1.3.6.
80 American Bar Association Section on Taxation 'Report of the Task Force on International Tax Reform' 59 *Tax Law* (2006) 659. See also K Vogel 'Worldwide v source taxation of income – A review and re-evaluation of arguments' (Part II) (1988) 16 *Intertax* 310–312.
81 American Bar Association Section on Taxation (n 80) 659; Vogel 'Worldwide v source taxation' (n 80) 310–312.
82 Dittmer 'A global perspective on territorial taxation' (n 32).
83 Dittmer (n 32).
84 Dittmer (n 32).
85 Barker 'International tax reform' (n 5) 656.
86 Dittmer (n 32).
87 The Conference Board of Canada, briefing by Danielle Goldfarb 'Direct investment abroad: A strategic tool for Canada' (Jan 2011) available at http://www.conferenceboard.ca/e-Library/abstract.aspx?did=3958, accessed on 29 September 2014.
88 P Vlaanderen 'Why exempt foreign business profits?' (2002) 25 *Tax Notes International* 1099.

than domestic workers. Studies show that the trend internationally for most multinational enterprises appears to be that low value-added work often moves to developing countries, but high value-added expertise work moves to developed countries.[89] Often overseas production does not change the aggregate level of employment (for example the factory in a given country would often stay), but that changes in composition are usually in managerial and technical employment.[90] It should also be noted that although territorial taxation is criticised for encouraging movements of mobile factors of production to various locations; there are other factors of production found in a nation that are sufficient to attract and retain economic activities. It is these national endowments that benefit economic activity that form the justification for territorial tax.[91] An example is economic rents, over which all countries, including developing countries, have real taxing power. A territorial tax on rents is thus one of the most justifiable cases for the taxation of all corporations in a source country.[92]

It is also argued that the territorial system can result in lower effective tax rates on foreign earnings which induce greater levels of profit shifting into low tax countries and the avoidance of domestic tax.[93] However, the motive for profit shifting is often to reduce overall tax burdens for multinationals and this often occurs (in the absence of anti-avoidance rules) when taxable income is reported in a jurisdiction different from that in which it would be reported. Thus profit shifting can occur whether a country applies a territorial or a worldwide system. Profit shifting is driven by global tax competition, which undermines both residence and source taxation. Tax competition undermines residence taxation because it makes it possible to earn capital income in other jurisdictions in ways that make it possible to escape taxation at home either by avoidance or by actual evasion (concealment). It undermines source taxation directly by allowing taxpayers the mobility to choose to locate in jurisdictions offering lower tax rates. Countries need to have the right anti-avoidance provisions in place. The most common schemes to reduce overall tax burdens and shift profits to low-tax jurisdictions often involve: transfer mispricing, manipulating the location of debt and the location of patents and other intangible property; all of which enable companies to overstate taxable income in low tax jurisdictions and understate income in high tax jurisdictions. These are the activities that erode the domestic income tax base thereby reducing domestic tax revenues.[94] So the argument that territorial systems *per se* can result in profit shifting and thus lower tax collection is not very convincing. Studies[95] have observed no statistical difference in the scope of profit shifting activity between territorial and worldwide systems.

Then there is a perception that worldwide systems are more prone to higher tax collections than territorial systems – this too is not a convincing argument. Of course the corporate tax rates that countries apply have to be taken into consideration, but if all factors remained constant, usually worldwide systems that permit deferral of taxes on active income result in effective taxes on such income being deferred (sometimes indefinitely) until repatriated. Non-repatriation of income is further encouraged by the fact that since worldwide systems generally apply the credit method to relieve double taxation, the credit for foreign taxes paid is normally limited to the amount of domestic tax payable, any extra foreign taxes must be paid. This can discourage repatriation of income and thus result in lower tax

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89 Dittmer (n 32).
90 RE Lipsey 'Home-country effects of outward direct investment' in M Feldstein, JR Hines & RG Hubbard (eds) *Taxing Multinational Corporations* (1995) 12.
91 Barker 'International tax reform' (n 5) 688.
92 Barker 'International tax reform' (n 5) 688.
93 Dittmer (n 32).
94 Dittmer (n 32).
95 KS Markle 'A comparison of the tax-motivated income shifting of multinationals in territorial and worldwide countries' Oxford University Centre for Business Taxation Working Paper 12/06 (Nov 2010) 2.

deductions in worldwide systems.[96] On the contrary, since territorial systems do not generally apply the credit method, but they generally exempt foreign source income from tax, this encourages repatriation of income. A study by Markle[97] shows that when it comes to revenue collection from repatriated income, territorial systems appear to be faring equally as well as, and in some cases better than, worldwide systems. Further research demonstrates that when countries attempt to poach revenue from income earned in other countries, they tend to receive no more than their territorial counterparts.[98]

Developments in the Basis of Taxation in South Africa

This historical investigation of how the basis of taxation has developed and been applied in South Africa can (in this author's view) be broken down into three main phases. The first phase shows that the initial income tax laws relied heavily on the source basis of taxation (the term 'source' rather than 'territorial' is used in the South African discussion as that is the statutory concept used). The second phase depicts the introduction of the worldwide basis of taxation (applying to residents) and the bolstering of anti-avoidance rules for outbound transactions by South African residents, while the source basis of taxation (which applied to non-residents) was largely neglected. The third phase shows a trend towards strengthening the source basis of taxation, creating a strong withholding tax regime and efforts taken to create a Headquarter company regime (explained below) that is relieved of various anti-avoidance rules.

Phase 1: Initial income tax laws based on the source basis

Before the introduction of income tax in South Africa, state revenue was mainly derived from trade levies, user fees, indirect taxes and mining taxes.[99] Income tax was introduced in South Africa (then referred to as the Union of South Africa[100]) in 1914 under the Income Tax Act No 28 of 1914, which had its origins in the New South Wales Act of 1895. The first income tax laws were based on the principle that taxes would be levied only on income that was sourced within the borders of the Union of South Africa.[101] After 1933 strict exchange controls applied to prevent the flow of funds out of South Africa. The 1914 first Income Tax Act went through numerous amendments, culminating in the enactment of the Income Tax Act 58 of 1962.[102] The 1962 Act consolidated the law relating to the taxation of income and donations. The initial section 9 of the Income Tax Act 58 of 1962 provided for certain circumstances under which an amount was deemed to have accrued to any person from a source within the Republic if it had been received by, accrued to or in favour of such person.

The 1962 Income Tax Act has also undergone various amendments.[103] However, the predominant use of the source basis of taxation opened up numerous loopholes for tax avoidance since income was taxed only when it was generated in South Africa. Before 1994 the South African government practised apartheid (racial segregation), and so economic sanctions were placed on the country by the international community and it was barred from international trade and relations. These actions, coupled with the stringent exchange control regulations, led to the dwindling of international trade in

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[96] Dittmer (n 32).
[97] Markle 'A comparison of the tax-motivated income shifting of multinationals' (n 95) 2.
[98] Dittmer (n 32).
[99] Strydom '2014: 100 Years of Income Tax in South Africa' Solidarity Press Releases (25 February 2014), available at https://solidariteit.co.za/en/2014-100-years-income-tax-south-africa/, accessed on 26 August 2014.
[100] After the second South African Anglo-Boer War (1899–1902), Britain took control of all parts of South Africa, and in 1910, a Union of South Africa was established with four provinces: the Cape, Natal, the Orange Free State, and the Transvaal.
[101] Meyerowitz *Income Tax* (n 9) para 7.3.
[102] Published in *Government Gazette* 250 of 1962.
[103] P Haupt *Notes on South African Income Tax* (2014) 5.

South Africa and so not much was done to develop tax laws to deal with cross-border transactions. This environment encouraged South African residents as well as non-residents to take advantage of the loopholes in the tax laws and to get involved in a wide variety of tax-efficient strategies in offshore jurisdictions.[104] In order to protect South Africa's tax base, over the years, the Income Tax Act deviated from a pure source basis and a hybrid system was adopted whereby the source basis of taxation was applied on active income and various deeming provisions (which were essentially based on the residence principle) were applied on passive income.[105] Nevertheless, there were still concerns about the right basis of taxation the country ought to apply. Thus over the years a number of commissions of inquiry into the matter were set up.

In 1951 the 'Steyn Committee' recommended that the source basis of taxation be retained owing to the then perceived complexity of changing to a residence system.[106] In 1970, the 'Franzsen Commission' recommended that the residence basis of taxation should be introduced as more income was beginning to flow out of South Africa without being taxed. This Commission pointed out that the introduction of the residence basis of taxation would not be such a complex procedure since the Income Tax Act had already deviated from a pure source basis through the introduction of various deeming provisions.[107] This matter was further investigated in 1987 by the 'Margo Commission'. This Commission highlighted the need to introduce a residence basis of taxation, noting that if exchange controls were lifted, a worldwide basis might be instrumental in curbing consequential tax avoidance. This Commission further pointed out that the 'independent national states' that then existed (and to some extent the existence of other countries in the Rand monetary area) exposed the system to schemes of avoidance, which a worldwide system of taxation could help to counter.[108] However, the 'Margo Commission' advised that as there are complexities in administering a residence-based taxation system, the source basis should be retained and the existing deeming provisions be extended.[109]

With the fall of apartheid in 1990, South Africa was reintegrated into the global economy. The heightened global trade and the mobility of capital in the modern world encouraged South African residents, both individuals and corporations, to make considerable cross border investments and since then, there has been continued international interest in South Africa by foreign investors. The increase in international trade and investments raised further concerns that the outflow of investments would lead to the depletion of South Africa's tax base. A decision had to be made as to whether South Africa's tax system should be based on the residence or source basis of taxation.

In 1997, the Katz Commission[110] was appointed to inquire into the ability of the tax system of South Africa to deal with the consequences of the globalisation of trade. The Katz Commission noted that the loopholes in South Africa's tax system that were augmented by the relaxation of exchange control regulations in mid-1997, required a change from the source to a residence basis of taxation in order to protect the country's tax base.[111] However the Katz Commission recommended that the residence basis of taxation should not be introduced drastically, but that there should be a gradual adjustment of the

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[104] Ginsberg *International Tax Havens* (n 2) 594–595.
[105] Katz Commission Report (n 4) paras 2.1.2 and 2.1.5; Ginsberg (n 2) 597.
[106] R Steyn (Chairman) 'First Interim Report of the Committee of Inquiry into the Income Tax Act' UG No 75-1951 at para 69 ('Steyn Committee Report').
[107] DG Franszen (Chairman) 'Commission of Inquiry into the Fiscal and Monetary Policy in South Africa: Taxation in South Africa. Second Report RP 86/1970' para 20.
[108] Katz Commission Report (n 4) para 2.1.3.
[109] CS Margo (Chairman) 'Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa RP 34/1987' paras 26–30.
[110] Katz Commission Report (n 4) 4.
[111] VJ Maren *The Taxation of Foreign Sourced Investment Income in the Hands of South African Residents* (1999) 21; Ginsberg (n 2) 597.

source-based tax system in order to facilitate South Africa's integration into the global economy. It was presumed that this would provide an optimum balance between the effects of the residence and the source bases of taxation and that this would protect South Africa's tax base until a residence-based system was fully adopted.[112] Consequently as from July 1997, in the interim, awaiting the introduction of the residence basis of taxation, sections 9C and 9D of the Income Tax Act (now deleted) were enacted. The then section 9C applied to investment income, which was defined as income in the form of any annuity, interest, rental income, royalty or any income of a similar nature.[113] The then section 9D was designed to tax foreign-source investment income in the hands of South African residents.[114] However, these provisions could not effectively counter offshore tax avoidance, because they covered a wide scope and they were poorly drafted.[115] As a result, many tax-planning schemes were entered into, in order to take advantage of the loopholes in these provisions.[116] There was thus a need to improve on these provisions if they were to be the foundation on which a new residence-based structure was to be built.

Phase 2: Residence system introduced, strengthening tax avoidance rules on outbound transactions while neglecting the source basis

Introduction of the residence basis of taxation

With the gradual phasing out of exchange controls, the introduction of a residence basis of taxation was inevitable. The tax authorities were convinced that the introduction of the residence basis of taxation would significantly broaden South Africa's tax base, limit the opportunities for offshore tax avoidance and also bring South Africa's tax system into line with international best practice.[117] Thus from the years of assessment commencing 1 January 2001, the residence-based system of taxation was introduced in South Africa, ushered in by the Revenue Laws Amendment Act 59 of 2000, which amended the Income Tax Act.

Currently, the principles that underlie the basis of taxation in South Africa are laid out in the definition of 'gross income' in section 1 of the Income Tax Act. This section makes a distinction between the basis of taxation applied to residents and that applied to non-residents.[118] Residents are taxed on a residence basis, in that their worldwide income is taxable in South Africa, irrespective of where it is earned.[119] The definition of 'residence' in section 1 of the Income Tax Act distinguishes between natural persons and persons other than natural persons. A natural person is resident in South African when the person is 'ordinarily resident'[120] in South Africa or when the person meets the requirements of the

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[112] Ginsberg (n 2) 597.
[113] Olivier & Honiball (n 7) 561.
[114] Maren *The Taxation of Foreign Sourced Investment Income* (n 111) 11.
[115] D Meyerowitz, TS Emslie & DM Davis 'Editorial: The Revenue Laws Amendment Act' (2000) 49 *The Taxpayer* 181.
[116] Maren (n 111) 28.
[117] Meyerowitz *Income Tax* (n 9) 181.
[118] The definition of 'gross income' in s 1 of the Income Tax Act.
[119] Section 1 of the Income Tax Act.
[120] In *Levene v IRC* [1928] AC 217, it was held that an individual is said to be 'ordinarily resident' in South Africa if it is his or her habitual and normal country of residence, in the sense of living here with some degree of continuity. In *Cohen v CIR* 1946 AD 174 (A) the court held that a person's ordinary residence 'would be the country to which he would naturally and as a matter of course return from his wanderings'. This would be the country a taxpayer might call his 'usual or principal residence and would be described ... as his real home'.

physical presence test.[121] A person other than a natural person is resident if incorporated, established or formed in the Republic or if it's place of effective management is located in the Republic.[122] The source basis of taxation was, however, not discarded. It is used to tax the income of non-residents derived from a South African source[123] and in taxing income attributed to permanent establishments (defined below) in the context of tax treaties.

Strengthening the nature of tax avoidance rules for outbound transactions

After the introduction of the residence basis of taxation commencing 1 January 2001, there followed a trend of strengthening laws to curtail tax avoidance for outbound transactions[124] by residents. Such laws included: controlled foreign company legislation, specific anti-avoidance legislation that dealt with investments in offshore trusts as well as transfer pricing and thin capitalisation provisions (to mention but a few).

Controlled foreign company provisions

In order to bring into the taxing net the income earned by South African-owned foreign entities and to counter the deferral of taxes, the worldwide taxation of South African residents is extended in the Income Tax Act, by deeming the income of a foreign company to be that of South African residents, notwithstanding the fact that the actual income is received by or accrues to a foreign company.[125] This is done through the use of CFC legislation set out in section 9D of the Income Tax Act. As pointed out above, this CFC legislation has its foundations in the previous section 9D, which was introduced in 1997.[126] With the introduction of the residence basis of taxation in 2001, the then section 9D was amended to strengthen its application and it has since gone through various other amendments. This legislation ensures that the deferral of taxes is curbed by taxing the South African owners of foreign companies on the income earned by those foreign companies, as if they had repatriated their foreign income as soon as it was earned.[127] A CFC is any foreign company in which South African residents own more than 50% interest in the profits or capital of the company or by means of voting rights. However, this definition excludes residents who are connected persons, who in aggregate hold more than 50% of the participation rights or voting rights in a controlled foreign company but individually hold less than 10% of the participation rights or voting rights in the controlled foreign company.[128] The CFC rules are

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[121] In terms of the definition of 'resident' in para (*a*)(ii) of s 1 of the Income Tax Act, a natural person who is not ordinarily resident in South Africa will be resident if he is physically present in South Africa for a period or periods:

- exceeding 91 days in aggregate during the current year of assessment and
- exceeding 91 days in aggregate during each of the five years of assessment preceding the current year of assessment and
- exceeding 915 days in aggregate during the five years of assessment preceding the current year of assessment.

[122] The concept 'place of effective management' is a treaty term, used as tie breaker rule in the case of dual resident entities. The meaning of the term is set out in the commentary on art 4(3) of the OECD Model Tax Convention on Income and on Capital (2014). For detailed discussion of the meaning of the term see: AW Oguttu 'Resolving double taxation: The concept "place of effective management" analysed from a South African perspective' (2008) XLI No 1 *The Comparative and International Law Journal of Southern Africa* 80–104.

[123] Meyerowitz *Income Tax* (n 9) para 7.3; Olivier & Honiball (n 7) 11.

[124] A transaction involving the export of capital or other resources from a country is referred to as an outward-bound transaction. See Arnold & McIntyre (n 28) 4.

[125] RD Jooste 'The imputation of income of controlled foreign entities' (2001) 118 *The South African Law Journal* 473–474; AP de Koker *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa* Vol 1 (2014) para 8.10.2.

[126] For a critical review of s 9D before its amendment, see Maren (n 111) 101.

[127] Jooste 'The imputation of income of controlled foreign entities (n 125) 474.

[128] This de minimis rule is set out in s 9D(2) of the Income Tax Act. See also De Koker *Silke on South African Income Tax* (n 125) para 5.44.

also subject to various exemptions.[129] From a policy perspective, these exemptions are part of a framework that seeks to strike a fair balance between protecting the tax base and the need for South African multinationals to be internationally competitive. The practical implication is that a taxpayer that derives income that is exempt from the CFC rules can defer South African tax (even indefinitely) on its foreign income until it is distributed as dividends to the shareholders and remitted to South Africa. In terms of section 6*quat*(1) of the Income Tax Act, in calculating the taxable income of a resident taxpayer, a rebate or unilateral tax credit is granted in respect of foreign taxes levied on their income. Despite the fact that the CFC rules closed many tax-avoidance loopholes, the rules have been riddled with many complex amendments that hinder their efficiency.[130] The complexity of this legislation is perhaps one of the reasons why there have been hardly any cases decided on this legislation since its inception.[131] Its complexity has also made it harder for tax administrators to trap the well-advised taxpayers who are one step ahead of them. Taxpayers are generally better off arranging their affairs in order to avoid the application of the legislation rather than risk an assessment under it.[132] This legislation also poses heavy compliance and administrative costs.[133] It is thus important that in designing laws to protect the tax base, not only tax revenue but also compliance costs should be considered. The compliance costs that flow from overcomplicated legislation should be weighed up against the revenue derived from taxing foreign entities.[134] Such compliance cost often makes it difficult for taxpayers to compete internationally, which may encourage them to give up their residence status, in favour of residence in a jurisdiction with more favourable tax rules.[135]

Taxation of income from offshore trusts

The residence basis of taxation was also strengthened in the context of South African residents' investments in offshore trusts. With the continuous relaxation of the Exchange Control Regulations, which began in 1997, there has been a tendency of South Africans residents to invest in offshore trusts.[136] South African residents have been known to transfer assets to offshore trusts by means of donations by especially parents resident in South Africa who desire their children who are resident in other countries to be able to inherit their wealth.[137] Assets can also be sold to non-resident trusts for cash or on loan account, which may or may not bear interest, depending on the circumstances of the case.[138] Over the years, the legislator came up with provisions to close opportunities for South African residents to avoid taxes by accumulating income in non-resident trusts. Section 25B(2A) of the Income Tax Act provides that if a resident person has had a contingent right to an amount accumulated in a non-resident trust for a number of years, and he/she acquires a vested right to any amount representing the capital of that non-resident trust, he/she will be liable in that year for tax on the accumulated income accruing to

[129] The foreign business establishment exemption in s 9D(9)*(b)*; the exemption from certain withholding taxes in s 9D(9)*(c)*; the exemption from South African taxable income in s 9D(9)*(e)*; the exemption of foreign dividends in s 9D(9)*(f)*; the exemption of income from interest, royalties, rentals and similar amounts in s 9D(9)(fA); and the capital gains exemption in s 9D(9) (fB) of the Income Tax Act.
[130] Editorial 'Taxation Laws Amendment Act of 2000' (2000) 49(11) The Taxpayer 181; Maren (n 97) 28.
[131] D Sandler 'Case notes: Tax treaties and controlled foreign company legislation' (1998) 1 *British Tax Review* 54.
[132] Sandler 'Case notes (n 131) 54.
[133] OECD *Studies in Taxation of Foreign Source Income* (n 67) 94.
[134] Olivier & Honiball (n 7) 428.
[135] Olivier & Honiball (n 7) 429.
[136] Ginsberg (n 2) 29 and 581; J Ware & P Roper 'The impact of residence-based tax on offshore trusts' (2001) 16 *Insurance and Tax Journal* 21.
[137] Ginsberg (n 2) 586; Olivier & Honiball (n 7) 556.
[138] Ware & Roper 'The impact of residence-based tax on offshore trusts' (n 136) 21.

him/her.[139] Another provision that can be applied to prevent tax avoidance when investments are made in offshore trusts is section 7(8), which provides that where a resident makes a donation, settlement or other disposition to a non-resident (other than a controlled foreign entity) that would have constituted income had that person been a resident, there shall be included in the income of such resident so much of that amount as is attributable to such donation, settlement or other disposition.[140]

Transfer pricing and thin capitalisation provisions

South Africa also has transfer pricing provisions in section 31 of the Income Tax Act, whereby the arm's length principle is applied to guard against profit shifting when related parties set prices at which they transfer goods or services between each other.[141] The arm's length principle provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[142] In 1995,[143] thin capitalisation rules were also introduced under the then section 31(3), to limit the deductibility of interest payments where resident entities are financed by disproportional ratios of debt as opposed to equity capital.[144] The initial thin capitalisation rules were based on a combination of a shareholder debt/equity formula and an arm's length approach. The sanction for being outside the prescribed thin capitalisation norms include a denial of the deduction of interest, as well as the treatment of the excess interest as a dividend for tax purposes.[145] In terms of the Taxation Laws Amendment Act 24 of 2011, thin capitalisation rules have now been merged with the transfer pricing rules effective from years of assessment commencing on or after 1 April 2012. Section 31 of the Income Tax Act requires that tax payable in respect of international transactions involving transfer pricing and financial assistance should be based on the arm's length principle. The South African Revenue Service (SARS) is of the view that merging of the rules is in line with international trends in that it offers greater certainty and minimises the scope for interpretational difficulties in domestic law and in tax treaties.[146]

Overview

In general the anti-avoidance provisions have been preventative in nature as taxpayers tend to carry out their activities in order to avoid their application. The South African Revenue Service is however aware that despite the above anti-avoidance provisions, this has not stopped well-advised South African residents from holding income offshore. In 2003, South Africa had to come up with the Exchange Control Amnesty and Amendment of Taxation Laws Act,[147] which granted amnesty for certain persons that had contravened the Exchange Control Regulations and certain tax Acts to regularise their affairs in respect to their foreign assets. The amnesty was to ensure maximum disclosure of foreign assets and

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139 See also Meyerowitz (n 9) para 16.142A; De Koker (n 125) para 12.15A.

140 See also De Koker (n 125) para 12.25A; A Duncan 'Hidden Assets' (July 2004) *De Rebus* 32.

141 SARS 'Practice Note 7 Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing' (6 Aug 1999) para 2.1; OECD 'Proposed Revision of Chapters I – III of the Transfer Pricing Guidelines: 9th September 2009 – 9th January 2010', available at http://www.oecd.org/dataoecd/1/57/43655703.pdf, accessed on 15 January 2010.

142 Article 9(1) of the OECD Model Tax Convention.

143 MM Katz (Chairman) Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa *Second Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa: Thin Capitalisation Rules* (1995) 1.

144 Katz *Second Interim Report* (n 143) 1.

145 Editorial 'Thin Capitalization: The Second Report of the Katz Commission' (1995) 44(9) *The Taxpayer* 162; De Koker (n 125) para 17.54.

146 Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 Part II(C) para 5.3.

147 Act 12 of 2003.

facilitate repatriation thereof to the country; thereby extending the tax base. By September 2004, a total of 16 033 applications had been adjudicated with levies paid totalling about R826 million.[148] In 2010, SARS came up with draft legislation regarding a voluntary disclosure programme to run from 1 November 2010 to 31 October 2011.[149] The draft legislation was intended to encourage taxpayers to come forward during this period to disclose any unpaid taxes and rectify their tax affairs so as avoid future non-discretionary imposition of interest. When the Tax Administration Act was enacted in 2011, provisions relating to the voluntary disclosure programme were permanently included in Part B thereof.[150]

Neglect of the source basis of taxation

From 2001 when the residence basis of taxation was introduced to apply to residents and the source basis of taxation was left to apply to only non-residents until 2011, when source statutory provisions were amended, not much was done to strengthen the source basis of taxation. Instead, as explained above, the legislators placed a lot of emphasis on bolstering tax laws applicable to outward-bound transactions[151] by residents, over tax laws applicable to inward-bound transactions[152] by non-residents. As a result, the tax system was rather more onerous for residents than for non-residents.

As background to explaining how the source system applied before the 2011 amendments, it is important to note that section 1 of the Income Tax Act clarifies that for non-residents, 'gross income' in relation to a year or period of assessment is the total amount, in cash or otherwise, received by or accrued to or in favour of such non-resident from a source within South Africa, excluding receipts or accruals of a capital nature, but including certain amounts whether of a capital or revenue nature as set out in paragraphs *(a)* to *(m)* of that definition. This general rule applies to both natural persons and persons other than natural persons (for example, companies). With the exception of non-resident companies, which are currently taxed at the rate of 28%, non-residents that derive South African source income are taxed at the rates that apply to residents and they are entitled to the deductions that apply to residents. Non-residents could also be subject to withholding taxes, which are discussed below.

Although non-residents are taxed on income from a 'source' in South Africa, the term 'source' has never been defined in the Income Tax Act. The meaning of 'source' in South Africa has historically been determined with reference to case law. One of the earliest cases that determined the meaning of source is the 1939 case of *Rhodesian Metals Ltd (in Liquidation) v COT*[153] in which it was held that '[s]ource means not a legal concept but something which a practical man would regard as a real source of income'[154] and that the ascertaining of the actual source is a practical hard matter of fact. This was confirmed in the 1946 seminal case of *CIR v Lever Brothers and Unilever Ltd*[155] in which it was decided that the source of income is established by first determining the originating cause (that is what the taxpayer does to produce the income) and then by locating the originating cause. In this regard Watermeyer CJ held that:

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[148] National Treasury 'Taxation', available at http://www.treasury.gov.za/documments/mtbps/2004/mtpps/Chapter%204.pdf, last accessed on 20 March 2009.
[149] National Treasury 'Draft Taxation Laws Second Amendment Bill 2010', available at http://www.sars.gov.za/home.asp?pid=294, accessed on 6 July 2010.
[150] Tax Administration Act 28 of 2011.
[151] Arnold & McIntyre (n 28) 4.
[152] A transaction involving the import of capital or other resources from a foreign country is referred to as an inward-bound transaction. See Arnold & McIntyre (n 28) 4.
[153] 1940 AD 432.
[154] *Rhodesian Metals Ltd (in Liquidation) v COT* 1940 AD 432 at 436.
[155] 1946 AD 441.

> 'the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else.'[156]

The courts acknowledged cases of multiple sources of income in that different causes and factors may contribute to the ultimate earning of income, some of which may originate inside and others outside of the country. Since the Income Tax Act did not provide for the apportionment of the source of income, the courts held that what must be considered was 'the main, the real, the dominant, the substantial source of the income'.[157] In the case of profits resulting from combined transactions; for example, 'buying and selling' or 'manufacturing and selling' in different countries, the 'dominant activities test' applied to determine the source of income.[158]

Since the 'source' of income has to be located in the geographical confines of a given country, it is important that the boundaries of a country are made clear especially for coastal countries such as South Africa, where a portion of the ocean along its coastline constitutes part of the country. In terms of the Revenue Laws Amendment Act 36 of 2007, the Income Tax Act was amended by adding the definition of the Republic of South Africa when used in a geographical sense, to include the territorial sea thereof as well as any area outside the territorial sea which has been or may be designated, under international law and the laws of South Africa, as areas within which South Africa may exercise sovereign rights or jurisdiction with regard to the exploration or exploitation of natural resources.

To determine the source of different types of income, case law specified the rules for the 'true' (actual) source of that income. A few examples of rules regarding the 'true' source of some types of income included the following:

- The true source of income from the sale of immovable property was the location of the immovable property.[159]

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[156] *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441 at 450.

[157] *CIR v Black* 1957 (3) SA 536 (A) at 543. This case concerned a stockbroker who carried on the business of buying and selling shares in Johannesburg, and who had a similar but clearly separate business in London. The authorisation or confirmation of the transactions was mostly given telephonically by the stockbroker in Johannesburg to his agents in London, who bought and sold the shares for him. Only the capital and certain overdraft facilities which he held in London were used to finance the London transactions. The Appellate Division held that it was reasonable to conclude that the main, real, dominant and substantial source of the income was the use of the stockbroker's capital in London and the conclusion and execution of the contracts in London. The income, therefore, was not derived from a source inside the South Africa and thus was not taxable here.

[158] In *Essential Sterolin Products (Pty) Ltd v CIR* 1993 (4) SA 859 (A) the taxpayer developed some medicine in South Africa, but registered it in West Germany. The active substance of the medicine was manufactured in South Africa and then exported to Germany where fillers were added, packed and marketed. The medicine had to be properly registered and patented in Germany before it could be sold in Germany. The dispute was about the right to a lump sum paid to the company for the right to be able to manufacture the medicine in the event that the company was unable to. It was held that the dominant cause of the income was the selling of the medicine, as the medicine could only be sold in Germany since that is where it was registered. Germany was the source of the income. In *Transvaal Associated Hide and Skin Merchants (Pty) Ltd v COT*, Botswana Court of Appeal, Botswana (1967) 29 SATC 97, the Appeal Court in Botswana found that the manufacturing or producing activity was the decisive factor. In this case, the taxpayer was a company registered in South Africa. The company bought, cured and worked hides in Botswana for sale in South Africa. Its contracts were concluded in South Africa and payment took place here. Although some of the judges disagreed, the majority ruled that the source of profit was Botswana since the purchase and working of the hides, and not their sale, was the dominant factor.

[159] *Rhodesia Metals Ltd* (in Liquidation) *v CoT* 1938 AD 282.

- The true source of income from the sale of movable goods was determined by considering: the place of conclusion of the contract, the performance by the seller, the payment by the buyer or a combination of the abovementioned possibilities. The decision depended on which was the dominant cause.[160]
- The true source of rent was where the asset was situated.[161]
- The true source of dividends was determined by reference to location of the share register.[162]
- The true source of royalty income that arose from created work or personal effort was where the work was done.[163]

However, diverging court decisions on the 'true' source of the different types of income often caused uncertainties. For example in the case of interest, it was held in the 1918 case of *COT v William Dunn & Co Ltd*[164] that the source of interest is the place where the capital is employed and that this need not necessarily be the place where the debt is located or the debtor resides. However in the 1946 case of *CIR v Lever Brothers and Unilever Ltd*,[165] the court held that the source of interest was not the debt but rather the granting of the credit, which is normally where the credit is made available; that is, where the creditor's business is located. The decision in the *Lever Brothers* case was however overruled by the 2002 decision in *First National Bank of Southern Africa Ltd v CSARS*[166] where the court ruled that the source of interest earned was the bank's business activities and operations in South Africa even though the loans were denominated in a foreign currency and were lent to customers outside South Africa. The court overlooked the narrow view in the *Lever Brothers* case of only considering where funds were made available but considered the whole transaction that generated the interest with a view to determining the location of its source. To ensure certainty of the source of income in cases such as the above, statutory 'deeming' source rules were enacted to apply to some categories of income. In the case of the source of interest, for example, the previous section 9(6) and 9(7) deemed any interest to be received or accrued from a South African source where such interest was derived from the utilisation or application in the country by any person of any funds or credit obtained in terms of any interest-bearing arrangement. Other examples of statutorily deemed source rules include:

- royalty income, which was deemed to be from a South African source if intellectual property was used in South Africa (then section 9(1)*(b)* – now amended).
- a capital gain or capital loss, which was deemed to be from a source in South Africa if it was in respect of the disposal of immovable property (or any right in immovable property) situated in the country.

In general, if the 'true' source of a receipt was outside South Africa but a statutory provision 'deemed' the source to be within South Africa, the deemed source rule prevailed over the 'true' source rule. Foreign source income existed only once it was determined that the income was neither actual (true) South African source under case law principles nor deemed South African source under the Income Tax Act.

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[160] *CIR v Epstein* 1954 (3) SA 689 (A).
[161] *COT v British United Shoe Machinery (SA) (Pty) Ltd* 1964 (3) SA 193 (FC).
[162] *Boyd v CIR* 1951 (3) SA 525 (A).
[163] *Millin v CIR* 1928 AD 207.
[164] 1918 AD 607.
[165] 1946 AD 441.
[166] 2002 (3) SA 375 (SCA).

Phase 3: Strengthening the source basis, creating a strong withholding tax regime and relaxing anti-avoidance rules for headquarter companies

Strengthening the source basis of taxation

Statutory changes to strengthen the source basis of taxation (which applies only to non-residents) were only introduced in 2011 by the Taxation Laws Amendment Act 24 of 2011. The source rules were amended to ensure a uniform system under the current section 9 of the Income Tax Act. The Explanatory Memorandum to the Taxation Laws Amendment Bill 2011 states that the previous source rules gave rise to uncertainty, which posed additional costs in respect of cross-border activities with little or no benefit for the fiscus. Part of this uncertainty stemmed from differing interpretations about the application of case law.[167] The new system represents an amalgamation of the case law, pre-existing statutory law and tax treaty principles.[168] The uniform source rules reflect international tax treaty principles (with a few added built-in protections) to ensure that the South African system is in line with international practices. Section 9 of the Income Tax Act provides for the rules for determining the source of different types of income. The case law source rules largely remain as a residual method for certain categories of income but the deemed source concept has been eliminated.

Source basis of taxation and tax treaties: Concerns regarding the permanent establishment concept

As noted above, the source basis of taxation is also relevant for the double tax treaties South Africa has entered into with other countries. Where a non-resident sets up a taxable presence (other than a separate legal entity) in South Africa, such a taxable presence is referred to in tax treaty terms as a permanent establishment (PE). For South African income tax purposes a PE is defined in section 1 of the Income Tax Act, with reference to the definition of the concept in article 5 of the OECD Model Tax Convention.[169] In terms of article 5(1) thereof, a PE is defined as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'. In terms of article 5(2), this would include a place of management; a branch; an office; a factory; a workshop; and a mine, an oil or a gas well, a quarry or any place of extraction of natural resources.[170] Article 5(4) sets out certain exclusions to the PE concepts and these are largely activities of an auxiliary or preparatory nature.[171] Article 5(3) sets out a special PE rule for a building site, construction or installation project provided it lasts for more than 12 months. The definition of a PE also covers a dependent agent who has authority to conclude contracts on behalf of the enterprise and habitually exercises this authority in the source country.[172] In terms of article 7(1) of the OECD Model Tax Convention, only profits attributable to a PE situated in a source state are taxable in that state. The significance of the PE concept is that it gives the country in which the PE is situated (the source country) the right to tax the PE's income, notwithstanding the fact that the PE has no separate legal existence.[173]

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[167] Para 4.2 (II) of the Explanatory Memorandum to the Draft Taxation Laws Amendment Bill 2011.
[168] Para 4.2 (III) of the Explanatory Memorandum to the Draft Taxation Laws Amendment Bill 2011.
[169] In *Downing v SIR* 1975 (4) SA 518 (A) the Appellate Division acknowledged that the OECD Model Tax Convention and its Commentary is an important guide in interpreting concepts used in South Africa's double tax treaties.
[170] Article 5(2) of the OECD Model Tax Convention.
[171] Article 5(4) of the OECD Model Tax Convention.
[172] Article 5(5) of the OECD Model Convention. See also L Dazinger *International Tax Law* (1991) 334; R Rohatgi *Basic International Taxation* (2002) 77.
[173] AA Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991) 1; AW Oguttu 'The challenges of taxing profits attributed to permanent establishments: A South African perspective' (2010) 64(3) *Bulletin for International Taxation* 172–200.

If a 'foreign company' (defined in section 1 of the Income Tax Act as any company that is not resident) receives income from a South African source (for example through its branch or an agency – a PE), the foreign company will be liable to tax in South Africa on income attributable to the branch or agency. Currently, non-resident companies that derive South African source income are subject to tax on their taxable income at a rate of 28%. A non-resident company doing business through a branch or agency in South Africa is also taxed on a source basis at a rate of 28%. With respect to capital gains tax (CGT) liability, which was introduced in South Africa from 1 October 2001,[174] paragraph 2 of the Eighth Schedule to the Income Tax Act provides that a non-resident is subject to CGT on the disposal of any immovable property situated in South Africa, or any interest or right in immovable property situated in the country, as well as any asset of a PE of the non-resident in the country.

Concerns have been raised in South Africa about the inability of SARS to effectively detect and monitor if PEs have been created in South Africa especially when non-residents set up representative offices that could escape the PE threshold on the pretext that the activities are auxiliary or preparatory in nature.[175] Similar concerns are raised with regard to consultants; for instance, those offering engineering services, whose stay in the country may be of a temporary nature. To detect the presence of such business enterprises and to determine whether they have created a PE in South Africa, rules should be put in place that require non-residents carrying on businesses in South Africa to register with SARS and to file tax returns. This will ensure that such non-residents are brought into the tax system for SARS to determine if they have created a taxable presence. Essentially the system should place the onus on the non-resident to prove that they have not created a PE. Lack of proper registration and monitoring of business activities is one of the reasons why certain foreign entities are improperly avoiding South African tax altogether. Having monitored if there is a taxable presence, the PE rules should then apply to PEs and normal source rules/withholding taxes should apply for those that do not meet the PE threshold.

Strengthening the withholding tax regime

Due to the fact that tax authorities often find it difficult to collect tax on the earnings of non-residents derived from business carried on within their boundaries, governments often impose withholding taxes on payments to non-residents. Generally a resident taxpayer is appointed as the non-resident's agent, and is obligated to withhold a certain percentage of tax from payments made to the non-resident and then pay it over to the tax authorities. If the resident agent does not comply with this duty or if he/she withholds an incorrect amount of tax, personal liability can be imposed on the resident agent.[176] From 2012, South Africa reinforced its source basis of taxation by increasing the types of withholding taxes levied, ensuring uniformity in the rates of withholding tax levied and ensuring a fairly similar structure in the working of the withholding taxes.[177] The analysis below sets out the salient features of the withholding taxes that are in place.

[174] Capital gains tax (CGT) was introduced under s 26A of the Income Tax Act and the Eighth Schedule to the Income Tax Act by the Taxation Laws Amendment Act 5 of 2001. The amount of a person's taxable capital gain for a year of assessment is therefore treated as a component of that person's taxable income and subjected to normal tax at the relevant rates applying to that person. CGT is therefore treated as a tax on income.

[175] Article 5(4) of the OECD Model Tax Convention.

[176] AW Oguttu 'An overview of South Africa's withholding tax regime' *TaxTalk* (March/April 2014).

[177] For details on the working of the withholding taxes set out below see Oguttu 'An overview of South Africa's withholding tax regime' (n 176).

Withholding tax on royalties

One of the oldest withholding taxes that South Africa has been levying is the withholding tax on royalties. Historically, in terms of the initial section 9*(b)* of Income Tax Act 58 of 1962,[178] royalties (being amounts derived from the use or granting permission to use, the imparting of or the undertaking to impart any knowledge directly or indirectly in South Africa of any patent, design, trade mark or copyright) were deemed to be sourced in South Africa whether such payment had been made by a person resident in or out of the country. In terms of the initial section 35(1) of Income Tax Act 58 of 1962, a non-resident recipient of a royalty in terms of section 9*(b)* was deemed to derive a taxable income equal to 30% of the amount of the royalty. In terms of section 35(2)*(a)* and *(b)* any person who incurred a liability to pay royalties to a non-resident was obliged to deduct or withhold 30% of the amount of the royalty in respect of such other person's obligation to pay normal tax, and pay it over to the Commissioner and this represented an advance payment of the tax on behalf of that non-resident. Subsequently, section 35(1) of the Income Tax Act was amended by section 39 of Revenue Laws Amendment Act 59 of 2000 to provide for the levying of a final withholding tax on royalties at a rate of 12%. Clause 39 of the Explanatory Memorandum on the Revenue Laws Amendment Bill 2000 clarifies that unlike the previous provisions, where an amount of 30% of royalty receipts and accruals would be included in taxable income, under the amended provision, any person liable to pay any such royalty to any non-resident was expected to withhold an amount equal to 12% of such amount as final withholding tax and pay it over to the Commissioner. The amendment came into effect on 1 January 2001 and applied for years of assessment commencing on or after that date. Section 35(1) was then repealed by section 80 of the Taxation Laws Amendment 22 of 2012, which inserted section 49B in the Income Tax Act to deal with the levying of a final withholding tax on royalties at a rate of 15% on the amount of any royalty paid by any person, to or for the benefit of any foreign person to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within South Africa in terms of section 9(2)*(c)*, *(d)*, *(e)* or *(f)* of the Income Tax Act. Section 49C states that the foreign person to whom a royalty is paid, is the one liable for the withholding tax on the royalties. Section 49D sets out certain exemptions from the withholding tax on royalties. Section 49E sets out the procedures and obligations placed on the resident to withholding the tax and section 49G sets out the procedures for the refund of the tax.

Withholding tax on foreign entertainers and sportspersons

This withholding tax was introduced in South Africa in 2006. In the Explanatory Memorandum to the 2005 Revenue Laws Amendment Bill, SARS recognised that it is difficult to collect income tax on the earnings received by foreign entertainers and sportspersons from activities that they perform in South Africa since they are present in South Africa for a short period of time, which impacts on SARS' ability to collect tax. The Revenue Laws Amendment Act 31 of 2005 inserted Part IIIA into the Income Tax Act, which levies a final withholding tax at a flat rate of 15% on the amount received by or accrued to a non-resident entertainer or sportsperson. Section 47(B)(1) provides an exemption from the tax for a non-resident person who is employed by a resident employer and is physically present in South Africa for more than 183 days in aggregate during any 12-month period in which the activity is exercised.

Withholding tax on the disposal of immovable property

This withholding tax was inserted in the Income Tax Act by the Taxation Laws Amendment Act 8 of 2007. In terms of section 35A of the Income Tax Act, any person who purchases immovable property

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[178] Published in *Government Gazette* 250 of 1962. Explained above.

situated in South Africa that is disposed of by a non-resident must withhold from the amount payable to the non-resident a withholding tax equal to: 5% if the non-resident is an individual; 7.5% if the non-resident is a company; and 10% if the non-resident is a trust. This is not a final withholding tax and a CGT calculation still has to be performed at the end of the year of assessment whereby excessive withholding can be refunded or additional tax paid.

Dividend withholding tax

From years of assessment commencing 1 April 2012, a dividend withholding tax was introduced in South Africa levied at a rate of 15%. In terms of section 64D to 64N of the Income Tax Act, the dividend withholding tax is levied on both resident and non-resident shareholders in respect of dividends paid by any company other than a headquarter company. The dividends tax is payable by South African resident companies or by non-resident companies listed on a South African exchange. In terms of section 64K(1), the liability for the dividends tax falls upon the beneficial owner of the divident who must pay the tax by the last day of the month following the month during which the dividend is paid by the company. The duty to withhold dividends tax is however imposed at the corporate level.

Withholding tax on interest

The Taxation Laws Amendment Act 31 of 2013 amended the Income Tax Act by the insertion of Part IVB in Chapter II of Act 58 of 1962, to deal with withholding tax on interest. Section 50B provides for the levying of a final withholding tax on interest, at a rate of 15% on the amount of any interest paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within South Africa in terms of section 9(2)*(b)*. Section 50C provides that a foreign person who receives a payment of interest is the one liable for the withholding tax on interest. In terms of section 50H(2) the levying of withholding tax on interest came into operation on 1 January 2015 and applies in respect of interest that is paid or that becomes due and payable on or after that date.

Withholding tax on service fees

The Taxation Laws Amendment Act 31 of 2013 amended the Income Tax Act by the insertion of Part IV in Chapter II of Act 58 of 1962, to deal with withholding tax on service fees. In terms of section 51A of the Income Tax Act, 'service fees' means any amount that is received or accrued in respect of technical services, managerial services and consultancy services. Section 51B provides for the levying of a final withholding tax on service fees, at a rate of 15% on the amount of any service fee that is paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within South Africa. Section 51C provides that a foreign person to which a service fee is paid, is the one liable for the withholding tax. Section 51H(2) provides that the withholding tax on service fees will come into operation on a date yet to be determined.[179]

It is hoped that the challenges of identifying non-residents' activities of a temporary nature (such as engineering and consultancy services) will be ameliorated by this withholding tax. This will also ensure that such non-residents' activities do not escape taxation on the pretext that they have not created a PE in South Africa. It is hoped that this withholding tax will ensure that such non-residents can file tax returns and are captured in the tax system. It is submitted that even though the principles set out in article 7(1) of the OECD Model Tax Convention suggest that the taxation of income of non-residents

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[179] Oguttu 'An overview of South Africa's withholding tax regime' (n 176).

in a source state should be limited to those attributable to a PE, the mere existence of a PE should not shield all locally sourced income from withholding taxes. South African sourced interest, royalties or service fees earned by foreign entities outside of the PE rule can still be subject to a 15% withholding tax, provided a tax treaty permits this.

Overview

It should be noted that the effectiveness of these withholding taxes is greater in cases where the non-resident's country of residence does not have a double tax treaty with South Africa. Where a double tax treaty is in place, the optimal effectiveness of South Africa's withholding tax regime will have to be backed up with double tax treaty reforms, through the renegotiation of older treaties or signing protocols to take into consideration the withholding taxes that are now in place.[180] Tax treaties based on the OECD Model Tax Convention set a limit on the rates of withholding taxes that may be levied by source countries.[181] Treaty negotiators often try to negotiate favourable rates for their countries. However, most of South Africa's treaties (generally based on the OECD Model Tax Convention) do not present favourable withholding taxes rates for South Africa. Now that the domestic withholding tax rate is generally uniform at 15%, it is imperative that our treaty negotiators renegotiate and negotiate better rates for South Africa.[182] It should however be noted that high withholding taxes (especially in a non-treaty context) can be a deterrent to foreign investment. Foreign investors prefer to base investments in jurisdictions with low withholding tax rates. Thus, in treaty negotiations, effort should be made to ensure a balanced approach that does not stifle foreign investment and at the same time preserves South Africa's tax base.[183]

Relaxing anti-avoidance rules for headquarter companies

In 1997 (when South Africa was still predominately applying the source basis of taxation), the Katz Commission recommended that South Africa's use of the source basis of taxation could be used to position the country as a head office, finance or management company location for investment into Africa north of its borders,[184] and that the location of multinational corporations in South Africa would be a vital strategy for the country's economic growth.[185] The Katz Commission also noted that if South Africa were to adopt the residence basis of taxation, this would not be conducive for basing foreign companies in South Africa.[186] The Katz Commission recommended that a favourable regime for corporate headquarter and holding companies should be enhanced through affording appropriate income tax exemptions to such companies.[187] The residence basis of taxation was nevertheless introduced in 2001 and, as discussed above, various anti-tax avoidance measures, such as controlled foreign company legislation, transfer pricing and thin capitalisation measures, were also adopted, which do not create a conducive fiscal environment for basing headquarter or holding/conduit companies.[188]

Desiring that South Africa take advantage of its regional economic and infrastructural superiority to position itself as a base for foreign investment into the rest of Africa, a headquarter company regime

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[180] Oguttu 'An overview of South Africa's withholding tax regime' (n 176).
[181] Olivier & Honiball (n 7) 273.
[182] Oguttu 'An overview of South Africa's withholding tax regime' (n 176).
[183] Oguttu 'An overview of South Africa's withholding tax regime' (n 176).
[184] Katz Commission Report (n 4) para 2.2.5.
[185] Katz Commission Report (n 4) para 2.2.2.
[186] Katz Commission Report (n 4) para 7.1.2.
[187] Katz Commission Report (n 4) para 9.32.
[188] A Rapakko *Base Company Taxation* (1989) 20–21.

(which was more of an intermediary holding company regime) was adopted in 2003.[189] This initial regime treated headquarter companies as non-residents and so they were taxed on a source basis. This meant that rules such as the CFC rules, which apply to residents, did not apply to the then headquarter companies. Transfer pricing provisions could only apply if a PE of the non-resident headquarter company was connected to a resident.[190] As non-residents, headquarter companies were taxed on certain capital gains that arose from the disposal of immovable property or any interest in such property in South Africa, and any disposal of assets attributed to a PE in South Africa.[191] And, as non-residents, the headquarter companies did not qualify for any benefits in South Africa's tax treaties that apply to residents only. The old headquarter company regime was ineffective since it did not have any tax relief measures that would attract the establishment of headquarter companies[192] and so the regime was repealed in 2004 by the deletion of the definition of a headquarter company from the Income Tax Act.[193] In 2010, the headquarter company regime (which is more of an intermediary holding company regime) was reinstated.[194] This time around, the legislators attempted to rectify the weaknesses of the old regime by ensuring that headquarter companies are now considered residents for tax purposes. This necessitated that certain anti-avoidance provisions had to be relaxed with regard to their application to headquarter companies so as to encourage foreign investors to base the same in South Africa. For example:

- The definition of a CFC was amended in 2011[195] to exclude headquarter companies in the determination of the participation rights and voting rights of South African residents in a foreign company. This amendment ensures that foreign subsidiaries of companies that qualify as headquarter companies are not treated as CFCs if the headquarter company has significant equity interests in those foreign subsidiaries.[196]
- In terms of section 31(5) of the Income Tax Act,[197] transfer pricing and thin capitalisation rules are relaxed with regard to headquarter companies. This section provides that financial assistance, for example interest-free loans, to foreign companies (in which a headquarter company holds an interest of at least 10%) is not subjected to the transfer pricing and thin capitalisation rules. Thus, the rules do not apply in instances of back-to-back cross-border loans involving the headquarter company. In addition, foreign creditors of the headquarter company are exempt from withholding tax on interest in respect of the back-to-back loans.
- In terms of section 64B of the Income Tax Act (as amended),[198] if a company qualifies as a headquarter company, the dividends it declares are exempt from income tax in the hands of the shareholders.

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[189] In terms of s 12(1)(*g*) and (*l*) of the Revenue Laws Amendment Act 45 of 2003. See generally Oguttu 'Developing South Africa as a gateway for foreign investment' (n 13).

[190] See s 31(1) as it applied before the Taxation Laws Amendment Act 7 of 2010.

[191] Para 2 of the Eighth Schedule to the Income Tax Act.

[192] Olivier & Honiball (n 7) 704.

[193] Section 12(1)(*g*) and (*l*) of the Revenue Laws Amendment Act 45 of 2003.

[194] Taxation Laws Amendment Act 7 of 2010; see generally Oguttu 'Developing South Africa as a gateway for foreign investment' (n 13).

[195] With effect from years of assessment commencing on or after 1 January 2011, the definition of a CFC was amended by s 16 of the Taxation Laws Amendment Act 7 of 2010 to provide that: a 'controlled foreign company' means any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies'.

[196] Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 Part III para 5(4).

[197] Introduced by the Taxation Laws Amendment Act 24 of 2011.

[198] Section 64B as amended by s 68(1)(*b*) of the Taxation Laws Amendment Act 7 of 2010 states: 'There shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the secondary tax on companies, which is calculated at the rate of 10 per cent of the net amount, as determined in terms of subsection (3), of any dividend declared by any company, other than a headquarter company, which is a resident'.

- Paragraph 64B of the Eighth Schedule to the Income Tax Act provides that a headquarter company is deemed to be a foreign company for CGT purposes and so CGT it not levied on the disposal of a shareholder's interest to a non-resident.

The headquarter company regime has however not been very effective, presumably due to South Africa's lack of clear policy on tax competition, which translates into lack of boldness to participate in this sphere (unlike the case of other countries such as Mauritius).[199]

International Trends

Countries generally select a tax system based on their own unique economic position or treaty requirements.[200] Examples of countries that usually apply the worldwide system include the USA, Chile, Greece, Ireland, Israel, Korea and Mexico.[201] Examples of countries that generally apply territorial systems are Canada, Germany, the Netherlands,[202] Malaysia and Singapore, plus many Latin American and African countries.[203] As indicated in section 4 above, internationally, there has been an increasing trend of developed countries moving towards the territorial system of taxation[204] due to the challenges of globalisation, which make the simplicity of the territorial system a more appropriate basis of taxation to apply.[205] Of the 34 OECD member countries, 27 employ some form of territoriality system or are gradually gravitating to this system.[206] Examples of OECD member countries that have moved or are gradually moving towards the territorial system include: Iceland in 2003, Czech Republic in 2004, Norway in 2004, Estonia in 2005, Turkey in 2005, Poland in 2007, Japan in 2009, the UK in 2009, New Zealand in 2009 and France in 2000.[207] Often the first steps towards this system entail building exemptions into tax treaties as a means of preventing double taxation and then gradually adopting broad exemptions for foreign affiliates.[208] The discussion below selects three countries and briefly explains their basis of taxation and the rationale thereof.[209]

Japan

Prior to 2009, Japan applied the worldwide basis of taxation. The then Japanese system provided foreign tax credits to prevent double taxation; allowed deferral of tax on active income until repatriation; and levied a very high corporate tax rate.[210] In the 2009 budget the then Japanese Minister of Economy, Trade and Industry announced that the country would move to a territorial system of taxation as part of a 'new growth strategy' designed to stimulate innovation in Japan through strengthening the competitiveness of Japanese companies in foreign markets and encouraging repatriation of overseas earnings.[211] Thus in 2009,

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199 See generally Oguttu 'Developing South Africa as a gateway for foreign investment' (n 13) 92–120.
200 Dittmer (n 32).
201 Rush & Mincieli (n 77) 34–39.
202 Dittmer (n 32).
203 Katz Commission Report (n 4) para 1.3.4.
204 The majority of countries in the Organisation for Economic Co-operation and Development (OECD) and the majority of the G8 countries have adopted the territorial tax system. See Tax Foundation 'The United Kingdom's move to territorial taxation', available at http://taxfoundation.org/article/united-kingdoms-move-territorial-taxation, accessed on 3 September 2014.
205 Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).
206 T Matheson, VJ Perry & C Veung 'Territorial vs worldwide corporate taxation: Implications for developing countries IMF [International Monetary Fund] Working Paper WP/13/205 (October 2013) 4.
207 Dittmer (n 32).
208 Dittmer (n 32).
209 Dittmer (n 32).
210 Dittmer (n 32).
211 Dittmer (n 32).

Japan moved from a worldwide basis of taxation to a generally territorial system. This move was primarily due to concerns that the worldwide system resulted in accumulation of foreign earnings overseas.[212] The second concern was that the worldwide system hampered the competitiveness of Japan's multinationals in global markets.[213] The Japanese legislators were of the view that the territorial system would be simpler to administer; would allow Japanese companies to grow in foreign countries; and would 'ultimately lead to additional investments and job creation within Japan'.[214] To promote the competitiveness of its companies and attract investment, Japan also lowered its corporate tax rate.

Japan's adoption of a territorial tax system was part of a broader tax reform to reduce the tax burden on the foreign-source income of Japanese multinational corporations by exempting dividends from non-Japanese subsidiaries from Japanese tax. The dividend exemption system replaced the previous foreign credit system that was used to prevent double taxation. The tax reforms also included some tighter anti-tax-haven rules.[215] For instance, to guard against erosion of the corporate tax base through income shifting, Japan enacted a series of strict transfer pricing and reporting regulations.[216] It also imposed rules based on effective tax rates of controlled foreign corporations. If any subsidiary pays an effective tax rate to foreign tax authorities of less than 20% and cannot prove that it is actively engaged in business, the dividend exemption does not apply. Japan also imposes 'thin capitalisation rules' to limit the ability of corporations to take on excessive debt on behalf of foreign affiliates, because the interest would otherwise be deductible for tax-exempt foreign earnings.[217] A 2012 study on the Japanese tax system indicates that the shift to a territorial system increased dividend repatriations by about 20% from 2009 to 2010.[218] Japan also reported an increase in corporate tax receipts in 2010.[219]

The United Kingdom

Soon after Japan moved to a territorial system, the United Kingdom (UK) followed suit. The UK tax system was originally founded on a worldwide basis of taxation but this was changed in 2009 to a largely territorial system, which predominantly focuses on taxing profits in the UK.[220] The UK's move to the territorial basis of taxation was a response to significant concerns that the previous emphasis on worldwide taxation was putting UK companies at a competitive disadvantage and providing a tax incentive for foreign, rather than UK, ownership of multinational groups.[221] The UK was also concerned that the worldwide system presented high compliance costs and was prone to tax avoidance schemes.[222] Under the territorial system, UK companies are taxed on the income generated within the UK but they are not directly taxed on the profits generated by their foreign subsidiaries.[223] The UK's move from a worldwide system also implied a shift from a foreign tax credit system (as the means of countering double taxation) to an exemption system.[224] In terms of section 931H of the Income and Corporations

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[212] Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).
[213] Markle (n 95) 2.
[214] United States Congress 'How Other Countries Have Used Tax Reform' (n 78) 34.
[215] T Neubig & BM Angus 'Japan's move to territorial contrasts with US tax policy' (27 April 2009) *Tax Notes International* 252.
[216] Dittmer (n 32).
[217] Dittmer (n 32).
[218] United States Congress 'How Other Countries Have Used Tax (n 78) 34.
[219] C Mead & T Keene 'Japanese Will Repatriate Funds After Earthquake, El-Erian Says', Bloomberg, Mar 15, 2011, available at http://www.bloomberg.com/news/2011-03-15/japanese-investors-to-repatriate-funds-after-quake-pimco-s-el-erian-says.html, accessed on 10 September 2014.
[220] Part 9A of the Corporations Taxes Act 2009 (CTA), which was introduced by the Finance Act 2009.
[221] See n 220.
[222] See n 220.
[223] J Gravelle *Moving to a Territorial Income Tax: Options and Challenges* (2012) 14.
[224] LP Feld, M Ruf, U Scheuering, U Schreiber and J Voget (Centre for European Economic Research) 'Effects of territorial and worldwide corporation tax systems on outbound M&As' Discussion Paper No 13-008 (2013) 4.

Taxes Act 1988 (ICTA) the UK exempts from tax various classes of foreign-source dividends[225] and allows domestic tax deductions for foreign-source expenses as is the case with most other territorial systems. Payments remitted to the UK that are generally deductible in the country of payment, as is the case with, for instance, royalties and interest payments, are not subject to tax when received in the UK.[226] Similarly, profits or losses attributable to a PE of the UK company in another country are usually taxed in that other country, and are not part of the company's taxable UK profits, either under the terms of a double tax treaty or by virtue of an election to ensure that profits and losses are disregarded.[227]

To prevent tax avoidance, the UK tax system has rules that govern how foreign profits earned by UK companies should be dealt with. The tax avoidance rules are designed not to put UK companies at a disadvantage when competing for business overseas, and also not to create a tax incentive for foreign takeovers of UK companies.[228] In general, the tax avoidance rules ensure that if a UK company has established companies in other countries, subject to certain exceptions, the taxable profits earned in other countries will not generally be subject to UK taxation (though losses in some circumstances may be eligible for group relief either at the time or when remitted to the UK). Such anti-avoidance rules include: the thin capitalisation rules under section 209(2)*(da)* of the ICTA, which limit the deductibility of interest payments; transfer pricing rules under Schedule 28AA to the ITCA; the regulations that qualify diverted intellectual property income as taxable; and the rules that enforce tax on controlled foreign companies based in low-tax jurisdictions (where effective tax rates are less than three-quarters of corresponding UK liability).[229] In line with the UK tax reforms, in 2013, the UK CFC regime was relaxed and narrowed to make it more territorial, in that it now targets only profits artificially diverted from the UK.[230] A 2012 study of the UK tax system indicates that the shift to the territorial system resulted in a 6% increase in tax revenue.[231]

The United States of America

The USA generally applies the worldwide basis of taxation. However, the system is practically a hybrid in that it has some elements of a residence basis whereby the income of the country's residents is taxed regardless of its location; and it also has elements of territorial tax in that all income earned within the country is taxed regardless of the nationality of the taxpayers.[232] The USA is the only member of the G8 that still taxes the worldwide active business income of its corporations.[233] The USA system allows its companies to defer tax liability on foreign 'active income' until it is repatriated.[234] Deferral is however curtailed in the case of certain types of passive income set out in Sub Part F (CFC provisions) of the

[225] US Congress (Joint Committee on Taxation) 'Background and Selected Issues Related to the US International Tax System and Systems that Exempt Foreign Business Income: Scheduled for a Public Hearing Before the Committee on Ways and Means on May 24, 2011' (2011) 42.
[226] Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).
[227] Section 5(3) of the CTA 2009; Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).
[228] Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).
[229] Section 747(1) and (2) of the Income and Corporations Taxes Act ('ICTA') of 1970.
[230] Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).
[231] Gravelle *Moving to a Territorial Income Tax* (n 223) 14. P Egger *Consequences of the New UK Tax Exemption System: Evidence from Micro-level Data* (2012) 8.
[232] Barker 'International tax reform' (n 5) 648; Gravelle (n 223) 1.
[233] Markle (n 95).
[234] See generally s 244 of the Internal Revenue Code of 1954. See also JD Kuntz & RJ Peroni *US International Taxation* Vol 1 (2005) at B3-124 to B3-125; BI Bittker & L Lokken *Federal Taxation of Income, Estates and Gifts* 3 ed (2005) 69.

Internal Revenue Code.[235] The USA grants tax credits for foreign taxes paid; however, the credit only offsets the USA tax due when income is repatriated. [236] The heavy taxation of repatriated profits causes companies to keep foreign earnings abroad, reinvested in overseas operations.[237]

Historically, most tax reforms in the USA have emphasised strengthening the worldwide taxation of residents and increased taxation of foreign source income.[238] The tax laws are geared towards protecting the domestic tax base from erosion due to residents' and non-residents' foreign activities.[239] Nevertheless, businesses leaders and various reports on tax reform have over the years been urging for tax reform that moves toward a territorial system with improvements to the various tax rules.[240] The USA tax system is criticised for being exceptionally burdensome in that it imposes heavy compliance costs, creates enormous distortions of economic activity, deters companies from headquartering in the US, and traps huge amounts of US corporate profits abroad; [241] yet the system does not bring in as much revenue as it ought to. [242] Other commentators also hold the view that tax reform in the USA would advance if it focused on the relation of a USA corporation's foreign income and enterprises with its domestic activities, and on the relation of a foreign corporation's foreign activities to its USA activities. The common denominator of both these focus areas is territorial taxation.[243] The supporters of gravitating towards the territorial system project a rise in revenue,[244] and a simplification in administration and compliance in the USA.[245]

Hallmarks of a Competitive Territorial Taxation System

The design of a country's territorial taxation system varies greatly from country to country.[246] An example of such variation is the extent to which a country allows for passive income to be brought into the tax base, although it should be noted that no country exempts such income entirely.[247] Furthermore, each country employing the territorial taxation system will have its own unique base-erosion measures to guard against income shifting abroad. There is also variation in the policy objectives associated with such a system of taxation: some countries, including Japan, aim for the protection of the corporate tax base in order to minimise incentives for profit-shifting and to promote robust tax yields; other countries, such as the Netherlands and Canada, regard the competitiveness of their companies as a primary concern and define narrowly what types of income are not eligible for exemption. Despite these differences, all

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[235] Subpart F income as defined in s 952(*a*)(1) and (2) of the Internal Revenue Code of 1954 consists of two principle categories of income, namely insurance income and foreign base company income. In terms of s 954 of this Code, the latter comprises the following: foreign personal holding company income; foreign base company sales income; foreign base company service income; and foreign base company oil-related income. See J Isenbergh 'Perspectives on the deferral of United States taxation of the earnings of foreign corporations' (1988) 66 *Taxes* 1063; PR McDaniel, HJ Ault & JR Repetti *Introduction to United States International Taxation* 5 ed (2005) 113.

[236] Gravelle (n 223) 1.

[237] Egger *Consequences of the New UK Tax Exemption System* (n 231) 3.

[238] Gravelle (n 223) 43.

[239] Barker 'International tax reform' (n 5) 687.

[240] This proposal was incorporated in President Bush's Advisory Commission's tax reform proposals. See President's Advisory Panel on Federal Tax Reform Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System (2006) 103; US Department of the Treasury (Office of Tax Policy) 'Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century (20 Dec 2007)', available at http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf, accessed on 10 September 2014.

[241] Dittmer (n 32).

[242] Gravelle (n 223) 12.

[243] Barker 'International tax reform' (n 5) 687.

[244] President's Advisory Panel on Federal Tax Reform Simple, Fair and Pro-Growth (n 240) 103.

[245] H Grubert & J Mutti *Taxing International Business Income: Dividend Exemption Versus the Current System* (2001) 4.

[246] US Congress (Joint Committee on Taxation) 'Economic Efficiency and Structural Analyses' (n 225) 44.

[247] Dittmer (n 32).

countries making use of the territorial taxation system exempt from tax all (or 95%) of the dividend earnings associated with active engagement of their companies abroad. Dittmer[248] points out the following 'best practices' that are common to competitive territorial tax systems:

- Transitions to territorial taxation have been accompanied by reductions in tax rates. Though rate reductions have been a global trend in their own right, lowering the tax rate is arguably instrumental in reducing the risks for increased profit shifting.
- Legitimate active business activity is not drawn into the passive income tax base, and passive income tax provisions are narrowly defined to capture only income artificially shifted overseas.
- They provide preferential treatment for intellectual property, to minimise the incentive to shift intangible property into low-tax jurisdictions.
- They permit deductibility of expenses associated with foreign income, to ensure no disincentive for locating R&D or management activity at home.
- They limit the deductibility of foreign interest costs with 'thin capitalisation rules' in order to guard against abusive income stripping, but not to the extent that deductibility of legitimate borrowing costs is disallowed.
- They limit profit shifting with transfer pricing rules based on the 'arm's length' standard. [249]

South Africa's policy makers should consider gravitating more towards the territorial system by adopting some mix of these basic features. Such a change would represent an improvement in terms of neutrality, efficiency and simplicity, and this would enhance the competitiveness of the economy.

Conclusions and Recommendations and Lessons Learned from the Past One Hundred Years

The discussion has shown that, just like the USA, South Africa currently applies a hybrid system whereby residents are taxed on a worldwide basis and non-residents on a source basis. However, the survey of South Africa's income tax laws over the last 100 years shows that there is no clear policy on where the country ought to be on the broad spectrum that runs from a pure worldwide system to a pure source/territorial system. Legislation to strengthen each of the bases of taxation appears to be enacted haphazardly. It is not clear whether the legislators' concern is more about protecting the domestic tax base from offshore tax avoidance or about preserving the competiveness of the economy. The last 100 years of income tax in South Africa have seen the proverbial pendulum of tax policy regarding the basis of taxation generally swinging from one extreme to the other. As noted above, the first income tax laws were predominately based on the source basis of taxation. The result and lesson learned from this policy extreme was that it opened up numerous loopholes for tax avoidance since income was taxed only when it was generated in South Africa. To rectify this negative consequence, the residence basis of taxation was introduced in 2001 to apply to residents (with the source basis of taxation remaining applicable to non-residents). The effect of this change in tax policy however resulted in the pendulum swinging in the opposite direction; that is, to the end point or extreme where attention focused almost exclusively on the residence basis of taxation. The lesson learned from this is that the income tax laws (such as the CFC rules) were more onerous to outbound investments than was the case for income tax laws (for example, PE rules and source rules) that applied to inward bound investments. This impacted on the competiveness of domestic companies. While South Africa was strengthening its outbound income tax

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[248] Dittmer (n 32).
[249] Dittmer (n 32).

laws, many developed countries around the world began to move towards largely territorial systems, the rationale being that this system ensures the competitiveness of domestic companies; encourages repatriation of foreign income; is simpler to apply; presents lower compliance costs; and has the potential to increase tax revenue.[250] Over the last few years, the policy makers seem to have learned from the negative consequences of the two extremes, as at present the tax policy pendulum appears to be positioned somewhere near the middle of the continuum, with the emphasis placed on both residence and source taxation. South Africa is now strengthening its source basis of taxation, developing a uniform withholding tax system and relaxing some anti-avoidance rules with respect to the headquarter company regime, to ensure the competiveness of the economy. It is recommended that South Africa continues on this track. It is not by coincidence that many developed countries are gravitating towards the territorial system. Although this system is not capable of resolving all of South Africa's fiscal problems, including the country's budgetary deficit, it nevertheless has fiscal and economic advantages over its worldwide counterpart. South Africa's administrative capacity is not strong enough for it to lean heavily towards the worldwide system. It is important that South African outbound multinational enterprises are not taxed and audited disproportionately compared to inbound multinational enterprises that may use South Africa as a 'tax haven'.

[250] Tax Foundation 'The United Kingdom's move to territorial taxation' (n 204).