

Principle of Residence Tax – transactions, tax and investments

INTERNATIONAL TAX

A crucial function for foreign investors assessing a potential investment jurisdiction is the rate of tax applicable for the investment, as well as the familiarity of, and the ease with which they can understand the applicable local laws. It is crucial to understand how taxation systems apply to residents and non-residents, and indeed, how such terms are defined, in order to correctly assess the investment attractiveness of a particular state.

Residency-based system Since 2001, South Africa has had a residency-based system of tax. A residency taxation system is founded on the principle that a state, which provides various services and amenities to its citizens, has a claim against those citizens for the amount required to fund the services it provides.

In contradistinction to a residency taxation system, many states will also tax the income derived by a person from commercial activities undertaken in their states. Thus a source-based system of tax imposes a taxation liability on income arising within a specific jurisdiction or territory. South Africa, while subscribing to a residence basis of tax, still implements a source-based system of tax in respect of non-residents. Each of the systems applies to both natural and juristic persons. The residency of a natural person will often depend on factors such as nationality, habitual living patterns, family ties, business links, as well as a test which considers the physical location of the person. South Africa applies two tests in determining whether or not a natural

person is a resident for the purposes of tax. Firstly the South African Revenue Service (SARS) would look to establish whether or not the individual can be said to be 'ordinarily resident' in South Africa based on their factual living patterns. The aim of the test is to assess if the person regards South Africa as their permanent home or domicile. If it cannot be said that a person is ordinarily resident, SARS will then apply a physical presence test which seeks to establish whether or not, owing to the number of days spent within the borders of South Africa, a person can be considered to have resided within South Africa. A person who is not ordinarily resident will be deemed to be a resident if he or she is physically present in South Africa for more than 91 days in each of the current and preceding five years and for a period or periods exceeding 915 days in aggregate during the preceding five years. The implication of being tax resident in South Africa, either by way of being considered to be ordinarily resident or by means of the physical presence test, is that residents are subjected to tax in South Africa on all of their worldwide income and capital gains. That being said, whenever income or capital gains are derived from a foreign jurisdiction by a resident, that person should always look to avail themselves of the alleviating provisions of any double tax treaty entered into by South Africa with that other country that will regulate the taxing of that investment or any gains derived thereon.

Juristic persons For juristic persons, the above-mentioned indicators of a residency system of tax have to be modified, because by its very nature, a juristic person cannot be subjected to tests involving physical presence and habitual living patterns. One is therefore required to look to the place of incorporation of the juristic person, or where the Place of Effective Management (POEM) of that person can be said to be situated. Numerous commentators have tried to establish exactly what is meant by the phrase 'effective management'. It is SARS's view (as outlined in Interpretation

Note 6 to the Act), that in order to determine the place of effective management of a juristic person, one must look to where the day-to-day operations of that entity are controlled and managed. This view differs slightly from international interpretations of the similar concept of 'management and control' and has not, as yet, been tested in front of a South African court of law. However, of particular interest is a point made in passing in the recently delivered judgment of the *Oceanic Trust Co. Ltd N.O vs C:SARS*. In this case, which considered whether a trust was a resident of South Africa by virtue of it having its place of effective management in South Africa, Louw J endorsed the principles laid down in the English case of *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor [2010] EWCA Civ 778* (Smallwood), delivered on 8 July 2010. Smallwood essentially provided that –

- The POEM is the place where the key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made; and
- The POEM will ordinarily be the place where the most senior group of persons (e.g. – but not necessarily – a board of directors) makes its decisions, and where the actions to be taken by the entity as a whole are determined.

The courts seem to agree with the international interpretation of the POEM as opposed to the meaning given to the phrase by SARS. SARS issued a Discussion Paper on Interpretation Note 6 (the Paper) in September 2011. In the Paper, SARS acknowledges that the meaning of POEM is problematic and in need of revision, but they give no indication of any possible change to their current practice of following Interpretation Note 6. It is envisaged that if SARS were to follow the international school of thought and change their current approach, many tax efficient structuring opportunities would present themselves. We submit that any revision of the law will have to be carefully considered to ensure that existing structures are not unfairly affected.

Non-residents Non-residents will only be subject to income tax in South Africa if the income is found to arise from a source

within South African. Owing to the variety of ways in which income can be earned and capital gains generated, the common law has historically defined certain tests to be applied in determining where the true source of income-generating activities can be said to be based. The overriding principle that has been established by the courts is that the true source of income is where it has its origins or where that income is derived.

New source rules Effective 1 April 2012, new codified source rules have been introduced into the Act. Important examples of the source rules in terms of this new section are as follows: Section 9(2) provides that amount is received by or accrues to a person from a source within South Africa if that amount –

- a) Constitutes a dividend received by or accrued to that person (a dividend is defined in Section 1 of the Act as an amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company);
- b) Constitutes interest as defined in section 24J where that interest –
 - Is attributable to an amount incurred by a person that is resident, unless that interest is attributable to a permanent establishment which is situated outside South Africa; or
 - Is received or accrued in respect of the utilisation or application in South Africa by any person of any funds or credit obtained in terms of any form of interest bearing arrangement.
- c) Constitutes a royalty that is attributable to an amount incurred by a person that is a resident, unless the royalty is attributable to a permanent establishment which is situated outside South Africa; or
- d) Constitutes a royalty that is received by or accrues in respect of the use or right of use or permission to use in South Africa any intellectual property defined in section 23I.

These new source rules, along with the others contained in Section 9(2), generally do no more than codify the principles established by common law and on the whole simply legislate principles already applied. Of interest to note is that sub paragraph (a) refers to a dividend, which is defined in

Section 1 of the Act, as an amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company. This definition also only came into effect on 1 April 2012. It is in the definition of dividend that the previous common law principle of source in relation to a dividend received, has been codified, with the new section 9(2)(a) merely linking this definition's application to a non-resident. The Companies Act of 2008 has no definition of a dividend. In conclusion, it can be said that the codified source rules create certainty regarding what constitutes South African source income. We do however; need more of the same regarding the place of effective management. In addition, we need to be careful that the rates of taxation adopted in South Africa, especially in relation to the dividends and foreign interest withholdings taxes, allow us to remain competitive in a global context. By Ross Robertson, Tax Consultant, Norton Rose SA

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