BASING THE SOUTH AFRICAN INCOME TAX SYSTEM ON THE SOURCE OR RESIDENCE PRINCIPLE – OPTIONS AND RECOMMENDATIONS

Chapter 1 – INTRODUCTION TO THE TAXATION OF INTERNATIONAL INCOME BY USING THE SOURCE AND RESIDENCE PRINCIPLES OF TAXATION

When a country's own citizens or residents transact business or invest abroad, or
foreigners trade or invest within its domestic jurisdiction, the tax system as it affects
these activities needs to balance carefully domestic and international economic
objectives. On a global basis, countries need to maintain orderly tax regimes to
promote international trade, and there is a need for accepted rules and conventions
limiting any one country's rights to tax its own citizens or residents operating or
investing abroad, or the citizens or residents of other countries doing so in its own
jurisdiction. Two mainstream principles or bases which have developed for this kind
of "international" taxation are respectively the source and the residence bases. On the
international level, these are then amplified by a network of bilateral Double Tax
Agreements which seek to remove any remaining potential conflicts and to eliminate
the danger of taxing the same income twice.

1.1 DEFINITION OF THE RESIDENCE PRINCIPLE

1.1.1 Under a residence system income which accrues to a resident of a
country should be subject to the taxes of that country. In the case of
the United States, all citizens, even if not resident, may be so subject
on their worldwide income; this is an exceptional position, and the
possibility of basing tax on citizenship is not considered further in this
report.
1.1.2 The basic rationale of a residence basis of taxation has been contrasted
to that of a source based system in the following terms by the
Appellate Division (Kerguelen Sealing & Whaling Co., Ltd v CIR,
1939 AD 487, 10 SATC: 363):
"In some countries residence (or domicile) is made the test of liability
for the reason, presumably, that a resident, for the privilege and
protection of residence, can justly be called upon to contribute
towards the cost of good order and government of the country that
shelters him. In others (as in ours) the principle of liability adopted is
'source of income'; again, presumably, the equity of the levy rests on
the assumption that a country that produces wealth by reason of its
natural resources or the activities of its inhabitants is entitled to a
share of that wealth, wherever the recipient of it may live. In both
systems there is, of course, the assumption that the country adopting

the one or the other has effective means to enforce the levy."
1.1.3 A less convincing argument is that resident taxpayers should all be
subject to the same tax system since they live in the same country. The
latter argument ignores the fact that the income in question is
generated under substantially different circumstances in other
jurisdictions. The differing tax treatment in the foreign country is
usually related to the particular circumstances pertaining to the
taxpayers operating in that system, for example low tax rates often
compensate for poor infra-structure or other deficiencies in order to
attract investment.

1.2 DEFINITION OF THE SOURCE PRINCIPLE

1.2.1 Under a pure source system income is taxed in the country where that
income originates, regardless of the physical or legal residence of the
recipient of the income.
1.2.2 In addition to the motivation emphasising enjoyment of the source
country's resources as noted by the Appellate Division in the
Kerguelen case, a source system is also motivated by the degree to
which it ensures fair competition between taxpayers in the particular
jurisdiction and taxpayers (competitors) from other jurisdictions.
1.2.3 The primary right of the "source" country to tax "active" business
income is widely recognized internationally and soundly anchored in

the principles underlying double taxation agreements – even where the
taxing country has a residence system.

1.3 APPLICATION OF THE RESIDENCE AND SOURCE SYSTEMS – INTERNATIONAL TRENDS

1.3.1 Nowhere in the world are either of these systems applied with
any degree of purity.

1.3.2 In terms of double tax treaties, and in many instances under the
national regimes of residence based countries, these countries are
generally required to exempt income generated in the other contracting
state or to provide a credit for the tax imposed in the source state.
Accordingly, all residence based systems still tax non-residents on
income sourced within their jurisdictions.

1.3.3 Countries with a source system have gradually extended the scope of
their taxes by statutorily deeming certain types of income (especially
of a passive nature) to be sourced within their jurisdictions, and
therefore to be subject to tax there. (They then, too, grant relief to their
taxpayers for taxes suffered in the source jurisdiction.) The arguments
in favour of taxing passive income generated abroad are more
pragmatic than convincing. Essentially, it is argued that the state of
residence of the taxpayer has enabled him to accumulate capital (to
lend offshore), to develop intangible property (to license offshore), or

to acquire a capital asset (to lease offshore), and that the taxpayer does
not actively use the infra-structure of the other state where another
taxpayer uses the capital or asset.

1.3.4 Both these systems, albeit in hybrid form, are strongly represented
amongst the tax systems of the world. In Latin America there is still a
strong territorial sentiment, although fairly recently both Brazil and
Argentina changed over to a residence based system. In the case of
Argentina, the Commission had evidence from various sources that the
change, introduced by way of a few cryptic lines of legislation in
1992, is as yet unsupported by any form of regulation or detail
resulting in serious problems. Malaysia also experimented with both
systems. From 1948 to 1967 the country's tax system was territorial,
with a remittance basis. In 1968 it changed to a worldwide system, but
this lasted only until 1973 whereafter it reverted to the territorial basis.

1.3.5 International bodies are also pointing towards territoriality or source as
a favoured system. In 1955 the International Chamber of Commerce
changed their earlier support for a word-wide basis of international
taxation to suggest that the source country should have 'the sole right'
to tax international income. At its 1984 Buenos Aires conference the

International Fiscal Association pointed out the economic disadvantages of worldwide taxation. The Association went on to
recommend 'a system of territorial taxation or exemption', and appealed to governments who had adopted the worldwide basis to reconsider their positions.
1.3.6 While the academic debate continues, the ultimate result of the two
systems is not that different once all the exceptions and compromises
are recognised. The system appropriate to a given country often is
dictated more by other factors such as economic strategies, net cross-border
capital flows, the relative sizes of the national and domestic economies, relative tax rates, history, and administrative capacity.

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