

**A critical review of the source and residence  
principles of taxation of income :  
A place for both principles in the  
South African tax system?**

**by**

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## SUMMARY

In support of a short dissertation entitled -

**"A critical review of the source and residence principles of taxation of income : A place for both principles in the South African tax system?"**

### Objectives

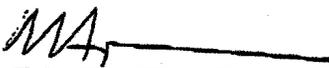
To review and critically examine the application of the source and residence principles regarding the taxation of income in South Africa, and to reveal the extent of the existence and application of a hybrid tax system in respect of the source and residence principles. To examine the legal principles and policy considerations arising from the existence of a hybrid tax system, inter alia, in the context of the Fifth Interim Report of the Katz Commission and consequent legislative developments, with a view to recommending, where appropriate, tax reform.

### Methodology and Approach

A review of relevant authority, literature, principles and legislation.

### Conclusion

To draw conclusions and recommendations regarding the merits of adopting a hybrid system in South Africa and, where appropriate, recommend legislative reforms particularly with regard to business income. 12/11



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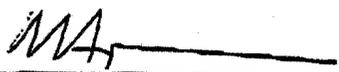
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## Key Terms



- 1 Source based tax system
- 2 The source and residence principles
- 3 The case for a hybrid system in South Africa based on both the source and residence principles
- 4 Real or dominant source
- 5 The apportionment of income between sources
- 6 The taxation of passive (investment) income on a worldwide basis (the residence principle)
- 7 The taxation of active (business) income on the basis of source
- 8 The Act and/or the 1997 Act (Income Tax Act of 1962 and/or Income Tax Act of 1997)
- 9 Section 9 deeming provisions
- 10 International income
- 11 Permanent establishment
- 12 Interest
- 13 Royalties

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The democratisation of South Africa and the lifting of sanctions has facilitated the country's re-entry into the global economy. South Africa is once more becoming involved in a host of international business activities including cross-border transactions. It is in this context that critical regard must be had to the need to adjust and reform South Africa's present source-based tax system to manage the economic consequences of exchange control relaxations and greater internationalisation, amongst other things, to prevent tax-motivated expatriation of funds.

It is submitted that while much of the tax consequences of international trade will be governed by double taxation agreements, the first step necessary in analysing the normal tax consequences and international dimensions of our tax system, to test compatibility with international practices, conventions and terminology, is to review the critical principle of source. This paper will also motivate the need for a hybrid system in South Africa, based on both the source and residence principles, in particular to address the question of the source of international income, and in so doing will consider the reforms required to obviate uncertainty and facilitate the internationalisation of our tax laws. The Katz Commission (hereinafter referred to as "the Commission")<sup>1</sup> suggests that in the complex world of international trade, no simple principle can be applied in pure form, and that both basic principles, namely source and residence, have typically been modified in the direction of some common middle ground.

This paper will consequently ignore the practical consequence of applying a tax treaty and look purely at the theoretical position by critically evaluating and reviewing the application of the source and residence principles regarding the taxation of income generally, and in particular the taxation of international income.

### **The Question of Source: A review of the principles**

South African normal tax is based on source. "Gross income" in Section 1 of the Act (hereinafter referred to as "the Act")<sup>2</sup> includes, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic. The question of source has proved to be one of the most problematic issues in income tax law. It is not defined in the Act and the courts have not attempted an exhaustive or all embracing, absolute definition: furthermore,

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<sup>1</sup> Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (March 1997), per M.M. Katz (Chairman)

<sup>2</sup> Income Tax Act No. 58 of 1962 as amended

the Act in a number of instances deems a source to be in the Republic irrespective of whether the income is in fact received or accrues in the Republic.

Meyerowitz<sup>3</sup>, with reference to *Kergeulen Sealing and Whaling Co, Ltd v CIR*<sup>4</sup>, contends that the reason for source as a test of liability for income tax is that a country that produces wealth by virtue of its natural resources or the activities of its inhabitants is entitled to a share of that wealth wherever the recipient may live. Residence, the other main principle underlying taxation on income, is premised on the view 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. The Commission<sup>5</sup> reveals that nowhere in the world is either system applied with any degree of purity: residence based systems, usually adopted by developed and net capital exporting countries have imported an element of the source principle by taxing the residents of foreign countries if they derive their income from within the domestic economy. In turn developing and net capital importing countries inevitably adopt source based systems but extend their tax nets by deeming passive income (e.g. investment income) received by residents to be from a domestic source and thus taxable, irrespective of where the income actually originates.

### **Source as the 'test' in South Africa**

In the absence of a statutory definition of source, it has been left to our courts to shed light on its meaning. As noted, no all embracing or universal meaning has been forthcoming and our courts have generally looked at the particular facts and circumstances of each case in determining whether an amount accrues or is received from a source within the Republic. In *Rhodesian Metals Ltd (in liquidation) v COT* determining and locating the source of a particular item was viewed as a 'practical hard matter of fact'<sup>6</sup>. The difficulty that often arises was summarised appropriately by Watermeyer CJ in *CIR v Lever Bros and Unilever Ltd*:-

*"The work ..... 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. Often the work is some combination of these ..... it is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries,*

<sup>3</sup> Meyerowitz D on Income Tax 1996 - 1997 Edition, The Taxpayer CC at 7 - 2

<sup>4</sup> 1939 AD 487 at 507

<sup>5</sup> supra, footnote 1 at 2 and (iii)

<sup>6</sup> 1941 AD 432, 11 SATC at 244

*and, consequently, after the activities which are the source of the particular "gross income" have been identified, the problem of locating them may present considerable difficulties, and it may be necessary to come to the conclusion that the "source" of a particular receipt is located partly in one country and partly in another ..... Such a state of affairs may lead to the conclusion that the whole of a receipt, or part of it, or none of it, is taxable as income from a source within the Union, according to the particular circumstances of the case, but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case".<sup>7</sup>*

This postulation it is submitted lends weight to the argument that there is sufficient authority in our law for the recognition and application of the principle of apportionment with respect to the source of income where more than one contributory source is found. In the discussion hereunder, it will be recommended that the principle of apportionment be enshrined in our law to obviate uncertainty and to provide the necessary legal framework to oblige our courts to apportion income between sources in a consistent and equitable manner. However, in order to understand the complexities, it is necessary to firstly review some of the important tests and factors employed by the courts in determining the source of income.

According to Watermeyer CJ<sup>8</sup> determining the source of income is a two-fold enquiry:-

- 1 determining what is the source from which income has been received and when that has been determined;
- 2 locating it to decide whether or not it is within the Union (my underlining).

He continues that the inference which should be drawn from judicial decisions is that the source of receipts for tax purposes is not the quarter from which 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 (being the *quid pro quo* which he gives in return for which he receives them).

Discerning the ratio decidendi in the Lever Bros case<sup>9</sup> is problematic. The case raised the question of liability for tax on the interest payable by a South African company which had stepped into the shoes of a Dutch company which had bought from an English company in Holland and / or England shares in companies carrying on business in different parts of the world and debts owed by Dutch companies. The purchase price for the shares and debt was payable ultimately in London and securities were given by the buyer which were held by an English company in London. The interest in question was paid by the South African company to

<sup>7</sup> 1946 AD 441, at 450 and 451

<sup>8</sup> supra, footnote 7 at 449 and 450

<sup>9</sup> 1946 AD 441

the English company from dividend proceeds received from shares held in an American company. No services were rendered by the English company in the Republic and no obligation resting on either party was performed in the Republic. It was held by Watermeyer CJ and Davis AJA that the interest on the purchase price was not from a source within the Republic, albeit for different reasons. Schreiner JA, dissented.

Meyerowitz<sup>10</sup> refers to the judgement of Watermeyer CJ as being the 'substantial majority judgement', which undoubtedly carries much persuasive value, in which it was postulated that the provision of money or credit, which is the service performed by the lender, and not the debt, is the originating cause or source of the interest. The source of interest therefore will be in the country where the credit was granted and not in the country where the debtor uses the money and from which the interest derives. On the facts, there were no activities by Lever Bros in South Africa (save in respect of those related to floating a company), and therefore the source of interest on money lent was found not to be located in South Africa. Davis AJA, only applied the test of the practical man, and regarding the location of source, he continued by stating that the practical man *"may have difficulty in deciding whether the source was located in England..... But the one place he would not choose would be South Africa"*<sup>11</sup>. In contrast Schreiner JA, came to the conclusion that the income was derived from property owned by the English company in the Republic, namely the debt owed by the South African company. Schreiner JA essentially argued that it is not a peculiar rule of law that the locality of a debt is dependant on the place where it is recoverable, i.e. where the debtor resided. It is respectfully submitted that this formulation or test, namely that the source of interest is where the debtor resides, is overly simplistic as it ignores material considerations such as where and how the debtor obtained the means to pay the interest on the debt, what arrangements were made for the transfer of funds to the creditor, where the relevant contracts were made and where the interest was payable.

In *Overseas Trust Corporation Ltd v CIR*<sup>12</sup> the court, per Innes CJ, held that source denoted origin, not location. In this case the taxpayer, Overseas Trust Corporation Ltd, was found not to have carried on business outside the country, and was held liable to pay tax on profits derived from the sale of shares in Germany as the profits had been earned from the employment within the Republic of capital for the acquisition of shares. Similarly, in *COT v Dunn & Co Ltd*<sup>13</sup>, the court looked at the place where capital was employed to earn interest. The interest earned was held to be of an incidental nature, and its source was the

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<sup>10</sup> Meyerowitz D and Spiro E on Income Tax, The Taxpayer CC (Looseleaf) at 60 and 61

<sup>11</sup> supra, footnote 7, at 464 - 465

<sup>12</sup> 1926 AD 444, 2 SATC 71

<sup>13</sup> 1918 AD 607

same as the real profits, which was the commission earned by William Dunn & Co as buying agent for various South African firms.

A further 'test' enunciated by our courts is that of the activities test. In *CIR v Epstein*<sup>14</sup>, Epstein, an agent in South Africa, entered into an agreement with an Argentinian partnership in terms of which Epstein would import and export certain commodities exclusively through the Argentinian firm. The Appellate Division examined the activities of the taxpayer, who bought the goods, and concluded that all the activities were carried out in the Republic which resulted in the earning of the profits in question, hence they were received from a source within the Republic. Schreiner, JA, dissented by holding that the source is not always where the taxpayer himself did or had done the acts which resulted in him receiving income. Meyerowitz it is submitted correctly points out that "it would be wrong to assume that this test can always be resorted to."<sup>15</sup> Take for example the case of *CIR v Black*:<sup>16</sup> the activities of a stockbroker, Black, included, it was found, two distinct acts of buying and selling shares in Johannesburg and London and that the real or dominant source of the income sought to be taxed was from a source in London.

### **Real or Dominant Source**

It is not uncommon that a variety of factors contribute to the acquisition of income, which income can have more than one source or originating cause some of which may or may not be within the Republic. Our courts have in such instances searched for the real or dominant source or cause of the accrual of income, as opposed to incidental or ancillary income. What is clear is that there is no conclusive test: the facts and circumstances of each case are more often than not decisive. The Legislature provides no assistance. Section 30 of the Act, which made provision for the apportionment of the taxable income of persons whose businesses extended beyond the Republic, has been repealed. The effect is that taxable income must be dealt with in the normal manner. The activities of a taxpayer inevitably result in the production of income as a result of the employment of either capital or labour, or both. If of a number of sources one is found to be dominant in the accrual of income, this dominant source is decisive for tax purposes. The Commission, referring to active or business income, believes that the tendency to find a dominant source "results in an all

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<sup>14</sup> 1954 (3) SA 689 (AD)

<sup>15</sup> supra, footnote 10, at 51

<sup>16</sup> 1957 (3) SA 536 (AD)

or nothing type gamble which is not in accordance with typical reality and poses a major concern to foreign investors."<sup>17</sup>

In testing this assertion, it is necessary to have regard to judicial authority. The location of the dominant source of an income may be reasonably straightforward where one particular activity is found to be critical.

In *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax, Botswana*<sup>18</sup> the court was faced with an operation which acquired treated hides in Botswana which were then transported to South Africa where the head office of the taxpayer marketed the hides to tanneries. The court identified the selling activities and the purchasing and initial preparation activities as contributing to the earning of income but the critical or dominant factor was found to be the initial preparation of the hides in Botswana without which there could have been no re-sale. The dictum of Maisels JA is crucial in understanding the courts dilemma -

*"in those cases in which all the activities of a business are performed in the same country, the determination of the locality of the source presents no problem..... the position is different when the activities of a person are performed in two or more countries. In such cases, it would appear that the locality of the source must be determined by reference to those of the activities which constitute 'the dominant or main or substantial or real and basic cause' of the accrual of the income..... On the facts of the present case, there would appear to be a good deal to be said for the view that the income should be apportioned between Botswana and South Africa..... But the Income Tax Proclamation..... contains no provisions for apportionment. Moreover, the appellant in its objection to the assessments made no claim that the income should be apportioned..... Which, then, of the activities of the appellant constitute the 'dominant or main or substantial or real and basic cause' of the accrual of income?..... as is pointed out by Schreiner JA in Epstein's case (supra) at 701, as between two countries in one of which goods are bought and in the other of which they are sold, the combined transaction resulting in a profit, such authority as exists is strongly if not uniformly in favour of the view that it is the country in which the goods are sold that is the country of origin of profit".<sup>19</sup>*

Meyerowitz<sup>20</sup> argues that it would be wrong to say that the Epstein case laid down as a general proposition that in cases of profits derived from combined transactions of purchases and sales it is the purchases which determine the source. On reviewing this case the activities of the taxpayer constituted his business, which was carried on in the Republic.

<sup>17</sup> Supra, footnote 1, at 19

<sup>18</sup> Court of Appeal, Botswana, 8th February; 23<sup>rd</sup> May, 1967

<sup>19</sup> supra, footnote 18, at 111 - 113

<sup>20</sup> supra, footnote 3 at 7 - 7

The dominant source in *Millin v CIR*<sup>21</sup> was found to be Mrs Millin's application of her wits and labour in writing a book in South Africa. The source of the whole of her income was therefore in the Union; in other words, the place where her labours were carried on was the real or dominant source of the income.

The question of multiple types of income arose in ITC 1491<sup>22</sup>, in which case a South African company developed a technique for re-surfacing bathtubs. The technique was licenced and the franchise income was made up of different components. Kroon J, in response to argument that the source of income arose from specific activities undertaken in terms of the franchise arrangements and not the business proper, stated that:-

*"there is nothing inconsistent or improper in determining different sources for different categories of income accruing to one business".*<sup>23</sup>

This situation on its own creates no difficulty as each separate type of income would probably be identified with a source which can then be located. But, where activities are carried on in two different countries and neither can be said to be the dominant source, will the law, according to Clegg<sup>24</sup>, permit the income to be apportioned between the sources (and thus the countries) on a fifty-fifty basis?

### **Arguments for Apportionment**

The Commission<sup>25</sup> points out that nations started making a choice between the residence and source principles by which to levy tax on income generated by international economic activity as trade and investment increased. The Commission essentially recommends that a practical and conceptual distinction be drawn between active (business) and passive (investment) income, and that active income be taxed on a source basis and be premised on the notion of business activity through a minimum presence within the taxing jurisdiction. Passive income in turn should effectively be taxed on a worldwide basis (i.e. the residence principle) which, it is pointed out, is similar to extending the current deeming provisions as to source to include all forms of passive income. This means that South African residents will pay tax on passive income irrespective of its source, i.e. irrespective of where in the world the income is earned. The implications of these proposals will be discussed in greater depth below.

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<sup>21</sup> 1928 AD 207

<sup>22</sup> 53 SATC 115 (1991)

<sup>23</sup> supra, footnote 22, at 127

<sup>24</sup> Clegg D Source for the Goose and the Gander (1996) 10 Tax Planning 41 at 42

<sup>25</sup> supra, footnote 1, at iii

An integral part of the Commission's recommendations regarding the source based taxation system of active income, which is not defined but is described as income derived from direct operational activity, is that the all or nothing dominant source approach adopted by our courts be replaced by a greater capacity in the system to allocate source. This in turn should be accompanied by rules of allocation of related expenditure, and "well-trying allocation methodologies of international tax law and tax treaty should form the basis of these rules".<sup>26</sup>

Clegg<sup>27</sup> acknowledges that the likelihood of two activities as mentioned previously being found to contribute exactly equally to the income arising is remote. He continues by arguing that it may be reasonably common to find the situation of a single type of income produced by a single type of activity which is carried on in two or more locations giving rise to a single and indivisible amount of income. The question would then be one of dominant location, which, it is submitted, is resolvable in the absence of any specific legislative provision with reference to the principle of apportionment. In ITC 607<sup>28</sup> the taxpayer received both taxable and exempt income derived by a single item of expenditure. Ingram CJ held that although the Act contained no provision for such apportionment's, it could be implied from the terms of Section 11 (2)(a) [now Section 11(a)] which permits only the deduction of such expenditure as is actually incurred in the production of the income.

Danziger<sup>29</sup> correctly points out that although our tax legislation makes no provision for the apportionment of a receipt or accrual between two or more sources, the courts will, in appropriate circumstances, grant apportionment where it is claimed by the taxpayer. It is submitted that the general structure of the Act has on occasion afforded the courts the opportunity to apply the apportionment principle. In CIR v Rand Selections Corporation Ltd<sup>30</sup>, a case which concerned expenditure incurred in earning a liquidation dividend which was split into taxable and non-taxable elements, Centlivres CJ said that "*the Commissioner has conceded, and I think rightly so, that a portion of the expenditure attributable to the income can be deducted under Section 11 (2)(a) [S11(a)]*"<sup>31</sup>. Corbett JA in CIR v Nemojim (Pty) Ltd<sup>32</sup> held that apportionment is a device which has been resorted to where expenditure in a globular sum has been incurred by a taxpayer for two purposes. He

<sup>26</sup> supra, footnote 1, at 11

<sup>27</sup> supra, footnote 24, at 42

<sup>28</sup> 14 SATC 366 (1945)

<sup>29</sup> Danzinger E *International Income Tax, The South African Perspective* (1991) at 107 (Butterworths)

<sup>30</sup> 1956(3) SA 124(A), 20 SATC 390

<sup>31</sup> supra, footnote 30 at 400

<sup>32</sup> 1983(4) SA 935(A), 45 SATC 241

went further and contended that apportionment is a practical solution to what otherwise would be an intractable problem and in a situation where the only other answers would produce inequity or anomaly.

In *Tuck v CIR*<sup>33</sup> the court was faced with a restraint of trade agreement containing elements of an employee incentive program, the consideration for both being shares in the company. Counsel for Tuck pointed out that the court had in the past approved the principle of apportionment in dealing with the deductibility of expenditure and that there was no reason why that principle should not be extended to the case where a receipt contained both a revenue and capital element. Corbett JA agreed, saying that *"in a proper case apportionment provides a sensible and practical solution to the problem..... It could hardly have been the intention of the Legislature that in such circumstances the receipt be regarded wholly as an income receipt, to the disadvantage of the taxpayer, or wholly as a capital receipt to the detriment of the fiscus"*.<sup>34</sup>

#### **The Case for a Hybrid System in South Africa**

It has been pointed out that the South African tax system is premised on the source principle, in that income is taxed in the country where that income originates, regardless of the residence of the recipient of the income. However, it is submitted that over the years the source principle has been extended by a number of deeming provisions, primarily in the form of Section 9 of the Act, the effect of which has been to bring passive or investment income derived from a source outside South Africa into the tax net. The consequence has been to create a hybrid system, which, it is submitted, has laid the foundation and conceptual framework for the Commission's proposal that a hybrid system be formally introduced on the basis of preserving the existing source based system for active income and the implementation of a residence basis for passive income to meet the demand of South Africa's reintegration into the world economy and a continued relaxation of exchange control regulations.

Friedland<sup>35</sup> believes that the Commission's report is a well written one which emphasises good business, not social engineering and that it contains well considered proposals for adjusting South Africa's present source based system to meet the needs and effects of greater internationalisation. In essence the report proposes a new system which distinguishes active income (income derived from operational activity) from passive income received from investments. In so doing active income should continue to be based on the source

<sup>33</sup> 1988(3) SA 819(A)

<sup>34</sup> supra, footnote 33, at 834

<sup>35</sup> Robin Friedland 'Katz's Fifth in the Right Key' Financial Mail, 11 April, 1997 at 28

principle but no detailed definition of source should be attempted, while passive income should be taxed on a worldwide basis. The meaning and effect of these proposals will now be examined in greater detail in the context of the existing sourced based tax system which, it is submitted, is already hybrid in nature in certain material respects. Significantly, the legislature has recently recognised the distinction between active and passive income, albeit in a limited context and application, in the form of Sections 9C and 9D of the new Act (hereinafter referred to as the 1997 Act)<sup>36</sup>, the implications and effect of which will be discussed below.

### The Taxation of Passive Income

It has been mentioned that South Africa has extended its source-based tax net by deeming a range of investment income, such as interest and royalties, to be from a source within South Africa, irrespective of where the income actually originates. It is recommended that passive income should effectively be taxed on a worldwide basis, which in essence is the same as extending the current deeming provisions as to source to include all forms of passive income. The effect is that South Africa will be following international precedent and practice as South African residents will pay local tax on passive income irrespective of its source. In so doing the tax base would be uncoupled from exchange control considerations and be protected from possible erosion when most exchange controls are lifted. Friedland<sup>37</sup> argues that extending the residence basis for passive income is necessary to prevent widespread avoidance when exchange controls no longer bar residents and emigrants from moving their funds abroad. From a revenue perspective, a worldwide system may also be more effective in securing the tax revenue on (passive) income that will be invested off-shore as exchange controls are lifted and capital mobility increases as a consequence. The legislature it is submitted has taken the first tentative step in the process of reforming our tax system by introducing certain 'short term' measures, in the form of Sections 9C and 9D of the 1997 Act, to protect the South African tax base in relation to the taxation of investment income, which means any income in the form of annuities, interest, rentals and royalties and similar income.

One of the important connecting factors with regard to the effective taxation of passive income is determining the legal meaning of 'residence' for both natural and juristic persons. The legislature has subsequently introduced a definition of 'resident' in Section 9C(1) of the 1997 Act, which means any natural person who is ordinarily resident in the Republic and any person other than a natural person which has its place of effective

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<sup>36</sup> Income Tax Act no. 28 of 1997  
<sup>37</sup> supra, footnote 35

management in the Republic. 'Ordinary residence' is not defined in the Act and our courts have over time had regard to certain factors which indicate ordinary residence status. In *Soldier v COT*<sup>38</sup> the court held that ordinary residence was a narrower concept than residence, and that the word 'ordinarily' emphasised that the residence must be settled, not temporary and casual. In *Cohen v CIR*<sup>39</sup> the court, per Schreiner JA, added that it would be natural to interpret 'ordinarily' by reference to a taxpayer's country of most fixed or settled residence, to which he would naturally and as a matter of course return. In *CIR v Kuttel*<sup>40</sup> the court, per Goldstone JA, followed this decision and held that, on the facts, the taxpayer had made his personal home in the United States of America, which was his place of principal residence. This accords with the internationally accepted concept of "habitual abode". In *ITC 1170*<sup>41</sup> the court took into account in finding the taxpayer to be ordinarily resident in South Africa the fact that he owned a house here, was employed by a South African company, operated a local bank account, returned at the end of his trip and his failure to acquire ordinary residence status in the United States. It is submitted that it should be left to the courts to determine the meaning of 'ordinarily resident', regard being had to factors such as the resident's habitual abode, as each case invariably turns on its own facts and circumstances.

The aforementioned definition of resident includes juristic persons which have their 'place of effective management' in the Republic. The rule for determining a company's residence was laid down in *De Beers Consolidated Mines Ltd v Howe*,<sup>42</sup> namely that a company is resident where its central management and control actually abides. This formalistic rule has been interpreted as meaning the place where the company's directors meet in order to exercise control over the company. However, it is submitted, the rule is open to manipulation as it does not address the question of effective as opposed to formal control, particularly in the context of nominee directors and company group structures. In most Double Taxation Agreements, for example, where a (juristic) person is a resident of both treaty states, it is deemed to be a resident of the state in which its place of effective management is situated. The more substantial and internationally acceptable concept of 'effective management' is contained in Article 4(3) of the OECD<sup>43</sup>, which has subsequently been incorporated into the 1997 Act via Sections 9C and 9D, to obviate uncertainty, align the provisions of the new Act with international practice and standardise the use of terminology particularly in the context of the vacuum

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<sup>38</sup> 1943 SR 131

<sup>39</sup> 1946 AD 174

<sup>40</sup> 1992 (3) SA 242 (A)

<sup>41</sup> 34 SATC 76 (1971)

<sup>42</sup> (1906) AC 455

<sup>43</sup> The International Model Tax Convention on Income and on Capital of The Organisation for Economic Co-Operation and Development (Report of the Committee of Fiscal Affairs, September 1992 as updated)

in which the provisions of the new Act have been introduced. The precise meaning of the concept "effective management" is however unclear: it could for example be interpreted as meaning the practical day to day management, irrespective of where the overriding control is exercised or the place of incorporation or organisation of a company.

Importantly, the Commission is not in favour of simply extending the current deemed source provisions: it points out that the deeming provisions are problematic, contain loopholes and have been manipulated in the past purely for tax reasons. Silke<sup>44</sup> reminds us that in the absence of a statutory definition of source the Act is helpful in that it distinguishes special receipts or accruals that are deemed to be from a source within the Republic irrespective of their actual source. The learned author continues that in certain cases the legislature has departed completely from the fundamental principle of taxing only income that has its source in the Republic, whilst in other instances that Act deems certain receipts or accruals to be from a South African source where the determination of the actual source presents practical difficulties. It is not within the scope of this paper to undertake an exhaustive analysis of all the deeming provisions contained in the Act. Instead, regard will be had to the effects of certain specific provisions of Section 9 of the Act with particular reference to two important kinds of passive income, namely interest and royalties.

### Interest

The Commission points out that most tax systems tax interest on a worldwide or residence basis because investment capital can be moved easily for tax advantage reasons. Because of exchange controls, South Africa has not been exposed to any significant outflows of capital and as a consequence only a limited degree of protection against capital outflow has been required in the form of Section 9(3) of the Act, which deemed certain bank and similar deposits off-shore to give rise to South African source income. Section 9A of the Act (investment income of foreign investment companies) was enacted as an anti-avoidance measure and is intended to deal with the situation where deemed source income is routed through a company in a neighbouring country to convert the income into tax free dividends. The Commission<sup>45</sup> believes that the said Section 9A, containing limited controlled foreign corporation rules, needs to be expanded to ensure that all forms of passive income are taxed on a worldwide basis to counter the inevitable tax avoidance that will flow from the lifting of exchange controls over South African residents investing off-shore. As a consequence it is

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<sup>44</sup>

Silke on South African Income Tax, Memorial Edition, Volume 1 by Alwyn De Koker, 1995, Butterworths at 5 - 16

<sup>45</sup>

supra, footnote 1, at 22

also recommended that all interest received by or accrued to South African ordinary residents should be subject to tax. It is submitted that Sections 9C and 9D of the 1997 Act was enacted for this express purpose. Interest flowing from South Africa in a residence based system of necessity requires a definition of the source of interest. The difficulties experienced by the court in *CIR v Lever Bros and Unilever Limited*<sup>46</sup> in determining the source of interest has been discussed, it having been essentially decided that the source or originating cause of interest on a loan is usually the provision of credit and that it is located where the credit was made available. Interest invariably arises from the performance of reciprocal obligations regulated under a contract, which, according to *Silke*<sup>47</sup>, are crucial in determining the source of income, so that an agreement entered into and performed by the creditor outside the Republic will carry much weight in support of the contention that the source of the interest is outside the Republic. These factors however, it is submitted, can only serve as a guide as regard must be had to the circumstances and facts peculiar to a case in determining the location of the source, which can be contractually manipulated. In the absence of clear authority and certainty as to the source of interest, the Commission<sup>48</sup> recommends that the source of interest should be statutorily defined as the location where the credit or funds are being applied, which in most cases would be where the debtor is located. The legislature has not responded in specific terms in this regard.

In interpreting these recommendations, a closer definition of source would for example bring interest earned on loans to local residents into the tax net. The Commission urges the continued exemption from South African tax of interest income earned by a non-resident who is not connected to the debtor. However, where interest flows from a source within the Republic to a non-resident who is a connected party (e.g. an overseas parent company), it should attract only a withholding tax. The Legislature has subsequently intervened by introducing "certain interim measures during the shorter term"<sup>49</sup> in the form of Sections 9C and 9D of the 1997 Act, which sections came into operation on 1 July 1997 and which include the extended Section 24J and Section 24K contemplation of interest. Some of the important new legislative provisions will now be examined in greater detail.

Significantly, the cumbersome, avoidable and geographically limited deeming provisions contained in Sections 9(2) (building society interest and dividends), 9(3) (bank interest) and 9(4) (loan and other interest)

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<sup>46</sup> supra, footnote 9

<sup>47</sup> supra, footnote 44, at 5 - 19

<sup>48</sup> supra, footnote 1, at 23

<sup>49</sup> Explanatory Memorandum to the Income Tax Bill (B45 - 97)

of the Act have been deleted as a consequence of the insertion of Section 9C of the 1997 Act. Section 9C(1) of the 1997 Act, in addition to providing for definitions of 'investment income' and 'resident', importantly incorporates the OECD<sup>50</sup> definition of 'permanent establishment'. The significance of this concept lies in the fact that an enterprise which is resident in one state becomes liable to tax in another state in respect of its activities there, if it acquires permanent establishment status, that is, if its presence or activities there justify the conclusion that the enterprise has a 'permanent establishment' in the other (source) state. This matter will be discussed more fully below.

Section 9C(2) of the 1997 Act contains a new deeming provision. The said section provides that any investment income received by or accrued to any -

*"(a) resident; and*

*(b) person (other than a resident) arising from the activities carried on by him through a permanent establishment situated in the Republic during any year of assessment, shall, for the purposes of the definition of 'gross income' in Section 1, be deemed to have been received by or accrued to such resident or person from a source within the Republic during such year of assessment"*

Section 9C(3)(a) in turn provides that the provisions of the section shall not apply to investment income of a resident arising from and effectively connected to the business enterprise conducted by such resident through a permanent establishment in any country other than the Republic, where such permanent establishment is suitably equipped for conducting the principal business of such substantive business enterprise.

It is submitted that, whilst Section 9C(2) (a) and (b) is reasonably capable of interpretation, Section 9C(3)(a) introduces new, undefined and untested terminology. Income 'arising from and effectively connected' to the enterprise, it is submitted, may have to be interpreted narrowly and restrictively to achieve the objects of Section 9C, namely to bring investment income from foreign sources into the tax net, and tests will have to be developed by our courts to determine the scope and extent of the application of the said section. In addition, it is submitted that determining whether an establishment is 'suitably equipped' will be an extremely difficult matter of fact, and be largely dependant on subjective enquiry. As it stands, Section 9C(3)(a) is vague, ambiguous and open to interpretation given its imprecise wording and construction.

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<sup>50</sup>

supra, footnote 43

The initial commentary on Section 9C of the 1997 Act has not been favourable. King<sup>51</sup> argues that Section 9C raises more questions than answers, and points out that the section will not apply where investment income arises from business activities outside South Africa where the income is 'effectively connected' to the business activities of a 'substantive' business conducted through a 'permanent establishment' which is 'suitably equipped' for conducting the principle business. The writer in this vein continues that whilst 'permanent establishment' carries an internationally accepted definition, the other concepts are not defined and are subjective in nature, causing fears that unless strict guidelines are published and adhered to, taxpayers may receive inconsistent treatment from different Revenue offices.

It is submitted that Section 9D of the 1997 Act is essentially couched in anti-avoidance terms, in that it has introduced certain regulatory measures in relation to income of controlled foreign entities as well as investment income, and is designed to prevent taxpayers avoiding tax on investment through the use of off-shore entities which allow income to be held off-shore not in the resident's own name, whereby the income is transformed into tax exempt dividend income, or by deferring or avoiding the taxation of income by accumulating or capitalising such income in a foreign entity. Section 9D(1) defines 'controlled foreign entity' as any foreign entity in which any resident or residents of the Republic, whether individually or jointly, and whether directly or indirectly, hold more than 50% of the participation rights, namely the right to participate in the capital or profits of, dividends declared, or any other distribution or allocation made, by the entity, or are entitled to exercise more than 50% of the votes or control of such entity. 'Foreign entity' in turn means any person, other than a natural person, which has its place of effective management in a country other than the Republic. The effect of Section 9D is to include in the income of any resident contemplated in the definition of 'controlled foreign entity' a proportional amount of any investment income received or accrued to such entity which bears to the total investment income received by or accrued to such entity. How this is to be determined exactly is unclear in the context of the principle of apportionment having been built into Sections 9D(2), (4) and (8). Section 9D (4) for example makes reference to income received or accrued by reason of or in consequence of any donation, settlement or other disposition, and the courts, it is submitted, may have regard to the case law developed in interpreting Section 7 of the Act in determining the principles to be applied in apportioning such amounts. It is further submitted that the Legislature has in principle been guided by the German Controlled Foreign Corporation rules in this regard, and which legislation accords generally

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<sup>51</sup> Ernie Lai King, in Finance Week June 26 - 02 July 1997 at 24

with the Commission's recommendations regarding the introduction of such rules. To give effect to the new provisions, Section 9 A is amended to provide that such section and Section 9D shall not apply in respect of the same investment income: investment income of a controlled foreign entity will firstly be dealt with under the provisions of Section 9D and any investment income to which Section 9D applies will not be dealt with under Section 9A.

It is submitted that the existing provisions under Section 9A have effectively been extended to cover all foreign jurisdictions and taxable entities as a consequence of the introduction of the 'foreign entity' and 'controlled foreign entity' definitions in Section 9D. This essentially accords with the Commission's recommendations in this regard. The effect has been to widen the tax net, as compared with the narrow application of and geographical limitations contained in Section 9A(1) in respect of foreign investment companies. In so doing, it is submitted further that an attempt has been made to avoid manipulation by widening the concept of 'control' by including in the definition any form of indirect control through a person holding more than 50% participation rights or voting rights in any such foreign entity.

The Taxpayer<sup>52</sup> is of the view that Sections 9C and 9D of the 1997 Act go further than their intended purpose of protecting the South African tax base by also covering income from investments which have no connection with South African capital or other sources and no connection with exchange control before or after its relaxation. By way of example, any immigrant to South Africa who has investment income from a foreign source is liable for South African tax solely because of his South African residence without any regard to the origin of the assets which produce the investment income. The same applies to a resident born here who has such income arising from, for example, a donation by a non-resident. In this context it seems to the Taxpayer that *"what our authorities have done is to 'jump the gun' before deciding whether or not to adopt a residence basis of taxation and have done so, with respect, in a half-baked manner which has created inconsistencies and inequalities as well as penalising immigrants."*<sup>53</sup>

### Royalties

The true or real source of royalty payments was decided in *Millin v CIR*<sup>54</sup>. The Appellate Division held that Mrs Millin's business of writing novels was based on the employment of her wits and labour. The copyright

<sup>52</sup> The Taxpayer, Volume 46 no. 6 at 106, various Eds.

<sup>53</sup> *ibid.*

<sup>54</sup> *supra*, footnote 21

produced was therefore income and not capital in nature, and the source of her royalties was based at the place where she as creator had applied her wits, skill and intellect, viz. in South Africa. In other words, the principle to be distilled from this case is that income derived from the exploitation of intangible property is regarded as sourced in South Africa if it was developed here, irrespective of where the asset is used to generate the royalties. The Commission points out that as a result such income generated by a South African resident is in effect already being taxed on a worldwide basis, rendering it unnecessary to make any material changes to the existing tax arrangements. What the Commission however recommends is that, for ease of understanding and international compatibility, the OECD<sup>55</sup> definition of royalties be adopted. The legislature has responded accordingly by defining royalties in materially the same terms.<sup>56</sup>

It is submitted that, as a consequence of the introduction of a definition of royalties, such definition will impliedly be incorporated in the deeming source provisions contained in Section 9(1)(b) and Section 9(1)(bA) of the Act, which have not been amended, notwithstanding the apparent limitation contained in Section 9C (1) of the 1997 Act. It is inconceivable that on the construct of the legislation the Legislature intended that different definitions, in the absence of express wording to this effect, be applied to the same concept. It is necessary at this point to reflect that when viewed holistically, Section 9 of the Act arose from a desire by the legislature to cater for certain receipts and accruals that would otherwise escape the tax net on grounds of source. The aforementioned Section 9(1)(b) provides that an amount shall be deemed to have accrued to any person from a source within the Republic if it has been received by or has accrued to or in favour of such person by virtue of -

"(b) the use or right of use in the Republic of or the grant of permission to use in the Republic -

(i) any patent ..... or any other property or right of a similar nature; or

(ii) .....,

wheresoever such patent, ....., property, right ..... has been produced or made or such right of use or permission has been granted ....."

Byala<sup>57</sup> believes that the true source and deemed source provisions may conflict, for example, when a taxpayer emigrates subsequent to creating a royalty producing stream in the Republic. He points out that the said Section 9(1)(b) applies only to royalties received or accrued by virtue of the 'use or right to use in the Republic' (therefore only covering royalties emanating from the Republic) whilst according to true source

<sup>55</sup> supra, footnote 43

<sup>56</sup> Section 9C(1) of the Income Tax Act no. 28 of 1997.

<sup>57</sup> Byala B True v Deemed Source (1992) 6 Tax Planning at 98.

principles any royalties received by or accrued to the emigrant creator from countries other than the Republic will be from a Republic source. He concludes that if an anti-avoidance interpretation is afforded to the said Section 9, it would appear that the deeming provisions contained in the section operate only when the true or real source of a receipt or accrual is not in the Republic.

As is the case with interest, the Commission recommends that anti-avoidance measures, including the controlled foreign corporation type rules embodied in Section 9A of the Act, should be extended to curb practices whereby the taxation of royalties are avoided through their transformation into dividends via facilitating off-shore structures. No material amendments have been made to Section 9A in this regard. It has been pointed out that Section 9D of the 1997 Act has introduced certain anti-avoidance measures in relation to income of controlled foreign entities as well as investment income, which includes royalties, and is designed to prevent taxpayers avoiding tax on investment through the use of off-shore entities which allow income to be held off-shore, thus avoiding South African tax or transforming the income into tax exempt dividend income. The effectiveness of these anti-avoidance measures remains to be seen, which, it is submitted, require testing and interpretation by our courts as to their meaning, ambit and scope.

The Commission<sup>58</sup> further recommends that royalties routed through an off-shore permanent establishment and not effectively connected with that permanent establishment should continue to be subject to taxation. In addition, and in line with the Commission's proposals as to the taxation of passive income, where royalties are effectively connected with such permanent establishment in that they are generated through the substantive business activity of that establishment, the royalties will not be taxable here in accordance with the basic principle that active income generated off-shore will not be considered as sourced in South Africa. The withholding tax on royalties received or accrued by non-residents should be fixed at a flat rate, and suitable foreign tax credits provided for.

It is submitted that, if the foregoing proposals are accepted, no material change will have to be made to this aspect of our tax system. However, an important advantage in adopting the Commission's recommendations would be to obviate uncertainty and align our tax system with international practices, concepts and terminology. The flow-through would be the introduction of suitable and effective anti-avoidance measures,

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<sup>58</sup>

supra, footnote 1 at 25

which it is submitted require striking a balance between being sufficiently detailed to be effective as opposed to being so elaborate as to be counter productive and unduly inhibiting of international trade and investment.

### Active Income

It has been mentioned that the South African tax system has developed on a source basis which, in accordance with the experience of other countries applying the source principle, has been extended by a number of deeming provisions rendering passive income derived from sources outside South Africa taxable here. This in effect has created a hybrid system in all but name. The Commission, it is submitted, has logically and rationally and in a conceptually sound manner recommended that the above be extended and a clear distinction be drawn between active and passive income, in terms of which active or business income, derived from direct operational activity, is to continue to be taxed on a source basis whilst passive or investment income is to be taxed according to the residence principle. In so doing, no detailed definition of source should be attempted, instead the general concepts used internationally of taxing business profits with reference to a combination of 'activity' linked to a 'permanent establishment' should form the basis of taxability. There are compelling arguments for such a conceptual differentiation, which will be discussed hereunder with particular reference to active income.

The case for the adoption of a hybrid system in South Africa in essence is premised on the business, financial and economic realities South Africa is faced with in the context of greater internationalisation and our re-entry into the global arena. The Commission<sup>59</sup>, in justifying its recommendation to continue taxing active income on a source basis, explains that because our tax rates are effectively higher than those of our trading partners, taxing on a residence basis would mean that our businesses would have to compete abroad at a competitive disadvantage as more tax would be paid on income earned in foreign countries than businesses in those foreign countries and by third country competitors operating in those countries. Conversely, foreign countries operating in South Africa will generally pay tax on income derived here at the same rate as domestic businesses. In this respect the Commission is firmly of the view that maintaining the source principle in respect of active income provides the kind of tax neutrality that is crucial to our participation in the global economy. In addition, unlike passive income, direct investment income which relates to active business is less mobile and cannot readily be switched in and out of South Africa. A further important

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<sup>59</sup>

supra, footnote 1, at 12 and 13

consideration in protecting the South African capital base is to enhance our role as an attractive base for regional investment, and it is the Commission's view that the source based system makes South Africa an ideal location from a tax perspective for the location of headquarter and finance companies.

The 1997 Act has, save in respect of defining 'permanent establishment' in the context of passive income, neither defined active income nor provided a legislative framework for the introduction of principles to regulate the determination of the source of active income. In defining active income, the Commission<sup>60</sup> recommends that reference should be made to the international treaty terminology of business income in conjunction with the concept of a permanent establishment, together with an illustrative but non-exhaustive list of activities which are regarded as active income for the sake of certainty. Consequently, passive income should not be separately defined, but should include all income which is not active income. The legislature has not taken this route in the design and construction of the 1997 Act. The Commission further recommends to counter tax-avoidance in the inevitable grey areas, there should be a rebuttable presumption in that certain income should be deemed to be passive income unless the taxpayer can show that such income was derived off-shore through a permanent establishment suitably equipped for the generation of such income. The Commission strongly recommends that South Africa follows the international trend of identifying a permanent establishment for the purposes of determining the liability for tax. In so doing the taxability of cross-border active income will be determined by the interaction between presence (through a permanent establishment) and activity. When, and to the extent that active income generated by the activity can be attributed to the permanent establishment, it should be taxed in the jurisdiction where that permanent establishment is located. In terms of Article 5(1) of the OECD Model, the term 'permanent establishment' is defined as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. Section 9C(1) incorporates this definition, for the purpose of sourcing passive income. The definition includes the following elements:

- the existence of a "place of business". This covers any premises, facilities or installations used for carrying on the business or enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal.

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<sup>60</sup> supra, footnote 1, at iv, 6 and 8

- this place of business must be "fixed", ie. it must be established at a distinct place with a certain degree of permanence and not be purely of a temporary nature. This implies that there has to be a link between the place of business and a specific geographical point.
- the carrying on of the business or conducting the business through this fixed place of business.

The approach of our courts has been that a business will exist in a country even if the activities exercised there comprise only a part of the taxpayer's profit-making operation, and that transactions carried out in a country may constitute a business in that country even if they are controlled from another country. Regarding the carrying on of a business, it has been held that the phrase is to bear its usual commercial meaning, and in *Platt v CIR*<sup>61</sup> it was held that the intention to make a profit was a material factor, along with other important considerations, such as the intention to carry on the business. The essence of a 'permanent establishment' therefor is some degree of physical presence or fixedness on the part of the enterprise in the other or source state, through which the business of an enterprise is wholly or partly carried on; it is submitted that a place of business is 'fixed' when it is established at a distinct place with a degree of permanence such that the place of business is not established for a brief temporary purpose (ie. the business must be carried on through the place of business on a regular basis). In *Transvaal Associated Hide and Skin Merchants v COT, Botswana*<sup>62</sup> the court stated that the word 'permanent' was in contradistinction to a merely temporary use of premises for purposes of trade, and the taxpayer's occupation of a shed at a annual rental showed that its occupation was permanent and not temporary or occasional, and could be regarded as continuing indefinitely. In *SIR v Downing*<sup>63</sup>, the Court held that an enterprise shall not be deemed to have a permanent establishment in another state merely because it carries on business in that state through a broker, provided such broker is acting in the ordinary course of his business. The Court found that what the broker did in managing Downing's share portfolio fell within the scope of what a broker normally does in carrying on a business as a stockbroker.

The foregoing recommendations, which have not been embraced by the Legislature, have to be examined in the context of the difficulties experienced by our courts in determining the source of income generally, and business income in particular. It has been emphasised that, in the absence of a statutory or universal definition of source, it has been left to our courts to grapple with a number of tests in an effort to shed light on

<sup>61</sup> 1922 AD 42

<sup>62</sup> *supra*, footnote 18

<sup>63</sup> 1975 (4) SA 518 (A)

its meaning and interpretation. The Legislature has not dealt with business income in the context of the 1997 Act. In addition, and in the absence of clear guidelines as to the source of business income, regard must be had to some of the important deeming provisions in respect of the source of active income, which deeming provisions the Commission believes "do not enhance definition and understanding, or any sense of underlying logic".<sup>64</sup>

Meyerowitz<sup>65</sup> is of the opinion that the deeming provisions are the reason why it has never been crisply decided whether in the case of the sale of goods for example the source of the resulting profits is the conclusion of the contract of sale, its performance by the seller, the payment by the buyer or a combination thereof. Instead, the learned author points out, the cases have as a rule confined themselves to enquiring whether or not the deeming provisions apply. In terms of Section 9(1)(a) of the Act, amounts accrued to or received by a person by virtue of a contract made by him in the Republic for the sale of goods, whether such goods have been delivered or are to be delivered in or out of the Republic, are deemed to be from a source within the Republic. This provision applies even if the seller only concludes the contract in South Africa.

The following principles can be distilled from Section 9(1)(a):

- 1 The seller falls under the deeming provision;
- 2 The sale must relate to goods (which has not been defined);
- 3 The taxpayer must have concluded the contract in South Africa.

The Commission points out that Section 9(1)(a) of the Act is a highly formalistic provision which deems the proceeds of a sale contract to be sourced where the contract was entered into, which can easily be manipulated and circumvented. Meyerowitz<sup>66</sup> in a similar vein questions the wisdom of the provision on the basis that it is often dependant on legal subtleties as to place of conclusion of contract, which can be varied, thereby rendering the provision ineffective. He continues that more appropriate connecting factors could have been chosen, such as the taxpayer carrying on the business of selling in the Republic.

Another deeming provision that has caused considerable difficulty in interpretation and application is Section 9(1)(d) of the Act, which provides that income accrued to or received by a person by virtue of services rendered or work or labour done by him in the carrying on in the Republic of any trade is deemed to be from a South African source, irrespective of whether the payment for such services or work or labour is to be made

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<sup>64</sup> supra, footnote 1, at 15

<sup>65</sup> supra, footnote 3, at 7 - 16

<sup>66</sup> supra, footnote 3, at 7 - 18

by a person resident in or out of the Republic and wheresoever payment for such service or work or labour is to be made. The material difference between this deeming provision and real or true source principles is that for the purpose of the deeming provision even the place where the services are rendered or where the work is done does not directly matter: emphasis is instead placed on income received or accrued by virtue of the service rendered or work done in carrying on a trade in the Republic. The deeming provision in effect means that a service may be rendered entirely outside South Africa, but as the service is performed in the carrying on of any trade here, the remuneration received is deemed to be from a South African source.

In ITC 749<sup>67</sup>, which concerned a fee received by an accountant practising in South Africa for work done in Mozambique, the court held that the close link between the work done outside the Republic and the carrying on of a trade in the Republic must be closer than that represented by the mere fact that the taxpayer is carrying on a trade here and that the work done outside the Republic is in the way of such trade or of the same nature as the work done by him in the Republic. A taxpayer who carries on a trade both in and outside the Republic, whose services rendered outside the Republic are performed in the carrying on of the trade outside the Republic, will not be caught by Section 9(1)(d). In ITC 1585<sup>68</sup> it was held that the section will not apply where the taxpayer has two distinct businesses, one within and the other outside South Africa.

The general rules relating to the determination of the source of income also apply to professionals who undertake a service outside the Republic for a fee. The actual source of the fee is not in South Africa as the service is rendered elsewhere, but Section 9(1)(d) of the Act may apply as the service may have been rendered in the carrying on of a profession in South Africa. ITC 56<sup>69</sup> is a case in point. Here the court held that the fees received by a South African accountant who had undertaken work in Lourenco Marques were deemed to be from a South African source because of his carrying on in Johannesburg the business of an accountant.

The courts have also applied the 'activities test', which was discussed earlier, to determine the source of income received for professional work. In CIR v Nell<sup>70</sup> the court was faced with a situation where an engineer, who practised in South Africa, went to Rhodesia to render certain services pertaining to his

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<sup>67</sup> ITC 749 (1952) 18 SATC 319

<sup>68</sup> ITC 1585 (1994) 57 SATC 81

<sup>69</sup> ITC 56 (1926) 2 SATC 178

<sup>70</sup> 1961 (3) SA 774 (A), 24 SATC 261

profession. Upon his return, he caused draft plans to be prepared from important working notes made in Rhodesia. The Appellate Division upheld the Special Court's finding that a portion of Nell's income was from a source outside South Africa and alternatively that the link between the services rendered in South Africa and Rhodesia was so tenuous that the services rendered in Rhodesia could not be said to have been rendered in the carrying on in the Republic of Nell's profession in terms of the equivalent of Section 9(1)(d) of the Act. Significantly, the court held it impossible to define the exact limits of the services rendered outside the Republic that would be rendered 'in the carrying on in the Republic of any trade'.

Section 9(1)(d) *bis* of the Act deems an amount to have accrued to a person from a source within the Republic if it has been received by or accrued to such person by virtue of -

"(d) *bis* any service rendered or work or labour done by such person outside the Republic, during any temporary absence of such person from the Republic, if such person is ordinarily resident in the Republic and such service is rendered ..... for or on behalf of any employer by whom such person is employed in the Republic, ....."

As the taxpayer must be ordinarily resident in South Africa, it follows that temporary absence cannot mean permanent absence. Meyerowitz<sup>71</sup> submits that an employee for example is temporarily absent from the Republic when the performance of his services or work in South Africa requires him to carry out a part thereof outside the country, but he is not temporarily absent when he is employed to perform services or work outside the country. In CIR v Whitfield<sup>72</sup> the taxpayer's work required him to regularly canvass customers outside South Africa, for which he received commission on sales. The court held that the regular selling trips were not 'temporary' and that the income earned for such work therefore fell outside the scope of Section 9 (1)(d) *bis*, which in Silke's view is a 'commercially controversial decision'.<sup>73</sup>

In the context of the aforementioned formalistic, unclear and avoidable deeming provisions, the Commission proposes that settled and accepted international guidelines be introduced into our law to enhance clarity and international compatibility. In so doing, most deeming source provisions will become unnecessary and should be scrapped within the framework of liability for tax arising from the identification of a permanent establishment and the activities attributed to it. Regrettably, the Legislature has not in the context of the 1997 Act dealt with this aspect of the recommendations which, it is submitted, is unfortunate as the proposals are

<sup>71</sup> supra, footnote 3, at 7 - 28

<sup>72</sup> 1993 (2) SA 236 (E)

<sup>73</sup> supra, footnote 44, at 5 - 29

pragmatic and sensible. If it is accepted that there is a justifiable basis on which to tax business income according to the source principle, it is further submitted that tax reform will also be required in respect of replacing the uncertain all or nothing dominant source approach presently favoured by our courts with a greater capacity in the tax system to allocate source according to settled international allocation methodologies and principles, namely allocating income to the presence (ie. permanent establishment) in the taxing jurisdiction. The facts of the matter are that our courts will consider granting apportionment where it is claimed by the taxpayer. Legislation could be drafted to assist the courts in apportioning income between its various sources. For example, and as per the Commission's recommendations, there could be law to the effect that there be attributed to each activity the taxable income which it may have been expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the other parts of its business. Legislation to formalise the principles in respect of the apportionment of income it is submitted would obviate uncertainty, internationalise this aspect of our tax law and instil investor confidence in our tax system.

It is submitted that the legislature has already taken the first tentative step in reforming the tax system by introducing Sections 9C and 9D of the 1997 Act, albeit as 'short term measures': it however clearly needs to go further and seize the unique opportunity provided to it by the Commission to facilitate South Africa's integration into the global economy by ensuring, in the form of precise legislation in respect of active income, that our tax laws are compatible with and complementary to international conventions, practices and terminology. It is submitted that it is reasonable to assume that, in the context of having introduced the aforementioned short term measures, the Legislature intends dealing with the question of active income in the medium term by introducing substantive legislation to this effect in the future, to settle this problematic aspect of our tax law.

### **Conclusion**

The 1994 democratic elections in South Africa heralded our return to and participation in the global economy. If it is accepted that South Africa's re-entry into full international trade is a core national economic objective, then it necessarily follows that the existing tax system as it affects international business transactions needs to carefully balance domestic and international economic objectives. In 1987 the Margo Commission remarked that -

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*"The Republic has an open economy and seeks to create an environment that will attract investment and facilitate trade. A hospitable fiscal environment is seen as an integral part of such endeavours. Transnational corporations are making valuable contributions to the growth of developing countries ..... and they should be encouraged".*<sup>74</sup>

The Commission points out that nations started making a choice between the source and residence principles in levying tax on income generated by international activity as trade and investment increased. It has been indicated that nowhere in the world has either of these systems been applied with any degree of purity; typically some middle ground has been found. The South African system has developed on the source basis which it is submitted is *de facto* a hybrid system, as it has been extended by a number of deeming provisions that bring passive or active income derived from sources outside South Africa into the tax net. Very simply, our source basis of taxation seeks to tax only income earned in South Africa, apart from the ineffective and formalistic deeming provisions which attempt to claw off-shore income back into the tax net, while exempting income earned outside of the country. The considerable uncertainty and difficulty faced by our courts, in determining or locating the source of income and the tests that have been employed, has been discussed. In this context, to enhance the collection of revenue and to internationalise our tax laws in the wake of South Africa's re-integration into the world economy, the Commission has published its report recommending important material and substantive reforms to our tax system, which report King believes is "a landmark development in the country's tax reform process and will have far-reaching consequences. Its proposals will engage both revenue services and taxpayers in a learning process that will require rapid application".<sup>75</sup> It is submitted that the challenge facing the Legislature is to take the necessary quantum leap and fully embrace the Commission's proposals by providing a legislative system for the taxation of active income, and in so doing lay to rest one of the most problematic areas of our income tax law.

The existing hybrid system and the ambiguity and uncertainty surrounding its meaning and application, it is submitted, has laid the foundation and conceptual framework for the Commission's proposal that a hybrid system be formally introduced on the basis of preserving the existing source based system for active income and the implementation of a residence basis for the taxation of passive income. It is submitted that the Commission's report is a well reasoned one which takes into account not only South Africa's emergence into

<sup>74</sup> Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, RP 34/1987 (per Margo J, Chairman), at 26.2

<sup>75</sup> *supra*, footnote 51, at 24

the global village but also of the taxation requirements of operating in an international environment. The Legislature, by introducing Sections 9C and 9D of the 1997 Act, albeit as interim measures designed primarily to protect the South African tax base because of the relaxation of exchange controls, has taken an important yet tentative step forward in endorsing certain aspects of the Commission's proposals relating to passive income. Regrettably, it is submitted, it has not seized the opportunity and gone further by dealing with the vexing issue of source in the context of business income and has made little effort to clarify our law in this regard or to achieve the objective of international compatibility. In the interim the problematic deeming provisions contained in Section 9 of the Act remain in force. The Commission correctly points out that "in a world where the two concepts of residence and source based systems are so close in their practical impact, using internationally familiar concepts and terminology contributes more to the required international integration than the label carried by the system".<sup>76</sup>

Whether or not our authorities have 'jumped the gun' in a 'half-baked' manner before deciding to adopt a hybrid system by only addressing investment income in Sections 9C and 9D of the 1997 Act, remains to be seen. What is apparent is that until comprehensive, clear and internationally compatible reforms are introduced, uncertainty, ambiguity and avoidance will prevail to the detriment of both the fiscus and taxpayers.

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supra, footnote 1, at 10