

**A CRITICAL ANALYSIS OF THE INCOME TAX IMPLICATIONS OF
PERSONS CEASING TO BE A RESIDENT OF SOUTH AFRICA**

by

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Declaration

This treatise is an original piece of work which is made available for photocopying, and for inter-library loan.

Signed

Date

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SIR v Downing

SARS v Pinestone Properties CC

*Wood v Holden**

* Foreign tax case

Summary

Over the last 10 years the South African fiscus has introduced numerous changes to the Income Tax Act (ITA) which affect the income tax implications of persons ceasing to be a resident of South Africa. The two main changes were:

- The introduction of a world-wide basis of taxation for residents
- The introduction of capital gains tax (CGT) as part of the ITA

The aim of this treatise was to identify the income tax implications of persons ceasing to be a resident of South Africa. Resulting from this research, several issues in the ITA have been identified, and the two major ones are summarised below.

Firstly, upon the emigration of the taxpayer, there is a deemed disposal of a taxpayer's assets in terms of paragraph 12 of the Eighth Schedule. It is submitted that the resulting exit tax may be unconstitutional for individuals. It is recommended that South Africa should adopt the deferral method within its domestic legislation for individuals who are emigrating. The deferral method postpones the liability until the disposal of the asset.

Secondly, on the subsequent disposal of assets by former residents where there was no exit charge in terms of the exemption under paragraph 12(2)(a)(i) of the Eighth Schedule. Depending on the specific double tax agreement (DTA) that has been entered into with the foreign country, taxpayers have been given

the opportunity to minimise or eliminate the tax liability with regard to certain assets. This should be of concern from the point of view of the South African government.

Further issues noted in this treatise were the following:

- It is submitted that the term 'place of effective management' has been incorrectly interpreted by SARS in Interpretation Note 6.
- It is further submitted that the interpretation by SARS of paragraph 2(2) of the Eighth Schedule is technically incorrect.

The above issues that have been identified present opportunities to emigrants to take advantage of the current tax legislation. It is further recommended that taxpayers who are emigrating need to consider the South African domestic tax law implications, respective DTA's, as well as the domestic tax laws of the other jurisdiction, not only on the date of emigration but also on the subsequent disposal of the respective assets.

Key words: Deemed disposal, Exit tax, Share dealer, Residence, Double tax agreements.

Chapter 1 Introduction

1.1 Background to taxation

Governments around the world tax citizens to fund the services the government offers its citizens. Taxation is explained as¹

'a system of raising money to finance government services and activities. Governments use the tax revenue to pay the cost of police and fire protection, health programmes, schools roads, national defence and many other public services'.

Over the last 10 years the South African fiscus has undertaken numerous changes to the income tax legislation of the country.

There are two principal ways in which a jurisdiction may impose taxation, namely the source based system or the resident based system. South Africa adopted a resident based system of taxation with effect for years of assessments commencing on or after 1 January 2001. Prior to this change, South Africa adopted a source based system of taxation.

Residents as defined are taxed on their world wide income and South Africa taxes non-residents on a source basis.

¹ *The World Book Encyclopaedia* Volume 19 1987 at 43.

South Africa further introduced capital gains tax (CGT) effective from 1 October 2001.

This treatise has its objective of examining the change of status from a resident to a non-resident.

The aim of this treatise is to provide a clear understanding of the income tax implications of emigration for natural persons as well as for non-natural persons. In doing so, the following issues will be addressed:

- When will the emigrant be classified as a non-resident?
- Is the meaning of 'place of effective management' in terms of Interpretation Note 6 correct?
- What are the CGT implications of emigrants? Are exit charges constitutionally correct?
- Has the South African tax base been adversely affected by incorrect wording of the double tax agreements?
- On assets where the taxpayer has been granted allowances and the taxpayer subsequently emigrates, is there a recoupment?

In order to achieve these objectives books, periodicals, tax articles, tax cases and NMMU resources will be scrutinised for relevant information. Information extracted will be analysed in accordance with its relevance in relation to this research project. Emphasis will be based on the tax planning opportunities as well as the protection of the South African tax base.

The approach of this treatise is as follows:

- Chapter 2 - To give a brief overview of the source based system (non-residents) versus the residence based system (residents as defined) as well as the introduction to the gross income definition.
- Chapter 3 – To explain the domestic and foreign interpretation of the term resident for both natural and non-natural persons.
- Chapter 4 – To explain the application of the double tax agreements (DTA's) that South Africa has entered into with other countries.
- Chapter 5 – To explain the capital gains tax (CGT) implications of ceasing to be a resident.
- Chapter 6 – To explain the income tax implications specifically relating to company migration.
- Chapter 7 – To give an overview of the other factors that need to be taken into consideration when ceasing to be a resident.

This treatise will not consider the exchange control implications on ceasing to be a resident.

Chapter 2 Key concepts

2.1 Source Based System

This system imposes taxation on the activities performed within its boundaries or deemed to be within its boundaries. The word 'source' is not defined in section 1 of the Income Tax Act (ITA).² There has, however, been a large amount of case law determining the interpretation of the word. The South African interpretation of the word 'source' is the originating cause or the activity from which the income arises. In *Lever Brothers & Unilever Ltd v CIR* Watermeyer CJ stated the following:³

'the word "source" ... is not the quarter whence they come of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo⁴ which he gives in return for which he receives them'.

Since the conversion from the source based system to the resident based system of taxation, the term 'source' is mainly relevant for non-residents and for purposes of the section 6*quat*, section 10(1)(*gc*) and section 9(1)(*g*) for residents.

² Act 58 of 1962.

³ 1946 AD 441, 14 SATC 1.

⁴ An equal exchange.

2.2 Resident Based System

This system imposes tax on the world wide income of all persons that are classified as residents.⁵

The reason for the adoption of a 'resident based system' was firstly to bring South Africa in line with other international jurisdictions and secondly to protect the South African tax base with regards to the relaxation of exchange control regulations.

The reason why the South African government had to implement strict exchange control regulations was due to the fact that in the past, South Africa taxed its residents on source. Therefore, South Africans could invest offshore and South Africa would not tax the income from those assets as the source was offshore.

Due to the change in the basis of tax in South Africa, the definition of gross income had to be amended to provide that persons who are resident in the Republic are taxed on their world wide income.

2.3 Gross income

The effect of the 'resident based system' can be seen in the definition of gross income in section 1 of the ITA. Gross income is defined in the ITA as follows:

'in relation to any year or period of assessment, means –

⁵ See section 1 of the ITA.

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, 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*, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including . . .’.

[Emphasis added]

The rationale for taxing residents on world wide income is due to the fact that if they live in a specific country, they enjoy the benefits of the country. The rationale for taxing non-residents on source is not as clear.⁶ Due to the fact that non-residents do not live in the country, they do not receive the benefits of the government. The main reason is that if the income was from a source within the Republic, a portion of these funds should be remitted to the South African Revenue Services (SARS). The justification of this basis is that if the taxpayer made profits in South Africa, the taxpayer should contribute to the costs of running the country.

⁶ L Olivier and M Honiball *International Tax: A South African Perspective* 3 ed 2005 at 51.

Chapter 3 Residence

3.1 Introduction

The concept of 'resident' is fundamental to the application of the world wide system of taxation. The crux of the correct application of the definition of gross income is the determination of 'resident'. The term 'resident' is defined in section 1 of the ITA as follows:

'means any –

(a) natural person who is –

- (i) ordinarily resident in the Republic; or
- (ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic –

(aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessments preceding such year of assessment; and

(bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment, in which case that person will be a resident with effect from the first day of that relevant year of assessment: Provided that . . .; or

(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management⁷ in the Republic,

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation’.

The effect of the double tax agreement overruling the definition of resident was inserted on 26 February 2003. This would answer the question what if in terms of domestic legislation the person is a resident but in terms of the double tax agreement the person is resident of the other contracting state. In essence, the double tax agreement overrides domestic legislation. See 4.2 below.

3.2 Natural Person

From a natural person’s point of view, there are two tests as to determine if the taxpayer is a resident. The first test is whether that person is an ordinary resident in the Republic. If the person is an ordinary resident then there is no need to enquire about physical presence. The second enquiry is based on physical presence in the Republic. These tests are mutually exclusive.

‘The term “residence” is a term unique to tax law and should not be confused with terms such as “nationality/citizenship” or “domicile”.’⁸

⁷ This terminology is also used and recommended by the Organisation of Economic Co-operation Development (OECD).

⁸ *International tax: A South African Perspective*, at 51.

3.2.1 Ordinary resident

As noted above one of the criteria to become a resident is if the person is 'ordinary resident' in the Republic. 'Ordinary resident' is not defined in the ITA. Due to the fact that the term is not defined in the ITA it must be given its ordinary meaning with reference to case law.

The following was held in *Lysaght v IRC*⁹ by Lord Warrington of Clyffe in a foreign case with regard to the distinction between residence and ordinary residence:

'I have come to the conclusion that it is now settled by authority that the question of residence or ordinary residence is one of degree, there is no technical or special meaning attached to either expression for the purpose of Income Tax Act.'

In *Cohen v CIR* it was held by Schreiner JA that:¹⁰

'[H]is ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual and principal residence and it would be described more aptly than other countries as his real home.'

In *Kuttel v CIR* it was held by Goldstone JA that:¹¹

'a person is "ordinarily resident" where he has his usual or principal residence, i.e. what may be described as his real home'.

⁹ 1928 A.C.234 at 249.

¹⁰ 1946 AD 174 13 SATC 362 at 371.

¹¹ 1992 (3) SA 242 (A) 54 SATC 298 at 306.

The term 'ordinary resident' is a narrower concept than 'resident'. A person can be resident in more than one place but can the person be ordinary resident in more than one place? In South Africa the Supreme Court of Appeal (previously the Appellant Division) has not yet ruled on whether a person can be ordinarily resident in more than one country. In *Cohen v CIR*¹² Schreiner JA favoured the interpretation that a person can have more than one residence but the person can only be ordinary resident of one country.

In 2002 SARS issued Interpretation Note 3 which summarizes their view of the term 'ordinary resident'. The Interpretation Note states that in determining whether a person is an ordinary resident in a country it is impossible to lay down hard and fast rules. It emphasizes that the term 'ordinary resident' must not be confused with 'domicile', 'nationality' and the concept of 'emigrating' for exchange control purposes.¹³ The Interpretation Note lists further factors which must be taken into account to determine whether the taxpayer is an ordinary resident. The factors are:

- most fixed and settled place of business
- habitual abode
- place of business and personal interest
- status of individual in country
- location of personal belongings
- nationality

¹² At SATC 371.

¹³ Same view as *International Tax: A South African Perspective* at 51.

- family and social relations
- political and other activities
- application for permanent residence
- period abroad
- frequency of and reasons for visits

It is important to note that the onus of proving that the emigrant is in fact a non-resident lies with the emigrant. This is consistent with section 82 of the ITA.

One important factor which was envisaged in the cases mentioned above as well as in the Interpretation Note is that when deciding on whether the taxpayer is an ordinary resident, physical presence is not a pre-requisite to be an ordinary resident.

3.2.2 Physical Presence Test

This test is purely, as the name suggests, based on the physical presence of the individual.

In terms of the 'resident' definition, if a person had to emigrate on 30 June 2009 he will be a resident from 1 March 2009 to 30 June 2009 and will be a non-resident from 1 July 2009 to 28 February 2010. One must understand that the physical presence test only comes into application after the year in which the person emigrates if the person is a natural person. This is evident in the definition of resident.

3.3 Non-Natural Person

There are numerous options available to entrepreneurs in South Africa who wish to create a business. The forms available in South Africa are:

- Company
- Partnership
- Close Corporation
- Trust

In terms of the definition of resident a person¹⁴ other than a natural person can be resident if:

- Incorporated, established or formed in the Republic or
- Place of effective management is in the Republic

3.3.1 Incorporated, established or formed

A non-natural person if incorporated, established or formed in the Republic will be a resident in the Republic unless the place of effective management (POEM) is outside the Republic.¹⁵ The term 'incorporated, established or formed' is not defined in the ITA.

¹⁴ Defined in section 1 of the ITA act as 'includes an insolvent estate, the estate of a deceased person and any trust.' Note that the word trust in the definition was included due to the fact that a trust is not a person (cf. *CIR v Friedman and others NNO* 1993 (1) SA 353 (A)). Furthermore note that the term partnership is not included. From a South African point of view it is the partners in the partnership who are assessed for tax and not the partnership (see section 24H of the ITA).

¹⁵ Only if a DTA has been entered into between the two contracting states.

Company

From a company's point of view, in order to register/form a company in South Africa, the Companies Act¹⁶ needs to be adhered to. In terms of section 32 of the Companies Act, any person may form a company by complying with the requirements of the Companies Act in respect of the registration of the memorandum and articles. A company will have to register with the Registrar of Companies. This would be the place where the company is incorporated, established or formed.

When the new Companies Act 2008 is promulgated, Close Corporations will not be allowed to be registered. However, if a Close Corporation has been registered prior to the date that the new act has been promulgated, the continuance of the Close Corporation is not affected or limited. At the time of the submission of this treatise, the Companies Act 2008 had not been promulgated.

Close Corporation

The same rules apply to the formation of a close corporation, except that the members will have to adhere to the Close Corporation Act (CCA).¹⁷ The section dealing with incorporation is section 14 of the CCA. The Close Corporation will have to register with the Registrar of Close Corporations.

¹⁶ Act 61 of 1973.

¹⁷ Act 69 of 1984.

Trust

A trust is not a legal entity but is a person as defined in section 1 of the ITA. In order to form a trust in South Africa, the documents must be registered with the Master of the High Court.

Partnership

A partnership is not a separate legal persona and the partners are treated as separate taxpayers in their own right.¹⁸ A partnership is not registered but it is constituted by an underlying partnership agreement. The formation of a partnership is where the agreement was signed.

3.3.2 Place of effective management

The other criterion in order to become a resident of the Republic is if the place of effective management (POEM) is within the Republic. Therefore, even if a non-natural person is incorporated in a country other than in the Republic, it can still be regarded as a resident of the Republic if the POEM is within the Republic.¹⁹ Unfortunately the term 'POEM' is not defined in section 1 of the ITA. The term POEM has to be determined in light of its ordinary meaning and in accordance with international precedent.

¹⁸ Section 24H of the ITA.

¹⁹ This is in line with the OECD commentary paragraph 21 on article 4.3. However, it should be noted that the POEM is not always the test in a tie-breaker position. For example the United States and the South African DTA states: 'where a company is a resident of both states, then it should be deemed to be a resident of the state in which it is incorporated'.

Prior to the introduction of the term 'POEM' as the test for establishing the residency of a non-natural person, non-natural persons were resident in the Republic if they were 'managed and controlled' in the Republic. As a result of the recommendation of the Katz commission,²⁰ the definition was changed to 'POEM'.

'The change will have the benefit of employing international and, therefore, commonly understood terminology.'²¹

However, the Katz commission did not define the term 'POEM'.

As the term has not been defined in the ITA, the term must be given its ordinary meaning with reference to case law. There has, however, been no case law on the term 'POEM' in South Africa.

SARS view

SARS issued Interpretation Note No. 6 on 26 March 2002, explaining its view on the meaning of the term 'POEM'. It must be noted that the Interpretation Notes that have been issued by SARS are not law and therefore not legally binding. They merely indicate how, as a matter of practice, SARS interprets provisions of the ITA whose interpretation maybe uncertain. In a recent tax case²² the courts overruled a specific Interpretation Note.

²⁰ Fifth Interim Katz Report in 1997.

²¹ Paragraph 6.1.2.1 of the Katz report.

²² ITC 1830 70 SATC 123.

In terms of Interpretation Note No. 6, SARS takes the view that:

'the place of effective management is the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets'.²³

It further states that:

'If these management functions are not executed at a single location due to the fact that the directors or senior managers manage via distance communication . . . the view is held that the place of effective management would best be reflected where the day-to-day operational management and commercial decisions taken by senior managers are actually implemented, in other words, the place where the business operations/activities are actually carried out or conducted. If the nature of the person, other than a natural person, is such that the business operations/activities are conducted from various locations, one needs to determine the place with the strongest economic nexus.'²⁴

The Interpretation Note has been questioned by learned authors.

'We consider that the views expressed in the interpretation note are tenable with a question mark in regard to 3.3 . . . Why should distance lend disenchantment to the place where the directors or senior managers exercise their management powers?'²⁵

²³ At 3.2 of interpretation note 6.

²⁴ At 3.3 of interpretation note 6.

²⁵ D Meyerowitz 'Resident: Place of Effective Management (Persons Other than Natural Persons)' (2002) 51 *The Taxpayer* 67.

OECD View

The OECD is an international organization that is represented by member countries. Most of the member countries are high income economies and regarded as developed countries. Despite South Africa not being a member of the OECD, it has followed the OECD model with respect to the DTA's it has entered into with other jurisdictions.

OECD commentary²⁶ states that:

'The place of effective management 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. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example the board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can only have one place of effective management at any one time.'

The updated commentary²⁷ amended this paragraph to state the following:

'The place of effective management is the place where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective

²⁶ Paragraph 24 of the commentary on paragraph 4.3 of the OECD Model (2005).

²⁷ Paragraph 24 of the 2008 OECD commentary on 4.3.

management. An entity may have more than one place of management, but it can only have one place of effective management at any one time.’

The major change to the commentary is the deletion of the phrase with reference to the board of directors. It has been noted by some authors that the reason for the deletion of the reference to the board of directors as the indicator of the POEM is not clear.

The change of the commentary could be seen as a step into the interpretation favoured by SARS in the Interpretation Note. However, it is submitted that even with the updated commentary, the key factor that needs to be assessed is the location where the key decisions are made and not where they are implemented.

Foreign precedent

In a UK case²⁸ the court considered the term POEM in terms of the UK-Netherlands Tax Treaty. The case concerned a corporate residence of a company incorporated in the Netherlands. This Dutch company was formed to hold specific shares in the UK companies, and embarked upon a set of transactions aimed to reduce the liability for UK Capital Gains Tax in respect of a sale by the Dutch company of its shareholdings in the UK companies. The company was managed by a Dutch director. The director acted upon the instructions from the advisors and shareholders based in the UK.

²⁸ Wood and another v Holden [2005] EWHC 547.

The UK authorities stated that the Dutch company had its place of effective management in the UK because the sole director merely took instructions from the UK based shareholders and advisors. The court rejected Inland Revenue's arguments.

Some of the more important points that came out of the judgement were as follows:

- In respect of the concepts of 'central management and control' and 'place of effective management' it is very difficult to see how the two tests could have led to a different answer²⁹
- The taxpayer must pass a low threshold in order to show that the board of directors is doing more than rubber stamping the decision of another person/advisor/shareholder. The amount of the activity is not critical, provided the decisions on the key policy and strategy of the company are made and taken in the specific jurisdiction
- Influence is not the same as control: the board of directors may act on the advice of advisors/shareholders but that does not mean that the board of directors has ceased to exercise central management and control.

²⁹ Judge Chadwick LJ at paragraph 44.

A South African article commentated on this specific issue.³⁰

‘A significance of *Wood v Holden* for South Africa is perhaps best illustrated within the context of an international tax planning structure. If the offshore company is only required to effect limited tasks and if these are dealt with by directors who are resident in the offshore jurisdiction who properly apply their minds to these tasks, and there is no reason to find that their decision is dictated by a third party, then the effective management of such company is to be located offshore and not in South Africa notwithstanding that the very structure was put into place for the benefit of the South African taxpayer.’

It was further noted in the article that:

‘Given the paucity of South African authority, it is likely that South African courts will find the precedent of *Wood v Holden* of considerable persuasion when dealing with a commercial operation which has a similar structure.’

In conclusion of the POEM of a person other than a natural person, if the directors of a foreign company sign documents without applying their minds on the specific issues/advice, it is then difficult to conclude that the residence of the company is in that foreign jurisdiction.

It has been held by Vogel that:³¹

‘What is decisive [in determining the place of effective management] is **not** the place where the management directives **take effect** but rather where they are **given**.’

³⁰ D Meyerowitz ‘Place of Effective Management’ (2007) 56 *The Taxpayer* 82.

³¹ K Vogel *Klaus Vogel on Double Taxation Conventions* 3 ed, at 105 of article 4.

In light of the above, it is doubtful whether the interpretation of the term 'POEM' by SARS is technically correct based on the commentary of the OECD model as well as foreign precedents. It is submitted, in agreement with Vogel, that the POEM is the place where the 'shots' are called for the entity as a whole and not where the decisions are implemented.

Chapter 4 Double Tax Agreements

4.1 Introduction

The South African government has entered into numerous double tax agreements with other countries to regulate taxing principles. Double tax agreements effectively allocate taxing rights between two countries in cases where both countries seek to tax the same income under their domestic tax legislation. There are two types of rights in terms of allocation, namely:

- Exclusive rights
- Non-exclusive rights

An exclusive right gives the right to levy tax to one of the states. A non-exclusive right gives both states the right to impose tax. This means that it is then necessary to look at the relief provisions in the agreement.

The purpose of the double tax treaties is:

- clarification of the taxing rights of each state;
- avoidance of double international juridical taxation; and
- prevention of fiscal evasion with anti-avoidance provisions.

4.2 Legal effect of the treaties

In South Africa and in most other jurisdictions, the domestic law provides that the country may negotiate treaties and that the treaties, once brought into

effect will have the effect of law.³² As a general principle, if there is a conflict between the two contracting states, the treaty will override domestic law.

The rules of the DTA generally override domestic law. The reason why the term 'generally' is used is due to the conflict in terms of section 9D of the ITA. If the company meets the criteria in terms of section 9D and is classified as a controlled foreign company the income may be 'imputed' into the shareholders taxable income. Assume that the company's place of effective management is in the foreign jurisdiction then the company is a resident of the foreign jurisdiction. In terms of section 9D the profits must be taxed in South Africa. This is not in terms of article 7 of the OECD model dealing with business profits.

It was held by *SIR v Downing*.³³

'as long as the Convention is in operation, its provisions, so far as they relate to immunity, exemption or relief in respect of income tax in the Republic, have effect as if enacted in Act 58 of 1962 (see s 108(2))'.

These views are also expressed by other learned authors.³⁴ Furthermore, SARS in the CGT guide, concludes that the provisions of the DTA will override paragraph 2(1)(b) of the Eighth Schedule.³⁵ For example, if a South African resident had to emigrate to Mauritius and owned shares in a property holding

³² See section 108 of the ITA.

³³ 1975 (4) SA 518 (A) 37 SATC 249 at 255.

³⁴ I Wilson 'International Tax – XII' (2005) 19 *Tax Planning* 8.

³⁵ SARS Comprehensive Guide to CGT, Issue 2, at 48.

company, on subsequent disposal of the property in terms of SA legislation paragraph 2(1)(b) of the Eighth Schedule is applicable. However, in terms of the DTA entered into between South Africa and Mauritius, South Africa does not have taxing rights. Hence the DTA has overridden the domestic laws of South Africa. For further explanation refer to 5.5.2 below.

Residence for individuals may be determined using one of the following methods:

- ordinary residence
- physical presence
- domicile
- permanent home
- prior period residence

For non natural persons, residence may be determined using one of the following methods:

- Incorporation
- POEM
- Formation
- Management and control

Due to the different tests for residence, it is possible for a person to be a resident in more than one jurisdiction. For example, if country X recognises residence based on domicile and country Y recognises residence on the

physical presence system, there could be instances in which the person is resident in both countries due to being domiciled in country X and physically present in country Y. Due to economic factors the OECD recommended that countries enter into double tax agreements (DTA).

There are 4 main models on which the DTA's are based:³⁶

- OECD model
- UN model
- US model
- Intra ASEAN model

This treatise will follow the OECD model, as the majority of the DTA's that South Africa has entered into is based on the OECD model.

4.3 Residence – Natural Persons

In terms of the OECD Model tax convention and in particular article 4 deals specifically with the term 'resident'. Paragraph 2 of the article is what is known as the 'tie-breaker test'. The 'tie-breaker test' is applied if a person is a resident of both countries.

Paragraph 2 of Article 4

'Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

- a. he shall be deemed to be a resident only of the state in which he has a permanent home available to him; if he has a permanent home

³⁶ I Wilson 'International Tax – II' (2003) 17 *Tax Planning* 42.

available to him in both states, he shall be deemed to be a resident only of the state with which his personal and economic relations are closer (centre of vital interests);

- b. if the State in which he has his centre of vital interests can not be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has a habitual abode;
- c. if he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the state in which he is a national;
- d. if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.'

4.4 Residence – Non-natural persons

Paragraph 4 of article 4 of the OECD states:

'Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.'

The purpose of the 'tie-breaker test' is to fix residence in one or the other contracting state. See 3.1 above.

Chapter 5 Capital Gains Tax

5.1 Introduction

Capital gains tax (CGT) was introduced into South Africa effective from 1 October 2001. It was decided by the drafters of the legislation to incorporate the CGT legislation within the ITA as CGT is regarded as a tax on income. At the time there were also administrative advantages to the inclusion within the ITA. The CGT legislation is incorporated into the ITA through section 26A which states:

‘There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule.’

5.2 Scope

The charging paragraph for CGT is paragraph 2 of the Eighth Schedule which states that:

- ‘(1) This schedule applies to the disposal on or after valuation date of –
- a) any asset of a resident; and
 - b) the following assets of a person who is not a resident, namely –
 - (i) immovable property situated in the Republic held by that person or any interest or right of whatever nature of that person to or in immovable property situated in the Republic;
- or

(ii) any asset which is attributable to a permanent establishment of that person in the Republic

(2) For the purposes of subparagraph 1(b)(i), an interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested right of a person in any assets of a trust , if –

- (a) 80 per cent or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and
- (b) in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20 percent of the equity share capital of that company or ownership or right to ownership of that other entity.'

What is critical to the applicability of CGT to the emigration of a person is whether the assets remain within the 'CGT net'. The term 'CGT net', which is often used by tax consultants, can be better explained as those assets that will still be subject to CGT upon realization of those assets.

What can be deduced from the charging paragraph above is that residents are subjected to CGT on their world wide assets but non-residents are only subjected to CGT if the assets meet the criteria per paragraph 2(1)(b) of the Eighth Schedule.

5.3 Major components for CGT

In order for CGT to be applicable there must be the following:

- an asset
- a disposal

Asset

The term asset is defined in the Eighth Schedule as:

‘includes –

- a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- b) a right or interest of whatever nature to or in such property’.

Disposal

The term ‘disposal’ is defined in the Eighth Schedule as:

‘means an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this schedule treated as the disposal of an asset, and dispose must be construed accordingly’.

Paragraph 11 of the Eighth Schedule states the following:

‘a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset and includes . . .’.

One can interpret that the definition of disposal is very wide. Furthermore, paragraph 12 of the Eighth Schedule caters for certain deemed disposals and acquisitions.

If we analyse the effect of the Eighth Schedule, all assets will fall under the definition of assets, whether trade or non-trade assets. If a share dealer sells his stock, the sale will be included in his gross income for the particular year due to the fact that the taxpayer is a share dealer and the stock effectively is his trading stock (i.e. not capital). Furthermore, in terms of the Eighth Schedule, there has been a disposal of an asset. Therefore, the sale is potentially subject to CGT as well.

However, if we look at paragraph 35 of the Eighth Schedule, dealing with proceeds from disposal, a very important principle is established.

Paragraph 35(3) states the following:

'The proceeds from the disposal of an asset by a person must be reduced by –
(a) any amount of the proceeds that must be or was included in the gross income of that person or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain; . . .'

The reciprocal provision for the base cost of an asset has been included in paragraph 20(3) of the Eighth Schedule. The paragraph states that:

'The expenditure incurred by a person in respect of an asset must be reduced by any amount which –

(a) is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person before the inclusion of any taxable capital gain; . . .'

The effect of paragraph 35 and paragraph 20 of the Eighth Schedule is that, generally, neutrality has been obtained. In other words there has been no double taxation between normal tax and CGT. For example, if a dealership sells a car for R 100,000 and the cost was R 80,000, the profit of R 20,000 will be included in the dealer's taxable income. From a CGT point of view proceeds and base cost is nil due to the fact that the same amount was included in the normal tax calculation.

5.4 Deemed Disposal

Paragraph 12 of the Eighth Schedule caters for circumstances in which there is a deemed disposal or acquisition. Paragraph 12 states the following:

(1) Unless subparagraph (4) applies, where an event described in subparagraph (2) occurs, a person must, subject to paragraph 24, be treated for the purposes of this schedule as having disposed of an asset described in subparagraph (2) for an amount received or accrued equal to the market value of the asset at the time of the event and to have immediately reacquired the asset at an expenditure equal to that market value, which expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

(2) Subparagraph (1) applies, in the case of –

- a. a person that commences or ceases to be a resident or a controlled foreign company, in respect of all assets of that person other than –
 - i. assets in the Republic listed in paragraph 2(1)(b)(i) and (ii);
 - ii. any qualifying equity share contemplated in section 8B, which was granted to that person less than 5 years before the date on which that person so ceases to be a resident; and
 - iii. any equity instrument contemplated in section 8C, which had not yet vested as contemplated in that section at the time that the person so ceases to be a resident;
 - iv. any right to acquire any marketable security contemplated in section 8A’

In terms of paragraph 12(2) read with paragraph 13(1)(g) of the Eighth Schedule, the day before the person ceases to be a resident there is a deemed disposal of certain assets. This deemed disposal is also known as an 'exit charge'³⁷. There is clearly a necessity to plan carefully when considering emigration. The reason, from an income tax point of view, is that if the person has many assets that do not remain within the CGT net, even though there is no physical disposal of the assets, the person is still deemed to dispose of all his assets that do not form part of the CGT net. This is very concerning and is critical to assess whether to emigrate or not. The reason is that regardless of actually disposing of the assets, there would be no cash inflow but yet there will be a CGT tax outflow.

The main reason why there is a deemed disposal of the assets is logically due to the fact of administration. It would be very difficult for SARS to monitor the disposal of foreign assets by former residents who have emigrated to a foreign country.

5.5 Emigration

There are a number of anomalies that arise on the issue of emigration and exit taxes. The possible anomalies occur at the following times:

- At the date of emigration
- Subsequent disposals
- Deferral of CGT

³⁷ In terms of paragraph 12(2)(1)(a).

5.5.1 At the date of emigration

In South Africa, there have been no cases referred to court in connection with the exit charges that are levied on emigration. However, in other jurisdictions there have been numerous cases dealing with the exit charges on emigration.

France

One of the leading cases dealing with the exit charges is a French case.³⁸ In this case, a French statute taxed the unrealised appreciation inherent in corporate stock held by long-term French resident upon transfer of his tax residence from France to another country. The court held that the exit charge on the unrealised appreciation of stock is not permissible. The court stated the following:

'The answer to the question referred must be that the principle of freedom of establishment laid down by Article 52 of the treaty (*now article 43*) must be interpreted as precluding a member state from establishing, in order to prevent a risk of tax avoidance, a mechanism for taxing latent increases in value such as that laid down in Article 167a of the CGI, where a taxpayer transfers his tax residence outside that state.'³⁹

[Emphasis added]

³⁸ Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie (C-09/02).

³⁹ At paragraph 69 of judgement.

European Treaty

The treaties of the European Union are a set of international treaties between Union member states which set out the constitutional basis of the European Union.

Article 43 of the European Treaty states:⁴⁰

‘any restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited’.

Article 48 of the European Treaty states:⁴¹

‘Companies/firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.’

Canada

In terms of the Income Tax Act of Canada⁴² there is a deemed disposal, subject to certain exemptions, of a person’s assets on emigration from Canada. In terms of section 220(4.5) of that Act, the taxpayer, who is an individual, may elect to defer the payment of tax on income relating to the deemed disposition, regardless of the amount, and pay it later, without interest, when the individual sells or otherwise disposes of the property. If the individual

⁴⁰ C 321 E (29.12.2006).

⁴¹ C 321 E (29.12.2006).

⁴² 1985,c.1(5th Supplement).

elects to defer the tax owing on the deemed disposition and if the amount of federal tax owing is more than \$14,500, the individual must provide acceptable security to cover any amount over \$14,500.

Australia

If the taxpayer ceases to be an Australian resident there is a deemed disposal of certain assets for their market value at the time a person ceases being an Australian resident. However, if the emigrant is an individual, the emigrant may choose to disregard all capital gains and capital losses made when he ceased to be a resident. The effect of making this choice to defer is that the increase/decrease in the value of the assets from the time of emigration to the next CGT event, is also taken into account in working out capital gains and capital losses on those assets.

South Africa

In terms of paragraph 12(2) of the Eighth Schedule, there is a deemed disposal of certain assets if the taxpayer ceases to be a resident. One of the exemptions to the deemed disposal rule is if the assets fall under paragraph 2(1)(b)(i) and (ii). In other words if the asset falls under paragraph 2(1)(b)(i) or 2(1)(b)(ii) the exit charge provisions will not apply.

A closer look at paragraph 2(1)(b)(i) and (ii)

This provision is made up of 3 parts:

1. Immovable property situated in the Republic

2. Any interest or right of whatever nature of that person to or in immovable property situated in the Republic
3. Any asset attributable to a permanent establishment of that person in the Republic

Immovable property

With regard to immovable property this is relatively straightforward. If the property is immovable property situated within the Republic then the property will remain within the CGT net and there will be no deemed disposal due to the exemption under paragraph 12(2)(a)(i). The Eighth Schedule does not specifically define the term immovable property. The term 'immovable property' is not defined in the ITA and is not defined in any other Act. Therefore the term must be given its plain meaning. The term 'immovable' is defined as

'impossible to move, not liable to be moved . . .'.⁴³

In terms of a legal textbook the term 'immovable' is defined as:

'land and everything that is attached to the land by natural or artificial means'.⁴⁴

Furthermore, the term 'property' is defined as

'means land in the Republic and fixtures thereon, and includes . . .'.⁴⁵

⁴³ *Chambers Twentieth Century Dictionary* 1972 at 653.

⁴⁴ Silberberg and Schoeman's: *The Law of Property* at 3.3.2.2 (My Lexisnexis).

⁴⁵ Transfer Duty Act No. 40 of 1949.

The term combined being “immovable property” must be interpreted to mean property that is not movable.

The term ‘immovable property’ is interpreted as:⁴⁶

‘refers to units of land and everything permanently attached to it by means of attachment, as well as sectional title units. All things that cannot be classified as immovables are movables’.

In conclusion the term ‘immovable property’ does not include shares in a company whose assets are majority immovable property situated in South Africa. These views have been accepted by SARS.⁴⁷

Interest or right in immovable property

The legislators identified this as a problem and inserted paragraph 2(2) of the Eighth Schedule specifically relating to interest in immovable property. This paragraph was recently amended by section 64(1) of the Revenue Laws Amendment Act 31 of 2005. The main impact of the change, according to SARS, is that post 1 February 2006 the gross market value of the assets of the entity must now be analysed instead of the net market value of the assets.⁴⁸

However, it is debatable whether this reflects the legislation.

⁴⁶ Juta Income Tax, 2006, *Commentary on Income Tax* (My Lexisnexus).

⁴⁷ SARS Comprehensive Guide to Capital Gains Tax, Issue 2, at 48.

⁴⁸ This is in line with the OECD commentary on Article 13 paragraph 4 at 28.4. This could be seen as a step in the right direction in that exit charges may in fact not be permitted as it is a limit on the freedom of movement on individuals.

Before the amendment paragraph 2(2) read as follows:

'(2) For the purposes of subparagraph (1)(b)(i), an interest in immovable property situated in the Republic includes a direct or indirect interest of at least 20 per cent held by a person . . . in the equity share capital of a company or in any other entity, where 80 per cent or more of the value of the net assets of that company or other entity, determined on the market value basis, is, at the time of disposal of shares in that company or interest in that other entity, attributable directly or indirectly to immovable property situated in the Republic . . .'

For example, if a person had a bond over the immovable property then the market value attributable to immovable property would be the net after reducing the market value of the property by the bond over the property.

The current paragraph 2(2) states the following:

'For purposes of subparagraph 1(b)(i), an interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership of a person in any other entity or a vested interest of a person in any assets of any trust if –

(a) 80 per cent or more of the market value of those equity shares, ownership or right to ownership, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock . . .'

The interpretation by SARS can only be explained on the basis that the liabilities are to be regarded as apportioned to the assets in proportion to their

market values. However, it can be argued that the liabilities that are attributable to the assets and used in determining the market value should be allocated to the specific assets to which they relate to and not apportioned on a gross value basis.

EXAMPLE			
Immovable property	100	Equity	110
Other assets	<u>50</u>	Loan	<u>40</u>
	150		150
SARS calculates the % attributable to immovable property as 67% (100/150).			
However, some may argue that this method does not take into account the market value of the equity shares.			
An alternative calculation is as follows:			
Immovable property	Other assets	Total	
100	50	150	
<u>(27)</u>	<u>(13)</u>	<u>(40)</u>	
73	37	110	
73/110 = 67%			
Therefore, SARS interpretation is correct only if the liability is apportioned equally over the assets.			

It is submitted that there is a feasible argument that if the loan is a specific loan over the immovable property, SARS interpretation is incorrect. However, this treatise will follow the approach of SARS based on the SARS CGT guide.

Effectively the amendment has resulted in there being less deemed disposals due to the fact that the loan will not affect the composition of assets over total assets.

From a South African point of view, one of the questions that should be asked is whether the exit charge levied in terms of paragraph 12 of the Eighth Schedule is constitutionally correct. In terms of section 21 of the Constitution⁴⁹ everyone has the right to freedom of movement and the right to leave the country.

Specifically section 21 of the Constitution states:

‘(1) Everyone has the right to freedom of movement.

‘(2) Everyone has the right to leave the Republic.’

If a tax is imposed on emigration, in terms of paragraph 12 of the Eighth Schedule, this can be seen as a conflict with a number of provisions in the Bill of Rights in the Constitution.

It has been held in an article in Moneyweb Personal Finance that:⁵⁰

‘The law as it stands seems rather harsh and unjust. A fairer provision would be for the capital gains tax liability to be calculated as at the date of departure, but only becomes due and payable when the asset is actually disposed of.’

As discussed above, a tax is charged on the emigration from South Africa even though there is no disposal of the asset. Unless the taxpayer can find funding for the tax obligation, he may not be able to afford to leave South Africa.

⁴⁹ Constitution of the Republic of South Africa Act of 1996.

⁵⁰ S Jones ‘Capital Gains Tax and Emigration’ (2007) *Moneyweb Personal Finance* can be found at www.moneyweb.co.za/mw/view/mw/en/page38?old=33213&sn=Detail.

Effectively, the tax exposure will possibly be a negative factor towards the individual's right to the freedom of movement and restricts his right to leave the country.

Why has the government not adopted a system like in Canada, Australia or other jurisdictions that have adopted a deferral of exit charges?

It has been held in an article in *De Rebus*:⁵¹

'South Africa's failure to take up similar measures may render its exit taxes vulnerable to constitutional challenge.'

While South Africa is not a member of the European Union, it remains important to consider the European Union's treatment over exit charges.

The French case, discussed in 5.5.1 above, concerned an individual. Would the same conclusion be reached if it dealt with a company?

The European Commission⁵² is of the view that:⁵³

'the interpretation of the freedom of establishment given by the ECJ in *de Lasteryrie* in respect of exit tax rules on individuals also has direct implications for MSs' exit tax rules on companies'.

⁵¹ B Ger 'Capital Gains Tax' (2004) *South African Attorney's Journal*.

⁵² The European Commission acts as an executive of the European Union.

⁵³ Exit taxation and the need for co-ordination of Member States' tax policies at 3.1 can be found http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfinal&an_doc=2006&nu_doc=825.

From a South African point of view, a company cannot transfer its legal residence. From a tax point of view (see 3.3 above), a company may transfer its residence through a change of POEM.

In the definition of residence, it excludes dual residence (see 3.1 above). However, legally the company is still incorporated within South Africa and has not changed its incorporation. This view is also the view expressed in a textbook:⁵⁴

‘A South African incorporated company would not cease to be a resident in South Africa for jurisdictional purposes if its place of effective management is moved outside of the country.’

It is submitted that, due to the fact that a South African corporation cannot transfer its legal residence, the exit charges for persons other than natural persons are not unconstitutional.

This could be the reason why Australia and Canada have adopted the deferral method only if the taxpayer is an individual (See above).

If the deferral method is adopted, it ensures that the tax base of South Africa is protected and benefits the individual in that there is no liability to tax upfront on the decision to emigrate. It is submitted that it would be advisable to SARS that

⁵⁴ G Maisto *Residence of Companies under tax treaties and EC law* Vol 15 2009 at 641.

if the deferral method is adopted, that security for the deferred tax is compulsory.

5.5.2 Subsequent disposal

As discussed above, if there is a decision to emigrate and there are assets within the CGT net, there will be no deemed disposal due to the fact of the exemption under paragraph 12(2)(a)(i). Is the South African tax base protected on subsequent disposal of these assets?

Once the person has emigrated from South Africa and taken up residence in the new foreign country, the person is a non-resident. In terms of domestic tax legislation, the capital gain on the disposal of immovable property situated in South Africa will be deemed to be from a South African source in terms of section 9(2) of the ITA as well as paragraph 2 of the Eighth Schedule. Also the capital gain from the disposal of equity shares, in which the holding is greater than 20%, where more than 80% of the market value is attributable to immovable property is deemed to be from a South African source. All other assets that are disposed of by a non-resident are not subject to South African tax.

Due to the fact that the emigrant is a resident of another country, one needs to consider the DTA that is entered into between the two countries. The specific article dealing with capital gains is article 13 of the OECD model.

Article 13

Capital Gains

Paragraph 1 of the DTA states that:

'Gains derived by a resident of a contracting state from the alienation of immovable property referred to in Article 6 and situated in the other contracting state may be taxed in that other state'.

This is what is known as a non-exclusive right. The reason why the contracting state where the property is situated has the primary right to tax the gain, is due to the economic connection between the source of the gain and the source state. Therefore, if a resident emigrates from South Africa and holds immovable property situated in South Africa there is no exit charge. However, on subsequent disposal the capital gain will be taxed in South Africa. In terms of the DTA the other country may also tax the capital gain. However, relief will be provided from South Africa and the recipient will request relief in terms of article 23 of the DTA.

In conclusion, with the sale of immovable property there is no loss to the fiscus. It is important to note that this article only applies to alienation of immovable property situated in the other state. Hence, it does not apply to gains of immovable property situated in the state of residence.⁵⁵

⁵⁵ This is in line with the OECD Commentary on Article 13 paragraph 1 at 22.

Article 6

Immovable property is defined in paragraph 2 as follows:

‘shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include the property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural sources; ships, boats and aircraft shall not be regarded as immovable property’.

The term law is not restrictive to tax law but to the entire law of the country in which the property is situated.⁵⁶ The major factor is whether the term immovable property includes shares in a company in which the majority of the company’s asset is attributable to immovable property.

The DTA specifically states that the term ‘immovable property’ must be given the meaning under the law of the Contracting State. It is clear that immovable property does not include shares in a company or an interest in a Close Corporation (refer to 5.5.1).

Disposal of shares

Once again due to section 9(2) of the ITA and paragraph 12(2)(a) of the Eighth Schedule the deemed source of the gain is in South Africa if 80% of the market

⁵⁶ *Klaus Vogel on International Tax Conventions* art 6 para 22.

value of the equity shares relate to immovable property and the emigrant holds greater than 20% of the shares. However, one needs to consider the implications of the DTA.

Article 13 paragraph 4 of the OECD model states the following:

‘Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.’

It is recognized in the OECD commentary⁵⁷ that many States either broaden or narrow the scope of this paragraph. From a South African point of view, it would be envisaged that this paragraph is not used for a number of reasons.

One of the reasons is that the paragraph above could be interpreted as being restrictive.

The definition of ‘company’ is defined in the DTA as

‘any body corporate or any entity that is treated as a body corporate for tax purposes’.

The term ‘equity shares’ is defined in section 1 of the ITA as:

‘means, in relation to any company, its issued share capital and in relation to a close corporation, its members’ interest . . .’.

⁵⁷ Article 13 paragraph 4 at 28.5.

A Close Corporation for the agreement purposes⁵⁸ is a Company. The OECD model refers to 'the alienation of shares' and not equity shares. The term 'shares' is not defined in the OECD model.

A member in a Close Corporation does not own shares. A Close Corporation does not issue shares to the members.

'It has what is referred to as members' interest.'⁵⁹

If the traditional approach to the interpretation of statutes (also known as the cardinal rule) is applied then it is submitted that the term 'shares' in the DTA does not include a member's interest in a Close Corporation.

However, the author is aware that the South African courts have adopted a more purposive approach.

'In later cases Courts have resorted to a purposive approach in fiscal matters as in the case of other legislation.'⁶⁰

If the purposive approach is adopted then it is submitted that the term "shares" will include a member's interest in a Close Corporation.

⁵⁸ For domestic purposes a Close Corporation is also seen as a company in terms of the definition in section 1 of the ITA.

⁵⁹ H Cilliers and M Benade *Entrepreneurial Law* 2 ed 2000 at 324.

⁶⁰ D Meyerowitz *Meyerowitz on Income Tax* 2007/2008 at 3.10A.

A closer look at more specific DTA's where South Africa and the other State have narrowed or broadened Article 13.

Luxembourg

Article 13 of the Luxembourg-South Africa DTA states the following:

Paragraph 1

'Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in the other State.'

Immovable property is defined in Article 6 as follows:

'The term shall have the meaning which it has under the law of the Contracting State in which the property is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships and aircraft shall not be regarded as immovable property.'

As noted above, in terms of South African law immovable property does not include shares.

Paragraph 2

'Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting

State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such fixed base, may be taxed in that other State.'

Paragraph 3

'Gains of an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.'

Paragraph 4

'Gains from the alienation of any property other than that referred to in paragraph 1, 2, 3 shall be only taxable in the Contracting State of which the alienator is a resident.'

Therefore, if a person emigrated from South Africa to Luxembourg with an investment in property companies, there will be no exit charge on emigration due to the fact of the exemption under paragraph 12(2)(a)(i) (assuming criteria are met). On subsequent disposal of the shares, in terms of Paragraph 4 of Article 13 of the DTA, South Africa does not have taxing rights to the capital gain.

This results in a tax planning opportunity to ensure that the country in which the individual emigrates to should have preferably no capital gains tax or has a

CGT rate less than the rate in South Africa. Refer to Example 2 below on an illustration of the benefit.

From SARS's point of view, the South African tax base has been reduced due to the unforeseen wording of the DTA.

Canada

Article 13 of the Canada-South Africa DTA states the following:

Paragraph 1

'Gains derived by a resident of a Contracting State from the alienation of immovable property in the other State may be taxed in that other state.'

Paragraph 2

'Gains from the alienation of movable property forming part of the business property of a permanent establishment of a resident of a Contracting State in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base may be taxed in that other State.'

Paragraph 3

'Gains from the alienation of ships or aircraft operated in international traffic by a resident of a Contracting State or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.'

Paragraph 4

'Gains derived by a resident of a Contracting State from the alienation of:

- (a) shares forming part of a substantial interest in the capital stock of a company which is a resident of that other State the value of which shares is derived principally from immovable property situated in that other State; or
 - (b) a substantial interest in a partnership, trust or estate, established under the law in the other Contracting State, the value of which is derived principally from immovable property situated in that other State,
- may be taxed in that other State.'

The paragraph goes on to define immovable property as

'includes the shares of a company referred to in subparagraph (a) or an interest in a partnership, trust or estate referred to in subparagraph (b) but does not include any property, other than rental property, in which the business of the company, partnership, trust or estate is carried on'.

Paragraph 5

'Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the Contracting State of which the alienator is a resident.'

Paragraph 6

'The provisions of paragraph 5 shall not affect the right of a Contracting State to levy, according to its law, a tax on the gains from the alienation of any property derived by an individual who is a resident of the other Contract State and has been resident of the first-mentioned State at any time during the six years

immediately preceding the alienation of the property if the property was held by the individual before he became a resident of that other State.'

The possible issues that arise can best be illustrated by way of an example.

EXAMPLE 1

Mr X decides to emigrate from South Africa to Canada. Mr X was extremely wealthy and had most of his properties in a company called Y (Pty) Ltd which is 100% owned by Mr X. The base cost to Mr X for the investment in Y (Pty) Ltd is R 50,000,000.

The balance sheet of the company on the date of emigration was as follows:

	<u>R</u>		<u>R</u>
Investment properties	90,000,000	Equity	50,000,000
Cash	10,000,000	Loan	50,000,000

Please note that the company did not migrate, Mr X emigrated. Furthermore the value for the properties above is the market value in terms of IAS 40.⁶¹ Assume further that Mr X disposed of the shares in Y (Pty) Ltd 5 years after emigration when the market value of the shares was R 200,000,000. Ignore the implications of section 35A of the ITA.

SOLUTION

Date of emigration

Mr X is deemed to dispose of his assets in terms of paragraph 12 of the Eighth Schedule. The investment in Y (Pty) Ltd is an asset but there is no deemed disposal in terms of paragraph 12(2)(a)(i) due to the fact that Mr X owns more than 20% of the shares of the company and the immovable property as a % of total assets is greater than 80%(it has 90% interest in immovable property).

Date of sale

On subsequent disposal by Mr X paragraph 1 of article 13 is not applicable due to the fact that he has not disposed of immovable property. He has in fact disposed of shares. However, this scenario is covered in terms of paragraph 4(a) of article 13 of the double tax agreement. Therefore South Africa has taxing rights to tax the capital gain on the disposal of the shares.

⁶¹ International Accounting Standards.

R

Proceeds	200,000,000
Base Cost	<u>50,000,000</u>
Capital Gain	150,000,000

In terms of section 26A of the Income Tax Act, Mr X must include 25% of the gain into his taxable income. Hence, tax payable at 40% will result in tax payable of R 15,000,000 to SARS.

Would the answer have changed if Mr X had held, instead of shares in X (Pty) Ltd, a 100% interest in a Close Corporation⁶² which in turn owned the properties?

On emigration, Mr X will be able to utilise the exemption under paragraph 12(2)(a)(i). This is as a result of paragraph 2(2) of the Eighth Schedule. If we look carefully at the wording in paragraph 2(2) an interest in immovable property is broken down into 3 categories:

1. Equity shares held by a person in a company;
2. Ownership or right to ownership in any other entity; or
3. A vested interest of a person in any asset of any trust

Mr X will fall under category 1 above due to the fact that equity shares includes an interest in a Close Corporation.

He will also fall under category 2 above due to the ownership in the Close Corporation (entity).

Therefore on emigration there will be no exit charge due to the fact that the investment will remain within the CGT net.

On subsequent disposal of the investment, the sale will be deemed to be from a South African source. As a result of the DTA between SA and Canada, we first need to refer to the agreement to determine which state has taxing rights.

Paragraph 1 of article 13 is not applicable due to the fact that it is not immovable property that is being disposed of. Does paragraph 4 protect the South African tax base?

Traditional approach of interpretation

It is submitted that the answer would be in the negative if the traditional approach of interpretation is adopted. The reasoning is as follows:

⁶² For income tax purposes the definition of company in section 1 includes a Close Corporation.

Paragraph 4(a) specifically deals with shares. Paragraph 4(b) refers to an interest in:

1. Partnership;
2. Trust; or
3. Estate

A member's interest in a close corporation does not fit into any of these categories and hence paragraph 4 of article 13 is not applicable giving taxing rights to Canada.

However, paragraph 6 of article 13 comes to the rescue for SARS. Paragraph 6 can be explained as overriding paragraph 5 (which states that any other property other than referred in paragraph 1,2,3 and 4 shall be taxable only in the state in which the alienator is a resident) giving taxing rights also to South Africa if the individual was a resident of the state in which he emigrated from and has been a resident of South Africa at any time during the 6 years immediately preceding the alienation of the property.

Therefore, as Mr X has disposed of the property 5 years after emigration, South Africa will have taxing rights and there is no loss to the fiscus.

It stands to reason that if the property was sold 7 years after emigrating to Canada there would be a loss to the fiscus of R 15,000,000 as paragraph 5 will be applicable and paragraph 6 will not apply due to the fact that the 6 years has been exceeded.

In order to rectify the matter the double tax agreement should be amended to include right of ownership in any entity as it is in South African domestic law or define shares as including member's interest in a Close Corporation.

Purposive approach of interpretation

It is submitted that if a purposive approach is adopted, the taxpayer will fall under paragraph 4(a) of the DTA and there would be no loss to the South African fiscus.

United Kingdom (UK)

Article 13 of the UK-South African agreement states:

Paragraph 1

'Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in the other State.'

Paragraph 2

'Gains derived by a resident of a contracting state from the alienation of:

- (a) shares, other than shares quoted on an approved stock exchange, deriving their value or the greater part of their value directly or indirectly from immovable property situated in the other contracting state, or
 - (b) an interest in a partnership or trust the assets of which consist principally of immovable property situated in the other contracting state, or of shares referred to in sub-paragraph (a) of this paragraph,
- may be taxed in that other state.'

Paragraph 3

'Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) may be taxed in that other State.'

Paragraph 4

'Gains derived by a resident of a Contracting State from the alienation of ships or aircraft operated in international traffic by an enterprise of that Contracting State or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that Contracting State.'

Paragraph 5

'Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 of this article shall be taxable only in the contracting state of which the alienator is a resident.'

Paragraph 6

'The provisions of paragraph 5 shall not affect the right of a Contracting State to levy according to its law a tax on capital gains from the alienation of any property derived by an individual who is a resident of the other Contract State and has been resident of the first-mentioned State at any time during the six years immediately preceding the alienation of the property if the property was held by the individual, or by the spouse of that individual, before the individual became a resident of that other State.'

Once again the same conclusion will be drawn as with the DTA with Canada. If the traditional approach is adopted the South African tax base is negatively affected due to the wording in the agreement. If we take the second scenario of Mr X (i.e. holds an interest in a Close Corporation instead of shares in a Company) but assume instead of emigrating to Canada, he emigrates to the

UK, he will still not be levied with exit charge due to the fact that the close corporation's market value with regard to the immovable property is greater than 80% of the total market value of the corporation. If Mr X decides to dispose of the interest in the Close Corporation 8 years later, he will not be subjected to tax in South Africa due to the fact that he has not disposed of shares but has in fact disposed of an interest in a close corporation.

Australia

Paragraph 1 of Article 13 states the following:

'Income, profits or gains derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed in that other state.'

Paragraph 4 of Article 13 states the following:

'Income, profits or gains derived by a resident of a Contracting State from the alienation of any shares or other interest in a company, or of an interest of any kind in a partnership or trust or other entity, where the value of the assets of such entity, whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies), is principally attributable to real property situated in the other Contracting State, may be taxed in that other State.'

[Own underlining]

The term 'real property' is defined in article 6 of the DTA as follows:

'in the case of South Africa, means such property which according to the law of South Africa is immovable property, and includes:

- (i) property accessory to immovable property;
- (ii) rights to which the provisions of general law respecting landed property apply;
- (iii) usufruct of immovable property; and
- (iv) a right to receive variable or fixed payments either as consideration for or in respect of the exploitation of, or the right to explore for or exploit, mineral, oil or gas deposits, quarries or other places of extraction or exploitation of natural resources’.

The Australian DTA protects the South African tax base due to the fact that the DTA includes the disposal of an interest in a South African entity in which the assets are principally attributable to real property. Therefore there is no reason to have included paragraph 6 of the UK and Canadian DTA in the Australian DTA.

Mauritius

Article 13 of the Mauritius-South African agreement states the following:

Paragraph 1

‘Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other state may be taxed in that other state.’

Paragraph 2

‘Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting

State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.'

Paragraph 3

'Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.'

Paragraph 4

'Gains from the alienation of any property other than that referred to in paragraph 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.'

The definition of immovable property in terms of Article 6 of the DTA does not include shares in a property company/close corporation/trust.

This provides an extremely beneficial tax planning opportunity for persons emigrating to Mauritius. There will be no CGT (from a South African point of view) on the subsequent disposal of shares in a company or an interest in a Close Corporation in which the market value of the assets is principally attributable to immovable property.

Furthermore, since Mauritius does not tax capital gains, those gains will not be subject to tax.⁶³

Summary

The best position for the emigrant is if, from a South African point of view, there is no exit charge and South Africa does not have taxing rights on subsequent disposal. Further benefit is if the new country of residence does not tax capital gains (i.e. Mauritius) or taxes capital gains at a lower rate than in South Africa.

One must consider whether the new country of residence has:

- a) a capital gains tax system and
- b) a new market valuation for the cost of the shares at the date in which the person became a resident (also known as 'upliftment of the base cost').

Possible issues may arise on the subsequent disposal of assets. These issues are best illustrated by way of an example.

EXAMPLE 2

Mr A is resident in Country X and decides to emigrate to Country Y. Mr A acquired an asset with a base cost of 100. On the date of emigration the market value of the asset was 500. Mr A decided to sell the asset for 1000 after 5 years from becoming a resident of Country Y.

Assume that Country X has an exit tax and that Country Y recognises market value at date of emigration as new base cost.

Mr A will be taxed on a capital gain of 400 in Country X.

Mr A will be taxed on a capital gain of 500 in Country Y on the disposal of the asset.

No anomalies arise due to the fact that the gain of 900 is split between the two countries.

⁶³ See Mauritius Tax Ruling 67 (TR67).

Assume that Country X has no exit tax (and no right to tax the gain on subsequent disposal) and that Country Y recognises market value at date of emigration as new base cost.

Mr A will not be subjected to tax in Country X due to the fact that there is no exit tax charged on the emigration of Mr A to Country Y.

Mr A will be taxed on a capital gain of 500 (1000 less 500) in Country Y. There is an anomaly in that Mr A does not get taxed on the 400.

Assume that Country X has an exit tax and that Country Y does not recognise the market value at date of emigration as new base cost.

Mr A will be taxed on a capital gain of 400 in Country X.

Mr A will be taxed on a capital gain of 900 (1000 less 100) in Country Y.

There is a further anomaly in that Mr A will now be taxed on a gain of 1300 where the actual gain was 900.

For example, a South African person (Mr Y) emigrates to the UK with an investment in property situated in Italy as an investment. The cost to Mr Y is R 400 000. The market value on emigration is R 1 000 000 and was sold 3 years after becoming a resident in the UK for R 2 000 000.

On emigration there would be a deemed disposal as no exemptions apply under paragraph 12. Hence, there will be a capital gain of R 600 000 that would be taxed in South Africa.

On becoming a UK resident, the person will **NOT** adopt a new base cost in terms of UK legislation.

Hence, on disposal of the property Mr Y will have to account for a capital gain of R 1 600 000. Mr Y will be liable to a tax in total of R 2 200 000 where the actual gain was R 1 600 000.

This is an area of concern and the emigrant should be aware of the potential double tax.

5.5.3 Deferment of CGT

South Africa has not adopted the deferral of exit charges as in Canada and Australia to name a few (see 5.5.1). If the recommendation is implemented by South Africa to defer the capital gain, does this give rise to further issues?

This is best illustrated by way of an example.

EXAMPLE 3

Mr X decides to emigrate from South Africa to Australia. He has the following assets:

	Sale MKT Value	Emigration MKT Value	Base Cost
Villa in Tuscany	R 15,000	R 10,000	R 2,500
House in Cape Town	R 4,000	R 2,500	R 1,000

Mr X decided to sell these assets 3 years after becoming a resident in Australia. Assume that South Africa has adopted the deferral of exit charges.

House in Cape Town

At the date of emigration, there is no deemed disposal for the house in Cape Town because it remains within the 'CGT Net'. On subsequent disposal, in terms of the DTA between Australia and SA, the gain may be taxed in both countries. The gain of R 3,000 will be taxed in SA.

Villa in Tuscany

At the date of emigration there is a deemed disposal in terms of paragraph 12(2) of the Eighth Schedule. The gain of R 7,500 will be taxed in South Africa but will elect to defer the gain.

At emigration

There would be no capital gain on the emigration and will only be payable on the subsequent disposal of the asset.

At sale

Sale of the Villa	R 15,000
Base cost (for Australian purposes)	<u>R 10,000</u>
Capital Gain (Taxed in Australia)	R 5,000

Due to the fact that the exit charge was deferred, the gain of R 7,500 will need to be taxed in South Africa. Does South Africa have taxing rights to tax this amount?

In terms of the DTA between Australia and SA, it would seem that SA does not have taxing rights to this gain.

There have been numerous foreign cases dealing with this particular issue. A Canadian tax case⁶⁴ dealt with this specific issue. In terms of Canadian domestic legislation, the exit tax is deferred until the asset has been disposed of. When the taxpayer emigrated from Canada to the United States of America (USA), he was not taxed in Canada on the capital gain made after becoming a resident of the USA. The taxpayer argued that in terms of the DTA between the USA and Canada, Canada did not have taxing rights to tax the capital gain.

It was held that there was no conflict between Canadian domestic law and the DTA and the treaty did not preclude Canada from the recovery of the deferred exit tax.

Article 13 refers to the 'alienation' of property. Therefore in the context of deferred exit charges, article 13 is not applicable due to the fact that in calculating the exit charge there was no 'sale'.

It was further held in the Canadian case that the CGT was levied on the basis that the taxpayer was deemed to have made the capital gains while he was still resident in Canada. The exit tax was imposed at the last possible moment of Canadian residency.

In conclusion, if South Africa had to adopt the deferral of the exit charges there would not be an anomaly with the future disposal of the assets with respect to the DTA. Therefore, if the deferral of the exit charges is adopted, the domestic law will not be affected by the DTA.

⁶⁴ Holbrook R. Davis v The Queen 80 DTC 6056 (Federal court of Appeal).

Chapter 6 Issues specific to company migration

6.1 Introduction

There could be a number of benefits why a company would choose to migrate from South Africa. The potential benefits of migration could be the following:

- Reduction in tax rates
- Reduction in withholding taxes
- Avoid exit charges
- Avoid shareholders tax

It is relatively easy for a company in South Africa to migrate. The company would migrate through a change of the POEM. It should be noted that even though the company was incorporated within South Africa, the company could still be a non-resident if the POEM is outside of South Africa. The reason is that in terms of the OECD model the POEM is seen as the 'tie-breaker test'. As soon as the company's POEM is outside South Africa, the company will be a non-resident. There are a number of tax issues that the planners should consider when deciding to migrate. The following issues, specifically relating to companies, would need to be addressed by the planner:

- Trading Stock
- Recoupment
- CGT
- Secondary Tax on Companies (STC)
- Controlled Foreign Companies (CFC)

6.2 Trading Stock

Trading stock is covered under section 22 of the ITA. If a taxpayer acquires trading stock the cost will be allowed as a deduction in terms of section 11(a) of the ITA. On subsequent sale of the trading stock, the proceeds will be of a revenue nature and will be included in the gross income of the taxpayer. If at the end of the year of assessment the taxpayer has not sold the stock, the cost price⁶⁵ of the stock will be added back in the taxable income of the taxpayer.

Section 22(8) of the ITA caters for circumstances in which the stock is not sold but there is a recoupment of either the cost price of the stock or the market value of the stock depending on the specific circumstances.

Section 22(8)(b)(v) states:

‘assets which were held as trading stock by any taxpayer cease to be held as trading stock by such taxpayers . . .’.

On the emigration of a company, is there a recoupment of trading stock in terms of section 22(8) of the ITA? It is submitted that the answer would be in the negative. The reason for this is that the company is still holding that trading stock as trading stock. Although there has been a change in the POEM, the company has not changed its intention from trading stock to capital assets.

⁶⁵ Less an amount which the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, not being shares held by a company in any other company, has been diminished by reason of damage or obsolescence.

6.3 Recoupment

Section 8(4)(a) of the ITA caters for circumstances in which the company has been entitled to a deduction in terms of the ITA and the asset has been subsequently sold, in which case if the asset was sold for more than the tax value⁶⁶ of the asset there would be a recoupment of previous deductions. The recoupment will be included in the taxpayer's income.

In order for the section to apply there must be expenditure that has been 'recovered or recouped'. The words 'recovered or recouped' are not defined in the ITA. They must therefore be interpreted according to their ordinary meanings. It was held by Magid J in *C:SARS v Pinestone Properties CC*⁶⁷ that:

'The most appropriate definition of the word "recover" in the Oxford English Dictionary (OED) is "to get . . . again into one's hands or possession; to regain possession of (something lost or taken away)." The OED definition of the word "recoup" is "to make up for, compensate for, make good"; and that of "recoupment" is "the act of recovering or recompensing; the fact of being recouped for loss or expense".'

It would be clear that the term 'recouped' and 'recover' is not applicable in the case where a company migrates from South Africa. It would be correct to interpret that on migration there would be no recoupment in income of the taxpayer.

⁶⁶ The term 'tax value' is the cost of the asset less the allowances granted in terms of the ITA.

⁶⁷ 2001 63 SATC 421.

6.4 CGT

The same rules apply to companies as they would to natural persons which have been discussed in detail. In terms of paragraph 12(2)(a) of the Eighth Schedule, there is a deemed disposal of all the assets excluding if the exemptions in paragraph 12(2)(a)(i) apply.

On the date the company ceases to be a resident, the company is deemed to have disposed of the assets at market value.

EXAMPLE 4

Assume that ABC (Pty) Ltd (ABC) changed its POEM from South Africa effective from 31 January 2008. ABC is a share dealing company.

<u>Balance sheet at 31 January 2008</u>	<u>R</u>
Trading Stock (Shares)	50,000
Equity	50,000

The market value of the shares at 31 January 2008 is R 80,000. The shares were acquired on 1 January 2008. The shares were disposed of on 28 August 2008 for R 100,000. The year end of the company is 30 September 2008. The shares held are in a manufacturing company and not in property held companies.

At the date of emigration

There will be no recoupment of the trading stock in terms of section 8(4)(a). Furthermore, section 22(8) of the ITA is not applicable as ABC is still a share dealer and has not ceased to hold the trading stock as trading stock.

There will be a deemed disposal in terms of paragraph 12(2)(a) of the Eighth Schedule. No exemptions apply.

Proceeds (Market value at date of emigration) ⁶⁸	R 80,000
Base cost ⁶⁹	Nil

⁶⁸ Note that paragraph 35(3) of the Eighth Schedule is not applicable due to the fact that no amount was included in income in terms of a possible recoupment.

Capital gain R 80,000

The amount that will be included in taxable income through section 26A of the ITA for ABC would be R 40,000 (80,000 at 50% inclusion rate)

At the date of sale

ABC is now a non-resident, in which case it will only be taxed on source or deemed source within South Africa.⁷⁰ It is assumed that the source of the sale is within South Africa, where the capital was employed⁷¹. Due to the fact that the source is within South Africa, it will form part of ABC's gross income.

The taxable income will be calculated as follows:

ABC (Pty) Ltd		R
Gross Income		100,000
Sales ⁷²	<u>100,000</u>	
Exempt Income		Nil
Deductions		(50,000)
Cost of Sales ⁷³	<u>(50,000)</u>	
Capital Gains		<u>40,000</u>
Taxable Income		<u>90,000</u>
Tax payable at 28%		25,200

In terms of South African domestic tax law, ABC will incur a tax charge of R 25,200 for a gain of R 50,000. This equates to an effective tax charge of 50.4%.

A tax planning opportunity is explained below.

If ABC changes its intention from holding the stock as revenue assets to that of capital assets there would be a deemed recoupment in terms of section 22(8)(b)(v).

On eventual disposal of the shares (now capital assets), ABC will be subject to CGT.

⁶⁹ Note that paragraph 20(3) of the Eighth Schedule is applicable due to the fact that ABC would have been granted a section 11(a) deduction on the acquisition of the trading stock.

⁷⁰ Definition of 'Gross income' in section 1 of the ITA .

⁷¹ *CIR v Black* 1957 (3) SA 536 (A), SATC 226.

⁷² Definition of 'gross income' in section 1 of the ITA.

⁷³ Deduction will be allowed in terms of section 11(a) of the ITA.

A revised tax computation is as follows:

ABC (Pty) Ltd		<u>R</u>
Deemed recoupment		80 000
Cost of sales		(50 000)
Capital gain		<u>10 000</u>
Proceeds ⁷⁴	100 000	
Recoupment	<u>(80 000)</u>	
Net Proceeds	20 000	
Actual Base cost	50 000	
S11(a) deduction	<u>(50 000)</u>	
Net Base Cost	Nil	
Taxable income		<u>40 000</u>
Tax at 28%		<u>11 200</u>

The above example is clearly an area of concern. There should be no deemed disposal for assets that are held as trading stock and will, when sold, still be included in the taxable income of the taxpayer due to the fact that the source of the income was from South Africa.

It is submitted that the application of paragraph 35(3)(a) of the Eighth Schedule will provide relief for the taxpayer. The reason is that this paragraph looks into the future to determine if any amount will be included in gross income. Therefore, as the sale of the trading stock in the future will be included in gross income, the proceeds for CGT purposes is nil.

⁷⁴ Paragraph 35 states that the proceeds must be reduced by the portion that has been taking into account in gross income (i.e. recoupment).

Tax planning opportunities are available for group companies wishing to change residence. If a company within the group wishes to migrate, it would be advisable in order to defer the tax charge, being a possible recoument and CGT charges, to make use of the company restructuring provisions in the ITA.⁷⁵

It is recommended that the company takes advantage of section 45 of the ITA. Section 45 of the ITA provides a 'roll over relief' to facilitate 'intra-group transactions'. 'Intra-group transaction' is defined in section 45(1) of the ITA as

'[a transaction] in terms of which an asset is disposed of by one company (hereinafter referred to as the "transferor company") to another company which is a resident (hereinafter referred to as the "transferee company") and both companies form part of the same group of companies as at the end of the day of that transaction'.

It is important to note that the transferee must be a resident. This is an anti-avoidance provision to ensure that when the assets that have been transferred in terms of section 45 have been disposed of, the transferee will be subjected to income tax.

Does the transferor have to be a resident in South Africa for the corporate rules to be applicable? In other words, can a group of companies with a holding company in a non-resident country make use of the corporate rules? In order

⁷⁵ Section 41 to 47 of the ITA.

for section 45 of the ITA to be applicable the two companies must form part of the same 'group of companies'. 'Group of companies' is defined in section 1 of the ITA as:

'Means two or more companies in which one company . . . directly or indirectly holds shares in at least one other company . . . to the extent that –

- (a) at least 70 per cent of the equity shares of each controlled group of company are directly held by the controlling group company, one or more other controlled group of companies or any combination thereof; and
- (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.'

Section 41(1) of the ITA limits the definition of 'group of companies'. For the purposes of section 41, a non-resident company is not part of a 'group of companies' unless that company has its place of effective management in the Republic.⁷⁶ It stands to reason that a foreign company that does not have its POEM (i.e. not a resident) in South Africa cannot apply section 45 of the ITA.⁷⁷

The relief granted in terms of section 45 of the ITA is essentially that the transferee will step into the shoes of the transferor. The assets will move across at the tax value of the transferor. The two companies are deemed to be the same person, with the effect that the transferee company is entitled to the remaining qualifying allowances or deductions on the asset to which the

⁷⁶ Section 41(1)(i)(ee) of the ITA.

⁷⁷ It is interesting to note that before the Revenue laws amendment act 2008, a company incorporated in a non-resident country was blocked from forming part of a group of companies in terms of section 41(1)(i)(aa) regardless of whether the place of effective management was in South Africa or not.

transferor company would have been entitled. The effect of this is best illustrated by an example. Refer to example 5 below.

6.5 STC

STC was introduced in South Africa during 1993. Only dividends declared on or after 17 March 1993 are subject to STC. The current STC rate is 10% of the net amount of a dividend declared by a company. During 2007 the Minister of Finance announced that STC would be phased out and replaced with a dividends tax. At the time of submission of this thesis dividends tax has not yet been made effective.

Section 64B of the ITA imposes STC on the net amount of any dividend declared by a resident company during a dividend cycle. STC is separate from and additional to a company's liability for normal tax. STC is only charged on distribution of profits. If a company earned profits of R 72 in year 1 after normal tax of R28 and decided that the company re-invest the R 72 in expansions of its operations there would be no liability for STC. The liability for STC only occurs when a dividend has been declared or there is a deemed dividend in terms of section 64C of the ITA. South Africa does not tax undistributed profits of a company.

If a company ceases to be a resident due to the change in the effective management of the company there is a deemed dividend in terms of section 64C(2)(f) of the ITA. Section 64C(2) states:

'For the purposes of section 64B, an amount shall, subject to the provisions of subsection (4), be deemed to be a dividend declared by a company to a shareholder, where –

(f) the company ceases to be a resident to the extent profits and reserves of that company are available for distribution immediately before so ceasing to be a resident (including any amount deemed in terms of the definition of 'dividend' in section 1 to be a profit available for distribution): Provided that any prohibition or limitation on any distribution contained in the company's memorandum and articles of association or founding statement or any agreement must be disregarded.'

There are certain exemptions which could be beneficial for an emigrating company. The main exemption is under section 64B(5)(f) which states:

'any dividend declared by a controlled group company as contemplated in the definition of "group of companies" which accrues to a shareholder (as defined in Part III) of that company if –

- (i) that shareholder is a company forming part of the same group of companies as the company declaring the dividend and that dividend is taken into account in the determination of the profits of that shareholder;
- (ii) . . .
- (iii) that shareholder would be subject to secondary tax on companies should that shareholder –
 - (aa) declare a dividend from that dividend so declared by that company; and

(bb) not elect that this paragraph must apply in respect of that dividend;
and . . .’.

If a company is changing residence and is part of a group of companies, it would be advisable firstly to declare a dividend to another company that is part of the same group of companies and secondly to elect that section 64B(5)(f) apply. In essence, there has been a deferral of STC that would have been charged under section 64C(2)(f). The effects of this as well as corporate relief are best illustrated by way of an example.

EXAMPLE 5

Mr X is the sole shareholder of H Holdings (Pty) Ltd (H Hold). H Hold owns 100% of H (Pty) Ltd (H). H owns 75% of the shares of S (Pty) Ltd (S). All 3 companies are incorporated in South Africa and have its POEM in South Africa. Mr X was advised by a tax consultant that the group will be more tax efficient if H was a resident in Country A. The POEM of H has moved to Country A.

The balance sheets of the companies prior to resident shifting are as follows:

	H <u>R</u>	S <u>R</u>
Equipment	1,000	500
Cash	500	500
Investment in S	<u>2,000</u>	-
Total Assets	<u>3,500</u>	<u>1,000</u>
Share Capital	100	100
Retain Earnings	<u>3,400</u>	<u>900</u>
Total Equity	<u>3,500</u>	<u>1,000</u>
	Market Value <u>R</u>	Tax Value <u>R</u>
Equipment	3,000	500
Investment in S	5,000	5,000

Discuss, including amounts, the tax implications of H changing residence to Country A. All assets were acquired post 1 October 2001. Both H and S do not hold any immovable property. Assume that H has not elected section 45 and section 64B(5)(f) of the ITA to be applicable.

Equipment

There will be no recoupment in terms of section 8(4) of the ITA because no amount has been recovered or recouped. However there will be a deemed disposal for CGT purposes:

	<u>R</u>
Proceeds	3,000
Base cost ⁷⁸	<u>500</u>
Capital gain	<u>2,500</u>

Investment in S

No recoupment in income because H is not a share-dealer and no deduction would have been claimed on the investment. There will be a deemed disposal for CGT purposes calculated as follows:

	<u>R</u>
Proceeds	5,000
Base cost	<u>2,000</u>
Capital gain	<u>3,000</u>

Total capital gain is R5,500 of which R2,750 will be included in the taxable income of the company. This will result of normal tax payable of R770.

In addition to normal tax payable, there is a deemed dividend in terms of section 64C(2)(f) of the ITA. The dividend will be calculated as follows:

	<u>R</u>
Revenue reserves	3,400
Less tax payable	<u>(770)</u>
Net revenue reserves	2,630
Undistributed profits	
- Equipment	2,000
- Investment in S	<u>3,000</u>
Total reserves	<u>7,630</u>

⁷⁸ Must be reduced by amount allowed as a deduction in calculation of the normal tax of the company.

STC payable is R763 (10% of R7,630)

Total taxes payable on the decision to change residence are R 1,533. This is a pure outflow of cash due to the fact that there has been no disposal of the assets.

Assume that H elected section 64B(5)(f) of the ITA to be applicable. There will be a normal tax charge of R770 as above. There will also be a dividend of R7,630 in terms of section 64C(2)(f) of the ITA. However, no STC is payable due to the fact that the exemption of section 64B(5)(f) is elected. Therefore, by electing the exemption, there is a tax saving of R763.

If the equipment is transferred to S before the company ceases to be a resident, section 45 will result in no normal tax consequences for the sale of the equipment.

Equipment

As the asset has been sold to S, there should be a recoupment under section 8(4) of the ITA. However, in terms of section 45 of the ITA the assets are transferred at the tax value to H.

	<u>R</u>
Proceeds	500
Tax value	<u>(500)</u>
Recoupment	Nil
CGT	
Proceeds	500
Base cost	<u>(500)</u>
Capital gain	Nil

6.6 CFC

There are numerous tax benefits that flow from earning foreign income especially if the taxpayer is situated in a tax haven. For example, if a South African resident invests in a property in a tax haven, the rentals earned will be included in the resident's South African taxable income due to the fact that South Africa taxes residents on world wide income. However, if the resident

sets up a foreign company and invests the amount offshore via this entity, the rentals will not be subject to South African tax, as it is earned by a non-resident. To counter the avoidance of tax, South Africa and a number of other countries, have included anti-avoidance sections within the domestic legislation. South Africa has included the relevant legislation in terms of section 9D of the ITA. Section 9D(2) states the following:

‘There shall be included in the income for the year of assessment of any resident who holds any participation rights in a controlled foreign company –
(a) on the last day of the foreign tax year of that controlled foreign company which ends during that year of assessment, an amount equal to . . .’

A controlled foreign company is defined in section 9D of the ITA as follows:

‘means any foreign company where more than 50 per cent of the total participation rights in that foreign company are held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents: Provided that . . .’.

Even if a South African incorporated company which has migrated and POEM is in a foreign jurisdiction it will fall under the term ‘foreign company’. The term ‘foreign company’ is defined in section 9D as a company which is not a resident.

In changing the residence of a company one must always be mindful of the possible tax consequences that could result from the application of section 9D of the ITA.

Chapter 7 Other factors

There are certain other factors that need to be taken into account when emigrating or when deciding to emigrate. They are as follows:

- Foreign exchange gains and losses
- Withholding taxes
- Anti-avoidance

7.1 Foreign exchange

As the former resident will become a resident of another country, this could result in potential foreign exchange implications. The former resident could dispose of the assets to South African residents or could dispose of the assets to other non-residents.

Assets that remain within the CGT net, as discussed above, will be subject to CGT.

The specific paragraph of the Eighth Schedule dealing with disposals in a foreign currency is paragraph 43(1), which states:

‘where a person during any year of assessment disposes of an asset for proceeds in a currency other than currency of the Republic after having incurred expenditure in respect of that asset in the same currency, that person must determine the capital gain or capital loss on the disposal in that currency and that capital gain or capital loss must be translated to the currency of the

Republic by applying the average exchange rate for the year of assessment in which that asset was disposed of or by applying the spot rate on the date of the disposal of that asset’.

Paragraph 43(2) goes on to state the following:

‘Where a person disposes of an asset, (other than an asset contemplated in subparagraph (1) or (4)) . . . after having incurred expenditure in respect of that asset which is either actually incurred or so denominated in another currency . . . that person must for the purposes of determining the capital gain or capital loss on the disposal of that asset –

(a) where the currency of expenditure is actually incurred or denominated in the local currency, translate the proceeds into the local currency at the average exchange rate for that year of assessment during which the asset was disposed of and must translate the amount of the capital gain or capital loss into the currency of the Republic by applying the average exchange rate for that year of assessment;

(b) where the currency of disposal is received or accrued or denominated in the local currency, translate the expenditure which is allowable in terms of paragraph 20, into the local currency at the average exchange rate for the year of assessment during which the expenditure was incurred . . . and must translate the amount of the capital gain or capital loss into the currency of the Republic by applying the average exchange rate for that year of assessment; and

(c) where neither the currency of disposal nor the currency of expenditure constitutes local currency –

- (i) translate the amount of expenditure, which is allowable in terms of paragraph 20, to the currency of disposal at the average exchange rate for the year of assessment during which the expenditure was incurred or treated as being incurred . . .
- (ii) translate the amount of the capital gain or capital loss determined in foreign currency to the local currency at the average exchange rate for the year of assessment during which the asset was disposed of, and must translate the amount of the capital gain or capital loss into the currency of the Republic by applying the average exchange rate for that year of assessment.'

The above paragraphs may be illustrated by a simple example as follows and are only applicable to residents (see paragraph 43(4) below and example 7).

EXAMPLE 6

Mr X is a resident of South Africa. He acquired an asset for USD 100,000 when the average exchange rate was R5 to the dollar. He disposed of the asset for USD 120,000 when the average exchange rate was R6 to the dollar.

Paragraph 43(1) is applicable and the gain is calculated as follows:

Proceeds	120,000
Base cost	<u>100,000</u>
Capital gain (USD)	20,000
Capital gain (ZAR)	120,000

Mr X has a total gain of R 220,000. His gain on the devaluation of the Rand being R 100,000 $((5-6)*100,000)$ is excluded from the capital gain.

Paragraph 43(2) is applicable where subparagraph (1) and (4) do not apply. Essentially, the effect of paragraph 43(2) of the Eighth Schedule is that if the proceeds are denominated in local currency (rands) and the base cost is denominated in foreign currency, the base cost must be translated into South African rands using the average rate when the expenditure was acquired. The same rules apply if the base cost is in South African rands and the proceeds are in a foreign currency. The proceeds must be translated into South African rands in order to determine the capital gain. If neither the proceeds nor the base cost is in rands, then the base cost must be translated into the currency of disposal and then translate the foreign currency capital gain or capital loss by applying the average exchange rate for the year of assessment.

The relevant paragraph relating to emigration is paragraph 43(4) of the Eighth Schedule which states:

'Where a person during the year of assessment disposes of any –

(a) foreign equity instrument; or

(b) asset the capital gain or capital loss from the disposal is derived or deemed to have been derived from a source in the Republic, as contemplated in section 9(2) (other than an asset contemplated in paragraph (b) of the definition of "foreign currency asset" in paragraph 84),

which was acquired or disposed of in any currency other than currency of the Republic, that person must for purposes of determining the capital gain or capital loss on the disposal of that asset, translate –

(i) the proceeds into the currency of the Republic at the average exchange rate for the year of assessment in which the asset

was disposed of or at the spot rate on the date of disposal of that asset; and

- (ii) the expenditure incurred in respect of that foreign equity instrument or that asset, as the case may be, into the currency of the Republic at the average exchange rate for the year of assessment during which that expenditure was incurred or at the spot rate on the date on which the expenditure was incurred
....'

This subparagraph overrides any other subparagraph within paragraph 43. The above can be best illustrated by way of an example.

EXAMPLE 7

Mr X emigrated from South Africa in 2008. His only asset was a house in Pinelands which he decided not to sell due to the slump in the property market.

In 2010, Mr X disposed of this property to a fellow non-resident for \$ 500,000 when the average exchange rate was R8 to the dollar. The base cost of the asset was R 3,000,000, being the price when he acquired the asset in 2002.

The capital gain will need to be calculated in terms of paragraph 43(4) of the Eighth Schedule because the deemed source of the gain will be in South Africa in terms of section 9(2) of the ITA. The proceeds will need to be translated into South African rands. Due to the fact that the base cost is already in rands no translation is necessary. The capital gain will be calculated as follows:

	<u>R</u>
Proceeds	4,000,000
Base cost	<u>3,000,000</u>
Capital gain	1,000,000

7.1.1 Foreign exchange specifically relating to companies

Section 25D(1) of the ITA states:

‘Subject to subsections (2) and (3), any amount received by or accrued to, or expended or loss incurred by, a person during any year of assessment in any currency other than the currency of the Republic must be translated to the currency of the Republic by applying the spot rate on the date on which that amount was so received or accrued or expended or loss was so incurred.’

Section 25D(3) states the following:

‘Notwithstanding subsection (1), a natural person or a trust (other than a trust which carries on any trade) may elect that all amount received by or accrued to . . . be translated to the currency of the Republic by applying the average exchange rate for the relevant year of assessment.’

In terms of section 25D, a company and a business trust may not elect to use the average exchange rate for the year. Even though, paragraph 43 of the Eighth Schedule states the spot or the average rate, section 25D overrides the Eighth Schedule.

7.2 Withholding taxes

South Africa has two types of withholding taxes namely,

- Withholding tax on royalties (section 35 of the ITA)
- Withholding of amounts from payments to non-resident sellers of immovable property (section 35A of the ITA)

In terms of South African domestic law, if a non-resident sells immovable property⁷⁹ situated in South Africa, the purchaser is required to withhold an amount determined in terms of section 35A(1) of the ITA.

Section 35A states the following:

‘Any person . . . who must pay any amount to any other person who is not a resident . . . must subject to subsection (2) withhold from the amount which that person must so pay, an amount equal to –

- (a) 5 per cent of the amount so payable, in the case where the seller is a natural person;
- (b) 7.5 per cent of the amount so payable, in the case where the seller is a company; and
- (c) 10 per cent of the amount so payable, in the case where the seller is a trust.’

The amount so payable is not a final tax but the amount is seen as an advance payment for the seller’s normal tax liability.⁸⁰

It is interesting to note that even if the non-resident disposes of its interest to a fellow non-resident, the fellow non-resident is required to withhold a withholding tax and pay over the tax to SARS within the time limits specified in terms of section 35A(4).

⁷⁹ Defined in section 35A(15) has the same meaning in terms of paragraph 2(1)(b)(i) and (2) of the Eighth Schedule.

⁸⁰ Section 35A(3) of the ITA.

A further point is that section 35A is only applicable if South Africa has taxing rights. For example, if the former resident emigrated to Luxembourg and subsequently sold his interest in a property company, South Africa does not have taxing rights and hence the transaction is not subject to section 35A.

Chapter 8 Conclusion

The introduction of the resident based system and capital gains tax has undoubtedly been a great success to the economy as a whole. However, it can be seen from the examples above that there are certain provisions of the ITA, read with the DTA's that lead to possible anomalies.

Issue 1

For individuals who are emigrating from South Africa it is essential to understand the income tax implications facing them not only at the time of emigration but also at the time of the disposal of the specific assets. It is submitted that the exit charges encountered by the individual may be unconstitutional as it limits the right of freedom. On the other hand, the exit charges facing non-natural persons are not unconstitutional. It is recommended that South Africa should adopt the deferral method of the exit charge for individuals only. This would be in line with other jurisdictions which have adopted the deferral method. If South Africa adopts the deferral method, it is submitted that there would not be a conflict on the subsequent recovery of the deferred tax.

Issue 2

On several occasions, the South African tax base has not been protected by the wording of the DTA's that have been entered into. In terms of paragraph 12(2)(a)(i) of the Eighth Schedule certain assets of a person ceasing to be a

resident are exempt from the exit charge. The reason for this is that on subsequent sale, these assets remain within the CGT net and should be taxed in South Africa. However, as the person emigrated from South Africa, the person is a non-resident in South Africa and a resident of the other jurisdiction. On the sale of the assets, it is necessary to refer to the relevant DTA's for the determination of which jurisdiction has taxing rights. It is very important for South Africa to have taxing rights to the subsequent disposal of the assets in terms of the respective DTA's which have been exempt in terms of paragraph 12(2)(a)(i) of the Eighth Schedule. This treatise has identified 3 categories for the disposal of shares that are attributable to immovable property that remain within the CGT net on emigration.

Category 1 – Examples: Mauritius and Luxembourg

Under this category, South Africa does not have taxing rights to the subsequent disposal of the shares that are attributable to immovable property. This is a loss to the fiscus as the taxpayer has been exempt from South African tax but on subsequent disposal South Africa does not have taxing rights.

Category 2 – Examples: Canada and United Kingdom

Under this category, South Africa has limited taxing rights to the subsequent disposal of the shares that are attributable to immovable property. If the shares that are disposed of are shares in a company, South Africa has reserved the right to tax the capital gain. However, if a traditional approach of interpretation is adopted and if the taxpayer disposes of his interest in a Close Corporation,

South Africa has reserved the right to tax the capital gain only if the interest in the Close Corporation is sold within 6 years from emigration. This, once again, presents a tax planning opportunity if the emigrant owns an interest in a Close Corporation. If a purposive approach to interpretation is adopted then South Africa reserves the right to tax the capital gain on the subsequent disposal of the interest in a Close Corporation.

Category 3 – Example: Australia

Under this category, South Africa has reserved the taxing rights to the subsequent disposal of the shares or member's interest in a Close Corporation that are attributable to immovable property. This is the category that the fiscus should adopt on all the agreements that are entered into.

Issue 3

Based on the categories above, the emigrant could be faced with double taxation or could benefit based on the other jurisdiction's domestic tax law. If, for example, the taxpayer emigrates with an interest in a Close Corporation to a country that recognises an upliftment of the base cost and South Africa does not have taxing rights to the sale, then this would result in the capital gain from the cost to the market value at the date of emigration being tax free. However, if the emigrant above emigrates to a country that does not recognise an upliftment of the base cost and the assets do not remain within the CGT net on emigration, there would be double taxation of the capital gain. Relief could be provided in terms of the respective DTA.

Issue 4

It is submitted there are two interpretations by SARS which may be technically incorrect. Firstly, the term 'POEM' in Interpretation Note 6 refers to the place where the day-to-day activities are performed. However, it is submitted that the POEM is where the decisions of the entity as a whole are taken and not where they are implemented. Secondly, the interpretation of paragraph 2(2) of the Eighth Schedule by SARS in the SARS Comprehensive CGT Guide may be incorrect. It is submitted that the interpretation may be incorrect if the property is specifically funded by the loan.

The issues identified above lead to tax planning opportunities to taxpayers as well as possible disadvantages to taxpayers. Due to the significance of the issues, it would be advisable for the fiscus to make the appropriate changes to the legislation, where necessary, and to consider the introduction of a deferral of the CGT exit charges chargeable to individuals.

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