

**SOME TAX IMPLICATIONS
FOR A SOUTH AFRICAN TAXPAYER
INVESTING IN THE UNITED STATES**

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The single most notable feature of international tax during recent years has been the emphasis placed on the elimination of tax avoidance particularly through the mechanism of "treaty shopping."

The United States has been the prime motivating force in this development, and it is instructive therefore to examine the approach of the United States in this regard insofar as it affects not only existing foreign investments in that country, but what it portends for the future.

As the Double Taxation Treaty between South Africa and the United States is both an inefficient tax saving mechanism and in any event about to be terminated, the determined effort by the United States to eliminate the practise of "treaty shopping" is of particular significance to the South African investor with current investments in, or plans to invest in the United States.

This thesis examines the approach of the United States to "treaty shopping" and its impact on the South African investor. The concept of "Source" as a criteria for South African taxation is examined and forms the backdrop against which alternative mechanisms for investing in the United States are considered.

(ii)

The effect of the cancellation of the United States/South African treaty is analysed and the necessity for the investor to use some form of "treaty shopping" is explored.

The strength of the United States attack in "treaty shopping" is traced through the development of the "substance over form" doctrine in different jurisdictions and the application of the court ruling by the Revenue authorities are highlighted.

The essential elements of international tax planning are reviewed and the tax implications for the South African executive who may be required to accept the responsibility for the United States investment are investigated.

The analysis serves to indicate what is submitted to be a narrowing scope for international tax planning and the importance of continually reviewing existing structures so as to ensure that they remain abreast of a constantly changing set of rules.

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1. INTRODUCTION

The United States has traditionally welcomed, and indeed encouraged, foreign investment in its economy. In 1791, Alexander Hamilton spoke warmly of encouraging the introduction of foreign capital into the fledgling United States economy.¹

"It is not impossible that there may be persons disposed to look with a jealous eye on the introduction of foreign capital, as if it were an instrument to deprive our own citizens of the profits of our own industry; but, perhaps there never could be a more unreasonable jealousy. Instead of being viewed as a rival, it ought to be considered as a most valuable auxiliary, conducing to put in motion a greater quantity of productive labour, and a greater portion of useful enterprise, than could exist without it."

The economic atmosphere in the United States has for some time been very attractive to foreign interests. Foreign companies have increasingly realized that efficient penetration into United States markets involves doing business in the United States rather than just with it.²

From a South African point of view, international expansion is in many instances the only avenue affording the giant conglomerates sustained growth as the degree of domination they have in the South African

1. Annals of Congress 994 (1791)

2. Sturm: Taxation of Foreign Investors in the United States, 55 Taxes 542 (1977), at 542

market is a self limiting factor to local growth.

Direct investment defined as giving "the investor operating control of the business firm involved as opposed to indirect or portfolio investment, which does not provide operational control"³ allows the establishment of production facilities and a direct presence which make it possible to reach markets that are otherwise inaccessible.

A foreign corporation which actually conducts a trade or business in the United States faces tax consequences far more complex than those that flow from the mere passive investment of funds. Not only are the domestic tax regulations encompassing inter alia the interplay of federal, state and city taxes as they impinge on trade between the States an important consideration when investing in the United States, but of vital importance too are the taxation issues which arise when a foreign person is the investor.

Income earned by foreign investors in the United States, is in principal subject to double taxation; once at the corporate level at the applicable rates and again at the withholding rates when distributed as dividends to foreign shareholders.⁴

3. Fannigan; U.S. Policy on Foreign Investment in the United States, 7 (Chamber of Commerce of the United States, 1974)

4. Sturm: op.cit., p.558

The reduction and elimination of these taxes is an important aspect of any investment across international boundaries and a sophisticated body of rules and regulations has evolved over the years, which facilitates international trade and investment by preventing excessive taxation being levied on the participants.

This thesis is concerned with certain of the tax implications that face the South African tax payer intent on investing in America. No attempt is made to canvass the vast gamut of tax issues that flow from such an investment, but instead certain select topics have been examined to provide a meaningful analysis of some of the more important considerations.

Writing this thesis against the background of an escalating call by the international community for trade sanctions against South Africa has, it is submitted, made the analysis all that more relevant. As the South African economy contracts under the impact of reduced international trade, investors will need to rely to an increasing degree for their earnings and dividend growth on the investments they are able to make in foreign countries, and indeed on the efficiency with which they are able to transmit those returns back to South Africa undiminished by taxation along the way.

2. SOURCE

2.1 General Principles

Only receipts and accruals of income derived from a source within the Republic or from a source deemed to be within the Republic are subject to tax in terms of the definition of "gross income" in s1 of the Act.

"Source" is not defined in the Act and it has been left to the courts to give the concept meaning.

Lord Atkin in the Privy Council case of *Rhodesia Metals Ltd v Commissioner of Taxes*⁵ went so far as to deny that source was even a legal concept:

"Source means not a legal concept but something which a practical man would regard as a real source of income; the ascertainment of the actual source is a practical hard matter of fact."

Watermeyer CJ indicated in *CIR v Lever Bros & Unilever Ltd*,⁶ that it was probably an impossible task to formulate a definition that would furnish a universal test for determining when an amount is received from a source within the Republic.

5. 1940 AD 432 at 436

6. 1946 AD 441, 14 SATC 1 at 13

The Lever Brothers case has been accepted as authoritatively laying down that by "source" is meant the "originating cause," (and not the quarter from which it is received) and that the problem involves an inquiry into two matters, namely : What is the originating cause of the income and secondly, is the originating cause in the Republic?

Where more than one cause can be ascribed to the accrual or receipt of the income and such causes are located in one or more other countries - the whole or part, or no part of the receipt might be regarded as constituting income from a source within the Republic. In such a situation, the courts look for the main, dominant or substantial cause. Incidental causes are disregarded and the total income is attributed to the main cause.

When none of the causes can be considered as being incidental it would follow that an allocation of the income between the different causes located in different places should be made.

In the Lever Brothers case, Watermeyer CJ said:

"It is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries and

consequently, after the activities which are the source of the particular 'gross income' have been identified, the problem of locating them may present considerable difficulties and it may be necessary to come to the conclusion that the source of a particular receipt is located partly in one country and partly in another."

But Watermeyer went on to state that:

"Such a state of affairs may lead to the conclusion that the whole of a receipt or part of it, or none of it, is taxable as income from a source within the Union, according to the particular circumstances of the case, but I am not aware of any decision which has clearly laid down what would be the governing considerations in such a case."

The Revenue Authorities however, appear to follow a more practical approach⁷ and accept in practise that a receipt may be apportioned between its causes and therefore tax only the portion derived from a local source. This approach is apparently followed as long as the foreign causes of the receipt are clearly identifiable and are not merely incidental.

The tests for determining the source of income have developed to include the place where the capital is employed⁸, where the business is earned or (the so-called business

7. Passer, A.: Tax Treaty Law. Juta and Co Ltd 1986. p.4
8. Overseas Trust Corporation v CIR 1926 AD 444, 2 SATC II

activities test)⁹ and where the contract is made¹⁰.

It is however, often difficult and sometimes impossible to extract general principles from the cases because as the courts have pointed out, it is dangerous to generalise in regard to source. Each case has to be decided on its own facts.

Nonetheless as pointed out in Black's¹¹ case:

"The decisions do give some indication of the kinds of tests, factors or considerations that should, according to the circumstances, be used when deciding where the source of the income was."

2.2 Business operations extending beyond the Republic.

Where a South African business extends beyond the Republic, Section 30 provides for an allocation of profits or losses and taxable income as determined by the following formulae¹².

$$A = \frac{B}{C}$$

Where A = the taxable income or (assessed loss) to be determined;

9. Rhodesian Metals, Ltd ibid.

10. CIR v Lever Bros and Another 1946 AD 441 at 452

11. 1957(3)SA 536(A), 21 SATC 226

12. Meyerowitz and Spiro: Income Tax in South Africa: Permanent Volume, p.54

Where B = the value of the taxpayers South African Assets;

Where C = the value of the taxpayers total assets;

Where D = the taxpayers total net profits (or loss) from all sources calculated in the manner provided in the Act for the determination of taxable income.

The section does not apply where the taxpayer carries on a business distinct or separate from his South African business, but it envisages one business extending beyond the Republic. Even where the section is applicable however, the Receiver may nonetheless accept satisfactory accounts of the taxpayer's business and determine the tax liability otherwise than laid down in the section.

The section neither defines "assets" nor does it specify how they are to be valued.

The provisions of this section may also be modified in particular cases in terms of the double taxation agreements entered into with other countries.

2.3 Income arising from certain types of activity

While it is beyond the scope of this document to perform a detailed analysis of the tax law as it relates to "source", it is instructive

to canvas briefly the interpretation of "source" as it relates to specific elements of income. This brief analysis will provide too a back-drop against which the effect of double taxation agreements may be measured.

2.3.1 Trading Commodities

Silke¹³ submits that the inference to be drawn from the courts is that the source of income derived from trading or manufacturing operations is in the Republic if the trader or manufacturer productively employs his capital and exercises his activities in the Republic.

Thus, the productive operations at a farm, factory or mine are the main cause of the income being earned¹⁴.

The relevance of the incidence of the taxpayers business also emerges from the following passage in Lord Atkins judgement in **Rhodesian Metals, Ltd (in liq)**(supra), where he said :

A doubt may be expressed whether the words borrowed by Stratford CJ, from Innes CJ, in the **Overseas Trust** case "productive employment of capital" really helps to define the situation. Is capital productively employed in the place where it purchases stock which is profitably sold elsewhere; or in the place where the stock which now represents

13. Silke, A.S.; Silke on South African Income Tax 10th Edition 1982, p.252

14. CIR v Epstein 1954(3)SA 689(A)

the capital is sold; or for the purposes of the test must both purchases and sales occur in the same place; or is it sufficient that the place of the direction of the employment of capital in purchasing and selling should denote where the capital is productively employed? Perhaps in other words it may be said, does it mean more than carrying on business in a place?"

Under certain circumstances however, the selling or buying activities may be sufficiently important to satisfy the source test itself.

Schreiner JA commented as follows in the **Transvaal Hide and Skin**¹⁵ case:

"When all the activities giving rise to the income consist of buying and selling, the country where the sales were made is generally held to be the source of the trading profit. But one can imagine cases where there is an unlimited market for the goods at a fixed price and the only business problem is to find sellers of the goods. In such cases the country where the goods were bought, if it was different from that in which they were sold, might properly be held to be the source of the profit."

Passos¹⁶ submits that the selling activities are usually elevated to an independant source where they are conducted on a continued basis and through a fixed presence distinct from Head Office.

15. Transvaal Associated Hide and Skin Merchants v CIT 29 SATC 97

16. Op.cit., p.7

2.3.2 Share Trading

In *Overseas Trust Corporation Ltd v CIR*¹⁷ it was held that in dealing with shares and other securities, the activity of buying and selling constitutes the main cause of the income. The use of independant brokers who merely execute the instructions of the taxpayer is simply an incidental factor.

Solomon JA said (at 458):

"Here again, applying the test of where the capital was employed which earned the profit, it is clear that more was employed in Germany. The capital employed was that with which the shares were bought which were afterwards sold in Germany. Had the company carried on part of its business in Germany by buying and selling shares there, the position would have been different. But it carried on no business in Germany; it merely sent shares there to brokers to realize in accordance with instructions. Any business carried on there was by the brokers, not by the company in Cape Town."

In *CIR v Black*¹⁸ where the taxpayer who was a stockbroker ordinarily resident and carrying on business in Johannesburg, derived a profit from share dealings in London, it was held that since "the main, the real, the dominant, the substantial source of the income was the use of the taxpayers capital in London and the making and the executing of the contract is London, the source of the profit was not in South Africa."

17. Op.cit., p.444

18. Op.cit., p.536

2.3.3 Royalties

Millin v CIR¹⁹ held that the source of royalties accruing to a novelist was where his wits, labour and intellect are employed.

Millin's case is also considered to be authority for regarding the source of income from copyrights, patents and trademarks as being in the place where they were created or perfected²⁰.

It is also considered that the act of registering patent rights in a country merely provides protection for the holder and is not the real source of the royalty²¹.

Where royalties are derived by a person who is not the original author or inventor but by a person who has acquired the rights from the author or inventor, the source or originating cause of the royalties may be the business of the owner of the rights, the employment of the capital invested in the acquisition of the rights, the contract providing for the earning of the royalties from the exploitation of the rights, or the use of the rights. Silke submits that this conclusion is reached because the royalties are not now derived from the wits, labour or intellect of the recipient, but from the ownership of the copyright or patent rights.

19. 1928 AD 207

20. Income Tax Reporter 15th February 1979 p.26

21. Silke, op.cit., p.250

Where royalties are derived from the use, the right of use or the grant of permission to the use in South Africa of a right or property, they will constitute South African deemed income and be taxable in the Republic. (s9(1)(bA)).

An inventor may perform all the work in connection with the creation of his patent outside South Africa, but because he allows the use of his rights in South Africa, the income derived is deemed to be from a South African source, (s9(1)(b)). Amounts derived from the outright disposal of the patent do not fall within the ambit of s9(1)(b) as payment is then received for the sale of the asset and not for its "use."

In terms of s6bis, a special rebate is available to any person whose taxable income includes any amount derived in respect of the use, right of use, or grant of permission to use certain property in any country other than the Republic. This rebate is intended to benefit Republic residents who derive royalties and other similar payments from the patents and other property that have their source in the Republic but are also taxable whether directly or by deduction in the foreign country in which the use of the property is permitted, and for which taxation there is no relief in terms of a double taxation agreement (see below p. 51).

2.3.4 Income from Services

The source or originating cause of income from employment and other services rendered is the services and the source of the remuneration is where the services are rendered.²²

Where the employee has contracted to render services both within and outside the Republic, the remuneration relating to the services rendered outside the Republic would not be from a South African source²³. But where the employee simply performs casual or occasional services outside the Republic, the full remuneration will be considered to be from a South African source²⁴.

In *Cot(SR) v Shein*²⁵, Tredgold CJ said :

"When a man is engaged to perform certain work in a given country but has minor duties which are purely subsidiary and incidental, that fall to be performed in another country, then I do not think it is a practical approach to suggest that portion of his income has its source in that other country. When he is not paid separately for these extraneous duties, it becomes particularly artificial to try to allot portion of his earnings to them."

The Court held further that services can be rendered by accepting responsibility just as

22. ITC 100 (1927), 3 SATC 250; ITC 266 (1932), 7 SATC 151;
ITC 396 (1937), 10 SATC 87; ITC 1088 (1986), 28 SATC 202;
ITC 1104 (1967), 29 SATC 46.

23. ITC 396 (1937), 10 SATC 87

24. ITC 738 (1951), 18 SATC 213

25. 1958(3)S.A. 14(F.C.), 22 SATC 12

much as by manual or other work, and when responsibility for a business is undertaken it is accepted at the place at which the business is being carried on, wherever the person undertaking that responsibility may be at the time.

A taxpayer ordinarily resident in the Republic is deemed to derive South African income when his absence from the country is temporary and he continues to render services for and on behalf of his employee in South Africa. A temporary absence is accepted by the Receiver to be one that does not exceed 183 days per year. (See chapter 8 for a more detailed analysis.)

The provisions of s9(1)(d) and s9(1)(d)bis may provide exceptions to the general rules for the determination of the actual source of income from employment and services rendered.

2.3.5 Rent

While the source of rent derived from immovable property is found at the place where the property is located, the source of rentals from movable property may be either the use of the property or the business of the lessor²⁶. With the letting of smaller items for a limited period of time as for example motor car hire, the business of the

26. COT v British United Shoe Machinery (SA) (Pty) Ltd 1964(3) SA 193(FC), 26 SATC 163

lessor rather than the property let was the source. Where the period of lease is for an extended period, the emphasis is more likely to lie on the property let and not the business of the lessor.^{26a}

The key factors in deciding the source of rentals may be summarized to include:

- the nature of the movables
- the duration of the lease
- the terms of the lease

2.3.6 Interest

Watermeyer CJ held in **VIR v Lever Brothers and Unilever Limited**²⁷ that the source or originating cause of the interest on a loan of money was not the debt but the services that the lender performs for the borrower, that is, the supply of credit in return for which the borrower pays him interest:

"In the case of a loan of money, the lender gives the money to the borrower, who in return incurs an obligation to repay the same amount of money at some future time and if the loan is one which bears interest, he also incurs an obligation to pay that interest ... As a rule, the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender and this supply of credit and the service which the lender performs for the borrower, in return for which the borrower pays

^{26a} Cp.cit., p.197

²⁷ Cp.cit., p.441

him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender."

Based on this judgement, it is considered²⁸ that the source of interest on a loan of money is not located where the loan has to be repaid, where the interest is payable, where the borrower uses the money or even where the agreement is concluded. It is instead the place where the credit is made available.

It follows that if a South African taxpayer needs to fund its activities abroad, it should not make the funds available to the borrower in South Africa for onward transmission to the foreign location, but the funds should be first transferred to the foreign country by the lender and only there should the credit be made available to establish the source of the interest as being non-South African.

In the case of *COT v William Dunn and Co. Ltd.*²⁹ the taxpayer, a company registered and carrying on business in England, was a buyer for South African traders and received remuneration for its services. It financed the purchases by purchasing the goods in its own name and then invoicing and shipping them to South Africa. Interest was charged on the balances due from time to time. It was held in this case that the source of the interest

28. Income Tax Reporter 15th February 1977 p.27

29. 1918 AD 607

was the English business of the company. It employed its own capital in carrying on its business in England and by so doing it earned the interest. The presence of the debtor in and the payment of the interest from South Africa did not affect the issue.

2.3.7 Dividends

In **Boyd v CIR**³⁰ it was held that the source of income from dividends is the shares and the shares are situated where they are registered irrespective of the source from which the company derives its income.

In **Lamb v CIR**³¹ it was held that when dividends are received from shares registered in a branch register in a country other than that in which the company is incorporated, the source remains the country of incorporation in which the principal register is situated if the law of that country deems the branch register to be part of the principal register.

The principles established in **Boyd** and **Lamb** are however of limited significance in view of the proviso to para (k) of the definition of 'gross income' in s1, in terms of which dividends from source outside the Republic are deemed to be from a South African source when derived by a person other than a company

30. 1951(3)SA 525(AD), 17 SATC 366

31. 1955(1)SA 270(AD), 20 SATC 1

ordinarily resident in the Republic, and in terms of S10(1)(k) dividends received or accrued to a company are exempt from tax.

Indeed for the South African taxpayer investing abroad, the consideration is normally the reduction of withholding taxes imposed on dividends being remitted from the foreign country to South Africa.

2.3.8 Directors Fees

A director's services in his capacity as such are deemed to be rendered at the head office of the company where the board of directors ordinarily transacts the business, and the directors fees are derived from that location irrespective of the place where the director resides and performs his services.³²

A distinction must be drawn as well between directors fees and the directors salary. In **ITC 266³³** it was indicated that a different source could be found for the directors fees and the salary paid to the same individual.

2.3.9 Deemed Source

Certain categories of income are in terms of Section 9 of the Act deemed to be from a source within the Republic. These include:

32. ITC 77 (1927), 3 SATC 72

33. ITC 266 (1932), 7 SATC 151

- alimony and maintenance (s9(1)(h))
- bank interest (s9(3) and exemptions (s10(1)(w))
- building society interest and dividends (s9(2))
- contracts of sale where the contract is concluded in South Africa (s9(1)(a))
- know-how payments (s9(1)(bA))
- mining and prospecting leases (s9(1)(cA))
- pensions (s9(1)(g)(i) and s9(1)(g)(ii))
- services rendered abroad during temporary absence (s9(1)(d)(bis))
- services rendered abroad by seamen or airmen (s9(1)(t))
- services rendered abroad for government bodies (s9(1)(e))
- shipowners and aircraft owners (s9(1)(c))
- use of patents, copyrights and similar rights (s9(1)(b))

3. ALTERNATIVE MECHANISMS FOR INVESTMENT IN THE UNITED STATES

3.1 The choice between a Branch or Subsidiary

One of the first decisions the foreign investor in the United States needs to make is that of whether to incorporate a United States subsidiary of a foreign company, or to establish a United States branch of a foreign company.

Under prior United States Law, there were distinct advantages in establishing a branch operation to conduct the foreign company's business in the Americas, rather than forming a subsidiary³⁴. The 1986 Tax Act (signed 22nd October 1986), will however eliminate these advantages but in some instances may even give the subsidiary an advantage³⁵.

3.2 Taxation of Foreign Corporations in the United States

A discussion on whether the foreign investor in the United States should consider the establishment of a branch operation or a subsidiary is rendered more meaningful by firstly canvassing the basis on which taxation is levied in the United States on a foreign corporation.

34. Mathison, J.J., Tax Management International Forum Vol 7 No 3
September 1986, p.32

35. Ibid. p.32

Two important concepts applied in determining the United States tax liability of a foreign person are concerned with, (a) the character and location of the foreign taxpayers economic activity, i.e. whether it is engaged in a trade or business (as opposed to investment), and whether the business, if one exists, is located within the United States; and (b) the relationship between the taxpayers income and his activities in the United States, i.e. whether his income is effectively connected with a United States trade or business.

3.2.1 Trade or Business

Whether the taxpayer is engaged in a trade or business within the United States depends upon the nature and extent of its economic contracts with that country³⁶. While it is clear that the entire business operation need not be centered in the United States, what constitutes "trade or business" is not made clear by the statute or the regulations promulgated thereunder. Relevant factors in determining the extent of economic penetration in the United States for the purpose of establishing the presence of a trade or business include³⁷:

36. CIR v Sperrmacet Whaling and Shipping Co, 281 F.2d 646

37. Bitker, B.L., and Eustice J.S.: Federal Income Taxation of Corporations and Shareholders 1979, Boston, p.17-13

- "a) the location of the production activities.
- b) the location of management (i.e. direction and control of the enterprise,)
- c) location of distribution activities (e.g. storage of goods, solicitation of orders, advertising and promotion, clerical functions, showrooms and samples, credit functions etc), and
- d) location of such other business functions as purchasing, financial activities, research, servicing of products, transportation and the like. Moreover, certain types of businesses such as mining or manufacturing are inherently local in character while at the other end of the spectrum, a wholly foreign enterprise that simply ships its product to customers in America has no trade or business in that country."

Between the two extremes the courts need to decide on the facts whether the trade or business exists and it is in essence a question of degree. The courts have elucidated a test for the involvement to be "considerable, continuous and regular³⁸", but have also found that "the ownership and leasing of real property, the collection of rentals therefrom and the performance of certain minimal acts customarily incident to the ownership of real property do not constitute engaging in trade or business.....³⁹"

38. Jan Casimir Lewenhaupt v Commissioner 20 T.C. 151(1953)

39. Herbert v Commissioner 20 T.C. 2633(1958)

3.2.2 Income "effectively connected" with a United States Business

In terms of the Foreign Investors Tax Act of 1966, only income "effectively connected" with the conduct of a trade or business would be taxable at the normal rates, while in terms of Section 881 of the Code, United States source investment income would be taxed at the special 30% rate applicable to foreign non-residents (or lower treaty rate where applicable) without allowance for any deductions. This tax rate is imposed or designated on categories of income generally defined as fixed or determinable annual or periodic investment-type income such as dividends, interest, rents and royalties which are not effectively connected with the conduct of a United States trade or business.

Under the 1966 Act (supra), a foreign investor now distinguishes between its "business" income and its "investment" income under s864(c), and computes the tax attributable to each category separately, and a dual tax status is thus created with respect to foreign investors in the United States.

The requirements for income to be "effectively connected" which are set out in terms of Section 864(c)(4) of the Code

require two factors to be considered⁴⁰. These are the "asset use" test, i.e. whether the income is derived from assets used in or held for use in the business, and the "business activities" test, i.e. whether the activities of the business were a material factor in the production of the income. If these two tests are satisfied and the income so generated is considered to have a proximate economic nexus with the United States business it is treated as business income (for the purpose of 871(b) and 882), otherwise it is taxed as investment income (under 871(a) and 881(a)).

3.3 Position under Prior Law

To the extent that the assets to be used in the United States are newly constructed or purchased, there were no significant implications for either a branch or a subsidiary. The depreciation allowances were the same in either instance.

Where the parent company transferred assets it owned and used elsewhere, there was no tax effect if the assets were transferred to a branch as the branch is the same persona as the parent. When the assets were transferred to a subsidiary the same results would apply in those instances where Section 351 and 361(a) of the Internal Revenue Code applies.

40. Bitker and Eustice, op.cit., p.17-16

The essence of Section 351⁴¹ is that "no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for its stocks or securities and if the transferor controls the corporation immediately after the exchange."

Section 361(a) provides that "no gain or loss shall be recognized if a corporation that is a party to a reorganization transfers property to another corporation that is a party to the reorganization."

If the parent were to transfer the assets to the American subsidiary at higher than its book value so as to enable the American company to enjoy higher wear and tear allowances, the United States could not attempt to tax this gain although it may well be taxed in the foreign jurisdiction.

It was possible therefore to commence trading in the United States with a branch of a foreign corporation and to possibly use initial United States losses against the domestic tax liability of the foreign corporation and then subsequently to incorporate the branch without adverse capital gains tax consequences.

As ongoing operations, the branch and the subsidiary would be taxed on their income

41. Bitker and Eustice, ibid, p.3-02

from the United States business in essentially the same way.⁴² The subsidiary would be taxed on income at graduated rates up to 46% while the branch would be taxed on its "effectively connected" income at these rates too. On any income not "effectively connected," it will be taxed at a flat 30% (see 3.2 above).

A difference in tax treatment between a branch and a subsidiary arises however when the operating income is repatriated to the foreign country.

When a subsidiary pays a dividend to its foreign parent, the dividend is subject to a 30% withholding tax (subject to the provisions of any treaty), but there is no withholding tax imposed when a branch remits profits to its shareholders unless more than 25% (50% prior to the new legislation) of the foreign parent's gross income has been derived from the United States during the preceding three years.

The use of a branch to conduct business in the United States may therefore, under circumstances where there is no appropriate treaty between the parent company's country and the United States, be used to avoid any double taxation that may arise. This facility has however been curtailed to an

42. Mathison; op.cit., p.32

extent following the introduction of the 1986 Reform Act.

If the subsidiary was capitalized with loan capital, the interest remitted to the foreign parent would be subject to the same 30% withholding tax and in addition would be subject to attack in terms of "the thin capitalization rule."⁴³ (See below p. 79)

The risk attached to a foreign investment is always considered to be higher than the equivalent investment in a home jurisdiction. It is relevant therefore to consider too the effect of a liquidation of the foreign investment structure chosen for the investment.

The liquidation of a foreign branch can be achieved for the most part without United States Tax consequences⁴⁴ even if the assets have appreciated substantially over their cost. However, Section 367⁴⁵ of the Internal Revenue Code will impose a corporate level tax on the liquidation of the United States subsidiary of a foreign corporation.

43. Internal Revenue Code, Section 385 (thenceforth abbreviated as for example IRC 385)

44. Mathison op.cit., p.33

45. IRC 367 is designed to prevent the tax free repatriation of previously untaxed foreign earnings and the repatriation of assets so as to reduce potential United States tax thereon.

3.4 Effect of the Tax Reform Act of 1986

The Tax Reform Act of 1986 eliminates⁴⁶ the 30% withholding tax that is payable when 25% (previously 50%) or more of the gross income for a three year period is effectively connected with United States business.

This measure achieves greater parity between the remittance of branch profits and the distribution of subsidiary earnings⁴⁷ by providing that the taxable base on which the branch profits tax is imposed is the earnings and profits of a United States branch of a foreign corporation attributable to its income effectively connected with a United States trade or business.

The tax will be computed⁴⁸ by reducing United States taxable income by the amount of United States tax and then reducing the resulting amount by any increase in net United States equity occurring during the year. This latter adjustment being designed to immunize from tax United States profits that are not repatriated. In other words, the tax base will be reduced to the extent that the branch's earnings are reinvested in the United States and will be increased to the extent that the reinvested earnings are deemed to be remitted to the foreign home office of the foreign corporation.

46. Conference Committee Report on Tax: Reform Act of 1986: Government Printing Office 1986

47. Ibid., p.11-647

48. Mathison, op.cit., p.33

The new Act does however not affect in any significant way the consequences of establishing the United States business in the form of either a partnership or as a subsidiary. However, a branch will be forced to keep United States earnings in the United States to avoid the new tax. Failure to do so would render the branch liable for the same double taxation as a United States subsidiary.

If a branch is liquidated after the new law, the reduction in United States equity caused by the liquidation will add to the taxable profits for that year with the result that all United States profits not previously taxed will be subject to tax in the year of liquidation.

3.5 Interaction of the Reform Act with Double Tax Treaties

The new Act identifies the following instances with relevance to Double Tax Treaties⁴⁹:

- "i) Corporations registered in treaty countries where the treaty precludes the imposition of both the current withholding tax and new branch level tax and where there is no Treaty Shopping (i.e. the corporation in question is more than 50% owned by residents of the treaty country). Such corporations will be exempt from both the current withholding tax and the branch level tax.

49. Ibid., p.34

ii) Corporations registered in treaty countries where the treaty precludes the current withholding tax and the branch level tax but where there is deemed to be Treaty Shopping (i.e. less than 50% ownership by residents of the treaty country). Such corporations will be liable to the branch level tax notwithstanding a treaty prohibition.

iii) Corporations registered in treaty countries where the current treaty precludes the reform tax but does not preclude the existing withholding tax, regardless of the existence or non-existence of Treaty Shopping. Such corporations will continue to be subject to the current withholding tax despite its general repeal."

As stated above, the formation of a branch operation in the United States could previously be utilized to avoid double taxation in instances where there was no double tax treaty, or where a treaty existed (as with South Africa) that provided inadequate relief. It is submitted that the new Act effectively reduces the scope of this mechanism to those instances contemplated in point (iii) above and of course only the extent that any such existing treaty rate is less than the statutory rate of 30%.

Mathison⁵⁰ submits further than where a treaty permits the reform tax either implicitly or expressly, it will be applied

50. Ibid., p.34

and he concludes that the bulk of foreign corporations organized in treaty countries will not have their tax burdens increased as a result of the new law. Notable exceptions however, will be those corporations registered in the Netherland Antilles which are not likely to pass the test of majority ownership by residents.

4. DOUBLE TAXATION AGREEMENTS

4.1 Objectives of Double Taxation Agreements

The main objectives of double taxation agreements are to minimize double taxation and prevent tax evasion⁵¹.

International double taxation arises with the levying of comparable taxes by two or more countries on the same income with respect to the same subject matter and for the identical period of time⁵². It may arise where, for example, one country levies taxes on the basis of source whilst another might levy tax on the same income on the basis of residence, or two countries with overlapping or conflicting concepts of source or residence might tax the same income. Again, different countries may have different concepts of taxable income or may differ in their allowances and timing of deductions.

Whilst the main objective of double taxation agreements are the minimization of the tax avoidance and double taxation, other reasons may include the facilitation of economic transactions and encouragement of investment and generally to further economic goals so that they constitute indirect instruments of foreign policy⁵³.

51. Atchabadian, A: Some aspects of International double taxation between developing countries. The Bulletin for International Fiscal Documentation 1971, p.451

52. Beale, R.J.E.: The law relating to double taxation agreements between South Africa and Zimbabwe: unpublished thesis UNISA 1981

53. Ibid., p.4

One of the intentions behind the creation of an international system of interlocking tax treaties is of course to foster international trade by correcting the distortions that would otherwise arise.

Arguably, tax planning may be seen as a valuable adjunct to the treaty making process without which they would neither achieve their full potential nor would they operate as intended.

4.2

Nature of the Agreements

Section 108 of the Income Tax Act empowers the State President to conclude tax treaties for the prevention, mitigation or discontinuance of the levying of tax on income, profits gains or donations and for the rendering of reciprocal assistance in the administration of their taxes (s108(1)).

The State President may only enter agreements within the scope outlined above, and he may not conclude a treaty that imposes or increases any tax, nor may any treaty provisions be interpreted as increasing or imposing any liability for tax⁵⁴.

South African treaties may modify and override the Act and form part of the statutory body of South African Tax Law.

54. Passoa, op.cit., p.63

The South African courts are thus competent to decide a claim founded on a tax treaty.

Under general principles of United States Law, international treaties and legislative enactments are of equal force. As a result where treaties and legislative provisions conflict, the latter in time prevails⁵⁵.

Two statutory provisions are relevant in this context : Section 894(a) of the code provides that income exempt under a treaty obligation in the U.S. remains exempt under the code despite any code provisions to the contrary, and Section 785 2(d) states that no provision of the code shall be applied where it is contrary to any treaty obligation of the U.S. in effect on August 16, 1954.

This provision is itself a legislative enactment and can be made inapplicable in particular situations.⁵⁶

Tax treaties generally cover a more limited economic universe than that encompassed by a particular country's domestic tax laws, being concerned as they are with the typical types of economic intercourse between the treaty partners. The treaties normally apply only to nationwide taxes levied by a party country, and the tax base included in a

55. Cook v United States 288 U.S. 102(1933)

56. For example the Subpart F rules of 1962; The Foreign Investment in Real Property Tax Act of 1980; the Branch Level Taxes amendment in the Tax Reform Act of 1986

treaty is selective rather than universal dealing only with specific categories of taxation. Areas of taxation not covered by the treaties continue to be governed by domestic tax rules.

A tax treaty is essentially a country-to-country bilateral contract negotiated by the executive branches of each country⁵⁷. As such, political compromise is inevitable in this area and the resulting document is usually a far less detailed codification of general principles than is the case with domestic tax law. Of more significance perhaps is the fact that the usual legislative participants in the domestic law process are absent in the treaty negotiation system.

4.3 The United States/South African Tax Treaty⁵⁸ ("The Treaty")

As this agreement will be terminated in terms of the sanctions legislation recently passed by the United States against the Republic, it is instructive to consider the agreement from the perspective of what the effect of this cancellation will be.

The Treaty is not a particularly generous treaty, and as such, direct investment in

57. Bitker and Eustice; 1985 Cumulative Supplement No 1 p.17-4

58. Convention between the Government of the Republic of South Africa and the Government of the United States of America for the avoidance of double taxation and for establishing rules of reciprocal administrative assistance with respect to taxes on income

America from South Africans has not been a favoured route to follow, and South African investors have tended to rely on foreign jurisdictions with more favourable United States treaties as a vehicle for their investment. An excursus through the Treaty follows:

Article III(i) of the Treaty is a general section that prevents the citizens of one of the contracting states residing within the other contracting state from being subjected to the payment of more burdensome taxes than the citizens of such other state. Obviously this protection will now fall away and citizens of either state may be in a position of paying more tax than a native resident of either country.

There is little authority on the question of what constitutes discrimination against foreign taxpayers for purposes of equal treatment or non-discrimination. Under the American Foreign Investment in Real Property Tax of 1980, Section 897 provides that foreign corporations which dispose of United States real property interests by means of dividend distributions or pursuant to redemptions or liquidation are subject to tax on the accrued gain in the property. United States corporations would not be subject to tax on comparable distributions and in an

attempt to avoid non-discrimination issues, the statute provides that any foreign corporation with a United States permanent establishment may elect for purposes of Section 897 to be treated as if it were a United States corporation.

In Article IV(1) the United States has undertaken to give a credit against its taxes imposed upon income derived by its citizens or residents from South African sources imposed by South Africans upon such income. This protection against double taxation will also fall away and expose residents and citizens of America to an element of double taxation in that jurisdiction. In practise it is unlikely to lead to much hardship, as the American system of granting unilateral relief from double taxation is well developed.

Article IV(2) provides that South Africans will not tax income derived from sources within the United States of America in accordance with the income tax laws of the Republic in effect on the day of entry into force of the Treaty, that is, 1 July 1946. Thus, a correct interpretation of this article necessitates an investigation into the South African tax laws in force at that date.

As the principle of source as a determining factor for tax liability in South Africa was both before and after 1946, part of the law, the cancellation of the Treaty would have no effect on the current taxability of American sourced income in South Africa.

Passos⁵⁹ states that by the acceptance of South African tax principles regarding the source of income to be those in force at the date of entry into force of the Treaty, South Africa also accepted that any subsequent amendments introduced in its tax laws deeming particular income to be of a South African source would also not apply. Passos submits further that there is then an implicit acceptance that if taxes have been introduced subsequent to the date of entry into force of the Treaty, those taxes will not be enforceable insofar as the income concerned is sourced within the United States.

This analysis begins to have relevance insofar as the permanence of the principle of "source" is entrenched. Were the South African principle of source to be abolished in favour of a more widely defined basis of tax, so long as the Treaty was in force, source would nonetheless continue to be a relevant test for the taxability of American sourced income, as source was a

59. Passos, op.cit., p.86

definitive part of the law before 1 July 1946. Income sourced in the United States would, for example, (for as long as the Treaty was operative) remain non-taxable in South Africa.

It follows therefore, that were the concept of source to be abolished in South Africa, the cancellation of the Treaty would allow American sourced income to be taxed in South Africa as well.

Article V(1) of the Treaty states that an enterprise of one of the contracting States is not subject to taxation by the other contracting state in respect of its industrial and commercial profits except in respect of such profits allocable to its "permanent establishment" in the latter state.

The definitions of "permanent establishment" vary from treaty to treaty but in general, the concept is used to represent the level of contact required to justify the imposition of a local tax. The concept is unknown in South African law but has relevance only for double tax treaties.

A permanent establishment may take the form of an office or other fixed place of business, or a resident agent of the taxpayer

with authority to enter contractual relationships.

As a general rule, a non-resident, alien or foreign corporation is taxed on its business income from U.S. sources at the usual United States tax rates. Technically, the tax is imposed on all income which is effectively connected with the foreign taxpayers American trade or business. This Code treatment of business income is modified by the Treaty to provide that a South African taxpayer will not be taxed on business income from sources within the United States unless that income is applicable to a permanent establishment located in America. If no permanent establishment is present, business income which would otherwise be subject to United States tax is exempt under the treaty.

While it is beyond the scope of this thesis to examine in detail the distinction⁶⁰ between the "trade or business" concept (which is discussed above in point 3.2) and "permanent establishment", the "trade or business" concept continues to play an important role in the United States taxation of foreign individuals and corporations as it determines the basic pattern under which the foreign taxpayers' income will be taxed.

60. For which see Williams; Permanent Establishments in the United States, 29 Tax Law 277(1976)

McDaniel and Auld⁶¹ submit that while a determination that a foreign individual or corporation maintains a permanent establishment in the United States will generally mean that a United States trade or business exists, the reverse is not the case. The trade or business concept is broader than the permanent establishment rules and therefore a foreign individual or corporation can often be engaged in a trade or business in the United States but still not be found to maintain a permanent establishment there.⁶²

It is submitted therefore, that the cancellation of the Treaty will result in the American Tax net being cast wider than is prescribed by the definition of "permanent establishment" which is a Treaty term, and will result in higher taxation being paid to the American revenue authorities.

Article VII - this article grants the contracting states the right to adjust taxable profits between related enterprises when the transaction between the enterprises have not taken place on an arms length basis.

The article restricts the imposition of this right to those situations where participation by one organization "in the management or

61. McDaniel and Auld: Introduction to United States International Taxation; Kluwer: 1981, p.55

62. Inez de Amodio v Commissioner 299 F.2d 623

capital of an enterprise in the other contracting state makes or imposes on the latter in their commercial or financial relations, conditions different from those which would be made with or imposed on an independent enterprise."

Section 31 of the Income Tax Act gives effect to the right conferred on South Africa as a contracting state to allocate income and expenses of related enterprises to reflect the principle of "arms length" pricing.

As the scope of this section is limited to those circumstances where one of the related parties is a foreign enterprise that is resident in the country with which a treaty has been concluded, the cancellation of the Treaty will remove the powers provided by Section 31 to the Receiver. The negating of Section 31 in this regard is however unlikely to be of much significance as the Receiver has other⁶³ tools at its disposal. Briefly and by example, they include the contention by the Receiver that certain costs have not been incurred in the production of a taxpayer's income, or that excessive expenditure was not incurred wholly in the carrying on of a trade and is therefore disallowable; costs incurred outside South Africa may be disallowed by the Receiver on

63. Passos op.cit., p.186

those portions he considers excessive; if the charging of high rates of interest, or other charges reflects an intention to use an assessed loss in the recipient's entity, the Receiver may disallow the set-off of the income against that loss.

In addition, South African exchange control regulations will ensure that excessive amounts are not charged to South African entities by the authorities withholding their permission for any such excessive charges leaving the country.

From an American point of view, the cancellation of the Treaty will have no effect, as Section 482 of the Code authorizes the fiscal authorities to allocate gross income, deductions and credits between related taxpayers to the extent necessary to prevent evasion of taxes or clearly to reflect the income of related taxpayers.

The Section has a very broad scope⁶⁴ and applies to domestic as well as international transactions and does not require a finding of a tax avoidance purpose on the part of the parties involved for a reallocation of income to be undertaken. In general, the tests applied under Section 482 are also relevant under the Treaties⁶⁵.

64. McDaniel and Auld op.cit., p.142

65. Ibid: p.149

The Treaty mechanism provides for the authorities of the two countries to consult on the redetermination of the income. If no such compromise can be reached, the taxpayer is faced with possible international double taxation.

For the taxpayer then, the cancellation of the Treaty will remove the benefits of having the authorities attempt to reach a compromise on his taxation.

The following benefits will be lost to individuals for personal services once the Treaty is cancelled:

- the non taxability of compensation paid by a contracting State to individuals not ordinarily resident in the other State will not be taxed by the second State. (Article VIII(i))
- pensions and life annuities derived from sources within one of the contracting States are exempt from income in the second State. (Article VIII(ii))
- a teacher from one of the States is exempt (if certain timing conditions are met) from paying tax on his teaching remuneration in the other state. (Article IX)
- students or business apprentices from one of the states residing in the other and studying or acquiring business experience is not taxable by the other state in respect of remittances received by them from the home state. (Article X)

- individuals of a contracting state are exempt from tax in the other state if:

- i) he is present in the other state for less than 183 days per year, and
- ii) the services he performs are on behalf of a resident in his home state, and
- iii) the profits or remuneration are subject to tax in the home state. (Article 11(1) and (2)) of the supplementary protocol of 1956).

This article is designed to facilitate international movement of employees for a short period of time and is a business benefit that will be lost by the cancellation of the Treaty.

4.4 Treatment of Investment Income

The Treaty does not cover the taxation of dividends, interest and royalties. As such, South African residents investing directly in the United States do not benefit from any reduction on the withholding taxes imposed by that country. As such, dividends, royalties and interest payable to a South African resident from America are subject to a 30% withholding tax, the same rate as is applicable to countries that have no Treaty with America at all. South Africa is also the only country which has a Treaty with America and to which the fuller non-treaty rate of 30% applies across the board⁶⁶.

66. International Tax Systems and Planning Techniques: B4.15.1
p.1,742

Needless to say, it would be most unusual for a South African company to invest directly into America. Instead, a country with a more favourable tax treaty with America is usually interposed to reduce the withholding taxes. In effect therefore, the Treaty has seldom been relied on by South African taxpayers investing in America.

4.5 Effect of Cancellation of the Treaty

From the above analysis, the effect of cancellation of the Treaty is shown to have a meaningful impact only in a few isolated instances and in most cases in regard to individuals rather than business enterprises.

Insofar as the Treaty provided a mechanism for the prevention and avoidance of tax by the exchange of information (Article XIV), is concerned, this too will fall away, (but see 4.5.1 below) Again, as the exchange of information relates only to taxes covered by the Treaty and as it has already been established that the treaty is seldom used, the loss of this particular provision is unlikely to be of much significance to the taxpayer either.

4.5.1 Internal Revenue Service Access to Records

Although the Treaty will be cancelled, the Internal Revenue Service still has a formidable array of procedures available to obtain information.

The geographic reach of an Internal Revenue summons is considered co-extensive with the broad range of information which the I.R.S. is permitted to summon under the Internal Revenue Code⁶⁷. The code permits the I.R.S. to require the production of information that "may be relevant" in the determination of correct tax. This is an extremely broad standard of relevance, and the geographic reach of the summonses is said to be "as far as the standard of relevance is broad."⁶⁸

If a summons is not complied with, district courts have jurisdiction to compel testimony or production of records of persons residing in the judicial district if they may be "found there".⁶⁹

In *United States v National Bank of Chicago*⁷⁰ it was held that a United States court could enforce a summons for non-U.S. based records from the foreign branch of a U.S. company. Similarly, a United States

67. Saltzman, M.I., IRS Access to Non-U.S. Based Records: Tax Planning International Review Vol 3, No 8 August 1986 p.3

68. *United States v Toyota Motor Corp*: 354, (D.1983)

69. IRC(SS) 7604(b)

70. *In re Grand Jury Proceedings: Bank of Nova Scotia* 691 F.2d 1384(11th Cir)

Court can order a foreign corporation with a U.S. branch to produce records based abroad and the courts can also order a U.S. subsidiary to disclose information about its foreign parent.⁷¹

Section 745(6) of the code provides as well that a non-U.S. corporation, trust or individual filing a petition in the Tax Court may be ordered by the court to produce books and records (wherever they may be situated) for inspection by the Service. Failure to comply may mean the striking of the pleading or the entry of a default judgement.

4.6 Foreign Tax Credits

4.6.1 The South African Perspective

As the South African system of taxation is based in part on a concept of source instances of international double taxation do not occur as a natural consequence of international trade or investment.

It is not surprising therefore, that the South African tax system contains no general statutory unilateral method providing relief from international double taxation. (By "unilateral relief" is meant the relief granted outside any commitment contained in bilateral international agreements.)⁷²

71. Toyota case - see note 68 above

72. Meyerowitz, op.cit., p.586

It is noted however, that the Franzen Commission recommended that should South Africa adopt a "world-basis" rather than a source basis of taxation, a general foreign tax credit provision should be adopted.⁷³

There are nonetheless certain limited specific unilateral exemptions contained in the South African Tax Act. (See 4.6.1.1 below), but when international double taxation occurs, that does not fall within one of the specific provisions, a deduction of the foreign taxes paid on the income which is also taxable in South Africa is not allowed.⁷⁴ This is to say, the taxpayer will be taxed twice on the same income.

To the extent that the cancellation of the Treaty will remove the bilateral tax credit provisions available in terms thereof, the only surviving relief will be the limited unilateral relief available in terms of the Act.

4.6.1.1 Unilateral Relief in Terms of the Income Tax Act

- a) Foreign Government Officials do not pay tax on their salaries and emoluments if they hold office in the Republic as an official of any foreign government (other than that of Namibia) provided such

73. Franzen Commission: 2nd Report: Taxation in South Africa: Second Report of the Commission of enquiry into Fiscal and Monetary Policy in South Africa. November 1970 R. p.86/70 paras 26,261,262,263

74. Passos, op.cit. p. 231

person is stationed in the Republic for that purpose and is not ordinarily resident in the Republic. (Section 10(1)(c)(ii)).

- b) Any amount received by or accrued to an author or a work in respect of the assignment of or grant of an interest in a copyright in the work is exempt from tax if the amount is taxable in a foreign country. The exemption is not available to any person who is not the first owner of a copyright, nor does it apply to a company. (Section 10(1)(m)).
- c) Any person (including a company) liable for tax on royalties and similar payments is entitled to a credit for the foreign taxes paid against normal tax payable on the same income. The income must have arisen from the use, right of use of grant of permission to use patents, designs, trade-marks, copyrights, models, patterns, plans, formulae, motion pictures, videos or discs for use in conjunction with television or any sound recording or advertising matter used or intended to be used in connection with television.

The Receiver will, in addition, only allow the rebate if the taxes have been paid in the foreign jurisdiction without any right of recovery by the taxpayer. (Section 6(bis)).

- d) Persons who are ordinarily resident in the Republic and domestic companies are exempt from tax on interest on loans to or deposits in any banking institution registered under the Banks Act 23 of 1965 or any similar institution wherever it is incorporated, formed or established and wherever it carries on business, if the Commissioner is satisfied that :

- i) such loan or deposit was made through and retained in a branch of such institution outside the Republic; and
- ii) it was made for the purposes of any business carried on by such person before he became ordinarily resident in the Republic for the first time out of funds which the Commissioner is satisfied were derived entirely by the taxpayer from sources outside the Republic; and
- iii) the interest is subject to payment of income tax by such person or company under the laws of the country within which the loan or deposit is retained. Section 10(1)(w).

It is submitted that the requirement of sub-section (ii) above renders the scope of this relief very narrow indeed.

The credit available under this section may not exceed the normal tax payable on these receipts in South Africa. The section will also not apply to royalties and similar payments that are exempt from South African tax in terms of Section 10(1)(m).

Passos⁷⁵ points out an anomalous situation that arises where certain tax treaties require the taxpayer to be subject to tax on his income in his country of residence before the exemption from taxation on copy right royalties will be granted in the country of source. Section 6(bis) is however only

75. Passos, op.cit., p.232

triggered by the fact that the copyright royalties are chargeable to tax in the foreign country.

Although the treaty is not as favourable for either country as are certain others, it does provide a certain degree of relief under certain circumstances, most particularly in the avoidance of double taxation. With the cancellation of the Treaty now imminent, the effect of double taxation as a deterrent on trade and investment amongst the nations should not be overlooked.

As stated by Meyerowitz⁷⁶:

"A wise Government cannot afford to ignore this and will enquire into the desirability or otherwise of granting (unilateral) relief at the cost of losing part of its revenue."

4.6.2 The United States Perspective

Unlike the South African tax system, the United States has a well developed and often complex system for the granting and regulation of credit for taxes paid in foreign jurisdictions.

Whereas the principle of "source" in South African tax law has resulted in a poorly developed system for granting unilateral relief, the American system of taxing its

76. Meyerowitz op.cit., p.568(A4)

residents and citizens on their entire net income "from whatever source derived"^{76a} has had the opposite effect.

A detailed analysis of the American system is beyond the scope of this paper, but certain key parameters are discussed below.

The most important provisions of the code relating to the taxation of foreign source income of domestic taxpayers are contained in Sections 901 to 908 of the Code. The rules may be summarized as follows⁷⁷:

- a) Only foreign "income" taxes can be credited. Property taxes, excise taxes, value added taxes, sales taxes, etc do not qualify.
- b) Only the foreign tax itself is creditable, not interest nor penalties thereon.
- c) The taxpayer must bear the legal liability for the tax, not merely its economic burden.
- d) The credit is elective (but if elected, the taxpayer thereby waives deductibility for such taxes under Section 275) (see below).
- e) The election to credit foreign taxes must be made for all creditable taxes and cannot be claimed on a partial basis.

American citizens, resident aliens and domestic corporations who pay income tax

^{76a} IRC II

⁷⁷. Bitker and Eustice: op.cit., p.17-30

methods for gaining relief from double taxation:

- i) To deduct those taxes from income as presented by Section 164(a) or,
- ii) To claim foreign income taxes paid or accrued as a credit against United States income taxes as allowed under Sections 901 to 908 and 960.

It is generally considered⁷⁸ to be to the taxpayers advantage to elect the foreign tax credit rather than the deduction, as the credit produces a dollar for dollar offset against United States tax liability, while the deduction is limited to the amount of the foreign income taxes multiplied by the taxpayers marginal United States tax bracket (i.e. a maximum reduction for an individual of 70 cents United States tax for each dollar of foreign tax paid.)

Article IV(1) of the Treaty, specifically states that the United States "shall deduct from the taxes thus computed [in the United States] the amount of Republic taxes paid." It is submitted that this may be construed to exclude the option of the United States taxpayer electing a foreign tax "credit" as discussed above and being obliged to accept the "deduction" alternative. If this contention is correct, the cancellation of the Treaty will remove this restriction and allow the United States taxpayer to choose to use the more favourable tax "credit" alternative.

78. McDaniel and Auld, op.cit., p.80

5. "TREATY SHOPPING"

5.1 The Mechanism

The mechanism whereby third parties utilize intermediate companies incorporated in a jurisdiction that affords tax benefits not available between the contracting states on a direct basis is known as "treaty shopping."

The intermediate country of choice would not only offer reduced taxation on income derived from the state of ultimate investment, but would also exact only a light or token tax on the income passing through the intermediate company. It would furthermore allow the remittance of funds accumulated to the alternate parent company at low rates of withholding tax.

While the practise of "treaty shopping" is completely legal, it is often considered as being an abuse of the treaties which are by nature bilateral agreements⁷⁹.

5.2 Anti-Avoidance Measures

With or without the Treaty in place, South African enterprises wishing to invest in America will make use of at least some element of "treaty shopping" in order to minimize their tax liabilities.

79. Passos, op.cit., p.264

It is appropriate therefore, to examine the anti-avoidance measures available in foreign jurisdictions and in particular, those available to the United States.

After placing the American approach in perspective, anti-avoidance will be considered under the headings of "substance over form"; restrictions placed on 'treaty shopping'; and the United States second withholding tax.

5.2.1 The United States Approach

The Committee on United States Activities of Foreign Taxpayers⁸⁰ endorsed the view "that Treaty abuse is becoming an increasingly serious problem that deserves attention". However, the Committee felt that the objectionable "treaty shopping" does not automatically arise with every treaty that the United States negotiates and because of the additional administrative burden that a general avoidance clause would entail, the anti-avoidance provisions should be included only in those areas where there is a prescribed abusive "treaty shopping" situation or the possibility of such a situation.

The Committee believed that the function of the anti-avoidance section was to assist in

80. New York State Bar Association Tax Section: April 27 1982

the development of more uniform and reliable Treaty interpretation⁸¹. They believed further, that the inclusion of such a provision would contribute to a clearer and more consistent statement of United States policy as to the limits on entitlement to treaty benefits.

The recent thrust of United States treaty policy has been centered on three goals⁸² :

- "a) To sharply limit the so-called "treaty shopping" or third party use problem where a foreign taxpayer artificially claims 'residence' in a treaty country in order to obtain the benefits of treaty exemption or rate reduction provision;
- b) to expand the flow of information exchange between the two treaty parties, and
- c) to expand efforts at mutual assistance for compliance in order to prevent tax avoidance."

All new treaties contain a specific anti-abuse provision attempting to curb third country use of the treaty by taxpayers who are not "economically active" in the treaty country and attempts are being made to insert such a provision in the older treaties through renegotiation.

Article 16 of the American Model Tax Treaty is representative of this approach. (See 5.2.3 below).

81. Burke, W.L., Report on Proposed United States Model Income Tax Treaty; Harvard International Law Journal Vol 23 No 2 1983 p.286

82. Eustice and Bitker 1985 Cumulative Supplement op.oit., p.17-6

5.2.2 Substance Over Form

The rule that the substance of a transaction rather than its mere form controls tax liability is one of very wide application⁸³, and has too a relevance for international tax planning which often through the use of a "treaty shopping" mechanism qualifies for attack.

Many cases have come before the courts in various countries for determination as to whether they are genuine transactions or merely shams.

It is proposed here to examine the application of the "substance over form" approach in the United States, South Africa and the United Kingdom.

5.2.2.1 The Approach of the United States

It has long been the rule that transactions lacking in economic substance or reality will be disregarded for tax purposes⁸⁴ and in the United States, it was stated in *Gregory v Helvering*⁸⁵ that:

"We cannot too often reiterate that taxation is not so much concerned with the refinement of title as it is with actual command over the property taxed - the actual benefit

83. Spitz B.: *International Tax Planning* 2nd Edition 1983 p.115

84. Bitker and Eustice *op.cit.*, p.15-37

85. 293 U.S. 465 (1935)

for which the tax is paid and it makes no difference that such "command" may be exercised through specific retention of legal title on the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency."

This case was the first in America to apply the substance over form test and concerned the question as to whether a transaction which in form fell within the meaning of a corporate reorganization which was tax-free in terms of the legislation was in fact to be regarded as tax free. The taxpayer had arranged a series of transactions which resulted in the precise conditions contemplated in the tax-free reorganization provisions, but the court stated that the question for determination was whether what was done, apart from a tax motive "was the thing which the statute intended."

It was held at 469 - 470 :

"The whole undertaking though conducted in the terms of [the statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation as the transaction upon its face, lies outside the plain

intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

Two basic principles may be distilled from the **Gregory** case :

- i) The doctrine of business purpose under which a transaction would be ignored if it were found to have no business purpose, and
- i) the sham transaction doctrine in terms of which a transaction entered into merely for tax avoidance purposes would be disregarded as having no substance.

The approach introduced by **Gregory v Helvering** gained momentum through a series of cases over the years. In **Higgins v Smith**⁸⁶ it was held that if the court did not disregard the share transaction it "would permit the schemes of taxpayers to supercede legislation in the determination of the time and manner of taxation".

The next landmark decision was that of **Walter S. Heller v Commissioner of Internal Revenue**⁸⁷ where substance over form was extended to cover the "step transaction". In this case the taxpayer entered a series of transactions specifically designed to bring them within the meaning of certain tax provisions in order to create deductible losses. The court refused to regard the

86. 388 U.S. 473 (1940)

87. 2 TC 371 (1943)

individual transactions separately to determine their tax consequences, but they were to be regarded as steps forming part of one transaction only. The court held at 382:

"....for income tax purposes, the component steps of a single transaction cannot be treated separately ... and...effect is to be given to the substance rather than the form. In determining the substance of a transaction, it is proper to consider the situation as it existed at the beginning and end of the series of steps as well as the object sought to be accomplished means employed, and the relation between the various steps".

Hunter Manufacturing Corporation v Commissioner of Internal Revenue⁸⁸ applied the business purpose doctrine with approval, and in **Goldstein v Commissioner**⁸⁹ the court held that in order for it to apply the doctrine of substance over form, two elements need to be present:

- i) The taxpayers motive of tax avoidance, and
- ii) an element of sham and lack of business purpose.

In **Waterman Steamship Corporation v Commissioner**⁹⁰ a word of caution was voiced in interpreting substance over form in that "the solution of hard tax cases require something more than the easy generalisation

88. 21 TC 424 (1953)
89. 364 F(2nd) 734
90. 430(2nd) 1185

that substance rather than the form of a transaction is determinative of its tax effects", and that "Gregory does not per se preclude a tax payer from decreasing his taxes or avoiding them by methods permitted by law".

This approach was followed in *Grove v the Commissioner*⁹¹ where it was held at 487 that even where a tax avoidance motive is present,

"foresight and planning do not transform a non-taxable event into one that is taxable. Were we to adopt the Commissioner's view, we would be required to re-cast two actual transactions into two completely fictional transactions we can discover no basis for elevating the Commissions form over that employed by the taxpayer in good faith. Useful as the step transaction doctrine may be it cannot generate events which never took place just so that an additional tax liability may be asserted to do so would be to engage in a process decision that is arbitrary, capricious and ultimately discriminative to traditional notions of judicial reviews. We decline to embark on such a course".

It is clear from the above that the principles established in *Gregory Helvering* offer no single test applicable to all situations. As with most issues, the solution will depend on the facts presented at the time.

An application of the substance over form doctrine is illustrated in the analysis of Internal Revenue Rulings 84-152 and 84-153 discussed below at paragraph 6.2.2 et seq.

5.2.2.2 The South African Approach

While the South African Courts would appear to have accepted the substance over form approach⁹², this is considered⁹³ not to be the case as the courts look to all the available facts in determining the true basis of the transactions. If the South African court finds that the real nature of their arrangement is accurately reflected in the form selected as the vehicle, such form will be recognised. This may be illustrated in the case of **Commissioner of Customs and Excise v Randles Bros and Hudson Limited**⁹⁴, which is often considered to be the locus classicus in the development of the substance over form test in a South African fiscal context.

The facts related to a scheme devised to overcome difficulties arising out of a change in customs regulations, and the Commissioner had argued that the transactions entered into should be ignored on the basis that they had a customs duty avoidance motive and were sham transactions. Watermeyer JA rejected the Commissioners view and referring with approval to **Zandberg v Van Zyl** (1910 Ad 309) said:

92. CIR v Saner 1927 IPD 162 at 171; Bailey v CIR 1935 AD 204

93. Levin H.R.: The tax consequences of dividend stripping, unpublished thesis WITS 1984

94. 1941 AD 369

"I wish to draw particular attention to the words 'a real intention', definitely ascertainable, which differs from the simulated intention; because they indicate clearly what the learned Judge meant by a 'disguised' transaction. A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition of tax.

A disguised transaction in the sense in which the words are used above is something different. In essence it is a dishonest transaction: dishonest in as much as the parties to it do not really intend it to have, inter parties, the legal effect which it promotes to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition and not subject to the tax. Such a transaction is said to be 'in fraudem legis', and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between parties. Of course, before the Court can find that a

transaction is 'in fraudem legis' in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties."

Levin⁹⁵ commented in this regard as follows:

"Accordingly, the South African courts will determine the real intention of the parties to the transaction i.e. the real nature of the transaction. In doing so, the form in which the parties elect to cast the transaction will be a factor to be taken into account but the court is not obliged to accept the form selected by the parties. It is open to the court to disbelieve and disregard the form adopted by the parties if the evidence indicates that their intention was to enter into a different transaction to that which appears from the form. On the other hand, there is no principle that form must be ignored. If the court finds that the parties intended the real nature of the transaction to be that which is reflected by the form chosen by them, such form will be given effect to. Provided that the intention of the parties is real, the fact that tax avoidance may have been the prime motive behind the form selected by the parties does not make the form subject to attack on the basis that it is a disguised transaction. In such circumstances the Commissioner will have to rely on the invocation of an anti-tax avoidance measure".

95. Levin, op.cit., p.141

5.2.2.3 The Approach of the United Kingdom

As an aid to understanding the wide scope that the acceptance of a "substance over form" doctrine provides, it is instructive to trace the development of this concept through the British Courts. It is in this context of particular interest to note that in 1935, where the courts of the United Kingdom were deciding the **Duke of Westminster**⁹⁶ case, which was the foundation of the formalistic approach in tax matters, the United States Supreme Court decided **Gregory v Helvering** which was the foundation of their "business purpose" approach. While England now appears to have moved towards the American approach with **Furniss v Dawson**⁹⁷, the Canadian, Australian and New Zealand Courts moved in the opposite direction⁹⁸.

W T Ramsay Limited v IRC,⁹⁹ was considered by Lord Diplock in **Burmah Oil** ¹to have marked a "significant change in the approach of the House in its judicial role to a pre-ordained series of transactions into which are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of

96. IRC v Duke of Westminster (1936) AC1

97. (1984) AC 494 (HL) 375

98. Oakey Obattoir (Pty) Ltd v F.C. of T(Australia) 84 ATC 4718
Challenger Corporation Limited v CIR(New Zealand) (1984) 6
NZTC 61867

Stubart Investments Ltd v R 84 DTC 6305(Canada)

99. 1982 AC 300 (HL)

1. IRC v Burmah Oil Company Limited (1982) STC 301(HL)

those particular steps would have been payable."

Ramsay did not establish a principle that "form" should be preferred to "substance" or "substance to form", but merely that the court was not confined to considering a transaction in isolation, but where a combination of transactions appears, the court is entitled to determine and give effect to the real nature of the whole even if this results in a particular transaction being ineffective. The emphasis in Ramsay did however, appear to limit the scope of its applicability to transactions that were self cancelling.

Finally, in *Furniss v Dawson*, Lord Brightman indicated that where tax avoidance is the object of a series of transactions, the court should look not to the commercial effects or lack of them in the series but at the commercial purposes of the participants and determine the liability for tax according to the substance of the scheme as a whole and its end result. Intermediate steps may be disregarded even though the series of transactions are not self-cancelling and have enduring legal consequences:

"The formulation by Lord Diplock in *Burmah* expresses the limitations of the Ramsay principle. Firstly, there must be a pre-ordained series

of transactions or if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax, not "no business effect." If these two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end results. Precisely how that end result will be taxed will depend on the terms of the taxing statute sought to be applied."

In essence, the court held that although the transaction was completely genuine and fully intended, it had no purpose other than tax avoidance and for that reason, should be struck down.

In his thesis **"The Parameters of Tax Planning"**², H Vorster suggests (at page 133) that the results of the judgement of Lord Bighton in **Furniss v Dawson**, may be stated as follows:

- "i) There must be a pre-ordained series of transactions or one single composite transaction which may or may not include the achievement of a legitimate commercial (i.e. business) end.
- ii) There must be steps inserted which have no commercial (business) purpose (not "no business effect") apart from the avoidance of liability to tax.

². Vorster, H.: unpublished thesis, WITS 1984

- iii) If the two ingredients exist, the court may disregard the inserted steps for tax purposes and must then look only at the end result."

It is submitted that this analysis is often descriptive of the "treaty shopping" structures utilized by South Africans for investment in America.

5.2.2.4 Conclusion

While Justinian seems to have provided at least some authority for the South African courts to apply a substance over form test in 4.22.1 where he stated "In contractibus rei veritas potius quam scriptura perspicere debet" (in contract the truth of the matter rather than the writing must be looked at), and which sentiment is echoed in the maxim "plus valet quod agitur quam quod simulate concipitur" (which is really done is of more account than what is pretended to be done), the courts have not risen to the bait.

It is submitted that the reason the South African decision developed a different approach in this area from either that of the United Kingdom or the United States in the presence of the general anti-avoidance provisions contained in Section 103 of the Act which defines specific parameters within which a tax avoidance scheme may be attacked. Jurisdictions which rely however on specific anti-avoidance sections in their legislation have found the need to develop a sophisticated "substance over form" doctrine to cope with obvious avoidance schemes which nonetheless fall within the provisions of the statute.

This contention is borne out by the approach adopted in both Australia and Canada where the courts³ have categorically rejected the **Furniss v Dawson** approach and both jurisdictions which contain wide ranging anti-avoidance provisions.

An illustration of how the doctrine of substance over form has been applied by the United States in attacking "treaty shopping" structures is considered below in paragraph 6.2.2.1.

5.2.3 Treaty Restrictions to Combat "Treaty Shopping"

Measures that have been applied internationally in treaties to counteract treaty shopping include:

- a) The exclusion of certain entities from the ambit of a treaty. For example, in 1963 a protocol was added to the United States Treaty with the Netherlands Antilles which prohibited the reduction of withholding taxes below the standard rate of 30% if the Netherlands Antilles Corporation was entitled to the special rate of tax levied on investment and royalty holding companies which range from 2,4% to 3% of passive income⁴. (There is nonetheless an exception to this rule.)⁵
- b) The denial of benefits to corporations resident in a contracting state generally when a specified minimum ownership (or control) is directly or indirectly held

3. *Stubart Investments Limited v R* 84 DTC 6305 (Canada)
Oakey Abattoir (Pty) Ltd v F.C. of T (Australia) 84 ATC 4718

4. Netherlands/U.S. Double tax treaty 1948 as extended to the Netherlands Antilles by 1955 Protocol and amended by 1963 Protocol

5. 1963 Protocol, art 1(2)(a) and (b)

by persons who are residents of a third country with which similar benefits have been agreed. An exception may be made, for example, to corporations whose shares are traded on a recognised exchange in a contracting state.

Article 16 of the United States Draft Model Income Tax Treaty of 1981 in an example of this type of restriction and reads as follows:

"ARTICLE 16

LIMITATION ON BENEFITS

1. A person (other than an individual) which is a resident of one of the Contracting States shall not be entitled under this Convention to relief from taxation in the other Contracting State unless :
 - a) more than 75 percent of the beneficial interest in such person (or in the case of a company, more than 75 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:
 - i) individuals who are residents of the United States;
 - ii) citizens of the United States;
 - iii) individuals who are residents of Australia;
 - iv) companies as described in sub-paragraph (b); and
 - v) the Contracting States;

- b) It is a company in whose principal class of shares there is substantial and regular trading on a recognised stock exchange in one of the Contracting States; or
 - c) the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as one of its principal purposes, the purpose of obtaining benefits under the Convention.
2. For the purposes of sub-paragraph (1)(b), the term "a recognised stock exchange" includes, in relation to the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc.
3. Where:
- a) income derived by a trustee is to be treated for the purposes of this Convention as income of a resident of one of the Contracting States; and
 - b) the trustee derived the income in connection with a scheme a principal purpose of which was to obtain a benefit under this Convention,

then, notwithstanding any other provision of this Convention, the Convention does not apply in relation to that income."

The United States views⁶ the model treaty program as indicative of the results that the country would like to and realistically expects to achieve in its income tax treaty negotiations. It should provide a focus for formulating and publicizing basic treaties policies of the United States and should serve as a centralized reference aid in the

6. Burke: Harvard International Law Journal op.cit., p.225

proper interpretation of both existing and future treaties.

With this philosophy in mind, the United States includes a Section 16 equivalent (amended slightly to take cognizance of particular requirements)⁷ in all its new treaty negotiations or renegotiations of existing treaties.

It is submitted that if the United States/South African Treaty was not being cancelled, pressure would have soon been imposed from the United States for its renegotiation. Of more significance however, (and this would apply with or without the Treaty in place) is that an attempt is being made by the United States to include Article 16 in the treaties with the Netherlands having recently succeeded in doing so with the Netherland Antilles. If this is successful many traditional off-shore structures used by South Africans for investing in the United States will need to be re-examined.

5.2.4 United States Second Withholding Taxes

Foreign corporations may be required to withhold United States Tax on payments by it to non-United States residents. This is known as the "second withholding tax"⁸ and

7. See in particular the renegotiated US/Netherlands Antilles treaty signed 8th August 1986

8. International Tax Systems Release 6 B4.5.6 p.1,747

arises where a foreign corporation derives 25% or more of its gross income for the three previous years from sources within the United States and pays this income to non-residents in the form of dividends or interest⁹.

This is an extension of the principle of "effectively connected" income and ensures that non-residents pay United States tax if the income was earned direct and not through an intermediate company. However, the provisions of most double tax treaties with the United States exempt dividend and interest from the provisions of these withholding taxes. See discussion above at paragraph 3.2.2 for recent changes in the law affecting this topic.

With royalties however, Section 861(a)(4) of the Code provides that royalties for the privilege of using a patent in the United States are treated as income from sources within the United States regardless of who earns the income.

Section 871(a)(1)(A) imposes a tax of 30% of the amount received from sources within the United States by a non-resident alien as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable annual or periodical gains,

9. IRC 5861(a)(1)(C) read with IRC 1442

profits and income. Sections 1441-2(a) and 1871-7(b) of the regulations provides that royalties are included in the items of income for which the withholding tax must be paid.

The issue was interpreted in Revenue Ruling 80-362 which provided that withholding tax must be levied on royalty payments to non-treaty residents who have interposed a conduit company for the purposes of reducing United States withholding taxes. The facts of the ruling were as follows :

"A, a citizen and resident of a country other than the United States or the Netherlands, licenses the United States rights on a patent to X, a Netherlands corporation unrelated to A. X agrees to pay A a fixed royalty each year in return for the patent license. X then relicenses the patent to Y, a United States corporation, for use in the United States. Y agrees to pay X royalties based on the number of units produced by Y each year under the patent. X's fixed royalty to A is not contingent upon the receipt of the royalties from Y. A's royalty income is not effectively connected with the conduct of trade or business within the United States within the meaning of Section 871(b) of the Internal Revenue Code .

The United States-Netherlands Tax Convention exempts royalty payments from the United States to the Netherlands from withholding taxes. There is no income tax convention between A's country of residence and the United States."

It was held in the ruling that the royalties from X to A are not exempt from taxation since there was no treaty between A's country of residence and the United States providing for such an exemption, as the royalties are paid in consideration of the privilege of using a patent in the United States.

In effect therefore, the conduit is ignored and the withholding tax applicable between the United States and the country of the ultimate beneficial receiver of the royalty payments is imposed. The approach taken here is reminiscent of that adopted in Revenue Ruling 84-152, discussed below at page 87.

As discussed above (p. 29), the new branch level tax has been introduced and includes a repeal of the so-called "secondary withholding tax." However, it is submitted that Ruling 80-362 will not automatically lose its relevance, as the branch level tax will not override the provisions of the treaties in all instances. It is submitted further that where the treaties are not overridden, Ruling 80-362 will still be relevant where a conduit company is used in circumstances similar to those quoted in the ruling.

However, the anti-treaty shopping provision as expressed in the branch-level tax

amendment provides¹⁰ that where treaty shopping occurs the branch level tax will override any existing or subsequently enacted treaty provision to the contrary (with certain exceptions) and apply the branch level tax. For these purposes "treaty shopping is deemed to exist if more than 50% (in value) of the stock of the foreign corporation is owned directly or indirectly or constructively by persons who are not residents of the country in which the corporation is organized.

This latter provision may be seen therefore as yet another statement of the attitude of the United States authorities to the unacceptability of "treaty shopping."

10. Fogarsi, A, and Renfro, D: Proposed U.S. Branch Level Tax:
Taxes International. Issue 74 December 1985 p.3

6. FINANCING CONSIDERATIONS

6.1 The "Thin Capitalization Rule"

The organizers of a corporation in the United States have freedom within the limits imposed by state law and business needs to create a capital structure comprising only share capital or a combination of share capital and debt. While the structure chosen will normally be governed primarily by non-tax factors, in some cases tax considerations will obviously play an important role.

While it is not necessary to canvass these considerations here, the cumulative effect of all the tax advantages of debt rather than capital may stimulate the excessive use of debt instead of equity investment in the corporate capital structure. Indeed, the attraction to gear the organization to its limit was considered so overwhelming, that it was feared that the increased fixed annual charges which were required to service the debt "would help to bring on insolvency with consequent economic dislocation and losses both to the enterprise and the national economy."¹¹ Needless to say, a debate raged in the United States over the need to regulate the capital structure of a company from the 1930's when it was first

11. Bitker and Eustice op.cit., p.4-3

raised by the scholars of corporate finance. In 1969 Congress enacted Section 385 authorizing the Department of Treasury to issue regulations determining whether particular types of corporate interests were to be treated as share capital or debt. In essence the Internal Revenue Service must be satisfied that the debt is true debt and not in substance equity. Should the I.R.S. not be convinced and succeed in treating the debt as equity, the interest deduction would be disallowed and payments of both interest and principal could be treated as dividends to the foreign parent and be subject to withholding tax.

Factors which may (but need not) be considered in the regulations include^{11a}:

- "a) Whether there is a written unconditional promise to pay on demand, or on a specified date, a fixed amount of money in return for an adequate consideration and to pay a fixed rate of interest (i.e. the formalities of the instrument and the transaction giving rise to it.);
- b) whether there is subordination to, or a preference over other debts;
- c) the rates of debt to equity;
- d) whether there is convertibility into stocks, and
- e) the relationship between stockholdings and holdings of the interest in question (i.e. whether the doubtful debt is held pro-rata to the equity interests.)"

11a Gitker and Eustice. op.cit., p.4-15

Several cases¹² attempted to define the correct debt equity ratios and a number of decisions held that the corporations "equity" was too "thin" to support the purported "debt" structure. Various tests have been laid down but the courts have recognised that what is excessive in one industry may be normal in another and that companies vary in their financial requirements even in the same industry.

The following guidelines indicate when a loan from a shareholder to its subsidiary will be regarded as bona fide debt. In general they require :

- i) A debt to equity ratio of 3 to 1 or less for related party debt;
- ii) A debt to equity ratio of 10 to 1 for all debt;
- iii) Interest and principal must be timely paid under the terms of the instrument.

The significance of the thin capitalization rule for the South African investor is discussed further below.

6.2 Choice of Debt Structure

6.2.1 Finance Companies

In terms of the Tax Reform Act of 1984 the thirty percent withholding tax on certain

12. John Kelley Co v CIR 326 U.S. 521(1946); Dobkin v CIR 15TC 31(1950) Kraft Foods Co v CIR 232 F.2d 118

interest paid by United States corporations and government agencies to foreign investors on bonds issued after July 18, 1984 was repealed.

Before the repeal, a flat rate of 30% was assessed on the gross amount of interest paid to foreign investors by United States borrowers as modified by double tax treaty provisions. Because the withholding tax reduced the return to foreign investors, it impaired the ability of United States corporations to compete in foreign capital markets, particularly in the Eurobond Market where most other bond issues are exempted from withholding taxes by foreign governments¹³. United States borrowers were however able to circumvent the withholding tax problem by establishing a finance subsidiary in a third country that enjoyed a favourable tax treaty with the United States. For example,¹⁴:

"Prior to the Tax Reform Act it was considered acceptable for U.S. Corporations raising funds in the Eurodollar Market to form Netherlands Antilles companies to raise funds themselves and issue loans for the equivalent amount to

13. Kung.F.H., Taxation: Repeal of thirty percent withholding tax on interest paid to foreigners. Harvard International Law Journal Vol 26 1985 p.304

14. International Tax Systems release 6 B4.1.5.2 p.1,745

the United States parent. Interest payments to the Antilles finance vehicle were deductible for United States tax purposes and no withholding tax needed to be levied on such interest payments from the United States, provided that the standard [forms] were completed. In their turn, the Antilles tax authorities would levy the investment company a rate of 30% on a minimal spread of one quarter of 1% of the amount of the loans if the lender was a bank, or 1% in all other cases, so that in view of the absence of any United States or Antilles withholding taxes levied on interest payable by Netherland Antilles corporations to non-residents, virtually no tax would be imposed on interest receivable by the ultimate lenders."

With the growing concern expressed by the United States over the use by foreign nationals receiving the benefits of a tax treaty to which their home countries were not a party, the repeal was made law.

The repeal applies to two categories of debt: registered debt and bearer debt, the latter of which is exempted provided that the issue has received a statement that the beneficial owner of the securities is not a United States person¹⁵.

Some confusion appears however, to exist with the meaning of "Registered Debt". Although Section 127(a)(1) of the Tax Reform Act of

15. Sections 127(a)(1) and (b)(1) of the Tax Reform Act of 1984

1984 defines "registered" form as having the same meaning given to it in I.R.C. 163(f), that section does not specifically define the term. Furthermore, although I.R.C. 163(f) does not confine registered debt to public offerings, the Treasury Department has publicized its position that the repeal does not apply to private offerings.¹⁶ As Treasury releases are not legislative in character, but serve merely to clarify provisions contained in statute law, their position as stated above is open to challenge in court.

Not all interest on registered and bearer obligations are however exempt. Interest is not exempt if it is paid to a foreign bank, a controlled foreign corporation or a person who has or is considered to have a 10% interest in the United States issuer¹⁷.

In addition, the provisions empower the Treasury to reinstate the withholding of tax on non-registered debt interest and that paid to persons in foreign countries which he determines do not provide the United States with sufficient information to prevent tax evasion by United States persons¹⁸.

16. Kung, op.cit., 307 fn 22

17. Tax Reform Act sections 127(b); 127(b)(i) and 127(a)(i) and (b)(i)

18. Ibid., section 127(a)(1)

Kung¹⁹ submits that the provisions reflect congressional qualms about the corporate practise of issuing Eurobonds through the Netherland Antilles, in particular a strong wariness about United States persons feigning status as foreign nationals or using secret bank accounts to avoid taxation. The system also gave rise to an inefficient capital market for offshore funds. Kung comments further that while the repeal appears to have fulfilled one of its objectives of increasing longer-term capital flows to the United States, the repeal will almost certainly threaten the Antilles' continued creditability as a major financial centre.

6.2.2 The Viability of Finance Companies

Recent trends in the approaches taken by the Internal Revenue Service in regard to offshore financing companies, suggest a hardening of attitude towards the more traditional financing mechanisms.

This is illustrated by the issue of two rulings by the I.R.S. in this regard, namely Revenue Ruling 84-152 and 84-153. The effect of these two rulings is a classic application by the Treasury of the substance over form argument being used to overcome "treaty shopping abuse."

19. Kung, op.cit., p.308

Kung¹⁹ submits that the provisions reflect congressional queries about the corporate practise of issuing Eurobonds through the Netherland Antilles, in particular a strong wariness about United States persons feigning status as foreign nationals or using secret bank accounts to avoid taxation. The system also gave rise to an inefficient capital market for offshore funds. Kung comments further that while the repeal appears to have fulfilled one of its objectives of increasing longer-term capital flows to the United States, the repeal will almost certainly threaten the Antilles' continued creditability as a major financial centre.

6.2.2 The Viability of Finance Companies

Recent trends in the approaches taken by the Internal Revenue Service in regard to offshore financing companies, suggest a hardening of attitude towards the more traditional financing mechanisms.

This is illustrated by the issue of two rulings by the I.R.S. in this regard, namely **Revenue Ruling 84-152** and **84-153**. The effect of these two rulings is a classic application by the Treasury of the substance over form argument being used to overcome "treaty shopping abuse."

19. Kung, op.cit., p.308

M Burge²⁰ stated in this regard:

"Unless the issue of conduits and treaty shopping are resolved at high level in the United States Treasury, there will be few ways of investing in the U.S. using any kind of treaty financing vehicle with complete certainty. Most corporations obtain their funds for U.S. investment from a related entity and very few will benefit from the repeal of U.S. withholding tax on interest from portfolio investment."

The facts of Ruling 84-152 are summarized²¹ as follows: A Swiss corporation owns 100% of an Antilles and a United States corporation. The United States corporation required additional funds. On 1 August 1984 the Swiss corporation lent funds to the Antilles subsidiary at a 10% interest rate and that subsidiary in turn re-lent the funds to the U.S. subsidiary at an 11% interest rate. Neither the United States nor the Antilles subsidiary was heavily capitalized and all the interest was paid. The Antilles company was not entitled to the special Antilles tax benefits available to investment companies and was thus subject to the full corporate tax rate on its taxable income (i.e. the 1% spread, less expenses) because the Antilles subsidiary did not obtain "complete dominion and control" over the

20. Harrison, D.: Tax Planning International Review: Problems of Link and Finance Companies Examined at Conference 1985 p.27

21. Op.cit., p.28

funds due to the fact that it was required to pay interest to its Swiss parent. It was thus a purely tax motivated conduit.

The ruling itself states that :

"Article VII(1) of the Convention as extended to the Antilles provides generally that interest (other than mortgage interest) derived from sources within the United States by a resident or corporation of the Antilles not engaged in a trade or business in the United States through a permanent establishment shall be exempt from United States tax. Article 1 of the 1963 Protocol, which limits the applicability of Article VIII(1) of the convention, does not apply because S, [the Antilles Company] is not entitled to any of the special tax benefits provided under Articles 13, 14 or 14A of the Netherland Antilles National Ordinance on Profit Tax of 1960, as in effect on September 1, 1963 or to substantially similar tax benefits granted under any law of the Antilles enacted after that date.

Article VII(1) of the United States - Switzerland Income Tax Convention (Swiss Treaty) provides that the tax imposed by the United States or interest derived from sources within the United States by a resident or corporation of Switzerland not having a permanent establishment in the United States shall not exceed 5 percent.

Under the facts presented here, in order for the interest exemption

under Article VIII(1) of the Convention to apply to interest paid by R, (the United States Corporation such interest must be 'derived by' S from R. The words 'derived by' refer not merely to S's temporarily physical possession of the interest paid by R, but S's obtaining complete dominion and control over such interest payments. See **Aiken Industries Inc v Commissioner** 56TC 925(1971). In substance, S, while a valid Antilles corporation never had such dominion and control over R's interest payments but rather was merely a conduit for the passage of R's interest payments to P (the Swiss Company). The primary purpose for involving S in the borrowing transaction was to attempt to obtain the benefits of Article VIII(1) interest exemption for interest paid in form by R, a domestic corporation to S, an Antilles corporation, thus resulting in the avoidance of United States Tax.

This use of S lacks sufficient business or economic purpose to overcome the conduit nature of the transaction even though it can be demonstrated that the transaction may serve some business or economic purpose. See **Gregory v Helvering** 243 U.S. 465 (1935) and **Aiken Industries Inc v Commissioner supra**. Thus, for purposes of interest exemption in Article VIII(1) of the Convention, the interest payments by R will be considered to be 'derived by' P and not S."

It was therefore held that the interest payments by R were not exempt from taxation

by the United States under Article VIII(1) of the Convention, as extended to the Antilles. Further, such interest payments were subject instead to a 5% United States withholding tax under Article VII(1) of the Swiss Treaty.

The ruling thus in effect ignored the interest spread retained by the Antilles Corporation and treated the entire interest payment as if it had been paid to the Swiss parent.

Burge²² criticizes the ruling for ignoring the authority in *Coplin v U.S.* (6Cl.Ct. 115(1984)) which relates to the question of fair construction of the tax treaties and is in contrast with the view of the I.R.S. that treaties should be subject to internal United States concepts including the "business purpose" concept developed in U.S. Case Law.

The concept of "dominion and control" implies²³ then, that a mere interest rate differential is insufficient to validate the commerciality of any intermediate finance company, but such companies should have a commercial reason to exist other than merely being used for reducing United States withholding taxes.

Revenue Ruling 84-153 was decided in the same way on somewhat similar facts except that the

22. *Op.cit.*, p.28

23. *International Tax Systems, op.cit.*, p.1,745

transactions were outbound involving a United States corporation seeking access to foreign capital markets through the interposition of a Netherland Antilles finance subsidiary.

6.2.2.1 An Analysis of the Rulings

i) The status of I.R.S. rulings

Although the Treasury Department is the agency delegated the responsibility for negotiating bilateral income tax treaties, it is the service that administers such treaties once they are negotiated. In its administration the service will from time to time issue revenue rulings which interpret a variety of provisions contained in a treaty.

A revenue ruling is in effect the opinion of the service as to the Internal Revenue Codes consequences as applied to a particular factual situation.

A ruling can thus be declared invalid by a court.

ii) The legal basis for Revenue Rulings 84-152 and 84-153

These two rulings are considered²⁴ to have far reaching implications that go beyond the

24. Granwell, A.W. Treaty Shopping - Recent United States Developments: Tax Planning International Review Vol 12 No 9 September 1985 p.7

rationale of the currently outstanding precedents relating to the negating of Treaty Shopping Structures. It is moreover unclear how these rulings affected other rulings which were neither cited in these two rulings; nor revoked or modified by the rulings. In addition, since rulings apply retrospectively as well as prospectively many structures created in the past may be vulnerable to attack under these rulings.

Granwell²⁵ considers the arguments available to the Internal Revenue Service in attacking treaty shopping structures under two broad headings : (a) the disregarding of interposed treaty shopping vehicles as a separate entity, and (b) the treatment of a treaty protected entity as a conduit for its foreign owners.

- a) The Internal Revenue Service has in the past argued that the interposed treaty protected entity was in essence a sham and should be disregarded as a separate entity with the result that the ultimate beneficial investor is deemed to receive the income directly. Granwell believes that this argument has not been generally accepted by the courts because they have construed the issues very narrowly.

The basic test for when the separate existence of a corporation should be

25. Ibid., p.10

recognized for tax purposes was laid down by the Supreme Court in **Moline Properties Inc. v Commissioner**²⁶ where it was held that :

"The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain advantage under the law of the State of Incorporation or to avoid or comply with the demands of creditors, or to serve the creators personal or undisclosed convenience, as long as the purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

The quantum of business activity required is unclear but minimal activity such as signing leases or maintaining a bank account will be enough to constitute business activity within the meaning of the **Moline** test.

In **Perry R Bass**²⁷ the court held:

"The Test, however, is not the personal purpose of the Taxpayer in creating a corporation. Rather, it is whether the purpose is intended to be accomplished through a corporation carrying out substantive business functions. If the purpose of the corporation is to carry out substantive business activity it will not be disregarded for Federal tax purpose."

26. 336 U.S. 422(1949)

27. 50 TC 598(1968)

Additional factors considered by the courts as evidence of separate corporate existence include, maintaining an office, a bank account, adequate books and records, holding required meetings and filing tax returns where appropriate.

- b) The alternative and more effective attack of a Treaty Shopping structure is that the entity is not in substance the beneficial owner of the income received from the Service state, but is simply a conduit. The effect of this argument is as indicated above not to disregard the treaty protected entity but to treat the income received by such treaty protected entity in the capacity of a conduit for the ultimate foreign investor.

The judicial basis for a challenge under this approach lies in the case of **Aiken Industries Inc.**,²⁸ which was cited in both the rulings. The facts of the case were simply as follows : A parent corporation registered in the Bahamas (which has no tax treaty with the United States) made an interest bearing loan to its United States subsidiary. Under the Internal Revenue Code, interest payments by the subsidiary to its parent would have been subject to the U.S. 30% withholding tax. Shortly before the first payment was made, the parent transferred the U.S. corporation's notes to a newly created

affiliate company in the Honduras in exchange for notes in the Honduran corporation. The Honduras had (at that time) a treaty with the United States, which under certain conditions exempted the Honduran recipient from the 30% U.S. tax on United States source interest income.

Citing *Gregory v Helvering*²⁹ the court noted

:

"That the fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to what the parties are otherwise entitled under the convention."

On the facts however, the court held that the Honduran company was acting as a mere conduit in that it was committed to pay out exactly what it collected in interest and its role should thus be ignored.

It was held (at page 933) :

"As utilized in the context of Article IX of the treaty, we interpret the terms 'received by' to mean interest received by a corporation of either of the contracting states as its own and not with the obligation to transmit it to another. The words 'received by' refer not merely to the obtaining of physical possession on a temporary basis of funds

29. Op.cit., p.469

representing interest payments from a corporation of a contracting state, but contemplate complete dominion and control over the funds."

It was thus held that the Honduran company was not the beneficial owner of the interest and was thereby not entitled to the treaty benefit.

This finding reflects the United States' view that treaty benefits should only extend to the beneficial recipient and not to its agent.

In both Ruling 84-152 and 84-153, the Internal Revenue Service chose to attack the treaty shopping structure on the basis of a conduit rather than a sham type of argument. Granwell however questions whether the Internal Revenue Service has correctly applied Aiken to the situations referred to in the rulings:

"..Aiken involved an easy case for applying a conduit approach. In the case of the rulings [84-152 and 84-153] the omission of the terms of the transaction other than the rates of interest, raises a number of questions. Since the rulings do not disclose the terms, it is unclear whether the back-to-back transaction may be proximate in time or amount, or merely require the obligation for a payment of a portion of the funds received by it. It would appear

that the rulings cannot stand for the proposition that all back-to-back transactions can be ignored as conduits [referring to earlier Revenue rulings.] If this is true, when will a transaction be upheld or disregarded? This determination would appear to require an examination of the facts and circumstances. Such factors as potential for profit, risk or loss and business reasons for the transaction would have to be carefully analysed. It is for these reasons in large part that some have argued that because of the imprecise facts, the I.R.S.'s reliance in these rulings on the Aiken case as misplaced. Moreover, the analysis contained in the rulings has to be considered in the context of other service precedents bearing on the issue."

Whether treaty benefits can be denied on the basis that treaty benefits do not extend to entities that are organized in a treaty jurisdiction solely to receive the benefits of a treaty which would otherwise be unavailable was considered in *Johansson v United States*,³⁰

In this case the court denied the benefits of the Swiss treaty to a non-Swiss national who sought to come within its terms by establishing Swiss residence and creating a Swiss corporation through which he was employed. The purpose of the structure was to avoid United States tax on the winnings of a prize fighter in the United States.

The court found that the treaty benefits should be denied because the entity utilized had no legitimate business purpose, but was a device used by Johansson to divert temporarily his personal income in the United States so as to escape taxation thereon. This approach was to be found too in the Aiken case (at 934) where it was said :

".....we cannot find that this transaction had any valid economic or business purpose. Its only purpose was to obtain the benefit of the exemption established by the treaty for interest paid by a United States corporation to a Honduran corporation. While such a tax-avoidance purpose motive is not inherently fatal to a transaction (see *Gregory v Helvering*), such a motive standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes."

To avoid then an Aiken type challenge, it is essential to have a valid economic or business purpose and there should further be no direct or indirect link between incoming and outgoing payments.^{30a}

Aiken would therefore appear to require more than a tax avoidance purpose and Granwell submits that even with the issue of Revenue Ruling 84-152 it would appear that an attack based solely on bad purpose should not be successful:

^{30a} Granwell op.cit., p.12

"since if such had been the thinking of the service, why would they have to describe the conduit nature of the transaction?"

Granwell³¹ submits further that the two rulings extend the findings of Aiken which involved a back-to-back transaction with essentially identical terms, to apply to the common situation of an interposed treaty protected entity in a back-to-back situation with a nominal business purpose and a profit element.

Although the precise scope of the two rulings remains uncertain and will with time be refined by the courts, the rulings do for all practical purposes emphasize the strict attitude of the American authorities to treaty shopping.

6.2.2.2 Quo Vadis

Burge concludes that future investments into the United States using any kind of treaty financing vehicle are clearly limited by the implications of Revenue Rulings 84-152 and 84-153, and warns that :

"merely complying with the formal treaty requirements will [not] assure you of the treaty withholding rate.

The alternatives are not adequate. The use of public offerings, bank

31. Granwell op.cit., p.12

borrowings and finance companies capitalized only with equity could be solutions in some instances. However, these do not cover the needs of the majority of foreign investors who seek to lend funds to U.S. enterprises in circumstances other than those covered by the repeal of the withholding tax."

The ability to finance investments in the United States through the traditional routes has thus been severely curtailed.

Human ingenuity always tends to find means of circumventing the regulations, and schemes involving back-to-back financing though the banking fraternity often tend to offer a partial solution.

It is submitted however, that the majority of the back-to-back schemes will fail the test of substances over form as discussed above, with the results that the applicable withholding tax between the ultimate lender country and the United States will be imposed.

In considering any South African relationship with foreign countries, the current political implications need also be considered. By example, a procedure which would not have an interest withholding tax implication, would be for an American Bank to provide finance to the American investment on the strength of a

guarantee from a South African Banking institution. However, in terms of the moratorium on foreign debt repayments, no foreign bank would be prepared to accept a guarantee from a South African institution.

Perhaps the only completely risk-free and tax neutral financing scheme available to the South African investing in the United States is to pledge the American Shares or assets that form the subject of the investment to an American Bank.

In the South African context, the cancellation of the Treaty will have no effect, as with or without its existence, the withholding tax from the United States to South Africa would be 30%.

7. INTERNATIONAL TAX PLANNING

The foregoing analysis of the circumstances with which the South African taxpayer wishing to invest in America has to contend, has highlighted, inter alia, two points:

- a) With or without the Treaty in place, the South African investor in America will need to make use of a third party country that enjoys a more favourable tax treaty with the United States, and
- b) The heightened awareness and sensitivity to what is considered to be an abuse of treaties, the so-called "treaty shopping" phenomenon has given rise to a plethora of anti-treaty shopping measures. These new developments will make it increasingly difficult for the South African investor abroad to construct effective tax structures in the future.

It is beyond the scope of this paper to examine particular offshore structures but several general comments are appropriate.

7.1 The "Pure Tax Haven"

One of the basic functions of a double tax treaty is to eliminate double taxation between two countries. It therefore follows that if one country does not have a system of taxation, then the question of double taxation does not arise.³² For this reason,

32. Rostenkowski, D.: Rostenkowski: blasts the Bermuda Conference, Taxes International Issue 10 June 1986 p.12

the "pure" tax havens are not included in the world's network of double tax treaties. They should therefore not be used to receive income directly from high tax countries unless no foreign withholding taxes are levied e.g. West Germany does not levy withholding tax on interest paid to non-residents so it may be possible in such circumstances to use a pure tax haven entity as the lender receiving interest directly. In other cases, it may be necessary to interpose a company located in a more favourable treaty country where interest may flow without withholding taxes at any level.

In cases where income may flow with the least amount of foreign taxation, pure tax havens may be a useful vehicle for accumulating such income before ultimately distributing it to the beneficial owner.

Countries that may be considered as pure tax havens include³³ the Bahamas, the Cayman Islands, the British Virgin Islands, Liberia, Panama, Turks and Caicos and Vanuata.

7.2 The "Quasi-Tax Haven"³⁴

Many countries commonly used in international tax planning are erroneously disclosed as tax havens, but which in fact have a basic and

33. Saunders M.R., International tax planning: choosing the right Business Centre: Tax Planning International Review Vol 12 No 11 Nov. 1985 p.15

34. Ibid., p.14 Saunders refers to these as "Business Centres"

often very sophisticated system of taxation. It is therefore necessary to examine more closely the requirements necessary to convert a non-tax haven into a useful international tax planning tool.

Saunders³⁵ lists the following requirements :

- "1) There must be a virtual absence of corporate or personal taxation on income and capital; or if residents are subject to tax on income and capital, then there must be concessions offered entitling certain entities to tax exemption.
- 2) If income is to be received from outside the country, then either no foreign withholding taxes should be levied on such income or if they are, an appropriate double tax treaty should reduce such tax to a nominal amount or zero.
- 3) There must be no withholding taxes levied by the country on distributions or payments to non-residents.
- 4) The legislation of the country should have no anti-avoidance legislation that withholds any of the above advantages, particularly where non-residents are involved.
- 5) Exchange control regulations, if any, must not prohibit the free flow of money between group members.
- 6) The country must be politically and economically stable, to permit long term planning and provide security of assets.

35. Ibid., p.32

- 7) Communication to the country must be adequate and inexpensive, and the local labour force should be adequate to effectively manage the local entity."

An element of practicability is also a requisite in planning an offshore structure. The elimination of time zones insofar as is possible is often important, and the choice of location should also lend credibility to the whole plan. "pure tax havens" as listed above can rarely be used for establishing active manufacturing or trading companies and a structure whereby a Bahamian company is included as a vital trading link between a South African and European customer can only support the "substance over form" attack if it arises.

8. THE TAXATION OF INTERNATIONAL EXECUTIVES

Once an investment in the United States has been made, the question of staffing the new enterprise must be considered. Invariably, South African personnel will be required to assist on a temporary basis in the initial absorption of the new investment and certain persons will be transferred to the United States on a more permanent basis.

The taxation of these individuals must be considered.

8.1 Distinction between resident and non-resident aliens

Section 1 of the Internal Revenue Code imposes a tax on the taxable income of every individual and taxable income in turn is derived from the Section 61 definition of gross income i.e. all income from whatever source derived. The term "source" embraces both the type of income derived and the geographical location within which the income is produced.³⁶

Under United States law, an individual is subject to unlimited tax liability, that is, he is taxable on his world-wide income on the basis of either citizenship or residence.

36. McDaniel and Auld op.cit., p.38

More specifically, he is subject to tax if:

- (1) he is a citizen of the United States, regardless of where he is resident, or
- (2) he is a resident of the United States regardless of citizenship.

8.1.1 Non-resident Aliens

All United States income is subject to personal income taxation, whether earned by a United States citizen, resident, alien or non-resident alien.³⁷ Thus, remuneration earned by a non-resident alien executive for work performed in the United States will be taxed if the remuneration is for services performed in the United States for or on behalf of a non-resident alien, individual, foreign partnership or foreign corporation that is not engaged in a trade or business in the United States unless the non-resident alien is not physically present in the United States for more than 90 days during the tax year, and compensation for such services does not exceed \$3 000.

The exemption is also dependent on the employer not having a permanent establishment in the United States.³⁸ Certain treaties (such as, for example, the South African United States treaty), may have more liberal provisions in this regard, extending both the number of days and the \$3 000 ceiling.

37. Wentworth, W.K.: Taxation of International Executives:
Deloitte Haskins and Sells: 1985 p.334

38. IRC 861(a)(3)

8.1.2 The Resident Alien

The 1984 Tax Reform Act provides that an individual should be treated as a resident of the United States for any calendar year or part of a calendar year if he meets one of the following tests :

- a) he is a lawful permanent resident of the United States at any time during a calendar year and has a relevant green card, although residency may only be deemed to take effect from the date when the individual first entered the United States, or
- b) he meets the substantial presence test, i.e. :
 - i) he is physically present in the United States for 183 days or more during the calendar year, or
 - ii) the number of days the individual is present during the current calendar year, plus one third of the number of days of physical presence during the preceeding year, plus one sixth of the number of days of physical presence during the second preceeding year equals or exceeds 183 days.

Unlike the United Kingdom rules³⁹ any amount of time spent in the United States in a day constitutes presence for that day, even if the executive was absent at midnight at the end of each day.

Exceptions⁴⁰ to the substantial presence test include situations in which the executive is

39. International Tax Releases op.cit., p.1,701

40. Ibid., p.1,701

present in the United States for less than 31 days in a current year; if the executive is present in the United States for less than 183 days in a year and can establish tax residence in a foreign country; or if the individual is a diplomat, teacher or student and does not intend to reside permanently in the United States.

8.2 Double Taxation Relief

A resident alien is allowed a credit against United States income tax for income taxes paid to foreign countries. The credit is limited to the amount of United States tax on the same income, although the excess foreign tax credit may be carried back two years and forward five years subject to the same limitation. Alternatively, foreign income taxes may be deducted in determining taxable income.

A resident alien is also entitled to a partial exclusion of income earned abroad if the resident alien is present in a foreign country or countries for at least 330 full days during a 12 month period. The annual exclusion is limited to \$70 000 (under the new Act) in 1985 and escalating up until 1990.

However, under the Treaty,⁴¹ the period of time required to be spent in South Africa is reduced to 183 days (Article II(1)(a), and no limitation is placed on the amount earned in South Africa, provided these earnings are taxed in America.

With the cancellation of the Treaty, the executive will become taxable on the income earned in South Africa and will have simply to rely on the \$70 000 exemption mentioned above.

8.3

The Treaty Provisions

In terms of the United States/South African Treaty, Article II(1) of the supplementary protocol provides that :

"An individual who is a resident of the United States of America shall be exempt from Republic of South Africa taxes, on profits or remuneration in respect of personal (including professional) services performed within the Republic of South Africa in any year of assessment if:

- a) he is present within with Republic of South Africa for a period or periods not exceeding in the aggregate 183 days during the year, and
- b) the services are performed for or on behalf of a person resident in the United States of America, and

- c) the profit or remuneration is subject to United States of America's Tax."

Article II(2) provides the reciprocal benefit to a South African resident earning remuneration in the United States and when the South African investor invests in America, it is possible that both Articles could be relevant to different employees.

The treaty is thus more generous than the American statute in that (a) for the non-resident alien it extends the period from 90 days to 183 days and has no limit imposed on the earnings, and (b) for the resident alien, the days presence outside the United States is reduced from 330 days to 183 days and again no limit is imposed on such foreign earnings.

In all instances the treaty provides for the avoidance of double taxation.

It is submitted that the cancellation of the Treaty will remove these benefits, particularly that of protection from double taxation in certain instances.

8.3.1 The South African employee working in the United States

With the cancellation of the treaty, the

South African resident employee, (i.e. the non-resident alien in America) working in the United States for longer than 90 days in a year may be taxed in America on his compensation paid in South Africa if it exceeds \$3 000 for that period (see above).

Now under South African law, the general principle applicable to the taxation of income from services rendered, places the service or originating cause of income from employment at the place where the services are rendered.

Broomberg⁴² points out that prima facie therefore, it makes:

"no difference to the tax liability of a South African employee whether his local employer sent him abroad or whether the local employer established a company abroad and the latter company employed the employee. In each case, according to the general rule, the source of income would be outside the Republic."

Section 9(1)(d)(bis) however alters this proposition and provides that an amount will be deemed to have accrued from a South African source if it accrues to any person by virtue of:

42. Broomberg, E.B.: Tax Strategy 2nd Edition 1983 p.137

"any service rendered or work or labour done by him outside the Republic during any temporary absence from the Republic is deemed to be from a source within the Republic provided that he is ordinarily resident in the Republic and the services are rendered or the work labour is done for or on behalf of any employer by whom he is employed in the Republic, whether the payment for such service or work or labour is or is to be made by a person resident in or out of the Republic and wheresoever payment for such service or work or labour is or is to be made."

If a foreign company is interposed as the employer, the provisions of Section 9(1)(d)(bis) will not apply and the employee will not be subject to tax in South Africa. It is submitted that with the cancellation of the Treaty, this mechanism for avoiding South African Tax and therefore double taxation became more significant than ever before. In circumstances where a South African employee is required to work for a while in the United States.

While the expression "temporary absence from the Republic" is not defined, Watermeyer J, held in ITC 1170⁴³:

"In my opinion it is not possible to lay down any hard-and-fast rule with regard to a time of absence which should be regarded as temporary.

Each case must be decided on its own facts and whether or not an absence is temporary must depend upon the circumstances of each particular case."

Nonetheless, Silke⁴⁴ reports that the Receiver does not invoke s9(1)(d)(his) if the temporary absence abroad extends over a period in excess of six months and that this concession is generated where the services are rendered in countries with which South Africa has no double taxation agreement.

8.4 Tax Planning for the South African Employee about to become a Resident Alien in the United States

From the foregoing, it is clear that an employee about to be transferred to the United States requires to do a certain amount of tax planning prior to his becoming a resident alien.

In view of the mechanical nature of the substantial presence test, it may be advisable for the employee to monitor accurately the number of days spent in the United States prior to his planned move to avoid adverse tax effects.

Furthermore, the employee should dispose of his South African capital assets prior to his qualifying as a resident alien under the

44. Silke op.cit., p.269

green card test or the substantial presence test, as should for example the family home be sold once he has become a resident alien, he may well be liable for tax on his capital gain tax (Section 871(a)(2)) in the United States.

While certain exemptions do exist to negate the capital gain tax liability, should the employee fail to qualify thereunder, he may well end up with a substantial tax liability and due to South African Exchange Control Regulations be unable to discharge the liability.

8.5

Moving Expenses

An employee or self-employed individual may deduct from his gross income the reasonable expenses of moving himself and his family from one location to the other provided the move is related to the commencement of work in a new location.⁴⁵

Within specified limits, deductible expenses include the cost of travel to the new location, transporting household goods and effects, pre-move house-hunting trips, temporary living expenses at the new location and the cost of disposing of the old residence and acquiring a new one.

The deductions are only granted if the expenses incurred for employment and the employee remains employed full-time for 39 weeks during the twelve month period immediately following the move.

Section 82 of the Code provides that any amount received or accrued directly or indirectly by a taxpayer from his employer as a payment or reimbursement of moving expenses must be included in the taxpayers gross income as compensation for services.

The employee is then allowed to deduct his expenses in terms of Section 272 to the extent to which they qualify as deductible moving expenses.

9. CONCLUSION

The need for South African companies to invest in foreign countries will continue unabated. The extent of heightened foreign public sentiment against South Africa is expected to make certain forms of investment increasingly difficult, but these will tend to be investments within the high profile consumer areas, rather than those that are more industrially based.

The trend in the approach being adopted towards international tax over the past few years, particularly by the United States, is set to continue for some time yet. This is to say, that tax haven structures are expected to remain under the spotlight at least until the United States has either, (a) renegotiated anti-avoidance sections into all the relevant treaties to which it is a signatory, or (b) rendered the use of tax havens inoperative by virtue of the aggressive application of the "substance over form" doctrine through the medium of Revenue rulings and other legislative enactments.

While the negotiation route takes longer to achieve the desired result, the continuous issuance of unfavourable rulings and the application of the principles enunciated therein, immediately raises the perceived risk of investing in the United States and dissuades the use of traditional tax haven structures.

The rate of change in the laws which regulate international taxation are further perceived to be entering a period of accelerating fluidity and dynamism which emphasizes the requirements for the chosen international tax structure to be designed with as much flexibility for change as possible.

The attributes required of the structure are those which facilitate its rapid and inexpensive move from one off-shore jurisdiction to another, so as to both remain ahead of the advancing tide of United States driven reform, as well as preserving the requisite tax savings.

Investment in the United States by South Africans have of late begun to require not only a requirement for reduced taxation on the income earned, but of increasing importance too, a need for secrecy as to the ultimate identity of the South African holding company.

While many foreign jurisdictions provide, in addition to their favourable tax laws, a degree of anonymity (for example the use of bearer shares coupled with minimal disclosure requirements) the disclosures required of foreign investors by the United States are often exhaustive.

Certain acquisitions will (if certain hurdles of size are exceeded) require ruling to be made with the Federal Trade Commission in terms of the Hart-Scott-Rodino Antitrust Improvement Act

of 1976. This filing requires the disclosure of not only the ultimate parent company of the acquiring company, but substantial detail regarding each and every other subsidiary of the ultimate parent, as well as information regarding any company which owns more than 5% of any of the companies disclosed in the filing.

A similar filing is required too, (where certain criteria are met), in terms of International Investment Survey Act of 1976, which while not as detailed as the Hart-Scott filing mentioned above, requires as well the disclosure of the foreign ultimate parent.

The confidentiality of the filings are protected to a certain degree by statute, but it is considered that this protection should not be relied upon if complete secrecy is fundamental to the investment being made.

Undeniably, investment by South Africans in foreign jurisdictions is likely to become more difficult to achieve, with fewer opportunities for efficient international tax planning. This is not to say that the investments will not take place, it merely emphasizes that a thorough investigation of the parameters in issue in making such an investment are more important than at any time in the past.

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