South African Institute of Tax Professionals

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The South African Revenue Service

Lehae La SARS

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PRETORIA

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BY EMAIL: policycomments@sars.gov.za

RE: DRAFT INTERPRETATION NOTE RELATING TO FOREIGN DIVIDENDS (SETION 10B)

Provided below are SAIT's comments relating to the draft interpretation note involving the taxation of foreign dividends (section 10B).

Before going into detail, we largely support the draft interpretation note and appreciate the comprehensive nature of the issues raised. Our comments mainly seek to clarify further ongoing practical issues not addressed and suggest that certain issues are better addressed outside the scope of the draft interpretation note.

1. Meaning of paid or payable (section 4.1.1(b) of the note)

   The term "paid or payable" is not that significant in respect of foreign dividends. This term has a more important role to play in respect of the dividends tax and the various withholding taxes. We would accordingly suggest that discussion of this issue be removed from this draft note so as not to create unintended repercussions elsewhere. The term "paid or payable" should instead be addressed more holistically rather than repeated in slightly different forms in separate SARS guidance addressing specific tax act sections. While the term is discussed in both the Dividends Tax Guide and the section 10B draft interpretation note, we are not sure how well co-ordinated both discussions apply in respect to one another. Both discussions admittedly overlap in part but the wording and emphasis differ, thereby possibly creating unintended disparities.

At a more technical level in terms of the note itself, we find the draft note a bit confusing. The first portion (end of section 4.1.1(b)) seems to be pushing the terms "paid or payable" towards "receipt or accrual". This push may be partly due to required co-ordination with the "receipt and accrual" foundation set out in section 10(1)(k). In the latter part of the note, the timing rules seem to be more in line with the Dividends Tax Guide (with the concept moving more in sync with cash-flow).[xxxx]
At a practical level, the concept of paid or payable needs to squarely address the following practical situations:

- Cash payments in respect of listed shares,
- Cash payments in respect of unlisted shares,
- Distributions of debt commitments (e.g. promissory notes, debentures and other "i-owe-you(s)") versus payment of those debt commitments,
- Debt set-offs (i.e. dividends amounting to debt cancellations),
- *In specie* dividends (e.g. distributions of shares held in companies other than the distributing company such as unbundlings).

We tend to favour an approach that treats the concept of "paid and payable" as reasonably congruous with cash-flow. This connection to cash-flow is important because payment of withholding taxes (e.g. for domestic dividends and other cross-border payments) requires available cash or assets. Hence, if an unlisted company declares a deferred cash dividend with the declaration (and legal rights) occurring on 15 June but only payable on 2 July, the "due and payable" date should be 2 July. This approach will be in line with the Dividends Tax Guide (and seemingly the latter part of the draft interpretation note). On the other hand, a distribution of a promissory note is an asset "in specie" that should trigger a paid or payable event even though the cash payment in terms of the note may be deferred (because the note itself is a stand-alone right that can often be independently transferrable).

2. Foreign dividends versus other forms of foreign payments (sections 4.1.1(e) and 4.1.3 of the note)

The draft note emphasizes distinctions involving interest-bearing debt versus dividend-bearing shares. However, the draft note says very little about the capital distribution versus dividend distribution

distinction in the case of a foreign company payor. While foreign return of capital distributions are discussed, these distributions are never fully compared or contrasted with foreign dividends (with only some implicit discussions occurring in the examples).

In effect, both foreign dividends and foreign return of capital distributions involve a "distribution or similar payment" with foreign dividends taking seeming preference. Presumably, if the tax laws of the applicable country treat the payment as a (non-deductible) "dividend" versus a "return of capital", this treatment should prevail for purposes of section 10B. The tax laws of many countries would treat the payment of distributions out of profit / earnings as dividends versus payments out of share capital / premium, the latter of which would be treated as return of capital distributions. If the tax laws are silent, the distinction should be determined by applicable foreign company law. This interpretation of the domestic and foreign dividend and return of capital definitions is implied but not expressly stated. We would suggest that the draft note address these issues.

One area of practical concern are foreign buybacks and liquidations. These distributions may *per se* fall outside both definitions. Many countries could view these distributions as being of a capital in nature at the shareholder-level regardless of whether the payments occur out of profit / earnings versus share capital / premium. If so, are these distributions viewed as *per* se return of capital distributions due to the *per se* capital gain result at the shareholder level? On the other hand, is it relevant whether earnings are reduced within the foreign paying company for purposes of the foreign tax law / company law? Presumably, the focus should be on foreign tax return or capital / earnings reduction so that the concept more closely matches the South African tax system.

3. Foreign company definition (section 4.1.2)

There is a generic discussion of the definition of foreign company that is not particularly helpful. Application to specific commonly used entities such as Limited Liability Companies and Dutch cooperatives would have greater value. Again, given the potential scope of this issue beyond section 10B, we would suggest that a separate interpretation note be utilised for this definition would be preferred so as not to create unintended consequences for or against the *fiscus*. The foreign company

definition applies in many circumstances and a comprehensive analysis from this definitional vantage point would make more sense.

4. Trusts (section 4.1.3(c) (opening and Example 9)

We agree that beneficial interests in a discretionary trust probably should not be viewed as "held" by a beneficiary for purposes of the 10 per cent minimum rule and other holding requirements of section 10B. However, what about *bewind* and other vesting trusts? While the income flows-through, what about the underlying "holding"? Even though the shares may be legally held by the trust, full beneficial ownership should effectively reside with the beneficiary.

A second question relates to the role of foreign versus domestic law. In particular, does one apply domestic or foreign law? Presumably, the foreign non-tax law should be the guiding principle; in which case, even discretionary trust holdings may represent a holding for the beneficiaries of a discretionary foreign trust.

Given the complexities and implications, these issues may be beyond the scope of the draft section 10B(4) interpretation given the larger implications. If so, we suggest that the whole discussion of trusts be dropped entirely and separately dealt with in terms of trust guidance.

5. *In specie* dividends in respect of JSE listed foreign shares (section 4.3.5))

We would suggest that an example be added to this portion of the draft note as a matter further clarity. The most prevalent form of *in specie* dividend in respect of JSE listed foreign shares would come as an unbundling of shares of a lower-tier foreign subsidiary. These foreign dividends will fall outside the dividends tax (see the "dividend" definition of section 64D) and be exempt under section 10B(4)(e)). This relief is in recognition of the fact that listed share unbundlings will often be exempt under the tax laws of the home foreign country.

6. Deductible dividends (section 4.3.6(a))

We agree that foreign dividends generating deductions for the foreign company payor should fall outside the scope of the section 10B exemptions as discussed in the draft interpretation note.

However, as a matter of clarity, the interpretation note should distinguish this situation from the situation where the deduction occurs at the recipient shareholder level.

More specifically, the United States does not provide a partial or full exemption when companies pay dividends to other companies. Instead, the United States provides relief against multiple forms of dividend taxation in respect of the same underlying earnings in the form of deductions when dividends occur between companies. For instance, assume Company A owns shares in Company B, and Company B distributes a dividend to Company A. In the United States, Company A must include the full dividend amount as gross income. However, U.S. tax law provides an automatic deduction against this gross income of varying percentages (e.g. 100, 80 or 70 per cent of the dividend received – section 243 of the Internal Revenue Code). This type of deduction is in lieu of the company-to-company exemptions normally found in commonwealth tax law and should accordingly be distinguished from company payor deductions (where hybrid / BEPS instruments would normally arise). Hence, the U.S. dividends-received deduction should not prevent application of the section 10B(4) foreign dividends exemptions.

7. <u>Indirect Dividends (section 4.3.8)</u>

The draft interpretation note touches upon certain aspects of section 10B(4) but misses key aspects. The note needs to focus more heavily on the concepts “with reference to” and “indirect”. The goal would be to emphasize improper windmill schemes versus incidental return flows.

We would suggest that an example be added to demonstrate how the “with reference to” concept applies in order to demonstrate the abuses of concern. In the typical abusive circumstance, interest payments are paid offshore based on a set formula with the foreign dividends returning in roughly comparable amounts. The net result is South African deductions matched with the return of exempt dividend income. Section 10B(4) is properly intended to override this mismatch. The formula of the returning dividends could be based on the initial cross-border interest (i.e. directly with reference to) or effectively matched (indirectly with reference to) against the initial cross-border interest.

Example. South African Company owns preference shares in a Foreign Special Purpose company that does not qualify as a section 9D controlled foreign company. Foreign Special Purpose Company borrows funds at Libor plus 2 per cent with the preference shares held by South African Company being obligated to pay Libor plus 1 per cent. The funds received by the foreign special purpose company are often secured in some way so they remain directed for their initial purpose (i.e. repatriation back to South Africa). These types of arrangements should clearly be held in violation of section 10B(4).

On the other hand, foreign dividends may be innocently trapped by the possible breadth of section 10B(4). A number of multinationals pay for incidental but recurring services offered by their subsidiaries. These services have no direct linkage with expected foreign dividends. However, profits from these incidental services could conceivably generate profits that are returned to South African as foreign dividends to the South African multinational.

Example. South African company owns all of the shares off foreign company that qualifies as a section 9D controlled foreign company. Foreign Company has an offshore business establishment of substantial size, which involves the provision of services. These varied services are provided to various customers, including the South African Company. Alternatively, a category of these services may be directed to the South African company. In most cases, the total cross-border services never amount to more than 5 or 10 per cent of total profits of the foreign company. The frequent question is whether the occasional unlinked dividend of Foreign Company triggers ordinary revenue under section 10B(4). We think that these incidental foreign dividends should fall outside section 10B(4) as a matter of interpretation (without going through the impossible task of specifically tracing earnings to dividends).

8. Clarification of Section 10B(5) (section 4.3.9)

This portion of the interpretation is quite helpful. While the goal of section 10B(5) is fairly narrow, the literal language is probably too broad. Therefore, the draft interpretation properly deals with the

main issue – i.e. treating foreign dividends through a chain of foreign dividends as falling outside section 10B(5).

The real question is what is the precise target of section 10B(5) (as well as section 10(3). As we understand it, the main goal of section 10B(5) is to ensure that the exemption for foreign dividends cannot be passed through intermediary products. For instance, annuity payments wholly or partially derived from foreign dividends should not be exempt (see explanatory memorandum to section 10B(4)). Similarly, financial product derivatives should also be in violation of section 10B(5). It is doubtful whether section 10B(5) is really needed to tax the cash bonus of Example 25 because this bonus would be taxable as ordinary revenue in any event.

We again thank you for the opportunity to comment on this matter and largely support the clarity that this draft note adds to the application of section 10B.

Yours sincerely,

Keith Engel

Chief Executive