South African Institute of Tax Professionals

1 July 2018

The South African Revenue Service
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BY EMAIL: policycomments@sars.gov.za

RE: DRAFT INTERPRETATION NOTE 93 (ISSUE 2): THE TAXATION OF FOREIGN DIVIDENDS

We write to comment on the draft interpretation note on the taxation of foreign dividends (issue 2) which has been updated primarily to reflect legislative amendments.

A. Section 10B(4)(a): Round-tripping Override of the Foreign Dividend Exemption

Section 10B(4) is a critical backstop to ensure that the foreign dividend participation exemption of section 10B(2) is not subject to abuse. The purpose of the foreign dividend participation exemption is to ensure that tax does not become a barrier to the repatriation of foreign subsidiary earnings back to South Africa. Unfortunately, certain round-tripping schemes previously existed where funds were shifted offshore and re-routed back to South Africa solely as a base erosion device. The movement of funds offshore occurred in deductible form (e.g. as interest, as a royalty or as service fees) and returned back to South Africa as tax-free dividends. Section 10B(4) ensures that this form of base erosion does not undermine the South African tax base. The key (as always) is the balance between the national objective of encouraging South African repatriations against artificial flows designed mainly or solely to undermine the tax base.

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We largely believe that the guidance in the interpretation note is helpful but request further clarification on specific points. Our main suggestions are to further highlight the actual avoidance techniques of concern and to ensure that certain subjective aspects of the anti-avoidance regime do not give rise to anomalous results.

- The trigger of section 10B(4)(a)(i)(aa) involving foreign dividends "determined directly or indirectly with reference to" deductible payments is generally well-understood but an additional example may be useful. For example, preference share dividends of a foreign company with a 5 per cent yield matched by cross-border debt owed to the foreign company of 5 per cent would be a clear linkage. A formula linkage would also be useful (with the dividend yield equalling the same yield as the interest less a percentage that represents a hidden fee).
- The trigger of section 10B(4)(a)(i)(bb)) involving foreign dividends that "arise[] directly or indirectly from" deductible cross-border payments is an important backstop to protect against artificial side-steps from the abuse outlined above. Unfortunately, the words are so broad that the words pick-up many situations where avoidance is not a driver (or even a consideration) for certain foreign dividends. The guidance in this area must accordingly be careful to draw this balance in what the interpretation note rightly identifies as a "facts and circumstances" approach. While no bright-lines can exist, we suggest a further set of examples.
    - Firstly, we note that dividends stem from a two-part process. The distributing company must initially generate net profits. A distribution (e.g. a dividend) can only occur once net profits exist. Hence, section 10B(4)(a)(i)(bb) should not apply where the foreign company's net income from the cross-border transaction is offset by corresponding losses. For instance, assume a foreign company has R1 million of pre-existing cash prior to 2017. Further assume in 2017 that the foreign company receives R350 000 of interest from a South African company, but that foreign company incurs R800 000 of net losses from its other activities during the same year. Under these circumstances, a foreign company distribution of R1 million should not fall within the anti-avoidance provision because the source of the cash cannot be the R350 000 of cross-border interest arising in 2017.
    - At a more basic level, if tainted cross-border payments are received along with other net income, how much of the foreign dividend falls within section 10B(4) – all or a pro rata portion of the foreign dividend?

- The examples contain an over-emphasis on CFCs. We submit that the CFC rules of section 9D contain many of their own anti-avoidance rules against passive income (e.g. interest and royalties) and against diversionary transactions (such as the rules triggering section 9D income when services are earned from a connected South African person (section 9D(9A)(a)(ii)). Given the plethora of these CFC anti-avoidance rules, most of the section 10B(4) examples should deal with foreign companies outside (or even deliberately escaping) the CFC regime. Section 10B(4) was mainly designed to target round-tripping outside of the CFC regime, such as independently controlled friendly special purpose vehicles (i.e. friendly facilitators). For instance, a foreign company may be mainly owned by a friendly financial institution. However, a South African company may be paying interest to that foreign company (outside the CFC regime) while holding participating preference shares in that foreign company. Both the interest and the preference share yield is somehow linked. It is this linkage that is key to the anti-avoidance rule of section 10B(4).
- Example 24 of the interpretation note: This example is missing some key linkages that would typically be present in practical cases of abuse. The facts fail to show the linkage between the South African (Resident Company B) and the dividend that round-trips back to the Resident Company A and B group. We suggest that the example be modified so that either Resident Company A or B own a special class of equity shares (i.e. participating preference shares) in the Foreign Company C and D group.
  - Note 1: We understand that the legislation does not appear to require this type of linkage between the South African payor and South African shareholder but suggest that the legislation be narrowed. Such an opened ended approach without this linkage is so overly-broad as to be a trap for the unwary and mostly impossible to uncover on audit.
  - Note 2: We agree that withholding taxes should be viewed as outside the 'subject to tax' exception because this tax applies only to normal taxes (see section 5(1)). Withholding taxes are not a 'normal tax' but separate taxes within the Income Tax Act. The rationale for this distinction should be made clearer in the interpretation note. (Query whether this outcome is correct as a legislative policy issue is another matter.)

- Example 25 of the interpretation note: This example is helpful in that it demonstrates a scenario where section 10B(4) will not apply because the technical service fees paid are negligible compared to the other business profits underlying the dividend and the technical fees were incidental in relation to the discretionary dividend. Given that the analysis is ultimately a facts-and-circumstances approach, we suggest some further examples.
  - Query. What is the nature of the tracing approach required for the linkage. If 5 per cent of the accumulated profits are tainted, does this mean that 5% of the subsequent dividend fall outside the participation exemption (or is all of the foreign dividend taxable). Is the mere existence of tainted profits sufficient to trigger the anti-avoidance rule if the tainted profits move beyond negligible amounts? Is a tracing of tainted profits to dividends required?
- Legislative note: Section 10B(4) is overly broad. The legislation needs to be narrowed to ensure that the payor and the dividend beneficiaries are somehow linked. The directly / indirectly test also needs to be narrowed so some form of avoidance purpose is required. SAIT will raise these concerns independently during the 2018-19 legislative Annexure C process.

B. **Section 10B(5): "Out of" Override of the Foreign Dividend Exemption**

We agree with the current views associated with section 10B(5), but the coherence of the interpretation note can be enhanced. It should be remembered that section 10B(5) is really the analogue to section 10(3)(a). The term foreign dividend applies only to foreign dividends – not to other payments of a different starting character merely because that payment is "out of "(i.e. economically derives from) a foreign dividend. Hence, the character of an annuity payment remains an annuity even if the annuity was ultimately derived from foreign dividends earned by the party paying the annuity. On the other hand, trust payments normally retain their underlying character for all tax purposes when paid to beneficiaries (in effect the foreign dividends are allocated to the beneficiaries, thereby retaining their underlying character).

- Note: The last paragraph on page 52 dealing with a beneficiary of a discretionary trust should link back to Example 9 of the interpretation note. The trust is a look-through entity so that the beneficiary is deemed to directly receive the foreign dividend of the trust (and the beneficiary fails to meet the 10 per cent threshold because the beneficiary fails to technically hold the requisite 10 per cent in the shares of the foreign company paying the dividend (with the trust directly holding the foreign shares instead)).

C. Example 13 – Section 10B(2)(c) Technical Point

At the end of Example 13, it is indicated that the non-exempt difference of R391 071 (R3 million – R2 608 929) is included in Resident Company A's income under section 9D(2). We query whether the gross amount is not rather included in gross income under paragraph (k) of the definition of "gross income" and the amount included in income is then reduced by the exempt amount of R2 608 929. This would be in line with the statement at the top of page 32.

We welcome the opportunity to comment on the draft guide and look forward to future engagements.

Yours sincerely

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