

EXPLANATORY MEMORANDUM

Title of instrument

The Double Taxation Relief (Taxes on Income) (South Africa) Order 2002.

Legislative Powers

This Order is made under section 788 Income and Corporation Taxes Act 1988 and section 277 Taxation of Chargeable Gains Act 1992.

Affirmative Resolution

This draft Order is subject to affirmative resolution. Further details of the double taxation agreement scheduled to the draft Order are annexed to this memorandum.

European Convention on Human Rights

The Paymaster General (Dawn Primarolo) has confirmed that, advice provided to her confirms that, the provisions of this draft Order are compatible with the European Convention on Human Rights.

Policy Background to the instrument

Double taxation Conventions aim to eliminate the double taxation of income or gains arising in one State and paid to residents of another State. They do this by dividing the taxing rights that each treaty partner has under its domestic law over the same income and gains. They provide additional protection for taxpayers by specific measures combating discrimination in tax treatment. More generally, Conventions benefit the taxpayer by ensuring certainty of treatment and, as far as possible, by reducing compliance burdens. Double taxation Conventions also serve an Exchequer protection role by including provisions to combat avoidance and evasion - not least by measures providing for the exchange of information between Revenue authorities. They also encourage and maintain an international consensus on the appropriate tax treatment of cross border economic activity and thus promote international trade and investment.

Regulatory Impacts

There are no significant regulatory impacts but taxpayers may, in some cases, have to make a claim to the Inland Revenue or the other country's fiscal authority in order to benefit from the convention. However, taxpayers will benefit from reduced compliance burdens and, in many cases, from having to deal with just one fiscal authority.

Financial Effects

The nature of a double tax convention is that one or both of the contracting states gives up all or part of their taxing rights so that a given source of income is taxed only once. Measured against a baseline of single taxation only, conventions do not therefore generally have an exchequer cost; rather, by encouraging cross border economic activity, they can lead to an increase in tax revenue. But where double taxation is unrelieved, the economic activity in question, and hence the higher tax revenue attributable to it, will often be only temporary.

Extent

The draft Order applies to the whole of the United Kingdom of Great Britain and Northern Ireland.

GENERAL

All the United Kingdom's recent Double Taxation Conventions largely follow the approach adopted in the OECD's *Model Tax Convention on Income and on Capital*. This Convention continues that approach. In addition, it reflects changes in policy and legislation in the United Kingdom since the entry into force of the existing Convention between the two countries, which this new Convention replaces.

NOTES ON DETAILS

ARTICLE 1 – PERSONS COVERED

The Convention is to apply to persons who are residents of one or both of the Contracting States (the United Kingdom and South Africa).

ARTICLE 2 – TAXES COVERED

This Article gives a definition of the taxes to which the Convention is to apply.

The existing South African taxes to which the Convention applies are the normal tax, the secondary tax on companies and the withholding tax on royalties.

The existing United Kingdom taxes to which the Convention applies are the income tax, the corporation tax and the capital gains tax.

The Convention is to apply also to any identical or substantially similar taxes subsequently imposed by either country in addition to or in place of the taxes mentioned above. A provision on these lines is usually included in our Conventions.

ARTICLE 3 – GENERAL DEFINITIONS

This Article defines a number of terms used in the Convention and provides a rule for determining the meaning of terms not defined in the Convention.

ARTICLE 4 – RESIDENCE

This Article establishes the meaning of "resident of" the United Kingdom or South Africa and lays down detailed rules for dealing with situations where individuals or other persons may be considered residents of both countries for tax purposes under their respective domestic law.

ARTICLE 5 – PERMANENT ESTABLISHMENT

The definition of a “permanent establishment” (PE) given in this Article departs from the OECD Model in certain areas. In particular, it expands the list of fixed places of business to include “an installation or structure for the exploration for natural resources”. It also provides that an enterprise is considered to have a PE if it carries on supervisory activities for more than twelve months in connection with a building site, construction, assembly or installation project. A final departure from the OECD Model is the inclusion, under the definition of a PE, of professional or independent services where the services or activities continue for more than 183 aggregate days in any twelve-month period in the fiscal year concerned.

Taken with Article 7, this Article prescribes the circumstances and manner in which businesses of one country may be taxed on their profits in the other.

ARTICLE 6 – INCOME FROM IMMOVABLE PROPERTY

This Article allows the country in which the property is situated to tax income from immovable property.

ARTICLE 7 – BUSINESS PROFITS

Unless an enterprise of one country carries on business in the other through a permanent establishment situated there, its profits will be taxable only in its country of residence.

Where the enterprise has a permanent establishment in the other country, that country will be entitled to tax profits attributable to the permanent establishment.

ARTICLE 8 – SHIPPING AND AIR TRANSPORT

This Article provides that profits of an enterprise from the operation of ships or aircraft in international traffic will be taxable only in the country in which the enterprise is resident. It also provides that profits derived from participation in a pool, joint business or international operating agency and profits from the incidental rental on a bareboat basis of ships or aircraft and from the incidental use or rental of containers shall likewise be taxable only in the country in which the operator is resident.

ARTICLE 9 – ASSOCIATED ENTERPRISES

This Article provides that appropriate adjustments may be made in determining the profits of an enterprise of one country where conditions made or imposed between the enterprise and an associated enterprise of the other country differ from those that would be made between independent enterprises.

Where such an adjustment is made to the profits of an enterprise by one country, the other country will make an appropriate adjustment to the amount of tax charged on those profits, in order to relieve the economic double taxation which might otherwise arise as a result of an adjustment by just one country. The competent authorities of each country may consult for this purpose.

ARTICLE 10 – DIVIDENDS

This Article contains the rules for the taxation of dividends paid by a company which is resident of one country to a resident of the other.

Paragraph (1) provides that dividends paid by a company resident in one country (the source country) to a resident of the other country may be taxed in that other country.

Paragraph (2) provides that such dividends will be exempt from tax in the source country if the beneficial owner is a company resident in the other country that controls at least 10 per cent of the voting power in the company paying the dividends. In all other cases the rate of tax in the source country will not exceed 15 per cent of the gross amount of the dividends, provided the beneficial owner is a resident of the other country.

Paragraph (3) defines the term “dividends”.

Paragraph (4) provides that where a resident of one country receives dividends from the other country and carries on business in that other country through a permanent establishment there, with which the holding from which the dividend arises is effectively connected, the provisions of paragraphs (1) and (2) shall not apply. The taxation of the dividends is then governed by Article 7 (Business Profits).

Paragraph (5) rules out the extra-territorial taxation by one country of dividends paid by a company which is a resident of the other country. The first country will not tax the dividends unless they are connected with a permanent establishment or a fixed base there or are paid to a resident of that country. There is a similar provision concerning undistributed profits.

Paragraph (6), an anti-abuse provision, ensures that the provisions of the Article will not apply if the shares or other rights in respect of which the dividend is paid were created or assigned mainly to take advantage of the Article.

ARTICLE 11 – INTEREST

This Article contains the rules for the taxation of interest paid by a resident of one country to a resident of the other.

Paragraph (1) provides that interest arising in one country and paid to a resident of the other may only be taxed in that other country, if such resident is the beneficial owner of the interest.

Paragraph (2) defines the term “interest”.

Paragraph (3) provides that where a resident of one country receives interest from the other country and carries on business in that other country through a permanent establishment there, with which the debt claim in respect of which the interest is paid is effectively connected, the provisions of paragraph (1) shall not apply. The taxation of interest is then governed by Article 7 (Business Profits).

Paragraph (4) provides that where, because of a special relationship between the payer and the recipient, the amount of interest paid is excessive, the relief under the Article will apply only to the interest that would be payable at “arm’s length”.

Paragraph (5), an anti-abuse provision, stipulates that the terms of this Article will not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the relevant debt claim to take advantage of the provisions of this Article by means of that creation or assignment.

ARTICLE 12 – ROYALTIES

This Article contains the rules for the taxation of royalties arising in one country and derived by a resident of the other.

Paragraph (1) provides that royalties arising in one country and paid to a resident of the other may only be taxed in that other country, if such resident is the beneficial owner of the royalties.

Paragraph (2) defines the term “royalties”.

Paragraph (3) provides that where a resident of one country receives royalties from the other country and carries on business in that other country through a permanent establishment there, with which the right or property in respect of which the royalties are paid is effectively connected, the provisions of paragraph (1) shall not apply. The taxation of royalties is then governed by Article 7 (Business Profits).

Paragraph (4) provides that where, because of a special relationship between the payer and the recipient, the amount of royalty paid is excessive the relief under the Article will apply only to the royalty that would be payable at “arm’s length”.

Paragraph (5), an anti-abuse provision, ensures that the terms of this Article will not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of

which the royalties are paid to take advantage of the provisions of this Article by means of that creation or assignment.

ARTICLE 13 – CAPITAL GAINS

This Article contains the rules for the taxation of capital gains arising in one country and paid to a resident of the other.

Paragraphs (1) and (2) provide that gains derived from the alienation of immovable property in one country by a resident of the other may be taxed in the country where the property is situated. Where gains arise to a resident of one country from the sale of certain shares (or rights deriving from a partnership or trust) whose value derives mainly from immovable property in the other country, they may be taxed in that other country.

Paragraph (3) provides that gains arising from the alienation of movable property relating to a permanent establishment maintained in the other country may be taxed in that other country.

Paragraph (4) provides that gains to a resident of one country from the disposal of ships or aircraft operated in international traffic shall be taxable only in the country where the taxpayer is resident.

Paragraph (5) provides that gains from the alienation of any other type of property will be taxable only in the alienator's country of residence.

Paragraph (6), an anti-abuse provision, ensures that an individual who emigrates may remain liable to capital gains tax in the country in which s/he was formerly resident in respect of disposals of property made within six years of his/her departure.

ARTICLE 14 – INCOME FROM EMPLOYMENT

Paragraph (1) provides that, in general, employment income of a resident of one country can be taxed in the other country if the employment is exercised there.

Paragraph (2) provides an exception to the general rule where an employee is present in the other country for not more than 183 days in any twelve-month period beginning or ending in the fiscal year concerned, the remuneration is paid by or on behalf of an employer who is not a resident of the other country and the remuneration is not borne by a permanent establishment which the employer has in the other country. Where all these conditions are satisfied the remuneration will be taxable only in the employee's country of residence.

Paragraph (3) provides that the remuneration of someone working on a ship or aircraft operated in international traffic can be taxed in the country where the operator is resident.

ARTICLE 15 – DIRECTORS’ FEES

The Article provides that directors' fees etc. can be taxed in the country of which the company paying them is a resident.

ARTICLE 16 – ENTERTAINERS AND SPORTSPERSONS

Paragraphs (1) and (2) provide that income in respect of the personal activities of entertainers and sportspersons can be taxed in the country in which those activities are exercised, whether it accrues to the entertainer or sportsperson or to some other person (e.g. a company controlled by him/her).

Paragraph (3) provides an exception to these rules where the visit of the entertainers or sportspersons is substantially supported by public funds of the other country or takes place under a cultural agreement between the two States.

ARTICLE 17 – PENSIONS AND ANNUITIES

Paragraph (1) provides that occupational pensions (other than pensions in respect of government service) and annuities will be taxable only in the country where the pensioner is resident.

Paragraph (2) defines the term “annuity”.

Paragraph (3)(a) provides that, contributions made by an individual who is employed in a country to a pension scheme in the other country, to which s/he was contributing immediately before departure from that other country (and which is accepted by the competent authority of the country where s/he is employed as generally corresponding to a recognised pension scheme in that country), shall be deductible for tax purposes and must be treated in the same way as contributions made to a pension scheme in the first-mentioned country.

Paragraph (3)(b) provides that the employer’s contributions to the pension scheme, as referred to in (3)(a), shall not be treated as the taxable income of that individual and shall be allowed as a deduction against the profits of the enterprise.

Paragraph (3)(c) defines the term “a pension scheme” for the purposes of sub-paragraph (a) and provides that such a pension scheme is recognised for tax purposes in a country if the contributions would qualify for tax relief in that country.

ARTICLE 18 – GOVERNMENT SERVICE

In general, remuneration paid to an individual in respect of services rendered to a country, or to a political sub-division or local authority of a country, will be

taxable only in that country. However, if the services are carried out in the other country by one of that country's own nationals resident there or by a resident who, although not a national, did not become a resident solely to render the services, then that other country will have the sole taxing right.

A pension paid in respect of services rendered to a country, or to a political sub-division or local authority of a country, will generally be taxable only in that country. But if the recipient is a resident and a national of the other country the pension will be taxed only in the other country.

These provisions do not apply in the case of remuneration or pensions arising in connection with a business.

ARTICLE 20 – STUDENTS AND APPRENTICES

This Article provides that payments for the maintenance, education or training of visiting students or apprentices will not be taxed in the country visited, provided the payments are made from sources outside that country.

ARTICLE 20 - OTHER INCOME

Paragraphs (1) and (3) provide that any item of income, wherever arising, not specifically covered elsewhere in the Convention, will be taxed by the country of which the owner is a resident, and may also be taxed in the other country if it is derived from a source in that other country.

Paragraph (2) provides that the provisions of Paragraph (1) will not apply, other than to income from immovable property, if the right or property in respect of which the income is paid is effectively connected with a permanent establishment maintained in the country of source. In that case, the provisions of Article 7 will apply.

ARTICLE 21 – ELIMINATION OF DOUBLE TAXATION

This Article sets out the methods by which double taxation is to be eliminated.

Paragraph (1) provides the details of how United Kingdom tax shall be allowed as a deduction against South African tax.

Paragraph (2) provides the details of how South African tax shall be allowed as a credit against United Kingdom tax. In the case of a dividend paid by a company resident in South Africa to a company resident in the United Kingdom controlling at least 10 per cent of the voting power in the paying company, the credit will take account of the South African tax payable by the South African company in respect of the profits out of which the dividend is paid.

Paragraph (3) provides that, for the purposes of paragraph (2), profits, income and capital gains owned by a resident of the United Kingdom, which may be

taxed in South Africa under the Convention, will be deemed to arise from sources in South Africa.

ARTICLE 22 - LIMITATION OF RELIEF

This Article provides that where any income or capital gain is relieved from tax in one country and tax is determined in the other country by reference to the amount remitted to or received in that other country, the relief in the first mentioned country is given only in respect of income or gains that is taxed in the other country.

ARTICLE 23 - NON-DISCRIMINATION

On lines recommended by the OECD, this Article provides that neither country shall impose discriminatory taxes (or requirements) on the nationals, permanent establishments and enterprises of the other. A proviso enables South Africa to impose tax on permanent establishments at a rate not exceeding by more than 5% its normal tax on companies.

ARTICLE 24 - MUTUAL AGREEMENT PROCEDURE

This Article permits a resident of one country, who feels that the actions of one or both countries will result for that person in taxation that is not in accordance with the terms of the Convention, to present his/her case to the competent authority of the country of which s/he is resident, or, if the case comes under paragraph 1 of Article 23, of the country of which that person is a national. It also provides that the competent authorities of the two countries may endeavour to resolve difficulties in the application or interpretation of the Convention.

ARTICLE 25 - EXCHANGE OF INFORMATION

This Article provides for the exchange of certain information between the competent authorities of the two countries. No information containing trade etc. secrets or information the disclosure of which would be contrary to public policy will be exchanged.

ARTICLE 26 – MEMBERS OF DIPLOMATIC OR PERMANENT MISSIONS AND CONSULAR POSTS

Paragraph (1) ensures that diplomatic or consular officials shall not receive less favourable treatment than they are entitled to under international law or under the provisions of special agreements such as the Vienna Convention on Diplomatic Relations.

Paragraph (2) ensures that relief from tax under the Convention will not be available to diplomats and their families in respect of income that has already be exempted from tax in one country by virtue of their diplomatic privileges.

(A foreign diplomat sent to represent his country in the UK is exempted from tax in the UK on income arising outside the UK by the Vienna Convention on Diplomatic Relations. If he could also claim relief from South African tax under the Double Taxation Convention as a resident of the UK he might therefore arrange to be exempted from tax (or substantially so) in both countries in respect of income arising in South Africa. It is not one of the purposes of the Convention to provide double exemption, and Paragraph (2) prevents this.)

ARTICLE 27 - ENTRY INTO FORCE

This Article provides that each country will notify the other that it has completed the procedures required by its law to bring the Convention into force. The Convention will enter into force on the date of the later of these notifications. It will generally take effect in the United Kingdom for income tax and capital gains tax from 6th April and for corporation tax from 1st April in the calendar year next following that in which the Convention enters into force. In South Africa it will take effect from 1st January in the calendar year following that in which the Convention enters into force.

It also provides that the United Kingdom/South Africa Double Taxation Convention signed in 1968 shall be terminated.

ARTICLE 28 – TERMINATION

This Article provides that the Convention may be terminated by either country giving at least six months' notice, following a minimum life of at least 5 years.

EXCHANGE OF NOTES

The Exchange of Notes contained in Part II to the Schedule constitutes a formal agreement between the Governments of both countries, and clarifies the way in which credit will be allowed in the UK for South Africa's secondary tax on companies.