

# A pre-implementation analysis of the new South African withholding tax on interest

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## **ABSTRACT**

*South Africa is in need of foreign direct investment (FDI) to increase economic growth and alleviate unemployment and poverty. To succeed in obtaining this FDI, South Africa must compete with the rest of the world for the available FDI. The global economic outlook is currently still uncertain and the growth of advanced economies are slowing down while Asia and Sub-Saharan Africa continue to grow at a steady pace. South Africa, as part of Sub-Saharan Africa, should take advantage of this growth on the African continent as well as internationally.*

*Although studies have been performed to ascertain the tax policies of countries, the role of taxation applied by countries and the effects of taxation on FDI, there have been few studies on the tax policies specifically in respect of withholding taxes on interest. The new South African withholding tax on interest, applicable to South African source interest payments to non-residents, has been proposed to be included in terms of sections 49A to 49H in the Income Tax Act (58 of 1962) and will become effective from 1 January 2015. These sections have been introduced to align the said withholding tax and the section 10(1)(h) interest exemption, applicable to normal income tax in respect of non-residents, to the withholding taxes on interest and interest exemptions applied globally. Attention should be focused on whether the aforementioned global alignment will be achieved with the introduction of this legislation as South Africa had previously applied a similar legislation called non-residents' tax on interest (NRTI) which appeared to be unsuccessful. Determining whether this legislation has been aligned with global practice will provide useful insight into whether this new legislation will promote, stagnate or be indifferent to FDI in South Africa, while at the same time not eroding the tax base with overly generous exemptions.*

*This study reviews and compares the taxes implemented globally specifically in relation to withholding taxes on interest in a selection of countries, namely the developing countries Brazil, Russia, India, China, Mozambique and Namibia and the developed countries Germany and Denmark. Other determinants which will also have an impact on the comparisons of these withholding taxes are, for example, normal and withholding tax interest exemptions and repo rates – all of which have been incorporated into this comparative study. Based on the literature reviewed and the comparative analysis, the*

*study concludes that the South African withholding tax on interest is effectively designed to keep attracting foreign lending in order to remain competitive in international markets. It is further shown that the South African legislation in respect of the section 10(1)(h) blanket interest exemption is aligned to that of global practice.*

**KEY WORDS:**

- BRICS
- Developing countries
- Developed countries
- Foreign direct investment (FDI)
- Interest
- Non-resident
- Normal and withholding tax interest exemptions
- Withholding tax

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**Table 1: Abbreviations used in this document**

<b>Abbreviation</b>	<b>Meaning</b>
BRIC	Brazil, Russia, India and China
BRICS	Brazil, Russia, India, China and South Africa
CFC	Controlled Foreign Company
DTA	Double Tax Agreement
EU	European Union
FDI	Foreign Direct Investment
GNI	Gross National Income
GNP	Gross National Product
IFDI	Inward Foreign Direct Investment
NRTI	Non-residents' Tax On Interest
NRST	Non-residents' Shareholders' Tax
SARS	South African Revenue Service
STC	Secondary Tax on Companies
TDCA	Trade, Development and Co-operation Agreement
UNCTAD	United Nations Conference on Trade and Development
UK	United Kingdom
USA	United States of America

## **CHAPTER ONE**

### **1.1 INTRODUCTION**

#### **1.1.1 BACKGROUND**

In the delivery of the 2012 budget speech, the South African minister of Finance, Mr Pravin Gordhan, stated that “[a]s a major mining economy, we should be benefiting more from the continued buoyancy in commodity markets internationally. We also need to take advantage of rising demand for agricultural and manufacturing goods. Some 85 million manufacturing jobs in China will shift to other countries over the years ahead.” He then went on to ask if South Africa has the right policies, conditions and boldness to enable South African businesses to gain from these immense shifts in the patterns of production and trade (SA, 2012c:5). Although studies have been performed to ascertain the tax policies of countries and the role of taxation applied by countries and the effects of it on FDI, there have been few studies on the tax policies, specifically in respect of withholding taxes on interest (Terhoeven, 2011:02).

Withholding taxes are used worldwide by taxation authorities as an administrative mechanism to trap the relevant tax before the non-resident escapes from the grasp of such authority (Roeleveld & West, 2007:1). South Africa levied a non-residents’ tax on interest (NRTI) which was a withholding tax levied from 1967 to 1988 on South African source interest payments to non-residents. NRTI had a similar application to non-residents’ shareholders’ tax (NRST) which was a withholding tax, albeit in relation to South African source dividends earned from 1962 to 1995 by a non-resident from a South African source (Mtawana, 2011:35). The Katz Commission pointed out that South Africa found itself in a more or less unique situation among competing developing economies in that non-resident equity investors were taxed at a comparatively higher rate than domestic equity investors, the difference being the imposition of NRST (Wood, 1995:33).

On 16 March 1988, the minister of Finance at that time, Mr Barend Du Plessis, presented the Department of Finance’s budget speech. It was the first budget following the publication of the Report of the Margo Commission which contained the

first steps on a planned path of tax reform. In his speech, the minister stated the following on tax reform: “Comprehensive tax reform does not happen frequently. One of its results is usually a redistribution of the tax load, which necessarily means that some taxpayers will ultimately pay less but others – unfortunately – more. This rearrangement of the tax load should therefore preferably take place gradually to avoid disruption as far as possible, and in this way the new objectives will be reached only after some years” (Anon., 1988:71). As part of the planned tax reform indicated above, NRTI was abolished with effect from 17 March 1988. The South African government had recognised that NRTI, although paid by non-residents, was effectively borne by the South African borrower (Anon., 1988:80).

The Income Tax Act (58 of 1962) (the “Act”) has once again been amended with the introduction of sections 37I to 37O during 2011 pertaining to withholding tax on interest, effective from 1 January 2013 (58 of 1962). The implementation date was, however, further deferred to 1 July 2013 in terms of the Taxation Laws Amendment Act 2012 (22 of 2012). These sections are further proposed to be replaced in terms of the draft Taxation Laws Amendment Bill 2013 (SA, 2013b:104). The proposed amendment would result in the deletion of sections 37I to 37O and the introduction of sections 49A to 49H which is essentially a replacement of the current sections 37I to 37O after effecting certain minor revisions. These sections will be effective from 1 January 2015 (SA, 2013b:118). The withholding tax will be subject to certain specific exemptions and general exemptions. Specific exemptions will apply in cases such as where the interest in question arises from the different spheres of the South African government, from any bank, financial assistance in terms of headquarter companies, listed debts, and collective investment schemes (58 of 1962). Furthermore, in terms of the general exemption, a foreign person will be exempt from the withholding tax on interest if the foreign person is a natural person who was physically present in the Republic of South Africa for a period exceeding 183 days in aggregate during the twelve months before the date on which the interest is paid. The foreign person will also be exempt from withholding tax if that person at any time during the twelve months before the date on which the interest is paid in respect of that debt claim carried on business through a permanent establishment in the Republic (58 of 1962). The new South African withholding tax on interest has been introduced into the South African tax legislation to align the section 10(1)(h) blanket interest exemption

with global practice so that South Africa can attract FDI without eroding the tax base (SA, 2010:69).

Under the provisions of section 10(1)(h) of the Act (58 of 1962), also referred to as the blanket interest exemption, non-residents have enjoyed a blanket exemption from normal income tax on interest from a South African source. This exemption has been available provided that the non-resident has not conducted business in South Africa through a permanent establishment or, if an individual, has not spent more than 183 days in South Africa during the twelve-month period before the date on which the interest is received by or accrued to that person (58 of 1962). This exemption has existed in the Act since its inception in 1962 and for many years prior to that in the Income Tax Act that preceded the current Act. This blanket interest exemption has provided tax planning opportunities, usually involving loans between related or connected persons or closely held companies where the borrower obtains a tax deduction for interest incurred, and the individual recipient obtains benefit from the exempt interest income (West, 2010:1).

In terms of global practice, most developed and developing economies presently exempt cross-border interest in relation to mobile portfolio debt and possibly incidental trade finance. Other forms of cross-border debt however remain fully taxable, subject to a flat rate form of withholding (SA, 2010:69). There are more generous forms of exemption which typically exist only through tax treaties where both countries believe that the cross-border interest will remain subject to a relatively high level of global tax (SA, 2010:69).

Interest exemptions were introduced in an effort to attract foreign debt capital to South Africa. The effort so far appears to have been successful and South African business has become increasingly integrated into the international community (Maxwell, 2008:1). Foreign investment in the area has as a result grown substantially over the past few years. With its advantageous location and a government receptive to FDI, South Africa certainly looks as though it is becoming increasingly competitive in global markets and therefore an international force to be reckoned with (Maxwell, 2008:1).

Since the section 10(1)(h) interest exemption has exempted all South African source interest paid or payable to non-residents (since non-residents are only subject to South African income tax in respect of income from a South African source), subject to the two exclusions indicated above, it has been overly generous from a competitive point of view by providing foreign debt with an advantage over local debt which lead to an erosion of the South African tax base (SA, 2010:69). With effect from the implementation date of the withholding tax on interest, the section 10(1)(h) interest exemption will be aligned with the withholding tax on interest. Should the interest, therefore, be subject to the withholding tax, it will be exempt from normal income tax and, likewise, if the interest is exempt from the withholding tax, it will be subject to normal income tax (58 of 1962).

The primary intention with the introduction of the withholding tax on interest is to align South African legislation in respect of the section 10(1)(h) interest exemption with global practice as explained above (SA, 2010:69).

Focusing on the above-mentioned information, the rationale for the study, the problem statement of the study and the objectives of the study are presented below.

### **1.1.2 RATIONALE FOR THE STUDY**

According to the Explanatory Memorandum on the Taxation Laws Amendment Bill 2010, there is a continued need for South Africa to attract foreign lending in the form of FDI and to remain competitive in the international debt capital markets (SA, 2010:72). FDI has been identified as a means for South Africa to acquire some funding to facilitate the provision of employment, alleviate poverty and, additionally, facilitate the transfer of knowledge and technology to improve and assist with South Africa's current socio-economic challenges (Terhoeven, 2011:61). However, it has been indicated that the blanket interest exemption has not achieved a fair balance between the attraction of foreign debt capital and the need to protect the tax base against potential erosion and has also not been in line with global practice (SA, 2010:72).

As a result of the blanket interest exemption, certain cycle schemes which allowed funds to be recycled to the payer have been created that involved many different forms of collusion so that interest is paid offshore so as to generate a deduction without any corresponding taxable income (Rood, 2010:1). The blanket interest exemption has also created an incentive for foreigners to fund businesses with higher amounts of debt capital as compared to equity capital. Although the thin capitalisation provisions attempt to limit some of this excess debt, these rules only act as a partial remedy (Fasset, 2011:167).

As already indicated, the previous income tax legislation regarding NRTI and the blanket interest exemption had its weaknesses. This highlights the main reasons for the introduction of sections 49A to 49H into the Act (58 of 1962). The new South African withholding tax on interest has been introduced to address the issues of the previous withholding tax. These issues include NRTI which was not effectively designed and the blanket interest exemption which was not aligned with global practice, as apart from the two exclusions indicated above, it exempted all South African source interest received by or accrued to a non-resident and was, thus, overly generous from a competitive point of view.

It is, therefore, important to ensure that the new legislation is designed effectively and that it addresses the factor of alignment of the blanket interest exemption to that of global practice while ensuring that a balance is achieved between attracting FDI and not eroding the tax base. It is also necessary to consider the legislation in terms of the current drive to make South Africa a headquarter destination for investing in Africa and the impact of the withholding tax legislation on such a drive (SA, 2010:72).

## **1.2 PROBLEM STATEMENT**

The purpose of this study is, therefore, to determine whether the new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to remain competitive in international markets and whether it will align the South African legislation in respect of the section 10(1)(h) blanket interest exemption with global practice.

### 1.3 OBJECTIVES

To address the problem statement, the study's objectives are:

- (i) To examine the previous South African withholding tax on interest relating to non-residents, including the reasons for its removal, and the income tax legislation prior to the new South African withholding tax relating to interest exemptions applicable to non-residents. This will be addressed in Chapter Two.
- (ii) To examine the new South African withholding tax on interest, including the reasons and motivation for the introduction of this new South African withholding tax on interest, the alignment with the section 10(1)(h) interest exemption and the legislative provisions of the withholding tax, including an overview of the sections 49A to 49H. The impact of the withholding tax on headquarter companies will also be examined. This will be addressed in Chapter Three.
- (iii) To examine the taxation of interest of non-residents in certain developed and developing countries. This will include examining the method of taxation, withholding taxes on interest, relief from double taxation in terms of double tax agreements (DTAs), normal and withholding tax interest exemptions and the repo rates implemented by these countries. This will be addressed in Chapter Four.
- (iv) To compare the withholding tax on interest with the taxation of interest earned by non-residents, relating to the selected countries' IFDI rankings, rates of withholding taxes on interest, normal and withholding tax interest exemptions, and repo rates implemented by the developed and developing countries. This will be addressed in Chapter Five.
- (v) To make conclusions and recommendations on the effective design of the new South African withholding tax on interest and whether it will align South African legislation in respect of the section 10(1)(h) interest exemption with global practice. This will be addressed in Chapter Six.

## **1.4 RESEARCH METHODS**

### **1.4.1. Research approach**

The literature review is conducted by obtaining an understanding and providing a summary of the range of past and contemporary literature (Bayat & Fox, 2007:35).

The present study uses historic research to analyse and obtain an in depth understanding of the previous withholding tax on interest and the reasons for its removal. Historical research which is largely a qualitative endeavor is used to describe past events and to present a factually supported rationale to suggest how and why they may have occurred (Leedy & Ormrod, 2013:170). The purpose of selecting this approach is to understand and also to explain the evidence, gathered from the data and the literature (Henning, Van Rensburg & Smit, 2004:3). The approach involves obtaining an understanding of withholding taxes, NRTI, including the factors and motivations surrounding its removal, and the current method of taxation applied to interest on a South African source for non-residents.

A comparative study will also be conducted. It will focus on the similarities and differences between withholding taxes and other determinants that have a direct and indirect impact on withholding taxes applied across the selected countries (Mouton, 2013:154).

Comparative studies can be performed using various different methods. Despite the type of comparative study used, research that crosses national boundaries are said to consider socio-cultural settings (Hantrais, 1995). Of late there has been a greater emphasis on contextualisation of comparative studies and cross-national comparisons are increasingly facilitating a means of gaining a better understanding of different societies, their structures and institutions (Hantrais, 1995). These comparative studies that compare data across countries and societies are known as cross-national and cross-cultural studies and are used to identify, analyse and explain similarities and differences across countries and societies (Hantrais, 1995). The present study focuses on a comparison of data across countries and therefore a cross-national comparative study is applicable.

The advantage of using a comparative study is that it allows for causal inferences between comparable items to be made which facilitate conclusions to be drawn about causal connections and associations (Mouton, 2013:154). This study makes causal inferences by drawing conclusions from the new South African withholding tax on interest by taking the effect of certain occurrences on other related determinants such as withholding and normal interest exemptions and repo rates into account. These inferences or associations will allow for comparisons of different viewpoints across different settings (Mouton, 2013:154). These cross-national comparative studies may also lead to new and exciting insights and therefore a deeper understanding of issues that are of central concern in different countries (Hantrais, 1995). In addition, it could lead to the identification of weaknesses in knowledge, it could point to possible further research and it could also assist the focus of analysis of the present study by suggesting new insights. Cross-national studies provide a means of confronting findings in an attempt to identify and highlight similarities and differences, not only in the observed information, but also in the search for possible explanations in terms of national similarities and differences (Hantrais, 1995).

The limitation of these comparative studies, however, is the degree of comparability of the cross-national information which is further influenced by the obvious constraints of differences in language and legislation (Mouton, 2013:154). The language barriers and constraints in obtaining updated legislations of the selected countries for this study provide evidence of these limitations associated with comparative studies. The ease with which consistent data can be obtained is also expected to affect the quality of the information regarding the selected comparisons (Hantrais, 1995). The above-mentioned limitations are compounded when comparisons are based on a secondary analysis of existing national data as it may not always be likely to apply agreed criteria uniformly (Hantrais, 1995). This limitation based on the use of secondary analysis was a factor in the execution of this study. However, a certain degree of uniformity was obtained by using tax summaries of Deloitte, Ernst & Young, PWC and PKF International limited. These cross-national comparative studies therefore demands more concessions in methods when compared to a single-country focus (Hantrais, 1995).

A comparative study will be conducted by the examination of the similarities and differences of the data in the form of numbers relating to the IFDI rankings, withholding tax rates, normal and withholding tax interest exemptions, and repo rates applicable to the study (Denscombe, 2007:254; Mouton, 2013:154). The comparative study will be performed using mainly data from secondary sources which are the written tax highlight summaries of the primary sources of information being the legislation of the respective countries.

Current legislation and literature on the withholding taxes on interest as well as other data obtained will be used in the comparative study. The legislation, literature and data will be considered to determine if the new South African withholding tax on interest has been effectively designed and if it will be implemented in order to align the South African legislation in respect of the section 10(1)(h) normal interest exemption with global practice.

#### **1.4.2. Research design**

As indicated, the study is focused on a literature review which consists of a selection of available documents on the topic and contains information, ideas, data and evidence (Hart, 1998:13). These are written from a particular perspective to express certain views on the nature of the topic, how it should be investigated and the effective evaluation of these documents in relation to the research (Hart, 1998:13). Data, textual evidence and its structure will be collected and examined and hence a largely historical research approach will be applied (Leedy & Ormrod, 2013:170). The review includes sources such as books, theses and dissertations, journal articles, newspaper and magazine articles, internet articles and electronic newsletters, articles by organisations dedicated to this field and publications by the South African government which include South African income tax legislation, explanatory memoranda and reports of commissions of inquiry.

The study uses a historical literature review to analyse and obtain an in-depth understanding of the previous withholding tax on interest and the reasons for its removal. The approach involves obtaining an understanding into withholding taxes, NRTI including the factors and motivations surrounding its removal, and the current method of taxation applied on interest from a South African source for non-residents.

The study uses a literature review to understand and discuss the reasons and motivation for the introduction of a new South African withholding tax on interest. The proposed sections 49A to 49H will be reviewed to include a background and overview of the new South African withholding tax on interest.

The study then proceeds by using a literature review to provide a background of the tax systems, specifically of withholding taxes on interest implemented by developed and developing countries. Focus areas will be on the method of taxation and normal and withholding tax interest exemptions implemented by developed and developing countries. A review of repo rates and tax rates will also be conducted to ensure that equitable comparisons can be made between the selected countries. The review of secondary sources namely tax summaries compiled by Deloitte, Ernst & Young, PWC and PKF is required due to the limited access of the income tax legislation of other countries as a source because of language barriers.

A comparison of the results obtained during the literature review is then made between South Africa and the developing BRICS countries, namely Brazil, Russia, India, China, the developing African countries Mozambique and Namibia and the developed countries Germany and Denmark. The focus will be on IFDI rankings, withholding tax rates on interest, normal and withholding tax interest exemptions and repo rates that were obtained.

The final step of this study will entail making inferences to answer the objectives by making interpretations, drawing conclusions and making recommendations on the basis of the data collected (De Vos, Strydom, Fouche & Delport, 2011:447). The interpretations, conclusions and recommendations will enable the addressing of the objective (v) and the problem statement on the effective design of the new South African withholding tax on interest and whether it will be implemented to align South African legislation in respect of interest exemptions with global practice.

#### **1.4.3. Countries to be considered:**

Developing countries, namely the BRIC countries, Mozambique and Namibia and developed countries, namely Germany and Denmark, will be considered.

### **1.4.3.1 Motivation for the selected countries**

#### **1.4.3.1.1 The BRICS countries**

South Africa became the fifth member of the BRICS group of countries on 24 December 2010 (Brand South Africa, 2011b). BRIC is an acronym that refers to the economies of Brazil, Russia, India, and China, which are seen as major developing economies in the world (Rosenberg, Not dated:1). BRICS, as it is known now that South Africa has become a member, is a powerful group of emerging economies which, according to the International Monetary Fund, will account for as much as 61% of global growth in three years' time (Brand South Africa, 2011b).

Brazil, Russia, India, and China were ranked 69th, 60th, 97th and 86th respectively in the Inward Foreign Direct Investment (IFDI) Performance Index which is a measure established by the United Nations Conference on Trade and Development (UNCTAD) to track competition between countries in respect of where FDI is focused. South Africa was ranked 128<sup>th</sup> in the IFDI Performance Index (UNCTAD, 2010). The admission of South Africa to BRICS as an emerging developing economy coupled with the fact that these BRICS countries all apply withholding taxes on interest and also use the source basis of taxation for non-residents will be used as a guideline to assess the withholding taxes in these economies in the present study.

#### **1.4.3.1.2 Developing African countries**

According to Zebst (2010:1), the African continent is playing a vital role in fuelling economic growth in emerging economic powerhouses like China, India and Brazil by supplying natural resources. Africa is therefore a worthwhile investment destination for multinational corporations from these nations making the continent an important area of potential market-led growth (Zebst, 2010:1). A population of close to one billion, half of whom are under 35 years in age, creates market and labour opportunities in abundance for the continent. Africa is now one of the world's fastest-growing regions and an analysis by *The Economist* found that over the ten years to 2010, six of the world's ten fastest-growing economies namely Angola, Nigeria, Ethiopia, Chad, Mozambique and Rwanda were in sub-Saharan Africa (Anon., 2011b:1).

South Africa is the economic powerhouse of Africa. Its location, sizeable economy, political stability and overall strength in financial services make it an ideal location for the establishment of regional holding companies by foreign multinationals (SA, 2010:77). South Africa is, furthermore, one of the world's largest producers and exporters of gold and platinum. Mining, services, manufacturing and agriculture compete with similar sectors in the developed world (The Heritage Foundation, 2012c:1). However, unemployment is high and poverty is widespread and in addition a majority of the population is poorly educated and lack access to basic infrastructure and services (The Heritage Foundation, 2012c:1). As a result of these positives and pitfalls, South Africa was ranked 128<sup>th</sup> in the IFDI Performance Index (UNCTAD, 2010).

Mozambique, which is South Africa's neighbouring country to the East is socio-economically speaking very similar to South Africa. It also held its first democratic elections in 1994 like South Africa and since then has been a model for development and post-war recovery (The Heritage Foundation, 2012a:1). Economic growth has been generally strong since the mid-1990s. Major exports include aluminium, shrimp and cash crops (The Heritage Foundation, 2012a:1). However, the country remains poor and troubled by state-sanctioned monopolies and inefficient public services. The country's informal sector accounts for most employment (The Heritage Foundation, 2012a:1). Mozambique was ranked 19<sup>th</sup> in the IFDI Performance Index which is way ahead when compared to South Africa's 128<sup>th</sup> ranking (UNCTAD, 2010).

Namibia, South Africa's neighbouring country to the West, has an economy which is closely linked with that of South Africa, its major trading partner and former administering power (The Heritage Foundation, 2012b:1). The country is rich in minerals, including uranium, diamonds, copper, gold, lead and zinc. However, weak infrastructure, high unemployment rate and problems in the utility and electricity sectors have hindered growth (The Heritage Foundation, 2012b:1). About a third of Namibia's population depends on subsistence agriculture and herding for their livelihood (The Heritage Foundation, 2012b:1). Official pressure on white and foreign landowners to sell their property to the Namibian government, so that "historically

disadvantaged” and landless Namibians can be resettled, has resulted in expropriations (The Heritage Foundation, 2012b:1). State-owned enterprises have operations in many key sectors (The Heritage Foundation, 2012b:1). Namibia was ranked 27<sup>th</sup> in the IFDI Performance Index which is once again leaps ahead when compared to South Africa’s 128<sup>th</sup> ranking (UNCTAD, 2010).

The similarities between South Africa, Mozambique and Namibia as emerging developing economies will be used as a guideline in the comparative study to assess the withholding taxes in these countries. The above guideline is further enhanced by the fact that both Mozambique and Namibia apply withholding taxes on interest payments to non-residents and also use the source basis of taxation for non-residents.

#### **1.4.3.1.3 Developed European countries**

Developed countries typically include the United States of America (USA), the United Kingdom (UK), Australia, New Zealand and several European Union (EU) countries (World Bank, 2012a). The paragraphs below provide reasons for the selection of the two countries that will be used in the present study.

In the USA, the world’s largest economy, taxes are levied by all three levels of government, namely federal, state and local (Deloitte, 2011a:9). People pay most of their taxes to the federal government, which has the power to spend that money on health care, defence and income security in any state it pleases. South Africa, on the other hand, does not have these different levels of taxation and therefore a comparison with the USA would not be beneficial for purposes of this study. The UK comprises of Great Britain (England, Wales and Scotland) and Northern Ireland. The UK is one of the world’s largest economies in which administrative aspects of the tax system are complex (Deloitte, 2011b:1-26). A comparison between UK and South Africa which is one of the smaller economies of the world as evidenced by the IFDI ranking and furthermore the administrative aspects of tax system in comparison are not as complex as the UK would therefore also not be beneficial for this study. (Deloitte, 2011b:1-26; UNCTAD, 2010). Australia is a democratic federal country with six states and two territories. The country is currently benefiting from a resources

boom which results in considerable commodity sales to and from Asia (Deloitte, 2012a:1-25). New Zealand is a small economy, dependent on commodity production in agriculture, fishing and forestry. New Zealand's economy depends on foreign trade with Australia as its main import source, followed by China, US and finally Japan (Deloitte, 2012b:1-22). In comparison to Australia and New Zealand economic growth in South Africa has since the early 1990s been driven mainly by the tertiary sector which includes wholesale and retail trade, tourism and communications. South Africa currently moving towards becoming a knowledge-based economy, with a greater focus on technology, e-commerce and financial and other services (Deloitte, 2013i:43). A comparison using Australia and New Zealand will also therefore not be beneficial to this study. The EU in comparison is, however, different as it is made up of countries and not states like the USA, Australia and New Zealand. In the EU people pay the overwhelming majority of their taxes to the governments in the individual countries like most other countries (Thompson, 2012:1).

The South African economy in comparison as a based on an upper middle income GNI results in the South African economy being classified as a developing or middle income economy (IMF, 2012:3; World Bank, 2012c:5). South Africa is well integrated in the world economy. This plays a central role in shaping the country's long-term prospects. Since 2000 the world has experienced strong economic cycles and shocks (Deloitte, 2013i:55). These have been reflected in domestic demand and GDP growth (Deloitte, 2013i:55). South Africa furthermore as a country has entered into the following preferential market access trade agreements:

- Southern African Customs Union (SACU).
- Southern African Development Community (SADC) FTA.
- European Union/South Africa Trade, Development and Cooperation Agreement (EU/SA TDCA).
- SACU-European Free Trade Association (EFTA) FTA.
- SACU-Southern Common Market (Mercosur) PTA.
- Bilateral agreements with Mozambique and Zimbabwe (Deloitte, 2013i:59).

The above preferential trade agreements are all either with African or European economies. This study will therefore include a selection of two European countries in addition to the BRICS countries and developing African countries already selected to be used in the comparison in this study.

In terms of the EU/SA TDCA preferential trade agreement South Africa has a joint country strategy paper that covers cooperation between South Africa and the EU in the years from 2007 to date. This joint country strategy was drawn up by South Africa, the European Commission and EU member states, all of which adopted the Paris Declaration of March 2005 (European Union, Not dated:1).

South Africa's trade relations with Europe, particularly with the EU, are fundamental to the country's economic development. The Trade, Development and Co-operation Agreement (TDCA) with the EU forms a considerable element of South Africa's reconstruction and development efforts (Maesti Web Consulting Services, 1996-2011). The relationship between South Africa and Germany has also developed into a strong socio-economic and political partnership since 1994 that has shown considerable growth in many areas (SA, 2011b:36). Germany has made significant new investments in the South African economy since the 1994 democratic election and remains one of the country's most important trading partners (SA, 2011b:36). Germany was ranked 104<sup>th</sup> in the IFDI Performance Index which is not far off from South Africa's 128<sup>th</sup> ranking (UNCTAD, 2010). Germany's ranking is the second closest to South Africa than any of the other BRICS countries, developing African countries and the selected developed European countries.

South Africa also enjoys excellent relations with Denmark which form part of the EU and Nordic countries which include Finland, Iceland, Norway and Sweden (SA, 2011b:37). As a result of the strong grassroots support in these countries for democratisation in South Africa during apartheid, relations have been established in virtually every field. Relations in the international arena between South Africa and Denmark have seen close co-operation on multilateral issues (SA, 2011b:37). Denmark was ranked 138<sup>th</sup> in the IFDI Performance Index which is close to South Africa's 128<sup>th</sup> ranking (UNCTAD, 2010). Denmark's ranking is furthermore the

closest to South Africa compared to any of the other BRICS countries, developing African countries and developed countries selected for this study.

The similarities between South Africa, Germany and Denmark are that they apply withholding taxes on interest, the source basis of taxation for non-residents and have the closest IFDI rankings compared to BRICS and the selected developing countries. As a result of the nature and scope of this study and due to the limitations as per paragraph 1.5.2, the focus of this study is limited to comparisons in relation to withholding taxes. With the focus on BRICS, developed and developing economies, only the German and Danish European countries have been selected for this study. These countries will be used to examine the withholding taxes on interest in respect of non-residents in these economies as in paragraphs 4.5 to 4.7 which will be employed in the comparative study in Chapter Five.

## **1.5 DELINIATIONS AND INHERENT RESEARCH LIMITATIONS OF THE STUDY**

### **1.5.1 Delineations**

The focus of the study was limited as follows:

- A comparison of information on the selected countries was performed primarily on the factors that influenced withholding tax on interest, such as withholding tax rates, normal and withholding tax interest exemptions, secondarily on the factors that influenced FDI, such as IFDI Performance Index ranking, and repo rates. The study did not, for example, take into account the size of the economies of the different selected countries in respect of the impact on attracting FDI.
- Only the method of taxation of non-resident corporations was considered with no consideration of other types of taxpayers (*e.g.* trusts).
- Due to the nature and scope of this study, a comparison of the taxation information was performed only for the countries included in the BRICS group (Brazil, Russia, India, China, and South Africa), two neighbouring countries of South Africa (Mozambique and Namibia) and two developed European countries (Germany and Denmark). In the event that a more detailed and

extensive list of countries were to be selected, the possibility exists that a different conclusion could be arrived at.

- The repo rates of the countries obtained in Chapter Four were obtained while conducting the study on 5 October 2013.
- The summaries compiled by Deloitte, Ernst & Young, PWC and PKF International Limited obtained in Chapter Four were obtained while conducting the study on 21 May 2013.
- The IFDI rankings obtained from the United Nations Conference on Trade and Development were based on a study between 1990 and 2010 and were obtained while conducting the study on 15 October 2012.

### **1.5.2 Limitations**

- An understanding of the previous NRTI in paragraph 2.3 was limited to the literature, i.e. tax legislation available due to the implementation and removal of the NRTI taking place more than 25 years ago.
- The review of the tax systems of the selected countries in Chapter Four relating to the method of taxation, withholding taxes on interest, relief from double taxation in terms of DTAs, normal and withholding tax interest exemptions implemented by the selected developing and developed countries, was limited to the available tax summaries. These summaries were compiled by Deloitte, Ernst & Young, PWC and PKF International Limited and were used due to the limited access of the income tax legislation of other countries as a source because of language barriers. Furthermore, there is no indication that the legislation relating (compared) to the tax summaries had been updated with most recent tax amendments.
- A consideration of additional challenges which could influence FDI, such as political stability, market size, ease of conducting business and labour costs have not been included in study.

## **1.6 ASSUMPTIONS**

The following assumptions are applicable to this study:

- With regard to the problem statement, the following should be noted in respect of “effective design”: Tax system design is closely linked to domestic and international investment decisions, including terms of transparency and fairness and strengthening domestic resources and is not just a question of raising revenue. It is also about designing a tax system that promotes inclusiveness, encourages good governance, matches society’s views on appropriate income and wealth inequalities and promotes social justice (G20 *et al*, 2011:9). “Effective design” in terms of the problem statement means that the South African withholding tax has been set at a level that will achieve the objective that the introduction of the sections 49A to 49H withholding tax legislation, sets out to achieve. The objective is that it must attract FDI and remain competitive in international markets and thus closely linked to achieve domestic and international investment decisions – without eroding the tax base at the same time.
- FDI is, amongst others, influenced by the tax policies of a country and therefore assumed that withholding tax rates and normal and withholding tax exemptions may impact on FDI (Terhoeven, 2011:14). No other factors other than these have been taken into account.
- For the purposes of this study, it is assumed that all companies incur additional surcharges and taxes and therefore are taxed at the effective tax rate as applicable to income tax.
- The study assumes that the interest paid to a non-resident will be linked to the repo rate and the repo rate has therefore been used as comparison between South Africa and the selected countries.
- The study assumes that FDI will be impacted more greatly by corporate entities, rather than individuals, and therefore the comparison in Chapter Five did not consider the tax rates of individuals.
- The study assumes that where the withholding tax is a final tax, it is withheld by the payer and paid over to the Tax Authorities in that country and therefore no additional income tax is levied on the recipient. As a result normal income tax on interest will not be applicable to non-residents subject to the withholding tax in that country and therefore there will be no related normal tax interest exemptions applicable to non-residents in those countries.

## 1.7 DEFINITION OF KEY TERMS

The following key terms are used in this study with the definitions provided below.

**BRIC:** An acronym that refers to the economies of Brazil, Russia, India, and China, which are seen as major developing economies in the world (Rosenberg, Not dated; Brand South Africa, 2011b; SA, 2013c).

**Foreign Direct Investment:** FDI is defined as a reflection of the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor” or “parent firm”) in an entity resident in an economy (a host country) other than that of the investor (“direct investment enterprise”) (OECD, 1996:7; Terhoeven, 2011:7).

**Place of effective management:** Place “where the day-to-day activities of the business take place”. This is irrespective of where the overriding control is exercised or where the board of directors meets (SARS, 2002).

**Resident:** Section 1 of the Act (58 of 1962) defines a resident as “any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.”

**Withholding tax:** Withholding taxes are taxes levied by one country on specific types of payments made by residents to non-resident recipients situated in another country (Easson, 2004:39; Honiball & Olivier, 2011:851).

## 1.8 CHAPTER OUTLINE

Chapter Two contains an overview of withholding taxes as an administrative tax collection mechanism, the legislative provisions with regard to NRTI, the factors and

motivations surrounding its removal and the taxation on interest for non-residents subsequent to the abolishment of NRTI.

Chapter Three contains an overview of the reasons for the introduction of the new South African withholding tax, an overview of sections 49A to 49H, and headquarter companies and their impact on the section 49B withholding tax of South African source interest paid to non-residents.

Chapter Four contains an overview of the taxation applied in the selected countries including the method of taxation, rates of withholding tax on interest, relief from double taxation in terms of DTAs, withholding and normal interest exemptions, and repo rates designed and implemented in a selection of developing as well as developed countries.

Chapter Five contains a comparison of South Africa with the developing and developed countries which were researched in Chapter Four and will be performed in order to determine if the new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to South Africa and remain competitive in international markets. The comparison also helps to determine if the South African withholding tax aligns the South African legislation in respect of the section 10(1)(h) interest exemption with global practice.

Chapter Six contains the overall conclusions and recommendations on the comparisons and analysis of the South African withholding tax after taking the above-mentioned chapters into consideration. This chapter highlights the key findings of the study, concludes the discussion on the study's objectives and their outcomes and provides recommendations for future research.

## **CHAPTER TWO**

### **SOUTH AFRICAN INCOME TAX LEGISLATION ON INTEREST PAID TO NON-RESIDENTS PRIOR TO THE WITHHOLDING TAX ON INTEREST**

#### **2.1 INTRODUCTION**

Withholding taxes are used worldwide by the taxation authorities as an administrative mechanism to trap the relevant tax before the non-resident escapes from the grasp of such authority (Roeleveld & West, 2007:1). The concept of withholding taxes in respect of income earned by non-residents is not new to South Africa as from 1962 to 1995 non-resident shareholders' tax (NRST) was imposed on South African dividends declared and non-residents tax on interest (NRTI) on South African source interest paid from 1967 to 1988.

The tax system in terms of section 10(1)(h) of the Act (58 of 1962) currently provides a blanket income tax exemption in respect of interest which is received or accrued during any year of assessment by or to any person who is a non-resident. This section 10(1)(h) blanket interest exemption, which is applicable until the implementation of the new South African withholding tax on interest when the revised section 10(1)(h) will become effective, states that, apart from the two exclusions, South Africa does not levy tax on interest paid to non-residents.

The objective of this chapter as described in objective (i), paragraph 1.3 is to examine the previous South African withholding tax on interest relating to non-residents, including the reasons for its removal, and the income tax legislation prior to 1 March 2014 relating to interest exemptions applicable to non-residents.

## **2.2 WITHHOLDING TAX AS AN ADMINISTRATIVE TAX COLLECTION MECHANISM**

### **2.2.1 Background**

Withholding taxes are taxes levied by one country on specific types of payments to recipients situated in another country. Withholding taxes are usually imposed as part of the general income tax law of a country and normally apply to payments made to non-residents (Easson, 2004:39). It may be argued that withholding tax is not a tax as such, but rather a method of collection employed by tax administrators to ensure payment of tax. Before withholding can be applied, there must be an underlying liability on behalf of a taxpayer (Legwaila, 2010:69).

Withholding taxes commonly apply to dividends, interest, royalties, rents, management or technical fees, fees to non-resident consultants or contractors and other payments of a similar nature to non-residents (Easson, 2004:39). Withholding taxes essentially allow for tax that is due on the income to be withheld at the source by the payer before the income is paid to the person entitled to the income. The tax liability is, therefore, settled before the payment is made to the recipient, thereby preventing the tax from escaping the relevant tax authorities.

The withholding obligation normally lies with the person making the payment. Generally the person receiving the amount has no right of recourse whatsoever against the person withholding the amount in respect of the amount legally withheld. However, a contractual arrangement between the parties may vary this general rule by allowing the payer to gross up the amount (Legwaila, 2010:69). The grossing up of the amount would therefore include the tax liability and result in the investor or person receiving the payment being in a tax neutral position. It is therefore important that there is a balance between not eroding the tax base by having generous exemptions and not having an excessively high withholding tax which will allow the grossing up of the interest amount, increasing the interest which the resident pays to the non-resident.

The rates of withholding taxes vary hugely according to country as some countries apply a single flat rate to all payments subject to a withholding tax whereas other countries apply different rates to different payments (Easson, 2004:40). These withholding tax rates are commonly around 25-30%, but are sometimes lower or higher (Easson, 2004:40). Exemptions for certain types of payments, for example dividends, interest and royalties, are also common (Easson, 2004:40). Treaty provisions between countries, however, do provide for a greater degree of uniformity in the application of withholding taxes. Withholding tax rates of 5% or 15% for dividends and 10% for interest, are prescribed by the OECD model. It is also prescribed by the OECD model that withholding taxes on royalties should be exempt from tax in the host country (Easson, 2004:40).

### **2.2.2 Withholding tax exemptions**

As an incentive for the attraction of foreign investment either generally or to promote particular objectives, some countries provide zero rates of non-resident withholding tax. However, the complete exemption from all forms of withholding tax is extremely rare, but it is sometimes granted for investments made in export processing zones and for payments made by Operational Headquarters which are companies that have chosen to co-ordinate their activities from a headquarter company located elsewhere than its parent due to operational reasons (Easson, 2004:69 &149).

The exemption of dividend payments from withholding tax is more common while the exemption of interest payments from withholding tax is less common as a form of incentive for the attraction of foreign investment (Easson, 2004:150). Previous studies have provided evidence to support the view that high withholding tax rates provide a disincentive to FDI (Easson, 2004:150). However, the evidence to indicate that exemptions or reductions to the rates that are below international norms, which will impact investment decisions especially in developing countries, is less clear (Easson, 2004:150). As a result of these studies, it was deduced that the better policy would be setting these withholding tax rates at moderate levels instead of granting special provisions to promote foreign investment. The studies further deduced that the existence of withholding taxes constitutes to some extent a

disincentive to repatriate profits and thus actually provides an incentive to reinvest them (Easson, 2004:150).

### **2.2.3 Withholding taxes in South Africa**

Apart from employees' tax in terms of Schedule 4 of the Act (58 of 1962) and dividends tax in terms of section 64E of the Act (58 of 1962) as a form of withholding tax, South Africa currently applies the following withholding taxes in respect of non-residents:

- a withholding tax on royalties in respect of non-residents in terms of section 35 of the Act (58 of 1962), since 1962,
- a withholding tax on foreign entertainers and sportspersons in terms of section 47B of the Act (58 of 1962), since 2006,
- a withholding tax on sale of immovable property in South Africa by non-residents in terms of section 35A of the Act (58 of 1962), since 2007, and
- a proposed withholding tax on service fees in terms of section 51A-H to be implemented from 1 January 2015 as per the draft Taxation Laws Amendment Act 2013 (SA 2013b:121).

Royalties received by or accrued to non-residents from a South African source as per the South African source legislation in section 9(2)(c) to 9(2)(f) of the Act (58 of 1962) are not taxed at the standard tax rate. The draft Taxation Laws Amendment Bill 2013 has proposed that the taxation of royalties paid or accrued to non-residents should be levied in terms of sections 50A-H (SA, 2013b:118). These proposed sections will result in the repealing of the previous section 35 of the Act (58 of 1962), which has been in place since 1962. Sections 50A-H will be applicable to royalties which include royalties in respect of imparting any scientific, technical, industrial or commercial knowledge or information and will be effective from 1 January 2015. The proposed amendment will result in these royalties being subject to withholding tax at 15%, which will be an increase from the 12% previously levied on the royalty income received until the implementation of the amended legislation (58 of 1962). The tax is a final tax and is required to be withheld and paid over to the South African Revenue Service (SARS) by the person making the royalty payment (58 of 1962).

Fees received by foreign sportspersons and entertainers for services delivered in South Africa are also subject to withholding tax in terms of section 47B(1) of the Act (58 of 1962). The rate of the withholding tax which is also a final tax to be levied is 15% and is required to be withheld and paid over to the SARS by the person making the payment (58 of 1962).

Another form of withholding tax in South Africa is a withholding tax on capital gains from the disposal by a non-resident of immovable property situated in South Africa. A person, resident or non-resident who makes payment to a non-resident natural person, company or trust for the acquisition of immovable property in South Africa is required to withhold an amount of 5%, 7.5% and 10%, respectively, of the amount payable in terms of section 35A of the Act (58 of 1962). The withholding of this tax is a prepayment and the non-resident will therefore still be required to submit a tax return for the year of assessment and be subject to normal tax at the end of the year (58 of 1962).

In terms of the unification of cross-border withholding taxes, the draft Taxation Laws Amendment Bill 2013 (SA, 2013b:121) has proposed a withholding tax on technical, managerial or consultative service fees and will be levied at the rate of 15% of the gross amount of fees paid to a foreign-resident. The proposed withholding tax will be included in sections 51A-H of the Act (58 of 1962) and will be effective from 1 January 2015.

On 1 April 2012, the secondary tax on companies (STC) of 10% was replaced with a 15% dividends tax in terms of section 64E of the Act (58 of 1962). STC was levied on the company declaring the dividend while dividend tax applies at the shareholder-level and as such shifts the liability onto the shareholder. Dividend tax, however, includes a withholding tax collection mechanism that is imposed on the payer of dividends. In terms of section 64E(1) of the Act (58 of 1962), the tax liability for the dividends tax is triggered when the dividend is paid to the shareholder.

In order to remedy the lack of coordination among withholding tax regimes, the Tax Administration Laws Amendment Bill 2012 proposed that these withholding regimes

be unified to the extent of coordinating and streamlining the rates, liability, timing and procedure of withholding taxes (SA, 2012d:113). These changes required adjustments to the interest and royalty withholding regimes, because the rules around the recently enacted dividends tax have been well debated and settled (SA, 2012d:113). These changes included a uniform withholding rate of 15% which aligns the royalty and interest withholding tax rate with the dividends tax rate (SA, 2012d:113).

### **2.3 APPLICATION OF NRTI**

NRTI, which was a withholding tax on South African source interest paid to non-residents, was introduced in 1967 at a rate of 10% (SA, 1967:08). Section 64A-F was inserted into the Act as per the insertion of *Part VI Non-residents tax on interest* in terms of clause 19 of the Income Tax Bill of 1967 but was subsequently abolished with effect from 17 March 1988 (Anon., 1988:80).

The South African tax system was previously source-based which means that the total amount received by or accrued to a taxpayer from a source within or deemed to be within South Africa was taken into account in order to calculate the gross income of that taxpayer and residency was not a criterion (SA, 2012a:09). South African residents, however, became taxable on the worldwide income basis as of the 1998 year of assessment (SA, 2012a:09). The worldwide income from investments including income received or accrued from foreign investments of a natural person who was a resident therefore became subject to normal tax on or after 1 July 1997 (SA, 2012a:09). As of the tax years commencing on or after 1 March 2001, South Africa moved from a source-based system of taxation to a residence-based system of taxation in respect of which all income of taxpayers who are residents, subject to certain exclusions, are subject to normal tax (SA, 2009:4). Non-residents are still, in terms of the gross income definition in section 1 of the Act (58 of 1962) subject to South African income tax on their income from a source within South Africa.

### **2.3.1 Levy of NRTI**

The levy of the 10% NRTI was provided for in terms of section 64A of the Act (58 of 1962). Section 64A applied to any amount of South African source interest accrued to persons as provided for in section 64D. Section 64D referred to persons (other than a company) as not ordinarily resident in the Republic, the deceased estate of a person not ordinarily resident in the Republic at his death and a company which was not a South African company if the debtor was ordinarily resident or carried on business in the Republic on or after 1 April 1967 (SA, 1967:08).

### **2.3.2 Legislative provisions of NRTI**

Section 64B of the Act (58 of 1962) determined that where interest was payable or was credited to any person having an address outside the Republic, such interest was deemed to have accrued to such person, estate or company liable for the tax. The above provision was applicable until the contrary was proved to indicate that the interest not deemed to have accrued. Furthermore, where the debtor was a deceased estate, the estate was deemed to be ordinarily resident or carrying on business in the Republic, if it was the status of the deceased person at the date of his death. Where the debtor was a company such company was deemed to be ordinarily resident in the Republic if it was registered, managed or controlled in the Republic (58 of 1962).

### **2.3.3 Exemptions**

The exemptions were provided for in section 64C of the Act (58 of 1962) and the following interest was exempt from NRTI:

- any interest that accrued from the South African government, local authorities, the Electricity Supply Commission (ESKOM) or the South African Reserve Bank (SARB);
- any interest on any amount borrowed outside the Republic not used for the purpose of producing gross income. This exemption was applicable provided that payment of interest including the repayment of the borrowed amount was made outside the Republic and these funds were derived entirely outside the

Republic out of the debtor's resources in the Republic. Alternatively the exemption applied if the amount borrowed was borrowed in the ordinary course of any trade carried out outside the Republic and was not specifically intended to be used for the purpose of producing gross income;

- any interest paid on money lent or advanced in the Republic by any person who had a permanent place of business in the Republic;
- any interest limited to a maximum of twenty rand in aggregate that accrued from any debtor to any person during any twelve month period ending on the last day of February;
- any interest on any bill of exchange or any promissory note relating to the purchase price of goods imported into the Republic, handled through a bank and the bank had certified on the bill or note that a document covering the importation of such goods had been exhibited to it;
- any amount in respect of any subscription share in any building society;
- any interest accrued to any ecclesiastical, charitable or educational institution of a public character; or
- interest accruing to any not resident bank that was entrusted with the principal foreign exchange reserves of that territory where the Minister of Finance applied this exemption.

#### **2.3.4 Deduction or withholding of NRTI**

The non-resident person, deceased estate or company to whom the interest accrued to or was received by was liable for the tax and there was either a deduction or withholding of NRTI which was provided for in terms of section 64E of the Act (58 of 1962). Interest received by a third party on behalf of the non-resident person, deceased estate or company to whom the interest accrued to or received by was subject to a deduction or withholding of the tax by the debtor (58 of 1962). Furthermore, any person in respect of whom the interest was received on behalf of, or in trust for, the person to whom such interest was entitled was also subject to a deduction or withholding of the tax in terms of section 64E (58 of 1962).

## **2.4 REMOVAL OF NRTI AND THE REASONS FOR ITS REMOVAL**

With effect of 16 March 1988, NRTI was abolished as a result of the recommendations by the Margo Commission (Anon., 1988:80). It was noted that NRTI produced minimal income, estimated to be a trifling R30 million a year compared to a budget tax revenue for that year of R42,8 billion (Anon., 1988:80).

It was also noted that NRTI was an obstructive factor in raising foreign finance overseas (Garach, 1988:128). Interest received by non-residents from a source within or deemed to be within the Republic was taxed in terms of both normal South African income tax subject to the section 10(1)(h) blanket interest exemption from normal tax and NRTI. The NRTI was then creditable against the normal tax attributable against that interest. The Katz Commission in its “5<sup>th</sup> Report on basing the South African income tax system on the source or residence principle – options and recommendations” noted that it was aware that in the past, when both these taxes had applied, in practice most taxpayers merely paid the NRTI without ever filing a return to be assessed for normal tax (SA, 1997:40).

During 1988 the South African government accepted in principle the recommendations made by the Margo Commission which contained the first steps on a planned path of tax reform as discussed in Chapter One, paragraph 1.1.1. The Budget speech during the 1988/89 tax year highlighted and implemented some of those recommendations. The budget proposals of that year attempted to achieve, amongst other things, to abolish certain forms of taxes which did not yield sufficient revenue (Garach, 1988:127). As part of the planned tax reform indicated above, NRTI was abolished with effect from 17 March 1988. The South African government had accordingly recognised that NRTI, although paid by non-residents, was effectively borne by the South African borrower as most taxpayers merely paid the NRTI which was withheld or deducted by the payer without ever filing a return to be assessed for normal tax (Anon., 1988:80).

## **2.5 TAXATION ON INTEREST FOR NON-RESIDENTS SUBSEQUENT TO THE ABOLISHMENT OF NRTI**

As indicated in paragraph 2.3 above, non-residents are subject to tax in South Africa on their income from a source within South Africa (58 of 1962). It is, therefore, important to ascertain the residence status of a taxpayer for purposes of applying the correct tax treatment.

A corporation is resident in South Africa if it is incorporated or effectively managed in South Africa. An individual is a resident if he/she is ordinarily resident in South Africa or physically present in South Africa in terms of the physical presence test for more than 91 days in the current year and each of the preceding five tax years and physically present in South Africa for a period exceeding 915 days in aggregate in the preceding five years (58 of 1962).

The source of interest, as per section 9(2)(b) of the Act (58 of 1962) which had been effective from 1 January 2012, is any interest received by or accrued to a person from a source within the Republic as defined in section 24J or deemed to have accrued to a person from a source within the Republic as contemplated in section 8E(2) (58 of 1962). The source of interest refers to where that interest is attributable to an amount incurred by a resident, unless the interest is attributable to a permanent establishment situated outside the Republic or if the interest received or accrued is in respect of the utilisation or application in the Republic of any funds or credit obtained in terms of any interest-bearing arrangement.

The South African tax legislation provides and has provided for normal interest exemptions to non-residents in terms of section 10(1)(h) and section 10(1)(hA) of the Act (58 of 1962), respectively. The section 10(1)(h) exemption has existed in the Act since its inception in 1962 and for many years prior to that in the Income Tax Act that preceded the current Act (58 of 1962) and was subject to amendments over the years.

Section 10(1)(h) provided, until the substitution of the current section 10(1)(h) in 2004 by the Revenue Laws Amendment Act (32 of 2004), for the exemption of the

following: interest from stocks and securities (including treasury bills) issued by the South African government including the South African Transport Services or any local authority with the Republic or the ESKOM or the South African Broadcasting Corporation provided that the non-resident did not carry on business in the Republic (58 of 1962). Section 10(1)(h) is no longer limited to stocks and securities only and applies to all interest as defined in section 24J or deemed interest as delineated in section 8E received or accrued during any year of assessment by or to any non-resident.

Section 10(1)(h) of the Act (58 of 1962) currently provides, until the implementation of the new South African withholding tax on interest after which the revised section 10(1)(h) will become effective, for a blanket income tax exemption in respect of interest which is received or accrued during any year of assessment by or to a non-resident. The above therefore means that South Africa does not levy tax on interest paid to non-residents. This exemption is subject to two exclusions when it will not be generally applicable to any non-resident. Firstly, the exemption does not apply to non-resident individuals that are physically present in South Africa for more than 183 days in aggregate during that year. Secondly, any person who is not a resident conducting business in South Africa at any time during that year the interest is received by or accrued to that person through a permanent establishment may not receive the exemption (58 of 1962).

The amended section 10(1)(h) which becomes effective with the implementation of the new South African withholding tax on interest will provide for any amount of interest which is received by or accrued to or to a non-resident to be exempt from normal tax and therefore be subject to withholding tax and equally, if the interest is exempt from the withholding tax it will be subject to income tax (SA, 2013b:37).

Another interest exemption was the section 10(1)(hA) exemption which was enacted in 1993 and deleted by the Revenue Laws Amendment Act (32 of 2004). Interest accruing to a non-resident for the period 1993 to 2004, when section 10(1)(hA) was applicable, was exempt from tax. It would seem that the intention of section 10(1)(hA) was to exempt interest from all sources within or deemed to be within the Republic received by or accrued to non-residents, while section 10(1)(h) in previous

legislation provided for the exemption of interest from stocks or securities only (Anon., 1995:65).

Although section 10(1)(hA) was deleted in 2004 from the Act (58 of 1962), the section 10(1)(h) interest exemption as well as a fixed monetary interest exemption in terms of section 10(1)(i) are still available to the taxpayer. The new section 10(1)(hA) is unrelated to this study and refers to amounts received by or accrued to the holder of a debt. The section 10(1)(i) interest exemption is available to a natural person (resident or non-resident) in terms of which the aggregate of any interest received by or accrued to the taxpayer from a South African source is exempt. In respect of the 2014 year of assessment, the section 10(1)(i) exemption provides that in the case of any person who was or would have been at least 65 years old by the end of the year of assessment, any interest that does not exceed R34 500 or in any other case does not exceed R23 800 is exempt from normal tax. Interest in excess of these amounts will incur normal income tax. Prior to the 2012 year of assessment, the section 10(1)(i) exemption also pertained to non-South African source interest and dividends in respect of natural persons.

## **2.6 CONCLUSION**

This chapter examined the previous South African withholding tax on interest relating to non-residents, the reasons for its removal and the income tax legislation prior to the new South African withholding tax on interest relating to interest exemptions applicable to non-residents. The findings as per paragraph 2.2 indicate that a mechanism of withholding taxes is successful in its intentions around the world – subject to certain exemptions. However, based on the legislative provisions with regard to NRTI and the factors and motivations surrounding its removal, it is evident that the NRTI did not yield a sufficient benefit for the *fiscus*. The R30 million that it raised a year only accounted for 0.07% when compared to a budget tax revenue for that year of R42,8 billion (Anon., 1988:80). Furthermore, the South African government had recognised that the NRTI withholding tax, although paid by non-residents, was effectively borne by the South African borrower.

The previous and current South African income tax legislation relating to South African source interest in respect of non-residents will be applicable until the implementation of the new South African withholding tax on interest. This chapter indicates that this legislation on taxation of South African source interest to non-residents has been generous due to the section 10(1)(h) interest exemption.

As a result of the normal income tax exemption in respect of non-residents who do not fall into the category of receiving interest provided the resident did not conduct business through a permanent business establishment or being physically present in the Republic for more than 183 days in aggregate during that year of assessment, it is evident that section 10(1)(h) has been generous. The findings of this chapter will be used as a basis for examination of the new South African withholding tax on interest in Chapter Three.

## **CHAPTER THREE**

### **THE NEW SOUTH AFRICAN WITHHOLDING TAX REGIME**

#### **3.1 INTRODUCTION**

South Africa is the economic powerhouse of Africa and its location, sizable economy, political stability and overall strength in financial services make South Africa the ideal location for the establishment of regional holding companies in Africa by foreign multinationals. Furthermore, South Africa's extensive network of tax treaties offers ready access to other countries in the region. South Africa is, therefore, a natural holding company gateway into the region (SA, 2010:80).

During the budget speech on 23 February 2011 it was announced that a unified cross-border withholding regime should be enacted in order to remedy the lack of coordination among withholding tax regimes. This change included a uniform withholding rate of 15% which applies to interest as well as other types of income to which withholding taxes apply (SA 2012c:117).

On 1 January 2015 the withholding tax on interest in terms of the provisions of sections 49A-H of the Act (58 of 1962) will become effective (SA, 2013b:118). The tax to be implemented will result in the withholding of taxes on South African source interest paid to non-residents. This chapter accordingly seeks to address objective (ii) in paragraph 1.3, namely the examination of the new South African withholding tax on interest. This includes the reasons and motivation for the introduction of this new South African withholding tax on interest, its alignment with the section 10(1)(h) interest exemption, the legislative provisions of the new South African withholding tax on interest and an overview of sections 49A-H which must all be obtained to address objective (ii) effectively. The impact of the withholding tax on headquarter companies will also be examined. This examination of the legislative provisions in sections 49A-H that will be implemented provide a basis for the comparison with the withholding taxes implemented in other countries as per Chapter Four. The reasons as to why the section 10(1)(h) interest exemption appears to be overly generous will also be investigated.

This chapter aims to contribute to the base of knowledge of this study by placing the new South African withholding tax on interest into context following the following discussion.

## **3.2 BACKGROUND**

In terms of the gross income definition in section 1 of the Act (58 of 1962), as indicated in paragraph 2.5, a non-resident is taxed for South African income tax purposes on the “total amount in cash or otherwise received by or accrued to or in favour of such a person from a source within the Republic”. The type of interest, as per section 9(2)(b) of the Act (58 of 1962) which is effective from 1 January 2012, is any interest as defined in section 24J as indicated above in paragraph 2.5.

The South African economy is in many areas highly developed. However, certain weaknesses still exist, partly because of remaining inequalities between the country's previously disadvantaged and advantaged residents and partly due to the country's international isolation until the early 1990s (Maxwell, 2008:1). The country and economy could, therefore, be said to be in a state of transition, as the South African government seeks to address the inequities of previous regimes and foster good international trade relationships with other countries (Maxwell, 2008:1).

FDI has been identified as a means for South Africa to acquire some funding to facilitate the provision of employment, alleviate poverty and additionally facilitate the transfer of knowledge and technology to improve and assist with South Africa's current challenges (Terhoeven, 2011:61). The main financial instrument components of FDI are equity and debt instruments. Equity instruments include common and preferred shares, reserves, capital contributions and reinvestment of earnings. Dividends, distributed branch earnings, reinvested earnings and undistributed branch earnings are components of FDI income on equity instruments. Debt instruments commonly include marketable securities such as bonds, debentures, commercial paper, promissory notes, non-participating preference shares and other tradable non-equity securities as well as loans, deposits, trade credit and other accounts, both payable and receivable (OECD, 2008:60). The United Nations Conference on

Trade and Development (UNCTAD) has established a measure to track competition between countries in respect of where FDI is focused using their Inward Foreign Direct Investment Performance Index (IFDI Performance Index) (Terhoeven, 2011:1).

South Africa is increasingly becoming party to the competition between countries in respect of FDI attraction. The South African government's efforts so far appear to have been successful and as a result South Africa's economy has been completely overhauled since the advent of democracy in the country in 1994 (Brand South Africa, 2011a). Bold macroeconomic reforms have increased competitiveness, grown the economy, created jobs and opened South Africa up to world markets (Brand South Africa, 2011a), enabling the South African business community to become increasingly integrated into the international community. With its advantageous location and a government receptive to FDI, as evidenced by the substantial growth over the past few years of foreign investment into the area, the South African economy is certainly providing a positive outlook with indications that it is becoming an international force to be reckoned with (Maxwell, 2008:1).

Furthermore, as discussed in paragraph 2.5, the South African tax legislation provides for a blanket normal income tax exemption under the provisions of section 10(1)(h) of the Act (58 of 1962). The blanket interest exemption was and still remains an integral part of the overall effort to attract foreign debt capital into South Africa and will still be effective after the implementation of the new South African withholding tax on interest (SA, 2010:72). The existing section 10(1)(h) exemption has been amended by the Taxation Laws Amendment Bill 2013 and is effective from the implementation of the new South African withholding tax on interest (SA, 2013a:66). The effect of the amendment is that non-residents will be subject to normal tax on interest if those persons have a "strong connection" (SA, 2012d:114) to South Africa by being physically present in South Africa for an aggregate of 183 days or more or by conducting business through a permanent business establishment during the year of assessment. If there is no "strong connection" to South Africa, normal tax does not apply. On the other hand withholding tax potentially applies when this "strong connection" does not exist (SA, 2012d:114).

### **3.3 REASONS FOR THE ALIGNMENT OF SECTION 10(1)(h) AND THE INTRODUCTION OF THE SOUTH AFRICAN WITHHOLDING TAX ON INTEREST**

As discussed in paragraph 2.5, in terms of section 10(1)(h) of the Act (58 of 1962), non-residents are exempt from South African income tax on local interest received, provided that that non-resident did not conduct business in SA through a permanent establishment or, if an individual, did not spend more than 183 days in South Africa during the year of assessment (58 of 1962). The existing section 10(1)(h) exemption has been amended as explained in paragraph 2.5 and is effective from the implementation of the new South African withholding tax on interest (SA, 2013b:38).

In terms of the amended section 10(1)(h) interest received by or accrued to foreign persons may fall within the normal tax rules and/or the interest withholding tax rules and will provide for any amount of interest which is received by or accrued to a non-resident. The non-resident will then be exempt from normal tax and therefore be subject to withholding tax and equally, if the interest is exempt from the withholding tax, it will be subject to income tax (SA, 2013b:37). Non-residents will be subject to normal tax on interest if those persons have a “strong connection” to South Africa. Alternatively, normal tax does not apply when this “strong connection” (i.e. when the foreign person only has a passive connection to South Africa) does not exist, in which case withholding tax potentially applies (SA, 2012d:114).

The section 10(1)(h) interest exemption also arguably provided foreign debt with a tax advantage over local debt, of which the latter was taxable. The exemption created cycle schemes which allowed funds to be recycled to the payer designed to undermine the tax base. These cycle schemes created deductible interest costs to the payer of the interest. The funds would then flow back to South Africa as foreign dividends which were exempt from tax by way of a participation exemption (SA, 2010:72). The payer would therefore not have any corresponding taxable income on the interest paid which was recycled to exempt foreign dividends. The participation exemption in terms of section 10B(2)(a), effective from 1 March 2012, provided local shareholders who held 10% of the total equity share capital and voting rights in the

foreign distributing company with an exemption of otherwise taxable foreign dividends (58 of 1962).

The section 10(1)(h) exemption also creates a situation where foreigners are incentivised in the context of closely-held or connected cross-border situations to fund businesses with higher or disproportionate amounts of debt capital in comparison to equity capital (SA, 2010:72). The current thin capitalisation anti-avoidance rules that are included as part of the transfer pricing legislation in terms of section 31 of the Act (58 of 1962) attempt to limit some of this excess debt. However, these rules only act as a partial remedy for the situation as the interest, finance charge or consideration payable for or in relation to the financial assistance is only disallowed to the extent that it is excessive in relation to the fixed capital of the business incurring the interest.

Most developed and developing economies presently exempt cross-border interest relating to mobile portfolio debt and incidental trade finance (SA, 2010:72). Other forms of cross-border debt remain fully taxable, subject to a flat rate form of withholding tax (SA, 2010:72). There are more generous forms of exemptions available, though these are only available through tax treaties where both countries believe that the cross-border interest will remain subject to a relatively high-level of global tax (SA, 2010:72). The current blanket exemption therefore appears to be overly generous from a competitive point of view (SA, 2010:72).

The rapid substantial growth of the South African economy and dismantling of the previous economic inequalities, policies and systems will need to be maintained (SA, 2010:72). For this reason there is a continued need for South Africa to attract foreign lending and remain competitive in the international debt capital markets (SA, 2010:72). However, the section 10(1)(h) exemption does not achieve a fair balance between the attraction of foreign debt capital and the need to protect the South African tax base against potential erosion (SA, 2010:72).

The draft Taxation Laws Amendment Bill 2013 has further proposed to amend the existing section 10(1)(h) exemption (SA, 2013b:38). The effect of the amendment as explained above would result in either normal or withholding taxation being applied

to both non-residents with and without a “strong connection” to South Africa. The amendment to section 10(1)(h) in this regard was expected (Lessing, 2010:1) to align the exemption with global practice. The amendment to the section 10(1)(h) interest exemption will be to enforce the primary intention of the introduction of section 49B due to the cross referencing of section 10(1)(h) to section 49D(3) which is to align South African legislation in respect of interest exemptions with global practice.

Furthermore, the current section 10(1)(h) should also be narrowed without affecting portfolio debt capital as indicated in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (SA, 2010:73). South Africa taxes the receipts and accruals of a resident on a world-wide basis which includes proportionate interests of tainted income of a Controlled Foreign Company (CFC) which is a foreign company that is more than 50% owned by South African residents. Income of a CFC includes passive income and diversionary income globally referred to as “tainted income” which is no longer exempt from withholding tax. Diversionary income reflects income arising in circumstances likely to lead to transfer pricing (SA, 2010:77).

The transfer pricing provisions in section 31 of the Act (58 of 1962) were, however, identified as a significant barrier as result of the application of transfer pricing to an arrangement whereby a foreign company makes a loan to the headquarter company located in South Africa (SA, 2010:77). The headquarter company would then on-lend those funds to another foreign location which would most likely leave the headquarter company with a non-deductible interest as the transfer pricing provision exists to prevent the flow of interest offshore to the extent that the foreign debt of a South African company is excessive in relation to its equity (SA, 2010:77). The non-deductible interest expense would therefore be owed to the foreign investor while being subject to corresponding taxable interest as a result of the on-lending (SA, 2010:77). In view of the above a headquarter company has become eligible for tax relief in terms of section 49D(1)(a)(i)(cc) as part of the regional headquarter company regime introduced to stimulate foreign companies from housing the African headquarter companies in South Africa. As far as is applicable to this study, the tax relief would generally entail the following: The headquarter company located in South Africa will not be deemed to violate the thin capitalisation provisions merely

because of the existence of back-to-back cross-border loans involving the headquarter company (SA, 2010:77-78) and foreign creditors of the headquarter company will be exempt from the withholding tax on interest for back-to-back loans (Burger & Goba, 2010:1; SA, 2010:78).

As a result of the concerns and efforts highlighted above, the narrowing of the exemptions will limit the exemption of cross-border interest to certain instruments or debt that are incidentally associated with cross-border trade in line with that of global practice (SA, 2010:73).

### **3.4 THE NEW SOUTH AFRICAN WITHHOLDING TAX ON INTEREST**

Part IVA of the Act (58 of 1962) which contains sections 49A-D in respect of the withholding tax on royalties has been proposed to be substituted by sections 49A-H in respect of withholding tax on interest and becomes effective on 1 January 2015 (SA, 2013b:118). The introduction of these sections will allow South Africa to stay within a dominant global paradigm while protecting the tax base against undue risk (SA, 2010:73). Section 49A-H was recently proposed to be included in the Act (58 of 1962) to substitute the previous section 37I-O of the Act (58 of 1962) (SA, 2013b:114). The above substitution is done in an effort to coordinate and streamline the rates, liability, timing and procedure for withholding taxes in the case of dividends tax, royalties and interest (SA, 2013b:110). The legislation below has incorporated the proposals of the amendments of the draft Taxation Laws Amendment Bill 2013 (SA, 2013b:114).

#### **3.4.1 Levy, liability for and withholding**

The new South African withholding tax on interest which effective date has been deferred to 1 January 2015 provides for the levy of the withholding tax on interest at a rate of 15% in terms of Section 49B(1) on the amount of South African source interest paid to or for the benefit of any foreign person (SA 2013b:114). A “foreign person” means any person that is not a resident (58 of 1962). For the new South African withholding tax on interest purposes, interest is deemed to be paid on the earlier of the date on which the interest is paid or becomes due and payable as per

section 49B(2). In line with the recently introduced dividend tax, the trigger date for withholding will be the date that a sum is paid or becomes due and payable (SA, 2012d:113). The withholding tax on interest is a final tax, as indicated by section 49B(3). In terms of section 49B(4), a person paying interest (hereafter referred to as “the payer”) to or for the benefit of a foreign person, who has withheld an amount of withholding tax on interest, will be deemed to have paid the gross amount of interest to that foreign person (SA 2013b:115). The withholding tax rate has been increased from 10% as per the original legislative provisions to 15%, thereby creating uniformity amongst the withholding rates for dividends, royalties and interest (SA, 2013d:77).

Such a foreign person to which an amount of interest is paid is liable for the new South African withholding tax on interest to the extent that the interest is regarded as having been received by or accrued to that foreign person from a source within the Republic, as indicated by section 49C(1) (SA, 2013b:115). Any amount of withholding tax on interest which is withheld and paid to the Commissioner by the last day of the month after the month during which the interest is paid, will be regarded as an amount that is paid in respect of that foreign person’s liability, as indicated in section 49C(2) (SA, 2013b:115).

Sections 49E(1)-(3) provides that any payer of the said interest to a foreign person has to withhold 15% tax from such a payment (SA, 2013b:115). This will be the case, except when the interest is exempt from the new South African withholding tax on interest in terms of either section 49D(1) (hereafter referred to as “the specific exemptions”), or in terms of section 49D(3) (hereafter referred to as “the general exemption”). Section 49E(1)-(3) requires that a declaration has to be submitted by the foreign person to the payer by a date determined by the payer or, if not determined, by the date of the payment, as prescribed by the Commissioner, indicating that the foreign person is exempt from it in terms of the general or specific exemption (SA, 2013b:115). The withholding tax rate of 15% should be reduced if the foreign person has submitted a declaration to the payer by a date determined by the payer or, if not determined, by the date of the payment, stating that he is subject to a reduced rate of tax as a result of the application of a DTA (SA, 2013b:115).

### 3.4.2 Exemptions

The following amounts of interest are subject to specific exemptions from the section 49B withholding tax, as provided for by section 49D(1):

- Any amount of interest paid to any foreign person by:
  - the government of the Republic in the national, provincial or local sphere;
  - any bank, the SARB, the Development Bank of Southern Africa or the Industrial Development Corporation;
  - a headquarter company for financial assistance that is not subject to the thin capitalisation rules as per section 31 of the Act (58 of 1962); or
  - in respect of any listed debt.
- Any amount of interest payable as contemplated by section 27(6) of the Securities Services Act (36 of 2004) to a foreign person that is a client as defined in section 1 of that Act (36 of 2004).
- Any amount of interest that is deemed to have accrued to a non-resident in terms of section 25BA(a) of the Act (58 of 1962).
- Any amount, not of a capital nature, received by or accrued to a portfolio of equity unit trusts to the extent that the amount is distributed by the portfolio to a person who is entitled to the distribution as in terms of section 25BA(a). The person who is entitled to the distribution, being a unit-holder within twelve months of its receipt by that portfolio, is deemed to have directly accrued to him on the date of the distribution (SA, 2013b:115).

Interest that is paid to a foreign person in respect of any amount advanced by that foreign person to a bank is in terms of section 49D(2) not exempt from the withholding tax on interest if the amount is advanced in the course of any arrangement, transaction, operation or scheme (SA, 2013b:115). In terms of the application of this section, the foreign person and any other person must be parties to the arrangement, transaction, operation or scheme. Furthermore, the exemption will not apply in terms of which the bank advances any amount to the other person on the strength of the amount advanced by the foreign person to the bank (SA, 2013b:115).

Therefore, the specific exemptions in respect of interest on amounts owed by domestic banks do not include back-to-back loan agreements designed to circumvent the 15% withholding tax (SA, 2010:70-71). An example of such a back-to-back transaction would be if a South African company seeks to borrow an amount from a foreign lender (SA, 2010:73). Instead of entering into a cross-border loan agreement with the foreign lender, the foreign lender places a deposit with a South African bank. The deposit in question is in turn tied to the loan from the South African bank to a South African company. Many of these back-to-back schemes would most likely violate the general anti-avoidance rule (SA, 2010:73) had it not been for the provisions of section 49D(2).

The specific exemption in terms of section 49D(1)(a)(i)(cc) on interest that is paid by a headquarter company to a foreign person for financial assistance that is not subject to transfer pricing, as a result of the application of section 31(5)(a) or (b), applies to interest paid to that foreign person by the headquarter company. This is due to the fact that a headquarter company is regarded as a non-resident company for many provisions of the Act (58 of 1962).

The general exemption from withholding tax in section 49D(3) provides that a foreign person will be exempt from the new South African withholding tax on interest if that foreign person:

- is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid; or
- has been allocated a taxpayer reference number as defined in the Tax Administration Act (SA, 2013b:116) in the case of the debt from which the interest arises is effectively connected to a permanent establishment of that person in the Republic.

The effect of this general exemption from withholding tax which is linked to the section 10(1)(h) exemption is that if the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax.

Under the revised proposal in terms of the draft Taxations Laws Amendment Bill 2013 (SA, 2013b:115), the exemption from the withholding tax on bank interest should apply to all forms of interest paid by a bank, regardless of whether a debt instrument is involved. Interest paid by the South African Reserve Bank, Development Bank of Southern Africa and the Industrial Development Corporation will also be exempt in terms of subsection 49D(1)(a)(i)(bb). This exemption is in line with the general exemption for interest paid by commercial banks (SA, 2012d:111).

These exemptions provide similarities and differences when compared to the exemptions provided for in terms of NRTI in paragraph 2.3.3 and are explained in comparison to the new South African withholding tax on interest exemptions below.

The following are the similarities between the exemptions in terms of NRTI and the new South African withholding tax on interest:

- The exemption of interest paid to any foreign person by the government of the Republic in the national, provincial or local sphere was also provided for in terms of NRTI, however, the NRTI exemptions also included interest from ESKOM which is not included in the above exemptions.
- The interest exemptions from a bank, namely the SARB, were also included in NRTI. However, it was limited to interest from the SARB and did not include interest from any bank, the Development Bank of Southern Africa or the Industrial Development Corporation. Interest accruing to any non-resident bank that was entrusted with the principal foreign exchange reserves of that territory, where the Minister of Finance applied the NRTI, was, however, exempt in terms of NRTI.
- Furthermore, interest from debts arising in the Republic by any person who had a permanent place of business in the Republic was also exempt in terms of NRTI.

The following are the differences between the exemptions in terms of NRTI and the new South African withholding tax on interest:

- There were no exemptions available to a headquarter company for financial assistance that is not subject to the thin capitalisation rules as per section 31 of the Act (58 of 1962) in terms of NRTI, as the headquarter company legislation had not been enacted then.
- Interest in respect of any listed debt or an amount of interest payable as contemplated by section 27(6) of the Securities Services Act (36 of 2004) and amounts of interest that were deemed to have accrued to a non-resident in terms of section 25BA(a) of the Act (58 of 1962) were also not exempt from NRTI.
- NRTI, did provide for an exemption of interest in respect of subscription to shares in any building society.
- Interest on amounts incurred not used to produce gross income borrowed outside the Republic from resources in the Republic, interest on bills of exchange and promissory notes, interest accrued to any ecclesiastical, charitable or educational institution of a public character were all specifically limited to NRTI and have not been included in the new South African withholding tax on interest.

The above exemptions available under NRTI and not included as part of the new South African withholding tax on interest exemptions once again highlight the weaknesses and generosity of the previous NRTI.

### **3.4.3 Payment and recovery of unpaid withholding tax**

In terms of section 49F, any person that withholds any withholding tax on interest must pay the tax to the Commissioner by the last day of the month following the month during which the interest is paid (SA 2013b:117). If a foreign person is liable for an amount in respect of the section 49B withholding tax, due to the tax not being withheld by the payer, the foreign person must pay the tax by the last day of the month following the month during which the interest is paid (SA 2013b:117). This is not applicable if the tax has been paid by another person (58 of 1962). This provision agrees with that of dividends in terms of section 64K and royalties in terms of section 35 which has been recently repealed and replaced by section 49A-D which is not yet

effective and is proposed to be replaced with the implementation of section 50A-H from 1 January 2015 (SA 2013b:121).

#### **3.4.4 Refund of withholding tax**

Where tax is withheld on interest per section 49E(1) and a declaration as prescribed by the Commissioner that the interest is subject to a reduced tax rate was not submitted to the payer by the payment date, whereafter such a declaration is subsequently submitted to the Commissioner, the withholding tax is refundable by the Commissioner to the person whom the interest was paid to in terms of section 49G (SA 2013b:116). The declaration must, however, be submitted to the Commissioner within three years after the payment of the interest in respect of which the declaration is made in terms of section 49G(c) (SA 2013b:117).

#### **3.4.5 Currency of payments made to SARS**

Where interest is paid or payable in the form of foreign currency, section 49H, determines that the interest must be translated to the South African Rand at the spot rate on the date that the payer withholds or deducts the withholding tax (SA 2013b:117). This section is in line with the rules for withholding in relation to foreign sportspersons and entertainers and dividends tax (SA, 2013b:121). A similar rule is proposed for withholding tax on royalties paid or payable in a foreign currency (SA, 2013b:121).

### **3.5 HEADQUARTER COMPANIES AND THE IMPACT ON THE NEW SOUTH AFRICAN WITHHOLDING TAX ON INTEREST**

#### **3.5.1 Investment barriers including withholding tax exemptions**

South Africa, as indicated in paragraph 3.1 above, is a natural holding company gateway into the African region. However, in order to serve as an ideal holding company jurisdiction, the thin capitalisation rules which have been included under the transfer pricing rules in section 31 of the Act (58 of 1962) were identified as a significant barrier (SA, 2010:80). In terms of these rules, as indicated in paragraph 3.3, if the South African holding company is financed with debt capital, the thin

capitalisation provisions serve as a critical barrier. The application of transfer pricing provisions to this arrangement would probably leave the holding company with non-deductible interest payments owed to the foreign investor while being burdened with corresponding taxable interest income from the on-lending (SA, 2010:80).

According to the Katz Commission in its “5<sup>th</sup> Report on basing the South African income tax system on the source or residence principle – options and recommendations of 1997”, South Africa’s then source-based tax system positioned it well as a head office, finance or management company location for investment into Africa north of its borders. The report stated that with the expectation of an important South African role in regional or even continental economic revival, the location would have impacted on South African investment into Africa. Other non-African investment into the continent via South Africa with its relatively developed financial structure and other infrastructural advantages would also have been impacted (SA, 1997:6). The aforementioned still seems to be the case, as described in the paragraph above, even though South Africa now applied the worldwide basis of taxation.

Subsequently, as of 1 March 2001, South Africa taxes the income of residents on a worldwide basis. This worldwide tax system includes proportionate interests of tainted income of a CFC. “Tainted income” of a CFC generally includes passive income and diversionary income (the latter of which reflects income arising in circumstances likely to lead to transfer pricing) (58 of 1962).

Thin capitalisation provisions also exist to avoid the flow of interest offshore to the extent that the foreign debt of a South African company is excessive in relation to the company’s equity. This excessive determination is a facts and circumstances test. Thin capitalisation could even apply if the foreign funds borrowed are immediately lent to offshore operations (58 of 1962).

South Africa is regarded as the economic powerhouse of Africa (SA, 2010:77) and, according to the National Treasury, South Africa is a natural holding company gateway into Africa as explained above (SA, 2010:77). South Africa’s high tax costs and strict exchange controls have previously deterred foreign multinational

companies from establishing headquarter companies in South Africa. Three specific barriers that deter foreign multinational companies from establishing headquarter companies in South Africa, as identified by the Department of National Treasury, include:

- (a) the application of section 9D and the CFC regime,
- (b) the application of section 64B and the liability for dividends tax of resident companies, and
- (c) the application of section 31 and the transfer pricing rules in respect of debt financing (SA, 2010:77).

These barriers have been addressed by the insertion of section 9I into the Act (58 of 1962) and relief-provisions in respect of thin capitalisation and transfer pricing rules that apply specifically to headquarter companies. These measures are regarded as incentives for multinational companies to establish their headquarter companies in South Africa (Stiglingh *et al.*, 2012:584).

South African tax legislation proposed in terms of section 49D(1)(a)(i)(cc) by the draft Taxation Laws Amendment Bill 2013, in respect of headquarter companies providing financial assistance that is not subject to the transfer pricing provisions, is proposed to be brought into legislation (SA, 2013b:115). This is due to the fact that a headquarter company is regarded as a non-resident company for many provisions of the Act (SA, 2013b:115). This legislation was introduced to address the barrier applying section 31 and the transfer pricing rules in respect of debt financing and results in the headquarter company becoming entitled to tax relief whereby the interest paid by a headquarter company will also be exempt from withholding tax on interest. However, this exemption will be limited to interest received from a loan that forms part of a back-to-back arrangement with the headquarter company acting as cross-border intermediary borrower and on-lender (SA, 2013b).

The exemption provided by section 49D(1)(a)(i)(cc) therefore addresses the barrier by applying section 31 and the transfer pricing rules in respect of debt financing in respect of the transfer pricing rules for headquarter companies. A headquarter company will not be considered to violate the thin capitalisation rules merely

because of the existence of back-to-back cross-border loans involving the headquarter company (SA, 2010:75). The impact of this should hopefully keep South Africa as natural and preferred holding company gateway into the region.

### **3.6 CONCLUSION**

Based on the examination and discussion, it is evident that South Africa is in need of FDI into its developing economy. At the same time South Africa needs to be competitive with other developing economies in attracting this FDI. It is apparent that the current interest exemption as per section 10(1)(h), as explained in paragraph 2.5, appears to have been overly generous and, therefore, not beneficial to the developing South Africa economy.

The discussion in this chapter examined the new South African withholding tax on interest, including the reasons and motivation for the introduction of this new South African withholding tax on interest, the alignment with the section 10(1)(h) interest exemption and the legislative provisions of sections 49A-H. The new South African withholding tax on interest will, in terms of these sections, address the weaknesses of NRTI not yielding a sufficient benefit for the *fiscus*, it being an obstructive factor in raising foreign finance, and also the weakness that although NRTI is paid by non-residents, it is effectively borne by the South African borrower as discussed in paragraph 2.4. This is achieved by coordinating and streamlining the rates from 10% to that of a uniform withholding rate of 15% to be in line with the uniform withholding tax regime. The new South African withholding tax on interest also defines in detail the applicable interest and persons liable when compared to the non-resident person, company, deceased estate or trust as defined in terms of NRTI. The new South African withholding tax on interest furthermore expands on timing and procedure, refunds and currency for payments of the withholding tax on interest which was not included in the previous NRTI, as evident in paragraph 2.3.

The exemptions available under NRTI and not included as part of the new South African withholding tax on interest exemptions also highlight the weaknesses and generosity of the previous NRTI. The weakness of the section 10(1)(h) prior to the

new South African withholding tax on interest being overly generous has been addressed by the revised section 10(1)(h) being aligned to sections 49A-H.

The major contributory factor for the removal of previous NRTI legislation as explained in paragraph 2.3 of not yielding a sufficient benefit for the *fiscus* and being effectively borne by the South Africa borrower will therefore be addressed in terms of the new South African withholding tax on interest.

The impact of headquarter companies on the new South African withholding tax on interest including the barriers of the thin capitalisation rules which have been included under the transfer pricing rules in the Act (58 of 1962) have also been examined. The mechanism to address these barriers identified by the headquarter company regime by means of the specific exemptions will be used in the comparison that is performed in the chapters that follow.

This examination of the legislative provisions in sections 49A-H to be implemented provide a basis for the comparison in Chapter Five with the withholding taxes implemented in other countries as will be examined in Chapter Four. The evidence to support the reasons as to whether the section 10(1)(h) interest exemption appears to be generous in comparison with other countries will also be investigated.

## **CHAPTER FOUR**

### **WITHHOLDING TAXES ON INTEREST IN OTHER COUNTRIES**

#### **4.1 INTRODUCTION**

As indicated in paragraph 2.2, withholding taxes are taxes levied by one country on specific types of payments to recipients of another country (Easson, 2004:39). Withholding taxes essentially allow for tax that is due on the income to be withheld at source by the payer before the income is paid to the person entitled to the income (Easson, 2004:39). The tax liability is, therefore, settled before the payment is made to the recipient, thereby preventing the tax from escaping the relevant tax authorities (Easson, 2004:39). Since withholding taxes are usually imposed as part of the general income tax law of a country and normally apply to payments made to non-residents, an investigation into the residence of taxpayers, basis of taxation as well as similar withholding taxes on interest will be performed (Easson, 2004:39).

This chapter provides an overview of the taxation applied in the selected countries including the method of taxation, rates of withholding tax on interest, relief from double taxation in terms of DTAs, withholding and normal interest exemptions and repo rates. The consideration of the repo rate is based on the assumption that the interest paid to a non-resident will be linked to the repo rate.

The investigation will include developed as well as developing countries. The rates and exemptions of withholding taxes vary hugely according to country, however treaty provisions between countries provide for a greater degree of uniformity in the application of withholding taxes. The rates, exemptions and treaty provisions will provide commonality among the comparatives and, furthermore, will also be useful for the comparison of the withholding taxes on interest.

This chapter will address objective (iii) in paragraph 1.3 to examine the tax systems relating to withholding taxes on interest implemented by developing countries, namely the BRIC countries (Brazil, Russia, India, China), Mozambique and Namibia,

and developed countries, namely Germany and Denmark. The above will ensure that equitable comparisons can be made.

## **4.2 DISTINGUISHING BETWEEN DEVELOPING AND DEVELOPED COUNTRIES**

The classification of countries as either “developing” or “developed” differs according to the definition of different international organisations. Three of the reputable organisations are the International Monetary Fund (IMF), the United Nations Development Programme (UNDP) and the World Bank (Nielsen, 2011:9).

A previous study by the IMF has revealed that the current classification systems of these organisations are quite similar in terms of designating countries as being either “developing” or “developed” (Nielsen, 2011:9). As the organisations reach broadly similar conclusions regarding the membership of the developed country grouping, the compositions of the developing country group are, equally similar (Nielsen, 2011:9). Given the large and diverse group of developing countries, all three organisations have found it useful to identify subgroups as described in the paragraphs to follow (Nielsen, 2011:9). For the purposes of this study, the World Bank’s definitions and classifications will be used to identify developing and developed economies (Nielsen, 2011:9).

For operational and analytical purposes, the World Bank’s (World Bank, 2012a) key criterion for classifying economies is gross national income (GNI) per capita, previously referred to as gross national product (GNP). Based on the GNI per capita, all economies are classified as low income, middle income (subdivided into lower middle and upper middle) or high income. Other analytical groups based on geographic regions and lending categories are also used (World Bank, 2012a).

The World Bank defines developing countries as those countries with low or middle levels of GNI per capita. The definition also includes the following five high-income developing economies namely China, Israel, Kuwait, Singapore and the United Arab Emirates. These five economies have been classified as developing despite their

high per capita income because of their economic structure or in terms of the official opinion of their governments (World Bank, 2012b).

All designated developed and advanced countries are encompassed for classification purposes in the World Bank's high-income group (Nielsen, 2011:9). The World Bank (World Bank, 2012a) defines developed countries as high-income countries. Most people in these developed countries have a high standard of living. These countries are sometimes also defined as industrial countries or industrially advanced countries or countries with a large stock of physical capital. As a result most people in these countries undertake highly specialised activities. According to the World Bank (World Bank, 2012a) classification, these include all high-income economies except the five high-income developing economies as indicated above. Contingent on who defines them, developed countries could also include middle-income countries with transition economies, because these countries are highly industrialised (World Bank, 2012b).

#### **4.3 CLASSIFICATION OF THE SOUTH AFRICAN ECONOMY AS A DEVELOPING COUNTRY**

The South African economy consists of a two-tiered economy: the first tier which rivals other developed countries and the second tier which has only the most basic infrastructure (Anon., 2011a:9). The "first tier" consists of the mining, agriculture, manufacturing, financial services, and retail sectors which is competitive with mature markets in terms of efficiency and level of sophistication. The "second tier" is South Africa's large informal economy that is best characterized as a third world economy (Schalkwijk, 2011:1). The economy is therefore productive and industrialised but also exhibits many characteristics associated with developing countries. These characteristics include a division of labour between the formal and informal sectors and an uneven distribution of wealth and income. The formal sector which is largely based on mining, manufacturing, services and agriculture is well developed (Anon., 2011a:9). The current listing of the South African economy as having an upper middle income GNI therefore results in the South African economy being classified as a developing or middle income economy (IMF, 2012:3; World Bank, 2012c:5).

## **4.4 COUNTRIES SELECTED FOR COMPARATIVE STUDY**

### **4.4.1 The BRICS countries**

During December 2010, South Africa was invited to join the BRIC group of countries after it applied to join the BRIC group of countries at the G20 Meeting of the world's leading economies in Seoul in November 2010 (Anon, 2010). South Africa accepted and has become the fifth member of the BRICS group of countries (Brand South Africa, 2011b). BRICS is a powerful group of emerging economies which, according to the International Monetary Fund, will account for as much as 61% of global growth in three years' time (Brand South Africa, 2011b).

The admission of South Africa to BRICS as an emerging developing economy coupled with the fact that these BRICS countries all apply withholding taxes on interest and also use source-based taxation for non-residents will be used as a guideline to assess the withholding taxes in these economies in the present comparative study.

### **4.4.2 Developing African countries**

According to Zebst (2010:1), the African continent is playing a vital role in fuelling economic growth in emerging economic powerhouses like China, India and Brazil by supplying natural resources (Zebst, 2010:1). Africa is a worthwhile investment destination for multinational corporations from these nations (Zebst, 2010:1). The continent is also an important area of potential market-led growth. A population of close to one billion, half of whom are under 35 years in age creates market and labour opportunities in abundance for the continent (Zebst, 2010:1). Africa is now one of the world's fastest-growing regions and an analysis by The Economist found that over the ten years to 2010 six of the world's ten fastest-growing economies were in sub-Saharan Africa (Anon., 2011b:1).

South Africa is the economic powerhouse of Africa (SA, 2010:77). South Africa's location, sizeable economy, political stability and overall strength in financial services make it an ideal location for the establishment of regional holding companies by foreign multinationals (SA, 2010:77). South Africa's network of tax treaties

furthermore provides ready access to other countries in the region. South Africa is, therefore, a natural holding company gateway into the region (SA, 2010:77). There has, therefore, been a drive to make South Africa a sought-after destination for the Regional Headquarter company location of foreign multinationals with the introduction of the Regional Headquarter company regime as discussed in paragraph 3.5. The new Regional Headquarter company regime was enacted during 2010 to ensure that the tax system did not act as a barrier to the use of South Africa as regional headquarter company destination by foreign multinationals wanting to invest mainly in Sub-Saharan Africa (SA, 2011a:92). In the process three hurdles were cleared, namely relief from tax on dividends to and from the headquarter company, relief from the controlled foreign company deemed income rules and also relief from transfer pricing (including thin capitalisation) in respect of back-to-back loans (SA, 2011a:92).

South Africa is, furthermore, one of the world's largest producers and exporters of gold and platinum. Mining, services, manufacturing and agriculture compete with similar sectors in the developed world (The Heritage Foundation, 2012c:1). However, unemployment is high and poverty is widespread. A majority of the population is poorly educated and lack access to basic infrastructure and services (The Heritage Foundation, 2012c:1). It should also be noted, as indicated, that South Africa was ranked 128th in the IFDI Performance Index (UNCTAD, 2010).

Mozambique, which is South Africa's neighbouring country to the East is socio-economically speaking very similar to South Africa (The Heritage Foundation, 2012a:1). It also held its first democratic elections in 1994 like South Africa and since then has been a model for development and post-war recovery (The Heritage Foundation, 2012a:1). Economic growth has been generally strong since the mid-1990s. Major exports include aluminium, shrimp and cash crops (The Heritage Foundation, 2012a:1). However, the country remains poor and burdened by state-sanctioned monopolies and inefficient public services (The Heritage Foundation, 2012a:1). The country's informal sector accounts for most employment. HIV/AIDS is also a serious problem (The Heritage Foundation, 2012a:1). Mozambique was ranked 19th in the IFDI Performance Index (UNCTAD, 2010).

Namibia, which is South Africa's neighbouring country to the West, has an economy which is closely linked with that of South Africa, its major trading partner and former administering power (The Heritage Foundation, 2012b:1). The country is rich in minerals, including uranium, diamonds, copper, gold, lead and zinc. However, weak infrastructure, a high unemployment rate and problems in the utility and electricity sectors have impeded growth (The Heritage Foundation, 2012b:1). About a third of Namibia's population depends on subsistence agriculture and herding for their livelihood (The Heritage Foundation, 2012b:1). Official pressure on white and foreign landowners to sell their property to the Namibian government, so that "historically disadvantaged" and landless Namibians can be resettled, has resulted in expropriations (The Heritage Foundation, 2012b:1). State-owned enterprises have operations in many key sectors. HIV/AIDS is also a serious problem (The Heritage Foundation, 2012b:1). Namibia was ranked 27th in the IFDI Performance Index (UNCTAD, 2010).

The similarities between South Africa, Mozambique and Namibia as emerging developing economies will be used as a guideline in the comparative study to assess the withholding taxes in these countries. The above guideline is further enhanced by the fact that both Mozambique and Namibia apply withholding taxes on interest and also use the source basis of taxation for non-residents (Deloitte, 2013e:2; 2013f:2). These factors will be used as a guideline in the comparative study to assess the withholding taxes in this economy.

#### **4.4.3 Developed European countries**

South Africa's trade relations with Europe, particularly with the EU, are fundamental to the country's economic development. The Trade, Development and Co-operation Agreement (TDCA) with the EU forms a considerable element of South Africa's reconstruction and development efforts (Maesti Web Consulting Services, 1996-2011). The relationship between South Africa and Germany has also developed into a strong socio-economic and political partnership since 1994 that has shown considerable growth in many areas (SA, 2011b:36). Germany has made considerable new investments in the South African economy since the 1994 democratic election and remains one of the country's most important trading partners

(SA, 2011b:36). Germany was ranked 104<sup>th</sup> in the IFDI Performance Index which is close to South Africa's 128<sup>th</sup> ranking (UNCTAD, 2010).

South Africa also enjoys excellent relations with Denmark which form part of the EU and Nordic countries which include Finland, Iceland, Norway and Sweden (SA, 2011b:37). As a result of strong grassroots support in these countries for democratisation in South Africa during apartheid, relations have been established in virtually every field (SA, 2011b:37). Relations in the international arena between South Africa and Denmark have seen close co-operation on multilateral issues (SA, 2011b:37). Denmark was ranked 138<sup>th</sup> in the IFDI Performance Index which is also close to South Africa's 128<sup>th</sup> ranking (UNCTAD, 2010).

The similarities between South Africa, Germany and Denmark are that they apply withholding taxes on interest, the source basis of taxation for non-residents and have the closest IFDI rankings compared to BRIC and the selected developing countries. As a result of the nature and scope of this study and due to the limitations as per paragraph 1.5.2 the focus of this study is limited to comparisons in relation to withholding taxes. With the focus on BRIC, developed and developing economies, only the German and Danish European countries have been selected for this study.

The above-mentioned countries will be used to examine the withholding taxes on interest in these economies below which will be used in the comparative study in Chapter Five.

#### **4.5 WITHHOLDING TAX ON INTEREST IMPLEMENTED IN THE BRIC COUNTRIES**

The following paragraphs provide an overview of taxation applied in the BRIC countries including the method of taxation, rates of withholding tax on interest, relief from double taxation in terms of DTAs, withholding and normal income tax interest exemptions and repo rates.

## **4.5.1 Brazil**

### **4.5.1.1 Method of taxation**

A corporation is a resident in Brazil if it is incorporated in Brazil and an individual is resident in Brazil if he or she is a citizen (Deloitte, 2013a:1-3; PKF, 2013a:14). In addition to citizens, the following are considered to be tax residents: naturalised foreigners, foreigners who hold a permanent or a temporary visa with a local employment contract from the date of arrival and foreigners who hold a temporary visa but no local employment contract after completing 183 days of residence in Brazil within any 12-month period (Deloitte, 2013a:1-3; PKF, 2013a:14).

Brazilian resident companies are taxed on worldwide income (Deloitte, 2013a:1; Ernst & Young 2011:134). A foreign company is subject to Brazilian taxation only if it carries out certain sales activities in Brazil through agents or representatives subject to certain requirements or through a domestic branch of the foreign seller (Deloitte, 2013a:1; Ernst & Young 2011:134). The source of interest income applicable to non-residents is determined by the location of the interest payer (Deloitte, 2013a:3).

The rate of corporate income tax is 15% (Deloitte, 2013a:3; PKF, 2013a:14). However, a combined rate of 34% is levied after the surtax and the social contribution on net profits (Deloitte, 2013a:3; PKF, 2013a:14). Brazilian resident individuals are taxed on worldwide income according to a sliding scale with a maximum rate of 27.5%. Non-residents are taxed only on income from Brazilian sources at a flat rate of 27.5% on earned income or 15% on other income (Deloitte, 2013a:3; PKF, 2013a:14).

### **4.5.1.2 Withholding tax on interest**

Interest paid to non-resident companies and individuals is generally subject to a 15% withholding tax. The rate of withholding tax is increased to 25% if the recipient is domiciled in a tax haven (Deloitte, 2013a:2; PKF, 2013a:14). The withholding tax on interest is a final tax (Yamamoto, 2012). The withholding tax payment is effected by the local payer of the interest on the non-resident's income (KPMG, 2013a:2).

#### **4.5.1.3 Relief from double taxation in terms of DTAs**

The 15% rate can be reduced to 10% by a tax treaty. However, the 10% rate generally applies to loans with a certain minimum term granted for specific purposes, for example the acquisition of capital goods. The 15% rate is considered for all other cases (PKF, 2013a:14; PWC, 2013a).

#### **4.5.1.4 Withholding tax exemptions and zero-percent withholding rates**

There are some withholding tax exemptions and zero-percent withholding rates established by domestic law. These rates are mainly related to export loans granted by export credit agencies, export financing as well as to loans granted by the International Finance Corporation or by governmental agencies and destined to the acquisition of equipment (Brazilian Chamber of Commerce, 2012:3).

#### **4.5.1.5 Normal income tax interest exemptions**

There are no normal income tax interest exemptions available to non-resident companies and individuals in respect of local interest (PKF, 2013a; PWC, 2013a; Yamamoto, 2012). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.5.1.6 Repo rate**

The repo rate as set by the Brazilian central bank is set at 9.00% for Brazil and is applicable as of 28 August 2013 (Central Bank Rates, 2013; Triami Media BV, 2009-2013).

### **4.5.2 Russia**

#### **4.5.2.1 Method of taxation**

The taxation residence status of an entity depends on whether it is incorporated under Russian or foreign law (Deloitte, 2013d; PKF, 2013d:1). An individual is a

resident if he or she spends more than 183 days in Russia during the 12-month period that corresponds to the calendar year (Deloitte, 2013d:2; PKF, 2013d:4).

Russian entities are taxed on their worldwide income and foreign entities are taxed on income from commercial activities undertaken in Russia and on passive income from a Russian source (Deloitte, 2013d:1; PKF, 2013d:1). The standard corporate taxation rate for resident and non-resident entities is 20% (Deloitte, 2013d:1; PKF, 2013d:1).

Resident individuals of Russia are taxed on their worldwide income and non-residents are taxed on Russian-source income. A 13% flat rate applies to most types of income of Russian residents and a 30% rate to non-residents on Russian source income (Deloitte, 2013d:2; PKF, 2013d:4).

#### **4.5.2.2 Withholding tax on interest**

Interest paid to non-resident companies and individuals is subject to a 20% withholding tax unless the rate is reduced under a tax treaty (Deloitte, 2013d:1; PKF, 2013d:5-7). The withholding tax on interest is not a final tax (Churilova, 2012).

#### **4.5.2.3 Relief from double taxation in terms of DTAs**

The 20% withholding tax rate on interest for companies and individuals can be reduced to 0%, 5%, 7%, 7.5%, 10% or 15% by a tax treaty depending on the specific country's treaty (PKF, 2013d:5-7; PWC, 2013d).

Foreign withholding taxes may be credited against Russian tax imposed on the same income up to the amount of Russian tax on the income (Ernst & Young, 2011:953; PKF, 2013d:3).

#### **4.5.2.4 Withholding tax exemptions and zero percent withholding rates**

There are no specific withholding tax interest exemptions available to companies and individuals in respect of local interest. However, some tax treaties reduce the rate as explained in the paragraph above (John, 2012; PKF, 2013d:1-7; PWC, 2013d). In

most cases a zero-percent tax rate applies to interest payments to the governments of contracting states and to payments guaranteed by the government (PWC, 2013d).

#### **4.5.2.5 Normal income tax interest exemptions**

Interest received on Russian currency (Rouble) and foreign currency deposits held at banks located in Russia is tax-exempt within specified limits and will be tax exempt if the annual interest rate does not exceed the following thresholds:

- 9% for foreign currency deposits, and
- the refinancing rate of the Central Bank of Russia increased by 5 percentage points for deposits in Roubles (Churilova, 2012).

This exemption is provided to all taxpayers irrespective of their residency status (Churilova, 2012).

The above exemption is not related to the 20% withholding tax that applies to interest that is not linked to a permanent establishment (Churilova, 2012; KPMG, 2013b:5). The exemption applies if the annual interest rate does not exceed the exemption rates. Interest received by non-residents from Russian legal entities, Russian individual entrepreneurs or foreign legal entities in connection with the activities of their permanent establishment in Russia, are taxed at 30% (Churilova, 2012; KPMG, 2013b:5). Interest income received in excess of the above thresholds is taxable at 35% (Churilova, 2012; KPMG, 2013b:5).

#### **4.5.2.6 Repo rate**

The repo rate as set by the Russian central bank is set at 8.25% for Russia and is applicable as of 14 September 2012 (Central Bank Rates, 2013; Triami Media BV, 2009-2013).

### **4.5.3 India**

#### **4.5.3.1 Method of taxation**

A corporation is resident in India if it is incorporated or wholly managed and controlled in India and an individual is a resident if he or she is a citizen of India or is deemed to be resident in India if he or she spends at least 182 days in the country in a given year or 60 days if the individual has spent at least 365 days in India in the preceding four years (Deloitte, 2013b:1-3; PKF, 2013b:1-12). A threshold of 182 days in the given year is applied instead of 60 days to citizens who leave India for employment purposes and visit for vacation purposes or as members of the crew of an Indian ship (Deloitte, 2013b:1-3; PKF, 2013b:1-12). A “not ordinarily resident” individual is one who has either not been a resident in nine out of the ten preceding years or who has been in India for less than 730 days during the preceding seven years (Deloitte, 2013b:1-3; PKF, 2013b:1-12).

Indian resident companies are taxed on worldwide income at a rate of 30% resulting in an effective rate of 32.445% taking into account the surtax and cess. A surcharge of 5% applies to domestic companies (2% to foreign companies) if income exceeds 10 million Indian Rupees (INR). An additional 3% cess is payable in all cases. Foreign source income derived by resident companies is subject to corporation tax in the same way as Indian income. A branch of a foreign corporation is taxed as a foreign corporation (Deloitte, 2013b:1-3; PKF, 2013b:1-12). Non-resident companies are taxed only on income from an Indian source at a rate of 40% resulting in an effective rate of 42.024% taking into account the surtax and cess (Deloitte, 2013b:1).

Individuals resident in India are taxed on worldwide income at progressive rates up to 30% plus the applicable cess. Non-residents do not pay tax on income earned outside India unless it is derived from a business controlled in India, the income is accrued or first received in India or is deemed to have accrued in India. A non-resident is subject to tax on Indian sourced income at progressive rates of up to 30% plus the applicable cess (Deloitte, 2013b:3; PKF, 2013b:1-12).

#### **4.5.3.2 Withholding tax on interest**

Interest paid to a non-resident is generally subject to a 20% withholding tax. The percentage is to be increased by a surcharge, education cess and secondary and higher education cess to compute the effective rate of tax withholding (PWC, 2013b). Interest paid to a non-resident on an infrastructure debt fund set up in accordance with the prescribed government guidelines will be subject to a 5% withholding tax plus the applicable surcharge and cess. Interest paid to a non-resident on debt incurred under a loan agreement or by issue of long term infrastructure bonds by an Indian company in foreign currency is subject to a 5% withholding tax plus the applicable surcharge and cess as of 1 July 2012. The loan agreement, however, needs to be approved by the central government and the funds borrowed between 1 July 2012 and 30 June 2015 (Deloitte, 2013b:2). If the non-resident does not have a tax registration number known as a Permanent Account Number (“PAN”), tax must be withheld at the applicable rate or 20% – whichever is higher (Deloitte, 2013b:2; PKF, 2013b:1-12).

The withholding tax on interest is a final tax. The payer is required to withhold taxes at the specified rate on payment of interest to the non-resident. Once taxes are withheld on the interest, it generally discharges the final tax liability of the non-resident recipient (Raval, 2012).

#### **4.5.3.3 Relief from double taxation in terms of DTAs**

The 20% withholding tax rate on interest for companies and individuals can be reduced to 5%, 10%, 12.5% or 15% by a tax treaty depending on the specific country treaty (PKF, 2013b:1-14; PWC, 2013b).

Foreign tax relief for the avoidance of double taxation is governed by tax treaties with several countries. If no such agreement exists, resident companies may claim a foreign tax credit for the foreign tax paid. The amount of the credit is the lower of the Indian tax payable and the foreign tax paid (Ernst & Young, 2011:476; PKF, 2013b:9).

#### **4.5.3.4 Withholding tax exemptions and zero-percent withholding rates**

No taxes are required to be withheld on interest payable on any securities issued by Central or State Government, securities listed on recognised Stock exchanges in India or few other specified categories (Raval, 2012).

#### **4.5.3.5 Normal income tax interest exemptions**

There are no normal income tax interest exemptions available to companies and individuals in respect of local interest (PKF, 2013b:1-14; PWC, 2013b). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.5.3.6 Repo rate**

The repo rate as set by the Indian central bank is set at 7.50% for India and is applicable as of 20 September 2013 (Central Bank Rates, 2013; Triami Media BV, 2009-2013).

### **4.5.4 China**

#### **4.5.4.1 Method of taxation**

An enterprise is a resident in China if it is established in China or if its place of effective management as defined is China (Deloitte, 2013c:1; PKF, 2013c:1). A foreign company will also be subject to China's income tax if it has an "establishment" in China or even if it does not have an establishment in China, but it derives income from a Chinese source (Deloitte, 2013c:1; PKF, 2013c:1). If a foreign company has an establishment in China, it will be subject to China's income tax on all income effectively connected with that establishment. Relief may be granted under a tax treaty (Deloitte, 2013c:1; PKF, 2013c:1).

A resident individual is an individual domiciled in the Chinese Mainland. The test for residence in China is based on whether an individual is usually or habitually residing in China due to household, family or economic involvement (Deloitte, 2013c:2).

Resident companies are taxed on worldwide income while non-resident companies are taxed on Chinese sourced income and income effectively connected with their establishments in China (Deloitte, 2013c:1; PKF, 2013c:1).

The standard company income tax rate for resident and non-resident companies is 25% (Deloitte, 2013c:1; PKF, 2013c:1). A resident individual is subject to individual income tax on his or her worldwide income (Deloitte, 2013c:2). Natural persons whether non-resident or resident of less than one year are subject to personal tax only on income which is Chinese sourced (Deloitte, 2013c:2). Non-resident individuals staying in China for a period exceeding one year but less than five consecutive full tax years are subject to individual income tax on income from a source in China ("China-source income") plus foreign income actually borne by Chinese entities or establishments (Deloitte, 2013c:2). Non-domiciled individuals staying in China for more than five consecutive full tax years are taxed on worldwide income as they are deemed to be domiciled after the five consecutive full year's period (Deloitte, 2013c:2). Individuals are taxed at progressive rates up to a maximum of 45% depending on the different income streams (Deloitte, 2013c:3; PKF, 2013c:5-6).

#### **4.5.4.2 Withholding tax on interest**

A 10% withholding tax, which is lowered from a 20% statutory rate, applies to interest paid to non-residents, unless the rate is reduced under a tax treaty. The withholding tax on interest is a final tax. The tax is collected by way of withholding by the payer of interest at prescribed rates (Khaw, 2013).

#### **4.5.4.3 Relief from double taxation in terms of DTAs**

The 10% withholding tax rate on interest for companies and individuals can be reduced to 0%, 5%, 7% or 7.5% by a tax treaty depending on the specific country's

treaty. In cases where the tax treaty has two different rates, the lower rate applies to interest payable to banks or financial institutions (PKF, 2013c:5-9; PWC, 2013c).

A tax credit is allowed for foreign income taxes paid or indirectly borne by the People's Republic of China (PRC) resident enterprises, but the credit is generally limited to the amount of PRC corporate income tax payable on the foreign-source portion of an enterprise's worldwide taxable income (Ernst & Young, 2011:208; PKF, 2013c:3). A non-resident enterprise with a permanent establishment in the PRC that derives foreign source income effectively connected to the permanent establishment can also claim a tax credit for income taxes paid in foreign jurisdictions, but the credit is limited to the PRC corporate income tax payable on such income (Ernst & Young, 2011:208; PKF, 2013c:3).

#### **4.5.4.4 Withholding tax exemptions and zero-percent withholding rates**

There are no withholding tax interest exemptions available to companies and individuals in respect of local interest (PKF, 2013c:5-9; PWC, 2013c).

#### **4.5.4.5 Normal income tax interest exemptions**

Interest income earned from State bonds and interest income earned by non-profit organisations are exempt from normal corporate income tax (Chan, 2012). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.5.4.6 Repo rate**

The repo rate as set by the Chinese central bank is set at 6% for China and is applicable as of 5 July 2012 (Central Bank Rates, 2013; Triami Media BV, 2009-2013).

## **4.6 WITHHOLDING TAX ON INTEREST IMPLEMENTED IN DEVELOPING AFRICAN COUNTRIES**

The following section provides an overview of taxation applied in the selected developing African countries, including the method of taxation, rates of withholding tax on interest, relief from double taxation in terms of DTAs, withholding and normal income tax interest exemptions and repo rates.

### **4.6.1 Mozambique**

#### **4.6.1.1 Method of taxation**

A company is resident in Mozambique if its head office or place of effective management or control is Mozambique or if the business is registered in Mozambique (Deloitte, 2013e:1; Ernst & Young, 2011:761). A resident in Mozambique for tax purposes is an individual who is a citizen of Mozambique. An individual is deemed to also be a resident in Mozambique if he or she resides in Mozambique for more than 180 days during a tax year or has a permanent residence in Mozambique at 31 December (Deloitte, 2013e:2).

A resident company is taxed on its worldwide income. A non-resident company is subject to tax only on its Mozambique source income. The standard company income tax rate for resident and non-resident companies is 32% (Deloitte, 2013e:1; Ernst & Young, 2011:761). Mozambique residents are subject to tax on worldwide income. A non-resident is subject to tax only on Mozambican source income (Deloitte, 2013e:2). Individuals are taxed at progressive rates of up to a maximum of 32% (Deloitte, 2013e:3).

#### **4.6.1.2 Withholding tax on interest**

In terms of the tax legislation in Mozambique withholding tax on interest is levied on interest paid to a resident or non-resident at a rate of 20%, unless the rate is reduced specifically for non-residents by a tax treaty (PWC, 2013e). An exception exists for payments to non-residents for telecommunications and international transport as well as the respective installation and assembly of equipment made by those same

entities which are subject to a 10% withholding tax rate (PWC, 2013e). The withholding tax is a final tax for non-residents. The payer has to retain the 20% WHT from certain payments abroad and then it has to pay the amount to the tax authorities (Meneses, 2013).

#### **4.6.1.3 Relief from double taxation in terms of DTAs**

The 20% withholding tax rate on interest for companies and individuals can be reduced to 0%, 8% or 10% by a tax treaty depending on the specific country's treaty (PWC, 2013e; Ernst & Young, 2011:760-764).

#### **4.6.1.4 Withholding tax exemptions and zero-percent withholding rates**

There are no withholding tax interest exemptions available to companies and individuals in respect of local interest (Ernst & Young, 2011:760-764; PWC, 2013e). A 0% rate applies to interest paid to Mozambican registered financial institutions (Deloitte, 2013e:1).

#### **4.6.1.5 Normal income tax interest exemptions**

There are no normal interest exemptions available to companies and individuals in respect of local interest (Ernst & Young, 2011:760-764; PWC, 2013e). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result, normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.6.1.6 Repo rate**

The repo rate as set by the Mozambican central bank is set at 8.75% for Mozambique as of 12 August 2013 (Bank of Mozambique, 2013; Central Bank Rates, 2013).

## **4.6.2 Namibia**

### **4.6.2.1 Method of taxation**

A corporation is resident in Namibia if it is incorporated in Namibia (Deloitte, 2013f:1). There is no definition for individuals who are resident in Namibia. Resident and non-resident individuals are, however, both taxed on source basis. The residence status of residents and non-residents is usually not relevant unless the non-resident is from a country that has concluded a tax treaty with Namibia (Deloitte, 2013f:2; PKF, 2013e:1).

Resident and non-resident companies are only subject to tax on Namibian source income. The standard company income tax rate for resident and non-resident companies is 34%, except for mining companies which are taxed at different rates depending on the mining activity (Deloitte, 2013f:1; PKF, 2013e:1).

Individuals in Namibia, whether resident or non-resident, are taxed on all income received or accrued from a Namibian source or deemed Namibian source (Deloitte, 2013f:2). Individuals are taxed at progressive rates up to a maximum of 37% (Deloitte, 2013f:3; PKF, 2013e:4).

### **4.6.2.2 Withholding tax on interest**

Withholding tax on interest is levied on Namibian source interest paid to a resident or non-resident at a rate of 10%, unless the rate is reduced by a tax treaty (Deloitte, 2013f:1; PKF, 2013e:4). No withholding tax on interest applies to interest paid on loan accounts to foreign entities (PWC, 2013f). The withholding tax on interest is a final tax as the interest on which it is paid is not added to or set off against any other income (Brand, 2012).

### **4.6.2.3 Relief from double taxation in terms of DTAs**

The 10% withholding tax rate on interest for companies and individuals rate can be reduced to 0% by a tax treaty depending on the specific country's treaty (PKF, 2013e:3-4; PWC, 2013f).

#### **4.6.2.4 Withholding tax exemptions and zero-percent withholding rates**

No withholding tax on interest applies to interest paid on loan accounts to foreign entities as Namibia uses the source basis of taxation (Janse van Rensburg, 2012; PKF 2012e:1-3; PWC, 2013f).

#### **4.6.2.5 Normal income tax interest exemptions**

There are no normal income tax interest exemptions available to companies and individuals on local Namibian interest (Brand, 2012; PKF 2012e:1-3; PWC, 2013f). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result, normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.6.2.6 Repo rate**

The repo rate as set by the Namibian central bank is set at 5.5% and is applicable as of 22 August 2012 (Bank of Namibia, 2013; Central Bank Rates, 2013).

### **4.7 WITHHOLDING TAX ON INTEREST IMPLEMENTED IN DEVELOPED COUNTRIES**

The following section provides an overview of taxation applied in the developed countries as defined in paragraph 4.2, including the method of taxation, rates of withholding tax on interest, relief from double taxation in terms of DTAs, withholding and normal income tax interest exemptions and repo rates.

#### **4.7.1 Denmark**

##### **4.7.1.1 Method of taxation**

A corporation is resident in Denmark if it is incorporated in Denmark or its day-to-day management is in Denmark (Deloitte, 2013h:1; PKF 2013f:1). An individual is a

Danish resident if he or she has a permanent residence and a "qualifying" stay in Denmark or spends more than six months in Denmark (Deloitte, 2013h:2; PKF, 2013f:3-4).

Danish resident companies are taxed on a worldwide basis, although profits and losses from foreign permanent establishments and real estate are exempt (Deloitte, 2013h:1; PKF, 2013f:1). Non-resident companies are taxed on Danish source income and branches are taxed the same as subsidiaries on source. The standard company income tax rate for resident and non-resident companies is 25% (Deloitte, 2013h:1; PKF, 2013f:1).

Danish resident individuals are subject to Danish taxation on their worldwide income. Non-resident individuals are subject to tax on Danish source income. Individuals are taxed at progressive rates with a maximum rate of 56% (Deloitte, 2013h:2; PKF, 2013f:3-4).

#### **4.7.1.2 Withholding tax on interest**

Interest payments to non-residents are generally exempt from withholding tax, although a 25% withholding tax applies to interest paid to foreign related entities that are not resident in the EU and outside any of the states with which Denmark has concluded a tax treaty (Deloitte, 2013h:1; PWC, 2013h). The withholding tax on interest is a final tax (Wittendorff, 2012).

#### **4.7.1.3 Relief from double taxation in terms of DTAs**

The withholding tax rate on interest can be reduced to 0% by a tax treaty depending on the specific country's treaty (PKF, 2013f:4-6; PWC, 2013h).

#### **4.7.1.4 Withholding tax exemptions and zero-percent withholding rates**

Withholding tax interest exemptions apply if the receiving company is directly or indirectly controlled by a Danish parent company or if the receiving company is controlled by a company resident in a state which has a DTA with Denmark and that company may be subject to CFC taxation (Ernst & Young, 2011:276-277; PWC,

2013h; Wittendorff, 2012). Furthermore, an exemption applies if the receiving company establishes that the foreign taxation of interest is not less than three-quarters of the Danish corporate taxation and that the interest is not paid to another foreign company subject to taxation less than three-quarters of the Danish corporate taxation (Ernst & Young, 2011:276-277; PWC, 2013h; Wittendorff, 2012). The EU interest directive may provide an exemption from withholding tax if the payee is an immediate parent, sister or subsidiary company resident in the EU (Ernst & Young, 2011:276-277; PWC, 2013h; Wittendorff, 2012).

#### **4.7.1.5 Normal income tax interest exemptions**

There are no normal interest exemptions available to companies and individuals in respect of local interest (PKF, 2013e:1-4; PWC, 2013h; Wittendorff, 2012). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.7.1.6 Repo rate**

The repo rate as set by the Danish central bank is set at 0.20% for Denmark and is applicable as of 5 February 2013 (Central Bank Rates, 2013; Triami Media BV, 2009-2013).

### **4.7.2 Germany**

#### **4.7.2.1 Method of taxation**

A corporation is resident in Germany if it maintains its registered office as determined by its Articles of Incorporation or its central place of management in Germany (Deloitte, 2013g:1; PKF, 2013g:1). An individual is resident if he or she is a citizen of Germany. Individuals are deemed to be resident if they are domiciled or their customary place of abode is in Germany. The latter is the case if the individual has spent more than six months of the relevant year in Germany. Domicile can be presumed where an individual has a permanent accommodation at his or her

disposal in Germany irrespective of whether that individual actually uses the accommodation (Deloitte, 2013g:2; PKF, 2013g:5-6).

German resident corporations are taxed on their worldwide income. Non-resident corporations are only required to pay tax on German source income. Branches are taxed on the same basis as subsidiaries. The rate of corporate income tax is 15%. However, a combined rate of between 30% and 33% is levied after taking into account the solidarity surcharge and trade tax (Deloitte, 2013g:1; PKF, 2013g:1).

German resident individuals are taxed on their worldwide income. Non-resident individuals are taxed only on German source income. Individuals are taxed at progressive rates with a maximum rate of 45%. However, an effective rate of 47.5% is charged after solidarity surcharge of 5.5% and church tax of 9% (Deloitte, 2013g:2; PKF, 2013g:5-6).

#### **4.7.2.2 Withholding tax on interest**

Interest paid to a non-resident, except for interest on deposits with German banks/financial institutions and certain hybrid instruments, is not subject to withholding tax. Interest on deposits with German banks/financial institutions is subject to withholding tax at 25% (Deloitte, 2013g:1; PKF, 2013g:4). The withholding tax on interest is a final tax as the tax obligations are fulfilled with the withholdings and no German tax return needs to be filed (KPMG, 2013c:).

#### **4.7.2.3 Relief from double taxation in terms of DTAs**

The 25% withholding tax rate on interest for companies and individuals can be reduced to 0% by a tax treaty depending on the specific country treaty (PKF, 2013g:6-8; PWC, 2013g).

The 2007 Annual Tax Act tightened the domestic anti-avoidance rule. It denies benefits under the treaties or an EU directive for a foreign recipient for dividends, interest or royalties, if any of the following circumstances exist:

- The parent company of the recipient would not be entitled to an equal treaty benefit had it received the income directly and the interposition of the intermediate holding company cannot be justified by good business reasons.
- The foreign recipient of the income does not derive at least 10% of its gross income from its own trading operations.
- The foreign recipient does not participate in the general commerce with fully equipped business facilities.

On 18 March 2010, the European Commission formally requested that Germany amend its anti-avoidance rule on withholding tax relief to conform it to EU tax objectives as presented by the Commission. Because Germany has not reacted to the European Commission's opinion in a satisfactory manner, the European Commission may decide to refer the matter to the Court of Justice of the EU (Ernst & Young, 2011:400).

#### **4.7.2.4 Withholding tax exemptions and zero-percent withholding rates**

Withholding tax exemptions may, however, be available under the EU Interest and Royalties Directive (within the EU) or the applicable tax treaty (Reus, 2013).

#### **4.7.2.5 Normal income tax interest exemptions**

There are no interest exemptions for companies and individuals in terms of both local and foreign interest as per the tax legislation in Germany (Deloitte, 2013g:1; PKF, 2013g:1-8). Furthermore, as the withholding tax is a final tax, no additional income tax is levied on the recipient. As a result normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in that country.

#### **4.7.2.6 Repo rate**

The repo rate, as set by the eurozone, is set at 0.50% for Germany and is applicable as of 2 May 2013 (Central Bank Rates, 2013; Triami Media BV, 2009-2013).

## 4.8 CONCLUSION

Objective (iii) as indicated in paragraph 1.3 was to examine the tax systems relating to withholding taxes on interest implemented by the BRIC countries, the developing countries Mozambique and Namibia and the developed countries Germany and Denmark. This has been detailed above. It included obtaining an understanding of the method of taxation, withholding taxes on interest, relief from double taxation in terms of double tax agreements (DTAs), normal and withholding tax interest exemptions and the repo rates implemented by these countries. These rates, exemptions and treaty provisions will be useful for the comparison of the withholding taxes on interest.

From the information obtained in this chapter, it can be concluded that the different selected countries all impose a withholding tax applicable to interest payments made to non-residents as part of the general income tax law of the country. The rates of withholding taxes vary hugely according to country with China and Namibia imposing the lowest rate at 10% and Germany and Denmark imposing the highest rate at 25%. There are interest exemptions from normal income tax for some of the selected countries. However, these are applicable only to residents. As a result of the withholding tax being a final tax, these normal income tax interest exemptions are not applicable to the non-residents that are subject to the withholding tax. The withholding tax that is a final tax is withheld by the payer and paid over to the Tax Authorities in that country and therefore no additional income tax is levied on the recipient. As a result, normal interest exemptions will not be applicable to non-residents subject to the withholding tax in that country. Treaty provisions applied between countries provide for a greater degree of uniformity in the application of withholding taxes. All of the countries examined above have limited exemptions from withholding tax on interest with the exception of China, Mozambique and Namibia who have no exemptions from withholding tax at all.

The information obtained on the taxation of interest of non-residents in the selected countries will be compared with the new South African withholding tax on interest in Chapter Five to determine whether it has been effectively designed. The above will ensure that equitable comparisons can be made between the selected countries.

## **CHAPTER FIVE**

### **A COMPARISON OF WITHHOLDING TAXES ON INTEREST IN SOUTH AFRICA WITH OTHER COUNTRIES**

#### **5.1 INTRODUCTION**

The new withholding tax on interest in South Africa including exemptions and its impact on headquarter companies have been examined in Chapter Three. The withholding tax on interest that is applied in the BRICS countries, selected developing countries (Mozambique and Namibia) and selected developed countries (Denmark and Germany) have been examined in Chapter Four. This included an examination of the method of taxation, rates of withholding tax on interest, relief from double taxation in terms of DTAs, withholding and normal interest exemptions and repo rates of the selected countries in order to make a comparison of the withholding taxes on interest. The comparison will be performed in order to determine if the new South African withholding tax on interest have been effectively designed in order to still attract foreign lending to South Africa and remain competitive in international markets. The comparison would also assist to actuate if the new South African withholding tax on interest aligns the South African legislation in respect of the section 10(1)(h) interest exemption with global practice.

This chapter will address objective (iv) of paragraph 1.3 to compare the new South African withholding tax on interest with the taxation of interest earned by non-residents implemented by the developing and developed investigated in Chapter Four. The comparison will involve their IFDI rankings, rates of withholding taxes on interest, normal and withholding tax interest exemptions and repo rates.

#### **5.2 SOUTH AFRICA'S NEW WITHHOLDING TAX ON INTEREST**

As discussed in paragraph 3.4, South African source interest paid to or for the benefit of any foreign person will be subject to the new South African withholding tax on interest at a rate of 15% with effect from 1 January 2015 (SA, 2013b:118). South Africa was ranked 128<sup>th</sup> in terms of FDI attraction as per the IFDI Performance Index (UNCTAD, 2010) and the repo rate is currently at 5% (Central Bank Rates, 2013;

Triami Media BV, 2009-2013). The intention of this legislation is to attract foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion (SA, 2010:72). Interest from certain entities and certain types of debt interest, a government debt, bank deposits, financial assistance in terms of headquarter companies, certain listed debts and collective investment schemes are, however, specifically exempt from the withholding tax and will be taxed in terms of South African normal tax (SA, 2013b:115). There is also a general exemption which is linked to the section 10(1)(h) exemption and the effect is that if the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from income tax and, equally, if the interest is exempt from the withholding tax, it will be subject to income tax (SA, 2013b:116).

### **5.3 COMPARISON OF THE WITHHOLDING TAXES ON INTEREST AND OTHER RELATED DETERMINANTS BETWEEN SOUTH AFRICA AND THE SELECTED COUNTRIES**

According to the review of the literature in Chapter Four, it has been established that all the countries apply the source basis of taxation for non-residents. The withholding tax rates of all the countries can be reduced by tax treaties between countries resulting in a lower withholding tax on interest, except for Brazil where the rate can be increased if the recipient is domiciled in a tax haven as explained in Chapter Four paragraph 4.1.5.2. As a result of the commonality and lack of value add of these determinants, the source basis of taxation and the relief from double taxation available in terms of DTAs will therefore not be used as a determinant in the comparison below.

The following table represents the comparative information gathered on the selected countries from the various sources considered in this study:

**Table 5.1: Comparison of withholding taxes and other related determinants between the countries**

Country	FDI ranking 1990-2010	Withholding tax rate	Withholding tax exemptions and or zero rating of withholding	Normal income tax exemptions	Repo Rate 5 Oct. 2013	Paragraph containing comparison	Page
South Africa	128	15%	Yes	Yes	5%	5.2 and all the paragraphs below	76
Brazil	69	15%	Yes	None	9%	5.4.1	78
Russia	60	20%	Yes	Yes	8.25%	5.4.2	81
India	97	20%	Yes	None	7.50%	5.4.3	83
China	86	10%	No	Yes	6%	5.4.4	86
Mozambique	19	20%	Yes	None	8.75%	5.5.1	89
Namibia	27	10%	Yes	None	5.5%	5.5.2	91
Denmark	138	25%	Yes	None	0.20%	5.6.1	94
Germany	104	25%	Yes	None	0.50%	5.6.1	94

**Source: Compiled from sources reviewed in Chapters Three and Four**

The withholding taxes on interest and other related determinants of the selected countries will hereafter be compared with South Africa according to the information indicated in Table 5.1 above:

## **5.4 ANALYSIS OF THE COMPARISON BETWEEN THE BRIC COUNTRIES AND SOUTH AFRICA**

### **5.4.1 Brazil**

Brazil, has been ranked 69<sup>th</sup> on receiving FDI in the world and second in the BRICS group which indicates its favourability as a receiving country of FDI in the BRICS group (UNCTAD, 2010). South Africa, however, has been ranked 128<sup>th</sup> on receiving FDI in the world and fifth in the BRICS group which indicates that South Africa is

lagging behind in the attraction of FDI when compared to the rest of the world and also to the BRICS countries. South Africa should therefore stimulate inward foreign investments and therefore the right economic and investment policies, conditions and boldness to enable South Africa to attract FDI should be implemented.

Brazil's withholding tax rate is set at 15% as indicated in paragraph 4.5.1, which is the same as South Africa (Deloitte, 2013a:2; PKF, 2013a:14). However, if the non-resident is situated in a tax haven, a 25% withholding tax rate applies, which is due to the fact that non-resident entities incorporated in a jurisdiction that qualifies either as a "low tax jurisdiction" or a "tax privileged jurisdiction" are generally subject to unfriendly Brazilian tax rules (Deloitte, 2013a:2; PKF, 2013a:14).

There are some withholding tax exemptions and zero-percent withholding tax rates established by domestic law for companies as discussed in paragraphs 4.5.1.4 and 4.5.1.5. These exemptions and withholding tax rates are mainly related to export loans granted by export credit agencies, export financing and loans granted by the International Finance Corporation or by governmental agencies (Brazilian Chamber of Commerce, 2012:3). These exemptions are furthermore available only to loans destined to the acquisition of equipment (Brazilian Chamber of Commerce, 2012:3). As the withholding tax is a final tax, no additional income tax is levied on the recipient. A result of the above is that normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in Brazil. South Africa, in turn, has both normal income tax interest exemptions and withholding tax interest exemptions.

The effect of these exemptions is that either the normal income tax interest exemption or the withholding tax interest exemption may apply. If the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax provided the non-resident is not receiving interest provided the resident did not conduct business through a permanent business establishment in the Republic during the year of assessment. In the event that the interest is exempt from the withholding tax and the non-resident is receiving interest through a permanent business establishment in the Republic during the year of assessment, normal income tax will apply to that interest. If the non-resident is not

subject to the withholding tax and does not receive interest through a permanent business establishment in the Republic during the year of assessment, the non-resident will not be subject to any tax on the interest.

Furthermore, as stated in the paragraph above, in terms of Brazilian law non-residents will never be subject to normal income tax as the withholding tax is a final tax. In the event of the focus falling solely on non-resident entities conducting business through a permanent business establishment, investors would favour Brazil to invest in as a result of the withholding tax being a final tax and the interest not being subject to normal income tax as a result. However, if this exception is excluded, non-residents in Brazil and South Africa will be indifferent to either country if the interest is subject to withholding tax interest exemptions. In Brazil it would not be subject to normal income tax, as explained above. In South Africa the interest will only be subject to normal income tax if the permanent business establishment exception is met. In all other cases the interest would not be subject to taxation which is similar to the case in Brazil. Investors would therefore be indifferent to the available normal income tax interest exemptions.

Considering the equal withholding tax rates, indifferent normal income tax interest exemptions available, South Africa is a more favourable investment destination as a result of the available withholding tax interest exemptions.

Brazil has a repo rate of 9.00% as per paragraph 4.5.1.6 which is higher than the 5% rate of South Africa. This will impact FDI as investors will be looking for a higher return on investment and therefore they will favour Brazil. Based solely on the consideration of the repo rates and the assumption that the repo rate influences FDI in a country, it can be deduced that South Africa's withholding tax rate should probably be lower than that of Brazil in order to favour the investor to invest in South Africa.

Based on the fact that these economies are both developing, are part of the BRICS group of countries and face similar developing economy challenges, this rate seems to be acceptable. South Africa has an advantage over Brazil to attract FDI as a result of the available withholding tax interest exemptions. However, the other factors

mentioned, such as the Brazilian repo rate which is favourable to the foreign investor and Brazil's current ranking in terms of receiving FDI based on the assumption that the repo rate influences FDI into a country, South Africa seems to be lagging behind as a FDI destination when compared to Brazil. Taking the above determinants into account, the new South African withholding tax on interest rate appears reasonable in order to incentivise FDI.

Based on the explanations above, the equal withholding tax rate, the favourable South African withholding tax interest exemptions, the indifference in normal income tax interest exemptions and the repo rate, although not as enticing to the investor as that of Brazil, the new South African withholding tax on interest rate, similar to that of Brazil, will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets.

#### **5.4.2 Russia**

Russia has been ranked 60<sup>th</sup> on receiving FDI in the world and first in the BRICS group which indicates that it is the largest receiving country of FDI in the BRICS group (UNCTAD, 2010).

The withholding tax rate in Russia is 20% as examined in paragraph 4.5.2 which is one of the higher rates amongst the BRICS group. The new South African withholding tax on interest rate is 15% which is moderately lower than that of Russia.

There are no specific withholding tax interest exemptions for companies in terms of local interest as per the tax legislation in Russia. However, interest received on Russian Rouble currency and foreign currency deposits held at banks located in Russia is exempt from normal income tax if the annual interest rate of the interest income does not exceed the threshold of 9 percent for foreign currency deposits and the refinancing rate of the Central Bank of Russia increased by 5 percentage points for deposits in Russian Roubles (Churilova, 2012; KPMG, 2013b:5). This exemption is provided to all taxpayers irrespective of their residency status. Interest income received in excess of the above thresholds is taxable at 35 percent (Churilova, 2012; KPMG, 2013b:5).

The South African section 10(1)(h) normal income tax interest exemption in terms of which interest is received or accrued during any year of assessment by or to any non-resident is exempt, provided that the exceptions of section 10(1)(h) are not applicable. This is contrary to the above-mentioned Russian normal income tax exemptions. The Russian normal income tax exemptions apply to interest that is linked to a permanent establishment as discussed in paragraphs 4.5.2.5 while the South African normal income tax interest exemption relating to interest received through a permanent business establishment during a year of assessment will be subject to normal income tax (58 of 1962). The Russian normal income tax exemptions are, furthermore, limited to Russian Rouble currency and foreign currency deposits held at banks located in Russia within specified limited interest rates (Churilova, 2012; KPMG, 2013b:5).

Russia has a repo rate of 8.25% as per paragraph 4.5.2.6 which is higher than the 5% of South Africa. This will impact FDI as investors will be looking for a higher return on investment and will therefore favour Russia. Russia has the highest repo rate in the BRICS group which makes it the most attractive country for FDI. Based solely on the consideration of the repo rates and the assumption that the repo rate influences FDI into a country, it can be deduced that South Africa's withholding tax rate is reasonable as it is lower than that of Russia and may potentially let the investor favour South Africa to invest in.

In comparison to Russia, the new South African withholding tax on interest rate is set at a lower level. Based on the fact that these economies are both developing, are part of the BRICS group of countries and face similar developing economy challenges, this lower rate seems to be reasonable with South Africa having an advantage over Russia to attract FDI as a result of the available normal income tax interest and withholding tax interest exemptions. The normal income tax interest exemptions implemented, however, indicate that the South African exemptions appear to be similar to those implemented in Russia as discussed above. The favourable repo rate, together with the fact that a 0% rate is implemented in Russia on interest from the governments of contracting states and to payments guaranteed

by the government can be assumed to be one of the reasons that Russia is ranked number one in the BRICS group in receiving FDI.

Furthermore, by considering the Russian repo rate which is favourable to the foreign investor and Russia's current ranking in terms of receiving FDI, based on the assumption that the repo rate influences FDI into a country, South Africa seems to be lagging behind as a FDI destination when compared to Russia. Taking the above determinants into account, the new South African withholding tax on interest rate, however, appears acceptable in order to incentivise FDI when compared with Russia and, furthermore, the rate does appear to be reasonable in terms of the overall comparison with Russia.

In conclusion, it appears, based on the lower withholding tax rate, the normal and withholding tax interest exemptions and the repo rate, although not as enticing to the investor as that of Russia, that the new South African withholding tax on interest rate when compared to Russia's will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets.

The normal income tax interest exemption of South Africa is more favourable than Russia as the Russian exemption only exempts interest income related to a permanent business establishment in Russia which is subject to certain minimum interest rate thresholds. The more favourable South African normal interest exemption, however, raises concern regarding the potential erosion of the tax base in South Africa. However, the amendment to section 10(1)(h) addresses the overly generous exemption that could potentially result in the erosion of the tax base to ensure that the South African tax base is protected from any potential erosion.

### **5.4.3 India**

India has been ranked 97<sup>th</sup> on receiving FDI in the world and fourth in the BRICS group which indicates that it is the second last receiving country of FDI in the BRICS group (UNCTAD, 2010). South Africa is a good 31 places behind India and is ranked 128<sup>th</sup> on receiving FDI in the world and fifth in the BRICS group.

The withholding tax rate in India is 20%, but the percentage is to be increased by a surcharge, secondary and higher education cess to compute the effective rate of withholding tax as examined in paragraph 4.5.3 which is one of the highest rates amongst the BRICS group. The new South African withholding tax on interest rate is 15% which is moderately lower than that of India. India, therefore, has the highest effective withholding tax rate as a result of the surcharge and cess as discussed above in the BRICS countries which is in excess of 20%.

There are no taxes required to be withheld on interest payable on any securities issued by Central or State Government, securities listed on recognised stock exchanges in India and few other specified categories as discussed in paragraphs 4.5.3.4 and 4.5.3.5. These withholding tax interest exemptions available to companies in India are limited when compared to South Africa which exempts interest from the government of the Republic amongst the other exemptions available as discussed in paragraph 3.4.2. As the withholding tax is a final tax, no additional income tax is levied and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in India.

South Africa, in turn, has both normal income tax interest exemptions and withholding tax interest exemptions. The effect of these exemptions is that either the normal income tax interest exemption or the withholding tax interest exemption may apply. The application of the normal tax interest exemption is, however, subject to the permanent business establishment exception. Non-residents not subject to the withholding tax and not receiving interest through a permanent business establishment in the Republic during the year of assessment will not be subject to any tax on the interest.

Furthermore, as stated above, in terms of Indian law, non-residents will never be subject to normal income tax as the withholding tax is a final tax. In the event of the focus falling solely on non-resident entities conducting business through a permanent business establishment, investors would be favoured to invest in India as a result of the withholding tax being a final tax and the interest not being subject to

normal income tax as a result. If the permanent business establishment exception applicable to the South African normal income tax exemption is excluded, non-residents in India and South Africa will be indifferent to investing in either country if the interest is subject to withholding tax interest exemptions.

India has a repo rate of 7.5% as per paragraph 4.5.3.6 which is higher than the 5% of South Africa. Based solely on the repo rates and the assumption that the repo rate influences FDI into a country, it will impact FDI as investors will be looking for a higher return on investment and would therefore favour India. India has the second highest repo rate in the BRICS group which makes it attractive for FDI. Furthermore, it confirms that India seems to be a better FDI destination than South Africa even though only marginally. By taking the above determinants into account, the new South African withholding tax on interest rate appears reasonable in order to incentivise FDI.

In comparison to India, the new South African withholding tax on interest tax rate appears to be set significantly lower. Consideration of the above should be given to the fact that the Indian economy is expected to overtake Japan by 2015 to become the third largest economy even though its withholding and normal income tax rates are at high levels (World Economic Forum, 2013). Based on the fact that these economies are both developing, are part of the BRICS group of countries and face similar developing economy challenges, this rate seems to be reasonable with South Africa having an advantage over India to attract FDI as a result of the available withholding tax interest exemptions. India has the highest withholding tax rate in the BRICS group and, therefore, based on the assumption that withholding tax rates will impact FDI to an extent, this withholding tax rate is sure to dampen FDI into India in comparison to South Africa.

In conclusion, it appears that, based on the withholding tax rate, the withholding tax interest exemptions, the indifference in normal income tax interest exemptions and the repo rate, although not as enticing to the investor as that of India, that the new South African withholding tax on interest rate, which is lower than India's, will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets.

#### **5.4.4 China**

China is the second largest economy in the world and has been ranked 86<sup>th</sup> on receiving FDI in the world and third in the BRICS group, which indicate that it is the midpoint receiving country of FDI in the BRICS group (UNCTAD, 2010).

The withholding tax rate in China is 10%, as examined in paragraph 4.5.4. It is currently the lowest rate amongst the BRICS group. The new South African withholding tax on interest rate is 15%, which is moderately higher than that of China.

There are no specific withholding tax interest exemptions for companies in terms of local interest as per the tax legislation in China. Interest income earned from State bonds and interest income earned by non-profit organisations are exempt from normal corporate income tax (Chan, 2012).

South Africa, however, has withholding tax exemptions compared to China which does not have any withholding tax exemptions. Furthermore, the normal income tax interest exemption in China is limited to interest from State Bonds and interest earned by non-profit organisations which is limited when compared to the normal income tax interest exemption available in South Africa. The above-mentioned normal income tax interest exemption relating to State bonds known as tax-exempt income is applicable to both residents and non-residents and will not be subject to tax to both residents and non-residents.

As the withholding tax in China is a final tax, no additional income tax is levied on the recipient. South Africa has both normal income tax interest and withholding tax exemptions in terms of which either the normal income tax interest exemption or the withholding tax interest exemption will apply, provided the permanent business establishment exception is not met.

As stated in the paragraph above in terms of Chinese law, non-residents will never be subject to normal income tax as the withholding tax is a final tax. The above-mentioned normal income tax interest exemption relating to State bonds known as tax-exempt income is applicable to both residents and non-residents and will not be

subject to tax to both residents and non-residents. In the event of the focus falling solely on non-resident entities conducting business through a permanent business establishment, investors will favour China to invest in as a result of the withholding tax being a final tax. However, if the permanent business establishment exception applicable to the South African normal income tax exemption is excluded, non-residents in China and South Africa will be indifferent to investing in either country if the interest is subject to withholding tax interest exemptions.

Considering the moderately higher withholding tax rate of South Africa, China can be construed to be a more favourable investment destination than South Africa due to an investor preferring to invest in a country such as China with a lower withholding tax rate than South Africa.

China has a repo rate of 6% as per paragraph 4.5.4.6 which is slightly higher than the 5% of South Africa. Based solely on the repo rates and the assumption that the repo rate influences FDI into a country this will impact FDI as investors will be looking for a higher return on investment and will therefore choose China. This will impact FDI as investors will be looking for a higher return on investment and they will, therefore, choose China even though only marginally. This confirms that China seems to be a better FDI destination than South Africa. Taking the above determinants into account and investors choice towards China as a FDI destination supported by the IFDI ranking when compared to South Africa, the new South African withholding tax on interest rate, however, still remains competitive to incentivise FDI.

In comparison to China, the new South African withholding tax on interest rate is set at a higher level compared to China. Based on the fact that these economies are both developing, are part of the BRICS group of countries and face similar developing economy challenges, this rate seems to be reasonable with China having an advantage over South Africa to attract FDI.

In conclusion, it appears that the new South African withholding tax on interest rate based on the withholding tax rate, withholding tax interest exemptions, the indifference in normal income tax interest exemptions and the repo rate which is less

attractive to the investor, when compared to China, will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets even though it may not be as easily attainable as in China.

#### **5.4.5 Conclusion on comparison of South Africa with BRICS**

The examination above indicates that the South African withholding tax rate, including the withholding tax exemptions available, results in South Africa having an acceptable withholding tax rate. The new South African withholding tax on interest rate, together with Brazil, is the mid-rate among the BRICS countries between India and Russia with the highest rate and China with the lowest rate. However, the withholding and normal income tax interest exemptions of South Africa are the most favourable amongst the BRICS countries which is a concern as these may still result in a potential erosion of the tax base. Nevertheless, when compared to the countries and the normal income tax interest exemptions available, the above potential erosion is in fact compensated by the normal income tax interest exemption. South Africa is indifferent to Brazil, India and China in terms of normal income tax interest exemptions as the withholding taxes in these countries are final taxes. Normal income tax and the related interest exemptions would therefore not apply in these countries. The rankings on receiving FDI in the BRICS group highlights that it is clear that the withholding tax rate and related exemptions do not impact directly FDI in a country. This is evidenced as there is no inverse relationship between the withholding tax rate including related exemptions and FDI for all countries with the exception of India, where a high withholding tax rate and a low IFDI ranking, indicating that the inverse relationship applies between these two determinants.

It is clear from the above comparisons taking into account the withholding tax rates, withholding tax interest exemptions available, impact of withholding tax on FDI and the repo rates applicable that the South African withholding tax does appear to be competitive with that of the BRICS group.

Furthermore, even though these BRIC economies are a more favoured FDI destination than South Africa, the new South African withholding tax on interest will

be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion as a result of the alignment of interest exemptions with global practice.

## **5.5 EXPLANATION OF THE COMPARISON BETWEEN THE DEVELOPING AFRICAN COUNTRIES AND SOUTH AFRICA**

### **5.5.1 Mozambique**

Mozambique has been ranked 19<sup>th</sup> on receiving FDI in the world in comparison to South Africa's 128<sup>th</sup> position (UNCTAD, 2010) which indicates that South Africa is lagging behind in attracting FDI when compared to the rest of the world and also to the developing African economies.

Mozambique's withholding tax rate is set at 20% as examined in paragraph 4.6.1 and is the highest withholding tax on interest in the selected developing African economies and is the same as that of Russia and India. The new South African withholding tax on interest rate is 15%, which is moderately lower than that of Mozambique.

There are no withholding tax and normal income tax interest exemptions for companies in terms of local interest in Mozambique as discussed in paragraphs 4.6.1.4 and 4.6.1.5. There is, however, an exception to the legislation in respect of which reduced rate applies to interest related to telecommunications and international transport as well as the respective installation and assembly of equipment made by those same entities. In terms of the above these industries are subject to a 10% withholding tax rate.

As the withholding tax is a final tax, no additional income tax is levied on the recipient. South Africa, has both normal income tax interest exemptions and withholding tax interest in terms of which either one or the other may be applicable. If the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax provided the non-resident is not

receiving interest through a permanent business establishment in the Republic during the year of assessment.

Furthermore, as stated in the paragraph above, in terms of Mozambican law, non-residents will never be subject to normal income tax as the withholding tax is a final tax. In the event of the focus falling solely on non-resident entities conducting business through a permanent business establishment investors would invest in Mozambique. However, if the permanent business establishment exception applicable to the South African normal income tax exemption is excluded, non-residents in Mozambique and South Africa will therefore be indifferent to investing in either country if the interest is subject to withholding tax interest exemptions. Once again the comparison highlights that the South African exemptions are more extensive than the reduced rate and 0% rate applicable to Mozambique.

The repo rate in Mozambique is set at 8.75% as per paragraph 4.6.1.6 which is the highest amongst the developing African economies and which is much higher than the 5% of South Africa. Based solely on the consideration of the repo rates and the assumption that the repo rate influences FDI into a country this will impact FDI as investors will be looking for a higher return on investment and will therefore favour Mozambique.

In comparison to Mozambique, the new South African withholding tax on interest rate is set at a marginally lower level. Based on the fact that these economies are both neighbouring and developing African economies that face similar developing economy challenges, this rate seems to be acceptable. South Africa has an advantage over Mozambique to attract FDI as a result of the lower rate and available withholding tax interest exemptions. Based solely on the repo rates and the assumption that the repo rate influences FDI into a country this will impact FDI as investors will be looking for a higher return on investment and will therefore favour Mozambique. Therefore, if consideration is given to the repo rate, Mozambique seems to be a better FDI destination than South Africa. Based on the examination of the above determinants, the new South African withholding tax on interest rate appears acceptable in order to incentivise FDI.

In conclusion, it appears based on the withholding tax rate, withholding tax interest exemptions, the indifference in normal income tax interest exemptions and the repo rate, even though not as enticing to the investor as Mozambique's, that the new South African withholding tax on interest rate which is lower than Mozambique's will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets.

### **5.5.2 Namibia**

Namibia has been ranked 27<sup>th</sup> on receiving FDI in the world in comparison to South Africa's 128<sup>th</sup> position (UNCTAD, 2010).

The withholding tax rate in Namibia is 10% as examined in paragraph 4.6.2 which is the lowest withholding tax on interest in the developing African economies selected. The new South African withholding tax on interest rate is 15%, which is moderately higher than that of Namibia.

There are no normal income tax interest exemptions for companies in terms of local interest in Namibia, as discussed in paragraphs 4.6.2.4 and 4.6.2.5. No withholding tax on interest applies to interest paid on loan accounts to foreign entities. As the withholding tax is a final tax, no additional income tax is levied on the recipient. A result of the above is that normal income tax and the related normal income tax interest exemptions will not be applicable to non-residents subject to the withholding tax in Namibia. South Africa, in turn, has both normal income tax interest exemptions and withholding tax interest exemptions. In terms of which either the withholding tax interest exemption or the normal tax interest exemption will apply. If the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax provided the non-resident is not receiving interest through a permanent business establishment in the Republic during the year of assessment.

Furthermore, as stated in the paragraph above, in terms of Namibian law non-residents will never be subject to normal income tax as the withholding tax is a final tax. In the event of the focus falling solely on non-resident entities conducting

business through a permanent business establishment investors will favour Namibia to invest in as a result of the withholding tax being a final tax. However, if the permanent business establishment exception applicable to the South African normal income tax exemption is excluded, non-residents in Namibia and South Africa will, therefore, be indifferent to investing in either country if the interest is subject to withholding tax interest exemptions. In all other cases the interest will not be subject to taxation which is similar to the case in Namibia.

The repo rate in Namibia is set at 5.5% as per paragraph 4.6.2.6. The repo rate is low in developing African economies and close to that of South Africa at 5%. Based solely on the repo rates and the assumption that the repo rate influences FDI into a country, it will impact FDI as investors will be looking for a higher return on investment and will therefore marginally favour Namibia.

In comparison to Namibia, the new South African withholding tax on interest rate is set at a higher level. Based on the fact that these economies are both neighbouring developing African economies that face similar developing economy challenges, this rate seems to be acceptable. However, South Africa has an advantage over Namibia to attract FDI as a result of withholding tax interest exemptions available to South Africa which Namibia does not have. Nevertheless, if the repo rate is considered, Namibia seems to be a marginally better FDI destination than South Africa. Based on the examination of the above determinants, the new South African withholding tax on interest rate appears reasonable in order to incentivise FDI.

In conclusion, it appears, based on the withholding tax rate, withholding tax interest exemptions, the indifference in normal income tax interest exemptions and the repo rate which is similar to that of South Africa, that the South African withholding tax rate. Though it is higher than Namibia's, it will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets.

### **5.5.3 Conclusion on developing African economies**

The examination above indicates that the South African withholding tax rate, including the exemptions available, results in South Africa having an average withholding tax rate among the developing African countries which is higher than that of Namibia but lower than that of Mozambique. Mozambique effectively has a higher rate than South Africa and Namibia, considering that the economies and challenges faced by these developing economies are similar. However, the withholding tax interest exemptions of South Africa are extensive and the most favourable amongst the developing African countries included in this study. The rankings on receiving FDI in the developing African countries highlight that it is clear that the withholding tax rate, including related exemptions, does not directly impact FDI in a country. This is evidenced as there is no direct relationship between the withholding tax rate including related exemptions and FDI for all developing African countries.

It is clear from the above comparisons taking into account the withholding tax rates, withholding tax exemptions available, repo rates, the FDI rankings of countries and the challenges faced as discussed in 4.4.2, that the new South African withholding tax on interest is competitive. Furthermore, even though these selected developing African economies are a more favoured FDI destination than South Africa, the new South African withholding tax on interest will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion.

## **5.6 EXPLANATION OF THE COMPARISON OF WITHHOLDING TAXES BETWEEN THE DEVELOPED COUNTRIES AND SOUTH AFRICA**

### **5.6.1 Germany and Denmark**

Germany is ranked at 104<sup>th</sup> and Denmark 138<sup>th</sup> on receiving FDI in the world which are in close proximity to South Africa's ranking of 128<sup>th</sup>. It may be assumed that developed countries are less in need of FDI when compared to developing countries. South Africa, however, is not developed and as a developing economy it needs to improve its ranking of 128<sup>th</sup> in respect of FDI.

Germany and Denmark are the countries with high withholding tax rates on interest as examined in paragraph 4.7.1 and 4.7.2 at 25% and the highest withholding tax rate of the countries selected for this study. In comparison to these two developed countries, the new South African withholding tax on interest rate appears to be set at a lower level as the rate of 25% is substantially higher than that of the new South African withholding tax rate of 15%.

Germany, Denmark and South Africa provide all exemptions on the withholding tax on interest. In Denmark, interest is not subject to withholding tax paid to a foreign group member company that is a tax resident in the EU. Certain other withholding tax interest exemptions apply for Denmark – mainly relating to CFC taxation as explained in Chapter Four in paragraph 4.7.2.4. In Germany withholding tax exemptions may, however, be available under the EU Interest and Royalties Directive (in the EU). There are no normal interest exemptions for companies as discussed in paragraphs 4.7.2.4 and 4.7.2.5 in terms of local interest in Denmark and Germany respectively. As the withholding tax is a final tax, no additional income tax is levied on the recipient.

South Africa, in turn, has both normal income tax interest exemptions and withholding tax interest exemptions. In terms of these exemptions, either the normal income tax interest exemption or the withholding tax interest exemption will apply. If the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax provided the non-resident is not receiving interest through a permanent business establishment in the Republic during the year of assessment.

Furthermore, as stated in the paragraph above, in terms of German and Danish law, non-residents will never be subject to normal income tax as the withholding tax is a final tax. In the event of the focus falling solely on non-resident entities conducting business through a permanent business establishment investors will favour Germany and Denmark to invest in as a result of the final tax. However, if the permanent business establishment exception applicable to the South African normal income tax exemption is excluded, non-residents in Germany and Denmark and South Africa

would therefore be indifferent to investing in either country if the interest is subject to withholding tax interest exemptions.

The repo rates for Germany and Denmark are at 0.50% and 0.20% respectively. Based solely on the repo rates and the assumption that the repo rate influences FDI into a country, South Africa's repo rate of 5%, which is higher than that of Germany's and Denmark's, will impact FDI as investors will be looking for a higher return on investments and will therefore favour South Africa.

In comparison to Germany and Denmark, the new South African withholding tax on interest rate is set at a moderately lower level. Based on the fact that these economies are developed compared to the other selected countries which are still developing, the difference in the rate seems to be acceptable. However, consideration should be given to the fact that a comparison between developing and developed economies provides greater differences in results than countries of the same level of development.

In conclusion, based on the withholding tax rate, normal and withholding tax interest exemptions, IFDI ranking and repo rate that the new South African withholding tax on interest rate which is lower than that of Germany and Denmark will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets.

## **5.7 CONCLUSION**

All the selected countries apply the source-based system for taxation of non-residents. The withholding tax rates of all the countries can be reduced by tax treaties between countries. This results in lower withholding tax on interest, except for Brazil as explained in Chapter Four. In the absence of such tax treaties resident companies may claim a foreign tax credit for the foreign tax paid, subject to certain limitations as imposed by the respective countries. A comparison of the new South African withholding tax on interest, including the normal income tax and withholding tax interest exemptions, with other countries identifies that the new South African

withholding tax on interest does appear to be competitive in the BRICS group of countries, similar developing African economies and the developed European economies. This comparison is based on the background obtained on the systems which these countries have implemented.

South Africa's withholding tax, when compared with the BRICS group of countries, lies at a midpoint between the highest and lowest. This current situation is acceptable by virtue of the fact that it is a member to that group and, furthermore, experiences similar developing economy challenges. South Africa also has an average withholding tax rate amongst the developing African countries which is higher than that of Namibia but lower than Mozambique. This is also acceptable by virtue of the fact that South Africa is also a developing African country and, furthermore, also experiences similar developing economy challenges. The difference between the South African and developed European economies' withholding taxes might be attributable to these economies being well developed and quite different to South Africa as evidenced above.

As the withholding taxes in most of the selected countries are final taxes, no additional income tax is levied on the recipient and the related normal income tax interest exemptions will not be applicable to non-residents subject to withholding tax in these countries.

South Africa has both normal income tax interest exemptions and withholding tax interest exemptions in terms of which either one or the other may be applicable. If the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax provided the non-resident is not receiving interest through a permanent business establishment in the Republic during the year of assessment. Non-resident's not subject to the withholding tax and not receiving interest through a permanent business establishment in the Republic during the year of assessment will not be subject to any tax on the interest.

Furthermore, as stated in the paragraph above, in terms of the legislation in these countries, non-residents will never be subject to normal income tax. In the event of the focus falling solely on non-resident entities conducting business through a

permanent business establishment, investors will favour these countries to invest in as a result of the final tax. In South Africa the interest would then be subject to normal income tax provided the permanent business establishment exception is met. In all other cases the interest will not be subject to taxation which is similar to the case in the other countries. Therefore, if this exception is excluded, investors would be indifferent to the normal income tax interest exemptions available.

Based on the comparisons above, after taking into account the determinants of the selected countries, South Africa has a withholding tax that will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion. The designed system is, therefore, an effective system of taxing non-residents on interest.

It was furthermore noted that in most of the selected countries normal income tax and the related interest exemptions were not applicable to non-residents as a result of the withholding tax being a final tax. Extensive exemptions do increase the country's FDI. However, they have the potential of eroding the South African tax base as discussed in Chapter 3 which has been addressed by the amendment to section 10(1)(h) which has been brought more in line with global practice than the blanket interest exemption.

Chapter Six will highlight the findings, indicators for achievement of the research objectives, a summary of contributions together with suggestions for future research and conclusions and recommendations on the effective design of the new South African withholding tax on interest. A conclusion on whether it will align South African legislation in respect of interest exemptions with global practice will also be provided. Chapter Six will, in addition, provide an overall conclusion on the research objectives to ensure that the problem statement has been addressed.

## CHAPTER SIX

### CONCLUSIONS AND RECOMMENDATIONS

#### 6.1 INTRODUCTION

As discussed in Chapter One, South Africa is one of the world's largest producers and exporters of gold and platinum. Mining, services, manufacturing and agriculture rival similar sectors in the developed world (The Heritage Foundation, 2012c:1). The high HIV/AIDS rate, high unemployment rate, widespread poverty, poor education and lack of access to basic infrastructure and services, however, still remain a major challenge for the country (The Heritage Foundation, 2012c:1). FDI has been identified as a means for South Africa to acquire some funding to facilitate the provision of employment, alleviate poverty and additionally facilitate the transfer of knowledge and technology to improve and assist with South Africa's current challenges (Terhoeven, 2011:61). The main purpose of this research was to examine and conclude on whether the new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to remain competitive in international markets and also to examine and determine if it will align the South African legislation in respect of the section 10(1)(h) blanket interest exemption with that of global practice.

The following research objectives (paragraph 1.3) were set out in order to address the problem statement:

- (i) To examine the previous South African withholding tax on interest and the income tax legislation prior to the new South African withholding tax on interest relating to interest exemptions applicable to non-residents. This has been addressed in Chapter Two.
- (ii) To examine the new South African withholding tax on interest, including the reasons and motivation for the introduction of this new South African withholding tax on interest, the alignment with the section 10(1)(h) interest exemption. This has been addressed in Chapter Three.

- (iii) To examine the taxation of interest of non-residents in certain developed and developing countries. This has been addressed in Chapter Four.
- (iv) To compare the withholding tax on interest with the taxation of interest earned by non-residents, implemented by the developed and developing countries. This has been addressed in Chapter Five.
- (v) To make conclusions and recommendations on the effective design of the new South African withholding tax on interest and whether it will align South African legislation in respect of the section 10(1)(h) interest exemption with global practice. This is addressed in the current chapter, namely Chapter Six.

This chapter summarises the findings and indicates the achievement of the research objectives. This summary is followed by a summary of contributions together with suggestions for future research. Finally, the conclusion is drawn with regard to whether the new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to remain competitive in international markets and whether it will align the South African legislation in respect of the section 10(1)(h) blanket interest exemption with global practice.

## **6.2 SUMMARY OF FINDINGS**

South Africa's current 128<sup>th</sup> IFDI ranking indicates that it is not a preferred FDI destination. FDI has, however, been identified as a means for South Africa to improve and assist with South Africa's current challenges as indicated in 6.1 above.

It is, therefore, evident that South Africa is in need of FDI into its developing economy. At the same time South Africa needs to be competitive with other developing economies in attracting this FDI. This study strengthens the argument that the current normal income tax interest exemption in terms of section 10(1)(h) appears to be overly generous and therefore not beneficial or competitive to the developing South African economy. Furthermore, it does not achieve a fair balance between the attraction of foreign debt capital and the need to protect the tax base against potential erosion as discussed in Chapter 3.

Chapter Two examined NRTI including reasons for and motivations regarding its removal. It revealed that the previous withholding tax did not yield a sufficient benefit for the *fiscus*. The new South African withholding tax on interest is, therefore, introduced to address weaknesses of the previous NRTI and current legislation in terms of section 10(1)(h).

Chapter Three examined the new South African withholding tax on interest, including the reasons and motivation for its introduction, the alignment with the section 10(1)(h) interest exemption and the legislative provisions of the withholding tax, including an overview of sections 49A-H. This study strengthened the argument that the current normal income tax interest exemption in terms of section 10(1)(h) appears to be overly generous and therefore not beneficial or competitive to the developing South African economy. The impact of headquarter companies on the new South African withholding tax on interest including the thin capitalisation rules in the Act (58 of 1962) which was identified as a significant barrier for South African holding companies financed with debt capital, was also examined. A mechanism to address the thin capitalisation barrier identified as a result of the headquarter company regime has been included by the headquarter company financial assistance withholding tax exemption provided. The impact of the above-mentioned withholding tax exemption in respect of headquarter company financial assistance should hopefully keep South Africa as a natural and preferred holding company gateway into the African region.

Chapter Four examined the taxation of interest of non-residents in certain developed and developing countries and revealed that the different selected countries all imposed, as part of the general income tax law of the particular country, a withholding tax applicable to interest payments made to non-residents. The rates of withholding taxes, exemptions from normal income tax and withholding tax vary according to country and treaty provisions between countries.

Chapter Five identified that the new South African withholding tax on interest is competitive with the BRICS group of countries as a result of the new South African withholding tax on interest rate having the midpoint rate among the BRICS countries and, furthermore, as a result of the withholding tax interest exemptions available in

South Africa. It is clear from the comparisons that the new South African withholding tax on interest appears to be competitive with that of the BRICS group which is a positive indicator for attracting FDI with regard to both foreign investors and the South African economy.

The comparison with similar developing African economies indicates that the new South African withholding tax on interest is also competitive with these countries. Withholding tax interest exemptions are available in South Africa when compared to the other developing African economies of Mozambique and Namibia. The new South African withholding tax on interest rate is at a midpoint between these two selected countries.

Furthermore, the new South African withholding tax on interest is reasonable when compared with the developed European economies. Even though the new South African withholding tax on interest rate is far below the two selected developed countries, the difference in the rate seems to be acceptable, as consideration needs to be given to the fact that a comparison between developing and developed economies provides greater differences in results than countries of the same level of development.

It was furthermore noted that in most of the selected countries, normal income tax and the related interest exemptions were not applicable to non-residents as a result of the withholding tax being a final tax. The section 10(1)(h) interest exemption available in South Africa will be applicable if interest is exempt from withholding tax. In the event that the interest is exempt from the withholding tax and the non-resident is receiving interest through a permanent business establishment in the Republic during the year of assessment normal income tax will apply to that interest. If the non-resident is not subject to the withholding tax and does not receive interest through a permanent business establishment in the Republic during the year of assessment, the non-resident will not be subject to any tax on the interest.

The new South African withholding tax on interest rate exemptions are more detailed when compared to the limited or in most cases non-existent withholding tax interest exemptions of the countries in the comparison and result in South Africa having the

most favourable exemptions among the selected countries. Extensive exemptions do increase the country's FDI. However, they have the potential of eroding the South African tax base which has been addressed by the amendment to section 10(1)(h).

### **6.3 ACHIEVEMENT OF THE OBJECTIVES**

This study conducted a literature review by obtaining an understanding and providing a summary of the range of past and contemporary literature given (Bayat & Fox, 2007:35).

The study used historic research to analyse and obtain an in-depth understanding of the previous withholding tax on interest and the reasons for its removal. Historical research, which is largely a qualitative endeavour, was used to describe past events and to present a factually supported rationale to suggest how and why they may have occurred (Leedy & Ormrod, 2013:170). The purpose of selecting this approach was to understand, and also to explain through argumentation, using evidence from the data and literature, what the study is about (Henning, Van Rensburg & Smit 2004:3).

A comparative study was also conducted. The focus of this study was on the similarities and differences between withholding taxes and other determinants which have a direct and indirect impact on withholding taxes applied across the selected countries (Mouton 2013:154). This comparative study was conducted by examining the similarities and differences of data in the form of numbers relating to the IFDI rankings, withholding tax rates, normal and withholding tax interest exemptions and repo rates applicable to the study (Denscombe, 2007:254; Mouton 2013:154). The comparative study was performed using mainly data from secondary sources which are the written tax highlight summaries of the primary sources of information being the legislation of the respective countries (Mouton 2013:71).

Current legislation and literature on the withholding taxes on interest, as well as other data obtained was used in the present study. The legislation, literature and data were considered to determine if the new South African withholding tax on interest has been effectively designed and if it will be implemented in order to align

the South African legislation in respect of the section 10(1)(h) normal interest exemption with global practice.

The problem statement investigated by the research study (paragraph 1.2) was: **To determine whether the new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to remain competitive in international markets and whether it will align the South African legislation in respect of the section 10(1)(h) blanket interest exemption with global practice.** In order to determine if the problem statement has been answered, it will first be determined if the individual research objectives have been met:

- (i) To examine the previous South African withholding tax on interest relating to non-residents, including the reasons for its removal, and the income tax legislation prior to the new South African withholding tax on interest relating to interest exemptions applicable to non-residents.

From the literature reviewed in order to address objective (i) (paragraph 1.3) the examination of the literature identified a similar withholding tax implemented during the early years of the Act (58 of 1962). The NRTI, as it was known, was in existence in the Act (58 of 1962) for many years without major changes to the legislation, which indicates that its intention to tax non-residents on South African source interest before it escaped the South African tax net was correct. However, the implementation/compliance was flawed as discussed in Chapter 2 whereby in practice most taxpayers merely paid the NRTI without ever filing a return to be assessed for normal tax.

The factors and motivations surrounding its removal, however, identified certain weaknesses of the NRTI. As a result it was removed from the legislation with the overriding reason being that the withholding tax did not yield a sufficient benefit for the *fiscus*. The R30 million that it raised a year only accounted for 0.07% when compared to a budget tax revenue for that year of R42.8 billion. Furthermore, the South African government had recognised that the NRTI withholding tax, although paid by non-residents, was effectively borne by the South African borrower.

The legislation on taxation of South African source interest to non-residents has been generous due to the section 10(1)(h) interest exemption. This section 10(1)(h) exemption currently exempts interest from normal income tax provided the non-resident is not receiving interest through a permanent business establishment in the Republic during the year of assessment. As a result of the above exemption and, more importantly, the fact that non-residents who do not fall into the above category of receiving interest through a permanent business establishment are exempt from taxation in respect of interest earned, it is evident that section 10(1)(h) has been generous. Based on these results, the research objective has been achieved.

- (ii) To examine the new South African withholding tax on interest, including the reasons and motivation for the introduction of this new South African withholding tax on interest, the alignment with the section 10(1)(h) interest exemption and the legislative provisions of the withholding tax, including an overview of the sections 49A-H. The impact of the withholding tax on headquarter companies will also be examined.

From the literature reviewed in order to address objective (ii) (paragraph 1.3), the examination of the literature identified that it is clear that South Africa is in need of FDI into its developing economy. However, at the same time South Africa needs to be competitive with other developing economies in attracting this FDI.

There has been an amendment to the section 10(1)(h) normal income tax exemption to enforce the primary intention of the introduction of sections 49A-H which is to align the South African legislation in respect of interest exemptions with global practice (22 of 2012). The effect of these exemptions is that either the normal income tax interest exemption or the withholding tax interest exemption will apply. If the interest received by or accrued to any non-resident is subject to the withholding tax, it will be exempt from normal income tax provided the non-resident is not receiving interest through a permanent business establishment in the Republic during the year of assessment. In the event that the interest is exempt from the withholding tax and the non-resident is receiving interest through a permanent business establishment in the Republic during the year of assessment normal income tax will apply to that interest. If the

non-resident is not subject to the withholding tax and does not receive interest through a permanent business establishment in the Republic during the year of assessment, the non-resident will not be subject to any tax on the interest.

There is, therefore, an important balance that should be achieved to stimulate FDI while at the same time not eroding the tax base by being overly generous. The new South African withholding tax on interest will therefore address the above weaknesses of the previous legislation of not yielding a sufficient benefit for the *fiscus* and being effectively borne by the South African borrower. This is achieved by coordinating and streamlining the rates to that of a uniform withholding rate to be in line with the uniform withholding tax regime and also by defining in detail the applicable interest and persons liable when compared to those defined in terms of NRTI. The new South African withholding tax on interest also expands on timing and procedure, refunds and currency for payments of the withholding tax on interest which was not evident in the previous NRTI. The weakness of the section 10(1)(h) normal income tax exemption being overly generous has also been addressed as discussed in Chapter 3.

The impact of the new South African withholding tax on interest on headquarter companies has been examined and the mechanism to address the barriers identified was addressed by the new South African withholding tax on interest. Based on these results, the research objective has been achieved.

- (iii) To examine the taxation of interest of non-residents in certain developed and developing countries. This will include examining the method of taxation, withholding taxes on interest, relief from double taxation in terms of DTAs, normal and withholding tax interest exemptions and the repo rates implemented by these countries.

From the literature reviewed in order to address objective (iii) (paragraph 1.3), the examination of the background of the different selected countries, all imposed as part of the general income tax law of the country, a withholding tax applicable to interest payments made to non-residents. The rates of withholding taxes and withholding tax interest exemptions vary hugely according to country. Treaty

provisions between countries provide for a greater degree of uniformity in the application of withholding taxes.

Based on the background obtained, the research objective has been achieved by providing the background of method of taxation, withholding taxes on interest, relief from double taxation in terms of DTAs, normal and withholding tax interest exemptions and the repo rates implemented by Brazil, Russia, India, China, Mozambique, Namibia, Germany and Denmark.

- (iv) To compare the withholding tax on interest with the taxation of interest earned by non-residents, relating to their IFDI rankings, rates of withholding taxes on interest, normal and withholding tax interest exemptions and repo rates implemented by the developed and developing countries.

The comparative study, in addressing objective (iv) (paragraph 1.3), compared the new South African withholding tax on interest with other countries, namely Brazil, Russia, India, China, Mozambique, Namibia, Germany and Denmark, and identified that the new South African withholding tax on interest appears to be competitive with the selected countries. The comparison used a background of the method of taxation, withholding taxes on interest, relief from double taxation in terms of DTAs, normal and withholding tax interest exemptions and the repo rates implemented as obtained from the systems which other countries have implemented to determine if the objective of comparing the withholding tax on interest with the taxation of interest earned by non-residents, implemented by the developed and developing countries has been met.

The different selected countries all impose a withholding tax applicable to interest payments made to non-residents as part of the general income tax law of the country. The rates of withholding taxes vary hugely according to country with China and Namibia imposing the lowest rate at 10% and Germany and Denmark imposing the highest rate at 25%.

Interest exemptions from normal income tax are available for some of the selected countries. However, these are applicable only to residents with the exception of

China and Russia where it is applicable to both residents and non-residents. As a result of the withholding tax being a final tax, these normal income tax interest exemptions are not applicable to the non-residents that are subject to the withholding tax. The withholding tax that is a final tax is withheld by the payer and paid over to the Tax Authorities in that country and therefore no additional income tax is levied on the recipient. Normal interest exemptions will therefore not be applicable to non-residents subject to the withholding tax in that country. Treaty provisions applied between countries provide for a greater degree of uniformity in the application of withholding taxes. All of the countries examined above have limited exemptions from withholding tax on interest with the exception of China, Mozambique and Namibia who have no exemptions from withholding tax at all.

The difference between the South African and developed European economies' withholding taxes are acceptable as these economies are well developed and quite different to South Africa as discussed in paragraphs 1.4.3.1.3 and 4.4.3 and further evidenced by the determinants in respect of IFDI rankings and repo rates. Based on the comparisons, after taking into account the determinants of the selected countries, South Africa has a withholding tax rate that will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion. It appears that the system, designed and implemented, is an effective system of taxing non-residents on interest. Based on these results, the comparison was effective and the research objective has been achieved.

- (v) To make conclusions and recommendations on the effective design of the new South African withholding tax on interest and whether it will align South African legislation in respect of the section 10(1)(h) interest exemption with global practice.

Based on the above study in order to address objective (iv) (paragraph 1.3), the conclusion is that the overall withholding tax rate, including withholding tax exemptions, has been designed effectively in that it will achieve the objective of attracting foreign lending to South Africa while remaining competitive in the

international debt capital markets and also ensuring that the tax base is protected from any potential erosion.

The withholding tax is appears to be competitive as it will be able to achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion even though these are more favoured FDI destinations than South Africa.

The new South African withholding tax on interest is in line with global practice as it brings South African legislation more in line with global practice than before the implementation of the new South African withholding tax on interest as interest will now be subject to this new withholding tax. It does not, however, align South African legislation in respect of the interest exemptions with global practice. It was noted that in most of the selected countries normal income tax and the related interest exemptions were not applicable to non-residents as a result of the withholding tax being a final tax. The section 10(1)(h) interest exemption available in South Africa, applicable if interest is exempt from withholding tax, will result in interest being subject to normal income tax provided the interest is connected to a non-resident's permanent business establishment.

In all other cases the interest will be exempt in terms of section 10(1)(h). Based on the conclusion reached, the research objective has been achieved.

#### **6.4 SUMMARY OF CONTRIBUTIONS**

As evident from the comparisons in paragraphs 5.3 to 5.6 above, the following summary of contributions can be made. The new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to remain competitive in international markets as:

- a) A comparison of the new South African withholding tax on interest with other countries, using the background obtained on the systems which other countries have implemented, identifies that the new South African withholding tax on interest appears to be competitive with the BRICS group of countries, similar

developing African economies and the selected developed European economies.

- b) Based on the comparisons and taking into account the
- withholding taxes applied and the rates at which they are applied,
  - the normal income tax and withholding tax interest exemptions,
  - FDI, and
  - repo rates

of the selected countries, South Africa appears to have designed and proposed to implement an effective system in terms of the new South African withholding tax on interest for the South African economy. The system is effective as it will achieve the objective of attracting foreign lending to South Africa while remaining competitive in the international debt capital markets and also ensuring that the tax base is protected from any potential erosion by taxing non-residents on interest payments received.

A moderate tax rate, as used by South Africa, will have an impact on the FDI as evident from the comparisons in paragraphs 5.3 to 5.6 above. The protection of the tax base from potential erosion will be addressed by the amendment to section 10(1)(h) which will result in the interest received by or accrued to a non-resident subject to the withholding tax being exempt from income tax and, equally, if the interest is exempt from the withholding tax, it will be subject to income tax provided the two exceptions of section 10(1)(h) are met. It was furthermore noted that in most of the selected countries normal income tax and the related normal income tax interest exemptions were not applicable to non-residents as a result of the withholding tax being a final tax. However, the interest exemptions are not in line with global practice as:

- a) The study revealed that most of the other countries do not apply any normal income tax interest exemptions. These normal interest exemptions, however, do not directly impact FDI as the other countries do not levy normal income tax and therefore the exemptions will not be applicable. Investors who do not have a permanent business establishment in the Republic during the year of assessment will therefore be indifferent to either investment destination.

- b) Furthermore, the new South African withholding tax on interest rate exemptions are more detailed when compared to the limited or in most cases non-existent withholding tax interest exemptions and result in South Africa having the most favourable exemptions among the selected countries. This study, incorporating the comparisons in Chapter 5, has also indicated that extensive exemptions increase the country's FDI. However, they have the potential of eroding the South African tax base which has been addressed by the amendment to section 10(1)(h).

SA should also consider the following method of attracting FDI:

- Exceptions in respect of reduced rates to the legislation on interest income similar to those available in Mozambique for telecommunications and international transport as well as the respective installation and assembly of equipment made by those same entities which allow the taxation of interest income at lower interest rates.

## **6.5 SUGGESTIONS FOR FUTURE RESEARCH**

Due to the limitations of this study, future possible studies may achieve different results. Some of the possibilities for further study in this area are therefore possible.

This study only focused on the withholding taxes on interest of the BRICS group, using similar developing economies, namely Mozambique and Namibia, as a result of their similarities when compared to South Africa. Developed European countries, namely Germany and Denmark, were used in the study as a result of their trade and other relations with South Africa. Comparisons with other countries that have implemented more successful methods of withholding tax on interest could prove to provide a greater insight into the topic. Similarly, a comparison with exclusively African countries will provide a greater insight into the topic of the methods of withholding tax on interest.

The present study did not address the issue of whether the foreign investor or the investee bears the cost of withholding tax. During the course of the study the

concept of tax gross-up was identified. In these instances, the international investment agreement between the investor and investee could stipulate that the withholding tax will be for the cost of the foreign investor. The concept of tax gross-up will then result in the foreign investor increasing the income according to the contract in order to ensure that the investor is not out of pocket and receives the same amount as in the case if withholding tax was not applicable. In the end, this arrangement is negative for South Africa as the receiver of FDI/investee will be paying the withholding tax with no resulting benefit for the *fiscus*. The cost for the borrower is, therefore, as a result, increased by making the costs of borrowing in South Africa more expensive in order to fund foreign investment. A detailed study focusing exclusively on the tax gross-up scenario and its impact on withholding taxes will provide insight into the topic.

## **6.6 CONCLUSION**

The main purpose of the introduction of the new South African withholding tax on interest is for the country to remain competitive in the international debt capital markets while addressing the continued need for South Africa to attract foreign lending. The background to this study indicated that there is a continued need for South Africa to attract foreign lending and to remain competitive in the international debt capital markets. This is further evidenced by South Africa being ranked 128<sup>th</sup> on the IFDI Index. There is, therefore, an important balance that needs to be achieved to stimulate FDI at the same time while not eroding the tax base by being overly generous.

It is concluded that a mechanism of withholding taxes as per NRTI has been successful in its intentions in South Africa previously, subject to certain exemptions as listed in Chapter Two. A result of the above is therefore that the new South African withholding tax on interest is introduced to address the above weaknesses in the previous legislation. These weaknesses are NRTI providing an insufficient contribution to the *fiscus*, including the fact that NRTI was effectively borne by the South African borrower, and the overly generous section 10(1)(h) exemption of the current legislation as identified in Chapter Three.

The different selected countries all imposed as part of the general income tax law of the country a withholding tax applicable to interest payments made to non-residents. The rates and exemptions of withholding taxes vary hugely per country and treaty provisions between countries and provide for a greater degree of uniformity by allowing for reduced rates and also ensuring that there is no double taxation on the interest payments in the application of withholding taxes as examined in Chapter Four.

The comparison in Chapter Five identified that the new South African withholding tax on interest appears to be competitive, taking into account a background of method of taxation, withholding taxes on interest, relief from double taxation in terms of DTAs, normal and withholding tax interest exemptions and the repo rates implemented as obtained from the BRICS group of countries, similar developing African economies and the developed European economies. It was, furthermore, noted that in all of the selected countries with the exception of Russia, normal income tax and the related interest exemptions were not applicable to non-residents as a result of the withholding tax being a final tax. The section 10(1)(h) interest exemption available in South Africa will be applicable if interest is exempt from withholding tax. In the event that the interest is exempt from the withholding tax and the non-resident is receiving interest through a permanent business establishment in the Republic during the year of assessment, normal income tax will apply to that interest. If the non-resident is not subject to the withholding tax and does not receive interest through a permanent business establishment in the Republic during the year of assessment, the non-resident will not be subject to any tax on the interest. The interest exemptions are not in line with global practice as explained in paragraph 6.3. However, these exemptions are more in line with global practice than the current interest exemptions until the implementation of the new South African withholding tax.

Based on the conclusion reached, new South African withholding tax on interest has been effectively designed in order to still attract foreign lending to remain competitive in international markets. However, it will not align the South African legislation in respect of the interest exemptions with global practice.

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