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Tax Update

Rebates to manage the effect of African withholding taxes

Transactions with customers in the rest of Africa have become a common occurrence in many South African businesses. A common feature of these transactions, particularly service transactions, is that taxes are withheld by the payer in the other African country. These withholding taxes are typically levied on the income amount (as opposed to the profit realised from the transaction) and are collected at rates as high as 25%. It is clear from the scenario below that these taxes could have a significant impact on the profitability of doing business with or investing in the rest of Africa.

> SACo renders technical services to a client in Malawi for a fee of R1 000 000. Malawi imposes a 15% withholding tax on technical service fees paid to non-residents. Given that SACo employs specialists to provide the service, it operates at a gross profit margin of 20%. Before the effect of any taxes, SACo therefore has revenue of R1 000 000 and operating costs of R800 000 relating to the transaction.
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> Malawi would withhold R150 000 at the source when the fee is paid. As a resident of South Africa, SACo is taxed on its worldwide income, with deductions being available. The company's taxable income in South Africa is R200 000, resulting in tax payable in South Africa of R56 000. Before the relief measures discussed in the rest of this newsletter, SACo's overall tax liability (R150 000 plus R56 000) would erode its full profits from the transaction.

A number of measures are available to reduce the effect of the transactions being taxed in both South Africa and Malawi. The particular relief available depends on the facts and circumstances of the particular transaction. The source of the income is critical to determine which relief measure will be applicable.

Income earned from a source outside South Africa

Section 6*quat* of the Income Tax Act ('Act') allows a rebate from South African tax if a resident's taxable income includes income from a foreign source.

Section 9 of the Income Tax Act contains source rules for a number of income streams. Notable exclusions are the source of income from the supply of goods or rendering of services. In these cases, principles laid down by case law must be considered. In the case of goods, it must be considered where the seller carries on its business, related activities as well as where capital is employed in order to determine the source of the income. In the case of services, the source of the income is likely to be the place where the services are rendered. The section 6*quat* rebate will therefore apply if a resident carries on business or services renders services abroad and is taxed on such income abroad.

Section 6*quat* however limits the total rebate available to the South African tax payable on foreign sourced income. This limitation applies on an aggregated level for all foreign sourced taxable income.

If the services in the example were physically rendered in Malawi by SACo, the section *6quat* rebate will be available. In that scenario, the South African tax would have been R56 000 on the profits from the services (assuming that this is SACo's only transaction for the year). The section 6*quat* rebate will therefore be R56 000 as the R150 000 exceeds the South African tax. This results in no tax being payable in South Africa but R150 000 is payable in Malawi. From a business perspective, SACo must take into account that its overall profit from the transaction will only be R50 000 on income of R1 000 000; this equates to a 5% profit margin after tax. The drop from 20% before tax to 5% after tax mainly results from the fact that a withholding tax on income does not acknowledge the costs SACo had to incur to generate the income. This type of withholding tax on income can therefore result in some transactions not being worthwhile pursuing due to low or no profit margin being left after tax.

Income earned from a South African source

From the discussion above it is apparent that the section 6*quat* rebate will not apply if the income arises from a business carried on in South Africa or from services rendered from South Africa. In this case, section 6*quat* allows a deduction (as opposed to a rebate)[1] for foreign taxes paid.

[1] Where a rebate would reduce the resident's South African tax payable with the full amount of foreign tax paid, the deduction only reduces the effective South African tax payable by tax rate applicable to the resident applied to the foreign tax (in the case of a company, 28% of the foreign tax). A rebate is therefore more favourable than a deduction.

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With effect for years of assessment commencing on or after 1 January 2012, section 6*quin* was introduced to provide relief in the form of a rebate in limited circumstances. This rebate is only available in respect of *South African source income* earned by a resident *from services* rendered from *within South Africa*. The rebate is furthermore only available if:

- ✓ The tax was withheld when the payment was made to the resident, if the tax is imposed by a country with which South Africa has concluded a tax treaty; or
- ✓ any tax is imposed by a country with which South Africa has not concluded a tax treaty.

The rebate is similarly to the section 6*quat* rebate limited to the South African tax payable on the relevant income (i.e. taxable income arising from the income). This limitation is however applied on an income-by-income basis (unlike section 6*quat* that applies to an aggregated basis).

Section 6*quin*(3A) was inserted into the Act and requires that certain information must be submitted to SARS in the form of a declaration in order to be entitled to the section 6*quin* rebate. On 3 May 2013, SARS released the FTW01 form to implement this requirement. A notice was issued on 2 July 2013, stating that the provisions of section 6*quin*(3A) become effective from 1 July 2013. The wording of the transitional provision would suggest that the FTW01 form is only required for taxes withheld during years of assessment commencing on or after 1 July 2013, even though it is not clear that this interpretation reflects SARS' intention. It is submitted that the safe route to follow would be to nevertheless submit the FTW01 form for any rebates claimed under section 6*quin* from May 2013 onwards. It is important to note that the FTW01 must be submitted to SARS in respect of each transaction where tax was withheld in the manner discussed above for which the resident contemplates claiming the section *6quin* rebate within 60 days from the date when the tax was withheld (not only at the time of assessment). The purpose of this submission is to give SARS an opportunity to attempt to recover the tax from the foreign government (if withheld contrary to the relevant treaty – see next part of the newsletter).

The effect of a section 6*quin* rebate will be similar to a section 6*quat* rebate. If the foreign tax is however refunded by the government of the other country, the taxpayer may be left in a position where it is only taxed in South Africa on the profits from the transaction. This could arguably be a more favourable position, but will only arise if the other government is not allowed to impose the tax on the relevant income.

Effect of tax treaties

As a resident of South Africa, the South African entities supplying the goods or services into the rest of Africa should qualify for the benefits of the treaty between South Africa and the other country (if there is a treaty). The effect of this treaty is important for at least two reasons.

Firstly, the rebate and deduction in terms of section 6*quat* are only available if the foreign tax can be proved to be payable without a right to recover it. If the foreign government however imposed a tax contrary to the treaty, the South African resident is not liable for such a tax and would not qualify for the section 6*quat* rebate or deduction in respect of this tax.

Secondly, many treaties limit the withholding tax rate on service fees or only allow the foreign government to tax business profits if the South African resident carries on such a business through a permanent establishment in the other country. In the absence of such a permanent establishment, the other country may not tax the income.

In cases where the treaty would not allow the other country's government to tax the income, the distorting impact of the withholding tax can be fully eliminated.

Concluding thoughts

The combination of an abundance of business opportunities that the rest of the continent may offer, together with the potential unanticipated effect of withholding taxes, can result in doing business into the rest of Africa being extremely tricky to say the least. Entities conducting business into the rest of Africa need to pay careful attention to the tax regimes of the other countries (in particular, when rendering services which are often the target of withholding taxes) as well as the total tax picture if the South African relief measures are taken into account. Failing to do so may result in entering into transactions that turn out to be a lot less lucrative than expected.

If you require technical tax or IFRS assistance or an inhouse seminar please feel free to contact Pieter van der Zwan at **083 417 5904** or **pieter@pvdz.co.za** or to visit **www.pvdz.co.za** and submit a request on the relevant page.