A re-evaluation of South Africa's headquarter company regime

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ABSTRACT

The South African headquarter company regime has been criticised for being a conduit company and for allowing South Africa to be used for 'treaty shopping' arrangements. Recent developments in the international tax sphere, arising from the implementation of the outcomes of the BEPS Project, could have an impact on the continued existence and feasibility of the headquarter company regime. The impact that these recent developments could have on the headquarter company regime has not been addressed by previous studies. In this regard, this study makes a valuable contribution to the existing body of knowledge. This study sought to determine, in light of the existing criticism of the headquarter company regime and recent international developments, whether the headquarter company regime still has a role to play in South African tax law and, if so, which aspects of the regime require revision.

The development of the headquarter company regime and the policy reasons for the creation of the regime were considered, as well as the existing criticism of the regime. The regime has certain inherent inadequacies which hamper its achievement of its policy objectives. This study makes recommendations for National Treasury to consider whether including the relief that was found to be lacking would facilitate the achievement of the regime's policy objectives. After gaining an understanding of the headquarter company regime's policy objectives and its shortcomings, selected recent developments in the international tax sphere, that may have an impact on the regime, were considered. This included Actions 5 and 6 of the BEPS Project, which relate to the OECD's work on harmful tax practices and the prevention of treaty abuse, respectively. The multilateral instrument, which was developed in order to implement tax treaty-related (DTA-related) BEPS measures, and the development of the 'beneficial ownership' concept, were also considered. This study found that the requirement of 'substance' is playing an increasingly important role internationally, both in regard to the evaluation of preferential regimes to determine whether or not they are harmful, as well as in determining entitlement to treaty (DTA) benefits. This study concludes that the headquarter company regime still has a role to play in South African tax law and that, in order for the regime to be able to achieve its policy objectives, as well as for the regime not to be considered a harmful preferential regime, access to the regime should be restricted to companies that meet prescribed levels of 'substance'.

KEYWORDS

headquarter company

base erosion and profit shifting (BEPS)

harmful tax practices

treaty abuse

principal purposes test

simplified limitation-on-benefits (LOB) rule

multilateral instrument (MLI)

beneficial ownership

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DECLARATION

I declare that: 'A re-evaluation of South Africa's headquarter company regime' is my own work; that all sources used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.

Phillip Jacobus Lourens

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LIST OF ACRONYMS AND TERMS USED

Acronym or term	Meaning
Action Plan on BEPS	A report published by the OECD in 2013 which identifies actions needed to address BEPS, sets deadlines to implement these actions and identifies the methodology and the resources needed to implement these actions (OECD, 2013b:11).
Action 5 Report	The OECD's final report on Action 5 of the Action Plan on BEPS (Countering Harmful Tax Practices more Effectively, taking into account Transparency and Substance), which was published during October 2015 (OECD, 2015a).
Action 6 Report	The OECD's final report on Action 6 of the Action Plan on BEPS (Prevent treaty (DTA) abuse), which was published during October 2015 (OECD, 2015b).
Action 6 Peer Review Documents	The document titled 'BEPS Action 6 on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Peer Review Documents', which was released by the OECD during May 2017 (OECD, 2017e).
ATAF	The African Tax Administration Forum
Authorised Dealer	Banks authorised by the Financial Surveillance Department of the SARB to deal in foreign exchange (SARB, 2018:14).
Authorised Dealer Manual	The Currency and Exchanges Manual for Authorised Dealers issued by the Financial Surveillance Department of the SARB under the powers delegated by the South African Minister of Finance (SARB, 2018:14).
BEPS	base erosion and profit shifting
BEPS Project	The project launched by the G20 and the OECD with the publication of the Action Plan on BEPS in 2013 (OECD, 2013b:11).
BEPS Report	The report released by the OECD in 2013, titled 'Addressing Base Erosion and Profit Shifting' in relation to a study commissioned by the G20 (OECD, 2013a; OECD, 2013c).
Convention on MAATM	The Multilateral Convention on Mutual Administrative Assistance in Tax Matters
covered DTA	A DTA specifically listed by a country as being covered by the MLI.
DEI	The Singapore development & expansion incentive
DTA	double taxation agreement

DTC	The Davis Tax Committee, which was appointed by the South African Minister of Finance in July 2013 to inquire into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability in South Africa (DTC, 2013:1).
FHTP	The Forum on Harmful Tax Practices of the OECD
Foreign Company	Any foreign company in which a prospective HQC/HQC holds at least 10% of the equity shares and voting rights.
GBC1	A Mauritian Category 1 Global Business Licence.
GBC2	A Mauritian Category 2 Global Business Licence.
GBL	A Mauritian Global Business Licence.
G20	A group of 20 nations that comprises a mixture of the world's largest advanced and emerging economies, representing more than 75% of global trade (G20, s.a.).
HQC	headquarter company
IFSC	International Financial Services Centre
Inclusive Framework	The Inclusive Framework on BEPS which allows interested countries and jurisdictions to collaborate with OECD and G20 members in the development of standards on BEPS-related issues and monitoring mechanisms to monitor the implementation of the BEPS Package (OECD, 2017c:11; OECD, 2018b).
IN6	SARS' Interpretation Note 6: Resident: Place of Effective Management (Persons other than Natural Persons)
IN18	SARS' Interpretation Note 18: Rebate or deduction for foreign taxes on income
ITA	The Income Tax Act No. 58 of 1962
Katz Commission	The Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa
LOB rule	limitation-on-benefits rule
OECD	The Organisation for Economic Cooperation and Development
MLI	The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
MOBAA	The Mauritian Offshore Business Activities Authority
MTC	The Model Tax Convention on Income and on Capital
National Treasury	The National Treasury of South Africa
NCOP	The National Council of Provinces, which is one of the two houses of the South African Parliament and takes part in the

	national legislative process (Parliament of the Republic of South Africa, s.a.).
NEPAD	The New Partnership for Africa's Development
PC	The Singapore pioneer certificate'
POEM	place of effective management
PPT	principal purposes test
Preamble	The preamble wording for DTA's prescribed by the Action 6 minimum standard on 'treaty shopping', which contemplates an express statement that the countries that are party to a DTA intend to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion, including by way of 'treaty shopping' arrangements
Prévost case	The Canadian case of *Prévost Car Inc. v. The Queen* 2008 T.C.C. 231.
Proviso	If a company seeks to qualify as an HQC, each shareholder of that company must hold 10% or more of the equity shares and voting rights of that company for the duration of the year in which the election to be an HQC is made. This requirement is subject to a proviso that, in determining whether or not a prospective HQC complies in any year of assessment in which it started to carry on a trade, the period during that year, before the prospective HQC started to carry on a trade, must be disregarded.
SADC	The Southern African Development Community
SARB	The South African Reserve Bank
SARS	The South African Revenue Service
South Africa	The Republic of South Africa
1998 Report	The OECD's 1998 report titled 'Harmful tax competition: an emerging global issue' (OECD, 1998:3).

1. INTRODUCTION

1.1. Background to the research area

Tax competition can be helpful because it can encourage governments to create fiscal environments that are conducive to generating growth and employment (Commonwealth Finance Ministers Meeting, 2000). Tax incentives are a manifestation of tax competition. Governments often choose tax incentives over other types of government action because it is easier to provide tax benefits than to correct a country's inherent, systemic deficiencies (Zolt, 2015:12).

A preferential tax regime is an appealing tax incentive to specifically target functions such as intragroup finance, the management of intangible assets, headquarter administration, and other overhead services that are not location specific and can be located in jurisdictions that offer favourable tax treatment (Genschel, 2002:255). The way in which business is conducted has changed significantly and the portion of cross-border transactions that take the form of mobile services and intangibles has increased (Easson, 2001:266). This encourages competition among countries to act as host country for businesses that can supply markets in several different countries from one location (Zolt, 2015:7).

By creating a hospitable fiscal environment in order to attract investment and facilitate trade (the Margo Commission of Inquiry into the Tax Structure of the Republic of South Africa, cited by the Katz Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, 1997 (the 'Katz Commission')), South Africa arguably also takes part in tax competition. The Katz Commission (1997) stated that the location of multinational corporations in South Africa is a vital strategy for the country's economic growth and that encouraging the formation of international corporate headquarters and holding companies in South Africa will be advantageous to the country's economy.

Section 9I of the South African Income Tax Act No. 58 of 1962 (the 'ITA') applies in respect of any year of assessment beginning on or after 1 January 2011 and provides for a headquarter company regime (hereinafter referred to as the 'HQC regime'). In terms of the HQC regime, certain domestic tax rules are relaxed with the aim of treating an HQC as a 'flow through' (Finance Standing Committee, 2010), so that only the profits that are generated in South Africa are taxed and not the money flowing through South Africa (National Council of Provinces Finance Committee, 2011). The aforementioned relief is aimed at promoting South Africa as a launching point into the region and allowing foreign investors to utilise South Africa as a central point for various regional equity fund investments (National Treasury, 2010:3).

The HQC regime has been criticised for, *inter alia*, not aligning with the recommendations made by the Organisation for Economic Cooperation and Development (the 'OECD') in its final report on Action 5 of the BEPS Project regarding, amongst other issues, harmful tax practices, and for potentially encouraging 'treaty shopping' (arrangements through which a person who is not a resident of a country may attempt to obtain benefits that a double taxation agreement ('DTA') grants to a resident of that country) (OECD, 2015b:17; DTC, 2017a:7; DTC, 2017b:92).

1.2. Literature review

1.2.1. **The development of the HQC regime**

The Katz Commission encouraged the creation of HQC's in South Africa, as it would benefit the South African economy for a variety of reasons (Katz Commission, 1997).

The Revenue Laws Amendment Act (59 of 2000) inserted the concept of an 'international headquarter company' into the ITA (58 of 1962). The aforementioned regime was repealed (South Africa, 2003) due to its ineffectiveness and the fact that it potentially constituted a harmful preferential tax regime (National Treasury, 2003:38).

The HQC regime was introduced into the ITA with effect from 1 January 2011 (South Africa, 2010). Since inception, it has had to compete with, *inter alia*, other African regimes in jurisdictions such as Mauritius and Botswana, which have developed fiscal policies to enable them to be bases for foreign investment into Africa (Oguttu, 2011:68).

1.2.2. **Existing criticism of the HQC regime**

The criticisms referred to in this paragraph were identified during a high level, preliminary consideration of South African scholarly writings. Zwarts (2013:108) is of the view that the interplay between the definition of 'resident' in section 1 of the ITA and section 9I, which provides for and regulates the HQC regime, could have a negative impact on the attractiveness of South Africa as an HQC destination.

It is not clear how the HQC regime, which lacks preferential treatment of management fees, will assist in achieving the objective of assisting in the development of intellectual infrastructure in South Africa through the transfer of skills (Gutuza, 2014:203).

Certainty for a multinational company that it will benefit under the HQC regime could allow it to plan effectively over the medium term. The HQC regime does not provide the necessary certainty and the annual election and compliance requirements make the benefit too temporary and costly (Mukumba, 2017:69). Mukumba (2017:abstract) goes further to say that the HQC regime has been inappropriately designed and is unattractive to multinational companies intending to invest in Africa.

According to Gutuza (2014:203), in regard to the payment of dividends, royalties and interest, an HQC can be seen as a 'true conduit company' because neither the source, nor the beneficial owner of such payments is located in South Africa. It therefore appears that a risk exists that an HQC could be disqualified from enjoying certain relief in terms of a DTA for failure to meet the 'beneficial ownership' threshold.

The likelihood of South Africa being used as part of 'treaty shopping' schemes is greatly increased by the nature of the HQC regime. This leaves the HQC regime in a position where, from a tax-policy perspective, it could be difficult to justify its continued existence (Mukumba, 2017:17). Mohamed (2015:33) shares this view and argues that if companies were to accept South Africa's invitation to establish HQC's in South Africa in order to invest in Africa and to benefit from South Africa's DTA's, such companies would be considered to be 'treaty shopping'.

1.2.3. **Recent developments in the international tax sphere**

The OECD was officially established on 30 September 1961, following the decision of the United States of America and Canada to join the Organisation for European

Economic Cooperation, which was established after World War II for the reconstruction of Europe (OECD, s.a. a). It has described itself as 'the linchpin of a major overhaul of the international tax architecture, whose aim is fighting against tax evasion, ending bank secrecy and tax havens, as well as addressing massive tax avoidance by multinational corporations' (OECD, s.a. b).

Whilst South Africa is not a member of the OECD, it is one of five 'key partners' (along with Brazil, China, India and Indonesia) contributing to the OECD's work (OECD, s.a. c). South Africa's role in international economic affairs is therefore acknowledged by the OECD. In light of this, it is important for South Africa, as a developing country, to ensure that its international tax laws and policies are aligned to international standards (Oguttu, 2010:187).

Due to tax policy concerns relating to BEPS, the finance ministers of the G20 (a group of 20 nations that comprises a mixture of the world's largest advanced and emerging economies, representing more than 75% of global trade (G20, s.a.)) called on the OECD to develop an action plan to address BEPS issues in a coordinated and comprehensive manner (OECD, 2013b:11). BEPS is where, due to gaps in the interaction of different countries' tax systems, and in some cases because of the application of bilateral DTA's, income from cross-border activities is artificially shifted in order to not be taxed anywhere, or to be only unduly lowly taxed (OECD, 2013b:10). As a result, the G20/OECD BEPS Project was launched with the publication of the 'Action Plan on BEPS' in 2013. The Action Plan on BEPS identifies actions needed to address BEPS, sets deadlines to implement these actions and identifies the methodology and the resources needed to implement these actions (OECD, 2013b:11).

As part of its mandate to inquire into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability in South Africa, the Davis Tax Committee ('DTC') issued reports wherein it recommends that certain of the OECD's recommendations arising from the BEPS Project be implemented in South Africa (DTC, 2017a; DTC, 2017:b). Where the implementation of OECD recommendations will require amendments to DTA's to which South Africa is a party, the DTC has stated that the costs and challenges of renegotiating DTA's will be alleviated by signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the 'MLI') which is the product of Action 15 of the BEPS Project, and will act as a simultaneous renegotiation of all DTA's (DTC, 2017b:3).

The MLI was signed by several jurisdictions, including South Africa, as part of a signing ceremony held in Paris on 7 June 2017 (OECD, 2017:3). As at 28 September 2018, 84 jurisdictions had signed the MLI (OECD, 2018a). According to the OECD (2017b), the MLI 'helps the fight against BEPS by implementing the tax-treaty related measures developed through the BEPS Project in existing bilateral treaties in a synchronised and efficient manner'.

Once the MLI comes into effect, South Africa's signature to the convention will serve as an amendment of many of South Africa's DTA's and will negate the need for bilateral renegotiations for the amendment of such DTA's, by incorporating certain provisions of the MLI into the existing DTA's (DTC, 2017b:101). The BEPS Project, and especially the MLI, may impact on the continued existence and feasibility of the HQC regime. The MLI may amend certain DTA's to which South Africa is a party, by introducing measures that may defeat the tax efficiency of investment structures in certain circumstances. The introduction of these measures may negate the relief enjoyed by HQC's (PwC, 2017b:6).

The BEPS Project follows research done by the OECD on the identification and elimination of harmful tax practices, in relation to which the OECD has stated that holding company regimes and similar preferential tax regimes do not necessarily constitute harmful tax practices, but may constitute harmful tax competition (OECD, 2000a:15). South Africa should seek to ensure that the HQC regime cannot be regarded by the OECD as a harmful tax practice or harmful tax competition.

1.3. Motivation of topic actuality

Porter (2014), Phumaphi (2014), Ward (2014), Mohamed (2015) and Mukumba (2017) considered the effectiveness and competitiveness of the regime. Arendse (2014) considered the challenges regarding the establishment of HQC's in African countries and Bennet (2012) considered what amendments are required in order to ensure the HQC regime benefits the South African fiscus.

Oguttu (2011) critiqued the HQC regime, taking into account the relief that it offers, but also referred to the fact that the HQC regime may be considered to be harmful tax competition. Furthermore, Zwarts (2013) researched the impact of the definition of 'resident' in section 1 of the ITA (58 of 1962) on the HQC regime and Gutuza's research (2014) compared the tax treatment of an HQC to that of a non-resident company using South Africa as a management base for trade and investment in Africa.

The majority of the existing research on the topic of the HQC regime was performed prior to the finalisation of the BEPS Project and the DTC's inquiry into the South African tax system, as well as prior to the publication of the OECD's 2017 'Progress Report on Preferential Regimes' (2017a). The impact that recent developments in the sphere of international tax could have on the continued existence and feasibility of the HQC regime has therefore not yet been researched and, in this regard, this study makes a valuable contribution to the existing body of knowledge.

1.4. Problem statement and research question

1.4.1. **Problem statement**

Recent developments in the sphere of international tax, such as the BEPS Project, and especially the MLI, could potentially have a significant impact on the continued existence and feasibility of the HQC regime. As stated above, the MLI may amend certain DTA's, to which South Africa is a party, to such an extent that the relief enjoyed by HQC's may be negated.

1.4.2. **Research question**

The research question this study sought to answer is:

In light of the existing criticism of the HQC regime and recent international developments, does the HQC regime still have a role to play in South African tax law and, if so, which aspects of the HQC regime require revision?

1.5. Objectives

1.5.1. **Main Objective**

The purpose of the research was to consider the potential impact on the HQC regime of selected recent developments in the sphere of international tax, when considered together with the existing criticism of the HQC regime.

The main objective of the research was to re-evaluate the HQC regime in order to determine whether or not it still has a role to play in South African tax law and, if so, to determine which aspects of the HQC regime require revision.

1.5.2. Secondary Objectives

The secondary objectives set out below were formulated in order to address the main objective. The achievement of each of the secondary objectives ensured that the main objective was achieved and the research question answered.

1.5.2.1. *Secondary objective 1*

To provide an overview of the development of the HQC regime to date and to determine the policy reasons for the creation of the HQC regime.

1.5.2.2. *Secondary objective 2*

In the re-evaluation of the HQC regime, the selected recent international developments (which were analysed under secondary objective 3) should not be analysed in a vacuum. In light of this, and in order to answer the research question, secondary objective 2 was to analyse the most significant points of criticism against the HQC regime to date in order to determine whether the regime has inherent inadequacies.

1.5.2.3. *Secondary objective 3*

To analyse selected recent developments in the international tax sphere that could have an impact on the continued existence and feasibility of the HQC regime.

1.6. Research design

1.6.1. Research method

McKerchar (2008:6) explains that, traditionally, two broad philosophical research paradigms exist: positivism and interpretivism. Each paradigm has different characteristics and produce different research and knowledge of a different nature.

In the positivist paradigm, the researcher is considered as being detached from the subjects under study and explanations are derived based on empirical evidence and tested theories. Interpretivism is founded on an ontology that the researcher cannot be detached from the subjects being studied and provides an understanding of social reality that is based on the subjective interpretation of the researcher.

The interpretivist researcher is likely to employ a qualitative methodology (McKerchar, 2008:7).

In the distinction between the traditional philosophical research paradigms, this study falls in the interpretive paradigm. A qualitative research methodology was applied to achieve the research objectives by gaining a deeper understanding of the HQC regime and the legal environment in which it was created and currently exists (McKerchar, 2008:17).

McKerchar proposes a view that legal research could be a research paradigm distinct from positivism and interpretivism (2008:8). According to the Pearce Committee (cited by McKerchar, 2008:18), two types of legal research can be identified, namely doctrinal or non-doctrinal. Doctrinal research is described as the traditional or 'black letter law' approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. In contrast, non-doctrinal research is characterised as research 'about law' rather than 'in law' and employs the methodologies commonly used in other disciplines (McKerchar, 2008:18).

The Pearce Committee further divided non-doctrinal research into reform-orientated and theoretical research (cited by McKerchar, 2008:19). Reform-orientated research is designed to accomplish change in the law, whereas theoretical research fosters a more complete understanding of the conceptual bases of legal principles. In this context, reform-orientated research is normative in nature, as it is aimed at determining not only what the current status of the law is, but also what the law ought to be by prescribing a norm or standard (Collins English Dictionary website, 2018).

For purposes of this study, McKerchar's proposal that legal research could be a different paradigm altogether was accepted as being appropriate. In the distinction between the doctrinal and non-doctrinal legal research, this study included both doctrinal and non-doctrinal elements. The doctrinal element of the study can be found in both chapters 3 and 4 which addressed the secondary objectives 2 and 3, respectively. A non-doctrinal element is found in chapter 5 in the form of suggestions for legal reform. To the extent that legal reform is suggested, the study can be described as reform-orientated.

The study was performed as a desktop study and the qualitative research methodology which it applied was document analysis. Data was collected by way of a literature review of printed and electronic material from South African national legislation, South African and foreign governmental policy documents, reports from South African and foreign commissions or committees of inquiry, South African and foreign case law, academic journals, authoritative textbooks and publications by international organisations such as the OECD.

Due to the nature of the study, documentation was the only necessary data source for this study. Documents provided background information and historical insight, which provided an understanding of the development of the HQC regime and indicated the conditions that impinge upon the HQC regime (Bowen, 2009:29). In analysing the documentary data, a content analysis exercise was performed whereby information was organised into categories related to the study's secondary objectives. Thereafter, a thematic analysis was performed whereby patterns within the data were identified and emerging themes became categories for further analysis (Fereday & Muir-Cochrane, 2006).

The advantage of document analysis as a qualitative research method is that it is efficient, both from a time and cost perspective, it ensures stability of data in that the investigator's presence does not alter what is being studied (Merriam, 1998:109). Moreover, it allows for accuracy in that exact names, references and details of events can be studied and included in the research report (Yin, 2009:102). A risk of using document analysis as a qualitative research method is biased selectivity (Yin, 2009:102). In performing this study, the risk of biased selectivity was mitigated by ensuring that documentary data is collected from the widest possible range of credible and authoritative sources. This ensured that the findings of the study can be validated by the support of other studies. This method of validation of the research findings in a qualitative study is referred to as 'cumulative validation' (Sarantakos, 2013:102).

1.6.2. **Paradigmatic assumptions and perspectives**

In conducting qualitative research, assumptions are made that are indicative of a certain stance toward the nature of reality and its characteristics, how researchers know what they know and the methods used in the process (Creswell, 2007:16).

1.6.2.1. *Ontological assumptions*

The study was based on an ontological assumption that reality is subjective and there are multiple realities. The study reported on these multiple realities by considering a variety of evidence from a variety of different sources (Creswell, 2007:17).

1.6.2.2. *Epistemological assumptions*

Epistemological assumptions relate to the relationship between the researcher and that which is being researched (Creswell, 2007:17). The study was based on the premise that knowledge can be acquired from authoritative sources and acknowledges that the strength of the knowledge acquired depended on the strength of the sources consulted. Authoritative sources were studied in depth in order to achieve the research objectives.

1.6.2.3. *Methodological assumptions*

Methodological assumptions relate to the process and the methods used in conducting research (Creswell, 2007:17). In qualitative research, the researcher uses inductive logic, studies the topic within its context and uses a method guided by the collection and analysis of data. The methodology that was followed in this study has been described above in paragraph 1.6.1.

1.7. Structure and overview of study

The chapters included in the study are set out below, together with an overview of the objective and proposed focus of each chapter.

1.7.1. Chapter 1: Introduction

This chapter provides background information to the research that was conducted, which provides context and serves as motivation regarding the actuality of the research question. This chapter also states the research objectives and explains the research method adopted in the study.

1.7.2. Chapter 2: Policy reasons for the creation of the HQC regime

The objective of this chapter is to provide an overview of the development of the HQC regime to date and to determine the policy reasons for the creation of the HQC regime. The purpose of this chapter is to achieve secondary objective 1, which it aims to do through a consideration of the following:

1.7.2.1. the development of the HQC regime;
1.7.2.2. the objectives of the HQC regime as stated by the South African government; and
1.7.2.3. the objectives of selected developing countries with the creation of similar regimes.

1.7.3. **Chapter 3: Existing criticism of the HQC regime**

As stated above in paragraph 1.5.2.2, in the re-evaluation of the HQC regime, the selected recent international developments (which are analysed in chapter 4) should not be analysed in a vacuum. In light of this, the objective of this chapter is to analyse the existing criticism of the HQC regime in order to determine whether it has inherent inadequacies and to achieve secondary objective 2. This chapter therefore considers the following criticism:

1.7.3.1. the definition of 'resident' in section 1 of the ITA could have a negative impact on the HQC regime;
1.7.3.2. the lack of preferential treatment of services and service income in the hands of an HQC hampers the HQC regime's ability to achieve certain of its policy objectives;
1.7.3.3. the annual requirements for qualification as an HQC are open to manipulation and create a significant compliance burden on an HQC;
1.7.3.4. private equity funds cannot utilise an HQC as an investment vehicle;
1.7.3.5. the limitation imposed by the HQC regime on the deduction of interest and royalty expenses negates the relaxation of the transfer pricing and thin capitalisation rules;
1.7.3.6. the HQC regime is not successful as a regional development tool; and
1.7.3.7. the HQC regime could lead to a loss of revenue for the South African fiscus.

1.7.4. **Chapter 4: Recent developments in the international tax sphere**

The objective of this chapter is to analyse selected recent developments in the international tax sphere that could have an impact on the continued existence and feasibility of the HQC regime and to achieve secondary objective 3.

This chapter therefore considers the OECD's work on harmful tax practices and Action 5 of the Action Plan on BEPS (Countering Harmful Tax Practices more Effectively, taking into account Transparency and Substance), Action 6 of the Action Plan on BEPS (Prevent Treaty (DTA) Abuse) and the implementation of the Action 6 minimum standard through the MLI, with specific focus on the preamble to DTA's, the principal purposes test (‘PPT’) and the simplified limitation-on-benefits rule (‘LOB rule’). This chapter also considers the development of the 'beneficial ownership' concept.

1.7.5. Chapter 5: Conclusion

The objective of this chapter is to summarise the findings from chapters 2 to 4 and to evaluate the extent to which the problem statement has been addressed and the research question has been answered.

2. POLICY REASONS FOR THE CREATION OF THE HQC REGIME

2.1. Introduction

The objective of this chapter is to provide an overview of the development of the HQC regime to date and to determine the policy reasons for the creation of the HQC regime. In order to determine whether or not the HQC regime still has a role to play in South African tax law, the history of the HQC regime and the purpose for which it was created must first be understood. This chapter will therefore consider the development of the HQC regime (see paragraph 2.2 below), the objectives of the HQC regime as stated by the South African government (see paragraph 2.3 below) and the objectives of selected developing countries with the creation of similar regimes (see paragraph 2.4 below), before analysing the HQC regime to determine the policy reasons for its creation (see paragraph 2.5 below).

2.2. The development of the HQC regime

The purpose of this section is to provide a brief background to the HQC regime and the events that preceded its creation. This section is not intended to be a detailed analysis of each amendment to the HQC regime since its inception.

2.2.1. Commissions of inquiry into South Africa's tax structure

As early as 1987, the Margo Commission (cited by the Katz Commission, 1997) reported:

> 'The Republic has an open economy and seeks to create an environment that will attract investment and facilitate trade. A hospitable fiscal environment is seen as an integral part of such endeavours. Transnational corporations are making valuable contributions to the growth of developing countries through their inputs of expertise and capital, and they should be encouraged.'

Ten years later, the Katz Commission (1997) stated that, under the source-based system of taxation, South Africa was well positioned as a location for a head office, finance or management company, as far as investments into Africa were concerned. At paragraph 1.2.1 of its fifth interim report, the Katz Commission explained (1997) that a sourced-based system of taxation is a system in terms of which income is taxed in the country where the income originates, regardless of the physical or legal residence of the recipient of the income.

The Katz Commission (1997) further stated that encouraging the formation of international corporate headquarters and holding companies in South Africa, will be advantageous to the economy, lead to the importation and retention of skills and, eventually, contribute to economic activity in the country. Having considered the conditions conducive to international holding companies prevailing in certain European and Asian countries, the Katz Commission concluded that South Africa could become a highly attractive location for 'these types of companies' (presumably, international holding companies). It also recommended that exemptions be introduced for South African headquarter companies, in terms of which fees earned by such headquarter companies would be exempt. As Oguttu (2011:89) correctly points out, the Katz Commission's report did not provide clarity as to whether the regime to be adopted should be a holding company regime or a headquarter company regime.

2.2.2. The introduction and repeal of the 'international headquarter company' regime

Section 1 of the ITA was amended by the insertion of the definition of the term 'international headquarter company' with effect from 1 January 2001, in respect of years of assessment commencing on or after that date (South Africa, 2000). This amendment coincided with South Africa's change from a largely source-based system of taxation, to a residence-based system of taxation (National Treasury, 2003:38).

An international headquarter company was specifically excluded from the definition of 'resident' in section 1 of the ITA, which makes it clear that the National Treasury of South Africa (‘National Treasury’) intended for the international headquarter company not to be subject to South Africa's residence-based system of taxation. The aforementioned exclusion appears to be an acknowledgement of the Katz Commission's statement in 1997 that South Africa’s source-based tax system positions it well as a head office, finance or management company location for investment into Africa.

As a result, an international headquarter company was not subject to South African income tax on its worldwide income, but only on income from a source located in South Africa. Furthermore, the international headquarter company was not subject to South Africa's controlled foreign company rules, foreign source dividend provisions and thin capitalisation and transfer pricing rules (South Africa, 2000).

In order to qualify for the international headquarter company regime, the company had to be exclusively foreign-owned and more than 90% of the value of the assets of such company had to represent interests in the equity share capital and loan capital of subsidiaries (which were not South African tax residents) of the company, and in which the company held a beneficial interest of at least 50% (National Treasury, 2003:38).

The definition of international headquarter company was deleted from section 1 of the ITA with effect from 1 June 2004, and the deletion applied in respect of years of assessment commencing on or after that date (South Africa, 2003). According to National Treasury (2003:38), under international best practice, the regime could have been viewed as a harmful preferential tax regime and was ineffective, firstly, because in terms of South Africa's exchange control regulations, 'the South African Reserve Bank restricted the currency flow of 90 per cent foreign owned South African subsidiaries' and, secondly, an international headquarter company could not qualify for benefits in terms of South Africa's DTA's with other countries. Gutuza (2013a:237) contends that the repeal of the international headquarter company regime merely three years after its introduction, could indicate that its introduction was not fully analysed, specifically in regard to the interaction between the non-resident status of the international headquarter company and South Africa's DTA's.

2.2.3. **The HQC regime**

The HQC regime was formally established when the Taxation Laws Amendment Act (7 of 2010) inserted the definition of the term 'headquarter company' in section 1 of the ITA and enacted relief for an HQC through various exceptions in the ITA. The definition of 'headquarter company' set out the qualifying criteria for companies to become HQC's. In 2011, the definition of 'headquarter company' in section 1 of the ITA was replaced and the qualifying criteria for HQC's moved to section 9I of the ITA (South Africa, 2011).

The current qualifying criteria for an HQC, as set out in section 9I of the ITA, are summarised briefly. Firstly, in order to be classified as an HQC, the company must be resident in South Africa for tax purposes (section 9I(1)(a)). This means that the company must be incorporated, established or formed in South Africa, or it must have its place of effective management in South Africa, and it must not be deemed to exclusively be a resident of another country for purposes of the application of a DTA to which South Africa is a party (in terms of the definition of ‘resident’ in section 1 of the ITA).

Secondly, each holder of shares in the company must hold 10% or more of the equity shares and voting rights in the company seeking to qualify as an HQC (the 'prospective HQC') for the duration of the year in which the election to be an HQC is made (in regard to this election, see further below). In determining whether or not a prospective HQC complies in any year of assessment in which the prospective HQC started to carry on a trade, the period during that year, before the prospective HQC started to carry on a trade, must be disregarded (section 9I(2)(a)).

Thirdly, at least 80% of the cost of the total assets of the prospective HQC must be attributable to one or more of the following types of assets: (i) any interest in equity shares in, (ii) any debt owed by, or (iii) any intellectual property licensed by the prospective HQC to, any foreign company in which the prospective HQC held at least 10% of the equity shares and voting rights (hereinafter referred to as a 'Foreign Company'). This requirement must be met at the end of the year of assessment for which the prospective HQC wishes to make an election, as well as all previous years of assessment (save for years in which the prospective HQC did not at any time own assets with a total market value of more than R50 000) (section 9I(2)(b).

Fourthly, where the gross income of the prospective HQC for the year of assessment in question exceeds R5 million, 50% or more of that gross income must consist of amounts in the form of (either or both of the following) (i) any rental, dividend, interest, royalty or service fee paid or payable by any Foreign Company, or (ii) any proceeds from the disposal of any interest in equity shares in a Foreign Company or of any intellectual property licensed to a Foreign Company (section 9I(2)(c)). Lastly, the company must make an election to be an HQC (section 9I(3)). This election takes place annually and must be made for each year of assessment of the company.

The relief for which a company that meets the qualifying criteria and elects to be an HQC is currently eligible, is discussed briefly below.

South Africa's controlled foreign company rules (set out in section 9D of the ITA), as they apply to foreign companies in which an HQC invests, are relaxed. In determining whether or not the requisite percentage of 'participation rights' (as defined in section 9D) or voting rights has been met in order for South Africa's controlled foreign company rules to apply, the participation rights or voting rights that are directly or indirectly held or exercisable by an HQC itself, must be disregarded (South Africa, 1962; SARS, 2016:23).

Dividend income which an HQC receives, or which accrues to it, and is then transferred to its non-resident investors, is generally not taxed in South Africa as a result of the interaction between section 9I and the dividends tax and foreign dividend participation exemption sections in the ITA. Similarly, interest and royalty income which an HQC receives, or which accrues to it, and is then transferred to its non-resident investors, is generally not taxed in South Africa. This is largely due to the fact that the ITA provides for an exemption from the withholding taxes on interest and royalties paid by HQC's, as well as the fact that the inclusion of the interest and royalty income received (or accrued) can be offset by the allowable deductions for interest and royalties paid to the non-resident investors in the HQC.

South Africa's transfer pricing and thin capitalisation rules (in section 31 of the ITA) are relaxed for HQC's. The ITA provides relief from these rules as they apply to the provision of debt finance (including the provision of security or a guarantee) and the licensing of intellectual property by a non-resident to an HQC in certain circumstances, as well as by an HQC to a Foreign Company.

In regard to the disposal by an HQC of shares in a Foreign Company, the ITA provides for an exemption of the proceeds (relief from capital gains tax) provided that certain requirements are met. Furthermore, the HQC regime provides for a relaxation of the provisions in the ITA pertaining to the conversion of income and expenditure from amounts in a foreign currency to South African Rand (including the determination of capital gains and capital losses in respect of assets disposed of or acquired in foreign currency) and the provisions pertaining to the determination of gains and losses on foreign exchange transactions.

All South African tax residents (including an HQC) qualify for relief in respect of foreign taxes proved to be payable on foreign-sourced income that is included in the resident's taxable income. This relief comes in the form of a foreign tax credit/rebate, which allows for the foreign tax, subject to certain limitations, to be deducted from the South African income tax. The Income Tax Act also provides for a deduction of foreign taxes (which do not already qualify for the aforementioned foreign tax rebate, in circumstances where the foreign tax was levied on South African-sourced income) in the determination of a resident's taxable income.

As the HQC must be a South African tax resident, it will also be considered to be a resident for purposes of the DTA's to which South Africa is a party and be entitled to the relief provided for in such DTA's, provided that all requirements prescribed by the relevant DTA are met.

From an exchange control perspective, the exchange control regulations of the South African Reserve Bank ('SARB') provide for a significant relaxation of exchange control restrictions where capital is transferred by an HQC to its non-resident investors and the Foreign Companies in which it invests (SARB, 2010; SARB, 2018:56).

2.3. The objectives of the HQC regime as stated by the South African government

2.3.1. General

Since before the creation of the HQC regime, South Africa has sought to create an environment that will attract investment and facilitate trade and has regarded a hospitable fiscal environment as an important part of its efforts (the Margo Commission, cited by the Katz Commission, 1997). As stated in paragraph 2.2.1 above, the South African government was advised by the Katz Commission (1997) that the formation of international headquarters and holding companies in South Africa will benefit the South African economy through the importation and retention of skills and an ultimate contribution to economic activity.

To the extent that the HQC regime can be considered to be South Africa's second attempt at the international headquarter company regime (Gutuza, 2013a:238), the objectives of the international headquarter company regime are relevant in determining the objectives of the HQC regime.

The international headquarter company regime was designed so that foreign investors could use South African facilities as regional headquarters (National Treasury, 2003:38) and 'in order to effect a tax neutral flow-through of foreign income', whilst still subjecting income from a source within South Africa to South African income tax (SARS and National Treasury, 2000)**.** No guidance as to the policy reasons for or the objectives of the creation of the international headquarter company regime is provided in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 (National Treasury, 2000b) and in the South African Revenue Service ('SARS') and National Treasury's responses to comments received on the Bill (South African Revenue Service and National Treasury, 2000). Moreover, South Africa's National Budget speeches for 1999 (National Treasury, 1999) and 2000 (National Treasury, 2000a) are silent on the introduction of the international headquarter company regime. This lack of guidance necessitates a consideration of external sources as to what the most likely reasons for the creation of the international headquarter company regime could have been. In this regard, it is reasonable to assume that National Treasury was, at least to some extent, guided by the reports of both the Margo Commission and the Katz Commission in the creation of the international headquarter company regime. On this basis, the ultimate objectives of the international headquarter company regime can be said to have included attracting investment and facilitating trade, importing and retaining skills and increasing the level of activity in the South African economy.

Although the international headquarter company regime was not successful, the South African government presumably hoped that the tax relief offered by the regime would attract foreign multinationals to set up international headquarter companies in South Africa and that these companies would purchase local, South African professional services in carrying out their corporates mandates (Bloom & Grant, 2011:211). Furthermore, it was presumably hoped that international headquarter companies would employ skilled and well-compensated professionals who themselves (in their personal capacities) would require goods and services from the local South African communities in which they base themselves, thereby creating indirect economic benefits for such local communities (Bloom & Grant, 2011:218).

2.3.2. Statements regarding the HQC regime

As part of National Treasury's role of advising the South African Minister of Finance on tax policy issues, it is tasked with designing tax instruments that can optimally fulfil their revenue-raising function and which must be aligned to the goals of government’s economic and social policy (South African government, s.a.). The various statements made by National Treasury regarding the HQC regime prior to its enactment by the Taxation Laws Amendment Act 7 of 2010 therefore provide insight into the South African government's objectives for the HQC regime. Statements made by National Treasury in relation to subsequent amendments to the HQC regime provide similar insights.

In National Treasury's 2010 budget review, it was stated that the South African government proposed measures to enhance South Africa's role as the 'gateway into Africa' and that further investigations would be done to enhance South Africa's attractiveness 'as a viable and effective location from which businesses can extend their African operations' (National Treasury, 2010a:78). Furthermore, it was stated that South African exchange control and tax rules that serve as barriers to the channelling of 'funds received from foreign locations … through South Africa to other foreign locations … will be reviewed' (National Treasury, 2010a:78).

Thereafter, in the media statement that accompanied the 2010 Taxation Laws Amendment Bill, National Treasury added that South Africa is the 'economic powerhouse of Africa' and 'has a developed infrastructure and an advanced financial services industry' which, together with its tax treaty network, 'make South Africa an ideal location for foreign investors to base the management of their regional operations' (National Treasury, 2010b:3). It stated that the HQC regime eliminates tax hurdles in order to allow foreign investors to utilise South Africa as a 'launching point into the region' and that amendments to South Africa's tax law were aimed at allowing foreign investors to utilise South Africa 'as a central point for various regional equity fund investments' (National Treasury, 2010b:3).

In the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2010 (National Treasury, 2010c:77), the HQC regime was referred to as the 'Regional Headquarter Company Regime'. In this document, National Treasury (2010c:77) stated that 'South Africa’s location, sizable economy, political stability and overall strength in financial services make South Africa an ideal location for the establishment of regional holding companies by foreign multinationals' and that South Africa 'is a natural holding company gateway into the region'. It was proposed that a definition of 'qualifying holding company' be introduced (National Treasury, 2010c:79), however, the term 'qualifying holding company' is not used in the sections in the ITA which delineate the HQC regime. Instead, a definition of the term 'headquarter company' was introduced and such term is used throughout the sections in the ITA which delineate the HQC regime.

In National Treasury's combined presentation with SARS before the South African National Assembly's Standing Committee on Finance on 29 August 2010, its Chief Director for Legislative Tax Design, Professor Keith Engel, explained that the proposed relief for a 'regional headquarter company' was to treat the company as a 'flow through' by relaxing South Africa's controlled foreign company rules, the tax charge on outgoing dividends and thin capitalisation rules relating to back-to-back loans (Standing Committee on Finance, 2010). Similar statements were made by representatives of National Treasury before the finance committee of the National Council of Provinces ('NCOP'), which is one of the two houses of the South African Parliament and takes part in the national legislative process (Parliament of the Republic of South Africa, s.a.). National Treasury advised the NCOP that it wanted to simplify investment into Africa and promote South Africa as a 'regional centre for head-quarter companies' and, therefore, unintended South African tax should be avoided, by taxing only the South African profit and not the money flowing through South Africa (NCOP Finance Committee, 2011).

Subsequently, National Treasury reported to the National Assembly's Standing Committee on Finance that mechanisms had been established to enable the setting up of HQC's in South Africa 'that would manage investment into the continent' (Standing Committee on Finance, 2011). According to the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012, the HQC regime 'is intended to facilitate South Africa’s role as a regional financial centre' (National Treasury, 2012:118). The same document equates a 'regional financial centre' to a 'holding company jurisdiction' and adds that the HQC regime provides tax benefits that are important to 'regional holding companies' (National Treasury, 2012:123).

2.3.3. Synthesis

National Treasury's statements appear to lack consistency. By way of summary, National Treasury has described South Africa as having the potential to become, with the help of the HQC regime:

- a location, gateway, launching point and central point from which to expand into the rest of Africa;
- a location for foreign investors to base the management of their regional operations;
- a location for the establishment of regional holding companies, as well as a natural holding company gateway;
- a regional centre for headquarter companies, and stated that mechanisms had been established to enable the setting up of HQC's in South Africa that would manage investment into the continent; and
- a regional financial centre and a holding company jurisdiction, and added that the HQC regime provides tax benefits that are important to regional holding companies.

It is difficult to ascertain from National Treasury's statements what exactly the intended role of an HQC and the HQC regime was. The above summary of National Treasury's statements indicates that there have been references to the HQC having both a holding company function and a managerial company function. Although it is acknowledged that managerial (headquarter) and holding company functions are not necessarily mutually exclusive, a distinction can be made between the two types of functions. Oguttu (2011:66) states that 'although headquarter companies are intermediary holding companies, not all intermediary holding companies are headquarter companies'. The reason for this is that headquarter companies, are created with a specific mandate to perform administrative and management functions, which are not necessarily performed by all intermediate holding companies (Legwaila, 2012:23; Olivier & Honiball, 2011:692). It is therefore interesting that a definition for the term 'qualifying holding company' was proposed, but never introduced and that the HQC definition was instead introduced (National Treasury, 2010b:79).

Despite National Treasury's various statements regarding the HQC regime, there is little indication of the specific benefits that the South African government seeks to derive from the HQC regime. This lack of clarity necessitates a consideration of the objectives of other developing countries in creating similar regimes in order to gain an understanding of the policy reasons for and intended benefits of such regimes.

2.4. The objectives of selected developing countries with the creation of similar regimes

The purpose of this section is not to perform an in-depth analysis of holding and headquarter company regimes in other countries. The purpose of this section is to establish what the objectives of selected developing countries were with the creation of holding or headquarter company regimes in their jurisdictions, in order to gain a deeper understanding of the objectives of the South African government with the creation of the HQC regime.

The regimes that will be considered are the International Financial Services Centre ('IFSC') regime in Botswana, the Global Business Licence regime in Mauritius, the International Headquarters regime in Thailand and the Approved Headquarters, Pioneer Certificate and Development & Expansion Incentive regimes in Singapore.

Botswana was selected due to its geographical proximity to South Africa and the fact that it, at least in theory, competes with South Africa for the hosting of companies seeking to increase their business presence in Africa. Mauritius was chosen on the basis that it is considered to be a successful gateway for investment around the world and especially in Africa, and because it, like South Africa and Botswana, is a member of the Southern African Development Community ('SADC') (Legwaila, 2011:2). Thailand was chosen purely based on the similarity between the title of its regime and that of the predecessor to South Africa's HQC regime, namely the international headquarter company regime. Singapore was selected due to its historical success as a jurisdiction in attracting and hosting regional headquarters for multinational enterprises, especially to cover the regions of Southeast Asia, South Asia and Oceania (Hayakawa & Shiino, 2018).

A general consideration of the objectives of governments with the creation of holding and headquarter company regimes precedes the consideration of the aforementioned specific regimes.

2.4.1. General

The majority of countries put in significant effort to attract foreign direct investment during their developmental stages (Legwaila, 2016:159). In this regard, tax incentives are often used to encourage local industries and to attract foreign direct investment (Easson & Zolt, 2002:2). Some of the benefits of foreign direct investment include increased employment and spill-over benefits such as demand for local goods, services and commercial premises, as well as the injection of international best practice (Bloom & Grant, 2011:218; Allen Consulting Group as cited by Avenell, 1996:7). Easson and Zolt (2002:10) acknowledge that the benefits that accrue to persons other than the investor, although substantial, may be difficult to quantify.

Years later, Zolt (2015:13) again mentions substantially similar benefits that could be derived from tax incentives aimed at attracting foreign direct investment, such as increased capital transfers, transfers of know-how and technology and increased employment (which, in turn, leads to increased spending power of residents and an increased demand for goods and services in general). Zolt (2015:13) further states that increased investment may increase government tax revenue from the investor itself, employees and the suppliers to such employees.

Legwaila (2016:159) contends that, in attracting foreign direct investment, the role of a country's tax regime is secondary to that of primary determinants such as market size, the availability of raw materials and the availability of skilled labour. However, when a country lacks the aforementioned primary determinants, it can lead to the tax regime being relied upon to attract investment (Legwaila, 2016: 159; Zolt, 2015:4). According to Zolt (2015:12), this is not surprising as it is generally easier for a government to provide tax incentives than to address more fundamental shortcomings in the economy of its country. A preferential tax regime, such as a holding company or headquarter company regime, is a manner in which tax incentives can be offered to investors in order to attract foreign direct investment (Inland Revenue Authority of Singapore, 2015; Lorenz & Partners, 2017:4).

Practically, the final destination of the money invested in a holding company is often the countries in which the holding company's underlying investments are located and not necessarily the country in which the holding company itself is located (unless it happens to be located in the same country as the underlying investments) (Legwaila, 2010:314; Mukumba 2017:6). Therefore, whilst there may be investment into the holding company itself, such investment may flow through the holding company (and out of the jurisdiction in which it is located) in circumstances where the holding company acts as conduit for the flow of finance or intellectual property to operating subsidiaries and the repatriation of profits back to the investor (Mukumba 2017:6).

Where a country struggles to attract foreign direct investment in operating subsidiaries (which is dictated by real commercial factors and is therefore less mobile (Katz Commission, 1997)) as a result of lacking characteristics such as good public infrastructure, a well-educated labour force, easy access to markets, etc. it may still be able to attract investment in activities that are not location specific (Genschel, 2002:254). Genschel (2002:255) argues that 'location-unspecific' activities (which include headquarter company functions such as administration, intragroup finance and the management of intangible assets) can be sensitive to tax considerations and governments often seek to attract investments in such activities through preferential tax regimes due to the fact that they have the potential to uplift the financial services industry, create quality employment opportunities for professionals and increase tax revenue.

According to Spitz (cited by Olivier & Honiball, 2011:692), headquarter company regimes are typically created in order to establish administrative centres, as the activities of such centres are often labour intensive and lead to increased employment. Bloom and Grant (2011:211) add that it is also typical for headquarter offices of companies to employ highly skilled, experienced and well-compensated professionals who acquire goods and services from the communities in which they live. In pursuing their corporate mandates, such offices may purchase professional services from the local market, such as auditing, management consulting and financial services, which gives rise to indirect economic benefits to the jurisdictions in which they are located (Bloom & Grant, 2011:211). Further strategic benefits of regional headquarter companies (for the jurisdiction which hosts them) are said to include an increased flow of business intelligence, improved business links with the region, the development of specialist services, as well as leverage over future foreign direct investment (Avenell, 1996:9).

As stated above in paragraph 2.3.3, a headquarter company can be described as a specific type of holding company (Oguttu, 2011:66). Therefore, holding companies that are not headquarter companies should arguably have the potential to bring about some of the positive effects of headquarter companies as set out above. However, pure holding companies, which are not created with a view to render auxiliary services in relation to the group's operational activities, would typically not have a significant physical presence in the countries which host them when they are mandated to focus on the holding of investments and to act as a conduit for finance and/or intellectual property (and the resultant dividends, interest and royalties), as they do not require a large staff complement to perform their functions (Olivier & Honiball, 2011:692; Mukumba, 2017:11). Therefore, whilst regimes that are created in order to attract such pure holding companies may give rise to similar economic benefits as headquarter company regimes, it arguably does so on a smaller scale.

2.4.2. The Botswana IFSC regime

According to the Botswana government (2013), the country effectively became a regional gateway for global financial and capital flows for the sub-Saharan region when it positioned itself as an international financial services centre in 2003. The intention of the Botswana government with the creation of the IFSC regime is for Botswana to become the ideal launch pad for investment into SADC (Botswana, 2013).

The Botswana IFSC forms part of a strategy that the government of Botswana put in place to reduce the country's reliance on mineral revenues and to seek an alternative driver of growth and employment creation (Lowtax, 2009; National Commissions for UNESCO, s.a.). The diversification of the Botswana economy away from mining (particularly diamond mining) was intended to reduce the country's vulnerability to external economic shocks and was one of the main focus areas of the country's eighth and ninth National Development Plans (Bank of Botswana, 2002:86; Botswana Ministry of Finance and Development Planning, 2003). The diversification was aimed at providing an environment which would allow private sector initiatives to take effect and, in this context, the IFSC is aimed at boosting the economy and creating jobs (Botswana Ministry of Finance and Development Planning, 2003). According to the Bank of Botswana (2000:6), the IFSC reflects Botswana's commitment to regional integration, both economically and financially, and was established based on a presumed comparative advantage as a result of the country's financial and business stability (Bank of Botswana, 2000:99).

Tax incentives for which IFSC companies are eligible include a flat corporate income tax rate of 15%, an exemption from withholding taxes on dividends, interest, royalties and management fees, as well as a unilateral credit for withholding taxes suffered in other jurisdictions, irrespective of the existence of a DTA between Botswana and the other country (Botswana Investment and Trade Centre, s.a.). Furthermore, Botswana's abolishment of all exchange controls enables the free repatriation of dividends and capital (Botswana Government, 2013; Botswana Investment and Trade Centre, s.a.).

In order for a company to register as an IFSC company, the company must be registered in Botswana and must apply to the International Financial Services Centre Certification Committee for a recommendation to the Botswana Minister of Finance and Development Planning who will then issue a certificate stipulating approved activities (Botswana Investment and Trade Centre, s.a.). In terms of section 138 of the Botswana Income Tax Act (Chapter 52:01, 1995), in evaluating an application for an IFSC certificate, the International Financial Services Centre Certification Committee must consider the number of Botswana citizens who will be employed and the capacities in which they will be employed, facilities proposed for the training and imparting of skills to Botswana citizens, whether provision is made for the eventual replacement of non-resident employees by Botswana citizens, and whether provision is made for the participation by Botswana citizens in the management of the business (Botswana, 1995).

The above factors indicate and lead to a conclusion that the establishment of the Botswana IFSC aims, *inter alia*, to create sustainable employment opportunities for suitably qualified citizens, enhance the skills base in the country and foster innovation and sophistication in financial and business services (Lowtax, 2009). Botswana's National Development Plan for 1997 to 2003 confirms that the enhancement of the skills base of the workforce was one of the policy reasons for the creation of the IFSC (Botswana Ministry of Finance and Development Planning, 1997:137).

2.4.3. **The Mauritian Global Business Licence regime**

The Mauritian Offshore Business Activities Authority ('MOBAA') was formed in 1992 and created a fiscal environment conducive to the establishment of foreign companies in Mauritius which had permission to access Mauritius' DTA network (Styger *et al*., 1999:232). MOBAA was later phased out and today, under the

Mauritian Financial Services Act (2007), foreign investors can set up companies which can apply for a Category 1 Global Business Licence ('GBC1').

In Mauritius, any 'corporation' (whether company, trust, société, limited partnership, limited liability partnership or foundation), can apply for a GBC1. A GBC1 entity must be managed and controlled from Mauritius and is resident in Mauritius for tax purposes, and, on this basis, it can qualify for relief in terms of Mauritius' DTA's (BLC Robert & Associates, 2018). A private company can also be licensed as a Category 2 Global Business Licence ('GBC2') company. A GBC2 entity is not considered resident for Mauritius tax purposes, is not liable to tax in Mauritius and cannot qualify for relief in terms of Mauritius' DTA's (BLC Robert & Associates, 2018). It is therefore not comparable to an HQC and is not considered further.

When the 'offshore company' regime (the forerunner of the global business regime) was introduced by the Mauritius Offshore Business Activities Act, 1992, applicant companies could only conduct certain approved activities, such as offshore insurance, offshore funds management, international financial services, operational headquarters, international consultancy services, aircraft financing and leasing, international licensing and franchising, international assets management, etc (Mauritius, 1992). This has since changed, and a company applying for a GBC1 may now conduct any business which has, as its ultimate purpose, an investment or a service to be made or rendered outside of Mauritius (Mauritius Financial Services Commission, 2007).

The Mauritian tax system in general, and especially the GBC1 regime, currently provides tax relief in various forms. For example, a GBC1 company (that is, a company holding a GBC1) can, *inter alia*, enjoy a favourable corporate income tax rate of 15% (which can be reduced to an effective rate of 3% through the use of various forms of foreign tax credits) (Legwaila, 2011:8), zero withholding taxes on dividends, interest and royalties, as well as the fact that Mauritius does not levy tax on capital gains and does not have controlled foreign company, thin capitalisation or transfer pricing rules (although the Mauritian Revenue Authority adheres to the arm's length principle, Mauritian law does not specify the methods to be used in making adjustments to reflect arm’s length conditions) (Werksmans, 2014; ENS, 2017). Furthermore, the lack of exchange control rules facilitates the free repatriation of profits, dividends and capital to foreign investors (BLC Robert & Associates, 2018).

The Mauritian tax system is constantly being adjusted (Legwaila, 2011:2) and this was again the case as recently as 13 July 2018 when then Mauritian Finance Bill, 2018 was released for consultation. The Finance Bill, 2018 covers measures announced in the Mauritian 2018-2019 budget and contains tax measures that affect the Mauritian global business sector (PwC, 2018a), but the provisions of the bill will only take effect once approved by the Mauritian Parliament and by the country's president (Osiris International Group, 2018). The changes to the GBC1 regime proposed by the Mauritian Finance Bill, 2018, include that the GBC1 will be renamed as 'Global Business Licence' ('GBL') and that the deemed foreign tax credit which a GBC1 company may currently enjoy will be abolished and replaced by a 'partial exemption regime' which will exempt 80% of certain income streams (including foreign dividends and foreign sourced interest income, subject to certain requirements being met) (PwC, 2018a). It appears that the effect of the aforementioned 'partial exemption regime' should be that certain income streams of a company holding a GBL will still be subject to an effective corporate income tax rate of 3%.

A brief discussion of Mauritius' economic history is important to determine the country's objectives and policy reasons in creating the GBC1 regime. Mauritius' size as a relatively small island and the fact that it is not endowed with natural resources has historically limited its development alternatives. This, together with the small size of the domestic market and the lack of a local technological base, gave rise to a need to increase economic openness and rely on international trade (Ramphul, 1989:5). After achieving independence in 1968, Mauritius was a mono-crop economy depending on the export of sugar. The country had very limited infrastructure, as well as limited access to higher education. In order to provide employment opportunities and a decent standard of living to the growing population, the country focused on industrialisation with an emphasis on labour-intensive industries (Ramphul, 1989:10). Manufacturing was first encouraged through an import substitution strategy that was aimed at building local expertise, but the country later turned to export-oriented industrialisation because of the limited local market (Treebhoohun, s.a.).

A labour shortage arose after the Mauritian economy experienced high growth rates as a result of a growing market for tourism, a rapid expansion in export-processing zones and stable growth in the sugar sector (Ramphul, 1989:18; Treebhoohun, s.a.). As a result, in the late 1980's there was consensus in the country that Mauritius' development strategy should shift away from labour-intensive to labour-saving technology and that the next phase in the country's development strategy should be the development of its financial services sector (Styger et al., 1999:230).

In a lecture at the Central Bank of Seychelles in December 1989, the governor of the Bank of Mauritius stated that an offshore banking project will constitute the first step in the development of Mauritius as an international financial centre, which would assist in modernising 'the economic structure of the country with a view to giving it a more marked international character'. He further correctly predicted that the country would soon host an offshore business centre wherein foreign companies would use Mauritius as a base for carrying out their international business activities (Ramphul, 1989:21). It is therefore clear that what is now known as the GBC1 regime (and may soon be renamed as the GBL regime) has its roots in Mauritius' strategy to steer away from labour-intensive industries and instead to develop the country as an international financial centre.

According to Styger et al. (1999:249), the Mauritian international financial services industry was created with the objectives of economic diversification, the transfer of know-how to Mauritians, expanding the services industry beyond tourism, creating high-value employment opportunities and, eventually, integration into the global economy. The aforementioned view is, at least in part, confirmed by the Mauritian Ministry of Economic Development, Financial Services and Corporate Affairs (2001), which states that Mauritius' economic diversification programme was aimed at developing financial services as the fourth pillar of the economy which will contribute to the creation of high value-added jobs. The original list of approved offshore business activities originally set out in the Mauritius Offshore Business Activities Act (Mauritius, 1992), evidences the objective to develop a financial services centre. Later statements made by the Mauritian Board of Investment (2007:6) reinforce these views and confirm that the reason that Mauritius is marketed as a platform for global business is to create employment and wealth with the aim of increasing the standard of living for the Mauritian population.

2.4.4. **The Thailand International Headquarters regime**

Thailand competes with its neighbouring countries for foreign investors who seek to establish trading hubs in Southeast Asia and announced the Thai International Headquarters regime by Royal Decree number 586, which came into effect on 1 May 2015 (Lorenz & Partners Co., Ltd, 2017:4; Thailand, 2015).

According to the Thai Department of International Economic Affairs (2016) Thailand has developed a twenty-year national strategic plan to drive its economy towards what is referred to as 'Thailand 4.0', with the policy objective of increasing national competiveness and the growth potential of the country's economy over the long term.

In order to achieve Thailand 4.0, the Thai government introduced the International Headquarters regime as part of a multi-faceted economic package (Thailand Department of International Economic Affairs, 2016). The International Headquarters regime is considered to be an improvement on the first and second Regional Operating Headquarters policies, introduced in 2002 and 2010, respectively (Thailand Board of Investment, 2015).

Section 3 of Royal Decree number 586 defines an 'international headquarters' as a company registered in Thailand which provides management, technical, financial or support services to its associated enterprises or branches in Thailand or abroad (Thailand, 2015). International headquarters services that qualify for tax privileges are managerial, financial, technical and support services, which include, *inter alia*, organisational administration, management and business planning, technical support services, sales promotion, business advisory services (e.g. financial management, marketing, accounting services, etc.) and treasury centre services (Thailand, 2015).

Under the Thailand International Headquarters regime, a company which has been approved as an international headquarters can enjoy, *inter alia*, exemptions from Thai corporate income tax on certain profits (including from services rendered to, and dividends and royalties received from, associated enterprises), reduced corporate income tax rates on certain profits, as well as exemptions from withholding tax on payments of dividends and interest to companies not established and not doing business in Thailand, provided certain requirements are met (Thailand, 2015). By granting tax incentives to international headquarters companies, Thailand effectively grants an exemption from its 'residential tax system' in terms of which companies that are registered in Thailand are subject to corporate income tax in Thailand on their worldwide profits (Lorenz & Partners Co., Ltd, 2017:4).

The regime also provides for a reduced personal income tax rate for expatriates who work for qualifying international headquarters companies, receive a specified minimum salary and reside in Thailand for at least 180 days per tax year (Thailand, 2015; Thailand Board of Investment, 2015). The aforementioned personal income tax relief for expatriates is an indication that the Thai government is committed to attracting skilled foreigners to live and work in Thailand. Royal Decree number 586 specifically and expressly acknowledges that the granting of tax privileges to international headquarters and the employees working in such headquarters is considered to be expedient in encouraging the establishment of more international headquarters in Thailand, in support of the Thai government's policy to support Thailand in becoming an investment hub (Thailand, 2015).

The Thai National Economic and Social Development Board (2017:30) acknowledges that trade patterns are likely to shift towards greater liberalisation and economic integration and that competition for trade and investment opportunities will therefore be intense. It is in this context that the International Headquarters regime was considered to be an area in which Thailand has the capacity to compete. By taking advantage of the country’s strategic location, the International Headquarters regime is intended to increase the production base of Thailand's service sector so that it can become a reliable source of future income (Thailand National Economic and Social Development Board, 2017).

2.4.5. The Singapore Approved Headquarters, Pioneer Certificate and Development & Expansion Incentive regimes

The International Monetary Fund (2018:200) views Singapore as an 'advanced economy' (as opposed to an 'emerging market and developing economy'). However, the country is still considered to be a 'developing country' (as opposed to a 'developed economy' or an 'economy in transition') by the United Nations (2017:142). The purpose of this study is not to determine whether Singapore has an economy that is advanced or one that is 'developing'. For purposes of this study, the United Nations' classification of Singapore as a developing country is taken as appropriate.

In 1999, as Singapore aimed to become a knowledge-based economy, Singapore's Economic Development Board launched an economic development strategy for the 21st century, called 'Industry 21' (Singapore government, 2017). The vision of Industry 21 is for Singapore to be a global hub of knowledge-driven industries, a leading centre of competence in knowledge-driven activities and a choice location for company headquarters (Singapore Economic Development Board as cited by Tan, 1999:8). 'Headquarters' was one of ten areas that received special attention from the Singapore Economic Development Board (Tan, 1999:10). By 1999, Singapore had already attracted many multinational companies to locate their international or regional headquarters in Singapore. The country sought to leverage on that reputation to attract more multinationals to locate their headquarters in Singapore, not only to manage their global and regional activities more effectively, but also to be the driving force behind new developments and launch high value-added ventures from their base in Singapore. The intention was for such activities to trigger a demand for more supporting business services, such as legal services, consultancy, market research and public relations (Tan, 1999:12).

Singapore's objective with the introduction of the Approved Headquarters regime was to encourage companies to use Singapore as a base from which to conduct headquarter management activities. In terms of this regime, companies could enjoy preferential tax rates on income derived from the provision of qualifying headquarter services to qualifying network companies or qualifying treasury, investment or financial activities (Inland Revenue Authority of Singapore, 2015). With effect from 1 October 2015, the Approved Headquarters regime was withdrawn (Inland Revenue Authority of Singapore, 2015). However, companies that carry out the global or regional headquarters activities of managing, coordinating and controlling business activities for a group of companies may now apply for the 'pioneer certificate' ('PC') or 'development & expansion incentive' ('DEI') for such headquarter activities if they commit to anchor substantive headquarter activities in Singapore (Singapore Economic Development Board, 2016:1).

In order to qualify for the PC or DEI regime for headquarter activities, quantitative and qualitative criteria are assessed by the Economic Development Board, including the employment created (including a consideration of the skills and level of expertise involved in the positions created, as well as the level of seniority of such positions), total business expenditure which generates spin-off to the economy and the level of commitment to growing capabilities in Singapore (taking into account the use of technology, the growing of skillsets and the transfer of knowledge) (Singapore Economic Development Board, 2016:1). The criteria assessed by the Economic Development Board are indicative of the objectives of the Singaporean government with the creation of the PC and DEI regimes, which can be said to be aimed at, *inter alia*, generating jobs and increasing employment, increasing local economic activity and increasing the transfer of knowledge and skills.

2.4.6. **Synthesis**

The objectives of Botswana, Mauritius, Thailand and Singapore with the creation of their respective regimes accord with the general reasons why preferential tax regimes in the form of headquarter company regimes are created as recorded by Avenell (1996), Genschel (2002), Olivier & Honiball (2011) and Zolt (2015). On a more specific level, in each of the countries considered, it was found that the relevant countries had (or have) economic diversification as a policy objective when they created their respective regimes. In those countries, economic diversification formed part of a long-term plan to protect the economy, by reducing the reliance on specific industries (which was especially true for Botswana and Mauritius), ensuring sustainable economic growth and growing the skills base in the country to enable it to compete in the region in which it is located (which was especially true for Thailand and Singapore). The qualifying criteria for the regimes considered reflect these objectives and expected benefits (some more so than others).

2.5. Analysis of the HQC regime

South Africa has stated that it wants to be the 'gateway into Africa', but the policy reasons for (and intended benefits of) the HQC regime are not clear from the HQC regime's qualifying criteria, unlike the regimes of the other developing countries that have been considered above. In light of the fact that the express statements by National Treasury provide little guidance in respect of the benefits that the South

African government seeks to derive from the HQC regime, and as it would be reasonable to conclude that the South African government would not have created the HQC regime with the sole intention of providing tax benefits to foreign investors, a deductive analysis is required to determine the policy reasons for the creation of the HQC regime. The South African government would only have created the HQC regime if it believed that it would benefit the country, in that the economic benefits of attracting investors through the regime would outweigh the possible loss of tax revenue for the country (Gutuza, 2013b:81). Moreover, the benefits that the South African government believed the HQC regime would bring about for the country would have formed the foundation of the policy reasons for its creation.

The HQC regime forms part of the hospitable fiscal environment that South Africa seeks to create in order to attract investment and facilitate trade, import and retain skills, and eventually contribute to economic activity in the country, as contemplated by the Margo and Katz Commissions. It is noteworthy that, despite the Katz Commission's recommendation that exemptions be introduced for South African headquarter companies, in terms of which fees earned by such headquarter companies would be exempt, the HQC regime does not exempt fees earned from typical headquarter and management services rendered by the HQC from South Africa to the Foreign Companies in which the HQC invests (and therefore lacks one of the key fiscal attributes of a regime conducive to the formation of international headquarter companies). This is unlike the regimes of Botswana, Thailand and Singapore, which offer preferential tax rates or exemptions for income from typical headquarter services. This also differs from Mauritius' regime, which offers different forms of foreign tax credits in order to reduce the effective corporate income tax rate of a GBC1 company (and may, going forward, offer a 'partial exemption regime' to companies holding a GBL).

The design of the HQC regime provides some insight into the objectives of the South African government in creating the HQC regime. The limitation of the investment into South African assets to 20% of the cost of the total assets of the HQC indicates that the HQC was intended to act as a flow-through for foreign investment, in that incoming foreign investments are not intended to remain in South Africa and are instead intended to pass through the HQC to its underlying investments. As a result of the aforementioned limitation, the HQC will not be able to make proportionately large investments into local, South African operations. It is acknowledged that the ultimate size and cost of the HQC's South African investments will be determined by the cost of the HQC's total assets. It may therefore be that whilst the South African government intended for the HQC's foreign investments to be four times the cost of its South African investments, it hoped that the sheer size of the foreign investments being made by the HQC would lead to respectable investments being made in South Africa.

Notwithstanding the aforementioned hope, the South African government must have been aware of the fact that the lack of an exemption from tax on headquarter and management services rendered by the HQC from South Africa to Foreign Companies in which the HQC invests, would discourage many multinational companies from using South Africa as a location for true headquarter company functions (such as, *inter alia*, marketing, financial, technical and administrative support services) and that the HQC regime would therefore not encourage large-scale job creation. It must be borne in mind that the HQC regime is not South Africa's only investment incentive and cannot be considered in a vacuum. South Africa also has other initiatives to attract investment which can be said to be aimed at creating significantly more employment opportunities than the HQC regime, such as, for example, the Automotive Investment Scheme (Department of Trade and Industry, s.a.). It can therefore be deduced that, whilst it may have been hoped that the HQC regime would create jobs for a number of professionals, large-scale job creation was not a policy reason for the creation of the HQC regime.

The HQC regime is a headquarter company regime only insofar as it allows the HQC to manage the holding of shares in underlying foreign companies, and act as a central point for debt finance and the licensing of intellectual property, whilst remaining tax neutral. Although an HQC would also have to manage the dividends, interest and royalties which flow through it to its investors, it remains more of an intermediate holding company than a true headquarter company. The assertion by certain authors that the term 'headquarter company' is a misnomer (Oguttu, 2011:90; Gutuza, 2014:191), is therefore appropriate.

Logic dictates that the benefits that the South African government believed the HQC regime would bring about for the country formed the foundation of the policy reasons for its creation. The intended benefits of and policy reasons for the creation of similar regimes in developing countries lead to a conclusion that the HQC regime was intended to attract investment (albeit that a limited amount of the investment was intended to remain in South Africa itself), attract and retain skilled employees and facilitate the transfer of skills to the South African workforce (*inter alia*, through the injection of international best practice and an increased flow of business intelligence), boost the local economy by increasing the demand for local goods and services and, ultimately, to increase tax revenue (more so from the increased activity in the local economy than from HQC's themselves).

A further possible policy reason for the creation of the HQC regime is offered by Gutuza (2013b:87), who argues that the regime should be seen as a regional development structure for Africa. South Africa acceded to the SADC Treaty (1992) in 1994 and is a founding member of the New Partnership for Africa's Development ('NEPAD') (NEPAD, 2016). SADC's objectives include the achievement of development and economic growth through regional integration (SADC, 1992:5). The mobilisation of the inflow of public and private resources into the Southern African region is one of the methods to be used to achieve SADC's objectives (SADC, 1992:6). The objectives and expected outcomes of NEPAD include sustainable economic growth and development, as well as increased employment (NEPAD, 2001:14). According to Gutuza (2013b:87), the objectives of SADC and NEPAD should be borne in mind when evaluating the purpose for which the HQC regime was created and it is unlikely that South Africa would have adopted the HQC regime if it clashed with its regional commitments. Whilst the HQC regime may not be intended to clash with South Africa's commitments under the SADC Treaty and NEPAD, it does not necessarily follow that the South African government's commitments under these plans were the policy reasons for the creation of the HQC regime.

2.6. Conclusion

This chapter considered the development of the HQC regime. It was found that the HQC regime arguably arose from early statements made by the Margo and Katz Commissions that South Africa should encourage inputs of expertise and capital by multinational companies and that encouraging the formation of international corporate headquarters and holding companies located in South Africa will be advantageous to the economy. The HQC regime was preceded by the unsuccessful international headquarter company regime and has been amended on various occasions to improve its functioning. The provisions that comprise the HQC regime are not contained in a single section in the ITA. Instead, the functioning of the HQC regime is a result of a combination of sections distributed throughout the ITA.

The objectives of the HQC regime as stated by the South African government were considered. It was found that, as far as the design and objectives of the HQC regime are concerned, National Treasury spoke on behalf of the South African government. National Treasury referred to the HQC having both a holding company function and a managerial (headquarter) company function. Although it is acknowledged that such functions are not necessarily mutually exclusive, it remains difficult to ascertain from National Treasury's statements what exactly the intended role of an HQC and the HQC regime was. National Treasury's statements provide little indication of the specific benefits that the South African government seeks to derive from the HQC regime.

The objectives of selected developing countries with the creation of holding or headquarter company regimes in their jurisdictions were also considered. The research found that these regimes were created as part of larger economic diversification plans and were generally aimed at creating employment opportunities, attracting and retaining skilled employees and facilitating the transfer of skills to the local workforce (often in the financial services industry), to enable the country to compete in the region in which it is located and generally to boost the local economy by increasing the demand for local goods and services. An analysis of the HQC regime, in light of all of the aforementioned findings, determined that the policy reasons for the creation of the HQC regime were similar to that of the other regimes considered in all material respects, save for not forming part of a clear economic diversification plan.

The HQC regime has been subject to significant criticism regarding, *inter alia*, its ability to achieve the objectives for which it was created. Chapter 3 will consider existing points of criticism against the HQC regime.

3. EXISTING CRITICISM OF THE HQC REGIME

3.1. Introduction

As stated above in paragraphs 1.5.2.2 and 1.7.3, in re-evaluating the HQC regime, the selected recent international developments (which are analysed in chapter 4) should not be analysed in a vacuum. As part of the literature review performed prior to conducting the research and in order to motivate the actuality of the research question, certain existing criticisms of the HQC regime were identified. In carrying out the research, further criticism was identified. In light of this, the objective of this chapter is to analyse the most significant points of criticism against the HQC regime to date in order to determine whether the regime has inherent inadequacies.

This chapter therefore considers criticism regarding the impact of the definition of 'resident' in section 1 of the ITA on the HQC regime (see paragraph 3.2), whether the lack of preferential treatment of services and service income in the hands of an HQC hampers the HQC regime's ability to achieve certain of its policy objectives (see paragraph 3.3) and whether the annual requirements for qualification as an HQC are open to manipulation and create a significant compliance burden on an HQC (see paragraph 3.4).

The criticism that private equity funds cannot utilise an HQC as an investment vehicle is also considered (see paragraph 3.5), as well as the criticism that the limitation imposed by the HQC regime on the deduction of interest and royalty expenses negates the relaxation of the transfer pricing and thin capitalisation rules (see paragraph 3.6). In addition, this chapter considers the claim that the HQC regime is not successful as a regional development tool (see paragraph 3.7) and the criticism that the HQC regime could lead to a loss of revenue for the South African fiscus (see paragraph 3.8).

3.2. The definition of 'resident' in section 1 of the ITA could have a negative impact on the HQC regime

Under a residence-based system of taxation, the general principle is that income which accrues to a resident of a country should be subject to the taxes of that country (Katz Commission, 1997). Conversely, under a pure source-based system of taxation, the general principle is that income should be taxed in the country where that income originates, irrespective of the physical or legal residence of the recipient of the income (Katz Commission, 1997). With effect from 1 January 2001, South Africa's tax system changed from a largely source-based system of taxation, to a largely residence-based system of taxation (South Africa, 2000). The aforementioned change necessitated the insertion of a definition for the term 'resident' in section 1 of the ITA.

The HQC qualifying criteria in section 9I of the ITA are heavily influenced by the definition of the term 'resident'. As stated above in paragraph 2.2.3, in order for a company to be considered to be a resident of South Africa for tax purposes (tax resident in South Africa), that company must be incorporated, established or formed in South Africa, or it must have its place of effective management ('POEM') in South Africa, and it must not be deemed to exclusively be a resident of another country for purposes of the application of a DTA to which South Africa is a party. Should a company be considered to be tax resident in South Africa as well as another country (with which South Africa has concluded a DTA) in terms of the domestic tax laws of both countries, the tax residence of that company must be finally determined through the application of what is generally referred to as the 'tie-breaker' rule in the applicable DTA (Olivier & Honiball, 2011:25; SARS, 2011:2). According to SARS (2011:2; 2015b:5), the POEM test is used as the tie-breaker rule in many of the DTA's to which South Africa is a party, particularly those DTA's which are based on the OECD's Model Tax Convention on Income and on Capital (‘MTC’).

The definition of 'resident' impacts the HQC qualifying criteria as follows: Firstly, it requires that the company seeking to become an HQC (a prospective HQC) must be tax resident in South Africa and, secondly, at least 80% of the cost of the total assets of that prospective HQC must be attributable to one or more of the following types of assets, (i) any interest in equity shares in, (ii) any debt owed by, or (iii) any intellectual property licensed by the prospective HQC to, any Foreign Company (as defined above in paragraph 2.2.3). The term 'foreign company' is defined in the ITA as any company which is not a resident. This means that the companies in which the prospective HQC invests must be incorporated, established or formed outside of South Africa and the POEM of such companies must not be in South Africa, or, alternatively, where such companies are incorporated, established or formed in South Africa, they must be deemed exclusively to be tax resident in another country in terms of a DTA to which South Africa is a party (for example, on the basis that their POEM is outside of South Africa).

According to Zwarts (2013:108), the interplay between the definition of 'resident' and the provisions in the ITA which delineate the HQC regime, as well as the circumstances in Africa, have an adverse effect on a company's ability to qualify as an HQC, and therefore the attractiveness of South Africa as an HQC destination.

Her criticism is premised on POEM (as one of the tests for tax residence) resulting in the HQC's subsidiaries becoming South African tax residents, which would cause the HQC (or prospective HQC) to fall short of the qualifying criteria for HQC status.

Zwarts (2013:98) argues that a company would not be able to qualify as an HQC if it has a single, centralised management team in South Africa which performs 'effective management services' for African subsidiaries in which it invests, which would be a necessary (or at least strategically valuable) offering, bearing in mind the shortage of skills in Africa. In order to meet the HQC qualifying criteria, the POEM of African companies in which the HQC invests should be outside of South Africa (so that such companies constitute 'foreign companies'). According to Zwarts (2013:110), this could reduce the benefit to foreign investors of establishing headquarters in South Africa, as such investors would still be required to ensure that that the 'persons performing the effective management function' are based at the subsidiaries in locations outside of South Africa.

In order to consider the validity of Zwarts' criticism, the meaning of POEM must first be considered and understood. The Katz Commission (1997) endorsed the POEM concept to be used in determining the tax residence of persons other than natural persons and concluded that the use of the term would have 'the benefit of employing international, and therefore, commonly understood terminology′. Despite being widely used, the term does not have a single, universally accepted meaning and its interpretation remains uncertain (SARS, 2011:5; Brunton, 2015:15).

The term 'POEM' is not defined in article 4 of the OECD MTC, but the following paragraph was included in the 2000 version of the commentary on article 4 of the OECD MTC (OECD, 2000b:71):

> 'The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the enterprise’s business are in substance made. The place of effective management will ordinarily be where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the enterprise as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An enterprise may have more than one place of management, but it can have only one place of effective management at any one time.'

In March 2002, shortly after South Africa's change from a largely source-based system of taxation, to a largely residence-based system of taxation, SARS issued the first version ('issue 1') of its 'Interpretation Note 6: Resident: Place of Effective Management (Persons other than Natural Persons)' ('IN6'). SARS' general approach as set out in issue 1 of IN6 was that a company's POEM is 'the place where the company is managed on a regular or day-to-day basis by directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets′ (SARS, 2002:3). The focus was on the location where policy and strategic decisions are executed and implemented by the senior management or directors of the company, rather than the place where the board of directors exercises ultimate authority over the company. SARS' approach to determining a company's POEM as set out in issue 1 of IN6 did not align with international precedents and interpretation, nor did it align with OECD guidance (Brunton, 2015:21; ENS, 2015; Werksmans, 2015).

In SARS' 2011 discussion paper on IN6 (2011:2), it acknowledged that taxpayers and practitioners raised concerns that foreign subsidiaries held by HQC's may be treated as South African tax residents under SARS' approach to determining a company's POEM, as outlined in issue 1 of IN6. SARS (2011:1) further acknowledged that if it were to be held that a foreign operating subsidiary of an HQC has its POEM in South Africa, it would negate many of the benefits offered by the HQC regime. It was therefore proposed that IN6 should be revised 'to address the legitimate concerns … that have been expressed by potential investors in HQC's′ and that the revisions should be aimed at relieving 'needless anxiety over situations involving foreign operating subsidiaries with bona fide foreign operations and "on the ground" top level managers responsible for the high level day-to-day running of those operations' (SARS, 2011:11).

SARS' second version ('issue 2') of IN6 was issued by SARS on 3 November 2015 and was welcomed by taxpayers and practitioners for being consistent with international jurisprudence and the approach adopted by the OECD (Werksmans, 2015; ENS, 2015). In issue 2 of IN6, SARS (2015b:4) records its amended approach to determining a company's POEM and states that the general principle is that a 'company's place of effective management is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made′. Brunton (2015:35) states that issue 2 of IN6 weaves together persuasive South African and British case law, together with the 2014 version of the commentary on the OECD MTC in concluding that '(o)perational management decisions are generally of limited relevance in determining a company's [POEM] … and must be distinguished from key management and commercial decisions…' and '(w)hat constitutes a key management or commercial decision as opposed to an operational management decision is critical as it is the former that is relevant in the context of establishing the [POEM]' (SARS, 2015b:11).

Issue 2 of IN6 adds that whilst certain fundamental decisions are often reserved for the shareholders of a company and such decisions generally affect the rights of the shareholders in their capacity as such or the company's existence (as opposed to its management), SARS (2015b:10) acknowledges that shareholder involvement can cross the line to the extent that a shareholder(s) effectively usurps the powers of the company's directors. In circumstances where an HQC usurps the powers of the Foreign Companies in which it invests, the POEM of such Foreign Companies may well be found to be in South Africa (in which case such companies may no longer be Foreign Companies and could instead be found to be tax resident in South Africa, depending on the tie-breaker clause in the applicable DTA), although this would depend on the specific facts of each case.

Zwarts' criticism was made prior to SARS issuing issue 2 of IN6 and must be considered in light of the reality that the HQC regime gives rise to the creation of more intermediate holding companies than true headquarter companies (Oguttu, 2011:90; Gutuza, 2014:191), because it lacks one of the key fiscal attributes of a regime conducive to the formation of international headquarter companies (namely no or low taxation on management services rendered by a head office to other entities in a multinational group (Katz Commission, 1997)). With this in mind, it appears unlikely that the POEM test for tax residence, as interpreted by SARS in issue 1 of IN6, would have caused the Foreign Companies in which an HQC invests to become tax resident in South Africa on the basis of the services rendered by the HQC to such Foreign Companies. Holding company functions such as the management of equity investments, debt funding and the licensing of intellectual property are unlikely to constitute the execution and implementation of strategic decisions of the Foreign Companies by their senior management or directors. Furthermore, even if an HQC were to render typical headquarter company services, such as administration, technical support services, marketing services and sales promotion, financial management and accounting services (refer to paragraph 2.4.4 above), such services would generally be support services to the real business of the Foreign Companies which would presumably be carried on outside of South Africa. Accordingly, it appears that Zwarts' criticism may, even in 2013, have been unjustified when the services that would typically be rendered by an HQC are considered. It would arguably be exceptional for an HQC to execute or implement the strategic decisions made by the senior management or directors of a Foreign Company in which the HQC invests.

It appears that a greater risk exists today that SARS could consider a Foreign Company in which an HQC invests to be tax resident in South Africa, under SARS' current interpretation of POEM (which accords with international views, including that of the 2014 version of the commentary on the OECD MTC). The reason for this is that it is more likely that the key management and commercial decisions that are necessary for the conduct of the business of a Foreign Company will, in substance, be made in South Africa, than it was that the HQC will execute or implement the strategic decisions made by senior managers or directors of the Foreign Companies, although it is acknowledged that this would depend on the facts and circumstances of each case (SARS, 2015b:7). An HQC should constantly review its level of involvement in the key management and commercial decisions of the businesses of its subsidiaries (the Foreign Companies) and be wary of usurping the powers of the Foreign Companies as was the case in *Unit Construction v Bullock* [1960] AC 351, [1959] 3 All ER 831, [1959] 3 WLR 1022, 38 TC 712, 38 ATC 351, [1959] TR 345, 52 R&IT 828. In this case, the court found that the parent company, and not its subsidiary companies, exercised the real management and control in all matters relevant to the determination of the location of central management and control of each of the subsidiary companies. SARS (2015b:11) states that 'shareholders sometimes limit the authority of, or provide guidelines for, the board and senior managers of a [subsidiary] company' and warns that 'these limitations of authority or guidelines must, in conjunction with all the other facts and circumstances, be reviewed … to determine whether … the shareholder is actually making the key decisions or whether the [subsidiary] company, although receiving guidance or some input, is still making them'. This is, however, a risk that can be avoided through proper planning of corporate processes and should therefore not be considered to be a major flaw in the design of the HQC regime itself.

3.3. The lack of preferential treatment of services and service income in the hands of an HQC hampers the HQC regime's ability to achieve certain of its policy objectives

3.3.1. The lack of preferential treatment of service income in the hands of an HQC

As indicated in paragraph 2.2.3 above, one of the qualifying criteria for companies seeking HQC status is that, where the gross income of a prospective HQC for the year of assessment in question exceeds R5 million, 50% or more of that gross income must consist of amounts in the form of (either or both of the following) (i) any rental, dividend, interest, royalty or service fee paid or payable by any foreign company in which the prospective HQC held at least 10% of the equity shares and voting rights (a Foreign Company), or (ii) any proceeds from the disposal of any interest in equity shares in a Foreign Company or of any intellectual property licensed to a Foreign Company. Therefore, whilst the qualifying criteria for the HQC regime includes service income as a source from which the HQC is required to earn its income when its gross income exceeds R5 million, it does not provide any relief for income earned from this source, unlike dividend, interest and royalty income.

As stated above in paragraph 2.5, the HQC regime is a headquarter company regime only insofar as it allows the HQC to manage the holding of shares in underlying Foreign Companies, and act as a central point for debt finance and the licensing of intellectual property, whilst remaining tax neutral. Notwithstanding the fact that an HQC acts more like an intermediate holding company than a true headquarter company, Gutuza (2014:197) is of the view that some level of management or coordination of the Foreign Companies will take place in South Africa. She argues that, an HQC's income will therefore include management fees, supervisory fees or coordination fees for services rendered by the HQC to Foreign Companies (Gutuza, 2014:197). Commitment fees for funds made available for drawdown could be added to this list. The HQC regime does not provide tax relief for income in the form of management fees received by or accrued to an HQC from Foreign Companies (Bennet, 2012:60; Porter, 2014:31; Zwarts, 2013:40). It also does not provide tax relief for supervisory, coordination or commitment fees. The lack of tax relief for HQC's on income earned from these sources does not assist South Africa's cause for becoming the 'gateway into Africa' (Gutuza, 2014:203). Any income from services rendered which is received by or which accrues to an HQC would be subject to tax in its hands at the full South African income tax rate of 28%.

Internationally, a key fiscal attribute of a regime conducive to the establishment of headquarter companies is the lack of taxation, or the imposition of minimal taxes, on management services rendered by a head office to other entities in a multinational group (Katz Commission, 1997). Therefore, as stated above in paragraph 2.5, the HQC regime lacks one of the key fiscal attributes of a regime conducive to the formation of international headquarter companies.

The attraction and retention of skilled employees and the facilitation of the transfer of skills to the South African workforce (*inter alia* through the injection of international best practice and an increased flow of business intelligence) formed part of the policy objectives of the HQC regime as determined in chapter 2. The lack of preferential treatment of income earned by HQC's in the form of management, supervisory, coordination or commitment fees may have an adverse impact on the number of foreign multinational groups willing to establish a regional headquarter company in South Africa. This may, in turn, impact on the HQC regime's ability to facilitate the injection of international best practice and an increase in the flow of business intelligence and, generally, to develop intellectual infrastructure in South Africa (Gutuza, 2014:203).

3.3.2. The lack of relief from South Africa's transfer pricing rules for services rendered by an HQC

As stated above in paragraph 2.2.3, South Africa's transfer pricing and thin capitalisation rules (in section 31 of the ITA) are relaxed for HQC's in that the ITA provides relief from these rules as they apply to the provision of debt finance (including the provision of security or a guarantee) and the licensing of intellectual property by a non-resident to an HQC in certain circumstances, as well as by an HQC to a Foreign Company.

In addition to the HQC regime not providing for the preferential treatment of an HQC's income earned from management and other services, where an HQC renders services to a Foreign Company in which it invests (as defined in paragraph 2.2.3) and which is a 'connected person' in relation to it, such services must be rendered on arm's-length terms, in that the terms and conditions of each transaction must be the same as terms and conditions that would have existed had the HQC and such Foreign Company been independent persons dealing at arm's length (in terms of section 31(2) of the ITA). Generally, and in simplified terms, a Foreign Company in which an HQC invests will be a connected person in relation to the HQC where the HQC holds more than 50% of the equity shares of or voting rights in such Foreign Company (in terms of the definition of ‘connected person’ in section 1 of the ITA). If the HQC renders services to connected Foreign Companies on terms or conditions that are not arm’s length, the HQC risks facing adjustments to its taxable income, as well as incurring penalties and interest (Deloitte, 2011). Deloitte (2011) submitted comments to SARS which described the lack of transfer pricing relief on 'non-funding transactions' as a 'shortcoming' in the hope that the HQC regime would be amended to make the regime more tax efficient and of wider application. To date, the provisions in the ITA which delineate the HQC regime have not been amended to provide for transfer pricing relief on services rendered to Foreign Companies in which an HQC invests.

The design of the HQC regime indicates that National Treasury intended for equity, debt and the licensing of intellectual property to flow through an HQC without being subject to a further level of tax, but always intended to collect income tax from income generated in South Africa. This accords with the statement made by National Treasury to the NCOP that the HQC regime should avoid unintended South African tax by taxing only the South African profit and not the money flowing through South Africa (NCOP Finance Committee, 2011). It also accords with what SARS and National Treasury stated in regard to the HQC's predecessor, the 'international headquarter company' - that it was created 'in order to effect a tax neutral flow-through of foreign income', whilst still subjecting income from a source within South Africa to South African income tax (SARS and National Treasury, 2000). Whilst the design of the HQC regime accords with certain of its policy objectives, the lack of relief from South Africa's transfer pricing rules as they apply to services rendered by an HQC to the Foreign Companies in which it invests, has similar negative consequences to what is set out above regarding the lack of preferential treatment of income from management and related services in the hands of the HQC.

3.3.3. The lack of a credit mechanism for foreign taxes suffered in respect of income from services rendered by an HQC from South Africa

Section 6*quin* was introduced into the ITA by the Taxation Laws Amendment Act, 2011 (South Africa, 2011) to allow South African entities to render services to African clients, in respect of African operations, in a commercially viable manner (Van der Zwan, 2015). The section allowed a limited foreign tax credit for foreign withholding taxes imposed in respect of income earned from services rendered from within South Africa and was intended to act as a form of relief from double taxation for South African multinational companies that render services to their foreign subsidiaries (National Treasury, 2011:101; National Treasury, 2015:51). Section 6*quin* was later repealed with effect from 1 January 2016, in respect of years of assessment commencing on or after that date (South Africa, 2015).

Prior to the repeal of section 6*quin*, Statham (2015:63) warned that HQC's providing South African-sourced services to clients in other African countries will potentially be exposed to double taxation if section 6*quin* is withdrawn. Van der Zwan (2015) commented, more generally, that the repeal of section 6*quin* may force South African service providers to establish headquarters outside of South Africa, potentially in low-tax jurisdictions, as was also pointed out by National Treasury (2011:100). The potential negative impact specifically on the HQC regime was pointed out by Statham (2015:i) when he commented that the repeal of section 6*quin* will cause foreign multinational groups to avoid basing their headquarters in South Africa and instead aim to establish their African regional headquarters in low-tax jurisdictions to reduce the cost of rendering headquarter services to African clients.

The relief provided for by section 6*quin* was not available solely to HQC's and the section did not specifically form part of the HQC regime. However, it was introduced merely a year after the HQC regime was proposed and concerns were raised in the comments received on the Taxation Laws Amendment Bills, 2010, that management fees earned by South African residents in respect of African operations are often subject to double taxation, as many African countries tax such fees even when the services which give rise to the income are rendered from within South Africa (National Treasury & SARS, 2010:32). National Treasury was specifically requested to make foreign tax credits available to HQC's in such circumstances, in order to prevent double taxation, but did not accede to the request and responded by saying that the issue in question went beyond HQC's and affects all South African taxpayers that manage African operations (National Treasury & SARS, 2010:32). In this context, and in light of the fact that National Treasury (2011:100) acknowledged in the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2011 that the lack of a foreign tax credit in circumstances where a foreign country levies withholding tax on service fees paid for services rendered from within South Africa is 'adverse to South Africa's objective of becoming a regional financial centre', it is reasonable to argue that section 6*quin* was at least partially intended to increase the allure of the HQC regime. It is therefore appropriate to consider the criticism and potential consequences of the repeal of section 6*quin* as a criticism of the HQC regime itself.

In order to understand and properly consider whether or not the criticism is justifiable, the role of foreign tax credits in general must first be considered. Olivier and Honiball (2011:6) explain that international trade carries an inherent risk of international double taxation, which, in the juridical or legal sense, refers to the same income being taxed in two different countries, in the hands of the same person. They explain that juridical double taxation may arise, for example, where the country in which a person is tax resident uses a residence-based system of taxation (meaning that it taxes its residents on their worldwide income) and the other country, in which the income is generated, levies tax on non-residents on a source basis (that is, on income from a source within that country), with the result that the person is subjected to tax in both countries (Olivier & Honiball, 2011:6).

Rohatgi (2005:70) explains that, in a DTA context, relief for juridical double taxation is usually granted by the country of the taxpayer's residence. Unless the country of the source of the income has agreed to forego or limit its rights under a DTA, such country is entitled to exercise its rights first, at the time that the taxable income arises, and the residence country is then required to give relief to the taxpayer to avoid double taxation. The 'credit method' is a method of providing relief from double taxation and provides residents a credit for taxes payable to the revenue authority of another country on foreign sourced income (in a South African context, this would refer to income from a source outside South Africa) (Olivier & Honiball, 2011:6; Rohatgi, 2005:70). The 'credit method' can also be referred to as the 'rebate method' (SARS, 2015a:4).

In addition to the credit or rebate method, the deduction method and the exemption method are also used in a domestic context to provide relief from double taxation (Olivier & Honiball, 2011:6). In terms of the deduction method, a resident is allowed to claim a deduction for taxes paid to a foreign state, whereas the exemption method exempts certain foreign-sourced income from tax in the country of residence. SARS (2015a:4) confirms that countries often provide for relief from international juridical double taxation in DTA's, although many countries, including South Africa, also provide unilateral tax relief in their domestic law. South Africa uses a mix of the rebate and deduction methods and supplements these methods with exemptions for foreign-sourced amounts received by or accrued to residents (SARS, 2015a:5).

According to issue 3 of SARS' Interpretation Note 18 ('IN18') (2015a:5), section 6*quat*(1) of the ITA 'is the principal mechanism used to provide relief for foreign taxes proved to be payable on income derived from a foreign source that is included in a resident’s taxable income', and foreign taxes that fall in this category do not qualify for a deduction in terms of section 6*quat*(1C) of the ITA. Being a credit or rebate method, section 6*quat*(1) provides for the deduction of foreign taxes against normal tax payable. Section 6*quat*(1C) is the embodiment of the deduction method in the ITA and allows a South African tax resident to claim foreign taxes, that do not qualify for the rebate under section 6*quat*(1) (in essence, foreign taxes payable on amounts from a source within South Africa), as a deduction in the determination of the resident's taxable income.

In the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2011, National Treasury (2011:100) explained that foreign tax credits are only available in respect of foreign taxes which are levied on foreign-sourced income and that 'no foreign tax credits are available in respect of South African-sourced income'.

This Explanatory Memorandum further stated that '(a) number of African jurisdictions impose withholding taxes in respect of services (especially management services) rendered abroad if funded by payments from their home jurisdictions … even when [DTA's] suggest that the practice should be otherwise. African imposition of these withholding taxes in respect of South African-sourced services is no exception'. This reality was also confirmed by Mazansky (2014:9). The aforementioned African withholding taxes result in double taxation, with only limited relief available to the South African taxpayers that suffer them, in the form of the section 6*quat*(1C) deduction. National Treasury (2011:100) acknowledged that while South Africa's position of not granting tax credits for foreign taxes levied on South African-sourced income is theoretically correct, the implications of this position are 'adverse to South Africa's objective of becoming a regional financial centre'. The ultimate effect of the aforementioned withholding taxes levied by African countries on service fees (when combined with South African income tax) was that the cost of rendering services from South Africa to clients in those African countries was increased and the profit margins on such services were eroded to the point where the commercial viability of providing such services from South Africa was threatened (Statham, 2015:31; Van der Zwan, 2015).

The introduction of section 6*quin* brought relief from double taxation and the administrative burden of trying to claim back the withholding tax from the foreign jurisdiction (Statham, 2015:2). The section 6*quin* rebate had a significant advantage over the section 6*quat*(1C) deduction in that the relief was provided in the form of a credit against South African income tax, as opposed to section 6*quat*(1C)'s deduction in the determination of taxable income. The repeal of section 6*quin* removed the aforementioned relief. Unfortunately, there has not necessarily been a change in the policies of the African countries levying withholding taxes on service fees paid by their residents to service providers in other countries, as can be deduced from the DTC's encouragement of SARS to actively engage with African revenue authorities in regard to this issue, to better enforce its rights in mutual agreement proceedings and to involve the African Tax Administration Forum ('ATAF') to resolve this issue (DTC, 2017b:12). The DTC (2017b:12) has acknowledged the concerns that section 6*quin*'s repeal could undermine South Africa as a location for HQC's and lead to various companies in the banking, retail, information technology and telecommunication industries relocating their service centres, and that the section 6*quin* foreign tax credit was arguably one of the reasons why such service companies based their headquarters in South Africa in the first place.

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015 (National Treasury, 2015:51) described section 6*quin* as 'a departure from international tax rules and [DTA] principles in that it indirectly subsidies countries that do not comply with the [DTA's]' and stated that 'South Africa is the only country in the world that provides for this kind of tax concession'. It added that section 6*quin* defeats the purpose of DTA's, because it encourages South Africa's DTA partners not to abide by the terms of the DTA (National Treasury, 2015:51). Furthermore, it is said that the section 6*quin* foreign tax credit resulted in a significant compliance burden on SARS. Consequently, section 6*quin* was repealed with effect from 1 January 2016 (National Treasury, 2015:51). Also with effect from 1 January 2016, section 6*quat*(1C) was amended to allow a deduction in respect of foreign taxes paid or proved to be payable without taking into account the availability of the mutual agreement procedure under DTA's (meaning that, even where the mutual agreement procedure is available, a taxpayer need not wait for the outcome of such mutual agreement procedure before claiming the section 6*quat*(1C) deduction (National Treasury, 2015:51)).

Whilst the reasons for the repeal of section 6*quin* offered by National Treasury in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015 can be appreciated and are theoretically correct, the reality remains that the impact of the withdrawal is that it placed South African service providers in the same position as they were before section 6*quin*'s introduction, as African revenue authorities still tend to levy significant withholding taxes on payments to foreign service providers. Prior to the repeal of section 6quin, Van der Zwan (2015) warned that this would be the case.

It must be acknowledged that it is not only South African providers of services to African clients (such as HQC's) that are exposed to withholding taxes on service fees levied by African countries. Service providers based in Botswana and Mauritius (if Southern African examples are used) would also suffer the withholding taxes in question. However, the important difference is that Botswana and Mauritius do offer preferential corporate income tax rates for their equivalents of HQC's (in this regard, refer to paragraphs 2.4.2 and 2.4.3 in chapter 2 above). By way of example, if it is assumed that the withholding taxes on service fees levied by certain African countries are unavoidable, and that National Treasury was correct in saying that South Africa was the only country in the world offering a foreign tax credit such as section 6*quin* (National Treasury, 2015:51), the service provider would be in a better position, tax wise, if it were tax resident in Botswana or Mauritius than if it were tax resident in South Africa. The reason being that, even if it suffered the withholding tax on service fees in addition to the corporate income tax in Botswana or Mauritius, those countries have lower corporate income tax rates than South Africa (at 15% in Botswana and 15% (with the possibility of reducing the effective rate to 3%) in Mauritius, versus 28% in South Africa).

A real risk of double taxation therefore exists for those foreign investors that decided to establish HQC's in South Africa, despite the country's lack of preferential income tax rates for income earned from services rendered to Foreign Companies. The relief provided by section 6*quat*(1), being a tax credit for foreign taxes on foreign-sourced income, will not be available to HQC's that suffer withholding taxes on service fees received from African countries where their clients are based, because the income arises from a source in South Africa and, in circumstances where the African country withheld tax contrary to the provisions of its DTA with South Africa, the foreign tax cannot be proved to be payable (Van der Zwan, 2015). Furthermore, the DTC (2017b:12) points out that if the words 'paid or proved to be payable*'* as used in deduction provision in section 6*quat*(1C) are interpreted as requiring an unconditional legal liability to pay the tax, the deduction would (similar to the 6*quat*(1) credit) also not be available in cases where another country withholds tax contrary to the provisions of a DTA. The DTC (2017b:12) therefore proposed that South African resident service providers should be able to enjoy a deduction under the section where tax is 'levied' or 'imposed' by a foreign government in the circumstances in question. This proposed change to section 6*quat*(1C) has, to date, not been effected and is not contained as a proposal in the Taxation Laws Amendment Bill, 2018.

To date, no substitute for section 6*quin* has been inserted into the sections of the ITA which delineate the HQC regime, nor in the rest of the ITA. Should SARS fail to heed the DTC's warning to engage with African revenue authorities regarding the levying of withholding taxes contrary to the provisions of a DTA, to better enforce its rights in mutual agreement proceedings and to involve ATAF to resolve the issue, the repeal of section 6*quin* is likely to significantly reduce the attractiveness of the HQC regime.

3.3.4. **Synthesis**

The findings of chapter 2 do not reflect the collection of corporate income tax revenue from HQC's as a primary objective of the HQC regime (refer to paragraph 2.5 above). However, this is not reflected in the fact that an HQC which renders the true headquarter company services (which would facilitate the achievement of the regime's primary, developmental objectives) does not enjoy South African tax relief in respect of the fees charged for and income earned from such services. This lack of relief hampers the achievement of certain of the HQC regime's primary objectives, such as the attraction and retention of skilled employees and the facilitation of the transfer of skills to the South African workforce through the injection of international best practice and an increase in the flow of business intelligence.

3.4. The annual requirements for qualification as an HQC are open to manipulation and create a significant compliance burden on an HQC

3.4.1. **The criticism of the proviso to the 10% shareholding requirement**

As stated above in paragraph 2.2.3, each shareholder must hold 10% or more of the equity shares and voting rights in a company seeking to qualify as an HQC for the duration of the year in which the election to be an HQC is made. This requirement is subject to a proviso that, in determining whether or not a prospective HQC complies in any year of assessment in which it started to carry on a trade, the period during that year, before the prospective HQC started to carry on a trade, must be disregarded (the 'Proviso').

When the HQC regime was first introduced, one of the qualifying criteria was that each shareholder must hold 20% (later reduced to 10%) or more of the equity shares and voting rights in the company seeking to qualify as an HQC for the duration of the year in which the election to be an HQC is made, as well as all previous years of assessment of the company (National Treasury, 2010c:78; National Treasury, 2011:94). In National Treasury's Explanatory Memorandum issued in respect of the Taxation Laws Amendment Bill, 2012 (National Treasury, 2012:124), it was stated that the so-called 'always qualification test' in respect of the 10% shareholding requirement will be removed due to the reality that 'in order to accelerate the legal establishment of [a company], many businesses prefer to acquire "off-the-shelf" companies' that are already in existence, and that 'these "off-the-shelf" companies are problematic from [an HQC] perspective' as they often fail the 'always qualification test' during their 'dormancy period' (the period before they are purchased and start trading). Mukumba's view (2017:68) is that the Proviso is open to manipulation 'because [HQC's] are not active trading companies' and that 'their activities consist largely of holding capital assets, rather than embarking on schemes of profit making'.

The term 'trade' is widely defined in the ITA and includes every 'profession, … business, employment, calling, occupation or venture, including the letting of property and the use of or the grant of permission to use any patent … or any design … or any trade mark … or any copyright … or any other property which is of a similar nature'. In the case of *Burgess v CIR* 1993 (4) SA 161 (A), 55 SATC 185, the court quoted, with approval, the statement made by Dowling J in ITC 770(1953) 19 SATC 216 at page 217, regarding the similar definition of the term 'trade' in Act 31 of 1941, that it was 'obviously intended to embrace every profitable activity and ... I think should be given the widest possible interpretation'. Accordingly, a company which licenses intellectual property should be considered to be carrying on a trade.

Furthermore, Rupping (2014:50) argues that, on the basis of the judgement in the case of *Commissioner for SARS v Tiger Oats Ltd* [2003] 2 All SA 604 (SCA) (the 'Tiger Oats case'), investment in the equity shares of subsidiaries by an active holding company (as opposed to a passive holding company) could constitute the carrying on of an enterprise, business or trade by such holding company. Rupping (2014:47) points out that a distinction should be made between a passive investor and an active investment holding company which performs activities in connection with its investments and that, according to the Tiger Oats case, only the latter can be regarded as carrying on business. In determining whether or not a company is carrying on business as an active investor, the specific facts and circumstances of the case must be considered, especially the scale and nature of the relevant company's activities (South African Institute of Tax Professionals, 2016:405). Notwithstanding the fact that the court in the Tiger Oats case had to decide whether or not the company carried on an enterprise in terms of the Regional Services Council Act 109 of 1985 (and not the ITA), the principles developed in that case have a direct bearing on the interpretation of the term 'carrying on any trade' (as such words appear in the ITA's provisions which regulate general deductions in the determination of taxpayers' taxable income) on the basis that the words included in the respective definitions are the same (Rupping, 2014:50).

At paragraph 32 of the Supreme Court of Appeal's judgement in the Tiger Oats case, the following is stated, 'It is conceded, and rightly so, that at least in so far as the respondent acts as banker for the group and makes interest bearing loans to its subsidiary and associated companies it is carrying on an enterprise'. On the basis of the aforementioned quoted statement it can therefore be argued that loans advanced by an investment holding company to its subsidiaries to fund the activities of such subsidiaries may, in certain circumstances, constitute a trade carried on by that investment holding company. Rupping (2014:51) points out there are counter arguments to such a view. However, the counter arguments are not relevant for current purposes.

Based on the above analysis, it can be argued that an HQC's investment in Foreign Companies (whether in the form of equity, debt or the licensing of intellectual property) could be considered as the carrying on of a trade, in certain circumstances. Mukumba's criticism (2017:68) that the Proviso is open to manipulation 'because [HQC's] are not active trading companies′ and that 'their activities consist largely of holding capital assets, rather than embarking on schemes of profit making' appears to be unjust when considered in light of the reality that, in general, headquarter companies are often formed by multinational groups to oversee and co-ordinate its commercial interests in a particular region (Legwaila, 2013:5). The counter-argument could be raised that the HQC regime is not a true headquarter company regime and rather allows the creation of intermediate holding companies (Oguttu, 2011:90; Gutuza, 2014:191). However, as Legwaila (2010:313) contends, intermediate holding companies 'can provide a means to own and manage a group of affiliates or subsidiaries in a particular region′. Therefore, whether the HQC acts as a true headquarter company or as an intermediate holding company, it is not precluded from carrying on a trade. The Proviso can therefore be defended on the basis that it serves a clear purpose, which is to ensure that the shareholding of any prospective HQC during its dormancy period' does not disqualify it from HQC status.

3.4.2. The criticism of the compliance burden on an HQC from a tax perspective

A company that elects to be an HQC must complete the RCH01 Schedule for companies electing to be HQC's, which is available on SARS' website (SARS, 2018a:63). This schedule, and all the supporting documents requested therein, must be attached to the income tax return of the company which elects to be an HQC. The schedule requires the company (the prospective HQC) to attach an organogram which indicates the shareholding in the company and, furthermore, requires the company to record in which country each of its shareholders are resident for income tax purposes (SARS, 2012). The tax residence of the shareholders in an HQC does not play a role in determining whether or not the substantive qualifying tax criteria for an HQC, as set out in section 9I of the ITA, have been met. However, as section 9I requires the election to be an HQC to be made 'in the form and manner determined by the Commissioner', the correct completion of the RCH01 Schedule becomes an additional administrative criteria which all HQC's must satisfy.

The qualifying criteria for HQC's, as imposed by the ITA for income tax purposes, are not aligned to the qualifying criteria imposed by the Authorised Dealer Manual (refer to paragraph 3.4.3 below) from an exchange control perspective (Arendse, 2014:20). For example, the ITA does not impose a restriction on the number of South African tax residents that may hold shares in an HQC, whilst for exchange control purposes, no more than 20% of the shares in an HQC may be held by persons who are South African exchange control residents (SARB, 2018:57). Moreover, the methods of calculation of the proportion of South African assets versus foreign assets are not aligned. For tax purposes, the criteria set out in section 9I of the ITA state that at least 80% of the cost of the total assets of the prospective HQC must be attributable to what will be referred to for current purposes as 'foreign assets' (for greater detail in this regard, refer to paragraph 2.2.3 above). For exchange control purposes, the Authorised Dealer Manual (SARB, 2018:57) merely states that 'at the end of each financial year, at least 80 per cent of the assets of the holding company must consist of foreign assets'. Therefore, whilst the ITA specifically requires the composition of the assets to be split on the basis of the cost of the HQC's total assets, the Authorised Dealer Manual's requirements are less clear and could be interpreted as 80% of the cost, value or number of the total assets of the HQC. Notwithstanding National Treasury and SARS' response to a comment received on the Taxation Laws Amendment Bill, 2010 (National Treasury & SARS, 2010:30), that the 'goal is to simplify compliance and enforcement as much as possible in order to enhance the success of the proposed [HQC] regime', the qualifying criteria for HQC's imposed by the ITA and by the Authorised Dealer Manual have not been aligned.

Mukumba (2017:66) submits that the fact that a prospective HQC is required to register with and report to two different authorities, together with the fact that the two authorities impose different qualifying criteria, creates an extensive administrative and substantive compliance burden. However, as the exchange control relief is critical to the HQC's functions and does not follow automatically once the qualifying criteria in the ITA have been met, an HQC has little option but to incur the further time and effort required to qualify for the exchange control relief in terms of the Authorised Dealer Manual.

Based on the above analysis, the criticism that there is a heavy compliance burden on a prospective HQC to ensure eligibility for tax and exchange control relief appears to be just. The uncertainty that could be created by the misalignment between the tax and exchange control qualifying criteria and the fact that the HQC has to report to two different South African authorities adds to the compliance burden. Mukumba's further criticism (2017:69), that the fact that compliance with the qualifying criteria has to be proven annually 'makes the benefit … temporary and costly', also appears to be appropriate. Whilst National Treasury may argue that compliance with the requirements is largely within the HQC's control, aspects that are not fully within the control of the HQC include the returns generated by the South African assets (which may be a maximum of 20% of the HQC's total assets). For example, if the South African assets of an HQC (which has gross income of more than R5 million in any year of assessment) unexpectedly generate significant dividends in any given year, such dividend income may exceed 50% of the gross income of that HQC, causing the HQC not to meet all of the criteria required to retain its status as HQC for tax purposes. The ITA's provisions which delineate the HQC regime do not cater for relief in these circumstances.

In defence of the decision to require annual compliance with the HQC qualifying criteria, together with annual reporting in the form of the RCH01 Schedule, National Treasury takes (what appears to be) a prudent position that 'incentives require annual reporting in order to measure their success and to protect against risks', which is 'necessary from a fiscal management point of view in order to measure the tax expenditure of the concession granted' (National Treasury, 2011:93).

3.4.3. The criticism of the compliance burden on an HQC from an exchange control perspective

Exchange controls exist in South Africa, *inter alia*, to prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa and their day-to-day administration is the responsibility of the Financial Surveillance Department of the SARB (SARB, s.a.; SARB, 2018:12). The Financial Surveillance Department authorises certain banks to deal in foreign exchange (these banks are referred to as 'Authorised Dealers') and issues the Currency and Exchanges Manual for Authorised Dealers (the 'Authorised Dealer Manual') under the powers delegated by the South African Minister of Finance (SARB, 2018:14). In simplified terms, the Authorised Dealer Manual sets out the transactions in foreign exchange that Authorised Dealers may undertake, whether or not on behalf of their clients, and details of the Authorised Dealers' related administrative responsibilities.

The Authorised Dealer Manual refers to 'international headquarter companies' without formally defining the term and merely sets out criteria that must be met before 'headquarter companies … may invest offshore without restriction' (SARB, 2018:56). It is presumed that the terms 'international headquarter companies' and 'headquarter companies' as used in this context refer to companies that meet the qualifying criteria set out in section B.2(D) of the Authorised Dealer Manual. For the sake of convenience, the term 'HQC' is used in this section to refer to the exchange control concept of 'international headquarter company'/'headquarter company'.

In order to enjoy the relief from South Africa's exchange control regulations, an HQC must register with the Financial Surveillance Department for reporting purposes and, provided that the HQC meets the criteria set out in section B.2(D) of the Authorised Dealer Manual, it will be allowed to invest offshore free from restrictions (SARB, 2018:56). The criteria that must be met are discussed below.

The HQC must be 'newly established' (SARB, 2018:56). This appears to mean that the HQC cannot be an existing company acquired as a shelf company which had a South African exchange control resident as its first shareholder, as more than 20% of the shares of such a company would have been held by a South African exchange control resident (refer to the discussion below). Such an interpretation is supported by the fact that the HQC must comply with the criteria discussed below for the duration of a year of assessment, as well as each previous year of assessment. Unlike the Proviso (discussed above in paragraph 3.4.1), which relaxed the 'always qualification test' which applied in respect of the 10% shareholding requirement as part of the HQC qualifying criteria in a tax context, there is no similar relaxation which exists in the Authorised Dealer Manual as far as the HQC qualifying criteria in an exchange control context are concerned. This misalignment in qualifying criteria further adds to the compliance burden of a prospective HQC.

No shareholder in the HQC may hold less than 10% of the shares and voting rights (SARB, 2018:57). As stated in paragraph 2.2.3 above, this requirement also forms part of the qualifying criteria for an HQC for tax purposes. Furthermore, no more than 20% of the HQC's shares may be directly or indirectly held by persons who are considered to be 'residents' for South African exchange control purposes. A person is a 'resident' for South African exchange control purposes if that person (which may be a natural person or legal entity) has taken up permanent residence, is domiciled or registered in South Africa (SARB, 2018:18).

Lastly, at the end of each financial year, at least 80% of the assets of the HQC must consist of foreign assets (SARB, 2018:57). The term 'foreign assets' is not defined in the Authorised Dealer Manual and is for current purposes assumed to refer to assets located outside the common monetary area (which would accord with the definition of the term 'non-resident area', defined in the Authorised Dealer Manual as 'all countries other than those included in the [common monetary area]'). Whilst the qualifying criteria for an HQC for tax purposes refers to the 'cost' of the total assets, the qualifying criteria for exchange control purposes is less clear, as the wording '80% of the assets' could refer to 80% of the total cost or value of the HQC's assets or to 80% of the total number of assets held by the HQC. In this regard, please refer to paragraph 3.4.2 above. Mukumba (2017:66) is of the view that the different criteria that apply to an HQC from a tax and exchange control perspective add to the already extensive compliance burden faced by the HQC's, both administratively and substantively. If the wording '80% of the assets' refers to 80% of the value of the HQC's assets, the prospective HQC will be required to perform annual valuations of its assets (Mukumba, 2017:67), which adds to the cost of compliance.

HQC's which meet the exchange control qualifying criteria are treated as non-resident companies by the Financial Surveillance Department (SARB, 2018:57). As a result, HQC's can freely borrow from abroad and may deploy such funds locally or offshore, with such transactions being regarded as occurring outside South Africa – a concession which is conducive to the establishment of HQC's in South Africa, as Oguttu points out (2011:89). However, notwithstanding the above, HQC's are nevertheless obliged to report all cross-border transactions, for statistical purposes (SARB, 2018:57). There is also an annual obligation on the Authorised Dealer of the HQC to submit a detailed organogram of the HQC and its most recent audited financial statements to the Financial Surveillance Department (SARB, 2018:57), which may unfortunately add to the HQC's compliance burden, as the responsibility for the preparation of the aforementioned organograms is likely to inevitably fall on the HQC itself (whilst the directors of the HQC will naturally have the responsibility to ensure that financial statements are prepared).

Oguttu (2011:89) criticised the exchange control qualifying criteria for HQC's on the basis that HQC's are exchange control residents, and therefore, despite the exchange control relief that HQC's may enjoy, there are 'other exchange control restrictive measures [that] still apply to them', such as, the restrictions against so-called 'loop structures'. The term 'loop structure' is not specifically defined in the Authorised Dealer Manual and, instead, is given meaning through section 10(1)(c) of the Exchange Control Regulations, 1961 (issued in terms of section 9 of the Currency and Exchanges Act No. 9 of 1933), read together with the relaxations allowed and conditions imposed by the Authorised Dealer Manual. A 'loop structure' exists where capital (including equity, debt and any intellectual property right) is exported from South Africa by a South African exchange control resident through an investment in an entity in a jurisdiction outside the common monetary area (Lesotho, Namibia, South Africa and Swaziland), which entity then re-invests all or part of such capital into the common monetary area in the form of the acquisition of shares, loan accounts or another interest in a South African resident company or asset (South Africa, 1961; SARB, 2018:82). Oguttu (2011:89) argued that these 'other exchange control restrictive measures' may deter foreign multinational groups from setting up HQC's in South Africa, and compel such groups to base their regional headquarters in jurisdictions that have no exchange controls, such as Botswana and Mauritius. Whilst Oguttu's criticism may have been accurate at the time that it was expressed in 2011, HQC's are not currently considered to be residents for exchange control purposes. As stated above, section B.2(D) of the Authorised Dealer Manual confirms that '[HQC's] will be treated by the Financial Surveillance Department as non-resident companies'. It follows that HQC's themselves are not subject to the limitations in respect of 'loop structures' which are imposed on South African exchange control residents.

An HQC can invest in another company which is incorporated in a jurisdiction outside the common monetary area and such other company may then make investments into the common monetary area without the aforementioned investments giving rise to a 'loop structure' in the hands of the HQC itself (SARB, 2018:57; Oguttu, 2011:89). However, because investments made into HQC's are considered to be investments into non-resident companies, in circumstances where South African exchange control residents have made investments into an HQC which ultimately invests back into the common monetary area, a 'loop structure' would be created in the hands of such South African exchange control resident investors in such circumstances (SARB, 2018:57).

South Africa's exchange control regulations relating to loop structures have been gradually relaxed (SARB, s.a.), and South African companies are now permitted to acquire up to 40% of the shares and/or voting rights in a foreign company, which may in turn hold investments and/or make loans into any country in the common monetary area (SARB, 2018:51). Having said that, South African exchange control resident companies that invest in HQC's are still limited to holding a maximum of 20% of the shares in an HQC, due to the exchange control qualifying criteria for HQC's (SARB, 2018:57). For this reason, and due to the fact that a maximum of 20% of an HQC's assets may be South African assets (although it is not clear whether this percentage is calculated on the total cost, value or number of the HQC's assets), the effective percentage South African investments in the hands of South African exchange control resident companies that may be made via an HQC in a 'loop structure' is limited to 4% of the assets of the HQC (calculated as 20% of 20% - whether on the total cost, value or number of the assets of the HQC). Admittedly, this is a restriction on the South African exchange control investors who choose to invest in an HQC, and not a restriction on the HQC itself.

If all of the investors into the HQC itself are foreign investors (i.e. none of the investors are South African exchange control residents), the HQC may hold all (100%) of the shares in a company outside of the common monetary area, which makes investments and/or loans into the common monetary area (SARB, 2018:51). However, in order to remain compliant with the exchange control criteria for HQC's, the HQC in these circumstances would still be limited to a maximum of 20% South African assets (SARB, 2018:57). This significantly reduces the HQC's flexibility with regards to making use of investment opportunities as they arise. In this (limited) regard, Oguttu's (2011:89) warning that restrictions imposed by South African exchange control regulations may compel multinational groups to base their regional headquarters in jurisdictions that have no exchange controls (such as Botswana and Mauritius, to use Southern African examples) remains valid.

Multinational groups that want to enjoy the tax relief offered by the HQC regime without being subject to the limitations of South African exchange control regulations, still have the option to incorporate a regional headquarter company outside of the common monetary area, whilst ensuring that the company has its POEM in South Africa. Provided that the HQC qualifying criteria for tax purposes are met, this approach could allow the company to enjoy the tax relief offered by the HQC regime (Lessing, 2014).

3.5. Private equity funds cannot utilise an HQC as an investment vehicle

In South Africa, it is typical for private equity funds to take the legal form of an *en commandite* partnership, the day to day management of which is undertaken by a general partner, with the balance of the partners (the investors) being referred to as 'limited partners' (Manton, 2015:39). The general partner has unlimited liability for the debts of the partnership, whilst the liability of the limited partners is limited to the amount of their capital contributions, on the condition that they are not involved in the management of the partnership (Manton, 2015:39).

In terms of South African tax law, a partnership is not included in the definition of 'person' in the ITA and partnerships are not considered to be taxpayers in their own right (refer to the judgment in the case of *Sacks v CIR* 1946 AD 31, 13 SATC 343). Therefore, where investments are made through a partnership, the investors are taxed as if they own the investments directly, according to the proportion of each partner's interest in the partnership (income therefore effectively flows through the partnership, retains its character and is then taxed in the hands of each partner). This will also be the case with partnerships formed or established under foreign law, provided that such foreign partnerships are also fiscally transparent (that is, not subject to tax at entity level (Olivier & Honiball, 2011:172)). A further consequence of a partnership not being considered to be a taxpayer in its own right, is that it is not considered to be a resident for purposes of DTA's. However, if a partnership is not treated as being fiscally transparent in one of the countries which are party to a DTA, it will be entitled to DTA benefits, as it will be a resident of at least one of the countries that is party to the DTA (Olivier & Honiball, 2011:186).

In circumstances where a private equity fund takes the form of a partnership which is fiscally transparent in both the partner/investor's country of residence and the investment jurisdiction (where the investments are located), it is the partner/investor (as opposed to the partnership) that must claim the relief under the DTA between his country of tax residence and the country in which the underlying investment is located (the source country), to the extent that such a DTA is available (Olivier & Honiball, 2011:172; Newham & Beilings, 2017:10). Such a DTA may provide relief from withholding taxes levied by the source country. However, in circumstances where there is no DTA, as is the case between some African and European countries, there will be no relief from withholding taxes for the partner/investor in question, which will then be levied at the full domestic statutory rate on that partner/investor, resulting in a less attractive investment and possibly discouraging investors (Newham & Beilings, 2017:10). For example, if a South African private equity fund in the form of a partnership makes investments in other African countries with which South Africa has concluded DTA's and has both South African tax resident investors as well as investors that are tax resident in countries that have not concluded DTA's with the African investment countries, only the South African tax resident investors will be eligible to claim relief from double taxation in terms of the relevant DTA's. The investment then becomes less attractive for the investors that are not eligible to claim DTA relief and face taxation both in the African source country and their own countries of residence. Therefore, a private equity fund constituted as a fiscally transparent partnership may not always be equally attractive to all foreign investors, especially in circumstances where no DTA exists between a foreign investor's country of tax residence and the countries in which the underlying investments of the private equity fund are tax resident.

As an alternative to using a fiscally transparent partnership as a private equity investment vehicle, making use of an investment vehicle in the form of a juristic person which is subject to tax in its country of residence, and which is therefore eligible for DTA relief, can mitigate the aforementioned negative tax consequences. Such a structure could make use of an investment company and be effective where the country in which the investor is tax resident has concluded a DTA with the country in which the investment company is tax resident and, in turn, the latter country has concluded a DTA/DTA's with the country(ies) in which the underlying investments are located (Newham & Beilings, 2017:10).

South Africa has concluded DTA's with a considerable number of countries, including many countries in Africa and this 'network of [DTA's] provides ready access to other countries in the region' (National Treasury, 2010c:77). Newham and Beilings (2017:10) argue that South Africa is well-placed to facilitate investments in Africa, but are of the view that the country lacks an appropriate investment holding vehicle for certain foreign investors to invest through and that the HQC regime is not suited for this purpose. Their criticism is that the requirement for each shareholder in an HQC to hold a minimum of 10% of the equity shares and voting rights in the HQC disqualifies those investors that would normally have played the role of general partner (and assumed the fund management responsibility) in a private equity fund structured as a partnership, on the basis that the 'general partner will never hold at least … 10% of the interests in the partnership and therefore the underlying HQC' (Newham and Beilings, 2017:11).

The qualifying criteria for a company to be able to elect to be an HQC are clearly set out in section 9I of the ITA and require a minimum holding of 10% of the equity shares and voting rights in the prospective HQC. In order to evaluate the fairness of Newham and Beilings' criticism, the accuracy of the statement that a general partner will 'never hold at least a 10% of the interests in the partnership' must be evaluated. The original purpose of the 10% equity shareholding and voting rights threshold must also be considered.

Dauds (2008:10) states that the purpose of the general partner's co-investment with the limited partners (other investors) in the private equity fund is to align its interests with the interests of the investors. This is also confirmed by Baks and Benveniste (2010:8). Dauds (2008:10) further states that the required co-investment is typically between 1% and 2% of the fund's total capital. There has been a recent trend for limited partners to require general partners to make proportionately larger contributions to private equity funds (Stephenson & Philipova, 2015). In a recent study of trends in the private equity industry, Investec (2018) found that, as the sizes of funds grow, the size of the investment made by general partners is expected to increase. More specifically, Investec (2018) found that limited partners are no longer satisfied with a 1% to 2% investment from the management team and, instead, the average investment by general partners has increased to 3.3%. Therefore, notwithstanding the recent trend for general partners to make proportionately larger contributions to private equity funds, the contribution seems to remain far below the threshold in the HQC qualifying criteria which would require a general partner to hold a minimum of 10% of the equity shares and voting rights in an HQC.

The 10% equity shareholding and voting rights threshold was specifically designed to align with the threshold for the 'foreign participation exemption' (for foreign dividends, in section 10B of the ITA, and for capital gains determined in respect of the disposal of equity shares in foreign companies, in paragraph 64B of the Eighth Schedule to the ITA) (National Treasury and SARS, 2010:29; National Treasury, 2011:94). By way of example, where an HQC receives dividends from one of the Foreign Companies in which it invests and in which it holds at least 10% of the equity shares and voting rights (this type of investment should make up at least 80% of the cost of its total assets), such dividends will be exempt in terms of the 'foreign participation exemption'. National Treasury and SARS (National Treasury and SARS, 2010:31) hold the view that dividends from '[an HQC] should be placed on par with foreign company dividends because foreign subsidiary profits should act as the originating source of the bulk of the headquarter company profits'. For this reason, and in terms of section 10B of the ITA, dividends paid or declared by an HQC also constitute 'foreign dividends' for purposes of the 'foreign participation exemption'. Therefore, where the criteria for HQC status have been met, investors in the HQC would automatically also meet the shareholding criteria of the 'foreign participation exemption'.

Newham and Beilings' criticism of the HQC regime as being inappropriate as a private equity investment vehicle therefore appears to be only partially justified. It is true that general partners are effectively excluded from being investors in HQC's, as they 'will never hold at least … 10% of the interests in the … HQC'. However, lowering the equity shareholding and voting rights threshold in order to allow general partners of private equity funds to hold shares in an HQC, which will automatically allow them to enjoy the relief offered by the 'foreign participation exemption', appears to be incompatible with National Treasury's original policy rationale (which appears to acknowledge that the HQC should be able to function as a conduit for foreign dividends, in that, where the HQC meets the 10% equity shareholding and voting rights threshold with regards to its own investments, and an investor meets the same threshold with regards to its investment in the HQC, the investor should enjoy the 'foreign participation exemption' in respect of the dividends flowing from the Foreign Company through the HQC into the hands of that investor).

In essence, lowering the equity shareholding and voting rights threshold for general partners of private equity funds would give such general partners an advantage over other investors that appears not to have been contemplated by National Treasury (that is, if the investor would not have been able to enjoy the 'foreign participation exemption' if it had invested directly into the Foreign Company, it should not be able to do so when investing in an HQC). In this regard, it is worth noting, for comparative purposes, that the funds market in Mauritius acted as host to approximately 970 global funds in 2016, that Mauritian law allows such global funds to be structured, *inter alia*, as companies holding GBC1 licences and, unlike the qualifying criteria for the HQC regime, Mauritian law imposes no minimum shareholding requirement on the shareholders of a company applying for a GBC1 licence (Moller, 2018:283; Mauritius Financial Services Commission, 2013).

3.6. The limitation imposed by the HQC regime on the deduction of interest and royalty expenses negates the relaxation of the transfer pricing and thin capitalisation rules

As stated above in paragraph 2.2.3, a company which meets the qualifying criteria and elects to be an HQC for a specific year of assessment can benefit from a relaxation of South Africa's transfer pricing and thin capitalisation rules (in section 31 of the ITA). The ITA provides relief from these rules as they apply to the provision of debt finance and the licensing of intellectual property by a non-resident to an HQC in certain circumstances, as well as by an HQC to any foreign company in which the HQC holds at least 10% of the equity shares and voting rights (a Foreign Company).

However, the extent to which interest and royalty expenses incurred by an HQC can be deducted is subject to a limitation. Section 20C of the ITA provides that interest and royalty expenses incurred in respect of debt finance advanced to, and intellectual property licensed to, an HQC by a non-resident is only deductible to the extent of the interest income (in the case of interest expenses) or royalty income (in the case of the royalty expenses) accrued to or received by the HQC from Foreign Companies. Porter (2014:50) argues that this limitation on the deduction of interest and royalty expenses conflicts with the relaxation of the application of South Africa's transfer pricing and thin capitalisation rules and, in fact, 'does not provide relief in practice'.

One of the comments on the HQC regime received by National Treasury in 2010 (when the HQC regime was proposed) was that the proposed relief from the thin capitalisation rules is too narrow, partly because 'any losses resulting from the arrangement are ring-fenced' (National Treasury & SARS, 2010:31). National Treasury and SARS rejected this comment and stated that the HQC regime should not enable taxpayers to use excessive interest to eliminate otherwise taxable South African income (National Treasury & SARS, 2010:31). This rejection and the reason given therefore indicates that National Treasury had hoped (perhaps as a secondary objective) that HQC's would have taxable income in South Africa and that it did not want the HQC regime to be misused as a vehicle in which to create assessed losses, or in which otherwise taxable income (perhaps earned from services rendered by the HQC's to Foreign Companies – in this regard, refer to paragraph 3.3.1 above) could be eliminated. Had the limitation imposed on the deduction of interest and royalty expenses, as discussed above, not been imposed, South Africa's opportunity of earning corporate income tax revenue from HQC's would effectively have been aborted.

The limitation imposed as discussed in this paragraph, does not change the reality that the HQC regime's relaxation of the transfer pricing and thin capitalisation provisions means that there is no limitation on the amount of debt finance that can be advanced to the HQC and the interest rate that may be charged on the debt financed advanced, and no limitation on the royalty that may be charged to the HQC. The only limitation is that the amount of interest and royalty expenditure that may be deducted is limited to the interest and royalty income accrued to, or received by, the HQC from the Foreign Companies in which it invests. Irrespective of the risk attaching to the debt finance advanced by the HQC to a Foreign Company, or to the licensing of intellectual property by the HQC to a Foreign Company, the HQC is not required to make a margin on the on-lending or licensing of intellectual property (that is, there is no requirement for the interest and/or royalty income received by or accrued to the HQC to exceed the interest and/or royalty expense incurred by the HQC) (DTC, 2017b:91). In light of the above, Porter's criticism that the HQC regime's relaxation of the application of South Africa's transfer pricing and thin capitalisation rules 'does not provide relief in practice', appears to be unjustified.

It is, however, interesting to note the DTC's comments regarding section 23M of the ITA. Section 23M effectively constitutes a form of thin capitalisation provision which limits the amount of interest that can be deducted by a taxpayer in certain circumstances. The section applies to debts owed to a creditor that is in a 'controlling relationship' with the debtor when the amount of interest paid by the debtor is, *inter alia*, not subject to any tax imposed in terms of the ITA in the hands of the person to whom the interest accrues. The result of the application of section 23M is that the actual amount of interest allowed as a deduction will be limited to an amount determined in accordance with a prescribed formula.

The DTC (2017b:91) points out that, the current version of section 23M (introduced with effect from 1 January 2015), does not exclude HQC's from its scope. As a result, the section's limitation on the deductibility of interest expenses may arguably be applied to restrict an HQC's interest deduction, if all the requirements of the section are met. When the DTC issued its final report on 'Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances' in 2017, it stated that it was expected that section 23M will be amended to specifically exclude HQC's from its scope, as it was not the intention to subject the HQC to tax on interest earned from Foreign Companies (DTC, 2017b:91). Since the DTC's aforementioned comments, section 23M has not been amended. The contemplated amendment is also not contained as a proposed amendment in the draft Taxation Laws Amendment Bill, 2018 which was released for public comment on 16 July 2018 (National Treasury, 2018). The potential negative impact of the application of section 23M of the ITA to interest expenses incurred by an HQC is that, if the interest expenses incurred by the HQC match the interest income received by or accrued to the HQC, but are partially disallowed through the application of section 23M, the HQC will be left with taxable interest income in its hands, contrary to what was intended by National Treasury, which stated that only an HQC's South African profit should be taxed in South Africa and not the money flowing through the country (NCOP Finance, 2011).

3.7. The HQC regime is not successful as a regional development tool

Gutuza (2014:201) states that National Treasury's Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (and the media statement which accompanied it) states that 'the objective of the headquarter company is to the benefit the Southern African region'. Gutuza (2013b:100) also states that 'the purpose and motivation of the introduction of the HQC regime is stated as being linked to the development of Southern Africa through the company being a gateway into this region'. On the basis of the aforementioned statements, Gutuza (2014:201) criticises the design of the HQC regime by stating that the provisions in the ITA which delineate the HQC regime do not indicate the fact that the regime is aimed at benefiting Southern Africa specifically and that this 'non-limitation … [has] the result that the stated objective is not met'. Gutuza (2013b:100) adds that the fact that the ITA's provisions which delineate the HQC regime do not indicate that the regime is intended to benefit and develop Southern Africa 'does undermine the use of the [HQC regime] as a regional development tool'.

A careful review of National Treasury's various statements (as set out above in paragraphs 2.3.2 and 2.3.3) indicates that Gutuza's claims regarding the objective and purpose of the HQC regime appear to be inaccurate. Whilst National Treasury referred to South Africa as being, *inter alia*, an ideal launching point into the region, an ideal location for the establishment of regional holding companies by foreign multinationals and a natural holding company gateway into the region, it did not state that the HQC regime is aimed at benefitting or developing the Southern African region. Gutuza's criticisms therefore appear not to be justified. Furthermore, in circumstances where there is no clear indication that the HQC regime was ever intended to be a 'regional development tool', criticism against the regime for not limiting its benefits to investments made in Southern Africa can be considered to be unreasonable.

3.8. The HQC regime could lead to a loss of revenue for the South African fiscus

South Africa established the HQC regime based on a belief that the economic benefits arising from the attraction of investors through the regime would outweigh the potential loss of tax revenue to the country (Gutuza, 2013b:81). However, Mukumba (2017:4) argues that the HQC regime may have gravely negative fiscal consequences for the South African state, as it is foregoing potential revenue from the type of international transactions which it attracts. He adds that, due to the fact that HQC's are more akin to intermediate holding companies than true headquarter companies, they tend to carry out little physical activity in South Africa, resulting in limited returns for South Africa in the form of direct investment, which ultimately does not justify the loss of revenue brought about by the HQC regime (Mukumba, 2017:14).

The general idea that offering more tax incentives could result in a loss of revenue if the new incentives do not attract sufficient new investment to offset the tax revenue lost in offering the incentive is supported by Terhoeven (2011:20). Easson and Zolt (2002:11) posit that tax revenue losses also arise when tax incentives are offered to projects that would have been undertaken even if the tax incentive had not been offered – this results in a saving for the investor and no gain to the jurisdiction offering the tax incentive. In contrast, a jurisdiction suffers no real loss of tax revenue in respect of investments that would not have been made without tax incentives, in fact, such investments could bring about revenue gains to the extent that the investors/investments become regular taxpayers or generate other tax revenue (e.g. increased profits from suppliers or increased wage taxes from employees) (Easson & Zolt, 2002:11).

If the above logic from Easson and Zolt (2002:11) is followed, South Africa would only lose tax revenue through the HQC regime if there are foreign investors that planned to route debt or equity finance, or the licensing of intellectual property, through a South African tax resident company even in the absence of the HQC regime. It is difficult to see why a foreign investor would find the aforementioned course of action attractive (as it is likely to subject the investor to, *inter alia*, South Africa's controlled foreign company, transfer pricing and exchange control rules). Furthermore, the existence of a significant number of such investors would be incompatible with the need to create the HQC regime in the first place and would mean that the 'significant barriers' to South Africa acting as an 'ideal holding company jurisdiction', as listed by National Treasury in the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2010 (2010c:78), never truly existed. On the assumption that there are very few foreign investors that intended to take this course of action, and that the HQC regime is aimed at attracting new investments which would not otherwise have been routed through South Africa, the HQC regime should not give rise to any real loss of tax revenue for South Africa.

Furthermore, if (hypothetically speaking) there are foreign investors that, even in the absence of the HQC regime, intend to use South Africa as a base for the location of (true) regional headquarters, such investors would presumably attach significant weight to South Africa's infrastructure, financial system and the expertise and skills that its professional community is able to offer at comparatively affordable prices due to the weakness of the South African Rand (meaning that such investors are not merely pursuing preferential income tax rates on income from headquarter activities). In light of the fact that the HQC regime does not offer preferential income tax rates on any of the services typically rendered by true headquarter companies, it follows that the regime is unlikely to cause South Africa to lose tax revenue as far as those investors (that would have based regional headquarters in South Africa irrespective of the availability of the HQC regime) are concerned.

Whilst it is acknowledged that it is difficult to determine which investments are undertaken solely due to tax incentives and to estimate what the levels of investment would be in an economy as a whole, with or without specific tax incentives (Easson & Zolt, 2002:11), it appears that Mukumba's criticism as discussed in this paragraph is not fully justified.

3.9. Conclusion

The aim of this chapter was to analyse the most significant points of criticism against the HQC regime to date in order to determine whether the regime has inherent inadequacies. Not all the criticism considered was found to be valid and appropriate. The valid criticism against the HQC regime could have a significant impact on the regime's ability to achieve its policy objectives as identified in chapter 2.

It was found that the HQC regime's lack of preferential treatment of service income, and the lack of relief from South Africa's transfer pricing rules as far as fees charged for services rendered are concerned, constrain its ability to achieve the policy objectives determined in chapter 2. In this regard, it is recommended that National Treasury investigate whether the granting of preferential treatment to HQC's in the form of an exemption (or partial exemption), preferential tax rate or special tax credits applicable to service income, as well as transfer pricing relief applicable to services rendered by an HQC to the Foreign Companies in which it invests, could cause the HQC regime to be considered to be a harmful tax practice. This issue is discussed further in chapter 4.

This chapter also found that, subsequent to the repeal of section 6*quin* of the ITA, there is a lack of relief for HQC's in respect of foreign taxes suffered on income earned for services rendered by HQC's from South Africa (i.e. South African-sourced service income), which makes the rendering of services from South Africa less profitable and may impact the commercial viability of such services. It is acknowledged that the repeal of section 6*quin* also impacts other South African tax residents that render services from within South Africa to clients in African countries. The fact that certain African countries levy withholding taxes contrary to the provisions of South Africa's DTA's cannot be considered to be a flaw in the design of the HQC regime and is a problem that should be addressed by SARS through continuous engagement with foreign revenue authorities and the improved enforcement of SARS' rights in mutual agreement proceedings. However, the fact remains that the lack of relief for HQC's in the aforementioned circumstances could have a negative impact on the HQC regime's ability to achieve its policy objectives. On the assumption that certain African countries will continue, at least for the foreseeable future, to levy withholding taxes contrary to the provisions of a DTA, it is recommended that National Treasury consider inserting a mechanism similar to the repealed section 6*quin* foreign tax credit/rebate into the HQC regime. It must, however, be considered whether such a mechanism, created specifically for the

HQC regime, would make the HQC regime a harmful tax practice. This issue is discussed further in chapter 4.

This chapter further found that there is a fairly significant compliance burden on HQC's (and prospective HQC's). The compliance burden imposed on HQC's by SARS and the SARB can to some extent be justified from a risk and fiscal management point of view. The application of South Africa's exchange controls have been significantly relaxed as far as HQC's are concerned, but the requirement for HQC's to report to two different South African authorities (SARS and SARB) adds to their compliance burden. In order to reduce the compliance burden for HQC's, it is recommended that National Treasury consider aligning or combining the HQC regime's qualifying criteria for tax and exchange control purposes. In addition, consideration should be given to only requiring HQC's to report to SARS, with SARS then sharing the information obtained with the SARB.

This chapter also found that, in circumstances where, for fact specific reasons, a fiscally transparent partnership will not be a suitable vehicle for a private equity fund, an HQC is not an appropriate alternative. The reason for this is that general partners of private equity funds are effectively excluded from being investors in HQC's due to the fact they will typically not hold at least 10% of the equity shares and voting rights in the private equity fund. The result is that, where general partners seek an alternative vehicle to a fiscally transparent partnership, such as an investment company which enjoys similar 'flow-through' treatment, such general partners have to look to jurisdictions offering regimes which do not impose minimum shareholding and voting right thresholds (for example, the Mauritian Global Business Licence regime). This leads to certain of the policy objectives for the creation of the HQC regime being frustrated, for example, the attraction of investment and skilled employees, as well as the transfer of skills. The equity shareholding and voting rights threshold was, however, imposed in order to allow investors who meet the threshold to automatically also enjoy relief in terms of the 'foreign participation exemption'. It is recommended that National Treasury investigate whether an exception to the equity shareholding and voting rights threshold specifically for general partners (in private equity funds constituted as HQC's) could facilitate the achievement of the HQC regime's policy objectives and whether or not such an exception would be open to abuse. It must also be considered whether or not such an exception could be considered to be a harmful tax practice. This last mentioned issue will be discussed in chapter 4.

Lastly, this chapter found that the thin capitalisation type provisions contained in section 23M of the ITA could have the unintended consequence that interest intended to flow through an HQC is subjected to tax in South Africa. It is proposed that section 23M be amended to specifically exclude HQC's from its scope, which accords with the DTC's proposals.

In light of the findings in this chapter, it is submitted that the HQC regime currently has significant inherent inadequacies that are likely to hamper the achievement of the policy objectives identified in chapter 2, if they are not addressed. The most significant shortcomings are the lack of preferential treatment of service income, the lack of relief from South Africa's transfer pricing rules as far as fees charged for services rendered are concerned, the lack of relief for HQC's in respect of foreign taxes suffered on South African-sourced service income and the compliance burden on HQC's and prospective HQC's.

Recent developments in the international tax sphere could have an impact on the continued existence and feasibility of the HQC regime. Chapter 4 analyses these recent developments.

4. RECENT DEVELOPMENTS IN THE INTERNATIONAL TAX SPHERE

4.1. Introduction

The objective of this chapter is to analyse selected recent developments in the international tax sphere that could have an impact on the continued existence and feasibility of the HQC regime and to achieve secondary objective 3. Since the introduction of the HQC regime in 2011, there have been significant developments in the international tax sphere. In order to keep this study to a reasonable length, this chapter only considers selected recent developments, which were selected for consideration based on their potential to have an impact on the continued existence and feasibility of the HQC regime itself and their potential to have an impact on the type of transactions expected to be entered into by HQC's in general.

This chapter considers the OECD's work on harmful tax practices and Action 5 of the Action Plan on BEPS (Countering Harmful Tax Practices more Effectively, taking into account Transparency and Substance), Action 6 of the Action Plan on BEPS (Prevent Treaty (DTA) Abuse) and the implementation of the Action 6 minimum standard through the MLI, with specific focus on the preamble to DTA's, the PPT and the simplified LOB rule. The development of the 'beneficial ownership' concept is also considered in this chapter.

This chapter further briefly considers selected recommendations made in paragraph 3.9 above to address the HQC regime's inherent inadequacies (identified in chapter 3) that are likely to hamper the achievement of the policy objectives identified in chapter 2, if they are not addressed. The recommendations that are considered have been selected based on the fact that they will make the HQC regime even more preferential and could potentially cause the HQC regime to become 'actually harmful'.

4.2. Developments in the international tax sphere: the OECD BEPS Project

The OECD is a global economic policy forum, which provides analysis and advice to countries, aimed at improving lives (OECD, 2013c). As stated above in paragraph 1.2.3, the OECD has described itself as 'the linchpin of a major overhaul of the international tax architecture, whose aim is fighting against tax evasion, ending bank secrecy and tax havens, as well as addressing massive tax avoidance by multinational corporations' (OECD, s.a. b).

In 2013, the OECD released a report titled 'Addressing Base Erosion and Profit

Shifting' (the 'BEPS Report') in relation to a study commissioned by the G20 (OECD, 2013a; OECD, 2013c). The report found that the international principles for the sharing of taxing rights failed to keep pace with the changing business environment and that outdated rules allow multinational entities to 'exploit differences in domestic tax rules and international standards' in order to eliminate or significantly reduce taxation (OECD, 2013a). The report concluded that a comprehensive action plan should be developed which identifies not only appropriate responses, but also mechanisms to implement such responses in a streamlined manner (OECD, 2013a:8).

Pursuant to the BEPS Report, the OECD developed the 'Action Plan on BEPS' (OECD, 2013b). The Action Plan on BEPS acknowledged that globalisation and the changing nature of international trade and multinational enterprises have created opportunities for these enterprises to significantly reduce their tax burden (OECD, 2013b:7). As a result, many governments have less tax revenue and increased costs of compliance, and individuals and domestic businesses have to bear more than their fair share of the tax burden (OECD, 2013b:8). The Action Plan on BEPS further acknowledged that, international standards on which DTA's are based, and which allocate taxing rights between countries, have over time revealed certain weaknesses which expose countries to BEPS. BEPS is where, due to gaps in the interaction of different countries' tax systems, and in some cases because of the application of bilateral DTA's, income from cross-border activities is artificially shifted in order to not be taxed anywhere, or to be only unduly lowly taxed (OECD, 2013b:10).

The Action Plan on BEPS identified actions needed to address BEPS, set deadlines to implement these actions and identified the resources needed and the methodology to implement these actions (OECD, 2013b:11). With the publication of the Action Plan on BEPS, the BEPS Project was launched with the aim of rewriting international tax rules to align them with economic developments and to 'ensure that profits are taxed where economic activities are carried out and value is created' (OECD, 2015c:3). A total of fifteen actions were identified to address the weaknesses in international tax rules (OECD, 2013b). Four of the fifteen actions include minimum standards which have to be implemented in order to properly address BEPS concerns. The four actions which include minimum standards are Action 5 (Counter Harmful Tax Practices more Effectively, taking into account Transparency and Substance), Action 6 (Prevent Treaty (DTA) Abuse), Action 13 (Re-examine Transfer Pricing Documentation) and Action 14 (Make Dispute Resolution Mechanisms more Effective).

This study only focuses on Action 5 (Counter Harmful Tax Practices more Effectively, taking into account Transparency and Substance), Action 6 (Prevent Treaty (DTA) Abuse) and, to a lesser extent, Action 15 (Develop a Multilateral Instrument). Other actions in the Action Plan on BEPS address issues such as tax challenges of the digital economy, the neutralisation of the effects of hybrid mismatch arrangements, the strengthening of controlled foreign company rules and the limitation of base erosion via interest deductions and other financial payments (OECD, 2013b). The Action Plan on BEPS also includes actions which address the prevention of the artificial avoidance of permanent establishment status, ensuring that transfer pricing outcomes are in line with value creation, establishing methodologies to collect and analyse data on BEPS (and the actions to address BEPS) and the disclosure of aggressive tax planning arrangements (OECD, 2013b). Whilst it is acknowledged that these other actions are likely to have a general impact on tax law and the application thereof internationally (and may well affect a specific HQC depending on the transactions entered into by that HQC), Actions 5, 6 and 15 have been selected based on their potential to have an impact on the continued existence and feasibility of the HQC regime itself and their potential to have an impact on the type of transactions expected to be entered into by HQC's in general (as opposed to only affecting individual HQC's).

The final reports on each of the 15 actions were consolidated into what is referred to as the 'BEPS Package', which was accepted by the G20 leaders at their summit in Turkey during November 2015. South Africa is part of the G20 and former president Jacob Zuma attended the summit on behalf of South Africa (G20, s.a.). After the acceptance of the BEPS Package, the focus turned to the implementation thereof. In the official communiqué issued after the aforementioned summit, the G20 leaders requested the OECD to develop a framework for the monitoring of the global implementation of the BEPS Project, which involves, on an equal footing, all interested non-G20 countries and jurisdictions which commit to the implementation of the BEPS Project (G20, 2015). The framework that was developed is referred to as the 'Inclusive Framework on BEPS' (but will be referred to herein simply as the 'Inclusive Framework') and allows interested countries and jurisdictions to collaborate with OECD and G20 members in the development of standards on BEPS-related issues and monitoring mechanisms to monitor the implementation of the whole BEPS Package (OECD, 2017c:11; OECD, 2018b).

4.3. The potential impact of the BEPS Project on the HQC regime

South Africa is not a member of the OECD, but is a 'key partner' to the OECD which contributes to the OECD's work (OECD, s.a. c). Furthermore, South Africa is a 'BEPS Associate' country (G20 countries that are not OECD members participated as 'BEPS Associates' since the inception of the BEPS Project) and a member of the 2018-2019 steering committee of the Inclusive Framework (OECD, 2017c:11; OECD, 2018c). The OECD is of the view that the reports that comprise the BEPS Package are 'soft law instruments' that are 'not legally binding but there is an expectation that they will be implemented accordingly by countries that are part of the consensus' (OECD, 2018d). According to Steenkamp (2017:196), it is arguable that South Africa is to some extent bound to follow the Action Plan on BEPS, when regard is had to the fact that South Africa is a G20 member and that the OECD's recommendations have become a 'globally accepted standard'. The fact that South Africa is a key partner to the OECD and is also part of the current steering committee of the Inclusive Framework, lends further credibility to Steenkamp's statement.

In recognition of the importance of the BEPS Project, the DTC had a specific sub-committee for BEPS (DTC, 2017a:1). In November 2017, the DTC released its final report on BEPS, which provided recommendations on how South Africa can incorporate the BEPS Project's minimum standards and best practice guidelines into its international tax framework (DTC, 2017c:5). The DTC specifically stated that South Africa has to consider how its ambition to be a gateway for African investment fits into the context of the Action Plan on BEPS (DTC, 2017c:6). In regard to OECD recommendations which will require amendments to South Africa's DTA's in order to implement, the DTC stated that the 'costs and challenges of re-negotiating … treaties will be alleviated by signing the multilateral instrument that is recommended under Action 15 which will act as a simultaneous renegotiation of all tax treaties' (DTC, 2017c:46). The 'multilateral instrument' referred to by the DTC is the MLI, which is the product of Action 15 of the BEPS Project and the purpose of which is the swift implementation of the DTA-related BEPS measures. The MLI provides signatory countries with flexibility with respect to ways of meeting BEPS minimum standards, as well as the possibility to opt out of provisions which do not reflect a BEPS minimum standard (with the possibility to opt in later). Where there are multiple ways to address BEPS, the MLI allows signatories to apply optional provisions (OECD, 2016a).

South Africa signed the MLI on 7 June 2017 (OECD, 2018a). However, the MLI will only enter into force in South Africa on the first day of the month following the expiration of a period of three calendar months beginning on the date of the deposit of its instrument of ratification, acceptance or approval (OECD, 2017b). To date, South Africa has not deposited its instrument of ratification, acceptance or approval with the OECD (OECD, 2018a). Once the MLI enters into force in South Africa, it will amend the DTA's specifically listed by South Africa as being covered by the MLI ('covered DTA's') according to the position elected by South Africa in respect of each of the articles of the MLI, but only to the extent that the position elected matches that of the other country which is a party to that covered DTA (it follows that, in order for a DTA to be amended, the other party to the DTA must also have listed that DTA as being a covered DTA). The BEPS Project, and especially the MLI, may impact on the feasibility of the HQC regime. The MLI may amend certain DTA's to which South Africa is a party to such an extent that the relief enjoyed by HQC's may be negated (PwC, 2017b:6).

As at October 2018, 122 countries have joined the Inclusive Framework (a prerequisite of which is a commitment to implement the BEPS Package) (OECD, 2018e; OECD, 2018f). Furthermore, as at 27 September 2018, 84 countries had signed the MLI (OECD, 2018a). On the assumption that the implementation of the BEPS Package under the constant monitoring of the Inclusive Framework will be as successful as the BEPS Project itself, and that a significant number of countries will eventually implement the BEPS Package, the feasibility of the HQC regime could be impacted (OECD, 2015c:4). Paragraphs 4.4 and 4.5 will consider the potential impact of BEPS Actions 5 and 6, respectively.

4.4. Final report on Action 5: Countering Harmful Tax Practices more Effectively, taking into account Transparency and Substance

The OECD released its final report on Action 5 (Countering Harmful Tax Practices more Effectively, taking into account Transparency and Substance) (the 'Action 5 Report') during October 2015 (OECD, 2015a). One of the findings of the Forum on Harmful Tax Practices ('FHTP') of the OECD as recorded in the Action 5 Report, was that the HQC regime was 'potentially harmful but not actually harmful′ (OECD, 2015a:64). This section will consider the finding of the FHTP and the likely thought process applied by the FHTP, before briefly considering the other outcomes of the Action 5 Report, as well as subsequent related events.

4.4.1. **History of the OECD's work on harmful tax practices**

Action 5 of the Action Plan on BEPS and the OECD's work on harmful tax practices are not new. The OECD was requested to 'develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998' (OECD, 1998:3). As a result, the Committee on Fiscal Affairs of the OECD commenced a project on harmful tax competition which led to the OECD's 1998 report titled 'Harmful tax competition: an emerging global issue' (the '1998 Report') (OECD, 1998:3). The purpose of the 1998 Report was 'to develop a better understanding of how tax havens and harmful preferential tax regimes, collectively referred to as harmful tax practices, affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally' (OECD, 1998:8).

The 1998 Report acts as the basis for the OECD’s work on harmful tax practices (OECD, 2015a:11). It defined the factors to be used in identifying harmful tax practices and developed a framework for determining whether a regime is a 'harmful preferential regime' (OECD, 1998:3; OECD, 2015a:19). The 1998 Report further created the FHTP to conduct and progress the work on harmful tax practices (OECD, 2015a:11). The framework for determining whether a regime is a harmful preferential regime is divided into three distinct stages: First, it is considered whether the regime falls within the FHTP's scope of work and whether it is a preferential regime; second, if the regime is a preferential regime, the four 'key factors' and eight 'other factors' listed in the 1998 Report are considered to determine whether the regime is 'potentially harmful'; third, if the regime is potentially harmful, the economic effects of the regime are considered to determine whether the regime is 'actually harmful' (OECD, 2015a:19).

The scope of the 1998 Report only extends to regimes that apply to income from geographically mobile activities (for example financial and other service activities, including the licensing of intellectual property) and regimes that relate to the taxation of income from such activities. The work therefore largely focuses on business taxation (OECD, 2015a:19). For a regime to be preferential, it must offer tax treatment that is more preferential than that which is offered by the general principles of taxation of the country in question (OECD, 2015a:19). If a regime falls within the scope of the FHTP's work and is preferential, the enquiry progresses to the second stage of the framework.

In the second stage of the framework, four 'key factors' and eight 'other factors' are considered to determine whether the regime in question is potentially harmful (OECD, 2015a:20). The four key factors to identify harmful preferential tax regimes are that the regime imposes a low or zero effective tax rate on the relevant income, the regime is 'ring-fenced', the operation of the regime is not transparent and, lastly, the jurisdiction in which the regime operates does not effectively exchange information with other countries (OECD, 1998:25).

The enquiry for the second stage of the framework starts with the 'low or zero effective tax rate' factor, which is considered a 'gateway criterion' (OECD, 2015a:20). However, the enquiry must always take into account each of the key factors (OECD, 1998:25). The eight other factors should also be considered, but are considered as giving more meaning to the principles underlying the key factors themselves (OECD, 2015a:20). Where a low or zero effective tax rate and one or more of the remaining factors apply, a regime will be characterised as potentially harmful (OECD, 2015a:21).

The eight other factors are: an artificial definition of the tax base, a failure to adhere to international transfer pricing principles, an exemption of foreign-sourced income from tax in the country of residence, a negotiable tax rate or tax base, the existence of secrecy provisions, access to a wide network of tax treaties (DTA's), regimes which are promoted as tax minimisation vehicles and, lastly, regimes which encourage operations or arrangements that are purely tax-driven (OECD, 1998:30).

Stage three of the framework for determining whether a regime is a harmful preferential regime would entail an analysis of certain economic considerations to determine whether a preferential regime that is potentially harmful is 'actually harmful', i.e. that it has harmful economic effects (OECD, 1998:26; OECD, 2015a:21). The economic effects of a potentially harmful regime are assessed on the basis of three considerations: first, whether the tax regime shifts activity from one country to the country providing the preferential tax regime, rather than generate significant new activity; second, whether the presence and level of activities in the host country are commensurate with the amount of investment or income; and third, whether the preferential tax regime is the primary motivation for the location of an activity (OECD, 1998:34).

4.4.2. **Action 5 of the Action Plan on BEPS: Counter Harmful Tax Practices more Effectively, taking into account Transparency and Substance**

According to Herzfeld (2014), there is academic and political consensus that the OECD's harmful tax practices initiative launched in 1998 largely failed to accomplish what it set out to do. The fact that several OECD member countries developed programs to attract and retain (i.e. compete for) mobile income, after the release of the 1998 Report, is an exemplification of the initiative's failure (Herzfeld, 2014).

The BEPS Report asked for proposals for the development of 'solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance' (OECD, 2013a; OECD, 2013b:17). As a result, the Action Plan on BEPS (OECD, 2013b) required the FHTP to update and improve its work on harmful tax practices, with an emphasis on requiring substantial activity for any preferential regime and improved transparency (which includes the compulsory spontaneous exchange of rulings related to preferential regimes) (OECD, 2015a:23).

To give effect to the aforementioned, the Action 5 minimum standard is divided into two parts: a process for the review of preferential tax regimes to determine whether or not they are harmful, and a transparency framework applicable to tax rulings (the 'transparency framework') (OECD, 2017d:9).

4.4.3. **The process for the review of preferential regimes**

The Action 5 Report sets out the findings of the application of the original factors in the 1998 Report to the HQC regime, but does not set out how each factor was considered and applied (OECD, 2015a:10). At the time of release of the Action 5 Report, the 'substantial activity' factor had only been applied to intellectual property regimes, which does not include the HQC regime (the HQC regime is considered to be a 'non-intellectual property regime' – OECD, 2015a:64).

The OECD's 2017 'Progress report on preferential regimes' provides a helpful explanation of how a finding of 'potentially harmful but not actually harmful' is arrived at and emphasises that it is based on a two-step process (OECD, 2017a:33). As a first step, the laws that govern the regime are reviewed and it is concluded that the design of the regime creates the possibility that the regime may have a negative effect on the tax base of other jurisdictions (i.e. that it is potentially harmful). The second step considers whether or not, practically, the regime has a negative impact and answers this question in the negative, on the basis of available historical economic data (OECD, 2017a:33). This section considers how the FHTP could have applied the key factors and other factors to arrive at its finding that the HQC regime is 'potentially harmful but not actually harmful'.

4.4.3.1. *Key factors*

In considering the laws that govern the HQC regime, the FHTP would have considered the key factors set out in the 1998 Report. Firstly, the FHTP would have had to consider whether or not the HQC regime could give rise to a zero or low effective tax rate (OECD, 1998:26). In order for the HQC regime to have been found to be potentially harmful, as a minimum, the zero or low effective tax rates factor must have been found to be present (OECD, 2004:66). According to the 1998 Report (OECD, 1998:26), a zero or low effective tax rate can arise due to the tax rate itself being low or because of the way in which a country's tax base, to which the tax rate is applied, is defined. The HQC regime could conceivably give rise to a very low effective tax rate due to the fact that the dividends received by the HQC could be exempt and the interest and royalties received, whilst not exempt, could be matched by expenses in the form of interest and royalties paid to investors (in this regard, refer to paragraph 2.2.3 above). This is supported by Gutuza (2014:202) who argues that the tax treatment of the HQC is similar to that of a non-resident company whose tax liability is dependent on the source of its income being located in South Africa and has little South African-sourced income (and that the HQC is therefore a true conduit).

Secondly, the FHTP would have considered whether or not the HQC regime is ring-fenced (OECD, 1998:26). The 'ring-fencing' of a regime has the effect of protecting the 'sponsoring country' (South Africa, in the case of the HQC regime) from the harmful effects of its own regime, with the result that the regime only negatively affects the tax bases of other countries (OECD, 1998:26). Ring-fencing either restricts the benefits of the regime to non-residents, or explicitly or implicitly denies the investors (that benefit from the regime) access to the domestic markets of the sponsoring country (OECD, 1998:28). The aforementioned denial may either be explicit or *de facto* (by denying tax privileges if and to the extent that business is carried on in the regime's domestic market) (OECD, 1998:28). The 1998 Report states that 'there are good reasons for the international community to be concerned where regimes are partially or fully isolated from the domestic economy' (OECD, 1998:26). It therefore appears that partial 'ring-fencing' could be sufficient to be considered harmful.

The HQC regime does not exclude South African tax resident investors, although such investors are limited to a maximum of 20% of the shares of the HQC if the HQC wants to enjoy the available exchange control relief (which it would arguably require in order to properly fulfil its functions – in this regard, refer to paragraph 3.4.2 above). As a further example of partial ring-fencing, the HQC regime's qualifying criteria requires that at least 80% of the cost of the total assets of a prospective HQC must be attributable to one or more of the following types of assets, (i) any interest in equity shares in, (ii) any debt owed by, or (iii) any intellectual property licensed by the prospective HQC to, any foreign company in which the prospective HQC held at least 10% of the equity shares and voting rights (defined previously as a 'Foreign Company'). This requirement must generally be met at the end of the year of assessment for which the prospective HQC wishes to make an election, as well as all previous years of assessment.

Moreover, the OECD (2004:68) states that, as part of the ring-fencing analysis, it is important to determine whether transactions or activities outside of the domestic market are taxed more favourably than similar transactions or activities in the domestic market. In this regard, it must be mentioned that section 20C of the ITA is headed 'Ring-fencing of interest and royalties incurred by headquarter companies'. This section explicitly states that where interest and/or royalties are incurred by an HQC in respect of financial assistance granted to or intellectual property licensed to the HQC by a non-resident company (which holds at least 10% of the equity and voting rights in the HQC), the amount that may be claimed as a deduction for tax purposes by the HQC in respect of such interest or royalties, as the case may be, will be limited to the interest or royalties, as the case may be, earned from on-lending funds or licensing intellectual property to a Foreign Company in which the HQC invests. Accordingly, if the HQC were to on-lend such funds or license such intellectual property to South African tax resident borrower or licensees, it would be precluded from claiming a deduction in respect of the interest and royalties that it incurs in favour of its foreign investors. Therefore, it is arguable that the HQC's transactions outside the South African market are treated more favourably from a tax perspective than transactions in the South African market and, as a result, that the HQC regime is (at least partially) 'ring-fenced'. In addition, National Treasury has, on at least one occasion, stated in writing that '[an HQC] effectively operates partially outside of South African taxing jurisdiction' (National Treasury, 2011:95).

Thirdly, the FHTP would have considered whether or not the HQC regime lacks transparency (OECD, 1998:28). For sufficient transparency, the administration of the HQC regime should satisfy both of the following conditions: Firstly, it must clearly set out when the regime would apply and what the requirements for qualification are so that the requirements may be cited against the authorities (the criteria for qualification as an HQC are clearly set out in section 9I of the ITA); secondly, details of the regime must be available to the revenue authorities of other countries concerned (OECD, 1998:28). It is not clear what exactly the second condition contemplates. Foreign revenue authorities would certainly have access to section 9I of the ITA. Furthermore, South Africa is a party to the 'Multilateral Convention on Mutual Administrative Assistance in Tax Matters' (the 'Convention on MAATM') which would require the country, in terms of Article 4, to 'exchange any information that is foreseeably relevant for the administration or enforcement of … [the domestic laws of another country that is also party to the convention]' (South Africa, 2014:12). The Convention on MAATM entered into force in South Africa on 1 March 2014 and it is therefore reasonable to assume that the FHTP would have taken it into account in arriving at its finding regarding the HQC regime (South Africa, 2014:12). Due to the availability of access to the ITA, as well as the wide wording of Article 4 of the Convention on MAATM, it is not likely that the HQC regime would have been found to lack transparency.

As the last key factor to be considered, the FHTP would have considered whether or not the HQC regime evidences a lack of effective exchange of information (OECD, 1998:29). According to the OECD (1998:29), the ability or willingness of a country to provide information to other countries is a key consideration in determining whether a regime has the potential to cause harmful effects. As stated above, the Convention on MAATM entered into force in South Africa on 1 March 2014. As one would expect after considering its name, this convention provides for various forms of administrative assistance in tax matters, including (but not limited to), the exchange of information on request, the automatic exchange of information, the spontaneous exchange of information, and the performance of tax examinations abroad (South Africa, 2014:12). South Africa is also party to various tax information exchange agreements and has a fairly wide network of DTA's which also allows for the exchange of information (SARS, 2018b; SARS, 2018c). In addition, South Africa is also party to the Multilateral Competent Authority Agreement on the Automatic Exchange of Financial Account Information, which it signed on 23 October 2014 and which, according to the OECD (s.a. d) 'operationalises the automatic exchange of information under the [so-called Common Reporting Standard] on the basis of′ article 6 of the Convention on MAATM (South Africa, 2016:5). In light of South Africa's comprehensive legal framework for the exchange of information (much of which was already in place when the FHTP considered the HQC regime), it appears to be unlikely that the FHTP would have concluded that the HQC regime evidences a lack of effective exchange of information.

4.4.3.2. *Other factors*

As stated above, the other factors are considered to give further meaning to the key factors themselves. This section will only consider the other factors which had the potential to impact the FHTP's findings regarding the HQC regime.

An exemption of foreign-sourced income from tax in the country of residence could serve as an indicator that the regime may be harmful. According to the OECD (1998:32), if a country exempts all foreign-sourced income from tax, the regime is a territorial system and may be particularly attractive because the exemption reduces the effective income tax rate, which could encourage the location of activities in such country for tax rather than business purposes. Entities which take advantage of these regimes could be used as conduits or to engage in 'treaty shopping', and may therefore have harmful effects on the tax bases of other countries (OECD, 1998:32). The HQC regime does not exempt all foreign income (although it exempts some foreign income, like dividends), but the provisions of the HQC regime function in a way that income can flow through the HQC from the Foreign Companies in which the HQC invests to the HQC's investors, without the imposition of South African tax (Standing Committee on Finance, 2010). An HQC may therefore be used as a 'conduit' or to engage in 'treaty shopping' and may, as a result, have a harmful effect on the tax bases of other countries (Gutuza, 2014:202; OECD, 1998:32).

The fact that an HQC, as a tax resident of South Africa, has access to a wide network of DTA's (in this regard, refer to paragraph 3.5 in chapter 3 above) may also serve as an indicator that the HQC regime may be harmful (OECD, 1998:32). Lastly, the fact that the provisions in the ITA which delineate the HQC regime do not require 'substance' and that National Treasury (2013:69) itself has described HQC's as companies 'subject to tax relief so that funds can be derived from foreign subsidiaries and transferred onward without incurring a layer of South African tax when no value is added within South Africa', may serve as an indicator that the HQC regime encourages operations or arrangements that are purely tax-driven, and involve no substantial activities, which is a further indication that the regime may be harmful (OECD, 1998:32). This last mentioned other factor is the source of the elaborated 'substantial activity requirement', which has been escalated by the Action 5 Report to being the fifth key factor, but has not yet been applied to non-intellectual property regimes such as the HQC regime (OECD, 2015a:23).

4.4.3.3. *Economic considerations*

As stated above, once a preferential regime is found to be 'potentially harmful', certain economic considerations are analysed to determine whether the regime is 'actually harmful'. In order for a regime to be actually harmful, it must have harmful economic effects (OECD, 1998:26; OECD, 2015a:21). The FHTP's finding that the HQC regime is 'potentially harmful but not actually harmful' means that the HQC regime was found not to have harmful economic effects. However, the FHTP's finding in this regard is not a final conclusion as the statistical data, on which the finding was based, may change (OECD, 2017a:33). Accordingly, South Africa will be required to facilitate the FHTP's work of monitoring the HQC regime by collecting data and providing same to the FHTP annually, which will enable the FHTP to revisit its conclusion (OECD, 2017a:34).

4.4.4. **The 'transparency framework'**

The other, distinct aspect of the Action 5 Report relates to the so-called 'transparency framework', which is the minimum standard on the compulsory spontaneous exchange of information on tax rulings (OECD, s.a. e). The transparency framework is not a focus of this study and will not be discussed in any great detail. For current purposes, it will suffice to state that the first analysis of individual countries' progress in the implementation of the transparency framework was conducted in 2017 and that South Africa is regarded as having met all of the prescribed standards (OECD, s.a. e). The OECD has made no recommendations to South Africa as far as the transparency framework is concerned. An analysis of South Africa's legal framework for the exchange of information (including the spontaneous exchange of information) appears as part of the analysis of the key factors in paragraph 4.4.3 above.

4.4.5. **The 'substantial activity' factor**

The framework for determining whether a regime is a harmful preferential regime, as set out in the 1998 Report, contained a 'substantial activity' requirement as one of the other factors to consider, but provided limited guidance on the application of this factor (OECD, 1998). One of the priorities of Action 5 of the Action Plan on BEPS was that 'substantial activity' should be required for any preferential regime (OECD, 2013b:18). The Action 5 Report made it clear that the substantial activity factor must, going forward, be considered together with the key factors as part of the framework for determining whether a regime is a harmful preferential regime (OECD, 2015a:23).

As stated above in paragraph 4.4.3.2, the substantial activities analysis was not applied to non-intellectual property regimes as part of the work that led to the Action 5 Report. The FHTP acknowledged that further work is required to determine which non-intellectual property regimes should be reconsidered in light of the substantial activity factor (OECD, 2015a:64). The FHTP's intention was to continue its work of reconsidering non-intellectual property regimes in light of the substantial activity factor during 2018 (OECD, 2017a:23). Since the publication of the Action 5 Report, the FHTP has reviewed 164 preferential regimes, but it appears that the HQC regime has not yet been reconsidered (OECD, 2017a:11). The regimes that the FHTP has reviewed since publication of the Action 5 Report were brought to its attention either through self-identification by jurisdictions with preferential tax regimes or through identification by a peer jurisdiction that is a member of the Inclusive Framework (OECD, 2017a:13).

The OECD has settled on the 'nexus' approach for testing the substantial activity factor, in terms of which non-intellectual property regimes (such as the HQC regime) will meet the substantial activity requirement if they grant benefits only to qualifying taxpayers and only to the extent that those taxpayers undertake the 'core income generating activities required to produce the type of business income covered by the preferential regime'. According to the OECD, the determination of the 'core income generating activities' will depend on the type of regime (OECD, 2015a:37).

The HQC regime lends itself to the creation of companies in the nature of holding companies that hold a variety of assets and earn different streams of income, such as, for example, dividends, interest and royalties (Oguttu, 2011:90; Gutuza, 2014:191). The HQC regime provides relief, *inter alia*, from South Africa's transfer pricing rules in certain circumstances and relief from withholding taxes (in this regard, refer to paragraph 2.2.3 above), but does not specifically require the HQC to have any 'substance' in South Africa. The OECD (2015a:40) states that 'letter box' and 'brass plate' companies should not benefit from holding company regimes and that the term 'core income-generating activities' pre-supposes having an adequate number of full-time employees with appropriate qualifications and incurring an adequate amount of operating expenditures to undertake the activities generating the income which enjoys preferential tax treatment in terms of the relevant regime (OECD, 2017a:40).

The DTC released its final report on Action 5 of the Action Plan on BEPS as part of its larger BEPS report on 13 November 2017. It commented that the HQC regime is in fact a holding company regime which enables multinational companies to use South Africa as a conduit for the channelling of passive income flows and that the regime had not been successful 'from the angle of preserving the competitiveness of the economy' (DTC, 2017a:31). The DTC acknowledged that the HQC regime needs to be examined against the backdrop of the substantial activity factor and proposed that reforms to the regime should be considered to incorporate minimum levels of 'substance' to avoid the HQC regime being labelled as a harmful tax practice (DTC, 2017a:7).

4.4.6. **Synthesis**

The HQC regime was found not to be 'actually harmful' when it was reviewed by the FHTP as part of the work for the Action 5 Report. However, the FHTP's finding is not final and may be reviewed. The OECD recognises (2015a:21) that countries may apply defensive measures to protect their tax bases even in situations which do not involve harmful preferential regimes. Accordingly, other countries may still apply defensive measures against the HQC regime notwithstanding the fact that the HQC regime is currently not considered to be 'actually harmful'. In this regard, Action 6 of the Action Plan on BEPS (Preventing Treaty (DTA) Abuse) is relevant.

4.5. Final report on Action 6: Prevent Treaty (DTA) Abuse

The OECD released its final report on Action 6 of the Action Plan on BEPS (Prevent treaty (DTA) abuse) in October 2015 (the 'Action 6 Report') (OECD, 2015b). The purpose of this section is to consider selected outcomes of the Action 6 Report and the potential impact that such outcomes may have on the HQC regime. Prior to considering the selected outcomes of the Action 6 Report, this section will consider the OECD's work in relation to the prevention of treaty (DTA) abuse that preceded the Action 6 Report.

4.5.1. **Action 6 of the Action Plan on BEPS: Prevent Treaty (DTA) Abuse**

The OECD (2013b:18) stated in 2013 as part of the Action Plan on BEPS that the international tax rules in existence at that stage 'need to be adapted to prevent BEPS that results from the interactions among more than two countries and to fully account for global value chains'. Certain preferential regimes were being used 'to channel investments and intra-group financing from one country to another through conduit structures', which was not intended by the bilateral relationships between countries and therefore international tax rules must be updated to be able to address these structures (OECD, 2013b:18). The OECD recognised DTA abuse as one of the greatest sources of BEPS concerns (OECD, 2013b:18). Action 6 was developed to address such concerns and read as follows:

> 'Develop model [DTA] provisions and recommendations regarding the design of domestic rules to prevent the granting of [DTA] benefits in inappropriate circumstances. Work will also be done to clarify that [DTA's] are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a [DTA] with another country. The work will be co-ordinated with the work on hybrids.' (OECD, 2013b:19)

4.5.2. Rules introduced to address treaty (DTA) abuse – the Action 6 minimum standard

The Action 6 Report introduced new DTA anti-abuse rules which address 'treaty shopping' (OECD, 2015b:9). 'Treaty shopping' involves strategies through which a person who is not a resident of a country which is a party to a certain DTA attempts to obtain benefits granted by that DTA to residents of that country, for example by establishing a 'letterbox' or 'brass plate' company in the country in question (OECD, 2015b:9). A 'letterbox' company is a 'company that is formally incorporated and registered under the laws of a particular jurisdiction but that lacks any further business substance' (IBFD, s.a.). 'Treaty shopping' poses a significant risk to countries' tax revenues and, in light of this, countries taking part in the BEPS Project (including South Africa) have committed to a minimum standard of protection against 'treaty shopping' (OECD, 2015b:10).

The Action 6 'minimum standard' includes, firstly, an express statement that the countries that are party to a DTA intend to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion, including by way of 'treaty shopping' arrangements. This statement should generally be included as part of the preamble to the relevant DTA (the 'Preamble') (OECD, 2017e:11). Secondly, the minimum standard requires countries to implement the aforementioned intention by including one of the following in their DTA's: both the PPT rule and, either a detailed or a simplified version of, the so-called LOB rule; the PPT rule by itself; or the LOB rule supported by another mechanism able to deal with conduit financing arrangements that are not already addressed by the DTA (OECD, 2015b:10; 2016b:22; OECD, 2017e:11).

The LOB rule is a specific anti-abuse rule that aims to ensure that DTA benefits are only granted to entities that meet certain conditions which require a sufficient link between that entity and its country of tax residence (OECD, 2015b:9). The PPT rule refers to the 'principal purposes test' (defined in the list of acronyms and terms used), which is a more general anti-abuse rule that requires a consideration of the principal purposes of transactions or arrangements (OECD, 2015b:9).

As the standard set by the Action 6 Report constitutes one of the four BEPS minimum standards, it is also subject to peer review by all the members of the Inclusive Framework to ensure that it is implemented accurately and timeously (OECD, 2017e:9). South Africa is a member of the Inclusive Framework and has therefore also committed to implementing the Action 6 minimum standard.

The OECD released a document titled 'BEPS Action 6 on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Peer Review Documents' during May 2017 (the 'Action 6 Peer Review Documents') (OECD, 2017e). The Action 6 Peer Review Documents set out the methodology and terms of reference for the conduct of peer reviews of the implementation of the Action 6 minimum standard which was due to commence in 2018 (OECD, 2017e:9). The peer review process is intended to culminate in an annual report on the implementation of the minimum standard and the OECD's objective is for the first annual report to be published in time for the January 2019 meeting of the Inclusive Framework (OECD, 2017e:12). As the peer review process is confidential, no part of the draft report (sent to delegates of the OECD's Working Party 1 on Tax Conventions and Related Questions before 15 October 2018) has been made publicly available (OECD, 2017e:14).

4.5.3. **Implementation of the Action 6 minimum standard**

A country will only be required to satisfy the minimum standard if requested to do so by another country that has also made a commitment to satisfy the minimum standard (i.e. it is also a member of the Inclusive Framework) (OECD, 2015b:19; OECD, 2017e:11). The OECD acknowledges that policies and legal environments differ from country to country and, for this reason, the Action 6 Report affords countries a degree of flexibility as to how to implement the minimum standard (OECD, 2018d).

The Action 6 minimum standard contemplates the adoption and incorporation of rules into DTA's. The implementation of the Action 6 minimum standard therefore requires the amendment of a large number of DTA's. After publication of the final BEPS Package, the OECD and G20 countries urged its timely implementation (OECD, 2017b). However, if each DTA has to be individually renegotiated and amended, 'the sheer number of [DTA's] in effect may make such a process very lengthy' (OECD, 2013b:24). Against this backdrop, the MLI was developed to expedite the implementation of the measures set out in the BEPS Package through the modification bilateral DTA's (OECD, 2018d).

As stated above, in order to join the Inclusive Framework, a country must commit to the BEPS Package, which includes the Action 6 minimum standard on 'treaty shopping' (OECD, 2018f). As at the end of October 2018, the Inclusive Framework had 123 members (OECD, 2018e). However, the latest list of signatories to the MLI indicates that only 84 countries have, as at 27 September 2018, signed the MLI (with a further six countries expressing their intention to sign) (OECD, 2018a). It follows that, as at the end of October 2018, there are 39 countries that have committed to the BEPS Package, but currently do not intend implementing the DTA-related measures through the MLI. These countries will have to use alternative means to meet the DTA-related BEPS minimum standards, for example through the bilateral renegotiation and amendment of existing DTA's.

4.5.4. South Africa's stance on the Action 6 minimum standard

As stated above in paragraph 4.3, South Africa signed the MLI on 7 June 2017, but has not yet ratified the MLI (OECD, 2018a). 76 DTA's have been listed by South Africa as being covered by the MLI (defined earlier as 'covered DTA's') (National Treasury, 2017:2). For purposes of this study, it is assumed that South Africa will, in due course, ratify the MLI.

South Africa has not made a reservation for the Preamble wording prescribed by the minimum standard on 'treaty shopping' not to apply on the basis that a covered DTA already contains the required Preamble language. Accordingly, once the MLI comes into effect for both South Africa and its DTA partners, the Preamble will be included in each of South Africa's covered DTA's, either in substitution for the existing preamble wording, or in addition to the existing preamble wording (OECD, 2016a:8). In regard to the three options listed above in paragraph 4.5.2, South Africa's stated position is that the PPT will apply by itself (that is, not supported by any form of LOB rule) (National Treasury, 2017:27). South Africa has also not indicated that the PPT will merely be an interim measure and that it intends to, at a later stage, adopt an LOB rule, in addition to or in substitution for the PPT (OECD, 2016a:13; National Treasury, 2017:27).

The PPT will, in essence, apply by default to covered DTA's (PwC, 2018b:7). Where, for example, one country which is party to a DTA chooses to apply a simplified LOB rule and the other country does not, the simplified LOB rule would generally not apply, and instead, the PPT would apply by default between those two countries (Danon, 2018:40; OECD, 2016a:9; OECD, 2016b:24). The PPT will, however, not apply when a country has indicated that a specific covered DTA already contains wording similar to the PPT and has, on this basis, made a reservation for the PPT not to apply to those covered DTA's (OECD, 2016a:13; PwC, 2018b:7). Having said this, the MLI also allows a country that has chosen to apply the simplified LOB rule (together with the PPT) to make an election that the whole of article 7 of the MLI (which addresses the prevention of treaty abuse and is aimed at meeting the Action 6 minimum standard) will not apply in circumstances where the other country which is party to the covered DTA in question has not chosen to apply the simplified LOB rule (and instead chose to apply the PPT by itself) (OECD, 2016a:13; OECD, 2016b:24). In these circumstances, the countries that are party to the covered DTA in question would be required to enter into bilateral negotiations to find a mutually satisfactory solution which meets the minimum standard for the prevention of treaty abuse (OECD, 2016b:25).

In this regard, the MLI presents two methods, for countries that have not chosen to apply the simplified LOB rule, for removing the risk that the whole of Article 7 of the MLI will not apply to a covered DTA. Both of these methods essentially allow the country that has not chosen to apply the simplified LOB rule (and has chosen to apply the PPT by itself) to make an election that where the other country has chosen to apply the PPT in conjunction with the simplified LOB rule, the first-mentioned country will either also apply the simplified LOB rule in conjunction with the PPT, or allow the other country to apply the simplified LOB rule in conjunction with the PPT when deciding whether or not DTA benefits should be granted (notwithstanding the fact the first-mentioned country only applies the PPT) (OECD, 2016b:24). South Africa has not made the aforementioned election (National Treasury, 2017).

At the time of the first signing of the MLI (on 7 June 2017), all of the signatories chose to implement the PPT (KPMG, 2017; PwC, 2017a). Moreover, PwC (2018b:7) recorded that, based on its analysis as at May 2018, all of the signatories to the MLI had chosen to apply options involving the PPT (either the PPT by itself or the PPT together with a simplified LOB rule). Notwithstanding the fact that South Africa has not chosen to apply the simplified LOB rule, South Africa's stated position may still change prior to ratification of the MLI. This study therefore considers the potential impact on the HQC regime of the inclusion of the PPT, as well as the simplified LOB rule, in DTA's to which South Africa is a party. Due to the fact that a detailed LOB rule would require significant customisation through bilateral negotiations, the MLI did not include a detailed LOB rule (OECD, 2016b:22). It follows that detailed LOB rules may differ from DTA to DTA. In order to avoid excessive reliance on a hypothetical example of a detailed LOB rule, this study does not consider the potential impact of a detailed LOB rule on the HQC regime. Prior to considering the potential impact of the PPT and the simplified LOB rule, the potential impact of the Preamble on the HQC regime will be considered.

4.5.5. The potential impact of the Preamble on the HQC regime

Once the Preamble is inserted into South Africa's covered DTA's, whether in substitution for or in addition to the existing preamble wording, it will have to be taken into account in interpreting and applying the provisions of such DTA's (Danon, 2018:40; OECD, 2015b:92). This is because, the rules of interpretation of treaties (such as DTA's) in the Vienna Convention on the Law of Treaties (1969) (the 'Vienna Convention'), provide, *inter alia*, that a 'treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose', and that the context of a treaty includes its preamble. It is generally accepted that Articles 31 to 33 of the Vienna Convention, regarding the interpretation of international treaties, reflect customary international law and therefore apply to all treaties, whether or not the countries concerned are parties to the Vienna Convention (Mbengue, 2016; Aust, 2018). For example, South Africa is not a party to the Vienna Convention, but considers itself bound by its provisions (South African Department of International Relations and Cooperation, s.a.).

An amended, covered DTA will include the Preamble which specifically states that the intention of the countries that are party to the DTA is not to create opportunities for non-taxation or reduced taxation 'through treaty shopping arrangements aimed at obtaining reliefs provided in [the DTA] for the indirect benefit of residents of third States' (OECD, 2016a:8). The inclusion of this statement provides an increased scope for revenue authorities to attack transactions viewed as arrangements which abuse the provisions of a DTA (PwC, 2017b:5). The risk of the HQC regime encouraging 'treaty shopping' by persons who are not tax resident in South Africa, but want to enjoy the tax benefits of South Africa's DTA's, has been pointed out before (DTC, 2017b:92; Mukumba, 2017:17). Mohamed (2015:33) goes as far as to argue that if companies were to accept South Africa's invitation to establish HQC's in South Africa in order to invest in Africa and to benefit from South Africa's DTA's, such companies would be guilty of 'treaty shopping'. It can therefore reasonably be argued that, where an HQC makes an investment in a Foreign Company and the country of residence of the Foreign Company is of the view that the HQC is guilty of 'treaty shopping', the revenue authority of that country will take into account the Preamble in interpreting the provisions of the relevant DTA in considering whether or not the HQC is entitled to tax relief in terms of that DTA. Such a consideration of the Preamble by that revenue authority increases the risk of a denial of DTA benefits to the HQC. Danon (2018:40) argues, however, that the Preamble itself should not be used to deny DTA benefits beyond the scope of an applicable anti-avoidance provision in the DTA. Therefore, any denial of tax relief in terms of a DTA would need to take into account all the relevant facts and circumstances, as well as the provisions of the relevant anti-avoidance provision in the DTA, such as the PPT.

4.5.6. **The potential impact of the PPT on the HQC regime**

The PPT is worded as follows:

> 'Notwithstanding the other provisions of this [DTA], a benefit under this [DTA] shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this [DTA].' (OECD, 2016a:8).

According to the Action 6 Report and the 2017 version of the commentary on the OECD MTC, the term 'benefit' includes, *inter alia*, all limitations (for example, a tax reduction, exemption, deferral or refund) on taxation imposed on the state of source and, therefore, the PPT rule is potentially applicable to dividends, interest, royalties and capital gains (Danon, 2018:42; OECD, 2015b:56; OECD, 2017f:589). Accordingly, a limitation (in terms of DTA) on the withholding tax that may be imposed on dividends, interest or royalties by the foreign country in which the Foreign Company (in which the HQC invests) is located, is considered a benefit for purposes of the PPT. Similarly, an exemption from capital gains tax in terms of a

DTA in respect of the sale of an asset (for example shares in a Foreign Company) by an HQC would also be a benefit for purposes of the PPT.

An analysis of recent scholarly articles by Chand (2015), Kok (2016), Weber (2017) and Danon (2018) shows that the PPT consists of three smaller tests, namely the 'reasonableness test', the 'subjective test' and the 'objective test'. Weber (2017:49) submits that the wording 'it is reasonable to conclude, having regard to all relevant facts and circumstances' is a reasonableness test, which objectifies the subjective test (see below) by requiring an objective analysis of the objective facts and circumstances. The impact of this reasonableness test is that a revenue authority may not merely assume that obtaining a DTA benefit was one of the principal purposes of an arrangement, or merely look at the effects of the arrangement to conclude that one of the principal purposes of an arrangement was to obtain a DTA benefit (Weber, 2017:50; Kok, 2016:406).

The subjective test enquires whether obtaining the benefit was one of the principal purposes of an arrangement or transaction that resulted directly or indirectly in that benefit (Kok, 2016:407). By implication then, even if an arrangement has many principal purposes and obtaining a tax benefit was merely one of the principal purposes, the arrangement will satisfy the subjective test (OECD, 2015b:58; OECD, 2017f:591). Thus, by referring to 'one of the principal purposes', the OECD has provided for a low threshold for the abuse of a DTA, which makes it easier for a revenue authority to conclude that the subjective test is met (Chand, 2015:487; Kok, 2016:407; Danon, 2018:45). Taxpayers may seek relief on the basis of the objective test (Kok, 2016:412).

If it is found that one of the principal purposes of an arrangement or transaction that resulted in a DTA benefit was to obtain such benefit, then the DTA benefit will not be granted unless the objective test is met. In order for the objective test to be met, the taxpayer must establish that, 'granting the benefit … would be in accordance with the object and purpose of the relevant provisions′ of the DTA (OECD, 2016a:8; Kok, 2016:407). However, this presents a significant challenge to the taxpayer, as it is generally difficult to ascertain the object and purpose of a specific DTA provision (Kok, 2016:407; Danon, 2018:40). It does not follow that, once a taxpayer has met a DTA provision's beneficial ownership threshold, it is implied that the granting of DTA benefits would be in line with the object and purpose of the relevant DTA provision (Kok, 2016:412). Under the PPT, if the subjective test has been met and a taxpayer is unable to establish that granting the DTA benefit would be in accordance with the object and purpose of the relevant DTA provision(s), it will not satisfy the objective test and will, accordingly, not be able to claim the relevant DTA relief (Chand, 2015:487; Kok, 2016:407; Danon, 2018:40).

The PPT is controversial, as it transfers the burden of proof from the revenue authority to the taxpayer (Chand, 2015:488; Danon, 2018:42; Eckert & Rossat, 2017). The revenue authority's conclusion that the subjective test was met must merely be 'reasonable', but need not be convincing or beyond reasonable doubt (Chand, 2015:488; OECD, 2015b:55; OECD, 2017f:588). In contrast, the taxpayer is required to 'establish' (which is akin to proving convincingly) that granting the benefit is in accordance with the object and purpose of the relevant provisions of the DTA. The burden of proof is therefore unbalanced (Chand, 2015:488).

The HQC has been accused of acting as a conduit for the income that it receives from the Foreign Companies in which it invests, which it channels to its investors (Gutuza, 2013b:82; Gutuza, 2014:203; Mukumba, 2017:6, DTC, 2017a:31). The PPT applies to conduit arrangements, as illustrated by the examples set out in the 2017 version of the commentary on the OECD MTC (OECD, 2015b:59; OECD, 2017f:591; Danon, 2018:43). Accordingly, in circumstances where an HQC is utilised as a conduit, there is a real risk that a foreign revenue authority could invoke the PPT against the HQC, to deny it DTA benefits.

Weber (2017:57) argues that the PPT is broad in that it could potentially apply not only in the case of artificial arrangements, but also where there are true commercial reasons for a transaction, but they are outweighed by tax reasons. In contrast, Danon (2018:48) argues that the subjective test is not as wide as it appears and that the PPT is in fact 'substance oriented'. His view appears to be supported by what is stated at paragraph 181 of the commentary on article 29 in the 2017 version of the commentary on the OECD MTC: 'where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit' (OECD, 2017f:591).

The HQC regime specifically contemplates and provides relief in respect of financial assistance (in the form of a loan) by a foreign investor to an HQC, which is then on-lent by the HQC to a Foreign Company in which the HQC invests, as well as cases where intellectual property is licensed to the HQC by a foreign investor and then sub-licensed by the HQC to a Foreign Company in which the HQC invests (in this regard, refer to paragraph 2.2.3 above). Realistically and practically, the intention in such instances is for the interest and royalties received by the HQC from the Foreign Companies to be used to pay interest and royalties to the foreign investor.

There is thus a level of interdependence between the income received by the HQC and its expenses incurred in favour of its foreign investors. Danon (2018:50) is of the view that the PPT is not automatically triggered when there is an interdependence between two income streams. Even when an interdependence between two income streams is found to exist, it must still be determined whether obtaining a DTA benefit was one of the principal purposes of the arrangement or transaction and whether or not the transaction or arrangement is 'inextricably linked to a core commercial activity' (OECD, 2015b:58). By way of example, the PPT would typically apply where an arrangement is not linked to a core commercial activity, and was instead specifically structured to eliminate withholding tax that would otherwise have been payable to the state of source (Danon, 2018:50).

In the context of an HQC, it can be argued that, where an HQC is used as a mere conduit and has no real 'substance' in South Africa (for example, it incurs no significant expenses in South Africa, has an insufficient number of employees to fulfil the functions for which it is remunerated, does not have appropriate premises and is merely a so-called 'letterbox' or 'brass plate' company), its transactions would not be 'inextricably linked to a core commercial activity'. This would increase the risk of a foreign revenue authority invoking the PPT and reasonably concluding that obtaining a DTA benefit was one of the principal purposes of an arrangement or transaction entered into by the HQC and which resulted directly or indirectly in that benefit (i.e. that the subjective test was met). Bearing in mind the unbalanced burden of proof and the challenges faced by a taxpayer to meet the objective test, the HQC may struggle to prove that granting the DTA benefit would be 'in accordance with the object and purpose of the relevant provisions' of the DTA. The aforementioned statement is further supported by the fact that South African scholars, such as Mohamed (2015:33) and Mukumba (2017:17), and the DTC (2017b:92) have referred to the risk of the HQC regime being used for 'treaty shopping'. Moreover, National Treasury (2013:69) itself has described HQC's as 'companies subject to tax relief so that funds can be derived from foreign subsidiaries and transferred onward without incurring a layer of South African tax when no value is added within South Africa', which may be interpreted by a foreign revenue authority as an acknowledgement that the HQC has no 'substance', is used for 'treaty shopping' purposes and there are no cogent commercial reasons for the HQC to be interposed between the foreign subsidiary (Foreign Company) and the investor(s).

This study acknowledges that the answer to the question of whether or not the PPT can be successfully applied to an HQC will depend largely on how the HQC in question operates – that is, whether or not the specific HQC has a core commercial activity to which its arrangements and transactions can be inextricably linked.

This would be a factual enquiry and may differ from one HQC to another. It is further acknowledged that, if the PPT is successfully applied to deny an HQC a DTA benefit, this is more likely to be due to the operations (or lack thereof) of that specific HQC, than the design of the HQC regime itself.

It should be noted that it is unlikely that SARS would attack the relationship and transactions between the HQC and its investors, given that the South African government effectively invites such investors to make use of the HQC regime, by making the regime available in the ITA. The relationship and transactions that could be under threat of attack under the PPT is therefore the relationship and transactions between the HQC and the Foreign Companies in which it invests (the contemplated attack would be launched by the revenue authority of the country in which the specific Foreign Company is tax resident). In circumstances where an HQC has premises in South Africa, employs an appropriate number of employees who are also appropriately qualified for the functions that they fulfil (for example, the buying and selling of shares in Foreign Companies, the borrowing of funds from investors and on-lending of such funds to Foreign Companies, and the obtaining of licences for the use of intellectual property and the sub-licensing of such intellectual property to Foreign Companies) and incurs an appropriate amount of expenditure in fulfilling its functions, the HQC is likely to be considered to be carrying on a core commercial activity in South Africa. The income which the HQC receives and the DTA benefits which the HQC claims (for example, in the form of reduced withholding tax rates) should in these circumstances be considered as being linked to such core commercial activity. It is arguably unlikely that the PPT could be invoked to deny DTA benefits in respect of transactions between the HQC and the Foreign Companies in which it invests, in the aforementioned circumstances.

4.5.7. The potential impact of the simplified LOB rule on the HQC regime

The simplified LOB rule is set out in paragraphs 8 to 13 of article 7 of the MLI (OECD, 2016a:10; OECD, 2016b:24). The general rule and starting point of the simplified LOB rule is that, subject to certain exceptions, a resident of a country which is party to a covered DTA shall not be entitled to a benefit that it would otherwise be entitled to under that covered DTA, unless the resident in question is also a 'qualified person' at the time that the benefit is to be granted (OECD, 2016a:10).

A company would qualify as a 'qualified person' only if such company's 'principal class of shares is regularly traded on one or more recognised stock exchanges', if the company is a 'non-profit organisation of a type that is agreed to by the [countries that are party to the covered DTA] through an exchange of diplomatic notes' or if, on at least half of the days of a twelve-month period that includes the time when the benefit in question would be granted, other persons who are residents of the country in which the company is tax resident and are entitled to the benefits of the covered DTA, own (directly or indirectly) at least 50% of the shares of the company in question (OECD, 2016a:10).

A company that wishes to enjoy both South African tax and exchange control relief in its capacity as an HQC will therefore not qualify as a 'qualified person' in terms of the simplified LOB rule, as the exchange control criteria for qualification as an HQC provides that no more than 20% of the shares in the HQC may be held, directly or indirectly, by persons who are South African exchange control residents (in this regard, refer to paragraph 3.4.3 above). Furthermore, it is highly unlikely that an HQC would be a non-profit organisation and that an HQC's shares will ever be traded on a recognised stock exchange, as both the tax and exchange control criteria for qualification as an HQC state that each shareholder may hold no less than 10% of the equity shares and voting rights in an HQC (refer to paragraph 3.4.3 above), and the trading of shares on a stock exchange could lead to many different shareholders each holding a small interest in the HQC. It appears that the simplest way to enable an HQC to be a 'qualified person' would be to allow such HQC to have at least 50% South African tax and exchange control residents. Research regarding the SARB's exchange control policy is beyond the scope of this study. However, it is recommended that National Treasury and the SARB consider relaxing the aforementioned limitation to allow at least 50% of the shares of an HQC to be held by South African exchange control residents (no limitation on shareholding by South African tax residents is currently imposed).

The simplified LOB rule makes provision in certain circumstances for a resident of a country that is party to the covered DTA to be granted DTA benefits in circumstances where such resident is not a 'qualified person'. One such exception to the general rule states that a resident of a country that is party to the covered DTA will be granted DTA benefits 'if, on at least half of the days of any twelve-month period that includes the time when the benefit would otherwise be accorded, persons that are equivalent beneficiaries own, directly or indirectly, at least 75 per cent of the beneficial interests of the resident' (OECD, 2016a:11). An 'equivalent beneficiary' is any person who would be entitled to benefits in respect of an item of income, which benefits are granted by a country that is party to a covered DTA, in terms of the domestic law of that country, the covered DTA in question or any other international instrument, and which benefits are equal to or more favourable than the benefits that would be granted (to the resident that is the topic of the enquiry) in respect of that item of income in terms of the covered DTA in question (OECD, 2016a:12). Therefore, where an HQC invests in a Foreign Company and is not a 'qualified person' in terms of the covered DTA between South Africa and the country in which the Foreign Company is tax resident, but 75% or more of the HQC's beneficial interests (equity shares and voting rights) are held (and have so been held for at least half of the days of any twelve-month period, including the time when the DTA benefit is to be granted) by persons who are 'equivalent beneficiaries' (in that such persons themselves would be entitled to benefits in respect of the item of income in question that are equal to or more favourable than the benefits that the HQC would have enjoyed had it been a 'qualified person'), then the HQC will still be entitled to the DTA benefit in respect of the item of income in question. The circumstances in which the aforementioned exception will apply appear to be very fact-specific and exceptional. Where the HQC regime is used in order to benefit from South Africa's fairly wide network of DTA's, due to the fact that the countries in which the foreign investors (which invest in the HQC) are tax resident have not concluded DTA's with the countries in which the HQC ultimately invests, it may be unlikely that the HQC's foreign investors would qualify as 'equivalent beneficiaries'.

A further exception to the general rule in the simplified LOB rule, is that the resident will be entitled to DTA benefits in respect of an item of income which is derived from the other country which is a party to the covered DTA in question, irrespective of the fact that such resident is not a 'qualified person', 'if the resident is engaged in the active conduct of a business in [its country of tax residence], and the income derived from the other [country which is a party to the covered DTA] emanates from, or is incidental to, that business' (OECD, 2016a:11). In this regard, the term 'active conduct of a business' specifically excludes certain activities, as well as any combination of the specified activities. The excluded activities are holding company operations, the provision of supervision or administration services in a group of companies, the provision of group financing and cash pooling services, as well as the making or managing of investments (except when made or managed by a bank, insurance company or registered securities dealer acting in the ordinary course of its business) (OECD, 2016a:11). The activities that are specifically excluded from the term 'active conduct of a business' therefore cover many of the activities that an HQC may undertake (in this regard, refer to paragraph 2.5 above).

The exception discussed immediately above is limited even further in that, where the income which is derived by the resident from the other country is derived from a business activity that the resident carries on in the other country, or from a person connected to it in such other country, the 'active conduct of a business' requirement will only be considered to have been met where the resident in question carries on an activity in its country of tax residence which 'is substantial in relation to the same activity or a complementary business activity carried on by the resident or such connected person in the other [country which is a party to the covered DTA]' (OECD, 2016a:11). In simplified terms, two companies will be considered to be connected to each other, for purposes of the simplified LOB rule, where one owns, directly or indirectly, 50% or more of the aggregate vote and value of the other, or another person owns 50% or more of the aggregate vote and value of both companies (2016a:12). It follows that, for purposes of the exception currently under discussion, where an HQC derives income from a Foreign Company in which it invests, and there is a covered DTA in place between South Africa and the country in which the Foreign Company is tax resident, which includes a simplified LOB rule (and the HQC is not a 'qualified person'), then, in order to enjoy DTA benefits, the HQC will be required to conduct an active business in South Africa. Furthermore, if the HQC holds 50% or more of the aggregate vote and value of the Foreign Company, the active business of the HQC must also be 'substantial in relation to the … activity … carried on by the' Foreign Company in which the HQC invests. Foreign investors who establish an HQC to act as a mere conduit are unlikely to meet these thresholds in order for the HQC to be able to enjoy DTA benefits. It is further arguable that, even where an HQC does not act as a mere conduit, and instead has a substantial business, with premises, equipment and employees in South Africa, and incurs expenditure in South Africa, but only provides finance and supervision and administration services to its group of companies, it will not satisfy the 'active conduct of a business' requirement.

The last exception to the general rule in the simplified LOB rule, is that, in circumstances where none of the aforementioned exceptions apply to a resident of one of the countries which is party to a covered DTA, the 'competent authority' (as such term is defined in the relevant covered DTA) of the other country which is party to the covered DTA, may, nevertheless, grant the DTA benefit in question after taking into account the object and purpose of the covered DTA (which would include the Preamble as discussed in paragraph 4.5.5 above), but only if the resident can demonstrate to the satisfaction of the 'competent authority' that 'neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under the Covered [DTA]' (OECD, 2016a:11). The phrase 'one of its principal purposes' should arguably be interpreted in the same manner as the phrase 'one of the principal purposes' in the PPT is interpreted (refer to paragraph 4.5.6 above). Therefore, if an HQC were to rely on the last exception as discussed in this paragraph, it would arguably have to show that obtaining DTA benefits was not at all one of the purposes for 'its establishment, acquisition [and] maintenance, [and] the conduct of its operations', or, if it was, that it was not a 'principal purpose', which it would have to do by showing that its operations are 'inextricably linked to a core commercial activity' in South Africa. In circumstances where the HQC has already failed to qualify for any of the other exceptions to the general rule in the simplified LOB rule (which would, *inter alia*, mean that the HQC also does not conduct an active and substantial business in South Africa), it appears that it would also be difficult for it to qualify for the last exception.

4.6. The development of the 'beneficial ownership' concept

Danon (2018:55) argues that the fact that Action 6 of the Action Plan on BEPS does not refer to the 'beneficial ownership' concept and addresses conduit structures exclusively on the basis of the PPT rule (or another anti-conduit mechanism that would produce similar results), implies that conduit structures must, going forward, be addressed using the PPT (or a similar rule). However, if the PPT does not form part of a DTA, it follows that it cannot be used to attack a conduit structure in order to deny DTA benefits.

If a country has neither signed the MLI, nor joined the Inclusive Framework, that country has not made a commitment to implement the BEPS Package. DTA's between South Africa and such countries (which include countries such as Botswana, Mozambique, Tanzania, Uganda and Zimbabwe, to name a few African countries) would have to be amended through bilateral renegotiations before they can reflect any of the BEPS proposals (SARS, 2018c; OECD, 2018e). This would, presumably, be fairly difficult in circumstances where a country has no interest in the BEPS Package. For purposes of this section of the study, Malek's view (2018:72) that the 'beneficial ownership' concept remains the most commonly used 'anti-treaty shopping' rule and therefore many countries will continue to rely on the concept, is taken as appropriate. To the extent that such countries apply the 'beneficial ownership' concept to address conduit structures, their interpretation of the concept will determine the impact that it may have on an HQC which invests in those countries.

Many countries consider the 'beneficial ownership' concept (which was introduced in 1977 and forms part of the majority of DTA's concluded after that year) to be the original response to DTA abuse (Danon, 2018:32; Malek, 2018:10). The concept is construed in one of two ways: namely a broad, substance-over-form approach, or a narrower, formal and legal approach (Malek, 2018:67).

The Canadian case of *Prévost Car Inc. v. The Queen* 2008 T.C.C. 231. (the 'Prévost case') is an example of the formal interpretation (Danon, 2018:32). According to Malek (2018:48), the Prévost case was the first common law judgment that addressed the meaning of the 'beneficial ownership' concept. In the Prévost case, the court defined 'beneficial owner' (at paragraph 100) as:

> '… the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short, the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income …'

Therefore, a holding company (including an HQC) is not necessarily merely a conduit company and may well be the beneficial owner of the relevant income.

An example of the broader, substance-over-form approach is found in Swiss case law. According to Danon (2018:32), in considering whether or not 'beneficial ownership' exists, Swiss case law looks at economic control, with a focus on the criterion of interdependence between income and whether or not there is an obligation to transfer such income to non-residents. Swiss courts generally hold the view that a person does not have economic control over income received where all (or an essential portion) of the income is transferred to non-residents, in fulfilment of a legal or factual obligation (Danon, 2018:32).

4.6.1. Uncertainties raised by the 1977 and 2003 versions of the commentary on the OECD MTC

When the 'beneficial ownership' concept was introduced into the OECD MTC, it was aimed at denying DTA benefits to agents and nominees (Danon, 2018:34). However, the 1986 OECD report titled 'Double Taxation Conventions and the Use of Conduit Companies' (1986) led to amendments to the 2003 version of the commentary on articles 10, 11 and 12 of the OECD MTC which clarified that '[a] conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties' (OECD, 2003:145).

The 2003 version of the commentary on the OECD MTC caused further confusion by stating that the term 'beneficial ownership' should not be 'used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance' (OECD, 2003:145; Malek, 2018:10; Danon, 2018:34). Through the aforementioned amendments, the 'beneficial ownership' concept developed from the narrower, anti-abuse provision which it was originally considered to be, to a broader test (Malek, 2018:10).

4.6.2. Narrowing of the 'beneficial ownership' concept in the 2014 version of the commentary on the OECD MTC

Prior to the 2014 revision of the commentary on the OECD MTC, a discussion draft and its revised version were published by the OECD in 2011 and 2012, respectively (OECD, 2011; OECD, 2012). These discussion drafts played an important role in the development of the 'beneficial ownership' concept (Malek, 2018:12). The suggestions set out in the 2012 revised version of the discussion draft were carried through to the 2014 version of the commentary on the OECD MTC, save for minor changes (Malek, 2018:14). A newly introduced paragraph (added to the commentary on article 10) read as follows:

> 'In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividends is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person' (OECD, 2014:189).

The 2014 version of the commentary on the OECD MTC lowered the threshold for beneficial ownership, in that a recipient of income would only fail to qualify as the beneficial owner when the income received is passed on to another person due to the recipient being 'constrained by a contractual or legal obligation' to pass on the payment received to another person, which constraint is evidenced by legal documents or facts and circumstances (Danon, 2018:34). The 2014 version of the commentary on the OECD MTC further provided that 'this type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions…' (OECD, 2014:189). It follows that where the recipient of income uses such income to satisfy an obligation, which it was bound by irrespective of whether or not income is received with which to satisfy such obligation, that recipient should still qualify as the beneficial owner of the income received (Eckert & Rossat, 2017).

If the scholarly writings considered above are taken as accurate, it is reasonable to conclude that it would be easier to meet the criteria for beneficial ownership under the narrower, and more legal and formal, interpretation of the concept as set out in the 2014 version of the commentary on the OECD MTC, than would be the case under the broader interpretation facilitated by the 2003 version of the commentary on the OECD MTC. The narrower, more legal and formal interpretation of the 'beneficial ownership' concept is also followed in the 2017 version of the commentary on the OECD MTC (OECD, 2017f:234).

4.6.3. Impact of the 'beneficial ownership' concept on the HQC regime

According to the OECD, the OECD MTC 'is a model for countries concluding bilateral tax conventions, plays a crucial role in removing tax related barriers to cross border trade and investment' and 'is the basis for negotiation and application of bilateral tax treaties between countries, designed to assist business while helping to prevent tax evasion and avoidance' (OECD, 2017g). The 2017 version of the commentary on the OECD MTC states that 'the worldwide recognition of the provisions of the [MTC] and their incorporation into a majority of [DTA's] have helped make the Commentaries on the provisions of the [MTC] a widely-accepted guide to the interpretation and application of the provisions of existing [DTA's]. This has facilitated the interpretation and the enforcement of these [DTA's] along common lines' (OECD, 2017f:12). However, the OECD MTC and the commentary thereon are not legally binding instruments (Burt, 2017:15; OECD, 2017f:18).

The interpretation given to the 'beneficial owner' concept will, to some extent, depend on the interpretive approach that a country takes, that is, whether the country follows a static or an ambulatory approach to the interpretation of DTA's. In terms of the static approach, a DTA should be interpreted based on the intentions of the parties at the time it was entered into (Olivier & Honiball, 2011:301). Subsequent developments are considered irrelevant, as such developments could not have been considered by the parties at the time the DTA was concluded. In contrast, the ambulatory approach states that the law in place at the time that the DTA is to be applied must prevail (as opposed to the law in place at the time that the DTA was concluded) (Steenkamp, 2017:198). The OECD (2017f:20) holds the view that existing DTA's 'should, as far as possible, be interpreted in the spirit of the revised Commentaries' (i.e. in accordance with an ambulatory approach), but acknowledges that 'amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles'. Amongst academic writers, opinions are divided between the static and the ambulatory approach to the interpretation of DTA's (Steenkamp, 2017:202).

If an HQC earns passive income in the form of dividends, interest or royalties from a Foreign Company in which it invests, and uses such income to satisfy obligations owing to its (the HQC's) foreign investors, a denial of DTA benefits (in terms of a DTA that has not been amended to take into account DTA-related BEPS proposals), on the basis that the HQC is not the beneficial owner of the income, appears to be more likely under the broader, substance-over-form approach contemplated in the 2003 version of the commentary on the OECD MTC (currently followed in Switzerland) than under the narrower, more legal and formal approach advocated for under the 2014 and 2017 versions of the commentary on the OECD MTC (which is more aligned to Canadian case law such as the Prévost case). The aim of this section was not to determine whether the static or ambulatory approach is the correct approach to the interpretation of a DTA, or whether the broader, substance-over-form or narrower, formal and legal interpretation of the 'beneficial ownership' concept is the correct interpretation, but rather to point out the impact that different interpretations could have on an investment structure which utilises the HQC regime.

4.7. High level consideration of recommendations made to address the HQC regime's inherent inadequacies

The HQC regime, in its current form, was found to be 'potentially harmful but not actually harmful'. The recommendations made in chapter 3, were made in order to facilitate the achievement of the policy objectives identified in chapter 2. Of the recommendations made in chapter 3, the selected recommendations discussed below are likely to make the HQC regime more preferential. Accordingly, the selected recommendations will not merely add to the HQC regime's status as being potentially harmful, but instead could potentially cause the HQC regime to become 'actually harmful', by causing the HQC regime to have harmful economic effects (refer to paragraph 4.4.1 above).

As stated above in paragraph 4.4.1, the economic effects of a potentially harmful regime are assessed on the basis of three economic considerations. The potential impact of the selected recommendations made in paragraph 3.9 of chapter 3 will each be considered, taking into account the three economic considerations: First, whether the tax regime shifts activity from one country to the country providing the preferential tax regime, rather than generate significant new activity (the 'first consideration'); second, whether the presence and level of activities in the host country are commensurate with the amount of investment or income (the 'second consideration'); and third, whether the preferential tax regime is the primary motivation for the location of an activity (the 'third consideration') (OECD, 1998:34).

4.7.1. Granting of preferential treatment to HQC's in the form of an exemption, preferential tax rate or special tax credits applicable to service income

This recommendation may well shift activity from another country to South Africa, rather than generate significant new activity, as contemplated by the first consideration. However, this would depend on the facts of each case. This recommendation is likely to increase the presence and level of activities in South Africa, which means that the harmful effect contemplated in the second consideration is unlikely to realise.

In regard to the third consideration, it may be difficult for the FHTP to conclude that the HQC regime is the primary motivation for the location of activities in South Africa, as South Africa arguably has certain commercially advantageous characteristics (such as good infrastructure (compared to the rest of Africa), a fairly educated financial sector workforce and a respected banking system).

4.7.2. Inserting a mechanism similar to the repealed section 6*quin* rebate into the HQC regime

The comments regarding the three economic considerations set out in paragraph 4.7.1 immediately above, apply equally to this recommendation.

4.7.3. Exception to the equity shareholding and voting rights threshold specifically for general partners (in private equity funds constituted as HQC's)

As stated in paragraph 3.9 of chapter 3, it is recommended that National Treasury consider whether an exception to the threshold in question could facilitate the achievement of the HQC regime's policy objectives and whether or not such an exception would be open to abuse. This question is beyond the scope of this study and is distinguishable from the question of whether or not the insertion of the exception could cause the HQC regime to be 'actually harmful' on the basis that it has harmful economic effects.

The special exception for general partners could potentially shift activity from another country to South Africa, rather than generate significant new activity, as contemplated in the first consideration. However, this may depend on whether or not the general partners themselves are willing to be based in South Africa. If existing South African general partners make use of the contemplated exception, or if new general partners decide to establish themselves in South Africa and thereafter make use of the exception for newly constituted funds, it could be argued that activity is not shifted from another country and instead significant new activity is generated in South Africa.

Provided that the general partners that make use of the contemplated exception have sufficient 'substance' in South Africa, which may be required for the proper running of a private equity fund in any event (i.e. irrespective of whether the fund is constituted as a partnership or an HQC), the exception should not give rise to the harmful effect contemplated in the second consideration. However, it is acknowledged that the facts of each case would have to be considered, and the data obtained monitored, in order to determine whether the harmful effect contemplated in the second consideration arises or not.

The comments regarding the third consideration set out in paragraph 4.7.1 above, apply equally to this recommendation.

4.8. Conclusion: The role of 'substance'

Bennet (2012:83) concluded that requiring HQC's to have 'substance' in South Africa will ultimately lead to increased employment and the transfer of knowledge, in addition to boosting trade. More recently, the DTC (2017a:6) stated in its final report on Action 5 of the BEPS Project, that 'there is potential for substantial job creation and tax revenue to the Government in the form of VAT and employees’ tax from which South Africa would benefit, as long as it ensures that it complies with the OECD’s substance requirements'. This study concurs with Bennet's finding and the aforementioned statement made by the DTC.

This chapter found that 'substance' will remain critical for the successful utilisation of the HQC regime by individual HQC's. However, more importantly, 'substance' has also become critical for the continued existence of the regime itself. The 'substantial activity' factor has been elevated to a key factor in the determination of whether a preferential regime is potentially harmful. It may be argued that a finding by the FHTP of the OECD and the Inclusive Framework that the HQC regime grants tax relief even in circumstances where an HQC lacks substantial activity will not necessarily make matters worse, as the HQC regime is already considered to be 'potentially harmful' based on, it appears, the application of the 'low or no effective tax rate' and 'ring-fencing' criterions. However, as part of stage three of the framework for determining whether a regime is a harmful preferential regime, certain economic considerations have to be analysed in order to determine whether a potentially harmful regime is 'actually harmful' (OECD, 1998:26; OECD, 2015a:21). The second of the three economic considerations is whether the presence and level of activities in the host country are commensurate with the amount of investment or income (OECD, 1998:35). This consideration therefore looks at whether or not the entity which utilises the preferential regime has sufficient 'substance' in the sponsoring country (the country which offers the regime). In the context of the HQC regime, this consideration will therefore enquire into the 'substance' (or lack thereof) of the HQC in South Africa. It follows that, a finding that the HQC regime grants tax relief even in circumstances where an HQC lacks substantial activity could tip the scale in favour of a finding that the HQC regime is a preferential regime that is 'actually harmful'. Restricting access to the HQC regime to companies that comply with prescribed 'substance' requirements would go a long way in shielding the HQC regime from a finding that it is 'actually harmful'.

This chapter also found that, where it appears that an HQC may be exposed to a denial of DTA benefits on the basis of an application of the PPT, it is unlikely that an application of the PPT will succeed in circumstances where the transaction in question is 'inextricably linked to a core commercial activity'. Therefore, if an HQC is established in South Africa due to, for example, South Africa's infrastructure (for example, quality airports and respectable mobile network coverage), respected banking system, as well as access to services from educated individuals in South Africa's respected financial services industry at affordable prices due to the weak South African Rand, and such HQC has premises which houses its equipment and facilities which can accommodate the employees who fulfil its functions, it is unlikely that the PPT will be invoked against the HQC (or, if it is, that it will be successful). In summary, if an HQC has sufficient 'substance' in South Africa, it can enjoy a certain level of comfort that the DTA benefits which it claims will remain intact and safe from the PPT.

It was further found that the criteria set out in the simplified LOB rule that have to be met in order for a resident of a country (which is party to a covered DTA) to be able to enjoy benefits under the DTA in question, are fairly stringent and onerous. In light of the current criteria that have to be met in order for an HQC to enjoy exchange control relief, it appears unlikely that an HQC will be considered to be a 'qualified person' and be able to enjoy benefits under a covered DTA on that basis. It was recommended that National Treasury and the SARB consider relaxing the aforementioned exchange control criteria to allow at least 50% of the shares of an HQC to be held by South African tax and exchange control residents.

Furthermore, it was found that it would take a very specific set of facts and special set of circumstances for 75% or more of an HQC's shareholding and voting rights to be held by 'equivalent beneficiaries' and for an HQC to enjoy benefits under a covered DTA on that basis. An HQC would be able to enjoy benefits under a covered DTA which includes a simplified LOB rule (even if the HQC is not a 'qualified person') if it conducts an active, substantial business in South Africa. However, the term 'active conduct of a business' is very specific and specifically excludes many of the activities that an HQC would typically undertake. It is clear that holding company operations, supervision or administration services in a group context, group financing and cash pooling services, as well as the making or managing of investments, would not constitute the active conduct of a business (subject to certain exceptions). However, where an HQC continuously and regularly obtains licences for intellectual property and sub-licenses such intellectual property to the Foreign Companies in which it invests, such activities have not been specifically excluded and may constitute the 'active conduct of a business'. It is, however, acknowledged that the level of activity carried out by the HQC is likely to have an impact on the final determination. Further activities which could assist an HQC in its argument that it actively conducts a business in South Africa include, for example, the provision of legal, marketing, financial management and accounting services (provided that the services offered go beyond mere supervision and administration services).

Lastly, it was found that, where a country with which South Africa has concluded a DTA is not part of the Inclusive Framework and has not committed to the implementation of the BEPS Package, it is likely that such country will apply the 'beneficial ownership' concept in order to address what it perceives as 'treaty shopping' or other forms of DTA abuse. In these circumstances, and where an HQC consistently applies income received from a Foreign Company in such other country to meet obligations owing to foreign investors, it is not clear that 'substance' in South Africa will always protect an HQC from a denial of DTA benefits in circumstances where the other country applies the broader substance-over-form interpretation of the 'beneficial ownership' concept (in the way applied in Swiss case law). If, however, the narrower, formal and legal interpretation is followed by the other country, an HQC should not struggle to meet the 'beneficial ownership' threshold in respect of income received from the Foreign Companies in which it invests, provided that it does not have an obligation to transfer such income to its investors which is conditional upon the receipt of the relevant income from the Foreign Companies (i.e. the obligation must be certain and must exist irrespective of whether or not income is received from the Foreign Companies). In these circumstances, and if the HQC has possession, use, risk and control of the income received (as contemplated in the Prévost case), it should be regarded as the beneficial owner of such income. Irrespective of which interpretation of 'beneficial ownership' is followed, if an HQC has 'substance' (for example in the form of appropriate premises, appropriately qualified and experienced employees and expenditure to advance the carrying on of its activities) in South Africa, and is able to use all or part of the income received from the Foreign Companies in which it invests to pay for such premises, employees and other expenses, it is likely to greatly assist (if not guarantee) the HQC to meet the 'beneficial ownership' threshold.

In order to protect the HQC regime itself (from becoming an 'actually harmful' preferential regime), as well as the investors that make use of an HQC as part of an international investment structure (against potential denials of DTA benefits based on 'treaty shopping' or other allegations of DTA abuse), it is proposed that prescribed levels of 'substance' be inserted as a prerequisite for access to the HQC regime.

In regard to the recommendations considered in paragraph 4.7 above, it is further recommended that National Treasury and SARS consider the issues identified in greater detail and engage with the FHTP and the members of the Inclusive Framework to ascertain to what extent the recommendations could expose the HQC regime to the risk of being considered 'actually harmful'.

5. CONCLUSION

5.1. Introduction

South Africa considers a hospitable fiscal environment to be an important element of its endeavours to create an environment that will attract investment and facilitate trade. The HQC regime, which was introduced into the ITA with effect from 1 January 2011, forms part of the aforementioned fiscal environment.

Since inception, the HQC regime has had to compete with similar regimes in other jurisdictions. It has been said that the HQC regime has not been successful in preserving the competitiveness of the South African economy. Scholars have also criticised the HQC regime for being a conduit company and for increasing the likelihood of South Africa being used as part of 'treaty shopping' schemes. Recent developments in the international tax sphere, arising from the implementation of the outcomes of the BEPS Project, could have an impact on the continued existence and feasibility of the headquarter company regime. The impact that these recent developments could have on the headquarter company regime has not been addressed by previous studies.

Against the aforementioned background, the problem statement for this study was formulated as follows (refer to paragraph 1.4.1):

> 'Recent developments in the sphere of international tax, such as the BEPS Project, and especially the MLI, could potentially have a significant impact on the continued existence and feasibility of the HQC regime. As stated above, the MLI may amend certain DTA's to which South Africa is a party to such an extent that the relief enjoyed by HQC's may be negated.'

This study sought to determine, in light of the existing criticism of the headquarter company regime and recent international developments, whether the headquarter company regime still has a role to play in South African tax law and, if so, to determine which aspects of the HQC regime require revision. In order to achieve this main objective, which also served as the research question for the study, the following secondary objectives were set: first, to provide an overview of the development of the HQC regime to date and to determine the policy reasons for the creation of the HQC regime; second, to analyse the most significant points of criticism against the HQC regime to date in order to determine whether the regime has inherent inadequacies; and third, to analyse selected recent developments in the international tax sphere that could have an impact on the continued existence and feasibility of the HQC regime (refer to paragraph 1.5.2).

The findings of each of the secondary objectives are discussed below, with reference to the previous chapters.

5.2. Chapter 2: Policy reasons for the creation of the HQC regime

The objective of this chapter was to provide an overview of the development of the HQC regime to date and to determine the policy reasons for the creation of the HQC regime. The purpose of this chapter was to achieve secondary objective 1, which it did through a consideration of the development of the HQC regime, the objectives of the HQC regime as stated by the South African government and the objectives of selected developing countries with the creation of similar regimes.

The HQC regime arguably arose from early statements made by the Margo and Katz Commissions that South Africa should encourage inputs of expertise and capital by multinational companies and that encouraging the formation of international corporate headquarters and holding companies in South Africa will be advantageous to the economy. The HQC regime has been amended on various occasions to improve its functioning (refer to paragraph 2.6).

As far as the design and objectives of the HQC regime are concerned, National Treasury spoke on behalf of the South African government. It is difficult to ascertain from National Treasury's statements what exactly the intended role of an HQC and the HQC regime was. National Treasury's statements provide little indication of the specific benefits that the South African government seeks to derive from the HQC regime. This lack of clarity necessitated a consideration of the objectives of other developing countries in creating similar regimes in order to gain an understanding of the policy reasons for, and intended benefits of, such regimes, as well as the HQC regime. Selected regimes in Botswana, Mauritius, Thailand and Singapore were considered. The research found that the selected regimes in these countries were created as part of larger economic diversification plans to protect the economy, by reducing the reliance on specific industries, ensuring sustainable economic growth and growing the skills base in the relevant country to enable it to compete in the region in which it is located. The qualifying criteria for the regimes considered generally reflect these objectives and expected benefits (refer to paragraph 2.4.6).

South Africa has stated that it wants to be the 'gateway into Africa', but the policy reasons for (and intended benefits of) the HQC regime are not clear from the HQC regime's qualifying criteria, unlike the regimes of the other developing countries that have been considered above. The HQC regime forms part of the hospitable fiscal environment that South Africa seeks to create in order to attract investment and facilitate trade, to import and retain skills, and eventually contribute to economic activity in the country, as contemplated by the Margo and Katz Commissions. It was established that the HQC was intended to act as a flow-through for foreign investment and that the HQC remains more of an intermediate holding company than a true headquarter company. Whilst it may have been hoped that the HQC regime would create jobs for a number of professionals, large-scale job creation was not a policy reason for the creation of the HQC regime (refer to paragraph 2.5).

This chapter achieved secondary objective 1 by considering the development of the HQC regime and concluding that the regime was intended to attract investment (albeit that a limited amount of the investment was intended to remain in South Africa itself), attract and retain skilled employees and facilitate the transfer of skills to the South African workforce, boost the local economy by increasing the demand for local goods and services and, ultimately, to increase tax revenue (more so from the increased activity in the local economy than from HQC's themselves) (refer to paragraph 2.5).

5.3. Chapter 3: Existing criticism of the HQC regime

In the re-evaluation of the HQC regime, the selected recent international developments (which were analysed in chapter 4) could not be analysed in a vacuum. In light of this, the objective of this chapter was to analyse the existing criticism of the HQC regime in order to determine whether it has inherent inadequacies and to achieve secondary objective 2. It was determined that not all the criticism considered is valid and appropriate. However, the criticism that was found to be valid could have a significant impact on the regime's ability to achieve its policy objectives as identified in chapter 2.

The HQC regime's lack of preferential treatment of service income, and the lack of relief from South Africa's transfer pricing rules as far as fees charged for services rendered are concerned, constrain its ability to achieve the policy objectives determined in chapter 2 (refer to paragraph 3.9). In this regard, it was recommended that National Treasury investigate to what extent the granting of preferential treatment to HQC's in the form of an exemption, preferential tax rate or special tax credits applicable to service income, as well as transfer pricing relief applicable to services rendered by an HQC to the Foreign Companies in which it invests, will facilitate the achievement of the HQC regime's policy objectives.

This chapter also found that there is a lack of relief for HQC's in respect of foreign taxes suffered on South African-sourced service income, which makes the rendering of services from South Africa less profitable and may impact the commercial viability of such services. This lack of relief could have a negative impact on the HQC regime's ability to achieve its policy objectives, as identified in chapter 2 (refer to paragraph 3.9). It was recommended that National Treasury consider inserting a mechanism similar to the repealed section 6quin foreign tax credit/rebate into the HQC regime.

There is a fairly significant compliance burden on HQC's (and prospective HQC's). The requirement for HQC's to report to two different South African authorities (SARS and the SARB) adds to their compliance burden (refer to paragraph 3.9). It was recommended that National Treasury consider aligning or combining the HQC regime's qualifying criteria for tax and exchange control purposes. In addition, consideration should be given to only requiring HQC's to report to SARS, with SARS then sharing the information obtained with the SARB.

It was established that, in circumstances where, a fiscally transparent partnership will not be a suitable vehicle for a private equity fund, an HQC is currently not an appropriate alternative. This leads to certain of the policy objectives for the creation of the HQC regime being frustrated, including, for example, the attraction of investment and skilled employees, as well as the transfer of skills (refer to paragraph 3.9). It was recommended that National Treasury investigate whether an exception to the equity shareholding and voting rights threshold specifically for general partners (in private equity funds constituted as HQC's) could facilitate the achievement of the HQC regime's policy objectives and whether or not such an exception would be open to abuse.

The thin capitalisation type provisions contained in section 23M of the ITA could have the unintended consequence that interest intended to 'flow through' an HQC is subjected to tax in South Africa (refer to paragraph 3.9). It was proposed that section 23M be amended to specifically exclude HQC's from its scope, which accords with the DTC's proposals.

This chapter achieved secondary objective 2, by determining that the HQC regime currently has significant inherent inadequacies that are likely to hamper the achievement of the policy objectives identified in chapter 2 (and as part of secondary objective 1), if they are not addressed. The recommendations made in this chapter, if implemented, are likely to make the HQC regime more attractive to investors that want to establish true headquarter companies in South Africa (as opposed to intermediate holding companies) and to make having 'substance' in South Africa more commercially viable.

5.4. Chapter 4: Recent developments in the international tax sphere

After gaining an understanding of the policy reasons for the HQC regime's creation (in chapter 2) and shortcomings in its design (chapter 3), the objective of this chapter was to analyse selected recent developments in the international tax sphere that could have an impact on the continued existence and feasibility of the HQC regime, and to achieve secondary objective 3.

The HQC regime was reviewed by the FHTP of the OECD and found to be 'potentially harmful but not actually harmful'. However, the HQC regime has not yet been tested against the 'substantial activity' factor, the importance of which has been elevated by Action 5 of the BEPS Project. A finding that the HQC regime grants tax relief even in circumstances where an HQC lacks 'substantial activity' could tip the scale in favour of a finding that the HQC regime is a preferential regime that is 'actually harmful'. It was recommended that access to the HQC regime be restricted to companies that comply with prescribed 'substance' requirements in order to shield the HQC regime from a finding that it is 'actually harmful' (refer to paragraph 4.8).

This chapter found that an HQC which has sufficient 'substance' in South Africa can enjoy a certain level of comfort that the DTA benefits which it claims will remain intact and safe from the PPT and that it is unlikely that an application of the PPT will succeed in circumstances where the HQC's transactions are "inextricably linked to a core commercial activity" (which could be the case if the HQC has sufficient 'substance' in South Africa) (refer to paragraph 4.8).

The criteria set out in the simplified LOB rule that have to be met in order for a resident of a country (which is party to a covered DTA) to be able to enjoy benefits under the DTA in question, were found to be stringent and onerous. In light of the current exchange control criteria for qualification as an HQC, it appears unlikely that an HQC will be considered to be a 'qualified person' and be able to enjoy benefits under a covered DTA on that basis. It was recommended that National Treasury and the SARB consider relaxing the exchange control criteria for qualification as an HQC to allow at least 50% of the shares of an HQC to be held by South African tax and exchange control residents. It was further found that, notwithstanding the fact that an HQC is not a 'qualified person', it would still be able to enjoy benefits under a covered DTA which, includes a simplified LOB rule, if it conducts an active, substantial business in South Africa (refer to paragraph 4.8).

This chapter also established that, irrespective of which interpretation of 'beneficial ownership' is followed, if an HQC has 'substance' in South Africa, and is able to use all or part of the income received from the Foreign Companies in which it invests, to pay for, for example, its premises, employees and other expenses, it is likely to greatly assist (if not guarantee) the HQC to meet the 'beneficial ownership' threshold (which is a pre-requisite for certain DTA benefits) (refer to paragraph 4.8).

This chapter achieved secondary objective 3 by establishing that recent developments in the international tax sphere could have an adverse effect on the continued existence and feasibility of the HQC regime, in its current form. A requirement to have prescribed levels of 'substance' in South Africa will not only have a positive effect on the success of the HQC regime (by facilitating the achievement of the policy objectives identified in chapter 2), but has also become essential for the survival of the HQC regime in the current international tax climate.

5.5. Suggestions for further research

It was recommended in paragraph 4.5.7 that National Treasury and the SARB should consider relaxing the exchange control criteria for qualification as an HQC to allow at least 50% of the shares of an HQC to be held by South African exchange control residents (no limitation is currently imposed on shareholding by South African tax residents), so as to allow HQC's to meet the 'qualified person' threshold in the simplified LOB rule. As this study was performed in partial fulfilment of the requirements for the degree 'Masters of Commerce in Taxation', it could not consider South African exchange control policy in detail. A consideration of the policy reasons for the difference between tax and exchange control qualifying criteria for HQC status is a potential topic for further research. In addition, it is suggested that further research consider if, and to what extent, the recommended relaxation will facilitate the achievement of the policy objectives for the HQC regime or clash with National Treasury and the SARB's tax and exchange control policy in general.

The recommendations considered above in paragraph 4.7 could only be considered at a high level. It is suggested that further research consider the recommendations in greater detail by, for example, comparing the recommendations to elements of other non-intellectual property regimes that have been found to be 'actually harmful' and have been requested by the FHTP and the Inclusive Framework to be abolished or amended (as published in the OECD's report titled 'Harmful Tax Practices - 2017 Progress Report on Preferential Regimes' (OECD, 2017a)).

5.6. Answer to research question and achievement of main objective

This study sought to determine, in light of the existing criticism of the headquarter company regime and recent international developments, whether the headquarter company regime still has a role to play in South African tax law and, if so, to determine which aspects of the HQC regime require revision. This main objective also served as the research question for the study.

In light of the conclusions reached above in respect of each secondary objective, it is concluded that the HQC regime still has a role to play in South African tax law. The policy reasons for the creation of the HQC regime have not changed and the HQC regime has not yet achieved its objectives. However, certain aspects of the HQC regime require revision to enable the HQC regime to play the role for which it was created and to ensure the survival of the regime in the current international tax climate.

The main aspects which require revision include the need for the preferential treatment of service income, relief from South Africa's transfer pricing rules as far as fees charged for services rendered are concerned and relief in the form of a tax credit/rebate in respect of foreign taxes suffered on South African-sourced service income. In addition, the compliance burden on HQC's and prospective HQC's should be lessened to make the regime more attractive for investors. Lastly, prescribed levels of 'substance' should be inserted as a pre-requisite for access to the HQC regime.

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