

# The residence definition within the framework of the headquarter company regime in the context of investment into Africa

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Mini-dissertation submitted in partial fulfilment of the requirements for the degree *Magister Commercii* in South African and International Taxation at the Potchefstroom Campus of the North-West University

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November 2013

## **ACKNOWLEDGEMENT**

I would like to take this opportunity to give thanks to my heavenly Father for the talents and abilities with which He has blessed me and which allowed me to complete my studies and this mini-dissertation.

Secondly, I would like to thank my supervisor, Professor Karina Coetzee, for all her guidance and encouragement throughout the completion of my mini-dissertation. Thank you to Alwina Brand for her insight and encouragement and Sakeenah Jacobs for her assistance during the performance of my research.

Finally I would like to thank my friends and family, specifically my parents and grandparents, for all their encouragement and patience throughout the completion of my studies. You have been pillars of strength to me when times got tough. I am forever grateful.

## ABSTRACT

Since the declaration of South Africa as the *Gateway to Africa* in 2010 by National Treasury, various changes have been made to South African legislation to make South Africa more attractive to foreign investors looking to expand their operations into Africa. The headquarter company regime was introduced with the purpose to provide a base from which these investments may be managed.

From a tax perspective this regime eliminates or reduces specific taxes or rates of taxes for companies who elect to be classified as headquarter companies, provided that certain requirements are met. These requirements refer specifically to investments in qualifying foreign companies. The reference to foreign companies inevitably requires that the *resident* definition be considered.

In South Africa residence of a person other than a natural person is the place where the company is incorporated, formed or established or the *place of effective management* which is a term subject to various interpretations. Regardless of the differences, all the interpretations refer to a senior level of management. Foreign incorporated companies with their *place of effective management* in South Africa are excluded from the definition should they qualify as controlled foreign companies with foreign business establishments subject to a high level of tax if the *place of effective management* is disregarded.

The lack of skills in African countries as a product of shortfalls in the quality of education result in challenges to establish appropriately skilled management teams in these countries. When a centralised management team is set up at the headquarter company in South Africa the African subsidiaries risk being *resident* in South Africa and therefore the structure would not qualify for the benefits of the headquarter company regime.

Further challenges arise when the exclusion to the *resident* definition is applied as shares held by a headquarter company are disregarded when the controlled foreign company status of the subsidiaries are determined. Therefore it is recommended that the headquarter company legislation be changed to correspond with successful regimes such as the Luxembourg and the Netherlands in that it does not only apply to foreign investment. It is further recommend that the *resident* definition be changed to exclude from the *place of effective management* test group structures that would comply with section 9I should the test be disregarded.

Key words:

- African skills;
- Controlled foreign company;
- Foreign business establishment;
- Foreign company;
- Gateway to Africa;
- Headquarter company regime;
- Holding company;
- Place of effective management;
- Tax resident.

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# CHAPTER 1 INTRODUCTION

## 1.1 INTRODUCTION AND BACKGROUND

All through history, tax has played an important role in the economy. The first taxes can be traced back to Ancient Egypt 3000BC, when farmers paid taxes to the Pharaoh (University of Pennsylvania, 2002:1). Taxation and tax law has come a long way since then, but it is as relevant and important to economies as ever.

Today, with businesses spanning across borders, income is taxed when there is a connection between the income and the country. The connection can be based on “residence jurisdiction” or “source jurisdiction”. Countries do not limit themselves to either one, but rather use a combination of the two to ensure residents are taxed on worldwide income and non-residents are taxed on income from a deemed source in the specific country. (Olivier & Honiball, 2011:9-10.)

The use of different bases of taxation in different countries results in instances where income is taxable in two countries. International double taxation can be the result of countries levying tax on the same tax basis or one country taxing the income based on residence and the other based on source. (Olivier & Honiball, 2011:10.)

Therefore, with the globalisation of economies and increased trade activities across borders it has become imperative for a country to have a clear definition of residence and deemed source income. This ensures transparency and effectiveness of their tax system.

Currently the South African Income Tax Act no. 58 of 1962 (“the Income Tax Act”) makes use of “residence jurisdiction” with incorporation of elements of “source jurisdiction”. All natural persons and persons other than natural persons that are residents based on the *resident* definition as per the Income Tax Act are taxable on worldwide income and persons not residents as defined are taxed on South African deemed source income. (The Income Tax Act, section 1.)

In order to curb the effect of international double taxation for persons regarded as residents of both South Africa and another state, South Africa has in numerous instances concluded double taxation agreements with those other states (Mosupa, 2003:178). South Africa has double

taxation agreements with over 70 countries of which 22 are countries within Africa. In instances where the application of domestic law results in a company being resident in both states, the tie-breaker rule pertaining to the double taxation agreement is used to determine the place of residence. (SARS, 2013a; SARS, 2013b.)

In the majority of double taxation agreements concluded between South Africa and other African countries the tie-breaker rule stipulates that the company will be regarded as resident of the country in which *place of effective management* is situated. In two of the 22 double taxation agreements, the tie-breaker is *place of management and control*. In only three of the double taxation agreements it is up to the competent authorities to settle the issue by mutual agreement. The table below is a complete list of double taxation agreements with African countries per the SARS website and the tie-breakers incorporated therein. (SARS, 2013a; Luker, 2010:90-92.)

Table 1.1: Tie-breaker rules concluded with African countries

<b>Country</b>	<b>Tie-breaker rule</b>
Algeria	Place of effective management
Botswana	To be settled by mutual agreement between the competent authorities
Democratic Republic of Congo	Place of effective management
Egypt	Place of effective management
Ethiopia	Place of effective management
Ghana	Place of effective management
Lesotho	Place of effective management
Malawi	Place of effective management
Mauritius	Place of effective management
Mozambique	Place of effective management
Namibia	Place of effective management
Nigeria	To be settled by mutual agreement between the competent authorities
Rwanda	Place of effective management
Seychelles	Place of effective management
Seychelles Protocol	Place of effective management
Sierra Leone	Place of effective management
Swaziland	Place of effective management
Tanzania	Place of effective management
Tunisia	Place of management and control
Uganda	To be settled by mutual agreement between the competent authorities

Zambia	Place of management and control
Zimbabwe	Place of effective management

The tie-breaker links to the second test of the *resident* definition. For the purposes of the study the *place of effective management* test, along with the exclusion to the *resident* definition will be investigated. The possible existence of a double taxation agreement would thus not have an impact on the results of the aspects being investigated.

The focus of the mini-dissertation will fall on the *resident* definition as defined by the Income Tax Act for persons other than natural persons. The definition refers to two separate tests through which tax residency can be determined.

The “resident” definition for corporate entities is defined in section 1 of the Income Tax Act as any person, excluding a natural person, which is incorporated, established or formed in South Africa or has its place of effective management in South Africa. This definition excludes specifically any person that is deemed by any double taxation agreement between the government of South Africa and another country to be exclusively a resident of such other country. (The Income Tax Act, section 1.)

As of 1 January 2013 an exclusion was incorporated into the definition. This exclusion provides for exclusion from the *resident* definition of companies who are *resident* based on the *place of effective management* test, but would comply with the following requirements if *place of effective management* is disregarded:

- The company would be a controlled foreign company with a foreign business establishment as defined in section 9D of the Income Tax Act; and
- The aggregate amount of tax payable within any tax year by the company in any other country other than South Africa would amount to a minimum of 75 per cent of the normal tax that the company would have paid in South Africa had it been a resident.<sup>1</sup> (The Income Tax Act, section 1.)

From the above definition it is evident that there are two aspects that determine residence in South Africa:

- place of incorporation, establishment or formation; or
- place of effective management.

For the purpose of determining residence, place of incorporation, establishment or formation is a question of fact and therefore fairly easy to determine. Determining the *place of effective management* can prove more challenging.

As guideline, SARS issued Income Tax Interpretation Note No 6 (“the interpretation note”) on 26 March 2002. This delineates the interpretation by SARS of *place of effective management*. The general approach as per the interpretation note is that *place of effective management* is the place where the company is managed on a regular or day-to-day basis by the 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.)

This interpretation is not shared by the Organisation for Economic Co-operation and Development (OECD). In the OECD’s Model Tax Convention on Income and on Capital, the term *resident* is defined in Article 4. In this article it is determined that where a person other than an individual is found to be a resident of both contracting states, the person is deemed to be resident of the State in which the *place of effective management* is situated. *Place of effective management* is not defined in Article 4, but in paragraph 3, sub-paragraph 24 of the OECD’s Commentary on Article 4. According to the commentary, the *place of effective management* is the place where “key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made”. (OECD, 2010a: C(4)-8.)

Until recently, the uncertainty arising from this difference has not been addressed in South African courts. In *The Oceanic Trust Co.Ltd N.O. v CSARS* (2011) judgment in this regard was not passed but the concept *place of effective management* was considered by the court. In the court’s consideration, they turned to the judgment delivered in *Commissioner for Her Majesty’s Revenue and Customs v Smallwood and Anor* (2010) EWCA Civ 778, on 8 July 2010. The principle of *place of effective management* as defined in the Smallwood case is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. This is in line with the commentary as set out by the OECD’s Model Tax Convention. (OECD, 2010a:90.) The court did not even consider the interpretation of SARS.

This gives an indication of what the South African court regards as the *place of effective management*. This interpretation can affect the outcome of future cases where dual residency is

contested and therefore this interpretation is relevant in the context of the meaning of *place of effective management* for South African tax purposes.

Both of these interpretations require a certain level of management. The interpretation note makes reference to three tiers of management:

- central management and control carried out by the board of directors;
- executive directors and senior managers, executing and implementing policies and strategic decisions; and
- carrying out of the day-to-day activities of the business. (SARS, 2002:3; Olivier & Honiball, 2011:25.)

While the interpretation note focuses on executive directors and senior managers, the OECD focuses on the board of directors. In both instances, the level of management requires management skills.

Currently there are significant shortages in Africa of management and specialised skills. An increase in the use of expatriate staff is expected over the next few years to bridge the gap. Companies would have to work strategically with the resources available to ensure success in growing businesses across Africa. (Maritz, 2012:1.) The dissertation will investigate the effect this has on the setting up of management structures and inevitably on the determination of residence for companies within these countries.

## **1.2 MOTIVATION FOR CHOOSING THIS TOPIC**

In 2010 National Treasury proposed an initiative to encourage global diversification from a domestic base, called *Gateway to Africa*. This initiative is focused on creating a legal and regulatory framework in South Africa that is more attractive to foreign investors “seeking to leverage South Africa’s infrastructure and skills base as a means of investing in the rest of the continent”. (National Treasury, 2010b:1.)

As part of this initiative, the headquarter company regime was introduced. The purpose was for headquarter companies that meet the requirements as per the Income Tax Act to enjoy certain tax benefits. These benefits include exemption from income tax on dividends received and dividends declared, are exempt from dividends withholding tax. The controlled foreign company

rules as set out in section 9D are not applied to the foreign subsidiaries and certain thin capitalisation and transfer pricing rules from and to the headquarter companies are relaxed. (Honiball & Kiloran, 2011b:30.)

In a discussion paper issued by SARS in September 2011, Discussion paper on Interpretation note 6 Place of Effective Management (“the discussion paper”), it was noted that the current legislation around headquarter companies provide these tax benefits to make the concept of headquarter companies more appealing to foreign investors. (SARS, 2011:2.)

The concern though does not relate to the headquarter company, but rather the foreign subsidiary. These subsidiaries risk being regarded as residents of the Republic, based on the *place of effective management* test in terms of both the current South African income tax law and the OECD’s model tax convention. (SARS, 2011:2.)

Should the foreign subsidiary be considered to be a tax resident for South African tax purposes, it would mitigate many of the benefits offered by the headquarter company regime. The foreign subsidiary will be required to compute its taxable income under South African tax law and then claim a rebate for taxes already paid in the other country. The foreign subsidiary will also be required to withhold dividend’s tax on any dividends declared. (Charalambous, 2011:1.)

The focus of the research would therefore be on the interplay between the headquarter company legislation and the *resident* definition on the backdrop of conditions present in African countries.

### **1.3 PROBLEM STATEMENT**

From the above, the following problem statement can be derived: Is the application of the *resident* definition appropriate within the context of the current headquarter company regime, specifically as it relates to investment into Africa?

## 1.4 OBJECTIVES

### 1.4.1 Main Objective

To determine whether the application of the term *resident* as defined in the South African Income Tax Act no. 58 of 1962 concerning persons other than natural persons, is appropriate in the concept of the headquarter company regime given the unique circumstances in African countries.

### 1.4.2 Secondary Objectives

The completion of the following secondary objectives will lead to the achievement of the main objective stated above:

- i) Obtain a basic understanding of the purpose behind the introduction of the headquarter company regime in South African tax legislation (chapter 2).
- ii) Obtain a basic understanding of the economic conditions present in South Africa compared to Africa (chapter 2).
- iii) Analyse the elements of an ideal holding and headquarter company regime (chapter 3).
- iv) Investigate the legislation implemented by selected countries that have successfully incorporated headquarter company regimes into their tax legislation. The investigation will focus on the elements incorporated into their legislation, what it aims to achieve and how this links with the concept of residence (chapter 3).
- v) Analyse and compare the South African headquarter company regime to these successful regimes to ascertain the difference (chapter 3).
- vi) Investigate the methods used in South Africa to determine residence and to summarise the different meanings of *place of effective management* with a focus on the word "management" and the different levels of management (chapter 4).
- vii) Investigate the exclusion to residence as incorporated into the Income Tax Act and the different elements that should apply for the exclusion to be in effect (chapter 5).
- viii) Apply the different elements of the legislation investigated to practical examples and determine the effect on the qualification of a structure for application of the headquarter company regime (chapter 6).
- ix) Draw a conclusion on the interplay between all the elements investigated and identify possible solutions (chapter 6).

- x) To conclude, recommendations will be made based on the results of the research performed in the achievement of the objectives set out above (chapter 7).

## **1.5 RESEARCH METHOD**

In the development of a research methodology, the ontological view of this study is based on an objective reality. As the main focus of this study is on legislation currently enacted, a realist approach will be followed.

The application of this legislation in various circumstances will ultimately yield the results that will answer the problem statement. Therefore from this epistemological view the legal research paradigm will be followed. A doctrinal study will be performed with the inclusion of a qualitative literature review of various books, academic journals, court cases and other published works.

The following countries will be analysed in the performance of the literature review:

- Luxembourg
- The Netherlands
- Switzerland

These countries were selected as they are popular for establishing holding and headquarter companies for multinational groups. (Honiball & Killoran, 2011b:29.)

Luxembourg is considered to be the “ideal gateway into the European market”. In the assessment consideration was given to the political, social and financial stability, the highly skilled workforce, the outstanding infrastructure and the attractive legal and tax environment. (KPMG, 2012a:2.)

Ernst & Young noted that there is a growing trend in the loss of corporate headquarters by the UK and US and the win of these companies by the Netherlands and Switzerland (2010:13). These countries are therefore growing in popularity for the establishment of headquarter companies. For the purposes of the dissertation these countries will be assessed in terms of the elements of their legislation which have resulted in their popularity for setting up headquarter companies.

## **1.6 STRUCTURE AND OVERVIEW**

The mini dissertation will be structured around the following chapters:

### **1.6.1 Chapter 2**

In this chapter, the purposes behind the changes to legislation regarding headquarter companies will be explored. This will include a brief discussion of the unique position of South Africa as part of the BRICS countries. It will also include a brief discussion on the economic reality within African countries.

### **1.6.2 Chapter 3**

The tax elements of an ideal holding and headquarter company regime will be investigated along with the difference between the two. The chapter will include an analysis of the headquarter company regimes in popular headquarter company locations. The results will be compared to the current headquarter company legislation in South Africa and the main differences will be highlighted.

### **1.6.3 Chapter 4**

This chapter will contain an analysis of the term *place of effective management*. The analysis will include the ordinary dictionary meanings of the words and the interpretations by the OECD and SARS.

Focus will be placed on the term “management”. Specific reference will be made to the different levels of management and how these levels relate to the concepts portrayed in the interpretation note and the interpretation by the OECD.

### **1.6.4 Chapter 5**

The exclusion incorporated in the *resident* definition will be explored in this chapter. The various components of this exclusion will be considered and the relevant legislation will be explored.

### **1.6.5 Chapter 6**

In this chapter, the legislation investigated above will be applied to various scenarios to get an understanding of how the legislation comes together from a practical perspective. The results of this chapter will give insight into the interplay between the various components of the Income Tax Act and will be the basis for suggested solutions.

### **1.6.6 Chapter 7**

In this final chapter, a conclusion will be drawn as to possible solutions to the conflicts arising between the tax benefits to the headquarter company and the tax consequences for the foreign subsidiary due to the *resident* definition. Recommendations will be made for improvement of the legislation to better suit the unique situation of South Africa with regard to the headquarter company regime.

## **1.7 CONCLUSION**

The changes to the legislation to create benefits to qualifying headquarter companies in South Africa is an indication that the South African government is aiming to make South Africa a more attractive destination for setting up headquarters for multinational groups of companies. In terms of current legislation the requirements for a company to be a headquarter company places a focus on investments into foreign companies. Given the backdrop of the economic and social realities of African countries that results in a lack of skills in those countries, the effect the *resident* definition has on the application of the headquarter company regime should be considered. The next chapter will explore the purpose behind the inclusion of a headquarter company regime in South African legislation.

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#### Notes

<sup>1</sup> This exclusion has been deleted retrospectively as of 1 January 2013 by the Taxation Laws Amendment Bill no. 39 of 2013 that was issued on 24 October 2013. As the aim of the study is to determine if the desired outcome is achieved by the legislation, the exclusion to the residence definition was not excluded from the study. It is still considered relevant to investigate the deficiencies of the legislation in an attempt to identify possible improvements.

## CHAPTER 2 SOUTH AFRICA – GATEWAY TO AFRICA

### 2.1 INTRODUCTION

In 2010, National Treasury introduced the concept of South Africa being the *Gateway to Africa*. They referred to South Africa as, the “economic powerhouse of Africa”. This was based on South Africa’s location, sizable economy, political stability and strong financial sector; this, coupled with a network of tax treaties, makes South Africa the ideal location for the establishment of regional holding companies for foreign investment into Africa (National Treasury, 2010a:77).

The purpose of this chapter is to establish what the concept of *Gateway to Africa* really is and what government aims to achieve with the inclusion of the headquarter company legislation in South African tax law. South Africa’s inclusion into the BRIC countries is considered and an analysis is performed between South Africa’s GDP and the 19 other African countries close to South Africa. These countries are also compared in terms of the ease of doing business.

The final component that will be discussed is the availability of skills in African countries. The reason for the inclusion of this discussion sprouts from the use of *place of effective management* as a measure of determining residence (please refer to chapter 3 for further discussion).

Through completion of this chapter, the first and second, secondary objectives (chapter 1.4.2) will be addressed. The first objective is to understand the purpose of the introduction of the headquarter company regime in South African tax legislation. The second secondary objective is to obtain a basic understanding of the economic conditions present in South Africa compared to other African countries.

The question that arises is why South Africa would want to position itself as the *Gateway to Africa*. The next part of the study will look at the reasons for establishing a headquarter company regime. As this chapter only endeavours to create a backdrop against which the *resident* definition and the effect on the headquarter company regime will be evaluated, detailed research was not performed into these aspects.

## **2.2 INTEREST IN AFRICA**

Africa is rich with a wide range of natural resources. These natural resources have contributed to strong economic growth, which in turn captured the attention of the international finance community. An increase is seen in the number of international companies expanding into the continent, along with an increasing interest in banking. (Subramoney, 2010:1.) The interest in Africa will be discussed in terms of the growth in African economies and the increase in foreign direct investment.

### **2.2.1 Growth in African economies**

Africa has countless business opportunities stowed in natural resources, oil and minerals (Chen, 2012: 46). South African President, Jacob Zuma, has committed to the North-South Corridor road and rail projects. These projects fall under the Presidential Infrastructure Championship Initiative started by The New Partnership for Africa's Development. They plan to boost trade and economic growth in Africa. The projects will stretch from Tanzania, across the Republic of Congo, Zambia, Malawi, Botswana, Zimbabwe and Mozambique to South Africa. (Anon, 2012: 30.) According to Chen, the improved transportation infrastructure will enhance regional integration between African countries and allow access to global markets. This will strengthen Africa's position during international negotiations. (2012:46.)

Dr Rob Davies (SouthAfrica.info, 2012:1), South African Minister of Trade and Industry, stated that Africa is recognised more and more across the world as the next growth frontier, with Asia being the first. Factors identified as the responsible drivers behind the growth in Africa included mineral products, a "consumer-driven boom in Africa", the fact that the continent did not experience a systematic financial or sovereign debt crisis and developments in infrastructure. All these factors have contributed to the growth in Africa. (SouthAfrica.info, 2012:1.)

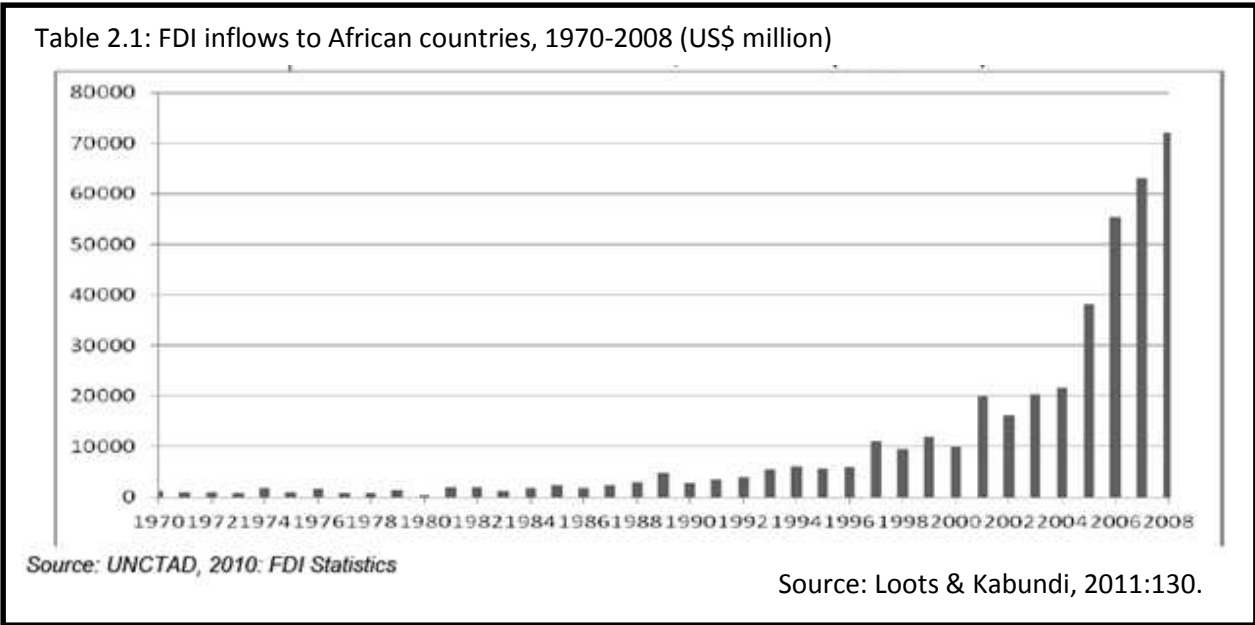
According to Forbes, Africa was the only region apart from Asia, showing growth during the recession in 2009. This growth has increased from two per cent in 2009 to 4.5 per cent in 2010 and five per cent in 2011. Forbes has indicated that Africa can become the second fastest growing region in the world. The various economic, political and social changes made throughout Africa improved the business environment and promotes foreign direct investment. Africa is therefore positioning itself to attract foreign investors. (Forbes, 2011:1.) The increase in foreign direct investment will be discussed in the next part of the study.

**2.2.2 Foreign direct investment**

There is a notable increase in foreign direct investment into the African continent. During the 1970s, an average of US\$1.1 billion per year flowed to the continent in foreign direct investment. The 1980s indicated a 100 per cent growth, up to an average of US\$2.2 billion per year and this tripled to US\$6.6 billion per year in the 1990s. This figure improved to an average of US\$35.2 billion per year in the period 2000 to 2008. Despite the global financial crisis affecting developed economies in 2007, foreign direct investment showed an exceptional increase from US\$38 billion in 2005 to US\$72 billion in 2008 – see Figure 1 below. (Loots & Kabundi, 2012: 130.)

These figures only make up 1.9 per cent of world inflows in the 1990s and three per cent of world inflows in the 2000s (Loots & Kabundi, 2012: 130). Despite the low distribution percentage, it clearly indicates increased investment interest in African countries.

United Nations Conference on Trade and Development (UNCTAD) (cited by Keho, 2012:67) claims that foreign direct investment has the potential to contribute to the long-term economic development of developing countries. A number of aspects can be affected by foreign direct investment including the generation of employment, the transfer of foreign skills and technology, increased productivity and improved exports.



It is submitted that the definite growth in African economies, coupled with the growing interest from foreign investors for expanding operations into the African continent, creates the opportunity for South Africa to act as first point of entry into the African continent.

### **2.3 SOUTH AFRICA'S INCLUSION IN BRICS**

Jim O'Niell first introduced BRIC as an acronym for the four biggest emerging economies identified in 2001. This included Brazil, Russia, India and China. (O'Niell, 2001: S.01.) It is expected that the global economic power will shift away from the developed G7 economies to these developing markets. (Pheeha & Troskie, 2011:28.)

Broken down to individual economies, Brazil has the largest economy in South America which focuses on oil exports. Russia shares in the abundance of oil, but also contributes toward other commodities. However, despite these positive attributes, Russia experienced difficulties transitioning to a more market-based system from its original planned economy. On the manufacturing front, India has emerged as a global leader. China is the leader among these countries with the largest GDP and population. China has built strong ties with western multinationals and owns a wealth of foreign reserves. (Investopedia, 2010:1.) These countries differ significantly when their economic, social and political environments are considered, but they were expected to show significant growth. (O'Niell, 2001: S.03.)

The invitation extended to South Africa to join the BRIC group of countries in December 2010 took the world by surprise. South Africa's inclusion was questioned as it is not thought to be justified. Dr Davies (Fynn, 2012:10) referred to the IMF's World Economic Outlook and stated that South Africa has a small population of 51 million compared to Brazil (197 million), Russia (142 million), India (1.2 billion) and China (1.3 billion). The same trend is seen when looking at Gross Domestic Product (GDP), as South Africa cannot compare with its \$443 billion in 2011, against \$2.6 trillion in Brazil, \$2.1 trillion in Russia, \$2 trillion in India and \$7.7 trillion in China. This notion is further supported by the fact that the BRIC countries are ranked among the seven largest (by area) countries in the world. South Africa is ranked as 25<sup>th</sup>. (Pheeha & Troskie, 2011: 28.)

O’Niell commented (Hervieu, 2011:1) that the inclusion of South Africa on its own into BRIC group of countries does not make sense. However, he continued to say that South Africa seen as representative of the African continent makes it understandable.

Dr Davies (Fynn, 2012:12) concurred and stated that if it is taken into consideration that South Africa is included among the BRIC countries as an emerging economy and also as a presence on the African continent it can be validated. He stressed the concept of *gateway* into Africa, rather than *gatekeeper*, as it cannot be expected that all trade and investment from the BRIC countries should go through South Africa. Dr Davies (South Africa.info, 2012:1) indicated that South Africa has an important role to play in the industrialisation of the African continent, as it can be regarded as the most industrialised country on the continent.

The inclusion of South Africa into BRICS, coupled with South Africa’s “*large economy, sophisticated financial services, relative political stability, sophisticated legal, banking and accounting sectors, sound regulatory practices, extensive double tax treaty network*” creates a favourable environment to locate regional headquarter companies (King, 2013:1). The implementation of a headquarter company regime will provide South Africa with a vehicle through which to form part of the growth and increase in foreign direct investment in Africa.

International headquarter companies are often the result of multinational groups of companies having considerable economic interest in regions distant from their ultimate head office. A headquarter company is formed within the region to manage the business interests in that area. The decision regarding the location of such a headquarter company is influenced in varying degrees by the tax consequences within the different jurisdictions present in the area. (Legwaila, 2011b:126.)

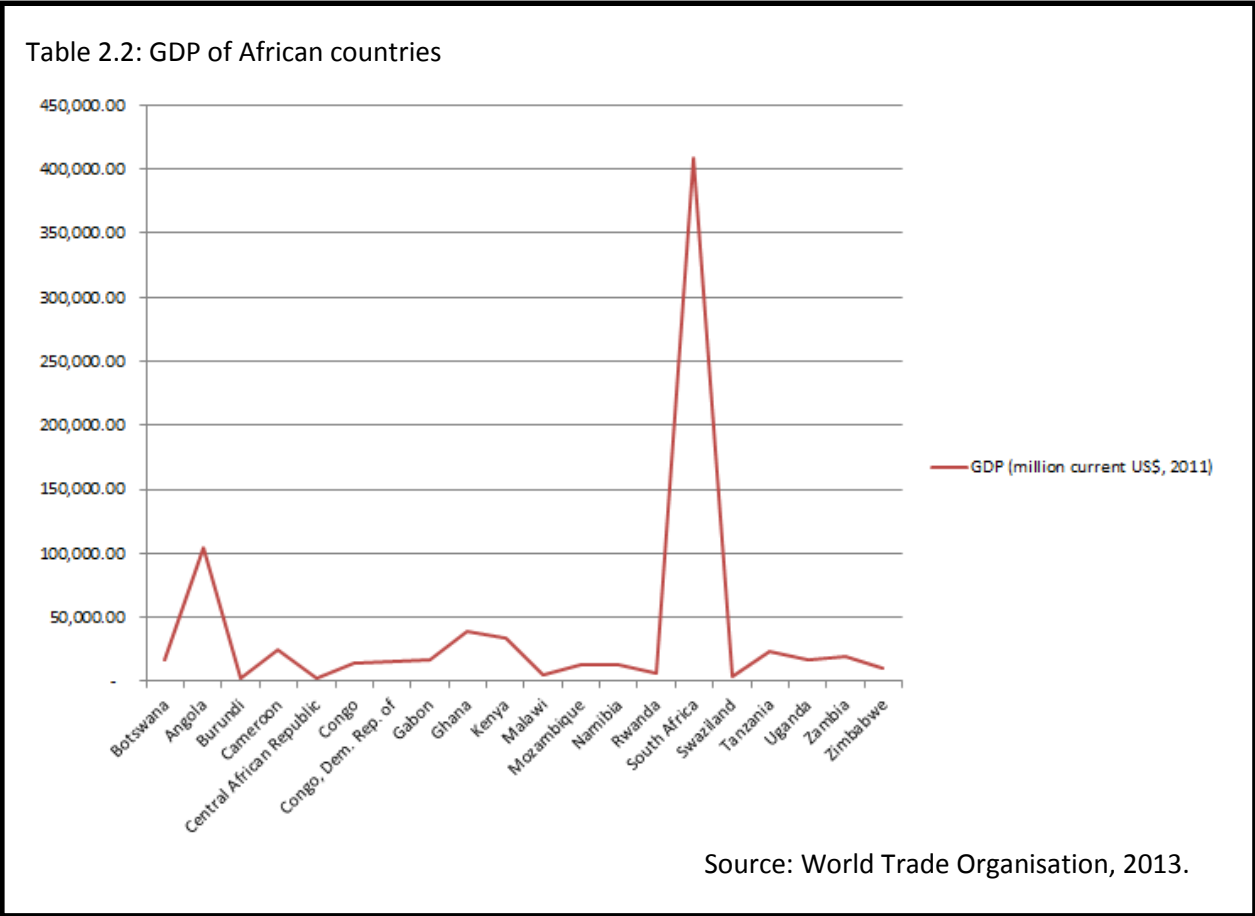
Countries such as Luxembourg, the Netherlands, Denmark and Mauritius have taken this into consideration in the development of their tax systems to attract investors to establish headquarter companies within their jurisdictions. This enables them to take advantage of the spill over benefits that is linked to the presence of such headquarter companies. South Africa has been added to the list with the introduction of the headquarter company regime in 2010. (Legwaila, 2011b:126-127.)

## 2.4 SOUTH AFRICA vs OTHER AFRICAN COUNTRIES

To gain a further understanding of South Africa’s leadership in Africa, some comparisons were made between South Africa and 19 other African countries closest to South Africa. The first comparison was made between the GDP’s of these countries.

From Table 2.2 it is evident that South Africa had the highest GDP in 2011 by far compared to the other African countries. Angola is second and had a GDP less than half of that of South Africa.

These same countries were compared in terms of ease of doing business. A document was issued by the World Bank on doing business across the world. The document analyses business regulations within 185 economies. Table 2.3 places the countries identified in Table 2.2 in order of the ease of doing business within each economy. South Africa ranked as number 39 of the 185 countries and the Central African Republic ranked last based on the findings of the report. (World Bank, 2013: 3.)



From the two comparisons it is clear that South Africa has a strong economy compared to other African countries and the regulatory environment is beneficial for the starting up of a business. Therefore it can be concluded that South Africa has various aspects making it favourable for setting up headquarters as first step to heading up expansion into Africa.

Table 2.3: Ease of doing business

Country	Ease of doing business
South Africa	39
Rwanda	52
Botswana	59
Ghana	64
Namibia	87
Zambia	94
Uganda	120
Kenya	121
Swaziland	123
Tanzania	134
Mozambique	146
Malawi	157
Burundi	159
Cameroon	161
Gabon	170
Angola	172
Zimbabwe	173
Democratic Republic of Congo	181
Congo	183
Central African Republic	185

Source: The World Bank, 2013:3

**2.5 AVAILABILITY OF QUALITY SKILLS IN AFRICA**

The availability of quality skills in Africa has to be considered as the tax residence of a corporate entity is determined with reference to its place of incorporation, formation and establishment and its *place of effective management* (chapter 1.1). It is submitted that the management of the business requires a certain level of skill.

The skills brought to the labour market are directly affected by the quality of education provided (Kanjee, Sayed & Rodriguez, 2010:85). It can therefore be concluded that quality education contributes to employees with the necessary skills and capabilities to perform the management functions within a business.

Higher level skills and knowledge are produced by secondary and tertiary education. (World Bank, 2009:1.) The World Bank has identified four reasons why the focus of tertiary education in Sub-Saharan African countries should be on quality rather than quantity. The first is that quality education is closely correlated with economic growth. Secondly, quality education equips persons with technical, communicational and cognitive skills that allow for better teamwork and the making of effective decisions. The third reason is that quality education and research are more likely to develop multiple connections within industries and encourage knowledge-based development. The final reason is that low quality education leads to graduates not finding employment. (2009:xxiii.)

Consequently Africa has limited access to human capital with the necessary secondary- and tertiary-level skills. The skills available are further subject to highly inconsistent quality, stifled in many instances by high mortality rates as a result of diseases on the one hand and expatriation on the other hand. (World Bank, 2009:xx.)

Strong growth in the number of universities within Sub-Saharan Africa has been noted for the past decades. Despite the positive growth, the quality of education has deteriorated. The World Bank Development Indicators show that only two-thirds of the population in these regions can read and write. (Müller & Haller, 2012:169.)

These shortfalls within the African secondary and tertiary education systems lead to shortages in appropriately educated human capital. As mentioned in chapter 1.1, there are currently significant shortages of management and specialised skills in Africa. It is expected that expatriate staff will be used to bridge the gap. This will require that companies work strategically with the resources available to ensure success in growing businesses across Africa. (Maritz, 2012:1.)

## **2.6 CONCLUSION**

This chapter aimed to address the first and second secondary objectives. The first secondary objective considered the purpose for the introduction of the headquarter company legislation into South African legislation.

From the investigation it is evident that there has been significant economic growth in Africa. The Presidential Infrastructure Championship Initiative was launched to improve infrastructure in Africa, to enhance integration of African economies, to augment access to global markets and boost this growth even further. Focus is shifting to the untouched natural resources and oil and minerals in these countries. (chapter 2.2.1.)

The past four decades have also indicated a staggering increase in interest from foreign investors. Foreign direct investment inflows showed an increase of more than 3000 per cent since the 1970s. (chapter 2.2.2.)

South Africa's inclusion into the BRICS countries is an indication of the country being one of the leaders on the African continent (chapter 2.3). Combined with South Africa's political stability, strong banking systems and sizeable economy it creates a favourable environment for establishment of headquarter companies to facilitate the flow of foreign investment and establishes business ties which open doors to the international markets (chapter 2.1). South Africa can therefore be the conduit pipe through which the foreign direct investment into the African continent is distributed.

In addressing the second secondary objective, namely to obtain a basic understanding of the economic conditions present in South Africa compared to other African countries, the GDP of the 19 African countries closest to South Africa was considered. It was clear from the comparison that among these countries South Africa had the strongest GDP in 2011. These countries were also compared in terms of the ease of doing business and South Africa was ranked the highest among them. (chapter 2.4.)

The World Bank has indicated that the quality of education in Sub-Saharan African countries is deteriorating. Quality secondary and tertiary education is required to produce higher level skills and knowledge. Thus there is limited access to sufficiently skilled human capital. There is a

need for companies to work strategically with the human resources at their disposal. (chapter 2.5.) Setting up management structures can therefore prove to be a challenge. The favourable economic environment present in South Africa compared to that of the other African countries, coupled with our ties to the other BRICS nations provides a base for setting up these management structures.

Given this background, the question that arises is whether the objectives behind the current legislation are attainable when taking into consideration the definition of *resident* as defined by the Income Tax Act? The next chapters will examine the headquarter company legislation included in the Income Tax Act, along with the legislation governing residence. The elements of an ideal headquarter company regime will be analysed. The provisions contained in the legislation of countries that are popular for setting up headquarter companies will be considered and these elements will be compared to the South African headquarter company tax legislation.

## **CHAPTER 3**

### **ANALYSIS OF HEADQUARTER COMPANY REGIMES**

#### **3.1 INTRODUCTION**

In the previous chapter it was evident that South Africa is actively undertaking to position itself as a *Gateway into Africa*. Laws are incorporated to make South Africa more attractive to investors for setting up headquarter companies for investment into Africa.

The increase in foreign investments has left countries competing for the attraction of foreign investment into their borders as well as through (Legwaila, 2012b:22). Investors interested in expanding their investments into a certain region, will often identify a specific country from which to head up their operations. There are various vehicles available to investors through which these foreign investments can be effected. One of these vehicles is the use of a base company in one country from which investments are then expanded into other countries within the same geographical region. (Oguttu, 2011:61.)

Base companies can take various forms depending on the ultimate purpose for which the investor wishes to use the base company. Base companies can be set up for the performance of different functions as “headquarter companies; intermediary holding companies; finance companies; service companies; trading companies; or as intangible holding companies”. The country from which to base their investments is chosen through careful consideration of the fiscal characteristics of the country and how that supports the functions to be performed by the base company. (Oguttu, 2011:64-65.)

In this chapter an analysis will be done of the difference between an intermediary holding company and a headquarter company. The characteristics of an ideal holding company regime and an ideal headquarter company regime will be explored, as well as the different tax reasons for establishing holding or headquarter companies. This is in response to the third, secondary objective (chapter 1.4.2).

Luxembourg, the Netherlands and Switzerland are among the countries that have successfully established themselves as popular destinations for headquarter companies. (Honiball & Killoran, 2011b:29.) The different aspects of the regimes in place in these jurisdictions are discussed briefly as a benchmark against which the South African regime can be assessed.

Focus will be placed on elements incorporated in their legislation, what is aimed to be achieved by the inclusion and how it links with residence. This is in response to the fourth secondary objective (chapter 1.4.2).

The final part of this chapter will analyse and compare the South African headquarter company legislation with that of the successful regimes to identify differences. This will be done in response to the fifth, secondary objective (chapter 1.4.2).

## **3.2 HOLDINGS COMPANIES vs HEADQUARTER COMPANIES**

Base companies can, among others, take the form of intermediary holding companies or headquarter companies (Legwaila, 2012b:23). On an international front there is a difference between holding companies and headquarter companies (Honiball & Killoran, 2011b:31). Intermediary holding companies hold and control the investments in the greater multinational group. Headquarter companies are generally more involved in the management of the business activities of subsidiaries within the region. (Legwaila, 2012b:23.)

The next part of the study will focus on the differences between the two types of base companies. This will provide a better understanding of what the purpose of these investments are. A brief analysis of the tax reasons for establishing a headquarter company will also be included.

### **3.2.1 Holding companies**

A holding company is defined in section 1 of the Companies Act no. 71 of 2008 as:

*“in relation to a subsidiary, means a juristic person that controls that subsidiary as a result of any circumstances contemplated in section 2(2)(a) or 3(1)(a);”*

Section 2(2)(a) differentiates between two instances that signifies *control*. Firstly, *control* in relation to a company is if that person together with any related or interrelated persons can directly or indirectly exercise the majority of the voting rights pertaining to the securities of that company. Secondly it is their right to elect or appoint the directors who collectively exercise the majority of the votes on the board (Companies Act 71 of 2008). Section 3(1)(a) defines the subsidiary relationship and states that a company is the subsidiary of a juristic person if the

juristic person *controls* that company. This *control* can be exercised by the juristic person, subsidiaries of the juristic person or nominees of that juristic person or its subsidiaries, alone or in combination. (Companies Act 71 of 2008.)

Holding companies can either be incorporated within the same country as the investor or in another country. When dealing with holding companies in countries other than that of the investor, one refers to an offshore holding company or an intermediary holding company. Offshore holding companies are usually associated with companies situated in tax havens. (Olivier & Honiball, 2011:689.)

Intermediary holding companies usually perform the functions relating to the actual investments made. They are responsible for investing in foreign operations, holding these investments and ultimately disposing of these investments. They rarely engage in the business operations of the foreign subsidiaries. The use of intermediary holding companies provides investors the ease of one single centralised legal entity controlling all investments in the same geographic region. (Oguttu, 2011:65.)

The jurisdiction in which such an intermediary holding company should be established will depend on the ability of the investor to efficiently accomplish the functions to be performed by the holding company within the jurisdiction. This will include an assessment of the tax and non-tax characteristics present in the jurisdiction. (Legwaila, 2012b:23.)

The following non-tax characteristics should be considered, among others, when deciding upon a jurisdiction for the establishment of an intermediary holding company:

- infrastructure as it relates to the economic and financial environment. This will include the banking system and the availability of financing. Communications infrastructure is also important as it directly affect the ability to communicate with the ultimate holding company and the foreign subsidiaries.
- the political stability and legal environment within the country.
- legislation regulating companies and employment.
- the accounting framework used and the requirements set out by it.
- the tax legislation that would affect the holding company.

- the availability of resources and human capital. Holding companies perform the management and control activities and therefore require highly skilled people in the fields of law, financial structuring, accounting and economics.
- the culture and languages of the natives. (Legwaila, 2012b:24; Olivier & Honiball, 2011:697; Udal, 2004:18.)

The above list refers to tax legislation affecting the holding company that should be considered when deciding on a location for an intermediary holding company. An ideal holding company regime will include the following tax aspects. (Legwaila, 2012b:25-44; Olivier & Honiball, 2011:697.)

- **Income tax**

Among the direct taxes imposed by law, income tax is the most important contributor to the fiscus. The imposition of income tax is therefore inevitable. What should be considered are the exemptions and allowances incorporated in the legislation that reduce the effective tax rate or that limit or reduce withholding taxes. (Legwaila, 2012b:29-30; Honiball & Wentzel, 2011:1; Olivier & Honiball, 2011:697.)

- **Capital gains tax**

The taxation of capital transactions are usually at a lower rate than the income tax rate of the company. A favourable regime incorporates low or no taxes on the gains resulting from the disposal or deemed disposal of investments. An ideal regime takes into account not only the rate at which tax is imposed, but also how the acquisition price is determined, the amounts included in the taxable gain, the provisions relating to sales between connected persons and the roll-over relief available to the taxpayer. (Legwaila, 2012b:26-29; Honiball & Wentzel, 2011:1; Olivier & Honiball, 2011:697.)

- **Taxation of dividends received**

Given the nature and purpose of an intermediary holding company, an ideal holding company regime does not impose taxes or imposes taxes at a low rate on dividends received by the intermediary holding company. This links with the imposition of low taxes on other income received by the company. (Legwaila, 2012b:30; Honiball & Wentzel, 2011:1; Olivier & Honiball, 2011:697.)

- **Withholding taxes on dividends**

Withholding taxes are a form of administrative intervention that require that the company declaring a dividend to a non-resident should withhold taxes on the dividend. The declaration of the dividend is the ultimate relinquishment of the income from foreign operations to the ultimate shareholders. As such, an ideal holding company regime will interpose low or no withholding taxes on dividends so declared. (Legwaila, 2012b:31; Honiball & Wentzel, 2011:1; Olivier & Honiball, 2011:697.)

- **Controlled foreign company legislation**

The provisions of controlled foreign company legislation taxes resident companies on the income of their foreign subsidiaries as if the income was earned by the resident company. The taxable income is determined according to the legislation applicable to the resident holding company. The term *controlled foreign company* is defined by the relevant legislation and differs from jurisdiction to jurisdiction. The main difference usually relates to the size of the qualifying interest, but this interest is usually linked to the ability of the holding company to control the timing of dividend declarations. Ideal holding company regimes do not contain provisions relating to the taxation of income earned by controlled foreign companies. (Legwaila, 2012b:35; Honiball & Wentzel, 2011:1; Olivier & Honiball, 2011:697.)

- **Thin capitalisation and transfer pricing**

Transfer pricing governs transactions between a resident company and its non-resident, related parties. The purpose of these provisions is to prevent prices being manipulated to result in tax benefits for the group. These provisions therefore endeavour to ensure that transactions are at arm's length. (Legwaila, 2012b:40-41; Olivier & Honiball, 2011:697.)

Thin capitalisation provision focuses on the funding of group companies through the use of excessive interest-bearing loans that result in big interest deductions in one country and the taxation thereof in another country. Penalties are imposed when the debt to equity ratio as well as the interest percentage is not reasonable or market related. An ideal holding company regime does not contain these types of provisions. (Legwaila, 2012b:42-43.)

- **Favourable network of tax treaties**

The most important characteristic of an ideal holding company regime is the availability of a favourable tax treaty network. Tax treaties prevent the imposition of double taxation as it

allocates taxing rights to the respective states. It also, in some instances, limits or reduces withholding taxes applicable and through doing so reduces the overall tax payable. When considering a tax treaty network it is not only the number of tax treaties enacted that should be considered, but also the content and features of these treaties. (Legwaila, 2012b:25-44; Olivier & Honiball, 2011:697.)

### **3.2.2 Headquarter companies**

Headquarter companies are holding companies that perform additional functions for the other companies within the group. As such the requirements set out above are applicable to the choice of location for a headquarter company, though the nature of headquarter companies result in additional characteristics that need to be considered. (Oguttu, 2011:67.)

In a multinational group of companies the headquarter companies are set up with the purpose to supervise, manage and organise the administrative and management functions for the foreign subsidiaries within the same region (Oguttu, 2011:66). Instances where these functions are performed by the headquarter company, the nature of its activities should be considered as it could affect the determination of *place of effective management* (Olivier & Honiball, 2011:690).

The activities typically performed by headquarter companies include tax management, accounting services, market research, treasury and auditing services. These types of services are in many instances labour intensive. (Oguttu, 2011:67.) These two aspects result in the following characteristics that should be added to the list above for the ideal location of a headquarter company regime:

- management fees received by headquarter companies from foreign group subsidiaries should not be taxed or taxed at a reduced rate; and
- no tax should be levied on the remuneration of employees who work exclusively in a different jurisdiction for a specified minimum period. (Oguttu, 2011:67.)

### **3.2.3 Tax reasons for establishing a base company**

Tax savings might not be the main consideration when deciding if a base company should be established, but tax consequences do form a major part in the decision. There are various tax

reasons why investors would consider the use of a base company rather than investing directly in a foreign country. (Legwaila, 2011b:127-128.)

The following are some of the reasons that have been identified as tax reasons for establishing a holding or headquarter company (Legwaila, 2011b:128-141; Olivier & Honiball, 2011:693-696.)

- **Deferring tax**

The main form of income that investors receive from their investments is in the form of dividends. The use of an intermediary holding company enables investors to control the income that is ultimately relayed to the investor. The intermediary holding company acts as a buffer between the subsidiaries and the ultimate holding company. All income from the foreign subsidiaries has to flow through the intermediary holding company. The intermediary holding company can therefore trap income that would not constitute exempt income in the hands of the ultimate holding company. The “trapped income” can be re-invested by the intermediary holding company. (Legwaila, 2011b:128; Olivier & Honiball, 2011:694-695.)

Capital gains tax can also provide a reason for the establishment of a holding company. One of the main purposes of an intermediary holding company is to hold, manage and dispose of investments. An intermediary holding company set up in a jurisdiction with low or no capital gains tax or where there are limited occurrences that are regarded as disposals, would therefore be more efficient in the achievement of its purpose. (Legwaila, 2011b:130; Olivier & Honiball, 2011:694).

- **Effective utilisation of credits on foreign taxes**

Different jurisdictions use different methods to reduce and prevent double taxation. Some of these methods include non-taxation of foreign income, allowances against taxable income for foreign taxes paid and tax credits for foreign taxes paid. Structuring the intermediary holding company in a way that mixes foreign income from high tax jurisdictions with low tax jurisdictions can reduce the amount of taxes ultimately paid in the group, depending on the legislation in the investor’s jurisdiction. (Legwaila, 2011b:132-133; Olivier & Honiball, 2011:695.)

- **Withholding taxes on dividends**

When dividends are paid to holding companies in another jurisdiction, they are often subject to withholding taxes in the jurisdiction of the subsidiary. Tax treaties in many instances contain provisions that reduce the amount of withholding taxes. In instances where another country has negotiated more favourable tax treaties than the investor country an intermediary holding company may be used to gain access to these treaties. (Legwaila, 2011b:133; Olivier & Honiball, 2011:693.)

- **Changing the nature of income**

Another reason for setting up an intermediary holding company is to allow the group to change the nature of income. The intermediary holding company can receive income in the form of royalties or interest and relay that as dividends to the ultimate holding company. This will require an analysis of the application of domestic tax legislation in both the country of the intermediary holding company and the investor company, as well as the tax treaties available to each. (Legwaila, 2011b:139-140; Olivier & Honiball, 2011:696.)

Investors are more inclined to establish an intermediary holding company when a combination of the above tax advantages can be obtained along with non-tax advantages (Legwaila, 2011b:128).

Various companies have successfully implemented headquarter company regimes into their tax legislation. The next part of the study will look at a few.

### **3.3 LEGISLATION OF POPULAR DESTINATIONS FOR HEADQUARTER COMPANIES**

Over the years many countries have endeavoured through strategic planning of their tax regimes to draw investors into establishing headquarter companies within their borders. The purpose is for these countries to obtain the benefits arising from the presence of these investments within their country. (Legwaila, 2011b:126.)

As previously noted, countries who have successfully incorporated these regimes into their tax systems include Luxembourg, the Netherlands and Switzerland. Each of these regimes will now be analysed.

### 3.3.1 Luxembourg

Luxembourg can be described as the ideal gateway into the European market. Located in the heart of Europe, the country boasts a stable political and economic environment. Companies established in this country have access to a highly skilled workforce and outstanding infrastructure. The legal and regulatory environment is ideal for businesses, with attractive tax regimes. (KPMG, 2012a:2.)

One of the main reasons Luxembourg is a popular destination for the establishment of headquarter companies is the favourable tax environment (Luxembourg for business, 2012:1). Luxembourg boasts the lowest level of VAT in the European Union. The tax legislation further includes various aspects that are attractive for headquarter operations. (KPMG, 2012a:4.)

The following aspects of Luxembourg tax legislation were identified as favourable for setting up headquarters:

- **Non-taxation of income from a foreign source and protection of investment**

Luxembourg has a tax treaty network containing 64 double taxation agreements in 2012 and the list is expanding. These treaties allocate taxing rights between residence and source states, preventing double taxation. The country also has more than 90 investment protection treaties that ensure economic and legal protection to foreign investors. (KPMG, 2012a:4; Luxembourg for business, 2012:1.)

- **Low or no withholding taxes**

The number of payments subject to withholding taxes in Luxembourg is few. There is no withholding tax on:

- interest payments (excluding interest on profit participating bonds);
- royalties payments relating to patents, trademarks and knowledge; and
- liquidation proceeds.

There is a 15 per cent withholding tax on dividends, but through domestic tax treaties this can be avoided. (KPMG, 2012a:4; LG@Vocats, 2007:1.)

- **Participation exemption regime**

In terms of this regime, qualifying participations are exempt from income, withholding and net wealth tax. These exemptions focus on dividends, capital gains and liquidation proceeds. (KPMG, 2012a:4; LG@Vocats, 2007:1.)

Various conditions need to be met depending on the type of participation exemption sought. Table 3.1 compiled from information published by KPMG sets out the requirements for each type of participation exemption (2012b:3-8).

Table 3.1: Requirements for each type of participation exemption

<b>Exemption required:</b>	<b>Income tax exemption for dividends, divestment gains and liquidation proceeds received</b>
Type of Luxembourg shareholder	<ul style="list-style-type: none"> <li>• A resident company, fully taxed in Luxembourg, covered by the European Parent-Subsidiary Directive</li> <li>• A resident company, fully taxed in Luxembourg, not covered by the European Parent-Subsidiary Directive</li> <li>• A permanent establishment situated in Luxembourg of:               <ul style="list-style-type: none"> <li>- a company under the European Parent-Subsidiary Directive;</li> <li>- a company resident in a country with which Luxembourg has a DTA; or</li> <li>- a company resident in Liechtenstein, Iceland or Norway.</li> </ul> </li> </ul> <p>(KPMG, 2012b:3.)</p>
Type of subsidiary held by the Luxembourg shareholder	<p>A company:</p> <ul style="list-style-type: none"> <li>• Under the European Parent-Subsidiary Directive</li> <li>• Not under the European Parent-Subsidiary Directive, but resident and taxable in Luxembourg</li> <li>• Not resident in Luxembourg but subject to tax comparable to Luxembourg income tax. (KPMG, 2012b:3.)</li> </ul>
Size of the shareholding interest held by the	<ul style="list-style-type: none"> <li>• Minimum of ten per cent of a subsidiary's share capital; or</li> <li>• Minimum acquisition price criterion:               <ul style="list-style-type: none"> <li>- dividends and liquidation proceeds exemption requires a minimum acquisition price of €1,200,000; and</li> </ul> </li> </ul>

Luxembourg shareholder	- divestment gains exemption requires a minimum acquisition price of €6,000,000. (KPMG, 2012b:4.)
Retention period	The minimum shareholding interest should be held for a minimum period of 12 months before the income is derived. (KPMG, 2012b:4.)

<b>Exemption required:</b>	<b>Withholding tax exemptions for distribution of dividends and payment of liquidation proceeds / Net wealth tax exemption for shareholding interests held</b>
Type of dividend payer	<ul style="list-style-type: none"> <li>• A resident company, fully taxed in Luxembourg, covered by the European Parent-Subsidiary Directive</li> <li>• A resident company, fully taxed in Luxembourg, not covered by the European Parent-Subsidiary Directive. (KPMG, 2012b:6.)</li> </ul>
Type of shareholder receiving the dividend	<ul style="list-style-type: none"> <li>• A company covered by the European Parent-Subsidiary Directive</li> <li>• A resident company, fully taxed in Luxembourg, not covered by the European Parent-Subsidiary Directive</li> <li>• A company resident in Liechtenstein, Iceland or Norway and subject to tax comparable to Luxembourg income tax</li> <li>• Resident in Switzerland subject to income tax with no exemption</li> <li>• A company resident in a country with which Luxembourg has a DTA and subject to tax comparable to Luxembourg income tax</li> <li>• A permanent establishment situated in Luxembourg of: <ul style="list-style-type: none"> <li>- a company under the European Parent-Subsidiary Directive;</li> <li>- a resident company, fully taxed in Luxembourg, not covered by the European Parent-Subsidiary Directive;</li> <li>- a company resident in a country with which Luxembourg has a DTA; or</li> <li>- a company resident in Liechtenstein, Iceland or Norway. (KPMG, 2012b:6.)</li> </ul> </li> </ul>
Size of shareholding	<ul style="list-style-type: none"> <li>• Minimum of ten per cent of a subsidiary's share capital; or</li> <li>• Minimum acquisition price criterion of €1,200,000. (KPMG, 2012b:7.)</li> </ul>

in dividend payer	
Retention period	The minimum shareholding interest must be held for a minimum period of 12 months before the dividend is derived. (KPMG, 2012b:7.)

The requirements set out in the table make it clear that the participation exemptions are not only applicable to investments held in foreign subsidiaries, but it also include companies resident in Luxembourg. To qualify for the application of the participation exemption a minimum shareholding of ten per cent or a minimum acquisition price is required with a minimum retention period.

- **Intellectual property rights**

Luxembourg has a special exemption for income from Intellectual Property Rights. As a result of this exemption, only 20 per cent of net royalties and capital gains from qualifying intellectual property rights are taxed. The resulting effective corporate tax rate is 5.76 per cent. (KPMG, 2012a:5; Luxembourg for business, 2012:1.)

- **Favourable VAT legislation**

The VAT rate applied in Luxembourg is the lowest in the European Union. Luxembourg is also the only country in the European Union that does not require VAT pre-financing. This is VAT paid by importers when goods are imported into the European Union before it is sold to the end consumers. (KPMG, 2012a:5.)

In 2011 new VAT provisions were introduced for VAT free zones in Luxembourg. Within these zones movable goods and ancillary services to transactions in these goods are exempt from VAT until the goods leave the zone. (KPMG, 2012a:5.)

- **Investment tax credit**

Investment tax credits encourage investment in fixed assets. A global tax credit of seven per cent is granted on the acquisition of investments for the past five years with a further three per cent on investments exceeding €150 000. Where enterprises invest in ecological equipment and projects, the credit is increased by one per cent. The tax credit on additional investments made during the year amount to 13 per cent. The result of the tax credits is an overall reduction in the corporate income tax. (KPMG, 2012a:5; Luxembourg for business, 2012:1.)

- **Taxation of expatriates**

Highly skilled expatriates are subject to favourable tax exemptions with regard to the remuneration received in relation to their specific assignment in Luxembourg. There are also specific tax relief systems for expenses incurred with regard to relocation to and from Luxembourg. (KPMG, 2012a:5.)

From the above analysis it is evident that various provisions have been incorporated in the Luxembourg tax legislation to make it an attractive location for foreign investors to set up a headquarter company. The provisions focus on foreign-sourced income, interest, royalties, dividends, liquidation proceeds, divestment gains, net wealth tax and taxation of expatriates. The provisions either reduce or eliminate tax or provide incentives for investment such as investment tax credit. The next country to be analysed is the Netherlands.

### **3.3.2 Netherlands**

There is a rise in interest in the Netherlands as prime location for holding companies. The key factors of the attraction are its location, infrastructure and favourable tax regime. (Gerritsen & Kuipers, 2012:1.)

The concept of holding or headquarter companies are not incorporated in the tax legislation of the Netherlands (Legwaila, 2012c:2). Residents are taxed on worldwide income and non-residents on income sourced within the Netherlands. The corporate income tax rate is 25.5 per cent. No distinction is made between ordinary income and capital gains. (Legwaila, 2012c:4.)

The benefits encompassed in the tax legislation that render the Netherlands a favourable location for a holding company are:

- **The participation exemption**

The purpose of a participation exemption is to eliminate double taxation of income transferred to shareholders. The rationale is that an enterprise is taxed on its income and this reduces profit available for distribution. When a dividend is subsequently declared, it is again subject to dividends tax. The participation exemption endeavours to remove or reduce the second tax. (Legwaila, 2012c: 11-12.)

In the Netherlands the participation exemption results in a full exclusion of the following qualifying elements from the tax base:

- dividends;
- capital gains ;
- refunds of foreign tax credits and foreign withholding taxes;
- losses made by subsidiaries
- realised exchange gains and losses on instruments used to cover the risk on qualifying participations; and
- hybrid loan instruments that function as equity in qualifying subsidiaries. (Legwaila, 2012c:13.)

The participation exemption will only apply where a qualifying participation is held. The requirements set out in Dutch legislation determine that a minimum shareholding of five per cent not held as inventory is required in the subsidiary which has to have capital divided into shares. (Legwaila, 2012c:13.) If the subsidiary is a foreign entity, the subsidiary must be subject to tax in the resident country. No level of tax is specified. The foreign share may also not be held as part of a portfolio investment. (Legwaila, 2012c:17.)

The fact that the participation exemption requires such a low shareholding makes it attractive for investors to set up a base company in the Netherlands. The exemption applies to both local and foreign subsidiaries and does not require the holding company to have as its sole economic activity the holding of the shares in its subsidiaries. (Legwaila, 2012c:13-14.)

- **Tax treaty network**

The Netherlands has a very extensive tax treaty network consisting of treaties with more than 80 countries (Legwaila, 2012c: 10; Gerritsen & Kuipers, 2012:1). These treaties provide for no withholding taxes on interest, dividends and royalties in many instances (Legwaila, 2012c: 10).

- **Advanced tax ruling system**

The ability to discuss tax positions with the Dutch tax authorities is another benefit of the Dutch tax system. These discussions can be formalised into agreements that provide certainty as to how certain structures and transactions will be taxed. (Van Min, 2009:1; Legwaila, 2012c:10-11.)

These three aspects, though not specifically aimed at holding companies, do provide a favourable tax jurisdiction for setting up holding companies. The benefits are focused on exemption of dividends, capital gains, qualifying realised exchange gains and losses and qualifying hybrid loan instruments. There are also refunds of foreign taxes and provision for losses made by subsidiaries. These are supported by the extensive tax treaty network and the advanced tax ruling system.

An additional benefit is that company structures where only limited shareholdings are held in the subsidiaries will still stand to benefit from these provisions and these provisions are also available regardless of whether interests are held in foreign or domestic companies. The next part of the study will analyse the legislation of Switzerland.

### **3.3.3 Switzerland**

In Switzerland the Swiss Confederation, canton and community all have taxing rights. The maximum corporate income tax rates ranges between 11.4 per cent and 24.4 per cent. The minimum rate is five per cent depending whether the company qualifies for a special tax regime. (KPMG, 2013:1.)

In order to qualify for holding company status, three requirements should be met:

- the company should have as its main purpose to hold and manage equity investments in the long term;
- a minimum of two-thirds of the market value of the assets should exist out of qualifying equity investments or a minimum of two-thirds of the income should be derived from qualifying equity investments. The investment need only be “substantial” in order for it to qualify. No minimum participation is specified. Investments can be held in local or foreign companies; and
- the holding company itself may not be actively performing commercial activities within Switzerland. This does not limit it from performing such activities outside the Swiss borders. Activities that are generally accepted are managing and providing services to itself and other companies in the group, providing debt financing to the subsidiaries and holding and exploiting of intellectual property. (Reinarz, 2008:1; KPMG, 2013:1.)

In terms of Swiss tax legislation qualifying holding companies are granted privileged tax status that provides for the following benefits:

- no cantonal income tax is payable with the exception of income on Swiss real estate;
- The capital gains tax rate for Swiss holding companies is reduced to a rate of 0.01 per cent to 0.02 per cent;
- federal income tax is paid at the normal rate of 7.83 per cent. There is a participation deduction available on dividends from and capital gains on the disposal of qualifying participations;
- a network of almost 90 tax treaties provides for additional relief from double taxation;
- domestic tax does not provide for relief on withholding taxes at the rate of 35 per cent. Some of the tax treaties do, however, provide for relief. Switzerland also has a bilateral agreement with the European Union in terms of which dividends paid by a Swiss company to a parent in the European Union will be exempt from withholding tax, provided certain requirements are met;
- unrealised capital losses on participations are deductible for tax provided that they can be economically justified and the impairment is disclosed in the financial statements. Realised capital losses on the sale of participations are also deductible;
- no withholding taxes are applicable to royalties, management fees, service fees and technical assistance fees subject to certain exclusions; and
- Switzerland does not have controlled foreign company legislation. (KPMG, 2013:3-5; Reinartz, 2008:1.)

The participation deduction will only be applicable to qualifying participations. For this purpose a holding company has to hold a minimum of ten per cent of the company or the participation has to have a minimum market value of CHF 1 million. The tax payable will be reduced in the same ratio as net income from qualifying participations to total net income. (KPMG, 2013:3.)

### **3.3.4 Main features of the successful regimes**

It is submitted that there are some common features that can be identified in the above successful regimes. All three regimes reduce their effective income tax rate through various methods. These measures include provisions in the form of participation exemptions or deductions on dividends from and capital gains on disposal of qualifying participations. The domestic tax legislation or tax treaties provide for no or reduced withholding taxes on dividends,

interest and royalties. All these regimes are enhanced by large networks of tax treaties that aim to limit double taxation.

Another commonality in the above regimes is the fact that the benefits listed are not limited to companies holding participations in foreign enterprises. The benefits are available to holding companies holding shares in local enterprises as well. The qualifying shareholding sizes are also relatively small and range between five per cent and ten per cent.

In the following part of the study the South African headquarter company regime will be analysed.

### **3.4 THE SOUTH AFRICAN HEADQUARTER COMPANY REGIME**

The South African headquarter company regime was introduced into the South African tax legislation in 2011. The term *headquarter company* is defined in section 1 of the Income Tax Act. (Honiball & Killoran, 2011b:30; The Income Tax Act, section 1.)

The following three requirements need to be met for a company to qualify as a headquarter company:

- each shareholder should hold, alone or collectively with other companies within the same group, a minimum of ten per cent of the equity shares and voting rights in the company (The Income Tax Act, section 9l(2)(a));
- of the total assets of the company, 80 per cent has to be attributable to:
  - interest in the equity shares of foreign companies of which the company hold a minimum of ten per cent;
  - loans to foreign companies of which the company hold a minimum of ten per cent; and
  - intellectual property licensed to foreign companies in which the company hold a minimum of ten per cent (The Income Tax Act, section 9l(2)(b)).
- where the company's gross income in a year of assessment exceed R5 million, 50 per cent of the income must consist of:
  - rental, dividends, interest, royalties or fees paid by a foreign company in which the company holds a minimum of ten per cent; or

- proceeds relating to the disposal of foreign shares or intellectual property licensed to foreign companies in which the company holds a minimum of ten per cent (The Income Tax Act, section 9I(2)(c)).

(Deloitte, 2013:1.)

The benefits that arise from classification as a headquarter company include the following (Deloitte, 2013:2):

- **No dividends tax**

The South African tax legislation makes provision for both withholding taxes on dividends as well as income tax on dividends.

The provisions of section 64E of the Income Tax Act impose a dividends withholding tax on dividends declared by any company. This provision excludes headquarter companies. As such, no dividends withholding tax is payable on dividends declared by a headquarter company. (The Income Tax Act, section 64E.)

The definition of *foreign dividends* as it is included in section 10B(1) of the Income Tax Act includes dividends declared by a headquarter company. In turn section 10B(2)(a) declares that foreign dividends declared to a person who alone or together with other companies within the same group holds a minimum of ten per cent of the equity shares and voting rights in the dividend declaring company, is exempt. Given the requirements of a headquarter company as discussed above all shareholders of a holding company will qualify for this exemption. (The Income Tax Act, section 10B.)

- **Controlled foreign company legislation does not apply**

Controlled foreign company legislation is governed by section 9D of the Income Tax Act. In terms of section 9D(1) the controlled foreign company legislation explicitly excludes shares held in participation and voting rights by headquarter companies. Section 9D(2) further exempts headquarter companies from imputing their portion of income of controlled foreign companies in which they do hold more than ten per cent of participation rights into their taxable income. (The Income Tax Act, section 9D.)

- **Exemption of thin capitalisation and transfer pricing rules**

The following transactions, operations, schemes or agreements are excluded from the provisions for thin capitalisation and transfer pricing by section 31(5) of the Income Tax Act:

- so much of financial assistance received from a foreign resident that is given as financial assistance to a foreign company in which the headquarter company holds, alone or collectively with other companies within the same group, a minimum of ten per cent (qualifying share);
- financial assistance provided to a foreign company by the headquarter company in which it holds a qualifying share;
- so much of use, permission to use or right of use of intellectual property defined in section 23I that is granted by a foreign resident to a headquarter company as is in turn granted to a foreign company in which the headquarter company holds a qualifying share; and
- the use, permission to use or right of use of intellectual property defined in section 23I that is granted by the headquarter company to a foreign company in which it holds a qualifying share. (The Income Tax Act, section 31.)

- **Gains from the sale of foreign investments**

The Eighth Schedule to the Income Tax Act provides for exemption of capital gains and losses from the disposal of equity shares in a foreign company by a headquarter company. Paragraph 64B(2) states that the gains and losses from such a sale by a headquarter company must be disregarded in calculating capital gains and losses of the company, provided that the headquarter company held a qualifying share immediately before the disposal of the shares. (The Income Tax Act, section 64B.)

- **Interest and royalty income paid to non-residents**

In terms of section 37K(1)(a)(cc) of the Income Tax Act an amount of interest paid to a foreign resident will not be subject to withholding tax provided that it is paid by a headquarter company on financial assistance to which section 31 does not apply in terms of section 31(5). (The Income Tax Act, section 37K.)<sup>2</sup>

Any royalty payments made to a foreign resident by a headquarter company for the use, right of use or permission to use of intellectual property as defined by section 23I of the Income Tax Act and to which section 31 does not apply in terms of section 31(5), is exempt from royalties withholding tax in terms of section 49D(b). (The Income Tax Act, section 49D.)

- **Tax treaties**

The South African Revenue Service (“SARS”) has published on their website two lists of Double Taxation Agreements they have entered into. The one list contains all treaties concluded with African countries and the total number included in the list is 22. The other list contains all the treaties entered into with other countries and includes a total of 60 treaties. South Africa therefore has a total number of 82 tax treaties in force with the aim to reduce instances of double taxation. (SARS, 2013a:1; SARS, 2013b:1.)

It is submitted that the above analysis highlights that the headquarter company regime endeavours to reduce the tax imposed on headquarter companies. The next part of the study will compare the South African legislation with the successful regimes.

### **3.5 SOUTH AFRICAN REGIME vs SUCCESSFUL REGIMES**

The South African headquarter company regime in many instances have the same features as the successful regimes. It compares well to these regimes in that it does not raise withholding taxes on qualifying interest, dividends and royalty payments. It does not raise capital gains tax on the disposal of qualifying foreign shareholdings. The country has a large network of tax treaties that limit instances of double taxation.

These characteristics along with the exclusion of headquarter companies from controlled foreign company legislation and the exemption of certain qualifying transactions and agreements from transfer pricing and thin capitalisation rules result in the South African regime conforming to the ideal holding company regime. Legislation, however, does not provide for exemptions relating to management fees

The main difference that is evident from the above analysis is that South Africa limits the headquarter company legislation to companies holding significant interests in foreign companies. A headquarter company may hold a maximum of 20 per cent of its assets in resident companies. The benefits listed above are in many instances also only limited to the foreign companies in which the headquarter company holds qualifying interests. From the analysis of the successful regimes it was found that a similarity between the regimes is that the benefits are available irrespective if the qualifying share is held in local or foreign enterprises.

## 3.6 CONCLUSION

An intermediary holding company is a vehicle through which investors can invest into foreign subsidiaries. The intermediary holding company provides the investor with a physical presence within the same geographical region as their investments. (chapter 3.2.1.)

Intermediary holding companies obtain, hold and dispose of the foreign investments on behalf of the ultimate investors. These companies can also perform administrative and management services on behalf of their foreign subsidiaries. When these additional functions are performed, the company is known as a headquarter company. (chapter 3.2.2.)

Jurisdictions popular for the establishment of these types of companies incorporate various provisions into their legislation to ensure that these entities are exposed to low or no tax on dividends, income and capital transactions and that they are not subject to controlled foreign company rules. Withholding taxes are also limited or absent and intercompany management fees are not taxed. (chapter 3.2.)

Investors are motivated by various tax and non-tax reasons when deciding if such a vehicle should be used. The main tax reasons focus on the effective utilisation of provisions and tax treaties within another country's tax legislation that result in lower taxes for the group than would otherwise have been obtained. The ability to trap income and change its nature is also another reason for establishing a holding company. (chapter 3.2.3.)

Ideal holding company and headquarter company regimes focus, from a tax perspective, on efficiencies that result in lower costs. These are the main drivers behind these regimes.

In the global market Luxembourg, the Netherlands and Switzerland are among the countries considered to be favourable locations for the establishment of holding or headquarter companies. An analysis of the regimes incorporated in all three these countries indicated similarities relating to the exemption of certain amounts from corporate income taxes or withholding taxes. The focus is mainly on elements such as dividends, interest and royalties. Overall the combination of domestic tax legislation and tax treaties available in these jurisdictions result in a reduction and in some instances an elimination of the effective tax rates applicable. (chapter 3.3.)

The South African tax legislation makes provision for various exemptions from corporate income tax and withholding taxes. Again the focus is on elements such as dividends, interest and

royalties. There are provisions exempting headquarter companies from controlled foreign company legislation and thin capitalisation and transfer pricing rules. (chapter 3.4.) In this regard, the headquarter company regime conforms to the elements set out as an ideal holding company regime (chapter 3.5). However, as indicated in chapter 3.2.2 a headquarter company regime requires additional provisions for exemption of management fees in the hands of the headquarter company.

The difference identified between the South African regime and the successful regimes that is of specific importance for the topic under discussion is the fact that in South Africa the headquarter company regime is limited to qualifying shares held in foreign companies (chapter 3.5). The effect of this difference will be further explored in the next chapters.

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#### Notes

<sup>2</sup> The Taxation Laws Amendment Bill no 39 of 2013 promulgated on 24 October 2013 provides for this same exemption under the insertion of section 50D(1)(a)(i)(cc) under Part IVB of the Act (2013; chapter 98).

## CHAPTER 4 ANALYSIS OF THE MEANING OF “PLACE OF EFFECTIVE MANAGEMENT”

### 4.1 INTRODUCTION

In the previous chapter it was concluded that headquarter company legislation has as its aim to reduce and limit taxes. Specific focus is placed on low or no tax on dividends, income and capital transactions. Companies that fall within these regimes are not subject to controlled foreign company rules. Provision is also made for limited or no withholding taxes and intercompany management fees are free of tax.

When deciding on establishing a headquarter company investors are attracted by both tax and non-tax reasons. It is the reduced or limited tax consequences in terms of headquarter company regimes that provide the incentive from a tax perspective. The tax legislation of Luxembourg, the Netherlands and Switzerland that provide these incentives were examined. All three countries have incorporated legislation that focuses on the reduction or elimination of taxes on dividends, interest and royalties. They also make use of tax treaties to facilitate these provisions.

The main difference between the legislation in these jurisdictions and South Africa is that these jurisdictions make the provisions available to local and foreign entities. South African legislation is limited to significant holdings in foreign entities.

As such, it is necessary to examine the *resident* definition as it is applied in South African tax legislation. This will require an understanding of how the residence of persons other than natural persons is determined and how these tests are applied.

Companies are not natural persons but rather synthetic edifices designed with an express purpose to fulfil certain business needs. As such the determination of a company's residence will also depend on synthetic constructions. (Van der Merwe, 2006:121.) As indicated in the first chapter, *resident* as per the Income Tax Act is determined with reference to two tests, the place of incorporation, formation and establishment, and the *place of effective management* (chapter1.1).

The place of incorporation, formation and establishment is a statutory aspect and therefore it is a more factual measure. Companies need to log the required documents at the Registrar of Companies and thus these documents are available for inspection by the public. This measure is also susceptible to manipulation as the formal process of registration does not necessarily correspond with the economic reality of the entity. (Van der Merwe, 2006:121.)

The second test is less synthetic as it looks at the substance of the company rather than the legal form. The term *place of effective management* is not defined by the Income Tax Act and interpretation thereof is not applied consistently through the different tax jurisdictions. (Van der Merwe, 2006:122.) When an entity conducts business activities in more than one country, it is important to establish in which country the entity is a resident for tax purposes. In the application of the domestic laws of the two countries, it may indicate that the entity is a tax resident in both countries. This is called dual residency. (Olivier & Honiball, 2011:31-32.)

Dual residency can lead to international juridical double taxation. In such an instance a single economic transaction is taxed in more than one State due to the fact that a person or entity is regarded as being resident in both States. (Vogel, 1997:10.)

The existence of double taxation discourages international trade and ultimately it diminishes global welfare. As domestic rules often do not address instances of double taxation resulting from dual residency, double taxation agreements are needed to allocate taxing rights between the two states. (Olivier & Honiball, 2011:6.)

The purpose of this chapter will be to determine the meaning of the term *place of effective management* with a focus on the word *management*. The next part of the study will consider the method by which the term will be evaluated. Through doing so, the sixth, secondary objective will be met (chapter1.4.2).

## **4.2 METHOD OF INTERPRETATION**

### **4.2.1 Purposive approach**

A study performed by John Tretola (2006: 73-98) considered the different approaches taken by the Australian High Court and the House of Lords in the interpretation of tax legislation over a

period of 70 years. This study focused on the observations of Justice Graham Hill, considered to be the leading Australian tax judge for over a decade, to identify the correct approach for the court in the interpretation of tax legislation.

As per the findings of the study, it was clear that in the interpretation of legislation by the courts the purposive approach was considered to be most favoured. In the application of this approach, the ordinary meanings of words should be applied in a manner that will comply with the legislative purpose of the legislation. (Tretola, 2006:73.)

The same concept is applied in the interpretation of treaties. The Vienna Convention on the Law of Treaties stated that the interpretation of the treaty should be done in good faith through applying the ordinary meaning of the terms of the treaty given the object and purpose of the treaty. (United Nations, 1969:12.)

Courts in South Africa and other common law countries have also applied this approach. In ITC 1619, 59 SATC 309 (1996) it was held that the court will afford the ordinary, literal and grammatical meaning to the words used by the Legislature. The court will only deviate from this meaning where it does not agree to the context, background and purpose of the whole statute.

As *place of effective management* is not defined by the Income Tax Act, it is therefore necessary to consider the ordinary dictionary meaning of the words, taking into account international precedent and interpretation (Williams, 2009:15). The ordinary dictionary meaning from different dictionaries will be considered with a focus on the words “effective”, “manage” and “management”. Please refer to chapter 4.3.

#### **4.2.2 Intention and purpose of the Income Tax Act**

The ordinary dictionary meanings are not sufficient to provide guidance as to the interpretation of the legislation, but regard should also be had to the purpose or object of an Act (Tretola, 2006:10). Lord Scarman (House of Lords, 1980:28) agreed with this concept in *Fothergill v Monarch Airlines Limited* when he stated that:

*“...if there be ambiguity or doubt, or if a literal construction appears to conflict with the purpose of the convention, the court must then, in my judgment, have recourse to such aids as are*

*admissible and appear to it to be not only relevant but helpful on the point (or points) under consideration.”*

Judge Mummery agreed with this statement in *Inland Revenue Commissioners v Commerzbank* (1990) STC 285 and elaborated that (*IRC v Commerzbank*, 1990):

*“..construing words according to their 'general and ordinary meaning' or their 'natural signification' are to be a starting point or prima facie guide and 'cannot be allowed to obstruct the essential quest in the application of treaties, namely the search for the real intention of the contracting parties in using the language employed by them'.”*

It is therefore necessary to assess the meaning of the term *place of effective management* not only with reference to the ordinary meaning of the words, but also with reference to the intention and purpose behind the words. An investigation will therefore be performed from both a domestic and an international perspective.

Domestically the interpretation on the part of the South African Revenue Service (SARS) is of importance. SARS issued Income Tax Interpretation Note No. 6 to provide guidance regarding the meaning of the term. Please refer to chapter 4.4 for the investigation performed.

On the international front, the interpretations held by the Organisation for Economic Co-operation and Development (OECD) provide insight into the term. The OECD Model Tax Convention is the most influential Model Tax Convention and it is used by numerous countries, regardless if the country is a member of the OECD or not. The Model Tax Convention in itself is not a tax treaty, but it can serve as a basis when tax treaties are negotiated. Although it is not a member of the OECD, South Africa has also used the OECD Model Tax Convention for that purpose. (Du Plessis, 2012:31.)

As the OECD model tax convention is used as basis for tax treaties, the commentary thereto has been widely accepted. This commentary is also followed in the interpretation of the tax treaties. (Oguttu, 2009a,112) The OECD commentary will therefore also be considered in chapter 4.5.

### **4.2.3 Enforceability of Interpretation Notes and OECD commentary**

The ultimate test is how the South African courts will interpret the term. Any contention in the matter will be brought before them. It should thus be considered how enforceable the Interpretation Notes issued by SARS are, as well as the views held by the OECD.

It is accepted that the interpretations published by SARS do not constitute law and therefore do not have to be considered by the courts. This view was corroborated in ITC 1675 62 SATC 219 where it was argued by the Commissioner's representative that SARS is not even bound by the Practice Notes. (Olivier & Honiball, 2011:42.) SARS indicates on their website that "interpretation notes are intended as guidelines to stakeholders on the interpretation and application of the provisions of the legislation administered by the Commissioner". The interpretations by SARS can therefore not be relied upon as being final.

When considering the enforceability of the commentary issued by the OECD, it is necessary to understand the legal framework within South Africa. The Constitution of the Republic of South Africa (Act 108 of 1996) states in section 233 that a court must favour the interpretation that is consistent with international law above an interpretation that is inconsistent with international law.

Tax treaties are classified as international agreements. The courts are therefore bound by constitutional law to follow the interpretations of customary international law. In this regard consideration should be given to the Vienna Convention on the Law of Treaties, 23 May 1969 and the Commentary on the OECD Model Tax Convention.(Oguttu, 2009a: 111&112.)

The Vienna Convention is a codification of customary international law. As such the Convention will apply to the interpretation of treaties in South African tax courts, despite the fact that South Africa has not signed the convention.(Oguttu, 2009a:111.)

The Commentary to the OECD Model Tax Convention is not legally binding in South African courts. As the Commentary is widely used as an interpretational aid in the consideration of treaty provisions, South African courts have recognised and applied the OECD commentary in legal proceedings. It was held in ITC 1503 that a treaty should be interpreted based on common

law rules relating to the interpretation of legislation and the OECD Commentary. (Oguttu, 2009a:112.)

It is therefore evident that the courts will be able to apply both the interpretation by SARS and the OECD, but are not legally bound by either one. Previous findings of the court will be discussed in chapter 4.6. The first step will follow, being an analysis of the ordinary dictionary meanings.

### 4.3 ORDINARY DICTIONARY MEANINGS

The following definitions were obtained from the Concise Oxford Dictionary (1995):

- “*Effective* (at 432): 1a having a definite or desired effect. b efficient. 2 powerful in visual, emotive etc. effect; impressive. 3a actual; existing in fact rather than officially or theoretically (*took effective control in their absence*). b actually usable; realisable; equivalent in its effect (*effective money; effective demand*). 4 coming into operation (*effective as from 1 May*). 5 (of manpower) fit for work or service.”
- “*Manage* (at 827): 1. Organise; regulate; be in charge of (a business, household, team, a person’s career, etc.) 2 (often foll. by *to* + infin.) succeed in achieving; contrive (*managed to arrive on time; managed a smile; managed to ruin the day*). 3a (often followed by *with*) succeed in one’s aim, esp. against heavy odds (*manage with one assistant*). b meet one’s needs with limited resources etc. (*just about manages on a pension*). 4 gain influence with or maintain control over (a person etc.) (*cannot manage their teenage son*). 5 (also *absol.*; often prec. by *can, be able to*). to cope with; make use of (*couldn’t manage another bite; can you manage by yourself?*) b be free to attend on (a certain day) or at (a certain time) (*can you manage Thursday?*). 6 handle or wield (a tool, weapon, etc.) 7 take or have charge or control of (an animal or animals, esp. cattle)”
- “*Management* (at 827): 1 the process of managing or being managed; the action of managing. 2a the professional administration of business concerns. Public undertakings, etc. b people engaged in this. c or the people in charge of running a business, regarded collectively.”

Dictionary.com defines “effective” as able to produce an expected result or to accomplish a purpose (Dictionary.com, “effective”). “Manage” is defined as to bring able to succeed in

accomplishing or to direct or govern (Dictionary.com, “manage”). “Management” is defined as an act of managing or a person that exercise control or direction of the business (Dictionary.com, “management”).

It is evident from the above definitions that the term *effective management* refers to the control of the business, exercised in a manner leading to the accomplishment of a purpose. It is also evident that *management* is referring to a more senior level of personnel as it refers to “control” and “direction of business affairs”.

As noted in chapter 4.3.2 the ordinary meaning of the words cannot be regarded in isolation. In the next part of the study the interpretation by SARS will be considered.

#### **4.4 INTERPRETATION BY THE SOUTH AFRICAN REVENUE SERVICE**

SARS issued Income Tax Interpretation Note No. 6 (“the interpretation note”) to provide a guideline for the meaning of the term *place of effective management*. As indicated in the interpretation note, the term *effective management* or *effectively managed* does not have a universal meaning, even though it is commonly used by various countries. (SARS, 2002:2.)

When referring to *management* the note also identifies three tiers of management:

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities; and
- the place where the day-to-day business activities are carried out/conducted.

(SARS, 2002:3.)

SARS is very clear in the interpretation note that *management* does not focus on the shareholder function and therefore does not relate to shareholder control or control by the board of directors. The focus is placed on the purpose and business of the company. (SARS, 2002:2.) This indicates that SARS looks at the second tier of management identified above for the purpose of determining the place of effective management.

It becomes evident from the interpretation note that the factors indicative of *place of effective management* relate to the implementation and execution of policies and the strategic decisions

taken by the board of directors (SARS, 2002:3). SARS provides a list which is not exhaustive or specific, but which aims to provide some guidance as to the facts to be considered as follows:

- where the centre of top level management is located;
- location of and functions performed at the headquarters;
- where the business operations are actually conducted;
- where controlling shareholders make key management and commercial decisions in relation to the company;
- legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer;
- where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- the frequency of the meetings of the entity's directors or senior managers and where they take place;
- the experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- the actual activities and physical location of senior employees;
- the scale of onshore as opposed to offshore operations; and
- the nature of powers conferred upon representatives of the entity, the manner in which those powers are exercised by the representatives and the purpose of conferring the powers on the representatives. (SARS, 2002:4-5.)

SARS also takes into account the fact that the factors and activities listed above do not necessarily take place at the same location. SARS focuses on the place where business operations and activities are carried out through the implementation of operational, management and commercial decisions made by senior levels of management. Where this is done from various locations, *place of effective management* is considered to be the place with the strongest economic nexus. (SARS, 2002:4.)

Engels (Director of Corporate and International tax at KPMG) stated that *effective management* in the context of taxation does not refer to the competence or capabilities of staff. Engels provides the following example making use of a company manufacturing widgets to explain. (2010:1; cited by Luker, 2010:20.)

Again, three levels of management are identified. The top-level management will make the strategic decision to manufacture pink widgets based on the trends in the market. The managers of the entity will then supervise the day-to-day manufacturing of the widgets, deal with customers, place orders etc. *Effective management* is considered to be the level of management that includes the executive directors and senior managers who are responsible to implement the decision to manufacture the pink widgets. Implementation includes the decisions regarding the location of the factory, the machinery to acquire and the type of manufacturing process (Engels, 2010:1; cited by Luker, 2010:20).

From the above analysis it is evident that the *place of effective management* is greatly dependent on a certain level of management. It is therefore considered necessary to obtain an understanding as to what is meant with the different levels of management.

Businessdictionary.com defines *top management* as the top level executives who are in charge of the entire business and who take responsibility for it. The board of directors will formulate policies and top management will translate it into practical strategies, goals and objectives. The success of the business lies in the hands of top management. (BusinessDictionary.com, 2012.)

*Middle management* is defined as the managers who implement the strategies, goals and objectives set by top management. They are usually the heads of the various departments within the organisation. (BusinessDictionary.com, 2012.)

*Lower management* consist of the organisational supervisors placed above non-managerial employees. They are responsible for the performance of the employees and form the first line of managers. (BusinessDictionary.com, 2012.)

The interpretation note clearly indicates that focus should be placed on middle management. In the next part of the study the term will be considered from an international perspective.

#### **4.5 INTERPRETATION BY THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)**

Article 4 of the Model Tax Convention determines that where a person other than a natural person is found to be taxable in two contracting states, residence will be deemed to fall in the country where *place of effective management* is situated (OECD, 2010b:M-13). The Model Tax

Convention does not define the term *place of effective management*, but the OECD does provide their interpretation of the term in the commentary to the Model Tax Convention.

*Place of effective management* as defined in paragraph 3, sub-paragraph 24 of the commentary to the Model Tax Convention is where “key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made” (OECD, 2010b:C(4)-8). Additional factors listed in the commentary that should be considered include where the meetings of the board or equivalent body are usually held, where the chief executive officer and other executive officers usually carry on their activities, where the senior day-to-day management of the person is carried out, where the person’s headquarters are located, which country’s laws govern the legal status of the person and where the accounting records are kept. (OECD, 2010b:C(4)-9.)

As is evident from the above analysis, the OECD considers the activities performed by the top-level management. This is different to the SARS interpretation that places focus on middle level management. This difference may cause conflict when evaluating the residence of an enterprise, which is a whole topic on its own. The consensus between these two interpretations lies in the fact that both are referring to a senior level of management and that is of import to the topic at hand. The following part of the study will look at the interpretation of the court.

## **4.5 INTERPRETATION BY THE COURTS**

### **4.5.1 The interpretation by the South African courts**

Until recently there have been no South African tax cases that included a consideration of *place of effective management*. This changed in 2011 with *The Oceanic Trust Co. Ltd N.O. v C: SARS* (“Oceanic Trust”).

The South African Institute of Tax Practitioners (SAIT Technical, 2011:1) stated that the insight obtained from the Oceanic Trust case is valuable in attaining certainty over the approach of the court to the interpretation of the term. In this case the tax residency of the Mauritian trust was considered. In order to determine the *place of effective management*, the court deliberated on the matter of *Commissioner for Her Majesty’s Revenue and Customs v Smallwood & Anor* (*HMRC v Smallwood*, 2010).

In the Oceanic Trust case, the applicant is a company that was registered and incorporated in Mauritius in terms of Mauritian laws and was the sole trustee of a trust established in Mauritius, Specialised Insurance Solutions (Mauritius) (“SISM”). SISM was established by a Deed of Settlement that provided that the applicant is the original trustee, that the laws of Mauritius would govern the agreement and that the trustee shall conduct and maintain their main place of business in Mauritius. (Oceanic Trust v SARS, 2011.)

SISM’s main business was conducted as captive reinsurer of mCubed Life Limited (“mCubed Life”) as of 2000 up until 2006 when it was terminated and its business was transferred to Emerald Insurance Company. mCubed Life transferred the premiums of policies reinsured with SISM to SISM and these included, among others, assets invested in South Africa by SISM. SISM made use of a South African asset manager to manage its investments in South Africa. Based on the agreement, SISM had to return the assets and any growth thereon, deducting any expenses incurred in terms of the policy and deducting fees to which SISM was entitled to, to mCubed Life when a policy came to an end. (Oceanic Trust v SARS, 2011.)

During the entire period of operation, SISM regarded itself as only liable for tax in Mauritius and not South Africa. In 2009 SARS raised an assessment of income tax, additional tax and interest for the 2000 to 2007 years of assessment amounting to R1,5 billion. (Oceanic Trust v SARS: 2011.)

Louw J (2011: 30-31) stated in The Oceanic Trust case that “the key features of Smallwood relating to the *place of effective management* of an entity relevant to this case, are”:

- the *place of effective management* is the place where **key *management and commercial decisions*** that are *necessary for the conduct of the entity’s business are in substance made*;
- the *place of effective management* will *ordinarily* be the place where the most senior group of persons (e.g. a board of directors) makes its decision, where *the actions to be taken* by the entity as a whole are determined;
- however, *no definite rule can be given and all relevant facts and circumstances must be examined* to determine the *place of effective management* of an entity;
- there may be more than one place of management, but only one *place of effective management* at any one time;

- the decision was based not only on the general test for *place of effective management* but also on the specific sections of the UK legislation which provided that the trustees be treated as a single and continuing body of persons who shall be treated as resident in the UK unless the general administration of the trusts is ordinarily carried on outside the United Kingdom and the trustees or the majority of them for the time being are not resident or not ordinarily resident in the United Kingdom; and
- the court undertook a painstaking analysis of the facts and the way the scheme was set up and was implemented in order to come to the conclusion on where the *place of effective management* of the trust in that case was. (Oceanic Trust v SARS, 2011: 30-31.)

The judgment in the Smallwood case corresponded with interpretations of the OECD. The judges in the Oceanic Trust case indicated that the *key management and commercial decisions* are the focus. In this case, no minutes could be furnished to support the claim that the trustee made these decisions in Mauritius. Instructions regarding the trust's investments in South Africa were given by a company wholly owned by a company listed on the JSE. It was therefore concluded that even though the trustee was situated in Mauritius, some of the key management and commercial decisions were not taken by him.

It can therefore be concluded that the South African courts are leaning towards the place where the actions to be taken by the entity as a whole are decided upon.

#### **4.5.2. Interpretation by other courts**

A well-known case when considering tax residence of corporations is *De Beers Consolidated Mines Limited v Howe* (1906). The company, incorporated in South Africa and having its head office in Kimberly, was controlled by three life governors and sixteen ordinary directors. The company had an office in London and two of the three life governors and nine of the sixteen ordinary directors resided in the United Kingdom, while the others were resident in the Republic of South Africa. Weekly meetings were held in Kimberly and London and minutes were exchanged. In most instances decisions were made by majority vote of all directors. As such, no decisions were made without the input from the London directors and no decisions were ever overruled by the directors in Kimberly. (*De Beers Consolidated Mines Limited v Howe*, 1905:1.)

In this case Lord Loreburn (*De Beers Consolidated Mines Limited v Howe*, 1906:1) stated that the tax residence of a company should be determined based on where the company's real business is carried on. He further elaborated that the real business is carried on where the central management and control of the business takes place. The company was therefore found to be resident in the United Kingdom where the majority of the directors were situated and conducted meetings. (*De Beers Consolidated Mines Limited v Howe*, 1906:1.)

*Central management and control* has been used by various countries in the determination of corporate tax residency from a domestic point of view. This test is specifically used in British law when dual residency is not being considered. The *place of effective management* becomes relevant for the United Kingdom when a company is considered to have dual residency. (Van der Merwe, 2002:87.)

In *Wood and Another v Holden* (HMTC) 2006, it was found that the *place of effective management* and the *place of central management and control* is the same place. This view was not shared in *Smallwood v HMRC* (2008) as the idea that it is the same was dismissed by the judges.

In *Laerstate v The Commissioner of her Majesty's Revenue and Customs* (2009) it was conceded that *central management and control* is usually situated where the board of directors meet. Where it becomes evident that the board is not responsible for the high level decisions, the true source should be considered to identify the place of central management and control. (*Laerstate v The Commissioner for her Majesty's Revenue and Customs*, 2009:31.)

#### **4.6 INTERPRETATION BY TAX AUTHORS**

There is also much dissension among tax authors regarding the place of residence and what determines the place of residence when looking at management. A few of these interpretations were considered.

Meyerowitz (2008:5-6) is of the opinion that *effectively managed* normally coincides with the place where the directors meet to discuss the business of the company. This place may differ from where the business is carried on or managed. He has, however, stipulated that the facts of

the case may reveal that it is where the directors conduct the affairs of the business and not where the board meets.

He therefore considers the place where the board of directors meet, taking into account how the company is structured and managed. This view is shared by Vogel who is of the opinion that the *place of effective management* is where critical policies are in essence made. He considers the place where directives are given rather than effected to be of importance. The focus is not on the person who provides supervision of the company's activities but rather where the authorised company representative manages the business. Vogel distinguishes between commercial and non-commercial activities and considers the first to be controlling. (Vogel, 1997: 262.)

The focus according to Vogel (1997: 262) is the place where top-level management make decisions that have an effect on the activities of the business. *Effective management* is therefore not where the day-to-day decisions are made or implemented.

Olivier (cited by Olivier & Honiball, 2011:29) regards the place where the "most vital" management actions take place to be the place of residence when referring to management. Thus, this view further supports the interpretations noted above.

Van der Merwe (2002:88-89) disagrees with this interpretation and states that the *place of effective management* includes the place where management and administration are executed day-to-day. He concluded that the inclusion of the term *place of effective management* instead of *place of management and control* and the repealing of the latter term from all instances where it was used in South African tax legislation indicates an express preference of a different concept as that indicated by *place of management and control*. As *place of management and control* refer to the place where superior policy and strategic decisions are made, the term *place of effective management* clearly refers to the day-to-day management.

The focus of the interpretations is placed on higher level management and decisions made by them. The place where these decisions are implemented cannot be excluded, but the place where the decisions are ultimately taken is the deciding factor. (Luker, 2010:36.)

## 4.7 SUMMARY

The following deductions may be made from the above analyses:

### 4.7.1 Interpretation of SARS

SARS interprets the term *place of effective management* as the place where a senior level of management implement policies and strategic decisions taken by the board of directors. In their interpretation senior level management refers to senior managers and directors.

### 4.7.2 Interpretation by the OECD

From the Commentary to the Model Tax Convention it is clear that the OECD focuses on the place where the key management and commercial decisions for the conduct of the business are made. In this interpretation the most senior level of management is considered. Typically this would include the board of directors.

### 4.7.3 Interpretation by the courts

From the analysis made of different court cases, it is evident that there are various interpretations as to where residence lies in the context of corporations. Two different measures have been used in the past, being *place of effective management* and *place of central management and control*. The interpretation of both these terms resulted in a consideration of top-level management making the key management and commercial decisions.

### 4.7.4 Interpretation by tax authors

The central theme to all the interpretations held is management by a more senior level of personnel. This can refer to the making of key management and commercial decisions by top-level management or the implementation thereof by middle-level management.

### 4.7.5 Summary

SARS makes it clear that it bases *residence* on where *place of effective management* is situated with a focus on **middle level management**. The OECD also bases *residence* on *place of effective management* but it focuses on **top level management**. The courts and authors differ amongst themselves on whether *residence* should be based on *management and control*

or *effective management*. They also refer to either **middle** or **top level management** but do not consent on either one.

## 4.8 CONCLUSION

Through completion of this chapter, the sixth, secondary objective (chapter 1.4.2) was addressed namely to determine the meaning of the terms *place of effective management*. Various interpretations exist when looking at corporate tax residence and the meaning of *place of effective management* and *place of central management and control*. All these interpretations include consideration of management limited to middle and top-level management. The focus is placed on the function of strategic and commercial decision making, impacting on the business of the entity by the board of directors or most senior persons and the implementation of these decisions by senior managers and directors.

It can therefore be concluded that the deciding factors in the determination of corporate tax residence is based on a certain level of skill and experience. This requires personnel with the necessary qualifications and abilities to enable them to make and implement the important decisions within the business to give direction and purpose to the entity.

As of January 2013 an exclusion provision was written into the *residence* definition of the Income Tax Act. In order to completely comprehend the impact the interplay between the *residence* definition and the headquarter company legislation has, this exclusion would have to be considered. In the next chapter the details of this exclusion will be examined. This will require the performance of an analysis of various components of the tax legislation.

## **CHAPTER 5**

### **ANALYSIS OF EXCLUSIONS FROM THE DEFINITION OF “RESIDENT”**

#### **5.1 INTRODUCTION**

In the previous chapter it was concluded that determining the residence of a company is essential if that company extends its business into other countries, even if it is through foreign investment. The two tests to be applied are in many ways controversial. The first test of place of incorporation, formation and establishment is susceptible to manipulation. The second test of *place of effective management* is subject to controversial interpretations among the various jurisdictions, tax authorities, tax courts and experts.

With the inception of 2013, the *resident* definition was altered to provide for certain exclusions.<sup>3</sup> In this chapter, this change will be analysed to ascertain the effect it has on residency of foreign entities. Through the completion of this chapter the seventh, secondary objective (chapter 1.4.2) will be addressed namely to investigate the exclusion to the *resident* definition as incorporated into the Income Tax Act and the requirements that should be complied with before the exclusion will come into effect.

#### **5.2 CHANGES TO THE INCOME TAX ACT**

Since 1 January 2013, an exclusion was incorporated into the definition of *resident* by section 2 of the Taxation Laws Amendment Bill no 22 of 2012. The additional component included in the definition, as it applies to persons other than natural persons, now reads as follows in section 1 of the Income Tax Act:

*“...but does not include-*

*(B) any company if-*

*(AA) that company is incorporated, established or formed in a country other than the Republic;*

*(BB) that company has its place of effective management in the Republic;*

*(CC) that company would, but for the company having its place of effective management in the Republic, be a controlled foreign company with a foreign business establishment as defined in section 9D(1); and*

(DD) *the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that company in respect of any foreign tax year of that company is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that company had that company, but for this subitem (B), been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined-*

- (i) *after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and*
- (ii) *after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that company;” (The Income Tax Act, section 1.)*

The purpose and application of this addition to the Income Tax Act should be considered, as well as the effect it has on the foreign subsidiaries in terms of the headquarter company regime.

### **5.3 APPLICATION OF THE INCOME TAX ACT**

The purpose of the exclusion was to reduce the number of instances in which double taxation arises. The exclusion focuses on foreign owned subsidiaries and sets out a list of requirements that have to be met for the exclusion to apply (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & De Swardt, 2013:59).

The exclusion will apply in instances where a foreign company has its place of incorporation, formation and establishment outside of the Republic and its *place of effective management* in the Republic, in other words, dual residency. Should the *place of effective management* be disregarded, the entity should qualify as a controlled foreign company with a foreign business establishment. As a final requirement, the foreign company should be subject to a comparable level of tax in any country other than South Africa. For purposes of determining if a high level of tax is paid, a benchmark of 75 per cent or more of taxes that would have been paid in South Africa had the Income Tax Act been applied, should be used. (Stiglingh, *et al.*, 2013:59-60; The Income Tax Act, section 1.)

As discussed in chapter 3, the place of formation, corporation and establishment is fairly easy to determine as it is based on facts. The *place of effective management* is more difficult to

determine and would require consideration of the various facts and circumstances applicable to the situation.

The additional requirement of the company being a controlled foreign company with a foreign business establishment is a matter of consideration of the definitions provided in section 9D. The final requirement stating that the foreign company has to be subject to a high level of tax would have to be determined based on the legislation applicable in the jurisdiction in which it is incorporated.

## **5.4 CONTROLLED FOREIGN COMPANIES (SECTION 9D)**

### **5.4.1 Background**

Taxpayers conducting business in the global markets have various strategies through which they aspire to minimise their global tax exposure. A company incorporated in a low tax jurisdiction is often used to house foreign income and through doing so defer the tax effect thereof in the hands of the investor until the declaration of dividends. In an attempt by countries to avoid the erosion of their tax base through the growing use of foreign subsidiaries, anti-tax avoidance rules have been enacted in various jurisdictions. (Oguttu, 2009a:73-74.)

Controlled foreign company (CFC) legislation was incorporated in the South African Income Tax Act as a way of preventing the avoidance of tax by South African residents through the use of foreign companies through which to conduct their foreign operations and capturing the profits at a place where it is not taxed in South Africa. In essence it widens the net of taxable income of South African residents. (Stiglingh, *et al.*, 2013:584) The South African CFC legislation has at aim to include income derived by the CFC which is of a passive nature or is the result of controversial transactions between the CFC and the South African resident (Haupt, 2013:439).

The focus is on situations where the foreign subsidiaries are used as an intermediary for foreign income. Olivier and Honiball provide the example of investment in US Treasury bonds. Should a South African tax resident invest directly in these bonds, they will be taxed in South Africa on the interest earned. Should the same resident rather set up a foreign company that does not fall within the South African tax resident definition and invest the same money in US Treasury bonds through the foreign company, the interest will not, in the absence of CFC legislation, fall

within the taxable income of the resident other than to the extent that it is declared as dividends. (Olivier & Honiball, 2011:559.)

The term *controlled foreign company* is defined in the Income Tax Act. For the CFC legislation to apply, the foreign company would have to be a CFC as defined. In the next part of the study this definition will be analysed.

#### **5.4.2 Controlled foreign company definition**

A foreign company can only qualify as a CFC if it is a *foreign company* as defined in the Income Tax Act. Section 1 defines a foreign company as a company that is not a resident. (Olivier & Honiball, 2011:562; The Income Tax Act, section 1.) This will mean that the company would have to be incorporated outside of South Africa and have its *place of effective management* outside of South Africa. (Haupt, 2013:442.)

A *controlled foreign company* is defined in section 9D of the Income Tax Act as:

*“any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies”*

The definition makes it clear that section 9D is an anti-avoidance provision with the aim of including into the tax net of South African residents income earned by a foreign company over which the South African resident can exercise a manner of control. The distinction between voting rights and participation rights is important as it will determine whether income will be attributed to the South African tax resident in terms of section 9D(2) and if the net income of the CFC will be included in the taxable income of the South African shareholders. Even though both tests are used for the classification of a company as a CFC, profits will only be attributed to the South African tax resident where the resident holds the minimum share in the participation rights stated in section 9D (Olivier & Honiball, 2011:567-568; Van Schalkwyk & Van Schaik, 2012; The Income Tax Act, section 9D(2).)

The participation rights and voting rights held by a headquarter company in a foreign company are disregarded when determining if that company is a CFC as defined. In essence the

headquarter company is not regarded as a South African resident when calculating the percentage of participation and voting rights held. (Haupt, 2013:441; The Income Tax Act, section 9D.)

Participation rights are defined in section 9D as it pertains to foreign companies as firstly the right to participate in all or part of the rights attached to a share or interest of a similar nature. This first part excludes voting rights. The second part includes voting rights to the extent that no rights as contemplated in the first part exist or those rights exist but cannot be allocated to a single person. (Stiglingh, *et al.*, 2013:595; The Income Tax Act, section 9D.)

The definition also only considers participation and voting rights held by residents other than headquarter companies. Despite this exclusion, the shareholders of the headquarter company are pulled into the ambit of attribution of the profits in terms of section 9D(2)(B). This provision determines that the participation rights held by a resident indirectly through a headquarter company in a CFC will result in the inclusion of net income of the CFC in the taxable income of such a resident. (The Income Tax Act, section 9D(2)(B).)

As the exclusion requires that it should be a CFC with a foreign business establishment, the concept of foreign business establishment should also be investigated.

## **5.5 FOREIGN BUSINESS ESTABLISHMENT**

As previously mentioned, section 9D is an anti-avoidance provision. The purpose of the provision is to prevent taxpayers from turning taxable income into non-taxable income, deferring or avoiding taxation in South Africa through accumulating income and profits in the CFC without distribution thereof through dividends. Included in section 9D is a number of exclusions that result in the net income of the CFC not being allocated to the taxable income of the South African shareholders. (Van Schalkwyk & Van Schaik, 2012: 67; The Income Tax Act, section 9D(9).)

Of these exclusions, the *foreign business establishment* exclusion is the main exclusion. This exclusion has at aim to exclude from attribution of net income relating to the *foreign business establishment* to the taxable income of the South African resident. Through excluding such income, the legislator is in effect excluding income derived from legitimate business activities. .

(Van Schalkwyk & Van Schaik, 2012: 67; Olivier & Honiball, 2011: 581; The Income Tax Act, section 9D(9).)

The term *foreign business establishment* is defined in section 9D(1) of the Income Tax Act. The definition identifies five instances that indicate the existence of a *foreign business establishment*. Each of these categories has its own requirements that have to be met. (Olivier & Honiball, 2011:582; The Income Tax Act, section 9D(1).)

The requirements of each category are as follows:

Category 1 - paragraph a of the *foreign business establishment* definition

- A fixed place of business
- The location of which is outside of the Republic
- Used by the CFC for the carrying on of its business
- For a minimum period of one year
- On the condition that:
  - The business is conducted through one or more offices, shops, factories, warehouses or other structures;
  - The primary operations of that business is conducted on-site at that fixed place of business by suitable staff including both managerial and operational employees;
  - The primary operations of that business is conducted at that fixed place of business with suitable equipment;
  - The primary operations of that business is conducted at that fixed place of business at suitable facilities;
  - The main and sole purpose for having the location of that fixed place of business outside the Republic is not for the postponement or reduction of any tax imposed by any sphere of government in the Republic. (The Income Tax Act, section 9D(1); Olivier & Honiball, 2011: 582.)

It is clear that these requirements have the purpose to ensure that the fixed place of business does not just exist on paper. The requirements ensure that this fixed place of business has economic substance. (Olivier & Honiball, 2011: 582.) This component of the definition therefore

distinguishes between a shell, non-operational company and a legitimate operational company (Stiglingh, *et al.*, 2013:601).

The above requirements are opened up to take into account structure, employees, equipment and facilities held by another company where the following statements apply:

- The other company is taxed as a result of being resident, having its *place of effective management* or complying with other similar criteria in the same country as to where the fixed place of business is situated;
- The other company and the CFC is part of the same group of companies; and
- The structures, employees, equipment and facilities held by that other company and used by the CFC is located in the same country as the fixed place of business. (Olivier & Honiball, 2011:582; Stiglingh, *et al.*, 2013:593; The Income Tax Act, section 9D(1).)

This additional component to the definition takes into account the fact that when one looks at multinational corporate groups, business activities are separated into different legal structures. The definition is therefore broadened. (Olivier & Honiball, 2011: 582.)

Category 2 - paragraph b of the *foreign business establishment* definition

This category includes into the concept of *foreign business establishment* any prospecting or exploration operations for natural resources or the mining or production operations of natural resources at a place outside of the Republic. This requirement will only be met to the extent that the operations are carried on by the CFC. (Olivier & Honiball, 2011:583; Stiglingh, *et al.*, 2013:594; The Income Tax Act, section 9D(1).)

Category 3 - paragraph c of the *foreign business establishment* definition

Any construction or installation that relates to buildings, bridges, roads, pipelines, heavy machinery or comparable projects is brought into the ambit of *foreign business establishment* by this category. These operations have to be carried on by the CFC at a site located outside of the Republic for a minimum period of six months. (Olivier & Honiball, 2011:584; Stiglingh, *et al.*, 2013:594; The Income Tax Act, section 9D(1).)

#### Category 4 - paragraph d of the *foreign business establishment* definition

This paragraph brings into the definition *bona fide* farming activities performed on agricultural land located in a country outside of the Republic. This component as all the others has the requirement that the activities have to be performed by the CFC itself. The reference made to a *country outside the Republic* indicates that a single overseas location has to be identified as is the case with paragraph a. In paragraph b and c the requirement only refers to a *place outside the Republic* which does not have to be a single country, but can also include offshore locations. (Olivier & Honiball, 2011:584; Stiglingh, *et al.*, 2013:594; The Income Tax Act, section 9D(1).)

#### Category 5 - paragraph e of the *foreign business establishment* definition

Where a vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for the purpose of transportation, fishing, prospecting or exploration for natural resources or mining or production of natural resources it constitutes a *foreign business establishment*. This requirement will only be met if these activities are performed directly by the CFC or a company within the same group of companies that is also located within the same country of residence of the CFC. (Olivier & Honiball, 2011:584; Stiglingh, *et al.*, 2013:594; The Income Tax Act, section 9D(1).)

From this analysis of the exclusion incorporated in the *residence* definition, it is clear that companies with legitimate foreign businesses and in which South African residents hold significant shareholdings (more than 50 per cent of the participation or voting rights) are not considered to be residents for South African tax purposes. For the purpose of this study, the *foreign business establishment* requirement is considered to be met as the focus is on instances where foreign investors are investing in Africa as to capitalise on the growth within the African continent. The foreign companies considered in the study therefore are set up for legitimate business purposes and not for the avoidance of tax.

## **5.6 APPLICATION TO FOREIGN COMPANIES UNDER THE HEADQUARTER COMPANY REGIME**

As discussed in chapter 2, in essence the concern relating to the *residence* definition sprouts from the introduction of the headquarter company regime into the South African tax legislation and the purpose behind the legislation so enacted. In order to clearly understand the effect of the above changes to the foreign companies under the headquarter company regime, the definitions and requirements pertaining to the Income Tax Act as it relates to headquarter companies, should be considered.

### **5.6.1 Headquarter company legislation**

A headquarter company is defined by the Income Tax Act as a company that has elected to be a headquarter company in terms of section 9I(1) for any year of assessment (The Income Tax Act, section 9I(1)). An election is only made with reference to a specific year of assessment and can therefore be changed in any subsequent years (Haupt, 2013:482; The Income Tax Act, section 9I).

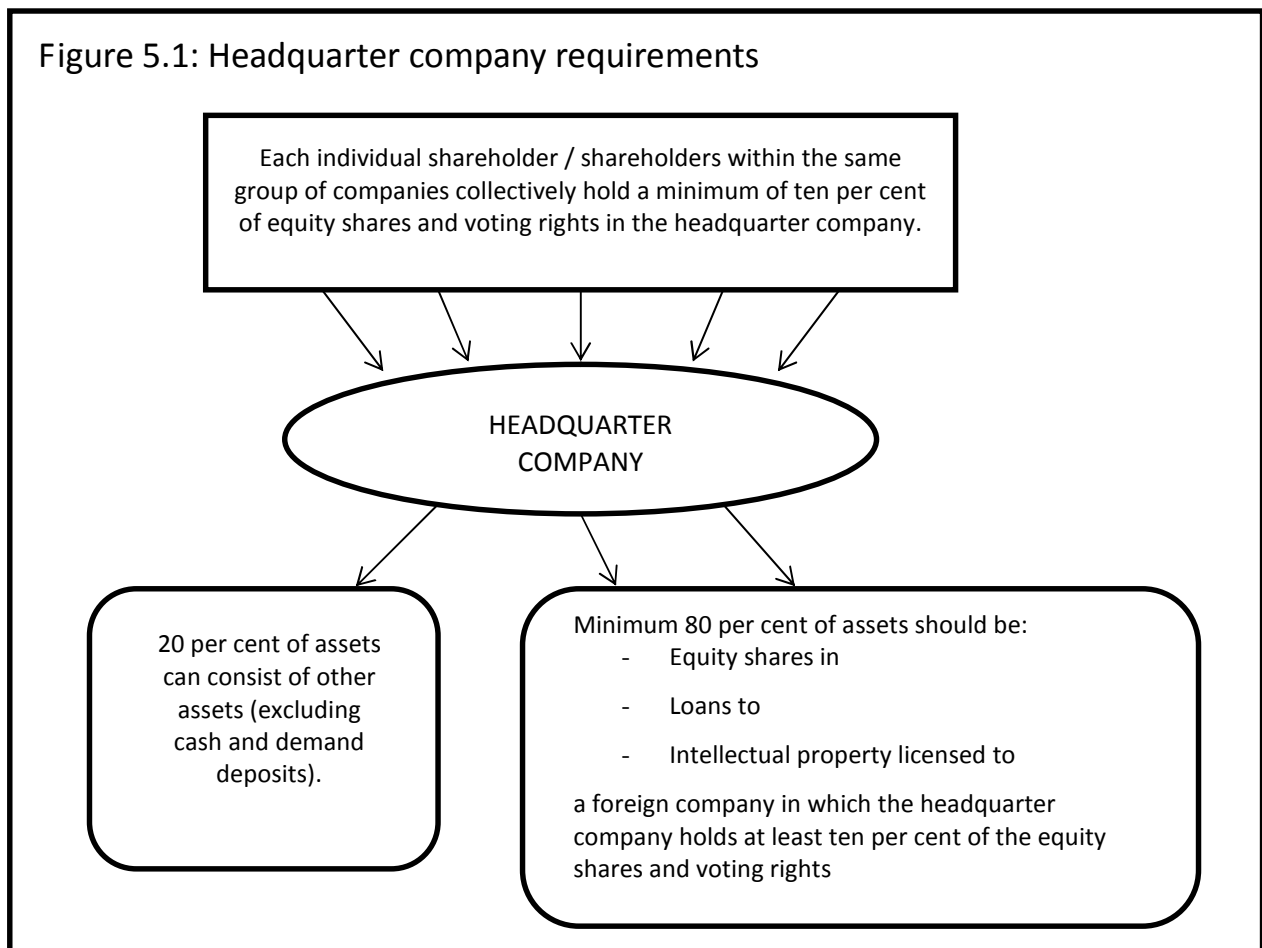
Application of headquarter company legislation is voluntary and section 9I(1) provides any resident company that complies with the requirements set out in section 9I(2) the option of electing to fall within this provision. These requirements entail:

- For the year of assessment every shareholder of the company (alone or together with other companies within the same group as the shareholder) should hold a minimum of ten per cent of the equity shares or voting rights within the company. This requirement should only be considered as of the period in the year of assessment which the company commenced the carrying on of a trade. The period prior to this should be disregarded.
- At the end of the current and previous years of assessment the company should hold a minimum of 80 per cent of the cost of all assets in :
  - Any interest in equity shares;
  - Any debt owed by; or
  - Any intellectual property (as defined by section 23I) that is licensed by the company to,

a foreign company in which that company (alone or together with other companies within the same group of companies) hold a minimum of ten per cent of the equity shares and voting rights (Stiglingh, *et al.*, 2013:569; The Income Tax Act, section 9I(2)).

Equity shares are defined in section 1 of the Income Tax Act as any share in a company. This definition excludes shares that carry a right to participate beyond a specified amount in a distribution. Distribution includes for the purpose of this definition dividends and returns of capital. (The Income Tax Act, section 1.) This implies that an equity share does contain a participation right. For the purpose of this study all shares held in a foreign entity will be considered to be equity shares containing participation rights as the aim of this study is to determine the interplay between the legislation relating to headquarter companies and the *resident* definition.

Figure 5.1 is a summary of the headquarter company requirements as discussed above.



(Adapted from Haupt, 2013: 483.)

**5.6.2 Effect on determination of *residence* of foreign companies held by Headquarter companies**

It is submitted that the above changes to the Income Tax Act can therefore have an effect on the determination of *residence* of the foreign companies held by headquarter companies. The above legislation will be applied in various practical scenarios.

5.6.2.1 Scenario 1

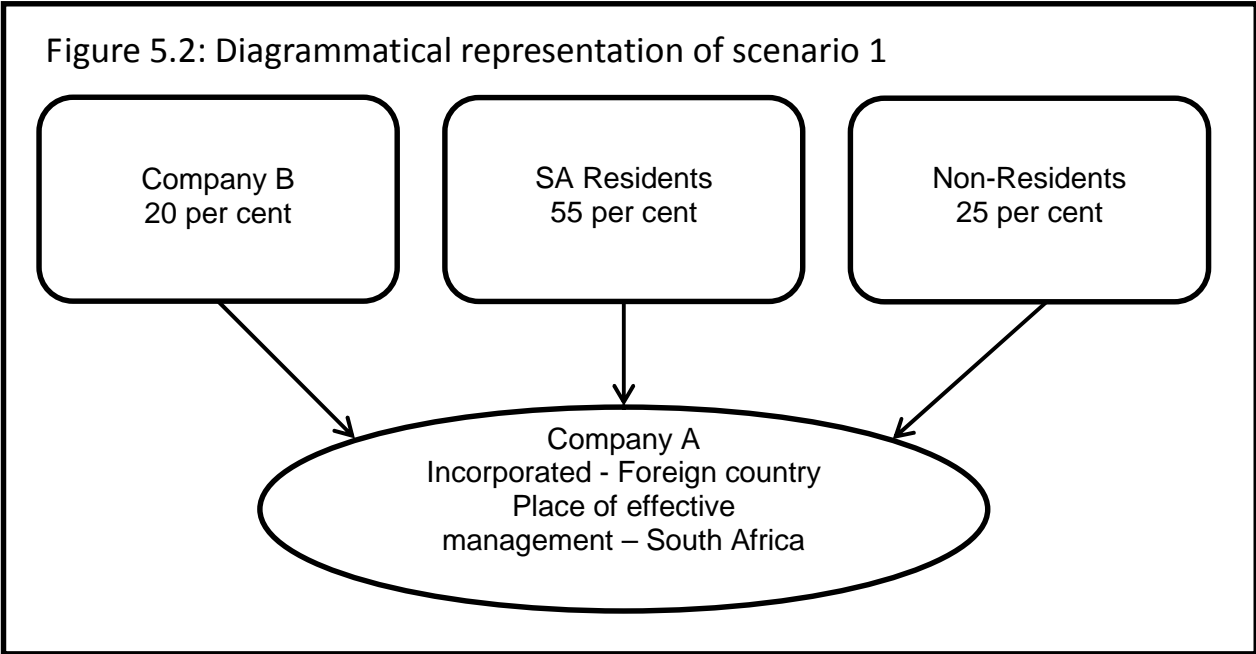
**The following is submitted as an example of the practical application:**

Company A is a company incorporated in a foreign country with its place of effective management in South Africa. Company A also has a foreign business establishment as defined by the Income Tax Act in the country of incorporation. The total tax paid in the foreign country for the year of assessment is more than 75 per cent of the tax that would have been payable in terms of South African tax law had it been a South African resident.

Company B is a South African resident, wholly owned by a foreign company and has elected to be a headquarter company in terms of section 9I.

Company A has the following shareholders:

Company B holds 20 per cent of the equity shares consisting of both participation and voting rights.



Other South African residents hold collectively 55 per cent in the equity shares consisting of both participation and voting rights.

Non-residents hold 25 per cent of the equity shares consisting of both participation and voting rights.

**Application of the Income Tax Act:**

The Income Tax Act will now be applied to the information provided in scenario 1. The different components of the *resident* definition have been set out in the table below and the information is compared to each of these aspects.

Table 5.1: Application of relevant legislation to scenario 1

<b>Section 1 – Resident definition</b>	<b>Application of the Income Tax Act</b>
<p>b) <i>person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic</i> (The Income Tax Act, section 1.)</p>	<p>In the determination of the residence of company A, the company would be considered to be a South African resident by virtue of the fact that the <i>place of effective management</i> is in South Africa.</p>
<b>Section 1 – Exclusion from the definition</b>	<b>Application of the Income Tax Act</b>
<p>(B) <i>any company if-</i>            (AA) <i>that company is incorporated, established or formed in a country other than the Republic;</i>             (BB) <i>that company has its place of effective management in the Republic;</i> (The Income Tax Act, section 1.)</p>	<p>Company A is incorporated in a foreign country, but has its <i>place of effective management</i> in South Africa.</p>

<p><i>(CC) that company would, but for the company having its place of effective management in the Republic, be a controlled foreign company with a foreign business establishment as defined in section 9D(1) (The Income Tax Act, section 1.)</i></p>	<p>55 per cent of the participation and voting rights are held by South African residents (excluding companies that elected to be headquarter companies and do not have resident shareholders), therefore the more than 50 per cent requirement is met and company A is a CFC.</p> <p>Company A has a foreign business establishment in the foreign country.</p>
<p><i>(DD) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that company in respect of any foreign tax year of that company is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that company, had that company, but for this sub-item (B), been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined-</i></p> <p><i>(i) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and</i></p> <p><i>(ii) after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that company (The Income Tax Act, section 1.)</i></p>	<p>The total tax paid in the foreign country is at least 75 per cent of the tax that would have been payable had the company been a South African resident.</p>

Scenario 1 results in a situation where Company A is not a *resident* for South African tax purposes due to the effect of the exclusion in the definition. Shares held by South African residents are already more than the requirement for classification as CFC without having to consider shares held by the headquarter company. The findings are thus conclusive.

#### 5.6.2.2 Scenario 2

**The following is submitted as an example of the practical application:**

Company A is a company incorporated in a foreign country with its place of effective management in South Africa. Company A also has a foreign business establishment as defined by the Income Tax Act in the country of incorporation. The total tax paid in the foreign country for the year of assessment is more than 75 per cent of the tax that would have been payable in terms of South African tax law had it been a resident.

Company B is a South African resident, wholly owned by a foreign company and has elected to be a headquarter company in terms of section 9I.

Company A has the following shareholding:

Company B holds 50 per cent of the equity shares consisting of both participation and voting rights.

Other South African residents hold collectively 50 per cent of the equity shares consisting of both participation and voting rights.

**Application of the Income Tax Act:**

The Income Tax Act will now be applied to the information provided in scenario 2. Again the different components of the resident definition have been set out in the table below and the information is compared to each of these aspects.

Figure 5.3: Diagrammatical representation of scenario 2

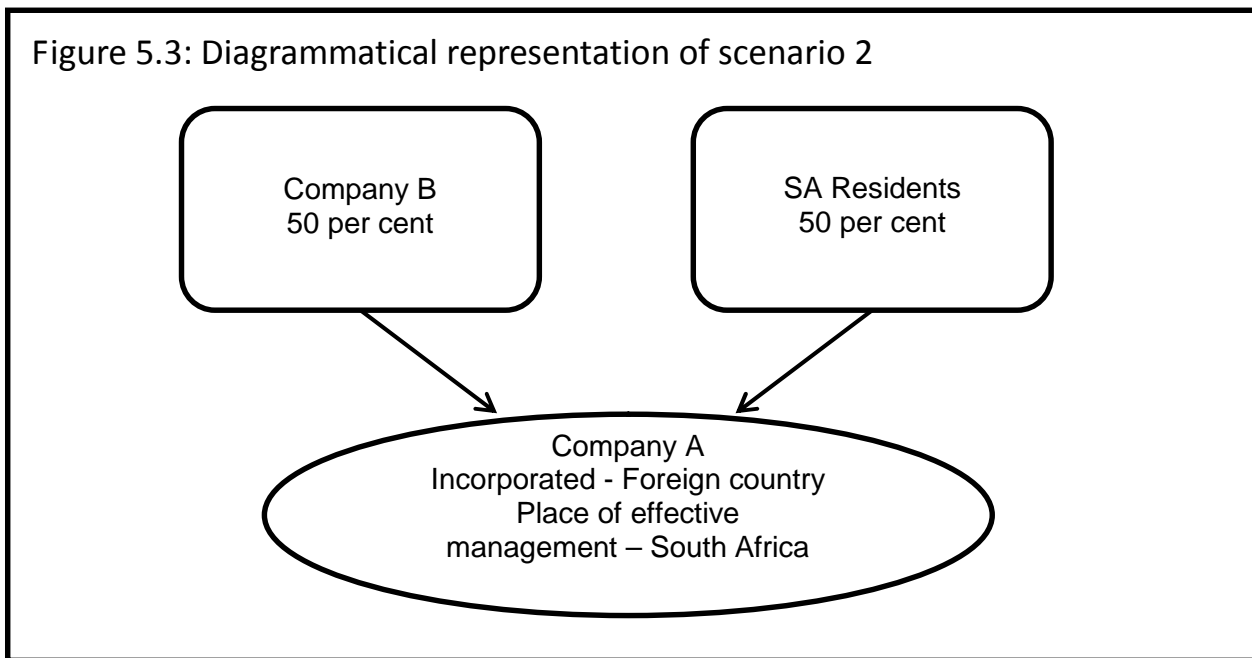


Table 5.2: Application of relevant legislation to scenario 2

Section 1 – Resident definition	Application of the Income Tax Act
<p>b) <i>person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic (The Income Tax Act, section 1.)</i></p>	<p>In the determination of the residence of company A, the company would be considered to be a South African resident by virtue of the fact that the <i>place of effective management</i> is in South Africa.</p>
Section 1 – Exclusion from the definition	Application of the Income Tax Act
<p>(B) <i>any company if-</i>            (AA) <i>that company is incorporated, established or formed in a country other than the Republic;</i>            (BB) <i>that company has its place of effective</i></p>	<p>Company A is incorporated in a foreign country, but has its <i>place of effective management</i> in South Africa.</p>

<p><i>management in the Republic; (The Income Tax Act, section 1.)</i></p>	
<p><i>(CC) that company would, but for the company having its place of effective management in the Republic, be a controlled foreign company with a foreign business establishment as defined in section 9D(1) (The Income Tax Act, section 1.)</i></p>	<p>50 per cent of the participation and voting rights are held by South African residents (excluding companies that elected to be headquarter companies and do not have resident shareholders), therefore the more than 50 per cent requirement is not met and therefore company A is not a CFC.</p> <p>Company A has a foreign business establishment in the foreign country</p>
<p><i>(DD) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that company in respect of any foreign tax year of that company is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that company, had that company, but for this sub-item (B), been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined-</i></p> <p><i>(i) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and</i></p> <p><i>(ii) after disregarding any loss in respect of</i></p>	<p>The total tax paid in the foreign country is at least 75 per cent of the tax that would have been payable had the company been a South African resident.</p>

<p><i>a year other than that foreign tax year or from a company other than that company</i> (The Income Tax Act, section 1.)</p>	
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In this scenario Company A is a *resident* for income tax purposes due to the fact that its *place of effective management* is in South Africa and it does not meet the requirements of the exclusion. The South African shareholders do not hold the required minimum shareholding in Company A, because the shares held by the headquarter company have to be disregarded.

It is submitted that in instances where a headquarter company holds less than 50 per cent of the participation or voting rights in a foreign company with its *place of effective management* in South Africa, it is possible that the foreign company would not be regarded as being a South African resident depending on the compilation of the other shareholders of the foreign company.

It is further submitted that in instances where the headquarter company (with no South African shareholders) holds 50 per cent or more of the participation or voting rights in the foreign entity, the exclusion will not apply as the foreign entity will not be a CFC. The foreign company will therefore still be regarded as being a South African *resident* based on the *place of effective management*. This can potentially cause the headquarter company not to qualify in terms of section 9I as a headquarter company due to the fact that any investment in, loan to or intellectual property licensed to the foreign entity will not contribute to the qualifying 80 per cent of the assets. The next chapter will look at the effects of this.

## **5.7 TAXATION LAWS AMENDMENT BILL NO. 39 OF 2013**

This exclusion was deleted by section 191 of the Taxation Laws Amendment Bill no. 39 of 2013 issued on 24 October 2013. The Explanatory Memorandum on the Taxation Laws Amendment Bill (2013; clause 191) indicated that the exclusion was deleted as it is considered an obsolete provision. In the absence of the exclusion any equity shares held by or assets owned by a South African resident related to a company incorporated in a foreign country with its *place of effective management* in South Africa, will not contribute to the qualifying 80 per cent of assets requirement for the application of section 9I.

## 5.8 CONCLUSION

Residence of persons other than natural persons is determined based on two aspects namely incorporation, formation or establishment and the *place of effective management*. With effect from 1 January 2013 the Income Tax Act provides for an exclusion from this definition. The revised definition excludes from being a resident in South Africa any foreign incorporated company which:

- Has its *place of effective management* in South Africa, which would make it a South African tax resident;
- Would be a CFC with a foreign business establishment had the *place of effective management* been outside of South Africa; and
- Pays tax in the foreign country that is at least 75 per cent of the tax it would have paid as a resident of South Africa.

For a foreign company to be a CFC as defined, South African residents should hold an aggregate of more than 50 per cent of the participation or voting rights in the company.

The CFC should then have a foreign business establishment as defined. The Income Tax Act identifies five instances where a *foreign business establishment* is considered to exist. All these instances indicate that the CFC is involved in legitimate, substantive business activities in the foreign country or in a place outside the Republic.

When the shareholding in the foreign company is considered, all shares held by South African headquarter companies should be disregarded, but any residents holding shares in the headquarter company and therefore holding shares indirectly in the foreign company should be considered. A headquarter company is a company that elected to be a headquarter company in terms of section 9I of the Income Tax Act. To qualify for this election the company should meet two requirements:

- The shareholders of the company should individually or collectively hold a minimum of ten per cent of the shares in the company in the same group of companies; and
- The company should hold a minimum of 80 per cent of all their assets in equity shares, debt owed by and intellectual property licensed to the foreign company in which the company holds a minimum of ten per cent of the equity shares and voting rights.

In the examples it was submitted that a foreign company with its *place of effective management* in South Africa would only become eligible for being excluded from being a resident if the percentage share in the participation and voting rights of the foreign company held by a headquarter company with only foreign investors is less than 50 per cent.

This chapter investigated the exclusion to the *resident* definition and the requirements that have to be complied with before the exclusion would come into effect. This addressed the seventh, secondary objective (chapter 1.4.2).

The next chapter will combine the legislation discussed in chapter 3, chapter 4 and this chapter. The purpose would be to determine the effect the different components of the legislation have on each other. This effect will then be considered against the backdrop of the current situation in Africa as portrayed in chapter 2. Through the completion of the next chapter the main objective will be addressed which is to determine whether the term *resident* as defined in the South African Income Tax Act no. 58 of 1962 concerning persons other than natural persons, is conducive to the concept of a headquarter company regime given the unique circumstances in African countries that result in a lack of skills in those countries.

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#### Notes

<sup>3</sup> This exclusion has been deleted retrospectively as of 1 January 2013 by the Taxation Laws Amendment Bill no. 39 of 2013 that was issued on 24 October 2013. As the aim of the study is to determine if the desired outcome is achieved by the legislation, the exclusion to the residence definition was not excluded from the study. It is still considered relevant to investigate the deficiencies of the legislation in an attempt to identify possible improvements.

## CHAPTER 6 PRACTICAL APPLICATION OF THE INCOME TAX ACT

### 6.1 INTRODUCTION

In chapter 2, the purpose behind the headquarter company regime was investigated. This investigation made it clear that National Treasury wishes to benefit from the growing interest for investment into Africa. Therefore, South Africa is positioning itself to become the *Gateway to Africa*. The introduction of the headquarter company regime has the purpose of making South Africa an attractive destination to foreign investors wishing to expand operations into the African continent.

The elements of an ideal holding company and headquarter company regime were examined in chapter 3. The distinguishing factor between these two types of regimes was found to be the level of involvement with the companies in which an interest is held. A holding company would merely hold and manage the investments. A headquarter company would additionally provide administrative and management services to these companies.

Legislation of countries that are popular destinations for headquarter companies as well as the South African legislation was analysed. The features of these regimes, along with that of the ideal regimes were compared to the South African regime. The main difference identified was the fact that the South African legislation limits the benefits of the regime to interests held in foreign companies. Any interest in a foreign company that is found to be resident in South Africa based on *place of effective management* would not be considered to be a qualifying interest in terms of the headquarter company legislation.

Residence being the distinguishing factor was investigated in chapter 4. The two tests used to determine residence were discussed. The place where a company is incorporated, formed or established was found to be a question of fact. The *place of effective management* was found to be subjective and the interpretation thereof was found to be controversial. The common aspect in all of these interpretations was the fact that the *place of effective management* should be determined based on a senior level of management.

Excluded from the *resident* definition are companies incorporated in a foreign country with their *place of effective management* in South Africa, provided certain requirements are met (chapter

5)<sup>4</sup>. These requirements include that the non-resident should qualify as a controlled foreign company with a foreign business establishment when the *place of effective management* is disregarded and the company has to pay tax in the foreign country at a minimum of 75 per cent of the amount that it would have paid in taxes in South Africa.

In this chapter the findings of these chapters will be combined and applied to practical examples of company structures. The aim is to determine how the interplay of these provisions affect each other and the qualification of a structure for application of the headquarter company legislation. This is in response to the eighth and ninth, secondary objectives (chapter 1.4.2).

## 6.2 PRACTICAL APPLICATION

For this part of the study, four scenarios will be considered. In each scenario it has to be determined if Holdco will qualify for election as a headquarter company. In all four scenarios the foreign company (Subco) is incorporated in an African country, but it has its *place of effective management* in South Africa. The scenarios will change with regard to two aspects; residence of Holdco's shareholder and size of Holdco's interest in Subco. Scenario C has an additional change in the residence of Subco's other shareholder.

These scenarios were created around the above aspects, as they will determine if the company will meet the definition as a controlled foreign company, when *place of effective management* is disregarded. This requirement, along with the required foreign business establishment and the more than 75 per cent of taxes that would have been paid in South Africa, will determine if the exclusion to the *resident* definition will apply. Ultimately the *resident* status of Subco will determine if Holdco qualifies as headquarter company.

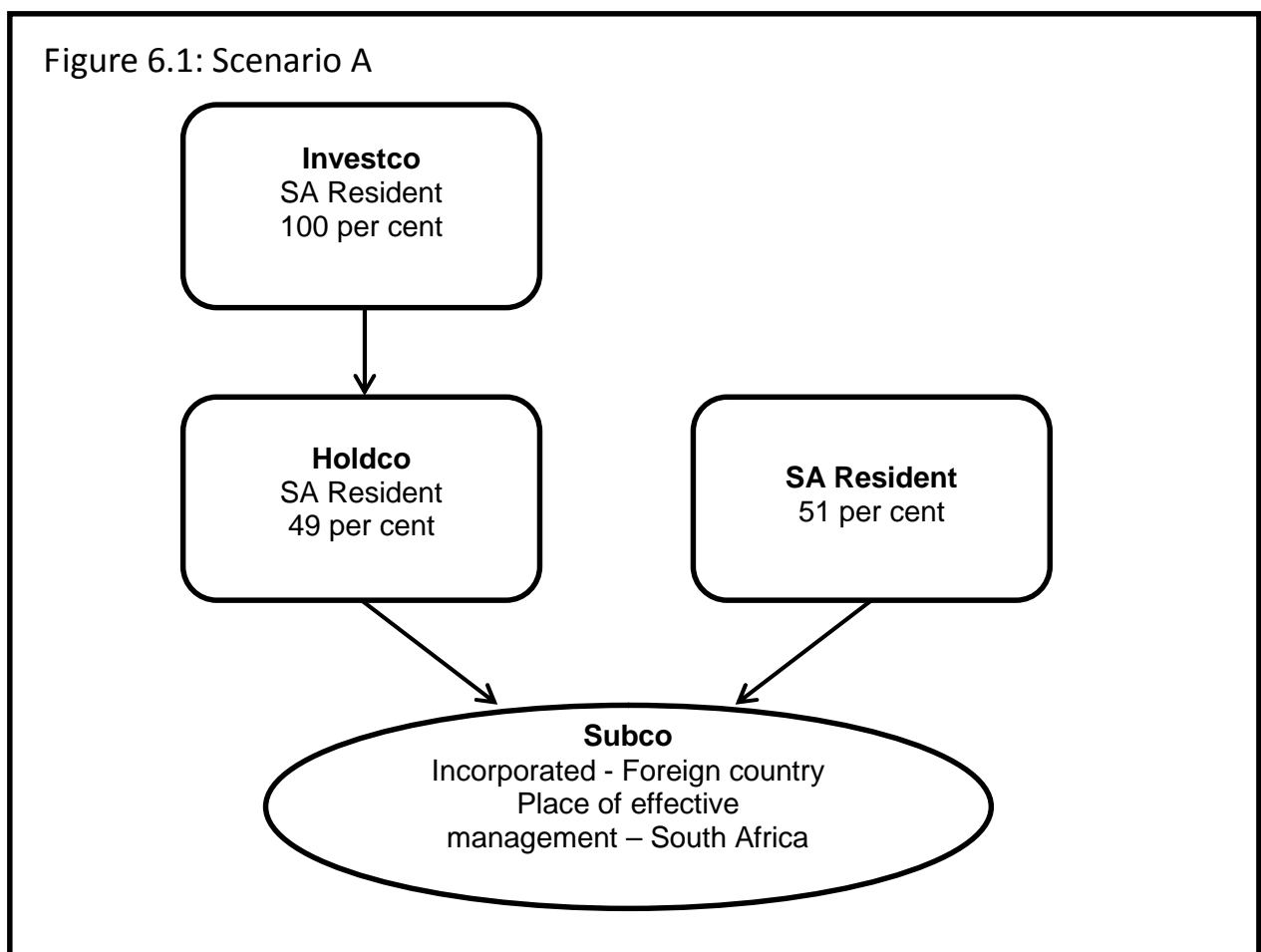
Scenario A will look at the situation where Holdco has a South African shareholder and holds 49 per cent of the shares in Subco. In Scenario B Holdco has the same size shareholding, but Holdco's shareholder is a foreign resident. Holdco has a 51 per cent shareholding in Subco in Scenario C and D, but Holdco is held by a South African resident in Scenario C and a foreign resident in Scenario D. Scenario C also differs in that the remaining shares of Subco is held by a foreign resident as oppose to a South African resident like the other scenarios.

## Scenario A

Holdco is a company established in South Africa by a South African resident. Holdco is wholly owned by the South African resident, Investco, and its *place of effective management* is situated in South Africa. All assets held by Holdco relate to its investment in Subco.

Holdco holds 49 per cent equity shares with participation and voting rights (for purposes of this example *shareholding* refers to participation and voting rights) in an African incorporated entity, Subco. The latter, Subco has a foreign business establishment in an African country. The remaining 51 per cent is held by another South African resident that does not qualify as a headquarter company. The *place of effective management* of Subco is in South Africa. Currently Subco is subject to tax in the African country equal to more than 75 per cent of the tax that he would have paid in South Africa.

Holdco will elect to be a headquarter company in terms of section 9I, if the company qualifies.



## **Application of the Income Tax Act:**

### **Residence of Subco:**

Subco is incorporated in the African country and has its *place of effective management* in South Africa. Based on the two tests, Subco is a tax resident in South Africa. (the Income Tax Act, section 1.) The requirements of the exclusion should be considered to determine if they apply.

The exclusion requires that Subco should qualify as a controlled foreign company with a foreign business establishment if the *place of effective management* is disregarded. (The Income Tax Act, section 1.) Subco has a foreign business establishment in the African country and pays tax in that country at more than 75 per cent of the taxes it would have paid in South Africa. It should therefore only be considered if Subco is a controlled foreign company as defined with exception of *place of effective management*.

### **Controlled foreign company requirement:**

Subco will qualify as a controlled foreign company if more than 50 per cent of the participation rights or 50 per cent of the voting rights of Subco is held by qualifying South African residents. This excludes South African headquarter companies.

The shareholding in Subco is held entirely by two South African residents. The one shareholder holds 51 per cent and is not a headquarter company. The other company (Holdco) will elect to be a headquarter company, if it qualifies. Holdco will qualify only if Subco is a foreign company. If Holdco does not qualify, Subco will be a controlled foreign company as 100 per cent will be held by South African residents. This is more than 50 per cent which is the requirement of the Income Tax Act (The Income Tax Act, section 9D(1)).

If Holdco qualifies as a headquarter company the tax residence of Holdco's shareholders would have to be considered. Holdco is fully owned by a South African resident and therefore Holdco's shareholder and the other South African resident hold 100 per cent of Subco. Subco qualifies as controlled foreign company as more than 50 per cent of its shares are held by South African residents. (The Income Tax Act, section 9D(1)).

Regardless of the status of Holdco or its holding company in this scenario, Subco will be a controlled foreign company as the other South African resident alone meets the 50 per cent requirement. Subco is therefore a controlled foreign company with a foreign business establishment.

Subco is also subject to tax in the African country equal to more than 75 per cent of the tax it would have paid in South Africa. Therefore Subco meets the second requirement of the exclusion (The Income Tax Act, section 1). Subco complies with the requirements of the exclusion and is therefore not a resident for tax purposes in South Africa.

#### **Headquarter company status of Holdco:**

Holdco will qualify as a headquarter company if it has a maximum of 10 shareholders, each holding a minimum of ten per cent in Holdco. Furthermore, 80 per cent of Holdco's assets should relate to interest in, loans to or intellectual property licensed to the foreign company.

Holdco is a South African resident (complies with section 9l(1)(a)) with a single shareholder (complies with section 9l(2)(a)). The only assets held by Holdco relate to its investment in Subco, a foreign company as defined (not a South African resident). Holdco's assets are therefore 100 per cent attributed to a foreign company in which it holds more than ten per cent of the equity shares and voting rights (complies with section 9l(2)(b)). Holdco therefore meets all the requirements per section 9l and may therefore elect to be a headquarter company for tax purposes.

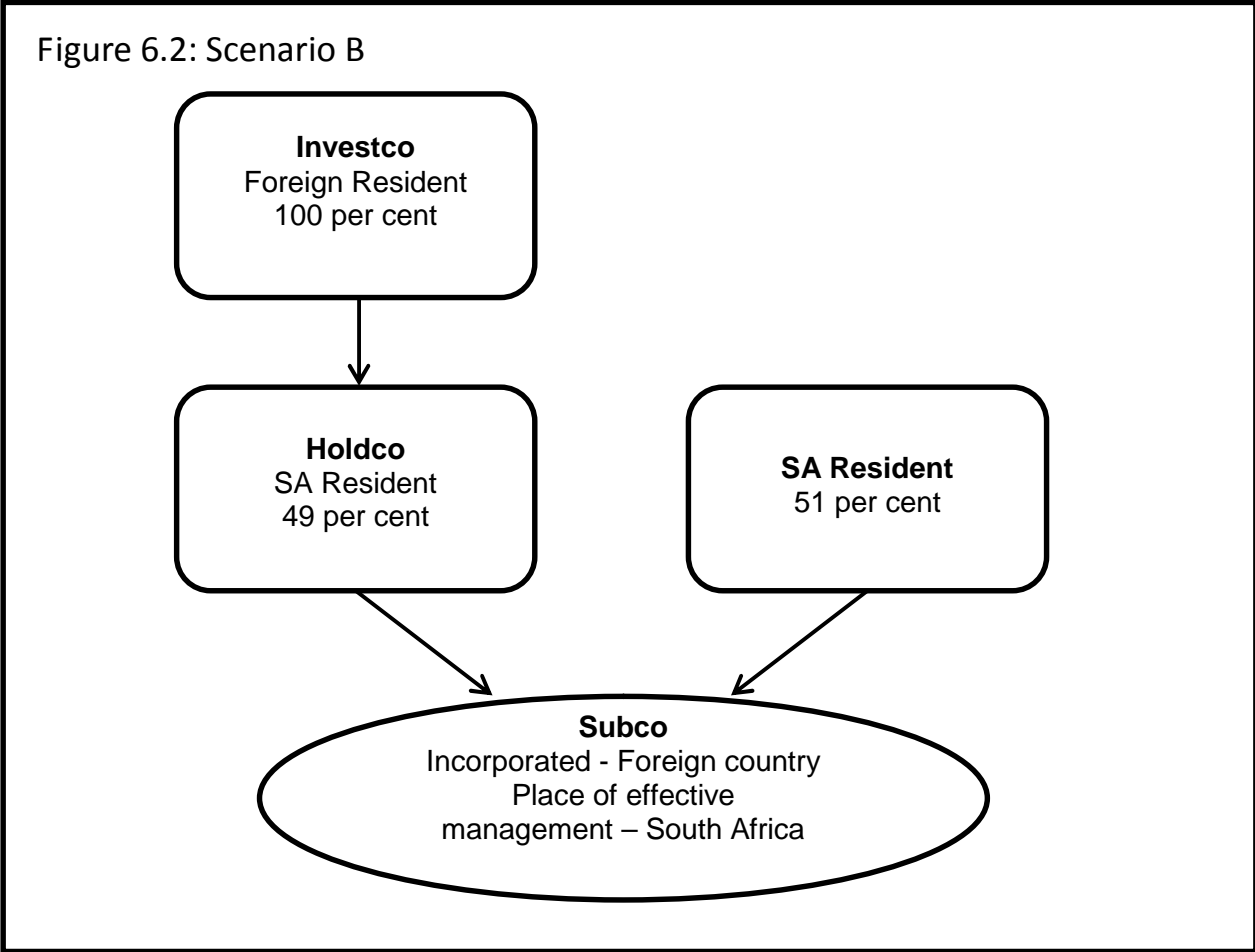
This example provides that in instances where Holdco is the minority (less than 50 per cent) shareholder and only has South African shareholders, it would depend on the combined shareholding of Holdco's shareholders and the other shareholders of Subco, whether Subco is a resident or not. This in turn will affect the application of the headquarter company regime.

#### **Scenario B**

Holdco is a company established in South Africa by a foreign investor. Holdco is wholly owned by the foreign investor, Investco, but its *place of effective management* is situated in South Africa. All assets held by Holdco relate to its investment in Subco.

Holdco holds 49 per cent equity shares with participation and voting rights (for purposes of this example *shareholding* refers to participation and voting rights) in an African incorporated entity, Subco. Subco has a foreign business establishment in the African country. The remaining 51 per cent is held by another South African resident that does not qualify as a headquarter company. The *place of effective management* of Subco is in South Africa. Currently Subco is subject to tax in the African country equal to more than 75 per cent of the tax that he would have paid in South Africa.

Holdco will elect to be a headquarter company in terms of section 9I if the company qualifies.



## **Application of the Income Tax Act:**

### **Residence of Subco:**

Subco is incorporated in the African country and has its *place of effective management* in South Africa. Based on the *place of effective management* tests, Subco is a tax resident in South Africa. (The Income Tax Act, section 1.) The requirements of the exclusion should be considered to determine if they apply.

The exclusion requires that Subco should qualify as a controlled foreign company with a foreign business establishment if the *place of effective management* is disregarded. (The Income Tax Act, section 1.) Subco has a foreign business establishment in the African country and pays tax in that country at more than 75 per cent of the taxes it would have paid in South Africa. It should therefore only be considered if Subco is a controlled foreign company as defined with exception of *place of effective management*.

### **Controlled foreign company requirement:**

Subco will qualify as a controlled foreign company if more than 50 per cent of the participation rights or 50 per cent of the voting rights of Subco is held by qualifying South African residents. This excludes South African headquarter companies.

The shareholding in Subco is held entirely by two South African residents. The one shareholder holds 51 per cent and is not a headquarter company. The other company will elect to be a headquarter company if it qualifies. Holdco will qualify only if Subco is a foreign company. If Holdco does not qualify, Subco will be a controlled foreign company as 100 per cent will be held by South African residents. This is more than 50 per cent which is the requirement of the Income Tax Act (The Income Tax Act, section 9D(1)).

If Holdco qualifies the tax residence of Holdco's shareholders would have to be considered. Holdco is fully owned by a foreign investor that is not a South African resident. Therefore the shareholding held by the other South African resident will be considered in isolation. As this

resident holds 51 per cent, the requirement of the Income Tax Act is met (The Income Tax Act, section 9D(1)). Subco is a controlled foreign company with a foreign business establishment.

This scenario shows that the status of Holdco or the residence of its holding company is irrelevant when the remaining shareholding in Subco already meets the controlled foreign company requirements. In these situations the *place of effective management* would not pose a threat to the application of the headquarter company legislation.

Subco is also subject to tax in the African country equal to more than 75 per cent of the tax it would have paid in South Africa. Therefore Subco meets the second requirement of the exclusion (The Income Tax Act, section 1). Subco complies with the requirements of the exclusion and is therefore not a resident for tax purposes in South Africa.

#### **Headquarter company status of Holdco:**

Holdco will qualify as a headquarter company if it has a maximum of 10 shareholders, each holding a minimum of ten per cent in Holdco. Furthermore, 80 per cent of Holdco's assets should relate to interest in, loans to or intellectual property licensed to the foreign company.

Holdco is a South African resident (complies with section 9I(1)(a)) with a single foreign shareholder (complies with section 9I(2)(a)). The only assets held by Holdco relate to its investment in Subco, a foreign company as defined (not a South African resident). Holdco's assets are therefore 100 per cent attributed to a foreign company in which it holds more than ten per cent of the equity shares and voting rights (complies with section 9I(2)(b)). Holdco therefore meet all the requirements per section 9I and may therefore elect to be a headquarter company for tax purposes.

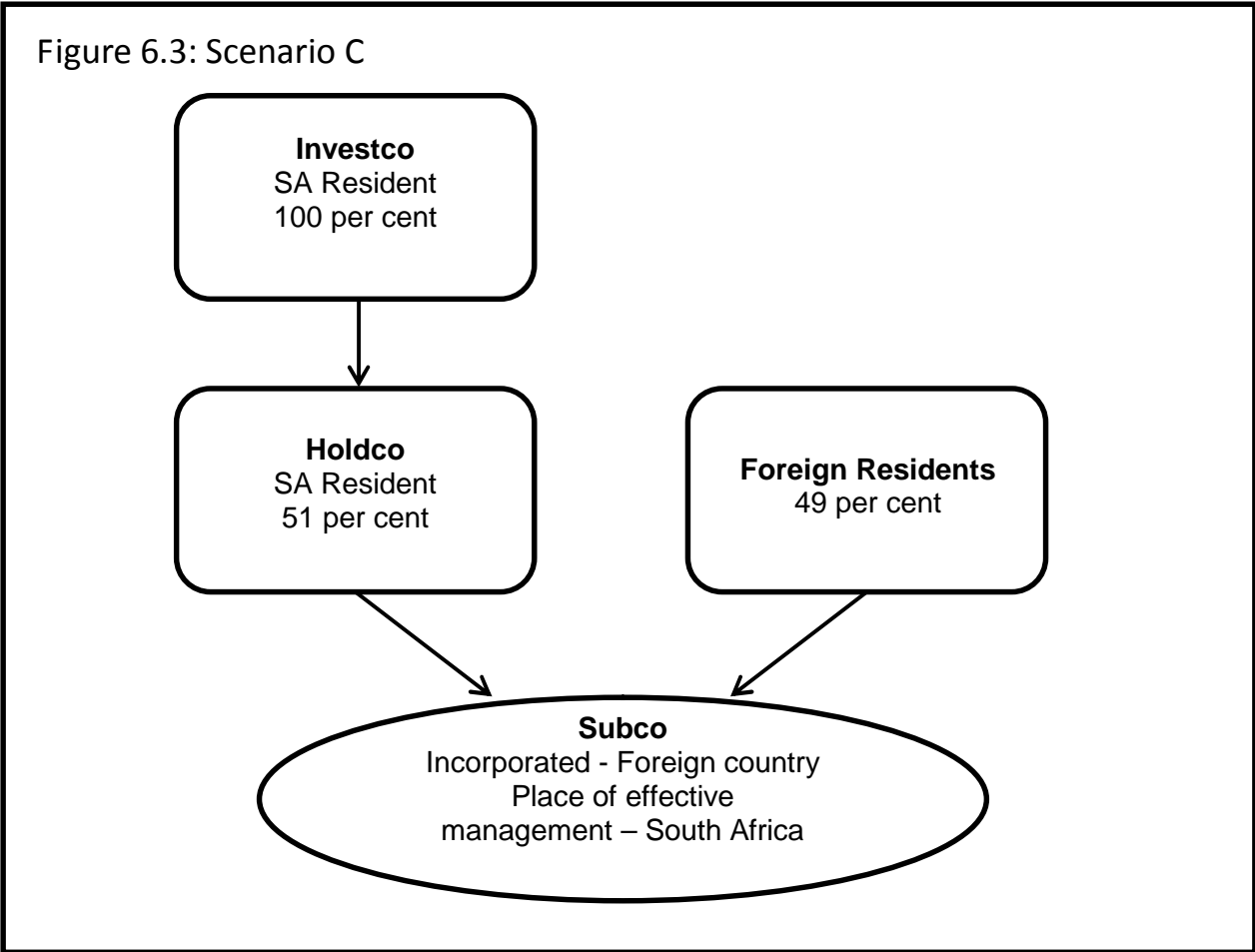
From this example it is evident that where Holdco is the minority (less than 50 per cent) shareholder of Subco and only has foreign shareholders, the resident status of Subco will depend purely on the other shareholders. This again affects the applicability of the headquarter company legislation.

**Scenario C**

Holdco is a company established in South Africa by another South African resident. Holdco is wholly owned by the South African investor, Investco, and its *place of effective management* is situated in South Africa. All assets held by Holdco relate to its investment in Subco.

Holdco holds 51 per cent equity shares with participation and voting rights (for purposes of this example *shareholding* refers to participation and voting rights) in an African incorporated entity, Subco. Subco has a foreign business establishment in the African country. The remaining 49 per cent is held by a foreign investor that is not a tax resident in South Africa. The *place of effective management* of Subco is in South Africa. Currently Subco is subject to tax in the African country equal to more than 75 per cent of the tax that he would have paid in South Africa.

Holdco will elect to be a headquarter company in terms of section 9I if the company qualifies.



## **Application of the Income Tax Act:**

### **Residence of Subco:**

Subco is incorporated in the African country and has its *place of effective management* in South Africa. Based on the two tests, Subco is a tax resident in South Africa. (The Income Tax Act, section 1.) The requirements of the exclusion should be considered to determine if they apply.

The exclusion requires that Subco should qualify as a controlled foreign company with a foreign business establishment if the *place of effective management* is disregarded. (The Income Tax Act, section 1.) Subco has a foreign business establishment in the African country and pays tax in that country at more than 75 per cent of the taxes it would have paid in South Africa. It should therefore only be considered if Subco is a controlled foreign company as defined with exception of *place of effective management*.

### **Controlled foreign company requirement:**

Subco will qualify as a controlled foreign company if more than 50 per cent of the participation rights or 50 per cent of the voting rights of Subco is held by qualifying South African residents. This excludes South African headquarter companies.

The shareholding in Subco is held entirely by two South African residents. The one shareholder holds 49 per cent and is not a headquarter company. The other company will elect to be a headquarter company if it qualifies. Holdco will qualify only if Subco is a foreign company. If Holdco does not qualify, Subco will be a controlled foreign company as 100 per cent will be held by South African residents. This is more than 50 per cent which is the requirement of the Income Tax Act (The Income Tax Act, section 9D(1)).

If Holdco qualifies the tax residence of Holdco's shareholders would have to be considered. Holdco is fully owned by a South African resident and therefore the entire shareholding will be considered to be held by South African residents. This is more than 50 per cent which is the requirement of the Income Tax Act (The Income Tax Act, section 9D(1)).

Regardless of the status of Holdco, Subco will be a controlled foreign company as the holding company of Holdco is a South African resident. Whether Holdco qualifies or not, the 51 per cent will be considered to be owned by a South African resident that is not a headquarter company (directly by Holdco if it does not qualify or indirectly by Holdco's shareholder). Subco is therefore a controlled foreign company with a foreign business establishment.

Subco is also subject to tax in the African country equal to more than 75 per cent of the tax it would have paid in South Africa. Therefore Subco meets the second requirement of the exclusion (The Income Tax Act, section 1). Subco complies with the requirements of the exclusion and is therefore not a resident for tax purposes in South Africa.

#### **Headquarter company status of Holdco:**

Holdco will qualify as a headquarter company if it has a maximum of 10 shareholders, each holding a minimum of ten per cent in Holdco. Furthermore, 80 per cent of Holdco's assets should relate to interest in, loans to or intellectual property licensed to the foreign company.

Holdco is a South African resident (complies with section 9l(1)(a)) with a single shareholder (complies with section 9l(2)(a)). The only assets held by Holdco relate to its investment in Subco, a foreign company as defined (not a South African resident). Holdco's assets are therefore 100 per cent attributed to a foreign company in which it holds more than ten per cent of the equity shares and voting rights (complies with section 9l(2)(b)). Holdco therefore meet all the requirements per section 9l and may therefore elect to be a headquarter company for tax purposes.

This example makes it clear that where Holdco is the majority (more than 50 per cent) shareholder of Subco the shareholdings of the other shareholders do not determine the resident status of Subco. The determinant in this instance is the resident status of Holdco's shareholders in combination with the other residents.

## **Scenario D**

Holdco is a company established in South Africa by a foreign investor. Holdco is wholly owned by the foreign investor, Investco, but its *place of effective management* is situated in South Africa. All assets held by Holdco relate to its investment in Subco.

Holdco holds 51 per cent equity shares with participation and voting rights (for purposes of this example *shareholding* refers to participation and voting rights) in an African incorporated entity, Subco. Subco has a foreign business establishment in the African country. The remaining 49 per cent is held by another South African resident that does not qualify as a headquarter company. The *place of effective management* of Subco is in South Africa. Currently Subco is subject to tax in the African country equal to more than 75 per cent of the tax that it would have paid in South Africa.

Holdco will elect to be a headquarter company in terms of section 9I if the company qualifies.

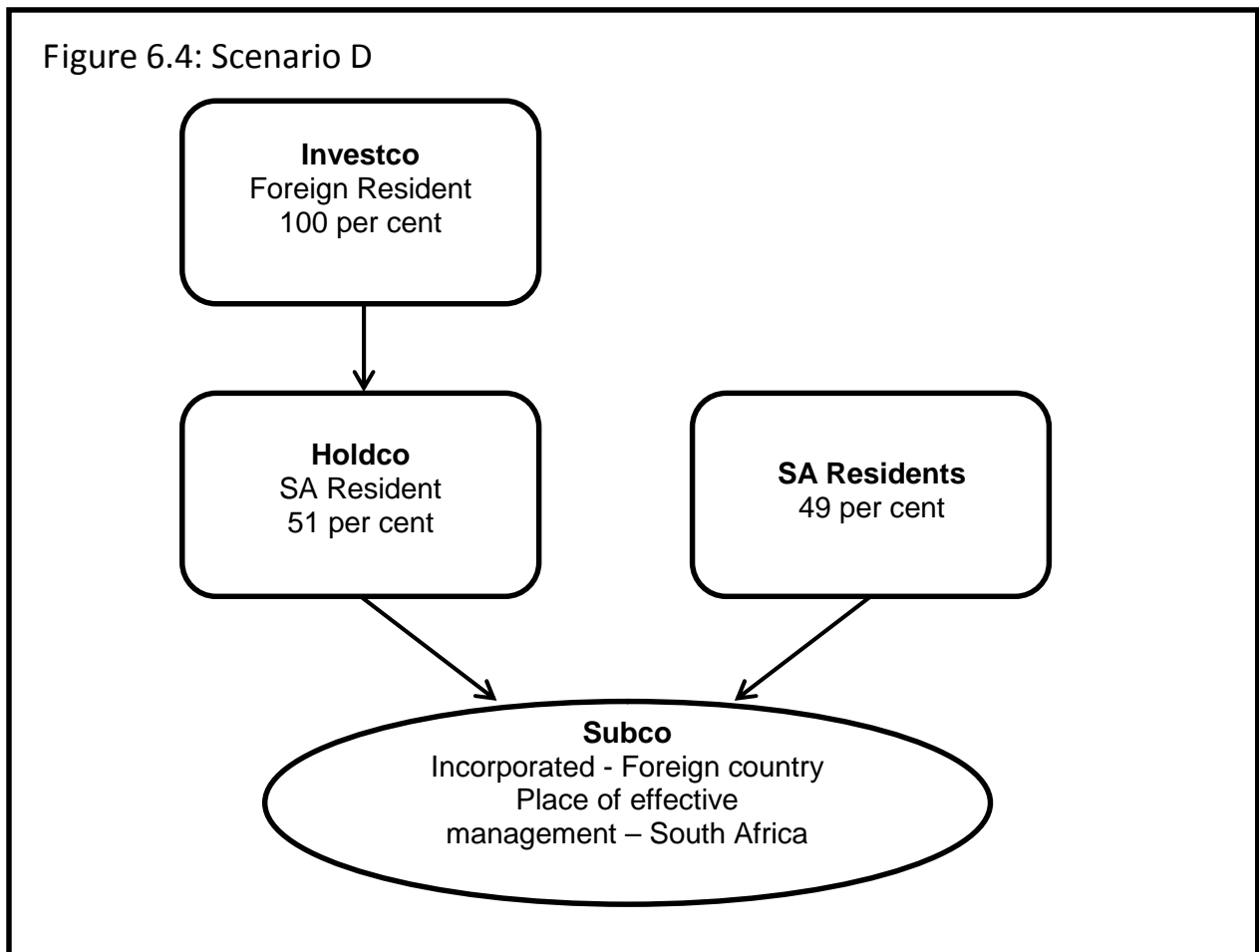
### **Application of the Income Tax Act:**

#### **Residence of Subco:**

Subco is incorporated in the African country and has its *place of effective management* in South Africa. Based on these tests, Subco is a tax resident in South Africa. (The Income Tax Act, section 1.) The requirements of the exclusion should be considered to determine if they apply.

The exclusion requires that Subco should qualify as a controlled foreign company with a foreign business establishment if the *place of effective management* is disregarded. (The Income Tax Act, section 1.) Subco has a foreign business establishment in the African country and pays tax in that country at more than 75 per cent of the taxes it would have paid in South Africa. It should therefore only be considered if Subco is a controlled foreign company as defined with exception of *place of effective management*.

Figure 6.4: Scenario D



**Controlled foreign company requirement:**

Subco will qualify as a controlled foreign company if more than 50 per cent of the participation rights or 50 per cent of the voting rights of Subco is held by qualifying South African residents. This excludes South African headquarter companies.

The shareholding in Subco is held entirely by two South African residents. The one shareholder holds 49 per cent and is not a headquarter company. The other company will elect to be a headquarter company if it qualifies. Holdco will qualify only if Subco is a foreign company. If Holdco does not qualify, Subco will be a controlled foreign company as 100 per cent will be held by South African residents. This is more than 50 per cent which is the requirement of the Income Tax Act (The Income Tax Act, section 9D(1)).

If Holdco qualifies the tax residence of Holdco's shareholders would have to be considered. Holdco is fully owned by a foreign investor that is not a South African resident. Therefore the shareholding held by the other South African resident will be considered in isolation. As this resident holds 49 per cent, the requirement of the Income Tax Act is not met (The Income Tax Act, section 9D(1)). Subco is not a controlled foreign company with a foreign business establishment.

In this scenario it would make a significant difference if Holdco qualifies as a headquarter company or not as this would determine the tax residence of Subco. In the same instance it makes a significant difference if Subco is a South African tax resident or not as this would determine if Holdco qualifies as a headquarter company.

At the moment when the exclusion has to be considered, Holdco does not qualify as a headquarter company as Subco has qualified as a South African tax resident based on the *place of effective management* test. The shareholding held by Holdco would therefore also be considered to determine if Subco would qualify as a controlled foreign company if *place of effective management* is disregarded.

Holdco together with the other South African resident holds 100 per cent of Subco, which is more than the 50 per cent requirement of the Income Tax Act (The Income Tax Act, section 9D(1)). Subco would therefore be considered to be a controlled foreign company with a foreign business establishment in the African country.

Subco is also subject to tax in the African country equal to more than 75 per cent of the tax it would have paid in South Africa. Therefore Subco meets the second requirement of the exclusion (The Income Tax Act, section 1). Subco complies with the requirements of the exclusion and is therefore not a resident for tax purposes in South Africa.

#### **Headquarter company status of Holdco:**

Holdco will qualify as a headquarter company if it has a maximum of 10 shareholders, each holding a minimum of ten per cent in Holdco. Furthermore, 80 per cent of Holdco's assets should relate to interest in, loans to or intellectual property licensed to the foreign company.

Holdco is a South African resident (complies with section 9I(1)(a)) with a single foreign shareholder (complies with section 9I(2)(a)). The only assets held by Holdco relate to its investment in Subco, a foreign company as defined (not a South African resident). Holdco's assets are therefore 100 per cent attributed to a foreign company in which it holds more than ten per cent of the equity shares and voting rights (complies with section 9I(2)(b)). Holdco therefore meets all the requirements per section 9I and may therefore elect to be a headquarter company for tax purposes. (The Income Tax Act, section 9I.)

As soon as Holdco meets the requirements of section 9I(2) and elects to be a headquarter company in terms of section 9I(1), this will have an impact on the determination of the tax residence status of Subco as already indicated above (The Income Tax Act, section 9I). The shareholding in Subco will now consist of 51 per cent held by Holdco, a headquarter company and 49 per cent held by another South African resident that is not a headquarter company. The portion relating to Holdco will be disregarded and instead the shareholders of Holdco will be considered. This is a foreign investor that is not a tax resident in South Africa. This will result in only 49 per cent being held by qualifying South African residents which is less than the requirement of the Income Tax Act (The Income Tax Act, section 9D(1)). Subco will then not qualify as a controlled foreign company and the exclusion will not apply (The Income Tax Act, section 1).

From this scenario it is clear that the legislation will result in an enigma that can cause problems in the application of the various parts of the legislation.

### **6.3 EFFECT OF THE ABOVE FINDINGS**

The above practical examples make it clear that the residence status of the foreign incorporated company will affect the applicability of headquarter company legislation. This part of the study will look at what can be understood from the above examples.

In scenario A, Holdco was not the main (more than 50 per cent) shareholder. The main shareholder was the South African resident that did not qualify as a headquarter company. Subco was excluded from being a South African tax resident by virtue of the fact that it qualified as a controlled foreign company with a foreign business establishment when *place of effective management* was disregarded. This combination of facts resulted in Holdco qualifying for

election to be a headquarter company and in effect enjoying the benefits related to headquarter company legislation.

Had the other shareholder not been a South African resident, Subco would not have qualified for the exclusion as the total South African shareholding would not have met the requirement of the *resident* definition (The Income Tax Act, section 1). Holdco (if it was not a headquarter company) and Holdco's shareholder (if Holdco did qualify as the headquarter company) are both tax residents of South Africa, but the shareholding is only 49 per cent. This is less than the requirement of controlled foreign company legislation (The Income Tax Act, section 9D(1)). In this instance Holdco would not qualify for election to be a headquarter company and will not be able to benefit from the headquarter company legislation.

The only difference between scenario A and scenario B is that Holdco's shareholder is a foreign investor that is not a South African tax resident. All the other facts stayed the same and therefore the outcomes were exactly the same. The reason is that in this scenario it does not matter if the shareholder of Holdco is a South African tax resident or not. The exclusion will apply in this scenario as the main shareholder is a qualifying South African tax resident. This shareholder holds a minimum of ten per cent and more than 50 per cent in the African company. As a result Subco will be a controlled foreign company (The Income Tax Act, section 9D(1)) and the exclusion will apply (The Income Tax Act, section 1).

In scenario C and scenario D, Holdco is the main shareholder. From these scenarios it is clear that in such an instance, the tax residence of Holdco's shareholder is the distinguishing factor.

In scenario C, Holdco is wholly owned by a South African resident. When legislation is applied to determine the tax residence of the African country, the exclusion will apply regardless if Holdco is a headquarter company or not. If Holdco is a headquarter company, Holdco's shareholder will be considered. As this is a South African tax resident, Subco will be considered to be a controlled foreign company for purposes of the exclusion and therefore Subco will not be a South African tax resident. If Holdco is not a headquarter company, Subco will still be a controlled foreign company for the purposes of the exclusion and therefore Subco will not be a South African tax resident.

In both of these instances Subco is not a tax resident and Holdco will qualify as a headquarter company. Holdco will therefore benefit from the headquarter company legislation.

Had the other shareholder been a South African resident, it would not have made a difference to the results, because the other shareholder is not the main shareholder. The shares held directly by Holdco and indirectly by Holdco's shareholders who are South African residents already meet the requirement. Where there more than two shareholders, the shareholders would have to be considered in combination.

The last scenario (Scenario D) indicates that there is an enigma in the Income Tax Act. In this scenario Holdco is the main shareholder and Holdco's holding company is a foreign investor that is not a South African tax resident. In applying the various relevant components of the Income Tax Act a circle effect is created.

Holdco will only qualify as a headquarter company if Subco is not a tax resident of South Africa. On the other hand Subco will only not be a tax resident of South Africa if Holdco is not a headquarter company.

The tax residence of the other shareholder does not have an effect in this scenario as the shareholding only amounts to 49 per cent. The majority of the shareholding that will determine if Subco would qualify for the exclusion belongs to Holdco.

## **6.4 RELEVANCE TO THE TOPIC**

In chapter 2, it was found that there is significant growth in Africa and a definite increase in foreign direct investment into Africa. National Treasury has indicated that it had at aim to establish South Africa as the *Gateway into Africa*. The purpose of the inclusion of the headquarter company legislation was to make South Africa more attractive to foreign investors wishing to expand their operations into Africa.

It was also found that there is a shortage of skills available in Africa. This is the result of the lack of available, quality education in African countries. It was also found that as a result companies expanding into Africa would have to work strategically with the skills available to them. It is submitted that a reasonable assumption would be that a foreign investor would be able to

benefit from centralising functions as far as is possible when expanding operations into Africa to ensure effective and efficient utilisation of the skills available.

Chapter 4 indicated that the residence of a foreign incorporated company would be determined based on the *place of effective management*. The study into the meaning of this term indicated that there are various interpretations by various tax jurisdictions and tax authors. The common element between the various interpretations is the fact that all of them refer to a senior level of management.

It is submitted that the effective management function is typically a function that can be centralised by foreign investors investing in Africa as it is the distinguishing characteristic between a holding company and a headquarter company. Given the analyses performed in chapter 3 of the purpose behind headquarter companies, this function would typically be performed by a headquarter company.

Against this background, it becomes realistic that the *place of effective management* of the African country will be situated within the headquarter company. South Africa wants to establish a platform that is attractive to foreign investors to set up headquarter companies in South Africa. The examples that have a foreign investor as the only shareholder in Holdco also become relevant as the focus is on foreign investment into Africa.

The examples proved that in the absence of the exclusion the headquarter company legislation will not apply as soon as *place of effective management* is situated in South Africa. The exclusion succeeded in certain instances to prevent this adverse effect towards the application of headquarter company legislation, but it was also found to be limited to instances where other South African residents hold the qualifying interest in the African country or where the headquarter company has South African shareholders who then indirectly hold the qualifying interest.

The exclusion therefore does not succeed in preventing that the *resident* definition has a negative impact on the attractiveness of South Africa as a headquarter company destination. A foreign investor would have to ensure that *place of effective management* is not situated in South Africa. The headquarter company would therefore not be able to perform a centralised management function. If *place of effective management* is situated in South Africa, the foreign

investor would have to ensure that other South African residents hold the qualifying share in the foreign company for the exclusion to apply. This implies that the foreign investor will only be able in this instance to invest in less than 50 per cent of the foreign company.

## **6.5 TAXATION LAWS AMENDMENT BILL NO. 39 OF 2013**

As noted in the previous chapter the exclusion to the *resident* definition has been deleted retrospectively as of 1 January 2013. (2013: section 191) The effect of the deletion will be that all the above scenarios will result in Holdco not qualifying as a headquarter company.

Any equity shares held in, loans to or intellectual property licensed to a foreign company that has its *place of effective management* in South Africa will not contribute to the 80 per cent of assets requirement of section 9I. These assets can therefore cause the South African resident wishing to elect to be a headquarter company to not meet the requirements.

This will affect the attractiveness to foreign investors of South Africa as headquarter company destination in that the foreign investor would not be able to centralise the management function of their African operations in South Africa. The size of the shareholding in the foreign company and the shareholdings of other South African shareholders will no longer have an effect on the headquarter company status other than the minimum shareholding requirement of ten per cent.

The exclusion did not function effectively as was proven by the above practical examples. The deletion of the exclusion is therefore a confirmation of the findings of that component of the study. However, it is still evident that the original *resident* definition (before the addition of the exclusion) had an adverse effect on the attractiveness of the headquarter company regime. The exclusion failed to address this effect and created additional issues with reference to the application of the headquarter company legislation. The deletion eliminates the additional issues, but the original issues prevail.

## **6.6 CONCLUSION**

This chapter had at aim to address the eighth and the ninth, secondary objectives, namely to determine how the provisions affect each other and the qualification of a structure for the application of the headquarter company legislation (chapter 1.4.2).

Four scenarios were used to determine how the legislation flows together. In the first two scenarios Holdco was not the main shareholder (less than 50 per cent shareholding) and the other shares were held by a single South African tax resident that is not a headquarter company. The only difference between the two scenarios was that Holdco's shares were held in scenario A by a South African tax resident and in scenario B, by a foreign investor that is not a South African tax resident.

These two scenarios had the exact same results as the *residence* of Subco was determined with reference to the main shareholder. Due to this fact Subco was found to not be a South African tax resident, the headquarter company legislation applied. Had the exclusion not been incorporated into the Income Tax Act, the result in both instances would have been that the headquarter company legislation would not be applicable.

Scenario C and D had Holdco as the main shareholder (more than 50 per cent). The remaining shares were held by a foreign tax resident in scenario C and a South African tax resident in scenario D. In scenario C, Holdco was wholly owned by a South African tax resident and in scenario D, Holdco was wholly owned by a foreign tax resident.

These two scenarios made it clear that in instances where Holdco is the main shareholder, the tax residence of Holdco's shareholders become of great importance. If Holdco's shareholders are South African tax residents, the exclusion will apply and Subco will be a foreign company as defined. This will result in Holdco qualifying for election to be a headquarter company and it will therefore benefit from headquarter company legislation.

When Holdco's shareholders are foreign tax residents, the exclusion will result in a circle effect. Subco will only be a non-tax resident (which would result in application of the headquarter company legislation) if Holdco is not a headquarter company, because Holdco's shareholding will then result in Subco qualifying as a controlled foreign company with a foreign business establishment. If Subco qualifies as a non-tax resident, then Holdco will qualify as a headquarter company and its shareholding will not result in Subco qualifying as a controlled foreign company and in effect then the headquarter company legislation will not be applicable.

Had there been no exclusion to the resident definition, this enigma would not exist. In such an instance the result of the tax legislation as it currently stands would be that the headquarter company legislation will not apply as Subco is a South African tax resident.

The findings of this chapter are relevant to the topic as the purpose behind the inclusion of the headquarter company legislation indicate that South Africa aims to attract foreign investors expanding into Africa. The growth in Africa and the increase in foreign direct investment into Africa indicate that there is a trend for significant investment into Africa by foreign investors.

From the analysis in chapter 3 of the difference between holding companies and headquarter companies it was found that the headquarter companies are holding companies with the exception that they provide additional management and administrative services to their subsidiaries. Given the lack of skills in African countries, it is a reasonable assumption that the centralisation of these functions in a headquarter company would be more effective and efficient to strategically utilise the available skills.

Companies would not qualify for the benefits of the headquarter company legislation where they are held by foreign investors and own significant shareholdings in African countries for which it provides effective management services. This was illustrated in the above examples.

It can therefore be concluded that the *resident* definition seen along with the headquarter company legislation and the conditions in African countries does not allow for effective application of the different components of the Income Tax Act. This in turn does not fulfil the purpose of making South Africa an attractive destination for foreign investment into Africa.

Foreign investors wishing to expand operations in Africa would only be able to benefit from the South African headquarter company legislation in so far as the headquarter company in South Africa or any other South African resident does not perform the effective management function of the African company in South Africa.

The final chapter will provide solutions to the inefficiencies between the application of the *resident* definition and the headquarter company legislation. This will be in response to the tenth, secondary objective (chapter 1.4.2).

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## Notes

<sup>4</sup> The exclusion has been deleted retrospectively as of 1 January 2013 by the Taxation Laws Amendment Bill no. 39 of 2013 that was issued on 24 October 2013. Due to time constraints the exclusion is still incorporated in the study and the application of this exclusion is still incorporated in the examples. The effect of the deletion on the scenarios presented was briefly discussed at the end of the chapter.

# CHAPTER 7 CONCLUSION

## 7.1 INTRODUCTION

The problem statement of this dissertation was to determine if the application of the *resident* definition is appropriate within the context of the current headquarter company regime, specifically as it relates to investment into Africa (chapter 1.3). This also corresponds with the main objective of the dissertation.

In response to the above problem statement the following secondary objectives were identified:

- i) Obtain a basic understanding of the purpose behind the introduction of the headquarter company regime into South African tax legislation.
- ii) Obtain a basic understanding of the economic conditions present in South Africa compared to Africa.
- iii) Analyse the elements of an ideal holding and headquarter company regime.
- iv) Investigate the legislation implemented by selected countries that have successfully incorporated headquarter company regimes into their tax legislation. The investigation will focus on the elements incorporated into their legislation, what it aims to achieve and how this links with the concept of residence.
- v) Analyse and compare the South African headquarter company regimes to these successful regimes to ascertain the differences.
- vi) Investigate the methods used in South Africa to determine residence and to summarise the different meanings of *place of effective management* with a focus on the word “management” and the different levels of management.
- vii) Investigate the exclusion to residence as incorporated into the Income Tax Act and the different elements that should apply for the exclusion to be in effect.
- viii) Apply the different elements of the legislation investigated to practical examples and determine their effect on the qualification of a structure for application of the headquarter company regime.
- ix) Draw conclusions on the interplay between all the elements investigated and identify possible solutions.
- x) To conclude, recommendations will be made based on the results of the research performed in achievement of the objectives set above.

The first and second secondary objectives (chapter 1.4.2) were addressed in chapter 2. The objectives were to obtain a basic understanding of the purpose behind the introduction of the headquarter company regime into South African legislation and to gain a basic understanding of the economic conditions in African countries.

The study in this chapter found that National Treasury aims to establish South Africa as a *Gateway to Africa* (chapter 2.1). The African continent is recognised as the next growth frontier. Countless business opportunities have presented themselves in various sectors in the African markets. This has resulted in an increase in foreign direct investment into Africa (chapter 2.2). The inclusion of South Africa in BRICS places South Africa in the unique position with direct access to the biggest emerging economies. The headquarter company legislation was therefore incorporated into the Income Tax Act with the purpose of enabling South Africa to be the link between the opportunities within this untapped continent and not only BRIC, but also the rest of the world (chapter 2.3).

It was also noted in this chapter that there is a lack of management and professional skills in the African continent. These gaps are the result of poor secondary and tertiary education. This shortage of skills requires companies to work strategically with the human resources available when expanding into Africa. South Africa, with its strong economy and ease of doing business compared to the other African countries, is a favourable environment for setting up centralised management teams managing the operations in Africa. (chapter 2.4.)

## **7.2 THE HEADQUARTER COMPANY REGIME**

In chapter 3, the elements of an ideal holding and headquarter company regime were investigated in response to the third, secondary objective. A further investigation was performed into the elements incorporated in the legislation of popular destinations for headquarter companies. This addressed the fourth, secondary objective. The final component of this chapter compared the results of the above investigations to the South African headquarter company legislation to identify the differences. With this the fifth, secondary objective was met.

The elements of an ideal holding and headquarter company regime were found to focus on reducing the tax liability of the holding company relating to income tax, capital gains tax, taxation on dividends, withholding taxes on dividends, taxation of controlled foreign companies

and transfer pricing and thin capitalisation rules. These regimes also include a network of favourable tax treaties. (chapter 3.2.)

Various tax reasons were identified for the establishment of a headquarter company. These include deferring or reducing tax, utilising foreign tax credits, reduction or elimination of withholding taxes on dividends and changing the nature of income (chapter 3.2.3).

Luxembourg, the Netherlands and Switzerland were identified as popular destinations for the establishment of headquarter companies. The elements incorporated into the legislation of these countries that contribute to this popularity were analysed.

The Luxembourg legislation that encourages investment through headquarter companies includes non-taxation of foreign sourced income, investment protection treaties, low or no withholding taxes on interest payments, royalty payments and liquidation proceeds, the participation exception, reduced taxes on royalties or capital gains related to intellectual property rights, the favourable VAT legislation, investment tax credits and special exemptions for highly skilled expatriates. The participation exemption focuses on exempting income relating to dividends, divestment gains and liquidation proceeds, as well as exempting from withholding taxes the payment of dividends and liquidation proceeds. (Chapter 3.3.1.)

From a residence perspective, the above legislation is not only available to companies holding mainly foreign investments. These provisions are available to companies holding shares in local companies as well. (chapter 3.3.1.)

The Netherlands incorporated three types of relief for holding companies. Their legislation, like Luxembourg, makes use of a participation exemption that provides for exclusion from the tax base dividends, capital gains, refunds of foreign tax credits and withholding taxes, losses made by subsidiaries, realised exchange gains and losses on qualifying investments and hybrid loan instruments. Like Luxembourg, they offer a wide network of tax treaties and have an advanced tax ruling system in place. These aspects together make this a favourable regime. These components of the legislation are also not limited to holding companies that mainly hold foreign investment. (Chapter 3.3.2.)

The final country analysed was Switzerland. In terms of Swiss legislation qualifying companies have the benefit of no cantonal income tax, capital gains tax at a reduced rate, participation deduction of dividends and capital gains on qualifying disposals, deduction of certain unrealised capital gains and a large network of tax treaties. These provisions can apply to investments in both foreign and local companies. (Chapter 3.3.3.)

When the above regimes were compared to the current South African legislation there were a number of similarities noted. These similarities include no tax on dividends, no controlled foreign company legislation applied, exemption from transfer pricing and thin capitalisation rules, exemption of capital gains from the sale of qualifying investments, no withholding taxes on interest and royalty payments to non-residents and a favourable network of tax treaties. These elements agree in essence to the provisions in the successful regimes as well as the elements of an ideal regime. The main differentiating factor is that the South African legislation will only apply to companies holding significant assets that relate to foreign companies. This requirement was not present in the successful regimes that were analysed.

### **7.3 THE *RESIDENT* DEFINITION – *PLACE OF EFFECTIVE MANAGEMENT***

This specific reference to foreign companies required that consideration be given to the *resident* definition. In chapter 4, the sixth secondary objective, namely to investigate the methods used in South Africa to determine residence and to summarise the different meanings of *place of effective management* with a focus on the word “management” and the different levels of management, were addressed.

The conclusion of this chapter found that different countries have different interpretations as to what *effective management* is and what aspects should be considered to determine the *place of effective management*. Despite these differences in interpretation, all of them refer to a more senior level of management. Whether the focus is placed on the board of directors making decisions or the managing directors implementing decisions, the level of management that is necessary will require a certain level of skills.

The following aims to summarise the different interpretations of *place of effective management*.

### **7.3.1 Interpretation – SARS**

The interpretation note issued by SARS indicates that the focus is placed on the place where the policy and strategic decisions made by the board of directors are implemented for regular day-to-day management and business activities. There are various facts listed that should be considered, but the main focus is on implementation (chapter 4.4).

### **7.3.2 Interpretation – OECD**

The OECD indicated in the Commentary to the Model Tax Convention that they place focus on where the most senior persons such as the board of directors make key management and commercial decisions, rather than where these decisions are implemented (SARS interpretation). (chapter 4.3.)

### **7.3.3 Interpretation – Courts**

The South African courts were found to be not bound legally to follow the interpretation notes issued by SARS as these do not constitute law (chapter 4.5.1). In the same instance, the court is required in terms of section 233 of the Constitution of the Republic of South Africa (Act 108 of 1996) to take into consideration any reasonable interpretation that is consistent with international law. Therefore the courts are legally required to consider the interpretation of the OECD, though again it is not bound to it (chapter 4.5.2).

Until recently there was no South African case law that considered the aspect of residence relating to persons other than natural persons. *The Oceanic Trust Co. Ltd N.O. v C:SARS* (2011) gave an indication of what the South African courts would regard as the *place of effective management* should they be required to make a judgement in future. In this case it was found that the courts disregarded the interpretation note. Instead they focused on the guidance provided in the leading British case *Commissioner for Her Majesty's Revenue and Customs v Smallwood & Anor* (2010) which corresponds with the OECD interpretation. (chapter 4.5.3.)

The court regarded the *place of effective management* to be where the key management and commercial decisions were made. Due to the limited evidence available in this particular case, the court had to look at minutes of meetings and the fact that investment instructions were given by a company wholly owned by a company listed on the JSE. It is therefore clear that should the

courts be required to provide judgement in this regard in the future, the OECD interpretation will likely be favoured. (chapter 4.5.3.)

In the De Beers and Laerstate court cases it was found that residence is situated where the *central management and control* of the business takes place. The Wood court case found that the *place of effective management* and the *central management and control* is in fact the same place. The Smallwood case dismissed this notion. The similarity in all these interpretations is that all of these cases refer to the place where senior levels of management make decisions or implement these decisions regarding the management of the business. (chapter 4.5.4.)

### **7.3.4 Interpretation – Tax authors**

Tax authors have differing views on what constitutes the *place of effective management*. The similarity in their views is that *place of effective management* is where the business is managed by more senior levels of personnel. This can refer to the making of key management and commercial decisions by top-level management or the implementation thereof by middle-level management.

## **7.4 EXCLUSION FROM THE *RESIDENT* DEFINITION**

In chapter 5, the seventh, secondary objective was addressed, namely to investigate the exclusion from the *resident* definition and the different elements that have to apply for the exclusion to be in effect. Excluded from the definition of *resident* is any company incorporated in a foreign country with its *place of effective management* in South Africa, if the company should qualify as a controlled foreign company (if *place of effective management* is disregarded) with a foreign business establishment and it pays tax in the foreign country equal to more than 75 per cent of the taxes that it would pay in South Africa. (chapter 5.2.)

The investigation concluded that a company is a controlled foreign company with a foreign business establishment if the total shareholding held in that company by South African residents is more than 50 per cent. To determine the total shareholding, only South African residents who hold alone, or collectively with other companies in the same group a minimum of ten per cent, should be included and any shares held by headquarter companies should be disregarded. Where the headquarter company has South African shareholders, their shareholding will be added to determine the 50 per cent. (chapter 5.4.) The foreign business establishment

requirement refers to a fixed place of business through which the company conducts its business (chapter 5.5).

The further investigation into what are the characteristics to qualify as a headquarter company, concluded that a company may elect to be a headquarter company should it have less than ten shareholders, each holding a minimum of ten per cent and 80 per cent of its assets are held as investments in, loans to and intellectual property licensed to foreign companies in which it holds a minimum of ten per cent. (chapter 5.3.1.)

It is clear that in order for a company's residence to be determined, one has to consider the headquarter company and controlled foreign company legislation. On the other hand, to determine whether headquarter company legislation or controlled foreign company legislation is applicable, one has to determine the foreign entity's tax residence. The effect of this interplay was considered in chapter 6.

## **7.5 PRACTICAL APPLICATION**

In chapter 6 a number of examples were submitted as method of determining the interplay between the various sections referred to by the *resident* definition. Four basic scenarios were used to determine the combined effect of the legislation. Various other scenarios exist, however, the scenarios used were considered sufficient for the purposes of the study.

The background information to the scenarios was consistent. The objective was to determine if the holding company would qualify for the application of the headquarter company legislation. The holding company (Holdco) only had qualifying assets related to shares held in an entity incorporated in an African country (Subco) and which had its *place of effective management* in South Africa.

The scenarios changed around two components. The one component was the size of the shareholding held by Holdco. The shareholding was changed between being the majority shareholder with 51 per cent to a minority shareholder with 49 per cent. In all instances the remaining shares were held by a single South African tax resident, with the exception of scenario C where the remaining shares were held by a foreign resident.

The second component that was changed was the tax residence of Holdco's shareholders. In the two instances it was a South African resident and in the other two a foreign tax resident.

With regard to the first component, the findings of these examples provided that in instances where Holdco was a minority shareholder, the applicability of the headquarter company legislation depended on the remaining shareholders in combination with Holdco's shareholders. In the examples the remaining shares were held by a single South African resident.

In the absence of the *place of effective management* test, Subco qualifies as a controlled foreign company as the South African resident held 51 per cent. Due to the application of the exclusion to the definition, Subco will not be a South African tax resident despite the fact that the *place of effective management* is in South Africa. Holdco may in this instance elect that headquarter company legislation be applied. The tax residence of Holdco's shareholders had no impact in this instance.

Where the remaining shares are not held by a South African resident or where Subco does not meet the requirements of a controlled foreign company (*place of effective management* disregarded), Subco will be a South African tax resident. In that instance the headquarter company legislation will not apply.

Where Holdco was the majority shareholder the tax residence of Subco depended on the tax residence of Holdco's shareholders. In the example where Holdco's shareholders were South African residents, Subco qualified as a controlled foreign company with the exception of *place of effective management* and then the exclusion applied. Subco was not a *resident* as defined and Holdco could therefore elect to be a headquarter company.

Where Holdco held more than 50 per cent and had a single shareholder which was a foreign tax resident, it was found that the legislation resulted in a circle effect. The qualification of Holdco as a headquarter company depended on the tax residence of Subco being outside of South Africa. Subco's residence status in turn depended on whether Holdco was a headquarter company or not. In all of the instances the headquarter company legislation would have applied to Holdco had the *place of effective management* of Subco not been in South Africa.

The deletion of the exclusion to the *resident* definition in terms of section 191 of the Taxation Laws Amendment Bill (2013) is a confirmation that the exclusion was not achieving an optimal result. The effect of the deletion on the scenarios investigated is that all the scenarios will result in Subco being a South African tax resident based on the *place of effective management* test. This results in Holdco not qualifying as a headquarter company.

The recent change to the Income Tax Act removes the anomaly created by the application of the various provisions of the Income Tax Act. It does, however, not provide a solution to the fact that a company would not be able to qualify as a headquarter company where effective management services are performed by the headquarter company.

The analysis of holding and headquarter companies indicated that in essence a headquarter company differs from a holding company in that the headquarter company is involved in the management of the subsidiaries as opposed to the mere holding of interests (chapter 3.1). This will particularly be of strategic value in Africa as there is a shortage of skills. A single centralised management team can perform the management activities of the African subsidiaries. (chapter 2.7.)

The study has shown, however, that in terms of the current legislation this will not be attainable with or without the exclusion. As soon as the foreign entity is effectively managed in South Africa, in terms of the latest legislation, it would be regarded as a South African tax resident and the headquarter company legislation would not apply.

## **7.6 POSSIBLE SOLUTIONS TO THE INEFFICIENCIES NOTED**

From the above findings it is clear that what seems to be the purpose behind the headquarter company legislation is not being achieved. The interplay between the residence definition, the controlled foreign company legislation (in terms of the old legislation) and the headquarter company legislation seems to have a negative effect on the attractiveness of South Africa as a headquarter company destination for investment into Africa. The revised legislation removes the enigma that resulted in the Income Tax Act, but it still does not enhance the attractiveness of South Africa as headquarter company destination.

The following two suggestions are submitted as possible solutions to resolve this negative effect:

The first relates to a change to the headquarter company legislation to not only apply to foreign investment. From the analysis of the successful regimes of Luxembourg, the Netherlands and Switzerland it was noted that they do not limit the benefits of their legislation in this regard to companies investing into foreign companies. The benefits of their legislation also apply to companies with investments in local companies. The application of their legislation is therefore not affected by their *resident* definition.

The second possible solution relates to a change to the *resident* definition. This solution would require the *resident* definition to disregard the *place of effective management* test in instances where the effective management function is performed by a South African tax resident, as a headquarter company, with the intention to conduct legitimate operations in the African country.

## **7.7 SUGGESTIONS FOR FURTHER STUDY**

The study above has not considered in detail the effectiveness of the headquarter company legislation as a whole to promote South Africa as a popular destination for establishing headquarter companies. This study has focused only on the interplay between the *resident* definition and the effect it has on the qualification of a company as a headquarter company. The detailed components of the headquarter company legislation will have to be considered in further studies.

## **7.8 CONCLUSION**

The headquarter company legislation was introduced in the South African legislation with the purpose to make South Africa more attractive to foreign investors. This legislation was focused on investments into Africa with the aim to benefit from the increased foreign direct investment into Africa and the growth in Africa.

The headquarter company legislation specifically refers to investments into foreign companies and as such the application of the legislation is influenced by the *resident* definition. The unique contribution of this study is in the finding that the circumstances in Africa and the tests within our

*resident* definition have an adverse effect on the qualification of a company for the application of the headquarter company legislation.

In essence the current legislation requires that the *place of effective management* of the African companies should be outside South Africa. This may result in inefficient utilisation of available skills if a foreign investor is expanding its operations into multiple African countries. The persons performing the effective management function would have to be situated at one of the locations outside South Africa which will reduce the benefit to the foreign investor of setting up a headquarter company in South Africa.

The exclusion from the *resident* definition proved to be ineffective. The exclusion only had the potential to succeed in supporting the headquarter company regime in instances where the foreign entity was held by South African residents who had a combined total of more than 50 per cent of qualifying shares. This reduced the attractiveness of the headquarter company legislation. It also caused an anomaly in the application of the Income Tax Act. The deletion of the exclusion succeeded in eliminating the anomaly, but it does not make any further provision that enhances the attractiveness of the regime.

The suggested solutions will ensure that the *place of effective management* test will not have a negative influence on the headquarter company regime. However, it should be considered how these solutions will affect other components of the Income Tax Act and if it would indeed achieve the purpose behind the headquarter company legislation.

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