

**The effectiveness of the 'place of effective management' tie-breaker rule
in the OECD Model Tax Convention**

By

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DECLARATION

I declare that: “***The effectiveness of the ‘place of effective management’ tie-breaker rule in the OECD Model Tax Convention***” is my own work; that all sources used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.

SIGNATURE

DATE

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ABSTRACT

Double taxation could arise in a situation where resident- resident conflicts occur. Resident–resident conflicts occur in the situation where both countries regard such a person as a “resident” for tax purposes under their domestic legislation. For that reason, all income that is earned by that person, irrespective of the jurisdiction it is earned in, will be subject to tax in both countries.

In order to resolve these conflicts, the Organisation for Economic Cooperation and Development’s (“OECD’s”) Model Tax Convention contains a tie breaker clause which states that a non-individual shall be deemed to be a resident only of the State in which the ‘place of effective management’ is situated.

It was found that although there were conflicting views, the expression ‘place of effective management’ was mainly determined with reference to the place where real management actually makes decisions on key business affairs of the company.

Based on the following reasons it was concluded that using ‘place of effective management’ as a tie breaker rule was ineffective.

- With improved communication technology and increased mobility of top level management, it makes it very difficult to pinpoint a single location where the ‘place of effective management’ is positioned;
- Changes to the generic managerial structures seen in the past, makes it increasingly complex to determine where the ‘place of effective management’ is situated; and
- There is no universal interpretation of the term ‘place of effective management’ within the international arena.

Against the backdrop that each option for determining the ‘place of effective management, analysed in Chapter 4 had its own flaws, it is almost impossible to determine a company’s residency based on a single test. It was therefore, recommended that the tie breaker rule consist of a hierarchy of the following tests.

1. Deemed to be resident of the country in which place of effective management is situated, as defined by SARS’ interpretation.
2. Deemed to be a resident of the country in which its economic nexus is the strongest.

3. Conflict to be resolved by mutual agreement between the two Contracting States.

Key words:

- Article 4;
- Companies;
- Double Taxation Agreement;
- Dual resident;
- International taxation;
- OECD Model Convention;
- Place of central management and control.
- Place of effective management;
- Taxation;
- Tax resident; and
- Tie breaker clause.

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CHAPTER 1: INTRODUCTION

1.1 Introduction and Background

There are varying bases upon which income may be taxed. Depending on the tax jurisdiction, tax can be imposed on the following bases: source and residence. In respect of the source (or economic) basis of taxation, the country will only impose tax when the economic activity is within, or deemed to be within, the country's boundaries (Wilson, 2003:1).

Alternatively, countries can impose tax by way of the residence (the personal or world- wide) basis of taxation. Under this taxing method, should the entity be classified as a resident in that jurisdiction, all the income earned by that entity, irrespective of the jurisdiction the income was earned in, will be taxed (Wilson, 2003:1). Accordingly, should the country levy tax according to the resident based taxation system, the entity's residence is key in determining whether a liability for tax will arise (Hinnekens, 2003:314).

It has been found that more often than not, double taxation will arise as a result of residence-source conflicts. However, an entity can also be subject to double taxation where residence-residence conflicts arise. Residence-residence conflicts occur in the situation where both countries regard such person as a "resident" for tax purposes under their respective domestic legislations. For that reason, all income that is earned by that person will be subject to tax in both countries (OECD, 2001:3). The residence-residence conflicts will be the focus of this study.

It has been found that various countries have different methods of determining the entity's tax residency. For example, the United States adopts a place of incorporation test, while Australia and the United Kingdom, adopt a central management and control test to determine the tax residence of companies. Accordingly, it is possible that a company is classified as a resident of two or more countries (Pinto, 2005:14).

Although the two countries might determine the entity's residency using the same criterion, dual residency could also arise in a situation where the two countries interpret the identical test differently (Hinneken, 2003:314).

In addition, should the method chosen by the country to determine tax residency of the entity, be of a complex nature, this might also give rise to a dual residency case as seen in the early English case of *Swedish Central Railway Co. Ltd v Thompson* (1925), "the central management and control of a company may be divided ... and if so, it may have more than one residence" (Hinneken, 2003:314).

Current trends are that companies may conduct activities not only in the countries in which they were incorporated, but in numerous other countries. With companies conducting ever increasing cross border trade activities, there has been a corresponding increase in double taxation as a result of residence-residence conflicts. In other words, a company can easily be classified as a "resident" in at least two countries.

To subject a taxpayer to taxation twice on the same income is considered to be inequitable. In addition, relief from double taxation will advance the free movement of goods between countries, which will benefit all countries since it will "encourage the allocation of capital and greater global production" (Carroll, 2002:41).

In an attempt to resolve the dilemma of residence-residence double taxation described above, the Organisation for Economic Cooperation and Development ("OECD") has devised a mechanism in terms of the Model Tax Convention. Article 4 of this Convention contains rules which effectively resolve this problem by treating the dual resident person as a resident of one State only. However, this arrangement will only apply if the respective countries have entered into a double taxation agreement.

The OECD is an association of 30 member countries that "work together to address the economic, social and environmental challenges of globalisation. The Organisation provides a setting where governments can compare policy

experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.” (OECD, 2008:1.)

Its member countries include Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

South Africa is not a member country of the OECD. However, it has been awarded an observer status in terms of which its representatives are permitted to attend the OECD meetings. Furthermore, South Africa has adopted the OECD Model as the basis for drafting its Double Taxation Agreements (DTAs).

Article 4 contains tie-breaker rules both for individuals and non- individuals, such as companies. The focus of the dissertation will, however, be on the latter. Paragraph 3 of Article 4 of the OECD Model Tax Convention states that a non-individual “shall be deemed to be a resident only of the State in which the **‘place of effective management’** is situated”. (own emphasis) (OECD, 2008:24)

Although the mini-dissertation is focused on the OECD Model Tax Convention, it is important to note that the wording of Article 4(3) of the OECD Model Tax Convention is identical to the wording contained in the United Nation’s Model Convention (Vogel, 1997:260).

Because South Africa has adopted the OECD Model Tax Convention to draft its DTAs, the majority of South Africa’s DTAs contain the OECD tie breaker rule contained in Article 4(3). (Annexure A, page 90)

A table is included in Annexure A (page 90), which summarises all Double Taxation Agreements South Africa has concluded and which are still in force, in terms of the company tie breaker rule contained in Article 4. Annexure A clearly shows that of the 70 Double Taxation Agreements that the South

African government has entered into, 54 of them, which constitute 77% of the total number of Double Taxation Agreements concluded, use the 'place of effective management' as a tie breaker rule. Although South Africa is not an OECD member country, it is clear from this that the present study is highly relevant to the South African situation.

1.2 Motivation for choosing the topic

It has, however, been established that in the present times the following flaws become evident if the 'place of effective management' is used as a tie breaker rule:

1 Improved technology

In the past, the place where

- (i) the company's business activities take place;
 - (ii) senior management meetings are held and their activities take place; and
 - (iii) the company is incorporated and where it has its registered office;
- would all be in a single location. In this sense, determining the 'place of effective management' was not difficult. This, therefore, justified the following statement, in paragraph 21 of the Commentary on Article 4 of the Model Tax Convention:

It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State.

There has, however, been an improvement in technology over the years and accordingly the companies' 'place of effective management' has proved increasingly difficult to determine.

With the advent of enhanced communications technology, such as video conferencing, companies can now hold meetings without requiring all persons to be physically located in one place. In this context, management could be located throughout the world, and therefore making it difficult to pinpoint a single location that can be classified as the company's 'place of effective management'.

According to Hinnekens (2003:315), the communications revolution allows for decision-makers of the company to be a lot more mobile since they are no longer required to physically meet in one place, but still be in a position to conduct corporate affairs via video conferencing and networking, from any remote place in the world. In this vein, Romano (2001:339) states that:

[T]he problem of determining the place of effective management is becoming increasingly important with the availability of advanced communications technology such as digital signatures, videoconferencing and electronic discussion group applications via the Internet. Such technology makes it unnecessary for a group of persons to meet physically in one place in order to make decisions.

2 Improved mobility

The increased number of companies operating global businesses has led to the concomitant increase in the mobility of top management. This mobility is necessitated by their need to manage the various business activities conducted throughout the world.

The fact that companies' senior management travel a lot more than in the past makes it more difficult to determine where the company is resident based on the 'place of effective management' principle. In this respect, the OECD (2001:9) states that:

It is not too difficult, for example, to envisage a situation where the managing director of a company who is responsible for the management of that company is constantly on the move. In some extreme cases, that person may consistently be making the decisions while flying over the ocean or while visiting various sites in different jurisdictions where his business is conducted.

Hinneken (2003:315) concurs with the above assertion and states that currently it has been found that the companies' boards of directors travel more extensively, and therefore companies hold their meetings anywhere in the

world, which is very different from the permanent headquarters seen in the past. The increased mobility, therefore, makes it very difficult to pinpoint a single location where the 'place of effective management' is situated.

3 Various interpretations of the phrase the 'place of effective management'
An added flaw is that, at present, there is no international consensus regarding the term, 'place of effective management', as countries tend to interpret the concept in accordance with their local tax laws (Hinneken, 2003:315).

1.3 Problem Statement

From the above the following research question can be formulated as the problem statement: is the term 'place of effective management' contained in Article 4 of the OECD Model Tax Convention effective in determining residency for companies?

1.4 Objectives

To address the problem statement in paragraph 1.3 above the following objectives are formulated to answer the research question.

1.4.1 Main Objective

To determine whether the term 'place of effective management' contained in Article 4 of the OECD Model Tax Convention is effective in determining residency for companies.

1.4.2 Secondary Objectives

The main objective in paragraph 1.4.1 above can be achieved by completing the following secondary objectives

- (i) Summarise what is meant by the term 'place of effective management', by referring to the following:

- Ordinary dictionary meaning of the words contained in the phrase (Paragraph 2.3, page 13)
 - OECD Commentary (Paragraph 2.4, page 15)
 - How is 'place of effective management' interpreted from a South African perspective (Paragraph 2.5, page 17)
 - Guidance provided by the term 'central management and control' in court cases (Paragraph 2.9.2, page 30)
 - Guidance provided by the term 'place of management' in various court cases (Paragraph 2.9.1, page 30)
 - Guidance provided by the courts regarding the term "effective" control (Paragraph 2.10, page 32)
 - Guidance provided by renowned authors (Paragraph 2.11, page 34)
- (ii) Based on the fact that the South African Revenue Services (SARS) and OECD interpret 'place of effective management' differently, how this will impact local court decisions. (Paragraph 2.6, page 21)
 - (iii) Assess the limitations in using 'place of effective management' as a tie breaker clause. (Chapter 3, page 40)
 - (iv) Critically analyse recommendations provided by the OECD to improve the tie breaker clause. (Paragraph 4.2, page 47)
 - (v) Analyse how various countries determine residency from a domestic point of view and consider whether this will be a more effective tie-breaker rule. (Paragraph 4.3, page 61)
 - (vi) Make possible recommendations to resolve the limitations in using 'place of effective management' as a tie breaker clause. (Chapter 5, page 75)

1.5 Research method

The dissertation will be completed by performing a non – empirical, evaluative literature review. Various sources will be considered, such as academic journals, court cases and relevant books.

A number of countries will also be selected, in order to complete the literature review. The countries that will be analysed during this study will include:

- Italy;
- United States of America;
- The United Kingdom;
- Australia;
- South Africa
- Canada; and
- Ireland.

The analysis that will be presented in respect of the above mentioned countries will include:

- how these countries interpret the term place of effective management;
- how these countries determine a company's tax residency from a domestic tax law perspective,
- whether the various ways the countries determine a company's residency from a domestic law will be a more effective tie breaker rule.

The above mentioned countries will be selected for the following reasons:

- South African tax law is mainly derived from these countries' (mentioned above) tax law, based on the fact that they are developed countries and have advanced tax systems when compared to South Africa;
- All of the above mentioned countries are members of the OECD;
- Like South Africa, the Irish and the United Kingdom tax law originates from United Kingdom common law;
- The countries have various ways of determining a company's tax residency, therefore illustrating why there has, currently, been an increase in the number of dual residency cases.

1.6 Structure and Overview

The mini dissertation will consist of the following chapters. Listed below are the chapters that will be included in the study and a brief overview of its contents.

1.6.1 Chapter 2

In Chapter 2, the term 'place of effective management' will be discussed particularly with regard to the extent of its meaning. This discussion will be done by referring to, *inter alia*, the ordinary dictionary meaning of the words contained in the phrase 'place of effective management'; the OECD and SARS interpretations of the phrase 'place of effective management' and how renowned international tax authors, such as K. Vogel, L. Olivier, M. Honiball, D. Meyerowitz, K. Huxham and P. Haupt, interpret the term.

In addition, consideration will also be given to how specific countries interpret the term 'place of effective management'. In light of the fact that 'place of effective management' is sometimes interpreted using the terms such as 'central management and control' and 'place of management', the meaning of these terms will also be considered.

1.6.2 Chapter 3

In this chapter, all the limitations in using 'place of effective management' as a tie breaker clause will be highlighted. These include limitations such as the difficulty to pinpoint a single location where the 'place of effective management' is situated due to improved communication technology and increased mobility of top level management. A further limitation identified, includes the complexity in determining where the 'place of effective management' of the company is situated based on the changes in the generic managerial structures seen in the past. Following the fact that to date no consensus has been reached on the interpretation of the term 'place of effective management', this is accordingly an additional flaw.

1.6.3 Chapter 4

In this chapter, the focus will be on how the inefficiencies highlighted in the Chapter 3 can be resolved. This will be achieved by evaluating the viability of the solutions recommended by the OECD and various countries' domestic residency tests.

The solutions recommended by the OECD include replacing the place of effective management concept with either the place of incorporation test, the place where directors/shareholders reside or where the economic nexus is strongest. A further recommendation by the OECD was to extend the guidance provided in the OECD Commentary with regard to 'place of effective management'. In addition the OECD recommended that a hierarchy of tests should be established or dual resident companies should be denied benefit under the DTA.

1.6.4 Chapter 5

Finally, in Chapter 5, a conclusion will be drawn on which is the most beneficial option to resolve the limitations noted in chapter 3.

1.7 Conclusion

In this chapter it was found that double taxation will arise in the situation where an entity is classified as a resident in two tax jurisdictions, also known as residence-residence conflicts. These conflicts are resolved for companies in Article 4(3) of the OECD Model Tax Convention which deems the company to be resident of the State where the company's 'place of effective management' is situated.

In order to determine whether the term 'place of effective management' contained in Article 4 of the OECD Model Tax Convention is effective in determining residency for companies, the study will begin, in the next chapter by analysing various sources to determine what is meant by the term 'place of effective management'.

CHAPTER 2: THE MEANING OF THE PHRASE ‘PLACE OF EFFECTIVE MANAGEMENT’

2.1 Introduction

As stated in the previous chapter (paragraph 1.1, page 1), the OECD Model Tax Convention contains a tie breaker rule in Article 4(3) which is intended to eliminate residence-residence conflicts for companies. The Article deems a company to be a resident of the State where the company’s ‘place of effective management’ is situated.

In this chapter, the first and second secondary objectives (1.4.2 (i) and (ii), page 6-7) will be considered. In other words the chapter will establish the meaning of the term, ‘place of effective management’. In addition the chapter will conclude on how local court decisions will be affected, due to the fact that SARS and the OECD interpret ‘place of effective management’ differently.

The following aspects are important to determine what is meant by the expression ‘place of effective management’.

- i. Ordinary dictionary meaning;
- ii. OECD Commentary;
- iii. South African Revenue Service Interpretation;
- iv. Various countries’ interpretations;
- v. Guidance provided by relevant court cases;
- vi. Interpretation of ‘place of effective management’ using various countries’ domestic tax law meanings;
- vii. Guidance provided by the courts regarding the term “effective” control;
and
- viii. Guidance provided by renowned authors.

2.2 Article 4(1)

In order to understand how companies fall into the ambit of Article 4(3), one has to consider how a company can be classified as a dual resident.

Article 4(1) of the OECD Model Tax Convention defines a resident of a country as “any person who, **under the laws of the State**, is liable to tax therein by reason of his domicile, residence, place of management or any other criteria of a similar nature.” (own emphasis) (OECD, 2008:25.)

Accordingly for treaty purposes the individual/non-individual will be defined as a resident of a specific country, should it be classified as a resident in the domestic tax laws of that country. Below, is Table 2.1, which lists countries and how they determine residency from a domestic point of view.

Country	Residency determined domestically
Italy	Place of management (Bizioli, 2008:527)
United States of America	Incorporation (Pinto, 2008:25)
The United Kingdom	Central management and control (Oguttu, 2008:85)
South Africa	Place of effective management (SARS, 1962: 38)
Canada	Central management and control (Oguttu, 2008:85)
Australia	Central management and control (Oguttu, 2008:85)
Ireland	Central management and control (Haccius, 2000:124)

Table 2.1: Specific countries' domestic tax residency tests.

There are a variety of tests to determine the corporate residence internationally. These include “incorporation, location of management, centre of administration, place of main activity, place of company seat, residence of the majority of shareholders, [and] residence of majority directors” (Carroll, 2002:44).

This aspect is reflected in Table 2.1, above, where four different tests are applied to determine the company's tax residence in the selected countries. The fact that each country determines its domestic residency differently suggests that Article 4(1) effectively gives rise to cases of dual residence.

As already stated, in instances where, as a result of Article 4(1), a company is classified as a dual resident, the OECD Model Tax Convention contains a tie breaker rule as per Article 4(3), in terms of which a company is deemed to be a resident of the State where the company's 'place of effective management' is situated.

2.3 Ordinary dictionary meaning

Article 31(1) of the Vienna Convention on the Law of Treaties, 1155 UNTS 33, issued on the 23 May 1969 it states that:

“A treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”.(own emphasis)

Owing to the fact that the meaning of the phrase 'place of effective management' is uncertain, the law of interpretation, as evident in the above article requires us to first look to the literal interpretation of the word to obtain its ordinary meaning. This is typically obtained from a dictionary.

The Shorter Oxford English Dictionary (2002:794) defines the word 'effective' as:

- “Concerned with or having the function of accomplishing or executing;
- Powerful in effect;
- That is concerned in the production of an event or condition; having the power of acting on objects;
- Fit for work or service;
- Having an effect or result;
- Actual, in effect”

The word, 'manage' is defined (at 1686) as:

- “Carry or conduct on (a business, an undertaking, an operation) Organise; regulate;
- Take charge of; and

- Control and direct the affairs of.”

The dictionary (at 1686) defines ‘management’ as:

- “The action of managing;
- The manner of managing;
- Control of things or persons; or in the conduct of an enterprise, operation etc.
- An instance of managing;
- The professional administration of business concerns; and
- A governing body of an organisation or business; as a board of directors; that group of employees administering and controlling an organisation, business etc. the group or class of managers.”

Burchfield (1998:239) defines ‘effective’ in the Fowlers’s Modern English Dictionary as “having a definite or desired effect, existing in fact rather than theoretically, coming into operation”.

Whereas, ‘effective’ is defined in the Webster’s Dictionary as “emphasises the actual production of an effect or the power to produce a given effect” (Merriam Webster Inc, 1984:280). ‘Manage’ is defined by the dictionary (at 520) as “conduct, control, direct, govern, rule, guide lead, steer”.

In summary, the combined dictionary meaning for the term effective management would be the “power to produce a given effect” while conducting or carrying on an operation. The dictionaries only define each individual word of the phrase in separate form. While this provides some guidance on the meaning of the term, we are unable to obtain clarity on its meaning solely through the dictionary. In the United Kingdom case of *IRC v Commerzbank AG* (1990) Judge Mummery summarised the approach to treaty interpretation as laid down by the House of Lords in *Monarch Airlines Ltd v Fothergill* (1980 &1981) in the following way:

A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an

international treaty: per Lord Fraser (at 285) and Lord Scarman (at 290). A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant United Kingdom legislative instrument: per Lord Diplock (at 279).

In that case (the Commerzbank case) the judge stated that 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".

Against this background, the OECD Commentary will now be considered in determining where a company is effectively managed.

2.4 OECD Commentary

The OECD Model and its Commentary provide a valuable collection of various international opinions. It contains views from all OECD member countries, certain non-OECD member countries, select international organisations and other interested parties (Van der Merwe, 2006:136).

The phrase 'place of effective management' is not defined in Article 4 of the OECD Model Tax Convention. However, paragraph 24 of the OECD Commentary, provides some guidance as to what was intended by the term 'place of effective management'.

It is important to highlight that 'place of effective management' is also used in Articles 8, 13(3), 15(3) and 22(2) of the OECD Model Tax Convention. However, in Article 4, no definition has been provided. (OECD, 2001:4)

The OECD Commentary on Article 4 of the Model Tax Convention states that 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, 2008:78.)

Paragraph 24 of Article 4, further states that:

The 'place of effective management' will ordinarily be where the most senior person or group of persons (for example a board of directors) make its decisions, the place where the actions to be taken by the enterprise as a whole are determined ... An enterprise may have more than one place of management but it can only have one 'place of effective management' at any one time. (OECD, 2005:82)

In paragraph 31 of the 2001 OECD discussion paper, the OECD reiterated that the factors to be examined include:

- the place where directors meet to make decisions relating to the management of the company,
- where the centre of top level management is located,
- where the business operations are actually conducted,
- where controlling shareholders make key management and commercial decisions; and
- legal factors such as, for example, the place of incorporation, the location of the registered office and the place of residence of the directors. (OECD, 2001:7-8)

In the draft Discussion Document, the OECD (2003) expressly provides that where the formal finalisation or approval of the relevant decisions takes place in a jurisdiction different from the one where the decisions were made, the place where the decisions are made will be the place of the effective management.

Hinneken (2003:316) further makes the point that should decisions be formalised somewhere else or by another person or group of persons, one

should consider the following factors in order to correctly determine where the 'place of effective management' is situated:

- The place where the decisions are effectively made by either the controlling shareholder or associated company;
- Should the board of directors not be responsible in making the relevant commercial and strategic business decisions, but is only required to approve the executive officers' decisions, one has to consider where the executive officers (president, vice-presidents, treasurer, etc.) perform their functions; and
- The place where key management and commercial decisions are in substance made, irrespective that they are approved at board meetings held in another country (Hinneken 2003:316).

In summary the OECD intended the phrase 'place of effective management' to mean where the:

- "key management and commercial decisions are made;
- most senior person(s) make the decisions; and
- actions to be taken by the entity as a whole are determined" (Oguttu, 2008:83).

2.5 South African Revenue Service ("SARS") Interpretation

On account of the fact that section 108(2) of the South African Income Tax Act, deems double tax agreements to be part of the South African Income Tax Act, it is often believed that the term 'place of effective management' in the double tax agreement and in the South African Income Tax is interpreted in the same way (Van der Merwe, 2002:79). However, this is not the case as SARS interprets the term very differently to the OECD.

On 26 March 2002, SARS issued the Income Tax Interpretation Note No. 6 ("the Interpretation Note"), which outlines their interpretation of 'place of effective management' for South African income tax purposes. The Interpretation Note states that:

The 'place of effective management' is the place where the company is managed on a regular 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.

Management by these directors or senior managers refers to the execution and implementation of policy and strategy decisions made by the board of directors. It can also be referred to as the place of implementation of the entity's overall group vision and objectives.” (SARS, 2002:3).

Emphasis is placed on action, and on the implementation of decision making as opposed to decision making *per se*. This is highlighted by the use of the words “day-to-day management” and “where policy decisions are being implemented” in terms of the said SARS note.

Contrary to international guidelines alluded to above, the Interpretation Note seems to focus on the place where senior management implement a decision in carrying on business operations or activities of the company, as opposed to where these decisions are taken. In this respect, less emphasis is placed on the location of board meetings, rather than on where senior management performs their daily functions.

It is important to note that the Interpretation Note distinguishes between shareholder control and control by the board and management. The latter focuses on the purpose of the business and is regarded by SARS as indicative of effective management (SARS, 2002:2).

The Interpretation Note emphasises the point that no definitive rule can be laid down in determining the ‘place of effective management’. It propagates that all the relevant facts and circumstances must be taken into account. Although the list of factors is not exhaustive or specific, these factors would include:

- “the place where the centre of top management is located;
- the location of functions performed at headquarters;

- the place where the business operations are actually conducted;
- the place where the controlling shareholders make key management and commercial decisions in relation to the company;
- legal factors such as the place of incorporation, formation or establishment and the location of the registered office and public offices;
- the place where the directors or senior managers or the designated manager, responsible for the day-to-day management, reside;
- the frequency of the meetings of the entity's directors or senior managers, and where such meetings 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 scales of onshore, as opposed to offshore, operations; and
- the nature of the 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 in question to the representative”.

(SARS, 2002:4-5.)

In addition to the above, SARS (2002:4) provides further guidance, in the Interpretation Note, on how to apply the term ‘place of effective management’, in practice. In paragraph 3.3 it states the following:

*If these **management functions** are executed at a **single location**, that location will be the ‘place of effective management’. This location might or might not correspond with the place from where the day-to-day business operations/activities are actually conducted from/carried out.*

*If these **management functions** are not executed at a **single location** due to the fact that directors or senior managers manage via distance communication (e.g. telephone, internet, video conferencing, etc.) the view is held that the ‘place of effective management’ would best be reflected where the **day-to-day operational management and commercial decisions taken by the senior managers** are actually*

implemented, in other words, the place where the business operations/activities are actually carried out or conducted.

*If the nature of the person, other than a natural person, is such that the **business operations/activities are conducted from various locations**, one needs to determine the **place with the strongest economic nexus**. (own emphasis)*

The essence of this is that should, through the use of modern technology, it become too difficult to pin point the day-to-day management of a company to a specific location, then, in terms of the SARS' approach the 'place of effective management' will be where the business operations are actually carried out (Oguttu & Van der Merwe, 2005:310).

In this respect, Engels (2010:1) views the management of a company as a pyramid, in which sense:

the apex of the pyramid represents top-level management, which would usually be represented by where the board of directors meets. These meetings and the decisions made there would usually represent where the strategic direction of the company is set. The foundation of the pyramid, in turn, represents the day-to-day management of ongoing operations. "Effective management," according to SARS's interpretation, would be somewhere in between these two, where strategic direction and decisions are implemented.

In further elaborating on this aspect, the author (2010:1-2) provides a practical example of a company that manufactures widgets. The top-level management is where it is decided that the strategy of the company should be to manufacture pink widgets. The day-to-day management would be where the managers of the factory supervise the daily manufacturing of pink widgets, deal with customers, place orders, and so forth. But effective management would be where the executive directors or senior managers implement the company's top level management strategy decision to manufacture pink widgets. For instance, this will be where the decisions are made in respect of

where the factory should be situated, what manufacturing process should be used and what machinery should be acquired or replaced.

2.6 SA guidelines differ from OECD Commentary and effect on local court decisions

As seen above, the SA interpretation differs from the guidance provided by the OECD Commentary. In this light, the secondary objective, paragraph 1.4.2 (ii) (page 7) will now be considered, by determining how the difference in opinion will affect local court decisions.

The matter of 'place of effective management' has not been brought before the South African courts as yet. It is questionable which of the tests for 'place of effective management' the South African courts will apply to decide on the case brought before it. Although there is no internationally consistent definition in use, the OECD Model Tax Commentary should represent this.

Should a dual residency matter come before a South African court, the question would be whether the respective court would be bound to follow the Interpretation Note issued by SARS. In this regard, it was found in ITC 1675 and 62 SATC 219, that this published view of SARS does not have statutory force. It is settled law that a Practice Note or an Interpretation Note is not law. In fact, there have been instances where the SARS themselves have used this argument in their favour (Olivier & Honiball, 2005:39).

Although South Africa is not an OECD Member country, the double tax agreements of South Africa are usually based on the OECD Model. It has been argued that with South Africa adopting the wording of the OECD Model to draft its double tax treaties, it is presumed that South Africa adopts the interpretation given by the OECD Commentaries (Van der Merwe, 1996:136).

Section 108 (2) of the Income Tax Act incorporates all the provisions of DTAs validly entered into by South Africa into the South African Income Tax Act. Consequently, the provisions of a Double Taxation Agreement have the same status as the provisions of the Act. However, when interpreting international law, section 233 of the South African Constitution (Act 108 of 1996) requires

that a court should give preference to any reasonable interpretation of the legislation that is consistent with international law over any interpretation that is inconsistent with international law.

In other words, where there is conflict between the domestic and international interpretation of where the company is tax resident, and where there is a Double Taxation Agreement in force, international interpretation should take preference. Thus, South African courts are still bound to have regard to international guidelines when they attempt to interpret the meaning of “place of effective management” in the context of a Double Tax Agreement.

This principle was confirmed by the Appellate Division in *CIR v Downing*, (1975). The court held that South Africa was bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the terms used in the OECD Model Double Taxation Convention. This is because South Africa has adopted that Model for its Double Taxation Agreements.

To the extent that there are OECD guidelines on the interpretation of the concept or other international commentaries expressing the common meaning of the phrase as utilised in Double Taxation Agreements worldwide, it is therefore submitted that the South African courts would take cognisance of such guidelines and commentaries to interpret the meaning in the context of a Double Taxation Agreement.

In this context, the next section will now consider how specific countries interpret the phrase ‘place of effective management’.

2.7 Various countries’ interpretations

Summarised below, are the various ways selected countries interpret the phrase ‘place of effective management’.

The chosen countries were selected for the following reasons:

- South African tax law is mainly derived from the selected countries' tax law, based on the fact that they are developed countries and have advanced tax systems in relation to South Africa;
- All of the selected countries are members of the OECD; and
- Like South Africa, the Irish and the United Kingdom tax law originates from United Kingdom common law.

2.7.1 Australia

In Australia, the 'place of effective management' would be determined having regard to:

- (a) "the place at which the directors meet to determine matters of management and control;
- (b) the residence of those directors and their roles individually and as a board in the management of the company;
- (c) where senior management was located and took decisions;
- (d) residence and place of operation of any other persons effectively controlling the company (i.e. the controlling mind or minds) and to whom senior management is answerable." (Hamilton, 1998:221.)

In practice, the Australian revenue authorities deem the place of effective management test to be similar to the central management and control test contained in the Australian tax legislation (Hamilton, 1998:221). This view of central management and control is discussed in further detail, in paragraph 2.9.2 below.

2.7.2 Italy

Italy concluded in its observation on the OECD Commentary on the term 'place of effective management' that it does agree with the interpretation of the term 'place of effective management'; however, it is of the opinion that the place where the main and substantial activity of the entity is carried on, should

also be taken into account when determining the 'place of effective management'.

Romano (2001:341) states that when the Italian tax authorities interpret 'place of effective management', "significance is attached to the place where the management directives are given and not to the place where they take effect."

The above is echoed by Bizioli (2008:527), who states that the Italian courts held that the 'place of effective management' is the place where the most relevant decisions in relation to the business of the companies were substantially made, independent of the place where they were formally taken.

2.7.3 United Kingdom

In the United Kingdom, the Inland Revenue seems to regard the 'place of effective management' as being where the day-to-day activities are carried out, which may not necessarily be where the main policy and strategy decisions of the company are taken. In other words, the United Kingdom tax authorities interpret the 'place of effective management' as the place where you can expect to find the executives (such as the finance director or sales director) and senior staff who actually make the business "tick" (Oguttu, 2008:92).

2.7.4 United States of America ("USA")

The position of the USA on the OECD Commentary on the term 'place of effective management' is that it (the USA) reserves the right to use the term in order to determine the company's tax residence. In the South African and USA Double Tax Agreement, the tie breaker rule states that the competent authorities of the Contracting States shall settle the question by mutual agreement. This effectively supports the observation made in the OECD Commentary.

2.7.5 Ireland

Usually, a company's 'place of effective management' will be positioned in the place where the central management and control of the company is located (Haccius, 2000:125). The central management and control test is one of the tests used in the Irish tax legislation to determine the company's tax residency.

Haccius (2004:221) asserts that the effective management, central management and control, and the "head and brain" tests propounded in the case of *De Beers Consolidated Mines Ltd v Howe* (1906) are all effectively the same, in the sense that "all three tests have regard to the place where the directors of the company in question, as the dominant power of that company, determine matters of policy and finance" (Haccius, 2004:221).

In the case of *Koitaki Para Rubber Estates Ltd. v FCT* (1941) at 244 per Rich ACJ, it was held that the "central management and control" of a company is located where the "pivot or axis" "on which the operations of the company hinge" is to be found, by reference to which "matters of policy and finance are determined".

2.7.6 Canada

Like the USA, Canada has concluded in its observation on the OECD Commentary on the term 'place of effective management' that it reserves the right to use the term in order to determine the company's tax residence. In the South Africa and Canada Double Tax Agreement, the tie breaker rule states that the residency of a company is deemed to be in the State of which the company is a national. If it is a national of neither of the States, it shall be deemed to be a resident only of the State in which its place of effective management is situated. This approach supports the observation made in the OECD Commentary.

2.8 Guidance provided by relevant court cases

In the United Kingdom case of *Laerstate BV v HMRC* (2009), the Her Majesty Revenue & Customs (“HMRC”) was successful in arguing that a Netherlands incorporated company was a United Kingdom tax resident, despite the board meetings being held and board resolutions being signed outside the United Kingdom.

Laerstate BV was a company incorporated in Netherlands and wholly owned by a Mr. Bock. Laerstate BV acquired a substantial stake in Lonrho. Mr Bock was subsequently appointed as CEO of Lonrho. Laerstate BV had sold its investment in Lonrho in two tranches and the HMRC had raised assessment showing that the capital gain on both sales were taxable in the United Kingdom as HMRC believed that Laerstate BV was tax resident in the United Kingdom.

The United Kingdom Tribunal was not only required to decide whether the company’s central management and control was positioned in the United Kingdom, in order to determine whether the company is a tax resident of the United Kingdom, but also required to conclude on whether the ‘place of effective management’ for the purposes of the United Kingdom –Netherlands double taxation agreement was positioned in the United Kingdom (Liebenberg, 2010:6).

The management of Laerstate BV (Bock and Trapman) ensured that they held the majority of its board meetings outside the United Kingdom to approve some important management decisions. Between board meetings (which were purposefully held outside the United Kingdom), Mr. Bock, whilst in the United Kingdom, was actively involved in ‘policy, strategic and management matters’ relating to Laerstate BV. Although Bock managed with the assistance of a certain Mr. Trapman, his (i.e. Trapman’s) involvement was secondary.

The taxpayer clearly put a great deal of weight on the board meetings that were held outside the United Kingdom, arguing that it was only the decisions taken at these meetings that constituted central management and control.

The Tribunal noted that it is incorrect to automatically make the assumption that the central management and control is located where the directors meet. This assumption will, however, be correct when a company is managed by directors in board meetings, as that control is normally found where the board meetings are held. On the other hand, if management meetings are held outside the board meetings the test is to determine who was managing the company by making high level decisions and where these decisions are made. According to the Laerstate fact pattern, it was clear that Laerstate was not managed through board meetings and thus it is incorrect to assume that the central management and control is located where the board meetings are held (Liebenberg, 2010:6).

The Tribunal found that Mr Bock not only performed activities that included policy, strategic and management matters in the United Kingdom, but decisions in this regard were resolved in the United Kingdom (Hughes, 2010:115). Accordingly, the Tribunal found that the central management and control was in the United Kingdom.

It is noteworthy that Trapman was the only director during the period when the second sale took place. The issue was whether Trapman did, in fact, manage Laerstate only by signing resolutions and documents. It was concluded that Trapman acted on Bock's instructions and did not make any of the decisions himself, as Trapman was not in possession of sufficient information necessary to be able to decide (Liebenberg, 2010:6).

The Tribunal found that the central management and control test does not confine itself to administration aspects of the decision making process, for instance, where various documents (those documents that are necessary to conclude the decisions that were made, such as legal contracts) are signed or where certain resolutions are made (Luder & Higham, 2009:5.)

Although Trapman concluded the decisions (for example, the signing of the necessary documents), it was held by the United Kingdom Tribunal that effectively Bock took the necessary decisions, as Trapman did not have the necessary information to make the decisions. It was highlighted in the case

that on certain occasions the minutes showed a misunderstanding of the important details of the transaction being approved. The United Kingdom Tribunal subsequently concluded that during the second sale the company's central management and control was also situated in the United Kingdom (Anon, 2009a:1).

It was found that effective management was located in the United Kingdom, as Mr Bock's activities which were conducted in the United Kingdom, were concerned with policy, strategic and management matters, whereas Mr. Trapman's activities were limited to signing documents when told to do so, and dealing with routine matters such as the accounts (Hughes, 2010:119).

An article on the Ernst and Young website (see Anon, 2009b:1-2) summarised the key principles that arose from the Laerstate case as follows:

- Determining residence is entirely a question of fact; there is no assumption that central management and control must be found where the board of directors meet.
- The residence of a company will not fluctuate merely by reason of individual acts of management and control taking place in different territories; the whole picture must be considered in each case.
- Residence should not be determined simply by considering particular actions of a company, such as signing of documents or the making of board resolutions; consideration also needs to be given to a more general overview of the course of business and trading.
- The mere physical acts of signing board resolutions or other documentation is not sufficient to constitute 'central management and control'; there needs to be substantive evidence that the board exercise central management and control.
- The key objective test is to ask whether the directors have, at the very least, the absolute minimum amount of information that a person would need to have in order to be able to make a decision at all.

In order to determine the company's 'place of effective management', one tends to focus on the directors of the company, including their decisions;

however, the shareholders of the company and their decisions should also be considered.

In the case of *American Thread Company v Joyce* (1911) at 163, it was held that:

The shareholders can, no doubt, by virtue of their votes control the corporation; they can compel directors... to do their will, but it does not follow that the corporators are managing the corporation. The contrary is the truth, they are not. It is the directors who are managing the affairs of the corporation.

In *Kodak v Clark* (1903), it was held that a controlling shareholder is defined to be an entity that:

- can interfere with the usual conduct of the business;
- has arranged to be constantly informed of the various transactions; and
- can influence how current transactions are dealt with (Vogel, 2006:194).

2.9 Interpretation of 'place of effective management' using various countries' domestic tax law meanings

As a result of the fact that the term 'place of effective management' was not defined, various countries interpreted the term using their own domestic tax law. This was allowed as Article 3(2) of the Model Tax Convention provides that where a term is not defined, a Contracting State can make use of the meaning of the term under the law of that State.

It appears that countries have equated the concept 'place of effective management' with concepts such as 'place of management' and 'central management and control', and have accordingly resorted to using the domestic meaning of the term (Oguttu, 2008:84).

The concepts 'place of management' and the concept 'central management and control', will be considered in more detail below, as this might provide more guidance on what is meant by the term 'place of effective management'.

2.9.1 Guidance provided by the term 'place of management' in various court cases

The term 'place of management' is a term used by a number of countries, such as Switzerland, Germany and the Netherlands as one of the tests to determine the residency of a company for domestic tax purposes.

The 'place of effective management' test in the OECD Model Tax Convention is similar to the place of management test used under German law (Vogel, 1997:162).

Vogel (1997:488) summarises the meaning of 'place of management' which has been decided by various German courts, as "the place where the management directives do not take effect but rather the place where they are given".

In other words, the term place of management that is used in German legislation is the place where the management's important policies are actually made and not where they are implemented.

2.9.2 Guidance provided by the term 'central management and control' in court cases

The concept of 'central management and control' is adopted by a number of countries, such as United Kingdom, Canada, Australia and Ireland, as one of the tests to determine the residency of a company for domestic purposes.

In *Wood and Another v Holden* (Inspector of Taxes) (2006), a United Kingdom case, the concept of 'central management and control' was discussed and compared to the meaning of the term 'place of effective management'. It held that the two tests are, for practical purposes, the same.

In the United Kingdom case of *The Trevor Smallwood Trust v HM Revenue and Customs* (2008), the terms 'central management and control' and 'place of effective management' were again compared. The judge cautioned that it is not correct to ask where the 'central management and control' is situated and

to say that the 'place of effective management' must be in the same place on the basis of Chadwick LJ's statement in *Wood v Holden* (see above).

In the *Smallwood* case, the judge further affirmed that "the two concepts, 'central management and control' and 'place of effective management' serve two separate purposes. 'Central management and control' determines whether the company is tax resident in a specific country or not whereas the purpose of 'place of effective management's' is to resolve cases of dual residence by determining in which of the two states it (a company) is to be resident. The court concluded that although, conceptually, the two terms were used in different contexts, there is essentially no difference between them." (*The Trevor Smallwood Trust v HM Revenue and Customs*, (2008) at 653.)

Consideration will now be given to the factors which international courts have applied to determine the place of 'central management and control'. This might provide valuable guidance (rather than providing us with a definitive answer) as to where the 'place of effective management' is positioned.

In the case of *De Beers Consolidated Mines Limited v Howe* (1906), the company was in the business of mining diamonds and also registered in South Africa. Its head office was situated in South Africa, and general meetings were always held in the country. Although some of the directors resided in South Africa, the majority of the company's directors resided in England. The directors' meetings were held both in South Africa and in the United Kingdom. However, the London meetings were where the "real control" was exercised as all the important business of the company except the actual mining operations was conducted in London. On this account the company was found to be United Kingdom tax resident. In that case, Judge Chancellor Loreburn stated the following:

A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business...the real business is carried on where the central

management and control actually abides. (De Beers Consolidated Mines Limited v Howe (1906))

The domestic terms, place of management and central management and control, which are sometimes used to interpret the term 'place of effective management', have been considered. The Article provides that the domestic meaning can be used to interpret terms used in the OECD Double Taxation Agreements, provided that it is not in conflict with the intentions of the Model Tax Convention.

It is the OECD's intention to only have one 'place of effective management' and if the domestic interpretation results in the 'place of effective management' being in more than one place this will be against the intention of OECD.

It could be said that by interpreting the term 'place of effective management' with other domestic terms, without taking the context of Article 4(3) into consideration, would definitely result in the uniformity which the OECD strives to achieve in its Model Tax Convention and Commentary being lost (Oguttu, 2008:87).

2.10 Guidance provided by the courts regarding the term "effective" control

It has been found that the phrase 'effective management' is criticised for being ambiguous as it is not clear what it could be describing. It could either represent the nature of management, or the level of management and management decisions. Accordingly the 'effective' test is a test which is difficult to apply and therefore requires that for each individual case the facts and circumstances are evaluated (Van der Merwe, 2002:81).

In the court case, *Wensleydale's Settlement Trustees v Inland Revenue Commissioner* (1996), the judge made the following comments in respect of "effective" management:

I emphasise the adjective 'effective'. 'Effective' implies realistic, positive management. The 'place of effective management' is where the shots are called, to adopt a vivid transatlantic colloquialism.

The above point was reiterated in the case of *R v Holden (Inspector of Taxes)* (2004). The court confirmed that simply signing resolutions or documents was not sufficient to create control. Instead, the court was concerned with the “effective decision” as to whether a resolution should be signed or not. It was the location of this decision that was of importance and not the place where the document were eventually signed.

In *Wood and Another v Holden (Inspector of Taxes)* (2006), Lord Justice Chadwick confirmed that:

We do not consider that the mere physical acts of signing resolutions or documents suffice for actual management. Nor does the mental process which precedes the physical act. What is needed is an effective decision as to whether or not the resolution should be passed and the documents signed or executed and such decisions require some minimum level of information. The decisions must at least to some extent be informed decisions. Merely going through the motions of passing or making resolutions and signing documents does not suffice. Where the geographical location of the physical acts of signing and executing documents is different from the place where the actual effective decision that the documents be signed and executed is taken, we consider that the latter place is where 'the central management and control' actually abides.

In the *Laerstate BV* case, which was discussed above (paragraph 2.8, page 26), it was found that although the only director concluded the decisions, by signing the relevant documentation, the decisions were in fact made by a resigned director, who was positioned in the United Kingdom. The Tribunal had come to this conclusion based on the fact that the director did not have all the necessary information to make the decisions. It was consequently found that the ‘effective’ management was located in the United Kingdom.

In 2008, the OECD Model was updated, and the following sentence in paragraph 24 of the OECD Commentary on Article 4 was removed:

The 'place of effective management' will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined. (OECD, 2005:82)

The removal of the above mentioned sentence avoids the situation where the OECD commentary is misread: that the 'place of effective management' is always considered to be the place where the board of directors meets, particularly where the board of directors simply ratifies or rubber stamps decisions that, in substance, are decided in another country (Russo, 2008:459).

The 2003 OECD Discussion Draft Paper makes it clear that the 'place of effective management' will not be where a decision, which has been made in a different jurisdiction is rubber stamped or finalised.

In summary, the place of 'effective' management is the place where the "real" board of directors (as opposed to appointed "straw men") actually make or take decisions on important business affairs of the company as opposed to the place where they are formally resolved ("rubber stamped").

2.11 Guidance provided by renowned authors

The viewpoint of OECD commentary was echoed by Vogel (1997:262), who states that:

According to this case law, the place of management of an enterprise is where the management's important policies are actually made . . . what is decisive is not the place where the management directives take effect but rather the place where they are given... The centre of management activities of the company generally is the place at which the person authorised to represent the company carries on his business-managing activities... A place from which a business is

merely supervised would not qualify. If the commercial and non-commercial management are located at different places, the location of the commercial management will be controlling. If the 'place of effective management' cannot be determined by application of these criteria, the top manager's residence will determine the residence of the company.

Vogel (1997:262) does not consider effective management to be positioned where the day-to-day decisions are made. In his view effective management is located where the top level management decisions, which influence the activities of the business are made. Vogel further asserts that in order for the top level management to make relevant decisions, they would have to be fully informed of the transactions of the business in order to make knowledgeable decisions.

Vogel's point of view was further confirmed by Olivier and Honiball (2005:57), who postulate that 'place of effective management' is the place "where the higher level of day-to-day running of the business takes place".

Meyerowitz (2008:5-7) holds the view that:

'Effectively managed' is a term used in double tax agreements following an OECD model. I consider that the 'place of effective management' is normally the place where in the case of the company the directors meet on the business of the company, which may differ from the place where the company carries on business or is managed by staff or directors individually and not as a board. Where the company has executive directors, the facts may reveal that the company is effectively managed where such directors, in contrast to the board of directors as a whole, conduct the company's affairs.

Carroll (2002:43) describes the term 'place of effective management' as the location of the highest level of decision making, which in all likelihood will lie with the directors unless in fact key decisions for the company as a whole are taken by others (for example, shareholders etc.).

To summarise, the authors interpret the term ‘place of effective management’ as decision making at a higher level of management rather than the mere day-to-day operations. However, there is no clarity on whether this concept is limited to the place where strategic decisions are taken as opposed to a combination of the decision making and carrying out of these decisions. Notwithstanding the various views on this subject, the authors have concluded that in determining the ‘place of effective management’ one cannot altogether exclude the place where executive management decisions are implemented. However, as there should only be one ‘place of effective management’, the place where decisions are ultimately taken should be decisive.

2.12 Conclusion

The above-mentioned paragraphs are summarised in a table (see table 2.2) and also in a non-tabular format below:

Reference point	Management decisions are made	Implementation of decisions made
OECD Commentary	✓	✗
SARS Interpretation	✗	✓
Australia Interpretation	✓	✗
Italy Interpretation	✓	✗
United Kingdom Interpretation	✗	✓
US Interpretation	Both the US and Canada do not use the term ‘place of effective management’ as a tie breaker rule, both countries have accordingly not interpreted the term.	
Canada Interpretation		
Ireland Interpretation	✓	✗
Court cases	✓	✗

Reference point	Management decisions are made	Implementation of decisions made
Place of management	✓	✗
Central management and control	✓	✗
Authors	✓	✗

Table 2.2: Summary of factors to consider when determining the 'place of effective management'.

2.12.1 OECD Commentary

According to the OECD Commentary, the organisation interprets the term to be the place where the **key strategy**, management and commercial **decisions are in substance made** by the most senior person or group of persons (for example a board of directors).

2.12.2 SARS Interpretation

SARS interprets the term 'place of effective management' as the country where the senior managers or **directors implement policy and strategy decisions** made by the board of directors.

2.12.3 Australian Interpretation

In Australia, the term 'place of effective management' is found to be where the **top level management** (including directors) considers all the facts and **make informed decisions**.

2.12.4 Italian Interpretation

In Italy the term 'place of effective management' is interpreted to be the place where the **most relevant decisions in relation to the company are made**.

2.12.5 United Kingdom Interpretation

Like the SARS interpretation of the term, the United Kingdom Revenue authorities interpret 'place of effective management' as the place **where the**

day-to-day activities are carried on, and it is thus irrelevant where the decisions are made.

2.12.6 USA and Canada Interpretation

Based on the fact that both the USA and Canada do not use the term 'place of effective management' as a tie breaker rule, both countries have accordingly **not interpreted the term**.

2.12.7 Ireland Interpretation

The term 'place of effective management' is interpreted by the Irish Tax Authorities as the place where "matters of policy and finance are determined"; that is, where the **key decisions regarding the company are decided on** (*Koitaki Para Rubber Estates Ltd. v FCT* (1941) at 244).

2.12.8 Court cases Interpretation

In the Laerstate court case it was found that the term 'place of effective management' will be located where the 'policy, strategic and management matters (that is, **high level decisions**) **are concluded on**. The court held that although decisions were made in the directors meetings, if the company is not managed through these board meetings, the location of these directors meetings is irrelevant.

2.12.9 Place of management

The OECD interpretation of the term 'place of effective management' mirrors how various countries, including Germany, interpret the term 'place of management'. It is therefore interpreted as the place **where the important decisions are made** and not where they are implemented.

2.12.10 Central management and control

The OECD interpretation of the term 'place of effective management' again mirrors how various countries interpret the term 'central management and control'. It is therefore interpreted as the place **where real control is exercised and key decisions are concluded**.

2.12.11 Authors

The authors have echoed each other and, in summary, they have interpreted the term as the place where the top management has the power and **actually exercises the power to influence the usual conduct of the business**. In this vein, Van der Merwe (2006:136) states that, “although internationally the phrase ‘effective management’ is not interpreted consistently, the scale tends to favour decision making on the highest level rather than day-to-day management as the appropriate basis” (Van der Merwe, 2006:136).

2.12.12 Conclusion

In summary, the ‘place of effective management’ should generally be determined with reference to the place where real management actually makes decisions on key business affairs of the company as opposed to the place where they are formally resolved and where the day-to-day administrative management activities are carried out.

Mindful of how the term ‘place of effective management’ is interpreted, the next chapter will consider the third secondary objective, which entails assessing whether using the term ‘place of effective management’ as a tie breaker clause is effective at allocating residency to one country only.

CHAPTER 3: THE LIMITATIONS IN USING 'PLACE OF EFFECTIVE MANAGEMENT' AS A TIE-BREAKER CLAUSE

3.1 Introduction

In the previous chapter, it has been established that the term 'place of effective management' is interpreted by the United Kingdom and the SA tax authorities, to be where the decisions are implemented. However, there is a broad consensus in other tax jurisdictions that the 'place of effective management' should be interpreted as the place where top level management in substance makes decisions and not where the decisions are implemented. (paragraph 2.12, page 36)

In this chapter the secondary objective contained in paragraph 1.4.2 (iii) (page 7) will be addressed. In other words the limitations in using 'place of effective management' as a tie breaker clause, will be addressed in this chapter.

3.2 Improved technology and globalisation

In the past, the company's business activities, management and directors' meetings and the place where the company was incorporated or had its registered office were all in one location. This made determining the 'place of effective management' fairly easy, and therefore explains the following statement contained in paragraph 21 of the Commentary on Article 4 of the Model Tax Convention:

"It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State" (OECD, 2008:77).

The enhanced communications technology of the present world, such as video and internet conferencing, allows companies to hold meetings in a manner that all persons are not required to be physically located in one place. Through this, senior management and directors may be located throughout the world, and therefore making it difficult to determine the company's single 'place of effective management' as each place each manager or director is

located in could be regarded as the company's 'place of effective management'.

Should senior managers make management and commercial decisions through Internet conferencing and each of those managers are located in various countries, it may be difficult to determine a single 'place of effective management' (Oguttu, 2008:89).

Carroll (2002:43) states that "the division of the company directors have been envisaged since at least the 1980s where it was considered that progress in telecommunications could enable an international enterprise to make its most important commercial decisions in the absence of formal board meetings." Currently it has been found that it has been increasingly difficult to classify 'place of effective management' into a single jurisdiction, with the effect that tax treaties do not provide tax relief for dual resident companies (Végh, 2001:162).

Hinnekens (2003:315) concurs with the above observation and states that with improved technology in respect of video conferencing and networking, the mobility of the decision-makers is enhanced. They are consequently no longer required to physically meet in one place. It has therefore become very difficult to pinpoint a single location where the 'place of effective management' is situated. This is the view shared by Romano (2001:339), who states that it has become increasingly difficult to determine the single place in which the 'place of effective management' is positioned, as technology such as videoconferencing and electronic discussion group applications via the Internet makes it unnecessary for a group of persons to meet physically in one place in order to make decisions.

3.3 Increased mobility of top level management

The increased number of companies operating global businesses had led to increased mobility of top management in order for them to manage the various businesses conducted throughout the world.

Currently, senior managers and directors are a lot more mobile and located throughout the world. Accordingly, it is questionable whether it would be possible to determine a single 'place of effective management' of a company (Davis, 2002:164). The current scenario of senior management of companies traveling a lot more than in the past, indeed makes it more difficult to determine where the company is resident, based on the 'place of effective management' principle. This dimension was predictably stated by the OECD (2001:9) thus:

It is not too difficult, for example, to envisage a situation where the managing director of a company who is responsible for the management of that company is constantly on the move and thus the directors may arrange to meet at different offices of the enterprise all around the world. In some extreme cases, that person may consistently be making the decisions while flying over the ocean or while visiting various sites in different jurisdictions where his business is conducted.

This resonates with Hinnekens' (2003:315) view that "with modern times, company's (peripatetic) board may travel and hold its meetings anywhere or on an internally rotating basis as distinct from a permanent headquarters office and accordingly the increased mobility can make it difficult to identify a single 'place of effective management'".

The above is further confirmed by the Confédération Fiscale Européenne (2009:473) which noted that:

*There has been a change in the modus operandi of the Boards of multinationals. Increasingly, the concept of a **Board of Directors** of a company, coming together to sit, generally in a particular place, but sometimes in **different places, to make key decisions**, is becoming less usual than in the past. (own emphasis)*

3.4 Various international views regarding 'place of effective management'

As seen in Paragraph 2.9 (page 29), countries tend to interpret the term 'place of effective management' in the same manner as in their domestic laws. Difficulties would obviously arise as the different states interpret the term 'place of effective management' differently.

For ease of reference, included below is a summary of how various selected countries interpret the term 'place of effective management'.

3.4.1 Australian Interpretation

In Australia the term 'place of effective management' is found to be where the **top level management** (including directors) considers all the facts and **make informed decisions**.

3.4.2 Italian Interpretation

In Italy, the term 'place of effective management' is interpreted to be the place where the **most relevant decisions in relation to the company are made**.

3.4.3 United Kingdom Interpretation

Like the SARS interpretation of the term, the United Kingdom Revenue authorities interpret place of effective management as the place **where the day-to-day activities are carried on**, and it is thus irrelevant where the decisions are made.

3.4.4 USA and Canada Interpretation

Based on the fact that, both the USA and Canada do not use the term 'place of effective management' as a tie breaker rule, both countries have accordingly **not interpreted the term**.

3.4.5 Ireland Interpretation

The term 'place of effective management' is interpreted by the Irish Tax Authorities as the place where "matters of policy and finance are determined"

in other words where the **key decisions regarding the company are decided on** (*Koitaki Para Rubber Estates Ltd. v FCT* (1941) at 244).

In this light, Hinnekens (2003:319) correctly highlights a situation where “even if that company would have in a Contracting State its ‘place of effective management’ in the sense of Article 4(3), such determination would not necessarily make it a resident of that State under local and as well as treaty rules, (for purposes of Article 3(1) and other treaty references), even if that state were to define corporate tax residence by reference by its ‘place of effective management’.”

Hinneken (2003:315) concludes that “countries tend to interpret the concept of ‘place of effective management’ in accordance with local tax laws rather than as an autonomous concept”. This therefore adds to the argument that using place of effective management as a tie breaker rule is ineffective.

3.5 Organisation network spread over number of countries

At present, companies are no longer conducted through legal entities but, rather, through divisions. This has resulted in an organisation network spread across different countries (Van der Merwe, 2006:124). This situation could, again, make it difficult to pin-point a single ‘place of effective management’. The implication of this aspect is that using place of effective management as a tie breaker rule will be ineffective.

3.6 Changes in generic managerial structure seen in the past

Hinneken (2003:315) postulates that where the management structure is no longer the “mono-centralised hierarchical one, but that of a bi- or polycentric networking operation”, tax residence of the enterprise can no longer be determined by the seat of effective management of the whole enterprise.” In addition, Engels (2010:1) believes that the determination of where effective management is located can be quite subjective. She further states that to distinguish between effective management, top level management and day-to-day management in practice is often ambiguous.

It is therefore clear that with the changes to the current management structure, it is now not conclusive as to where the effective management, top level management and day-to-day management are situated, and therefore it makes it increasingly complex to determine where the 'place of effective management' is situated.

3.7 Conclusion

After completing the secondary objective 1.4.2 (iii), it was found that there are a number of limitations in using 'place of effective management' as a tie breaker clause.

In the light of the situation described above, it is clear that the problem statement "is the term 'place of effective management' contained in Article 4 of the OECD Model Tax Convention effective in determining residency for companies?" should be answered in the negative.

It was found that the OECD Model Tax Convention tie-breaker clause relating to companies ('place of effective management' test) is not effective mainly because it is very difficult to pinpoint a single location where the 'place of effective management' is positioned. This is based on the improved communication technology, where decision makers are no longer required to hold meetings in one place. In addition companies are positioned throughout the world, therefore resulting in the increased mobility of top level management and directors.

The tie breaker clause also proved to be ineffective as there have been changes in the generic managerial structures of the past, which has made it very difficult to determine where the effective management, top level management and day-to-day management is situated. It was also found that the tie breaker clause was ineffective as there is no autonomous interpretation of term 'place of effective management' within the international arena.

Cognisant of the flaws identified above, the following secondary objectives will be considered in the next chapter:

- a. Summarise and critically analyse recommendations provided by the OECD to improve the tie breaker clause. (paragraph 1.4.2 (iv), page 7)
- b. Analyse how various countries determine residency from a domestic point of view, and consider whether this will be a more effective tie-breaker rule. (paragraph 1.4.2 (v), page 7)

CHAPTER 4: RECOMMENDATIONS TO RESOLVE THE LIMITATIONS HIGHLIGHTED ABOVE

4.1 Introduction

It was concluded in chapter 3 (paragraph 3.7, page 45) that using the 'place of effective management' to determine where the dual resident company will be deemed to be a tax resident, is ineffective mainly because businesses are run differently now, as compared to how they functioned in the past. For example:

- With improved communication technology, companies' directors and senior managers are no longer required to hold meetings in one place;
- With globalisation, companies are positioned throughout the world, therefore resulting in the increased mobility of top level management and directors; and
- Changes in the generic managerial structures of the past, has made it very difficult to determine where the effective management, top level management and day-to-day management is situated, and therefore it makes it increasingly complex to determine where the 'place of effective management' is situated.

Cognisant of the weakness of using 'place of effective management' as a tie breaker rule, the secondary objectives 1.4.2 (iv) and (v) (page 7) will be considered. Possible recommendations will be suggested and critically analysed to determine whether the recommended tie breaker rules will be more effective at eliminating dual resident conflicts. These will be outlined in the present chapter.

4.2 OECD Recommendations

The OECD 2001 Draft Discussion Paper (2001:10) summarises various options to possibly achieve a tie-breaker rule that will produce a situation where the company is deemed to be a resident of one country only. These options are:

1. Replace the 'place of effective management' concept, with one of the following tests:
 - 1.1. Place of incorporation, or in the case of an unincorporated association, place where corporate law applies to the establishment of the enterprise
 - 1.2. Place where the directors/ shareholders reside
 - 1.3. Place where economic nexus is strongest
2. Refine the 'place of effective management' test
3. Establish a hierarchy of tests, as applied in the individual OECD tie-breaker, so that if one test does not provide an outcome, the next test will apply; or
4. Deny dual resident companies the benefits under the Convention.

These options are now discussed in more detail below:

4.2.1 Replace the 'place of effective management' concept

In the 2001 OECD draft discussion document it was suggested that the 'place of effective management' tie breaker clause should possibly be replaced by one of the following tests:

- 1 Place of incorporation, or in the case of an unincorporated association, place where corporate law applies to the establishment of the enterprise
- 2 Place where the directors/ shareholders reside
- 3 Place where economic nexus is strongest

A critical reflection of each of these options will be presented in greater detail below:

4.2.1.1 *Place of incorporation*

Although the place of incorporation test allows for greater certainty and a reduction of administration and compliance costs, it is, however, easy to manipulate. Hinnekens (2003:317-318) confirms this position and states that “the option determining the residence of a company by reference to the state under the laws of which it is incorporated or exists, relies on [a] rather light criterion that is easily manipulated using limited human and technical resources to shift activities ... to a lower tax jurisdiction.”

For instance, if a company is incorporated in a tax haven and such a tax haven country has no other connection to the company’s business activities, assets or to the strategic decisions concluded by the senior managers or directors, this would present an easy manner to affect avoidance (Davis, 2002:164-165).

Further arguments against using the place of incorporation as a tie-breaker rule have been summarised by Végh (2001:162), who concludes that:

The place of incorporation is merely a formal tie and can be easily relocated. Furthermore, it does not give a solution in situations where a company is incorporated in a third country other than the countries of its activity and the company would like to apply the treaty concluded between the two countries of its activity but both the countries regard the company as a resident for tax purposes under their domestic laws.

Despite the fact that the incorporation test will provide great certainty, the “value of that certainty is dubious as the test is easily manipulated” (Kohl, 1998:444).

With reference to the OECD 2001 Draft Discussion Paper the following are arguments against the use of the place of incorporation as the tie-breaker test:

- A situation could occur where the only tie an enterprise will have to the jurisdiction in which it is incorporated or established is a formal tie and its

entire management, business operations and assets are located in a different jurisdiction (OECD, 2001:11).

- Should a company be incorporated in Country A and the business operations and assets are split between Country B and C. Should B and C both claim the company is a resident and the tie breaker clause contained in the treaty between the two countries is purely based on incorporation, this test will clearly not result in resolving of the double taxation (OECD, 2001:11).
- The enterprise's circumstances sometimes change over time, however the company's place of incorporation may not reflect of such changes (OECD, 2001:11).
- It is possible to change the place of incorporation of a company to another country with relative ease. Although this is a risk, this will not be too prevalent based on the capital gains tax implications attendant on the change (OECD, 2001:11).
- A situation could occur where a company is incorporated in more than one country (OECD, 2001:11).

According to the OECD 2001 Draft Discussion Paper, "using the place of incorporation or establishment as a tie-breaker for companies would produce a similar result to looking to where a individual was born as opposed to where they live" (OECD, 2001:11).

In summary, the place of incorporation test is considered an inappropriate tie-breaker rule, as it is a formal test, where an actual tie between an enterprise and the country of incorporation, is not required. In other words a situation could occur where the company is incorporated in one country but conducts its business activities in another country. A further weakness is that the simplicity of incorporating companies in low tax jurisdictions would encourage unacceptable levels of tax avoidance (Carroll, 2002:44).

4.2.1.2 Place where directors/shareholders reside

The fact that the incorporation test is a mere formal link suggests that it may be easily manipulated. One way of dealing with this problem is to turn the formal nexus into a substantial one. The substantial nexus refers to the “real ties” directors of a company will have with the tax jurisdiction in question. Provided more weight is given to the place of residence of the majority of the directors rather than their meeting place, the major tax planning opportunity the incorporation test creates in the internet era will be removed (Kohl, 1998:450).

Kohl (1998) believes that extending the ‘place of effective management’ definition would be a good idea. The author (p.446) states that

[T]he cases up to date do not give the residence of the directors any greater weight than their meeting place in establishing central management and control. However, given that the meeting place can be moved anywhere on the internet via servers, the residence of the directors should assume greater relevance in the future. The company residence test would thus indirectly take advantage of the stability of the residence test for individuals.

There are, however, authors who do not share the views articulated by Kohl. It is understood that most of these authors have recommended that the location of the residence of the directors or managers responsible for the day-to-day management replace the term ‘place of effective management’. It is argued that these individuals would need to reside at or near the place where the actual day-to-day business activities take place, and where the relevant decisions are implemented. However, where the company's business does not require the company as an entity to have a physical presence and allows managers to work and manage from a remote location, the location of the manager's place of residence would probably not be very useful in pinpointing a single place of company residence (Van der Merwe, 2006:133).

Végh (2001:162) does not believe that the place where the directors or shareholders reside will necessarily lead to a single solution of residence, based on the issues attached to the application of the residence concept. Carroll (2002:44) rejects this option because it may not result in a single place of residence, especially where the directors of the company manage the company from different countries.

A test relying solely on where the directors, senior managers or shareholders reside will not always give a clear result. The case in point would be the situation where the shareholders are not natural persons (OECD, 2001:11).

In summary, it is not recommended to formally extend the definition of 'place of effective management' to include the place where directors/shareholders reside. This is on account of the following reasons:

- With the application of individual residency concept, this will not result in a clear result.
- It could result in extreme untenable consequences as the shareholders might not necessarily be individuals.
- In the case where managers are allowed to work and manage by remote operation through the use of technology, the location of the managers' places of residence would probably not result in a single place of residency for the company.

4.2.1.3 Where the economic nexus is strongest

In this option, one would determine where the company has its strongest ties and deem that company to be a resident solely of that State. This option is not unique as a similar concept is used in individual tie-breaker purposes, where 'centre of vital interests' is used to determine the individual's tax residency. Carroll (2002:47) maintains that "essentially, the OECD view governments as service providers charging enterprises the consumption of government services."

This economic nexus argument is based on the idea that it is the place of the income-generating activity, rather than the jurisdiction where the income producer resides that results in the company making income and the tax jurisdiction should be compensated appropriately for the income earned by the company in the tax jurisdiction (Davis, 2002:168). In this vein, it could be argued that “if the State provides certain facilities and infrastructure for its residents, those who benefit most from such facilities and infrastructure ought to contribute to the State via resident-based taxes” (OECD, 2001:12).

Vogel, a theorist, argues that by focusing on where the **income** generating activity takes place, rather than the business activity, allows tax authorities to collect an appropriate amount of tax without resulting in double taxation (Davis, 2002:169).

An argument against the economic nexus test is that the test supports the source basis of tax, rather than residence basis of tax (OECD, 2001:12). However, Carroll (2002: 48) dismisses this argument and declares:

[T]he distinction drawn between the rationales of residence and source taxation is artificial. While taxation on the basis of residence under the existing rule may involve some cost to the host country, it is clear that the activities of the directors are economic in the sense of source-based rationale because they contribute to the production of income; similarly, while taxation on the basis of source by reference to the exercise of economic activities appears sound, those economic activities will involve some cost to that source country. Thus the residence rationale applies to the source tax, and the source rationale to the residence tax.

Although there are strong arguments to support the economic nexus test, one should consider whether the test will be easily applied. This point will be evaluated below.

If the economic nexus test is applied as the tie breaker rule based on the argument that it is compensating the government for the use of its services,

the economic nexus should be where the most substantial proportion of the enterprise's capital is located (Carroll, 2002:47).

Végh (2001:162) believes that the company's economic nexus is characterised by the location of the **“assets and labour used most extensively for the profit-generating activity**, which is similar to the ‘centre of vital interests’ test applied for individuals”. (own emphasis)

Economic connections to the State may be described as the extent to **“which land, labour, capital and enterprise** (being the factors of production) **are employed by the entity in its pursuit of profit”** (Davis, 2002:164). (own emphasis)

Where the business operations or activities are conducted from various locations, the approach adopted by SARS (2002:4) is that, ‘one needs to determine the place with the **strongest** economic nexus’. The Interpretation Note issued by SARS does however not explain or provide guidance on the phrase ‘strongest economic nexus’.

Oguttu (2008:101) concurs with this view as she maintains that “applying ‘economic nexus’ requires the ability to find the strongest or closest economic link”. Locating an entity's closest or strongest economic relations would also require the weighing up of the various factors. For example, (i) where the majority of the entity's employees and its assets are positioned, (ii) where the company carries on most activities, (iii) derives most of its revenue, or (iv) where its head quarters/ head office is positioned (Oguttu, 2008:101). Neither SARS nor the OECD provides guidance on the weighting of the above mentioned factors. This consequently makes it a difficult test to apply in practice.

The economic nexus test requires weighting to be given to the various economic nexus factors, which is proven to be rather subjective. This may, in the end, lead to widespread disagreement between tax authorities as to the place of residence of a particular company (Carroll, 2002:45).

In summary, the strongest argument in favour of the economic nexus test is that by using this test the State will be compensated in the form of taxes in situations where the company is using the State's facilities and infrastructure.

The only drawback in respect of this recommendation is that it will be very difficult to apply in practice as it will be very subjective as to where the "strongest economic ties" are situated. There are various factors which can determine the economic connection. These include labour, assets, where the company carries on most activities, where the company derives most of its revenue, or where the company has its headquarters. The effect of this situation is that it could result in a situation where there is no clear cut-answer.

4.2.2 Refine the 'place of effective management' concept

One of the ways that the OECD intends to adopt in refining the 'place of effective management' concept is by providing additional factors to consider when determining where the place of effective management' of the company is situated. It was recommended in the 2001 Draft Discussion document that the following additional considerations be included as part of the current OECD Commentary:

- The place where the key management and commercial decisions are in substance made;
- The place where the most senior person or group of persons make(s) the company's key strategic decisions; and
- Where the actions to be taken by the enterprise as a whole are in substance determined.

It has further been recommended by the OECD that the term 'place of effective management' can be further refined by considering and weighing up the following factors:

- The functions performed at the company's head office and where this is located.
- Where the 'place of effective management' is located with reference to the company's formation documents such as its articles of association.

- Where the company is incorporated.
- The importance of functions performed within each country.
- Where the majority of directors or senior managers reside.

The above recommendation is echoed by Davis (2002:164), who suggests that the term 'place of effective management' can be further refined by allocating weight to the importance of functions performed within each country as well as the determination of where the majority of directors or senior managers reside.

The 2003 OECD Draft Discussion Document stated how the OECD intended on expanding on the current commentary contained in paragraph 24. The Technical Advisory Group recommended the following additions to be made to the current OECD Commentary, in order to expand it (OECD, 2003:1):

*Where a board of directors formally finalises key management and commercial decisions necessary for the conduct of the entity's business at meetings held in one State but these **decisions are in substance made in another State, the 'place of effective management' will be in the latter State.*** (own emphasis)

*If there is a person such as a **controlling interest holder** (e.g. a parent company or associated enterprise) that **effectively makes the key management and commercial decisions that are necessary for the conduct of the entity's business, the 'place of effective management' will be where that person makes these key decisions.** For that to be the case, however, the key decisions made by that person must go beyond decisions related to the normal management and policy formulation of a group's activities (e.g. the type of decisions that a parent company of a multinational group would be expected to take as regards the direction, co-ordination and supervision of the activities of each part of the group).* (own emphasis)

*Where a **board of directors routinely approves the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the ‘place of effective management’ of the entity. In distinguishing between a place where a decision is made as opposed to where it is merely approved, one should consider the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed.** (own emphasis)*

(OECD 2003:2)

It can, therefore, be seen that the OECD intends on now focusing on where the decisions are in substance made. The location where directors meet to rubber stamp decisions previously made will be ignored.

The Confédération Fiscale Européenne, an association consisting of 29 tax advisory firms, and representing approximately 150 000 tax advisers, published an article in the European Taxation (CFE 2003:473). This article commented on the 2003 Draft Discussion Document issued by the OECD, which was discussed in detail above. In this regard the Confédération Fiscale Européenne (2003:473) recommended that the OECD make it clear that the additional considerations will only be met in exceptional circumstances.

In respect of the TAG’s final recommendation to expand the current OECD commentary, which has been detailed above, the Confédération Fiscale Européenne highlighted the fact that only when the board of directors approves the commercial and strategic decisions made by the executive officers, without an appropriate degree of consideration, only then should one consider where the executive officers perform their functions to determine where the ‘place of effective management’ is situated (CFE, 2003:473).

The Confédération Fiscale Européenne’s final comment on the refinement of the term ‘place of effective management’ was that it believes that there is insufficient guidance to allow for a “clear practical solution” (CFE, 2003:474).

The refinement of the current 'place of effective management' commentary, in theory, seems easily achievable. However, it is clear from the criticism by the Confédération Fiscale Européenne that this is not an easy task.

4.2.3 Establish a hierarchy of tests

In Article 4(2) of the OECD Model Tax Convention, the individual tie-breaker rules are established by a hierarchy of tests. The OECD 2001 Draft Discussion Paper (2001:13) had suggested that the possible structure for such a hierarchy may be:

- 'place of effective management';
- Place of incorporation;
- Economic nexus; and
- Mutual agreement.

In this option the 'place of effective management' test will still be the main test to determine the company's residence. Should the 'place of effective management' be split, the company would then be resident where the company is incorporated. Failing this, the company's residence will be determined firstly by determining where its strongest economic nexus is located and finally the place where the competent authorities of countries concerned have reached mutual agreement. As discussed earlier, the incorporation test is easily manipulated and therefore it is suggested that it should be ranked third below the economic nexus test.

In the 2003 OECD Draft Discussion Document, it was recommended that economic nexus test will consist of one of the following options:

- Option A: Where its economic relations are closer
- Option B: Where its business activities are primarily carried on
- Option C: Where its senior executive decisions are primarily taken (OECD, 2003:3)

Option A was created on the premise that the entity should be considered a resident and considered a taxpayer of the country in which it is making greater

use of economic resources such as the legal, financial, physical and social infrastructures of the country.

Guidance was provided in the 2003 OECD Draft Discussion document as to what factors should be considered to determine “where the economic relations are closer” which include various factors such as “in which State the entity has most of its employees and assets, carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from which State the entity derives its legal status” (OECD, 2003:5).

In Option B, the economic nexus will be determined where its business activities are primarily carried on. In terms of the 2003 OECD Draft Discussion document, this test will be determined by performing a functional analysis of the activities performed by the entity in the two countries, to establish which of the functions performed by the entity are clearly the most important (OECD, 2003:5).

In Option C, on the other hand, the economic nexus will be determined with reference to where its senior executive decisions are primarily taken.

It was recommended in the 2003 OECD Draft Discussion document (2003:5) that this test would be determined with reference to the place where the majority of senior executive decisions (e.g. the decisions of executive officers such as the president, vice-presidents, treasurer etc.) are taken. Based on the understanding that the senior executives in charge of the business of the entity are normally located at the company's head office, the decisions are deemed to be taken there, and therefore the economic nexus of the company will be deemed to be positioned there.

The Confédération Fiscale Européenne criticised Options A and B by stating that these options “lead to a blurring of the differentiation under the Model between taxing rights granted to source and residence states. They would also be potentially complex in their operation and practically difficult to apply in

a number of circumstances; for example, in cases where the function of a company is to provide group services in a number of different territories.” (CFE, 2003:474.)

Although the Confédération Fiscale Européenne believes that Option A and B will not resolve the issues noted in the current tie-breaker rule, it believes that “Option C comes closest, in principle, to the criterion of the present test, whilst offering a practical resolution where secondary considerations are required to be taken into account” (CFE, 2003:474).

4.2.4 Deny dual resident companies the benefit under the Convention

As a final option, it has been suggested that dual resident companies are denied the benefits contained in the DTA. The USA and Canada DTAs do deny certain benefits under their DTAs in order to discourage tax avoidance.

It is noted that dual residence is a result of conflicting residency rules of two legislations and is not necessarily related to tax avoidance. In other words, a situation where a company made its decisions entirely on a commercial basis but qualifies as a dual resident because of the domestic residency rules will be punished by the denial of treaty benefits, which is unreasonable (Végh, 2001:162).

The OECD views it to be unfair to disallow a dual resident enterprise double taxation relief where there is sound commercial rationale for their management structuring (Carroll, 2002:46).

The benefit would be that it would encourage companies to avoid becoming dual resident. However, it is clearly unfair to deny a company double-taxation relief where residency-residency conflict arose as a result of sound commercial structuring.

4.3 Various countries' domestic residency tests

In this part of the chapter an analysis will be performed to determine whether various countries' domestic tax residency tests will be a more effective tie-breaker rule. The countries that will be considered include:

- 1 United Kingdom;
- 2 Australia;
- 3 Ireland;
- 4 South Africa;
- 5 Italy;
- 6 United States; and
- 7 Canada.

4.3.1 United Kingdom, Australia, Canada and Ireland

The United Kingdom, Australia, Canada and Ireland use *inter alia* the concept of 'central management and control' in order to determine the residency of a company for domestic purposes. Refer to paragraph 2.9.2 (page 30) where 'central management and control' was also discussed in detail.

In the early United Kingdom court decisions of *Calcutta Jute Mills Co. Ltd v Nicholson* (1876) and *Cesena Sulphur Co. Ltd v Nicholson* (1876), it was found that a company is resident where the highest level of management is located, which is echoed in later cases.

In the cases *Wood and another v Holden* (Inspector of Taxes) (2006) and *The Trevor Smallwood Trust v HM Revenue and Customs* (2008), the concept of 'central management and control' was discussed and compared to the meaning of the term 'place of effective management'. In *Wood and another v Holden* (2006) it was held that the two tests are for practical purposes the same. However in *The Trevor Smallwood Trust v HM Revenue and Customs*

(2008), the judge cautioned that it is not correct to ask where the 'central management and control' is situated and to say that 'place of effective management' must be in the same place.

The Smallwood judge emphasised the point by stating that 'central management and control' determines whether the company is tax resident in a specific country or not, whereas the 'place of effective management's' purpose is to resolve cases of dual residence by determining in which of two states it is to be resident. However the court concluded that although conceptually the two terms were used in different contexts, there is essentially no difference between them.

In the case, *De Beers Consolidated Mines Limited v Howe* (1906), it was found that the directors meetings were held both in South Africa and in the United Kingdom, however the meetings in London were where the "real control" was exercised and accordingly the company was found to be United Kingdom tax resident. The judge held that the 'central management and control' will be found where the real business is carried on.

The crux of the test is to identify who exercises control over the key commercial decisions of the company. Normally, it is the directors rather than shareholders of a company who exercise this power, and control is most commonly exercised through meetings of the board of directors (Carroll, 2002:34).

Van der Merwe (2002:86) describes the central management and control as:

[T]he highest level of management as distinguished from immediate, day-to-day management. So, the relevant place is not necessarily where the company's manufacturing or trading activities take place, or where the goods or property are situated, but where the parameters governing these activities are set, or where the policies to be implemented elsewhere are conceived. Although company policy is usually determined by the board of directors, the notion of effective

management and control remains factual, since delegation is usually possible.

The company's management may be said to consist broadly of three levels. The highest is where the key policies and the company's strategy are determined. Below that level is where the executives and general managers supervise the day-to-day running of the business. At the bottom is where the actual activities take place. One of the problems with using central management and control to determine residency is that to establish the line between the top and the middle level management is not easy (Carroll, 2002:35).

In the case, *Swedish Central Railway Co. Ltd v Thompson* (1925), the judge held that a division of central management is possible. It was further held that if a company can have two places of residence, one of them must be the place where, in addition to being the place of registration, administration functions are performed which constitute the 'vital organic operations incidental' to the existence of the company.

Carroll (2002:40) provides an example which illustrates how problems can arise by the application of the principles:

Consider a simple fictitious example of an enterprise whose business is the provision of financial and investment services to an Irish consumer market. The enterprise is incorporated in another jurisdiction with which Ireland has not entered a tax agreement and which applies a low or zero rate of corporation tax. It uses servers, which are owned and maintained by an internet service provider located outside Ireland through which it contracts with, and provides its services to the consumer. A minority of its directors are based in Ireland and deal with any day-to-day business that may surface, while the majority (of the directors) are residents in a jurisdiction with which Ireland has no treaty agreement. All key decisions are made by a teleconferencing linkup between the Irish and foreign directors. This example suggests that the

company will not be resident in Ireland and therefore will not incur the liability to taxation on its worldwide profit.

Carroll (2002:48) concludes that the central management and control test is not a good tie-breaker test as companies are capable of structuring their top-level management in a manner which takes advantage of the test to reduce the tax liability of the company.

Kohl (1998:446) has made observations on the concerns raised in the Australian Tax Office discussion report, in respect of the difficulties encountered in applying the 'central management and control' test. For instance, internet facilities allow companies to influence the operations of their offshore subsidiaries more easily, and therefore the determination of where the 'central management and control' is situated is difficult. In general, the author's observations relate to the fact that the concerns are at least "partly unfounded" An example in this regard is the meeting of a company's directors via video conferences. He maintains that such a meeting is by no means "conclusive evidence in relation to the location of the central management and control of a company".

Provided a detailed inquiry is made into who really manages and controls a company, the central management and control test will remain fairly effective in the Internet age (Kohl, 1998:448).

The fact that a number of companies and authors believe the 'place of effective management' test and 'central management and control' tests are in essence the same will result in the weakness identified in respect of the 'place of effective management' test being equally applicable to the 'central management and control' test.

4.3.2 South Africa

SARS makes it clear in the Interpretation Note (SARS, 2002:3) that the 'place of effective management' would best be reflected where the day-to-day

operational management and commercial decisions taken by the senior managers are actually implemented.

Based on the fact that the actual implementation of the day to day decisions is likely to occur in one location, it can therefore be argued that SARS' interpretation of the term 'place of effective management' may limit the possibility of multiple country residence. Oguttu (2008:99), in this respect, says it could be argued that the SARS interpretation keeps pace with the discernible change in management structures, reporting lines and responsibilities as a result of modern multinational and electronic business environment.

There is, however, an argument against using the SARS interpretation of the term 'place of effective management' based on the fact that the implementation may consist of several separate actions undertaken in various jurisdictions, which in all likelihood may lead to a taxpayer having more than one 'place of effective management' during a particular tax year (Oguttu, 2008:100).

Olivier and Honiball (2005:56) maintain that it is not always clear where the transaction was implemented. This is another argument against using the SARS interpretation of the term 'place of effective management'. This weakness was portrayed by these authors in the example below:

A phone call is made by the South African resident director while based locally to arrange for the finance. However, the director flies overseas to sign the financial agreement. The question arises as to whether the transaction was implemented locally or overseas.

Oguttu (2008:100) states that determining the 'place of effective management' based on the SARS interpretation should not be too difficult if the company is involved in the manufacture and/or sale of tangible goods, provided the business activities or phases of such activities, are not conducted across the globe. However, it could be possible to manipulate the 'place of effective

management' should the company trade in intangible goods and services. This scenario will, therefore, possibly not result in a single place of residence.

Board meetings are no longer required to take place in one physical location, due to improved technology, and consequently a test based on the place where directors meet would be much easier to manipulate than the SARS approach (Oguttu & Van der Merwe, 2005:311).

The Interpretation Note issued by SARS provides a hierarchy of tests to ensure that a company has a single 'place of effective management' so that it becomes clear whether the company is SA tax resident or not.

The first test states that where the day-to-day management exists in a single location, that location will be the 'place of effective management', whether or not it corresponds with the place where the daily business operations are actually conducted or carried out.

The second test provides that where these management functions are not executed at a single location due to management operating by way of distance communication, the 'place of effective management' must be deemed to be "where day-to-day operational management and commercial decisions taken by senior managers are actually implemented" (SARS, 2002:4).

However Van der Merwe (2006:128) has criticised the test and stated that its application will not necessarily result in a single place of residence as a taxpayer may have several places across the world where operational and commercial decisions are implemented, and where the business activities, or parts or phases of such business activities, are carried out or conducted.

Despite the criticism, there is a third test, which states that where the decisions are implemented in several locations, "one needs to determine the place with the strongest economic nexus" (SARS, 2002:4).

Van der Merwe (2006:130) states that the economic nexus test requires the 'strongest' or 'closest' economic nexus to be located. This would require the

examination and weighing of several factors, such as the determination of the state in which the entity:

- has most of its employees and assets;
- carries out most of its activities;
- derives most of its revenues;
- has its headquarters;
- carries out most of its senior management functions; and
- derives its legal status.

The SA Interpretation Note does not provide any direction in respect of the method or guidelines on weight allocations and, accordingly, this test will be difficult to apply in practice (Van der Merwe, 2006:130).

4.3.3 Italy

From an Italian income tax perspective, persons other than individuals are considered to be resident if, for a greater part of the taxable period, “their legal seat, place of management or main business purpose is situated in Italy” (Romano, 2001:341). This view is further affirmed by Bizioli (2008:527), who argues that a company would be considered a resident if, “for most of the tax year, its registered office, place of management or the main and substantial activity is located within the territory of Italy”.

Each of these three requirements will be elaborated below:

4.3.3.1 *Legal seat*

The legal seat is indicated in the company’s formal documents such as the articles of incorporation/association (Romano, 2001:341). As discussed above, although the incorporation test is easy to apply, it is just as easy to manipulate and therefore it would not be an effective tie-breaker rule.

4.3.3.2 *Place of management*

The place of management is considered to be the place from which the main decisions are concluded by the company’s directors (Romano, 2001:341). In

the Italian Supreme Court decision No. 4172 of 10 December 1972, it was held that the place of management is situated where:

- the general meetings are held;
- the top level of management carry on the business; and
- the accounting books are maintained.

The Supreme Court decision No. 3028 further elaborated on the term, by saying that 'place of management' is where the business activities are performed and not where the assets and properties are located. In this regard, significance is attached to the place where the management directives are given and not to the place where they take effect (Romano, 2001:341).

Finally, recent Italian case law indicates that directors meetings are allowed to be conducted by way of video or teleconferencing, provided all the participants of the meeting are identifiable and can intervene at any stage. The board meeting is considered to be held in the country the president or chairman of the board attends the meeting (Romano, 2001:342).

The Italian courts have held that the meaning of 'place of management' is the place where the important decisions in relation to the business are made, and not where they are formally taken (Bizioli, 2008:528).

The fact that the 'place of management' is considered to be where the main decisions in relation to the company are made suggests that it will mirror where the 'place of effective management' is situated. The effect of this is that the weakness identified in respect of the 'place of effective management' test will equally apply to the 'place of management' test.

4.3.3.3 Main or exclusive business purpose

The main business purpose is deemed to be the essential activity conducted in order to directly pursue the basic goals indicated by the law or articles of incorporation. In respect of non-resident entities, regardless of the articles of

incorporation, the decisive criterion is the activity effectively performed within the Italian territory” Romano (2001:342).

4.3.4 United States of America

The US determines the company’s residence by reference to where the company is incorporated. As discussed above, although the incorporation test is easy to apply, it is just as easy to manipulate and therefore it would not be an effective tie-breaker rule.

4.4 Other solutions to provide a more effective tie-breaker rule

4.4.1 Use a term not reflected in countries’ domestic laws

As seen above, countries tend to interpret the term ‘place of effective management’, in the same way as in their domestic laws. In this regard, it was recommended that the term which was proposed in the League of Nations London Model (1946), where the ‘real centre of management is situated’, should be used. The fact that it is rarely used is an advantage because countries will not be tempted to use their own domestic law understanding to interpret the tie breaker rule (Jones, 2009:186).

Although applying the test “real centre of management “ as a tie breaker rule eliminates the weakness caused by the inconsistent view of the term ‘place of effective management’ within the international arena, it is unlikely that the other weaknesses will be removed. This option will, therefore, not be considered in any more detail.

4.4.2 Addressing the mobility issue

Article 4 does not provide guidance on the mobility issue discussed under paragraph 3.3 above. In Article 8 of the OECD Model Tax Convention, guidance is provided. Paragraph 8(3) states:

If the ‘place of effective management’ of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it

shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident. (OECD, 2008:28)

The OECD (2001:13) stated that it may be possible to draft a similar provision to Article 8 in order to assist in situations where the 'place of effective management' is mobile; for example, where a single board of directors meets in different locations. However, this will not correct the situation where the 'place of effective management' could be said to exist in various jurisdictions simultaneously. An example in this respect is where directors from different countries conduct meetings by way of video-conferencing.

Traditionally, courts have dealt with the problem highlighted above by inquiring where the chairman of the board of the directors is located, or where the main trading hub of the company is located (Kohl, 1998:446).

4.5 Conclusion

In this chapter the following objectives (paragraph 1.4.2 (iv) and (v), page 7) were considered:

- 1 Summarise and critically analyse recommendations provided by the OECD to improve the tie breaker clause; and
- 2 Analyse how various countries determine residency from a domestic point of view and consider whether this will be a more effective tie-breaker rule.

In summary the focus of the chapter was to determine how the limitations highlighted in Chapter 3 can be resolved. This was achieved by considering whether the solutions recommended by the OECD and the various countries' domestic residency tests are successful in resolving the current ineffective OECD tie breaker clause which was noted in Chapter 3. The solutions recommended by the OECD include replacing the place of effective

management concept with either the place of incorporation test; the place where directors/shareholders reside or where the economic nexus is strongest. It was further recommended by the OECD to extend the guidance provided in the OECD Commentary, establish a hierarchy of tests or deny dual resident companies the benefit under the Convention.

The shortcomings found in the above mentioned tests are summarised below:

1. Place of incorporation

It was found that should a company be deemed to be a resident of the country where the company's place of incorporation is situated, this is not a good tie breaker rule. The company's directors will be tempted to incorporate the company in low tax jurisdictions, as the test is easily manipulated, which would facilitate unacceptable levels of tax avoidance. A probable situation where a company can be incorporated in more than one country, is another reason why the 'place of incorporation' test will not be effective at determining the residency of a company. (Refer to paragraph 4.2.1.1, page 49)

2. Place where the directors/ shareholders reside

With improved technology, directors/senior management are allowed to work by remote operation, which implies that the directors and senior management will not be positioned in one location, therefore it will be difficult to pinpoint the single place of residence for all directors. In addition the test was criticised as the test will provide extreme results where shareholders are not individuals and due to the issues attached to the application of the individual residence concept. (Refer to paragraph 4.2.1.2, page 51)

3. Place where economic nexus is strongest

The test was criticised as it is a subjective test and it will be difficult to determine where the company's economic nexus is the strongest as there are various criteria which can be considered, with varying weightings. (Refer to paragraph 4.2.1.3, page 52)

4. Refine the 'place of effective management' test

Although the Confédération Fiscale Européenne had provided suggestions on how the OECD's recommended commentary should change it still felt that there is insufficient guidance to allow for a "clear practical solution" (CFE, 2003:474). (Refer to 4.2.2, page 55)

5. Establish a hierarchy of tests

In the hierarchy of tests option it was recommended by the OECD that as a first test, a company will be deemed to be a resident where its 'place of effective management' is situated. Should the company not be deemed to be a resident of one State only or is not a resident of either States, the OECD has recommended three options to determine where the company is tax resident, namely where the company's economic relations are closer, where its business activities are primarily carried on and where its senior executive decisions are primarily taken.

The first two options were criticised as the tests are difficult to apply in practice and it supported source rather than residence taxation. (Refer to paragraph 4.2.3, page 58)

6. Deny dual resident companies the benefits under the Convention

It was found that it was not fair to deny a dual resident company relief under the double taxation agreement, where there are valid business reasons which created the dual residency situation. (Refer to paragraph 4.2.4, page 60)

With respect to the secondary objective (paragraph 1.4.2 (v), page 7) a number of residency tests, which various countries use to determine the company's residency from a domestic tax point of view, was analysed and it was considered whether this it would be a more effective tie-breaker rule.

The residency tests analysed include:

1. Central management and control

2. 'Place of effective management' as interpreted by the South African Revenue Service (where the decisions taken by the senior managers are actually implemented)

3. 'Place of management' as defined in the Italian Tax legislation.

In summary, the following weaknesses were identified, should the above mentioned tests be used as a tie breaker clause:

1. Central management and control

With the 'place of effective management' and 'central management and control' tests being the same, the weakness identified in respect of the 'place of effective management' test will equally apply to the 'central management and control' test. Another weakness identified should 'central management and control' be used as a tie breaker rule was that the company could be structured in such a manner which takes advantage of the test and reduces tax liability. (Refer to paragraph 4.3.1, page 61)

2. 'Place of effective management' as interpreted by the South African Revenue Service

Based on the fact that the 'place of effective management' is deemed to be where the decisions are implemented, there is an argument against the test as implementation may consist of several separate actions undertaken in various jurisdictions. Therefore it will be difficult to locate one 'place of effective management'. (Refer to paragraph 4.3.2, page 64)

3. 'Place of management' as defined in the Italian Tax legislation

The 'place of management' and the 'place of effective management' tests are in essence the same. This will result in the weakness identified in respect of the 'place of effective management' test applying equally to the 'place of management' test. (Refer to paragraph 4.3.3, page 67)

In the final chapter, the final objective (paragraph 1.4.2 (vi), page 7) will be addressed, where possible recommendations are made to resolve the limitations in using 'place of effective management' as a tie breaker clause.

CHAPTER 5: CONCLUSION

5.1 Introduction

The problem statement (paragraph 1.3, page 6) in respect of this study was to determine whether the term 'place of effective management' contained in Article 4 of the Model Tax Convention is effective in eliminating double taxation for companies. This was also the main objective of this study.

In order to comprehensively answer the above mentioned problem statement, the following secondary objectives (paragraph 1.4.2, page 6) were set:

- (i) Summarise what is meant by the term 'place of effective management'.
- (ii) Based on the fact that the SARS and OECD interpret 'place of effective management' differently, discuss how this will impact on local court decisions.
- (iii) Summarise the limitations in using 'place of effective management' as a tie breaker clause.
- (iv) Summarise and critically analyse recommendations provided by the OECD to improve the tie breaker clause.
- (v) Analyse how various countries determine residency from a domestic point of view and consider whether this will be a more effective tie-breaker rule
- (vi) Make possible recommendations to resolve the limitations in using 'place of effective management' as a tie breaker clause.

The first secondary objective (paragraph 1.4.2 (i), page 6), namely to summarise what is meant by the term 'place of effective management', was considered in Chapter 2. In conclusion it was found that the 'place of effective management' should generally be determined with reference to the place where real management actually makes decisions on key business affairs of the company as opposed to the place where they are formally resolved, and where the day-to-day administrative management activities are carried out.

In order to determine what is meant by the term, 'place of effective management', a number of different sources were considered. Below is a

summary of the sources considered and how the various sources interpret the term 'place of effective management':

5.1.1 OECD Commentary

According to the OECD Commentary, the organisation interprets the term to be the place where the **key strategy**, management and commercial **decisions are in substance made** by the most senior person or group of persons (for example a board of directors). (Paragraph 2.12.1, page 37)

5.1.2 SARS Interpretation

SARS interpreted the term 'place of effective management' as the country where the senior managers or **directors implement of policy and strategy decisions** made by the board of directors. (Paragraph 2.12.2, page 37)

5.1.3 Australian Interpretation

In Australia the term 'place of effective management' is found to be where the **top level management** (including directors) considers all the facts and **make informed decisions**. (Paragraph 2.12.3, page 37)

5.1.4 Italian Interpretation

In Italy, the term 'place of effective management' is interpreted to be the place where the **most relevant decisions in relation to the company are made**. (Paragraph 2.12.4, page 37)

5.1.5 United Kingdom Interpretation

Like the SARS interpretation of the term, the United Kingdom Revenue authorities interpret 'place of effective management' as the place **where the day-to-day activities are carried out**. It thus becomes irrelevant where the decisions are made. (Paragraph 2.12.5, page 37)

5.1.6 USA and Canada Interpretation

Based on the fact that both the USA and Canada do not use the term 'place of effective management' as a tie breaker rule, both countries have accordingly **not interpreted the term**. (Paragraph 2.12.6, page 38)

5.1.7 Ireland Interpretation

The term 'place of effective management' is interpreted by the Irish Tax Authorities as the place where "matters of policy and finance are determined". This refers to the place where the **key decisions regarding the company are decided on**. (Paragraph 2.12.7, page 38)

5.1.8 Court cases Interpretation

In the Laerstate court case it was found that the term 'place of effective management' will be located where the 'policy, strategic and management matters (i.e. **high level decisions**) **are concluded**'. The court held that although decisions were made in the directors' meetings, if the company is not managed through these board meetings, the location of these directors' meetings is irrelevant. (Paragraph 2.12.8, page 38)

5.1.9 Place of management

The OECD interpretation of the term 'place of effective management' mirrors how various countries, including Germany, interpret the term 'place of management'. It is therefore interpreted as the place **where the important decisions are made** and not where they are implemented. (Paragraph 2.12.9, page 38)

5.1.10 Central management and control

The OECD interpretation of the term 'place of effective management' again mirrors how various countries interpret the term 'central management and control'. It is therefore interpreted as the place **where real control is exercised and key decisions are concluded**. (Paragraph 2.12.10, page 38)

5.1.11 Authors

The authors consulted echoed each other and in summary they interpreted the term as the place where the top management has the power and **actually exercises the power to influence the usual conduct of the business.** (Paragraph 2.12.11, page 39)

Chapter 2 considered the second secondary objective, which states how the varying interpretations will impact local court decisions. This consideration is based on the fact that SARS and the OECD interpret 'place of effective management' differently.

It was found that when interpreting international law, section 233 of the South African Constitution reference requires that a court should give preference to any reasonable interpretation of the legislation that is consistent with international law over any interpretation that is inconsistent with international law. This principle was confirmed by the Appellate Division in *CIR v Downing* (1975).

It was consequently found that where there is a Double Taxation Agreement in force, international interpretations should take preference. Thus, South African courts will still be bound to have regard to international directives, such as the OECD guidelines, when interpreting the meaning of "effective management" in the context of a DTA. This aspect is fully discussed in paragraph 2.6 above (page 21).

5.2 Ineffectiveness of 'place of effective management' as a tie breaker clause

In Chapter 3, the secondary objective (paragraph 1.4.2 (iii), page 7), namely to highlight the limitations in using 'place of effective management' as a tie breaker clause, was addressed.

It was found that the OECD Model Tax Convention tie-breaker clause relating to companies ('place of effective management' test) is not effective in determining the residency for companies. This is mainly because it very

difficult to pinpoint a single location where the 'place of effective management' is positioned. With the improvement in the communication technology, decision makers are no longer required to hold meetings in one place. In recent times, companies are found to be positioned throughout the world, therefore resulting in the increased mobility of top level management and directors.

The tie breaker clause also proved to be ineffective as there have been changes in the generic managerial structures of the past. Accordingly this has made it very difficult to determine where the effective management, top level management and day-to-day management is situated. In addition the tie breaker clause was also found to be ineffective as there is no autonomous interpretation of term 'place of effective management' within the international arena. (Paragraph 3.7, page 45)

5.3 Possible solutions to solve the inefficiencies noted

In Chapter 4, the following secondary objectives were considered namely:

- 1 Summarise and critically analyse recommendations provided by the OECD to improve the tie breaker clause (paragraph 1.4.2 (iv), page 7) and
- 2 Analyse how various countries determine residency from a domestic point of view and consider whether this will be a more effective tie-breaker rule. (paragraph 1.4.2 (v), page 7)

Table 5.1 below summarises all the possible solutions provided in chapter 4 and the inefficiencies noted (if any):

Solution provided	Inefficiencies noted
Place of incorporation	• Easily manipulated; • Major tax planning opportunity; • Incorporation in low tax jurisdictions would facilitate unacceptable levels of tax avoidance • As it is possible in certain jurisdictions to be incorporated in more than one country, the dual residency issue of the company will not be resolved easily. Refer to paragraph 4.2.1.1, page 49,

Solution provided	Inefficiencies noted
	where this is discussed in more detail.
Place where the directors/ shareholders reside	- Where directors/senior management are allowed to work by remote operation through the use of technology, the location of the managers' places of residence would probably not be very useful in pinpointing the single place of residence. - Might give rise to extreme results where the shareholders are not individuals. - Will in probability not result in a single solution of residence, because of the issues attached to the application of the residence concept. Refer to paragraph 4.2.1.2, page 51, where this is discussed in more detail.
Place where economic nexus is strongest	Subjective test and difficult to apply Refer to paragraph 4.2.1.3, page 52, where this is discussed in further detail.
Refine the 'place of effective management' test	Although the refinement of the term 'place of effective management' seems easy to achieve, it is clear from the criticism by the Confédération Fiscale Européenne (paragraph 4.2.2, page 55), that this will not be an easy task.
Establish a hierarchy of tests: •Option A:Where its economic relations are closer •Option B: Where its business activities are primarily carried on •Option C: Where its senior executive decisions are primarily taken	<u>Option A</u>: Supports source rather than residence. Practically difficult to apply. <u>Option B</u>: Supports source rather than residence. Practically difficult to apply. <u>Option C</u>: None Refer to paragraph 4.2.3, page 58, where this is discussed in more detail.
Deny dual resident companies the benefits under the Convention	Not fair to punish those companies that are residents of two states, where there was sound commercial rationale for their management structuring. Refer to paragraph 4.2.4, page 60, where this is discussed in more detail.

Solution provided	Inefficiencies noted
Central management and control	• Able to structure the top-level management in a manner which takes advantage of the test and reduces tax liability. • The place of effective management' test and 'central management and control' tests are in essence the same. This will result in the weakness identified in respect of the 'place of effective management' test equally applying to the 'central management and control' test Refer to paragraph 4.3.1, page 61, where this is discussed in more detail.
'Place of effective management' interpreted to be where the decisions taken by the senior managers are actually implemented. (South African Revenue Service interpretation of the term)	• Implementation may consist of several separate actions undertaken in various jurisdictions. Therefore this, may lead to a taxpayer having more than one 'place of effective management'. Refer to paragraph 4.3.2, page 64, where this is discussed in more detail.
'Place of management' as defined in the Italian Tax legislation.	• The 'place of management' test and the 'place of effective management' test are in essence the same this will result in the weakness identified in respect of the 'place of effective management' test will equally apply to the 'place of management' test Refer to paragraph 4.3.3, page 67, where this is discussed in more detail.

Table 5.1: Summary of all possible ways to improve the tie breaker rule and the inefficiencies noted (if any).

Although the above mentioned table highlights the fact that each recommended option has its own flaws, the focus of this chapter will now be placed on completing the final objective which is to make possible recommendations to resolve the limitations of using 'place of effective management' as a tie breaker clause.

5.4 The most effective tie-breaker rule

The flaws identified in Table 5.1 above emphasise the fact that it will be a complex task to determine an effective tie breaker rule that will deem a company to be a resident of one country only. In the light of the fact that it is almost impossible to determine a company's residency based on a single test, it is therefore recommended that the tie breaker rule consist of a hierarchy test (as in the OECD individual tie breaker rule).

It has been stated in the 2003 OECD Discussion Draft Document that the Technical Advisory Group had examined the comments received in respect of the 2001 OECD Discussion Draft document and found that the majority of the responses believed that the clarification of the 'place of effective management' concept, and developing a hierarchy of different approaches, could be an effective tie-breaker rule.

It is believed that the hierarchy test should consist of the following tests:

1. The residency of the company will be deemed to be in the country where the place of effective management is situated:
 - Defined by OECD Model Tax Convention; or
 - Defined by South African Revenue Service. (Refer to paragraph 5.4.1, page 82)
2. Should the above mentioned test not resolve the dual residency conflict, the company will be deemed to be resident of the country in which its economic nexus is the strongest. (Refer to paragraph 5.4.2, page 87)
3. Should the company still be regarded as a dual tax resident, this will be resolved by mutual agreement between the two Contracting States. (Refer to paragraph 5.4.3, page 87)

5.4.1 Place of effective management

Using 'place of effective management' to determine the residency of a dual resident company, for double taxation agreement purposes, has its

advantages as it is a practical test. The next consideration would be to determine whether the phrase 'place of effective management' should be interpreted in terms of the OECD or SARS definition.

In order to determine which interpretation will result in less inefficiencies, all the weaknesses identified previously in Chapter 3 will be analysed to determine whether these weaknesses will also apply if the term 'place of effective management' was interpreted using the SARS interpretation. In other words, the company's residency will be positioned in the country where the decisions taken by the senior managers are actually implemented. This is summarised through Table 5.2 below:

Inefficiency identified previously	Will the inefficiency noted be applicable if phrase is interpreted according to SARS guidelines	Further explanation as to why the inefficiency will be applicable or not.
Persons are no longer required to be physically located in one place to hold a meeting, due to improved technology such as video and internet conferencing.	X	Should the term 'place of effective management' be interpreted using SARS guidelines, it is not necessary to consider where the decisions are made.

Inefficiency identified previously	Will the inefficiency noted be applicable if phrase is interpreted according to SARS guidelines	Further explanation as to why the inefficiency will be applicable or not.
(Paragraph 3.2, page 40)		
Increased mobility of directors. (Paragraph 3.3, page 41)		Based on the fact that SARS believes that the phrase 'place of effective management' is positioned where the senior management or executive directors implement decisions made by the board of directors, it is thus irrelevant that there is an increase in the mobility of directors as focus is more on the senior management or executive directors.
Inconsistent view of the term 'place of effective management' within the international arena. (Paragraph 3.4, page 43)		Although consensus has not be reached in the international arena as to how the term 'place of effective management' should be interpreted, there are a number of countries that interpret the term in the same way as the OECD. With the OECD and SARS' interpretations being different, this will result in countries determining a company's place of effective

Inefficiency identified previously	Will the inefficiency noted be applicable if phrase is interpreted according to SARS guidelines	Further explanation as to why the inefficiency will be applicable or not.
		management differently, therefore resulting in the dual tax residency conflicts not being resolved.
Organisation network spread over number of countries. (Paragraph 3.5, page 44)	✓	Due to globalisation, companies are no longer located in one country only, and accordingly it might prove difficult to determine a single place where the decisions are implemented.
Changes in generic managerial structure seen in the past. (Paragraph 3.6, page 44)	✓	With the changes to the current management structure, there is now no clear distinction between senior management and the board of directors, and therefore this makes it increasingly complex to determine where the senior management implements decisions made by the board of directors.

Table 5.2: The weaknesses identified in chapter 3 and their applicability should 'place of effective management' be interpreted in terms of the SARS guidelines.

Oguttu (2008:100) states that determining the 'place of effective management' based on SARS' interpretation should not be too difficult if the company is involved in the manufacture and /or sale of tangible goods and provided the

business activities, or phases of such activities, are not conducted across the globe. However, it could be possible to manipulate the 'place of effective management' should the company trade in intangible goods and services, therefore possibly not resulting in a single place of residence.

Although interpreting the phrase, 'place of effective management' as recommended by SARS will result in inefficiencies, these inefficiencies are less than those identified had the OECD interpretation been used.

It is therefore believed that the SARS interpretation would result in less inefficiencies and therefore should be used to interpret the term. The above view-point is further supported by the fact that the factors that SARS takes into account are not as easily moved, as compared to the directors' meetings.

It is, however, recommended that the SARS interpretation of the term include the following additional consideration items to assist in identifying the 'place of effective management' and to add additional factors that are not easily moved:

- (i) The location of the company's actual business operations;
- (ii) The location of the company's head office;
- (iii) Where company accounts are prepared and audited;
- (iv) The residence the senior managers and executive directors; and
- (v) The location of the registered office and where the company was incorporated.

The OECD, in the 2001 Discussion Paper, also stated that the determination of a 'place of effective management' is a question of fact, and further went on to state that other relevant factors taken into account by the courts have included:

- Where the centre of top level management is located;
- Where the business operations are actually conducted;

- Legal factors such as the place of incorporation, location of registered office, public officer etc;
- Where the controlling shareholders make key management and commercial decisions in relation to the company; and
- Where the directors reside.” (OECD, 2001:7)

5.4.2 Country in which its economic nexus is the strongest.

This test is very similar to the previous test (place of effective management). It would thus be a logical second test as it can provide additional factors to be taken into account in order to resolve the dual residency issue.

Although there are strong arguments to support the economic nexus test, one of the main weaknesses identified is that it is a very subjective test and that to date no consensus has been reached as to the factors that should be taken into account and their respective weightings to determine where the company’s economic nexus is the strongest.

It is important to note that the economic nexus test is based on the premise that because the country is providing infrastructure and other resources for the company to operate and make income, that company should ‘pay’ in the form of taxes, for the use of such.

In this regard, it is imperative that the economic nexus test is determined “by the location of the **assets and labour used most extensively for the profit-generating activity**” (Végh, 2001:162). Davis (2002:164) also states that “economic connections to the State may be characterised by the extent to **which land, labour, capital and enterprise** (being the factors of production) **is employed by the entity in its pursuit of profit.**” (own emphasis)

5.4.3 Resolved by mutual agreement between the two Contracting States.

As with the individual tie breaker rule, it is recommended that the final hierarchy test should be that the competent authorities of the Contracting States shall settle the question by mutual agreement.

As shown in Annexure A (page 90), a number of the current double tax agreements that South Africa has concluded uses this test as a tie breaker rule. The use of this test will ensure that a consistent approach will be followed in each dual residency case.

As this is the last test, it will ensure that only a minimal number of cases will be referred to the competent authorities to settle.

5.5 Suggestions for further research

There are strong arguments to support the economic nexus test, however to date no consensus has been reached as to the factors and weightings which should be taken into account when determining where company's economic nexus is the strongest. In this regard this will have to be considered in further studies.

5.6 Conclusion

The hierarchy of tests is definitely one of the easiest ways to resolve dual residency cases, based on the fact that if one test does not resolve the conflict, hopefully the next test will.

The recommended hierarchy test consists of the following tests, which should be applied in the stated order:

- (i) The residency of the company will be deemed to be in the country where the place of effective management is situated.
- (ii) Should the above mentioned test not resolve the dual residency conflict, the company will be deemed to be resident of the country in which its economic nexus is the strongest.
- (iii) Should the company still be regarded as a dual tax resident, this will be resolved by mutual agreement between the two Contracting States.

In short, it was found that the SARS interpretation of the term 'place of effective management' would result in less inefficiencies than the OECD interpretation.

With this test being very similar to the previous test (place of effective management), this would be a logical second test, as this test can provide additional aspects to be taken into account in order to resolve the dual residency issue.

Although a possible solution has been highlighted above, it is imperative to note that the term 'place of effective management', economic nexus and other tie breaker rule tests have resulted in numerous debates in the past and it is unlikely that consensus will be reached in the near future as to which test(s) the tie breaker rule should consist of and how the term(s) should be interpreted. It is thus anticipated that, at least for the foreseeable future, the current situation will remain unchanged and the tie breaker rule contained in Article 4(3) will continue to be ineffective in determining where the dual resident company is resident for double tax agreement purposes.

Annexure A: Summary of all the tie breaker rules contained in the South African DTAs

Country	Tie breaker rule
Algeria	Place of effective management is situated
Australia	Place of effective management is situated
Austria	Place of effective management is situated
Belarus	The competent authorities of the Contracting States shall endeavour to settle the question by mutual agreement. In the absence of such agreement, the person shall not be entitled to claim any benefits provided by the Agreement.
Belgium	Place of effective management is situated
Botswana	The competent authorities of the Contracting States shall settle the question by mutual agreement
Brazil	Place of effective management is situated
Bulgaria	State in which it is incorporated
Canada	Of the State of which it is a national. If it is a national of neither of the States, it shall be deemed to be a resident only of the State in which its place of effective management is situated
China (People's Republic of)	Its place of effective management or its head office is situated
Croatia	Place of effective management is situated
Cyprus	Place of effective management is situated
Czech Republic	Place of effective management is situated
Denmark	Place of effective management is situated
Egypt	Place of effective management is situated
Ethiopia	Place of effective management is situated
Finland	The competent authorities of the Contracting States shall settle the question by mutual agreement
France	Place of effective management is situated
Germany	Place of effective management is situated
Greece	Place of effective management is situated
Ghana	Place of effective management is situated

Country	Tie breaker rule
Hungary	Place of effective management is situated
India	Place of effective management is situated
Indonesia	The competent authorities of the Contracting States shall settle the question by mutual agreement
Iran	The State in which its registered office is situated
Ireland	Place of effective management is situated
Israel	Place of effective management is situated
Italy	Place of effective management is situated
Japan	The competent authorities of the Contracting States shall settle the question by mutual agreement
Korea	Place of effective management is situated
Kuwait	Place of effective management is situated
Lesotho	Place of effective management is situated
Luxembourg	Place of effective management is situated
Malawi	Place of effective management is situated
Malaysia	The competent authorities of the Contracting States shall settle the question by mutual agreement
Malta	Place of effective management is situated
Mauritius	Place of effective management is situated
Mexico	The competent authorities of the Contracting States shall settle the question by mutual agreement
Mozambique	Place of effective management is situated
Namibia	Place of effective management is situated
Netherlands	Place of effective management is situated
New Zealand	Place of effective management is situated
Nigeria	The competent authorities of the Contracting States shall settle the question by mutual agreement
Norway	The competent authorities of the Contracting States shall settle the question by mutual agreement
Oman	Place of effective management is situated
Pakistan	Place of effective management is situated
Poland	Place of effective management is situated

Country	Tie breaker rule
Portugal	Place of effective management is situated
Romania	Place of effective management is situated
Russian Federation	Place of management is situated
Rwanda	Place of effective management is situated
Saudi Arabia	Place of effective management is situated
Seychelles	Place of effective management is situated
Singapore	Place of effective management is situated
Slovak Republic	Place of effective management is situated
Spain	Place of effective management is situated
Swaziland	Place of effective management is situated
Sweden	Place of effective management is situated
Switzerland	Place of effective management is situated
Taiwan	Place of effective management is situated
Tanzania	Place of effective management is situated
Thailand	The competent authorities of the Contracting States shall settle the question by mutual agreement
Tunisia	Place of effective management is situated
Turkey	Place of effective management is situated
Uganda	The competent authorities of the Contracting States shall settle the question by mutual agreement
Ukraine	Place of effective management is situated
United Kingdom	Place of effective management is situated
United States of America (USA)	The competent authorities of the Contracting States shall settle the question by mutual agreement
Zambia	Where the business is managed and controlled
Zimbabwe	Place of effective management is situated

(SARS, 2010)

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