

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

The essential element of limitation of liability to the unpaid portion of the share capital, which is generally available for companies worldwide, is one of the main drivers for investors to opt for forming companies both for local and international business ventures. Attendant upon this method of entrepreneurship are also other commercial benefits some of which are attainable through structural modifications and proper planning, including tax planning.

Among the most commonly used company structural modifications internationally are the Intermediary Holding Companies (hereinafter referred to as “IHC”). Briefly, these are companies that are established in a jurisdiction other than the jurisdiction of the investor in international company groups and hold shares in companies in the IHC’s jurisdiction, the jurisdiction of the investor and/or other jurisdictions foreign to both the IHC and the investor. The purposes for establishing these IHCs are manifold.

There are numerous social, political and economic key determinants with regard to the location of an IHC. Once numerous countries have been selected as possible locations for an IHC based on the key determinants, the tax systems of such countries are scrutinised to determine which would have the least adverse impact on the investment. The country with the most suitable tax system is then selected as the location for the IHC. Thus the remaining potential countries would be disqualified due to the incongruity of their tax systems. In this regard, the tax system plays a secondary, but vital, role as regards the decision as to where to locate the IHC.

At the same time, countries seek to attract foreign direct investment to their shores and to this end a tax system that is adverse to the operations of any of the forms of foreign direct investment, including IHCs, is undesirable.

1.2 PURPOSE

With the globalisation of the economy and the free movement of capital internationally, investors constantly seek ventures and business structures that would enable them to invest and conduct businesses utilising ultimate business vehicles tuned for their specific business needs. Depending on the objectives of large multinational structures, an increasing number of investors prefer to centralise the aggregate investments in one company formed specifically for the purpose of holding the wealth of the group.

In order to effectively maintain such a vehicle, care must be taken that the legal and tax system of the country where such vehicle is located do not erode the investments that the group seeks to protect and grow.

The suitability of a tax jurisdiction to host an IHC can be occasioned by an express interest by the tax jurisdiction to provide a suitable tax regime for IHCs. In some instances, however, such interest is not express. Furthermore, in some instances a tax system is designed to achieve certain tax policy objectives, other than, but not necessarily contrary to, providing an ideal tax structure for operation of IHCs. The latter often results in a tax system that inadvertently provides a suitable regime for IHCs.

The South African tax system consists of the normal tax instruments that are found in most tax systems such as corporate income tax, tax on dividends, capital gains tax, taxes on foreign exchange gains and controlled foreign company income, and transfer pricing and thin capitalisation provisions. In addition South Africa has a treaty network of 68 treaties.¹ These key instruments have an economic impact on international tax planning.

¹ See South African Revenue Service *Summary of all Treaties for the Avoidance of Double Taxation* <http://www.sars.gov.za/home.asp?pid=3906> accessed on 01 June 2009.

Akin to the tax system, although it is not a tax issue as such, is exchange control. The tax instruments in a tax system and exchange control provisions may or may not apply adversely to IHCs based on the specific facts of the IHCs operation. However, investors are often unnerved by the mere presence of such instruments or provisions.

Acknowledging the benefits that the IHCs would bring to South Africa, the South African government has clearly pronounced its objective to promote South Africa as a gateway for investment elsewhere in Africa. This objective requires that the tax system be reviewed and where possible revised to ensure that it does not inhibit the operation of holding companies in South Africa. In 1997 the Katz Commission² recommended an adjustment of the corporate tax system in order to appropriately accommodate the IHC and its operations. The benefits of having a suitable regime for IHCs and recommendations of the Commission and the South African government's response as regards policy in this regard are outlined below.

Against this background the purpose of this study is to determine whether the South African tax system provides a favourable legislative and corporate tax environment for investors to establish IHCs in South Africa. This study investigates the tax opportunities of setting up an IHC in South Africa to manage investments in domestic or foreign companies. In other words, this thesis will study the use of these investment vehicles as corporate entities resident in South African for tax purposes and to determine whether the South African tax policy and legislative framework are conducive for these vehicles to function optimally and competitively in a global market.

Various tax instruments will be reviewed in the context of South Africa to determine whether they inhibit such use or practically enable the operation of such structures. After an analysis of the South African policies and legislation as well as a relevant comparison with other jurisdictions, recommendations will be made for policy adaptations and legislative amendments with the aim of achieving government's goals.

² Katz Commission *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1997) Chapter 7.

1.2.1 Advantages to the South African Economy of hosting IHCs

According to Weigel *et al*³ “[i]ncreasingly, the ingredients of economic growth – created assets, technology, intellectual capital, learning experience, and organisational competence – are housed in company systems. To gain access to these ingredients developing countries need [IHCs] to participate in the domestic economy.” South Africa needs multitudes of companies to stimulate the economy and maintain a constant increased economic activity within its borders.

The benefits of attracting investment into South Africa through operation of IHCs are not direct in terms of interaction with the domestic economy by way of manufacturing, retail or other active business activities. Due to the technical nature of the functions of the IHC,⁴ the IHC depends largely on highly skilled personnel as opposed to unskilled labour and as such the staff component of the IHC is usually minimal. Therefore, the contribution of the IHC in the economy is not direct but consists mainly of the spillovers from the presence of professionals from other countries as well as retention of skilled labour.

Highly skilled professionals earn high salaries commensurate with their education and professional skills levels. This means that such professionals spend a lot more money than low-income earners. Money is in this way spent not only on basic commodities but also on luxury goods. These include air tickets, dining at expensive restaurants, usage of private doctors and hospitals, expensive private schools, luxury vehicles and luxurious houses. Mainly these have the spillover effects of increasing the labour demand and demand for commodities. Ultimately, the increased labour and demand for commodities results in increased revenue in the form of employees’ taxes and consumption taxes such as value-added tax.

³ Weigel *et al Foreign Direct Investment* (1997) 14.

⁴ See a discussion on the functions of an IHC in Chapter 2, par 2.6.

International businesses have a great stake in social stability and economic progress.⁵ The presence of a large number of international professionals could also increase South Africa's credibility as a country to live in and to visit, thereby ameliorating the country's international reputation as a crime capital of the world.

Companies also require the support of professional service providers such as lawyers, auditors and accountants. This form of support system is obtained within the country. In this way, professional service providers generate constantly increasing revenue. At the same time, they also get access to international markets and experience in international business transactions and business operations.

The attraction of IHCs to South Africa is that they represent investment that would otherwise not come to South Africa. Unlike other forms of foreign direct investment that take the form of labour-intensive activities such as manufacturing and mining, which require country-specific infrastructure, IHC activities could be undertaken in the majority of countries in the world. Without the investment, there would not be any tax from IHC activities and spillovers. Attracting IHCs would provide South Africa with the added revenue from the income tax collected directly from international professionals who work at the IHCs and indirectly from the services utilised by the IHC and its employees, such as value-added tax, airport taxes, excise taxes and transfer duties.

IHCs would also assist in retaining skilled labour within the country. As the Katz Commission observed, the formation of IHCs in South Africa would positively contribute to the overall economic activity in the country by retention and importation of skills.⁶ The exodus of educated professionals would be reduced by IHCs offering such professionals interesting, challenging and high-salaried jobs. As Musgrave⁷ avers, “[t]he loss of educated people is in fact a loss of human capital, often accumulated at public expense through publicly financed education.” Being employed in an IHC would ordinarily

⁵ The Netherlands American Community Trust <http://www.nactrust.org/background.htm> accessed on 02 April 2009.

⁶ Katz Commission par 7.1.1.

⁷ Musgrave “Fiscal Coordination and Competition in an International Setting” in (ed Musgrave) *Tax Policy in the Global Economy* (2002) 284.

expose the employee to the international business environment. The analysis of the suitability of the South African corporate regime for the operation of an IHC is based on an assumption that attracting more IHCs would be beneficial to South Africa.

1.2.2 South African Government's Objectives

During the course of 2004 the Director General of the National Treasury, Mr Lesetja Kganyago, announced the South African government's Financial Centre for Africa strategy.⁸ He stated that –

[r]ecognising the development challenges faced in Africa and the huge contribution that South Africa's financial markets could play in supporting this development, our government endorsed the development of a strategy to position South Africa as a Financial Centre for Africa.⁹

This economic strategy holds that South African capital markets can play a significant role in providing both debt and equity capital to where it is needed for infrastructural projects, direct investment and government finance within Africa. Government believes that a strong regional financial centre can both cater for the domestic economy and help cater for the capital needs of the entire African continent.¹⁰

Government's intention is to make South Africa a financial hub focused on the needs of the continent. To this end government, led by National Treasury, aims to position the South African financial sector as the most competitive, cost-effective, efficient and liquid capital market on the continent.¹¹

⁸ A financial centre is usually a low-tax, lightly regulated jurisdiction which provides the corporate and commercial infrastructure to facilitate the use of that jurisdiction for the formation and operation of offshore companies and for the investment of offshore funds.

⁹ See Mr Lesetja Kganyago's address at the Reuters Economist of the Year Award Ceremony on 11 August 2004 See *South Africa as a Financial Centre for Africa* http://www.treasury.gov.za/comm_media/speeches/2004/2004081101.pdf accessed on 11 November 2008.

¹⁰ *South Africa as a Source of Capital* http://www.whodunit.co.za/JSE/JSE_3107.htm accessed on 26 November 2008.

¹¹ See *South Africa as a Financial Centre for Africa* http://www.treasury.gov.za/comm_media/speeches/2004/2004081101.pdf accessed on 02 June 2009. The

South Africa has lately been relaxing its exchange control rules.¹² This ongoing relaxation of exchange controls is being used by government as a policy instrument to support the Financial Centre for Africa strategy.¹³ The dual listing of foreign companies on the Johannesburg Securities Exchange (JSE), which allows foreign companies to raise debt and equity finance on the JSE and the Bond Exchange, are a result of this strategy.¹⁴

In line with promoting foreign direct investment in South Africa as well as positioning the South Africa as a financial centre for Africa, government announced in its Budget Review of February 2004 that foreign companies, governments and institutions may list on South Africa's bond and securities exchanges.

The financial centre for Africa strategy is aimed at positioning South Africa as a significant competitor to other financial centres, such as London. The previous Minister of Finance¹⁵ hoped that, once the strategy is implemented, "companies will have the choice of conducting business in London or Johannesburg, and the choice will depend on how competitive South Africa's financial sector is relative to others". Should this competitive goal be achieved, African companies and countries will be able to access many options in terms of sources of capital.

The financial centre for Africa strategy is directly intended to provide a convenient gateway for infrastructural development in Africa. The aim of the strategy is to assist the Southern African Development Community ("SADC") and African companies and

model is intended to operate in much the same way as Singapore and Hong Kong cater to the capital needs of South-East Asia and the rest of the Asian continent.

¹² See National Treasury *Budget Review* (2004) 32; National Treasury *Budget Review* (2007) 30–31.

¹³ See National Treasury *Budget Review* (2007) 30–31.

¹⁴ See *South Africa as a Source of Capital*. South African individuals and institutional investors are able to participate in such listings through their foreign investment allowances.

¹⁵ Manuel T (MP) addressing the National Assembly on 20 August 2004 and responding to Mr Taljaard's question as to whether the creation of a Financial Centre for Africa in South Africa, as contained in the proposed Securities Services Bill, will require any policy amendments beyond the reform of the auditing profession and companies law or harmonisation of laws and/or regulations; if not, what is the position in this regard; if so, how does his ministry and the National Treasury intend to co-ordinate a 'financial diplomacy strategy' with the Ministry of Foreign Affairs within the SADC and the AU to facilitate an increased number of inward listings in accordance with the vision of creating a Financial Centre for Africa? See http://www.treasury.gov.za/publications/other/MinAnsw/2004/epifr_fsp_na.pdf accessed on 06 October 2008.

countries to raise cost-effective capital in the African markets for deployment in their own countries.¹⁶ In this regard the former Minister of Finance Mr Trevor Manuel stated:

According to research undertaken by the Treasury in partnership with the Policy Board in 2003, Africa (excluding South Africa) growing at 6% annually will require capital of some \$389 billion over a ten-year period. Given current domestic savings rates, about 4 out of every 10 dollars of that capital, or about \$150 billion over the next decade, will have to be raised from private international sources of capital. South Africa can play a key role to help fund Africa's expansion. South Africa can leverage its sophisticated capital markets infrastructure to facilitate the flow of foreign capital into African countries.¹⁷

Given the focus on Africa, the benefits for South Africa will mainly be more ancillary benefits and spillovers in relation to the direct developments in Africa.

1.2.3 Katz Commission Recommendations

The Katz Commission was a commission of inquiry which was appointed with a brief to inquire into the appropriateness and efficiency of the tax system and to make recommendations taking into account internationally accepted tax principles and practices. Arising from the Commission's reports were recommendations targeting tax laws with a view to reforming the system.¹⁸

In 1997 the Katz Commission acknowledged that encouraging the formation of international corporate headquarters and holding companies located in South Africa would be advantageous to the economy in two ways. Firstly, it would encourage local

¹⁶ See http://www.treasury.gov.za/publications/other/MinAnsw/2004/epifr_fsp_na.pdf accessed on 06 October 2008.

¹⁷ See http://www.treasury.gov.za/publications/other/MinAnsw/2004/epifr_fsp_na.pdf accessed on 06 October 2008.

¹⁸ Morekwa and Schoeman *Empirical Analysis of Progressivity of the Tax System in South Africa*, paper presented to the Essa Conference held in Durban South Africa on 7 September 2005 available on <http://www.essa.org.za/download/2005Conference/Morekwa.pdf> accessed on 08 June 2009.

investors to expand offshore without sending scarce human resources abroad. Secondly, it would encourage foreign investors to expand into Africa through South Africa. An important aspect of these factors is that South Africa would be able to import and retain skills and such skills would subsequently contribute to the overall economic activity in the country.¹⁹

The Katz Commission²⁰ identified the following as the key fiscal attributes of a regime conducive to the formation of international holding companies:

- (i) A reasonable double tax agreement network;
- (ii) The exemption of offshore corporate dividend income from local income tax;
- (iii) The exemption of other defined offshore corporate income from local income tax;
- (iv) The absence of local corporate capital gains tax;
- (v) Low or no local withholding tax on dividends paid to shareholders;
- (vi) An efficient local tax rulings system; and
- (vii) The absence of a tax on head office services rendered by the head office to the multinational group where the international holding company also performs the services of an international headquarter company.

In addition to such suitability, the Katz Commission recommended that “consideration be given to a statutory commitment that headquarter and holding companies established at the time of any change in legislation that affects this favourable status will be protected by a delayed implementation, or would be given a phase-in period in which to adjust.”²¹

At the time that the Katz Commission investigated the suitability of the South African tax system for the use of holding companies the residence tax system and the capital gains

¹⁹ Katz Commission *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* par 7.1.1.

²⁰ Katz Commission par 7.1.4. and 7.1.5.

²¹ Katz Commission par 7.1.8.

tax had not yet been introduced, but indeed considered. It was feared that the residence tax system and capital gains tax would make South Africa a less suitable jurisdiction for hosting holding companies. In addition to this, the Katz Commission considered that the system at the time (1997) had been less successful in attracting foreign investors for the following reasons:

- The investment climate was hostile prior to the country's democratisation;
- There was concern that a residence (worldwide) tax system would be introduced;
- The existence of exchange controls was a deterrent; and
- Certain items of income generated by headquarter companies are taxed in South Africa because they represented South African source income such as head office management services.²²

1.3 METHODOLOGY

This study will entail a review and reference to South African and international textbooks, journal articles, legislation and case law as well as international treaties.

One important stimulus to this research is the fact that there is a dearth of literature of South African provenance on aspects of international tax and tax treatment of holding companies in South Africa. Other than the leading South African international tax textbook, *International Tax: A South African Perspective*, authored by Professor Lynette Olivier and Mr Michael Honiball, there is no single authority in South Africa that comprehensively deals with international tax and the investment through holding companies and the context in which they function. Olivier and Honiball address the issues involving IHCs in a single chapter. This thesis expands on work done by these authors. It aims to outline the main tax aspects that impact on investments by use of an IHC and how these tax aspects could be improved to enhance South Africa's position as a suitable jurisdiction to host an IHC.

²² Katz Commission par 7.1.2.

1.4 A COMPARATIVE STUDY OF HOLDING COMPANY REGIMES

A comparative study is important in order to observe and learn from what other countries do differently (or the same) and, where appropriate, to adopt or adapt certain or all of the relevant practices. When adopting what other countries do, cognisance should always be taken of the fact that the historic, cultural, social, economic and political landscapes of the countries differ and that these factors generally determine government policies. Therefore, adopting foreign practices without a full appreciation of the differences may lead to practices that are out of sync with the social, economic and political landscape in South Africa.

1.4.1 The Netherlands

Historically, the Netherlands has played a key role in international tax planning. Currently it is a major player in international corporate structuring. It offers a wide range of facilities that offer both non-resident corporate and individual clients a broad range of tax advantages.²³ For decades, the Netherlands has encouraged an entrepreneurial spirit, an international perspective on business and open market policies. These historical factors, along with the country's secure political and economic climate, make it an ideal environment for international tax planning for investors from all over the world.²⁴ This environment is further enhanced by the Netherlands's network of tax agreements as well as the benefits that can be gained from basing an IHC in the Netherlands.²⁵ The Netherlands makes itself available for use to great effect by companies as an integral part of their tax planning.²⁶

²³ *Tax Planning Through The Netherlands* <http://www.icsl.com/pages/jurisdic/nether.html> accessed on 22 June 2008.

²⁴ See <http://www.anglo-legal.com/index.php?id=86> accessed on 08 June 2008

²⁵ See <http://www.dboffshore.com/offshore/html/location/netherlands.shtml> accessed on 08 June 2008.

²⁶ See <http://www.anglo-legal.com/index.php?id=86> accessed on 08 June 2008.

1.4.2 Mauritius

Mauritius is studied in this thesis due to its similarities with South Africa and its aggressive tax policies intended at encouraging the setting up of holding companies within Mauritius. Mauritius is a small multi-cultural African island situated in the southern Indian Ocean to the east of Madagascar. Like South Africa (i) it is an African country; (ii) it is a developing country; and (iii) it is a member of the SADC.

Furthermore, Mauritius is used successfully by multinational investors as a gateway for investment in countries in Africa and around the world. One of the reasons why investors use Mauritius as a holding company jurisdiction is that the country has adjusted its tax system specifically to attract interposition of companies for investment elsewhere. The Mauritian tax system is designed in such a way that non-resident-owned Mauritian companies pay as little tax as is possible in Mauritius.²⁷ These features make Mauritius the ideal country to study in order to assess and enhance the suitability of South Africa to host an IHC.

1.4.3 Other Jurisdictions

In addition to a discussion of the corporate tax regimes of the Netherlands and Mauritius, this thesis briefly analyses other corporate tax systems that are adapted to be suitable for IHCs. This thesis highlights special features in the tax systems of other countries in order to expose the reasons why some countries are not successful, regardless of having specific legislation to attract IHCs. To that end this thesis briefly studies the tax systems of three countries, Belgium, Ireland and the United Kingdom.

1.5 THE RELEVANCE OF EXCHANGE CONTROL

Exchange controls do not impose a tax. Exchange controls ensure that foreign currency acquired by residents is not retained offshore but repatriated back to their country of

²⁷ See in general regarding the Mauritian economy <http://www.gov.mu/> accessed on 01 June 2009.

residence. Furthermore, they prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held and control the movement into and out of a country of financial and real assets.

However, there could be a link between exchange control and taxation. Taxes are often used to discourage the expatriation of funds or assets out of a country.²⁸ Exchange controls, on the other hand, often discourage or prohibit such expatriation except in cases where express approval has been granted. Thus certain transactions that are tax-efficient could simply be combated by exchange controls. Because of these prohibitive powers, exchange controls are often used as a backstop for tax. As a result, exchange control is seen as an area of regulation that is studied and applied alongside the tax provisions. In the end, one cannot advise on international tax issues without reference to, and often reliance on, exchange control provisions applicable in the countries concerned. For these reasons, this study will include discussions on the application of exchange controls where applicable.

1.6 SCOPE OF THE STUDY

This study commences by defining an IHC and distinguishing the IHC from other business entities that are similar in nature and/or performing similar functions. Due to the nature of the IHC as a holding company incorporated in a jurisdiction other than the jurisdiction of the investors, the entities that it is distinguished from are either entities that are holding companies and/or those that operate at an international level.

This thesis further outlines the reasons why investors set up IHCs. There are both tax and non-tax reasons. Both are analysed. The characteristics that make a jurisdiction a suitable one for locating an IHC are discussed, as these are central to the decision by the investor on where to locate the IHC. These are characteristics that South Africa has to possess in order to be able to attract the formation of IHCs.

²⁸ For example, where a resident ceases to be a resident of a country, that resident is often deemed to have disposed of all his or her assets, resulting in capital gains tax being applicable in relation to those assets.

This is followed by a discussion of the international attitude towards, and treatment of, jurisdictions whose tax systems are ideal for locating IHCs, with a special focus on the reaction of the Organisation for Economic Cooperation and Development (hereinafter referred to as “the OECD”) to these regimes. The rationale for focusing on the OECD’s measures against harmful tax practices is that South Africa is an observer at the OECD’s Committee on Fiscal Affairs.²⁹ South Africa participates in the activities of more than ten OECD committees and a number of working groups as observer, and for some of them, as a participant on an equal footing with OECD Members. South Africa is working towards obtaining membership of the OECD in the future.³⁰

The European Union³¹ and the Group of Eight Industrialised Countries³² have also embarked on initiatives that are intended to curb harmful tax practices.

The above discussions will be followed by a comparative study of the Netherlands and the Mauritius tax systems and a detailed analysis of the tax provisions in South Africa that affect the operation of the IHC in South Africa. Finally, an analysis of the suitability of South Africa to host an IHC will be made. In this analysis, the key tax aspects that impact on IHCs in South Africa will be analysed to determine if they result in the South

²⁹ Organisation for Economic Co-operation and Development *China, South Africa to Participate in Work of OECD’s Committee on Fiscal Affairs* available on http://www.oecd.org/document/21/0,3343,en_2649_201185_32074069_1_1_1_1,00.html accessed on 09 June 2009

³⁰ See the Joint Statement by the previous South African Minister of Finance, Trevor A Manuel MP and The Secretary-General of the OECD, Angel Gurría, regarding Enhanced Engagement between South Africa and the OECD (15 July 2008) 2 available on <http://www.oecd.org/dataoecd/30/1/41088594.pdf> accessed on 18 February 2009.

³¹ For a discussion of the European Union’s initiatives against harmful tax practices see Kesti KPMG European Tax Handbook (2003) 14; Bennet International Initiatives Affecting Financial Havens (2001) 115; Bratton and McCahery “Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation” (2001) 28 *Common Market Law Review* 677.

³² The Group of Eight Industrialised Countries (“the G8”) comprises Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States of America. The G8 countries basically support the initiatives taken by the OECD. For further reading on the initiatives taken by the G8 countries see G8 Information Centre: The Birmingham Summit “G7 Initiative on Harmful Tax Competition (15–17 May 1988) available at http://www.g7.utoronto.ca/summit/1988_birmingham/harmfultax.html accessed on 18 February 2009.

African regime being suitable or adverse to the hosting of IHCs. Recommendations will then be made to further enhance South Africa's suitability as a host for IHCs.

This study does not discuss the tax implications for the subsidiaries of the IHC located either in South Africa or in foreign countries. Likewise, it does not discuss the tax implications of the shareholders of the IHC in their countries of residence, be it South Africa or elsewhere. In discussing the tax implications of the IHC in South Africa, this study does not address the tax implications of the employees of the IHC. Where reference is made to the taxation of subsidiaries and the shareholders, such reference will be limited to the purpose of determining the overall tax implications for the IHC. As a result any recommendations made with regard to the taxation of the IHC will not include recommendations regarding the treatment of these excluded areas of tax. Thus, this study and the recommendations made herein are limited to the taxation of an IHC as a separate legal entity. This thesis will not make any recommendations as regards the non-tax key determinants for the location of an IHC.

1.7 REFERENCE TO THE TAX ACT

References in this study to schedules, sections, or subsections are references to the Income Tax Act 58 of 1962 – unless otherwise stated or the context indicates otherwise.

CHAPTER 2

INTERMEDIARY HOLDING COMPANIES DEFINED AND DISTINGUISHED FROM OTHER SIMILAR ENTITIES

2.1 INTRODUCTION

In this chapter, the nature of an IHC is discussed. In essence an IHC is incorporated as a company that holds controlling interests in other companies. For the purposes of this study, the IHC should be located and conduct its business in South Africa. The shareholders of the IHC could be resident in South Africa or not. The focus is on an IHC whose subsidiaries are resident in African countries although some may be resident in South Africa.

Based on the above, in defining an IHC this chapter discusses the following main elements of the composition of the IHC: (i) an IHC as a company; (ii) the tax residence of an IHC; (iii) the nature of an IHC as a holding company and as a subsidiary; (iv) the intermediary nature of an IHC; and (v) the functions of an IHC.

An IHC is similar to numerous entities that operate at an international level. These business entities have immediate outward appearances that resemble an IHC in relation to their composition, purposes and activities. Due to these similarities the discussion in this chapter will include a comparison that distinguishes an IHC from these other entities. In certain instances the distinction hinges on the amount of focus that the business vehicle places on some activities and the extent to which the business vehicle undertakes certain of the activities.

In this chapter, the characteristics of entities similar to the IHC are identified and where necessary the tax treatment applicable to those entities is briefly mentioned. These

entities operate at an international level and therefore this section is not reliant on the definitions used in any specific countries.

It should be noted that oftentimes the substance of the nature of the non-resident company may be disguised by giving it a name that would suit the business structure, for example where an offshore holding company is disguised as an intellectual property holding company to take advantage of the possible royalty exemptions that may exist in the double tax agreement between the countries where the multinational company group members are resident. In this case the local anti-avoidance provisions would be used to combat such tax avoidance.

2.2 AN IHC AS A COMPANY

An IHC is a company. It is a legal entity separate and distinct from its members. In most countries' legal systems a company derives its existence from statute.¹ The capital of a company is divided into shares and owned by shareholders. However, the company is the owner of its assets and the members do not have proportionate property rights in the assets of the company. The capital of the company is raised by the issue of shares and the liability of the shareholders of a company is limited to the amount which each member has paid for his or her shares.² For South African income tax purposes, such company has to be a company as defined in section 1 of the Act and section 1 of the Companies Act.³

2.3 TAX RESIDENCE OF AN IHC

The term "holding company"⁴ is used to refer to a company which holds the majority equity share capital or voting rights in another company. Without any qualifying reference such company would normally be a company that is resident in the jurisdiction

¹ See *IBFD International Tax Glossary* (2005) definition of "company".

² As to the nature of a company see further *Salomon v Salomon & Co* 1897 AC 22; *Stellenbosch Farmers' Winery v Distillers Corporation* 1962 (1) SA 458 (A); *S v De Jager* 1965 (2) SA 616 (A); *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530.

³ See definition of "company" in s 1 of the Act and s 1 of the Companies Act 61 of 1973. Once the new Companies Bill comes into effect the IHC would be required to comply with the provisions of the new law.

⁴ See the comprehensive definition of holding company in 2.4 below.

of its shareholders, such country being the resident country also of the company or companies in which it holds majority shares or voting rights. Where this holding company is located in a country other than that of its shareholders a reference to such external existence characteristic is made, for example “intermediary,” “offshore” or “international.”⁵ In most instances this reference also mirrors the activities of such company.

The main consideration here is the characteristics that distinguish a local company from a foreign company. Put differently, the question is: what determines whether a company is situated or located in a foreign jurisdiction? Generally, a company can be said to be located or situated in a country where it is incorporated, formed, established or where its place of effective management is situated.⁶ However, the domestic laws of each country determine whether a company is resident in that country.

For South African income tax purposes a resident in relation to a company is defined in section 1 as “any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic”.⁷ Interpretation Note 6 defines the “place of effective management” as⁸ –

“the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised or where the board or 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.”

⁵ See *IBFD International Tax Glossary* definition of “holding company”.

⁶ See Article 4(3) of the Organisation for Economic Cooperation and Development Model Tax Convention. See also Vogel *Klaus Vogel on Double Taxation Conventions* (1999) 259–270.

⁷ See s 1.

⁸ The South African Revenue Service (“SARS”), *Practice Note 6*, issued on 26 March 2002.

This definition of place of effective management differs from the “Organisation for Economic Cooperation and Development (hereinafter referred to as “the OECD”) Model Tax Convention Definition and Commentary.”⁹ Furthermore, the definition differs from country to country. For example, in terms of the United Kingdom (hereinafter referred to as “the UK”) tax law the place of effective management of a company is the place where one would expect to find the executives and senior staff “who make the business tick” – the finance director, the sales director and the managing director.¹⁰

This might pose a problem where the company is effectively managed in more than one country based on the reading of the diverse definitions of place of effective management in those different jurisdictions. For example, where a company’s day-to-day management takes place in South Africa but the financial director and other senior executive staff are based in the UK, such company may be a resident in terms of the South African law as it is arguably effectively managed in South Africa. The company will also be tax-resident in the UK because of the location of the financial director and other executive staff.

The OECD Model Tax Convention on Income and on Capital (hereinafter referred to as “the OECD Model Convention”) uses place of effective management as the tie-breaker where a person other than an individual is resident of both contracting states.¹¹ A permanent establishment is defined as a “fixed place of business through which the business of an enterprise is wholly or partly carried on”.¹² It specifically includes a place of management, branch, office, factory, workshop and a mine, oil or gas well, quarry or any other place of extraction of natural resources. According to the Commentary on the OECD Model Tax Convention, a place of business “may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal.”¹³

⁹ See Article 4(3) of the OECD Model Tax Convention and OECD Model Tax Convention Commentary (2003) to Article 4(3) par 21–24.

¹⁰ See Collinson & Tiley *Tiley and Collinson UK Tax Guide 2006 – 2007* (2006) par 33. See also Miller and Oats *Principles of International Taxation* (2006) 52.

¹¹ Article 4(3) of the OECD Model Tax Convention.

¹² Article 5(1) of the OECD Model Tax Convention.

¹³ OECD Model Tax Convention Commentary (2008) to Article 5(1) par 4.

The residence of a company is determined in terms of the laws of the place where it is resident after taking into account any Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (hereinafter referred to as “double tax agreement”). For the purposes of this thesis, where there are no double tax agreements applicable in relation to the countries involved, a company would be treated as resident in the country where it has its place of effective management, unless the contrary is stated or the context indicates otherwise.

An IHC that is effectively managed in South Africa is taxable in South Africa on its worldwide income. Normally, subject to the provisions of a double tax agreement, a country in which a person is not resident will only tax such person on income sourced in that country. The tax liability is limited to income derived, arising or accruing from sources in that foreign country. Non-resident companies may also be treated differently in relation to local taxes: for example, they may be taxed on a different basis from residents, be required to pay additional taxes, or even be subject to rigorous tax withholding or compliance rules.¹⁴ This thesis studies the suitability of South Africa to host an IHC as a South African tax-resident.

2.4 AN IHC AS A HOLDING COMPANY AND A SUBSIDIARY

An IHC is a holding company of its underlying operating companies and at the same time a subsidiary of an ultimate holding company of a group of companies. The definitions of “holding company” and “subsidiary” are interdependent and will therefore be discussed together.

A holding company is a company that owns part, all, or a majority of other companies’ outstanding stock. It usually is a company which does not produce goods or services

¹⁴ Rohatgi *Basic International Taxation* (2005) 222–227. The treatment is not always adverse. The non-resident companies are sometimes exempt from taxes that residents would pay. For example, South African resident companies pay secondary tax on companies (“STC”) of 10% (reduced from 12.5% with effect from 1 October 2007) on the net amount of dividends they declare whilst non-residents do not necessarily pay tax on dividends declared from income derived from a South African source. However, non-residents pay a tax of 34% on the income of their South African branches.

itself; rather its purpose is to own shares of other companies.¹⁵ It is a company that owns part, all, or a majority of other companies' outstanding stock.¹⁶ Thus, in essence, for a company to be a holding company it should own enough voting stock in another company to control management and operations by influencing or electing its board of directors. Such a company is literally a super corporation which owns or at least controls such a dominant interest in one or more other corporation that it is able to dictate its policies through voting power.¹⁷

In the South African context, "holding company" is not directly defined for purposes of the corporate law. The Act also does not define holding and subsidiary companies. The Companies Act¹⁸ defines a holding company thus: "a company shall be deemed to be a holding company of another company if that other company is its subsidiary."¹⁹ In terms of the new Companies Bill²⁰ a holding company, "in relation to a subsidiary, means a juristic person or undertaking that controls that subsidiary".²¹ In terms of both these pieces of legislation, it is, therefore, the definition of subsidiary that determines what constitutes a holding company.

The definitions of subsidiary and holding company are premised on the control that the holding company has on the subsidiary. A holding company is basically "a company that holds the controlling shares in one or more companies so that they form part of the same group of companies."²² The definition of subsidiary in the Companies Bill is largely a replica of the definition in the Companies Act.

A company is a subsidiary of another if that other company is a member of it (the first-mentioned company) and satisfies one of the following requirements:

¹⁵IBFD International Tax Glossary definition of "holding company".

¹⁶ See Connell 'Holding Companies to Account: The Expense Apportionment Conundrum' 2004 *South African Law Journal* 117.

¹⁷ http://www.trueblueauctions.com/Auction_Terms.html accessed on 17 September 2008.

¹⁸ The Companies Act 61 of 1973 (hereinafter referred to as "the Companies Act").

¹⁹ See s 1(4) of the Companies Act.

²⁰ Companies Bill 61D of 2008. The South African company law is currently being amended by the introduction of the new Companies Bill. The new law is expected to come into effect in 2010.

²¹ Section 1 of the Companies Bill definition of "holding company".

²² Olivier and Honiball *International Tax, A South African Perspective* (2008) 297.

- holds a majority of the general voting rights in it;
- has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board; or
- has the sole control of a majority of the voting rights in it, whether pursuant to an agreement with other members or otherwise.²³

Where these rights are held by subsidiaries of another company, or by that other company together with its subsidiaries, such holding makes the company in which these rights or interests are held a subsidiary of that other company.²⁴ A company is also a subsidiary of another company if it is a subsidiary of that other company's subsidiary.²⁵

A subsidiary is an entity controlled by another entity. Control is the power to control the financial and operating policy of an entity in order to benefit from the activities of that other entity.²⁶ Control is presumed to exist when the other entity owns, directly or indirectly, more than half of the voting power of an entity unless it can be clearly demonstrated that such ownership does not constitute control.²⁷

The additional characteristics of “the power to control the financial and operating policy of an entity in order to benefit from the activities of that other entity” is core to the essence of a holding and subsidiary relationship.²⁸ In this regard it is noted that benefit is not limited to financial benefit. The holding company may also strategically direct the operations of its subsidiaries or the group.

In the discussion that follows, companies referred to would mainly satisfy the above requirement of control in relation to at least one company located either in the investor's country or outside of it. However, the manner of control and the benefit derived

²³ See s 1(3)(a)(i) of the Companies Act; s 3(1) of the Companies Bill.

²⁴ See s 1(3)(a)(iii) of the Companies Act.

²⁵ See s 1(3)(a)(ii) of the Companies Act.

²⁶ Kunst, Delpont and Vorster *Henochsberg on the Companies Act* (2008) 14

²⁷ See Kunst, Delpont and Vorster 14.

²⁸ See Kunst, Delpont and Vorster 14. See also Haydock “The Effect of the Amendments to the Definition of a Subsidiary in the Companies Amendment Act 82 of 1992” 1993 *South African Mercantile Law Journal* 166–180.

therefrom might differ. Often the holding and subsidiary relationship results in the companies forming a group of companies. Conversely, often the companies have to be in a group of companies to have a holding and subsidiary relationship.

2.4.1 Company groups

There is a distinction between companies which belong to a group of companies and which hold significant shareholdings in other companies, and those which hold a diversified portfolio of shares (or bonds) for a group of investors.²⁹ The former case is an example of a company group situation. A group of companies consists of at least one subsidiary company and its holding company or at least two subsidiaries of the same (common) holding company.³⁰

In some countries the definitions of holding company require that the holding company together with its subsidiary should form a group of companies. The South African law does not have such a requirement. However, where companies form a group of companies in terms of the Act, such companies would have a holding/subsidiary relationship.³¹

A group of companies is defined in the Act as follows:³²

“group of companies” means two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “controlled group company”), to the extent that—

- (a) at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one

²⁹ IBFD *International Tax Glossary* definition of “holding company”.

³⁰ “Glossary of Terms” http://www.veoliaenvironmentalservices.co.uk/pages/pack_glossary.asp accessed on 12 December 2009.

³¹ Definition of “group of companies” in s 1.

³² See definition of “group of companies” in s 1.

or more other controlled group companies or any combination thereof; and

- (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;

A distinction has to be made between a holding and subsidiary relationship and a head office and branch relationship. Whereas a subsidiary is a legal person in its own right, a branch is an extension of its parent company. It is a part or division of the parent company. They are one legal entity. When a company does business through a branch, the company is subject to tax on the profits of the branch wheresoever located. The company may also be taxable in the country where the branch is located on the profits of the branch based on the source rules.³³

2.5 THE INTERMEDIARY NATURE OF AN IHC

An IHC is a company that is interposed between two companies. It is therefore a subsidiary of one company and a holding company of other companies. In its nature, an IHC cannot be an ultimate holding company. At least one of the companies between which it is interposed should be located in a jurisdiction other than that of the IHC itself.³⁴

“Intermediary” holding companies are often interchangeably referred to as “intermediate” holding companies. In this study these companies are systematically referred to as “intermediary holding companies”. The distinction between “intermediary” and “intermediate” might be insignificant in common parlance. However, for the purpose of this study the correct reference is more important than in everyday usage. “Intermediate” used as an adjective is more akin to the interposition of an object between two points or objects. The *Collins Concise Dictionary* defines “intermediate” as “occurring or situated

³³ See Article 5 of the OECD Model Convention, read with Article 7 of the OECD Model Convention and the commentaries in respect thereof.

³⁴ Olivier and Honiball 297.

between two points, extremes, places, etc; in between”. Intransitively, it is to act as an intermediary or mediator.

On the other hand, intermediary is more akin to the person who is positioned between two points and *acts as a mediator*. The *Collins Concise Dictionary* defines “intermediary” as “a person who acts as a mediator or agent between the parties”. The *Oxford Advanced Learner’s Dictionary*³⁵ defines intermediary as “a person or organization that helps other people or organizations to make an agreement by being a means of communication between them”. Thus, the term “intermediary” as a noun emphasises both the entity and the functions of such entity.

Therefore, while it might not be particularly wrong to refer to them as “intermediate”, it is more accurate and precise to use the word “intermediary” for the subject of this thesis.

Olivier and Honiball also use the term “intermediary holding company”, which they consider to be wider than an “offshore holding company”, as an offshore holding company is seen as a holding company located in a tax haven.³⁶ They define an IHC as a holding company interposed between the foreign subsidiary and a resident shareholder of a multinational group of companies.

2.6 FUNCTIONS OF AN IHC

There are many business-driven motives for establishing a holding company. A holding company can provide a means to own and manage a group of affiliates or subsidiaries in a particular region. The setting up of a holding company can also result in operational and financial efficiencies, in particular when bundled with other business functions, including broader regional headquarter and management functions, group shared services,

³⁵ Hornby *Oxford Advanced Learner’s Dictionary of Current English* (2006) Seventh Edition definition of “intermediary”.

³⁶ Olivier and Honiball 297.

financing, cash management, and/or intellectual property (IP) ownership and management.³⁷

Unlike the functions of holding companies in general, the primary functions of an IHC are limited and focused. The primary functions of an IHC are to acquire, manage and sell investments in group companies, mainly its subsidiaries and in general to provide transactional and organisational flexibility in a group of companies.³⁸ In the context of a group's business, an IHC in an appropriate jurisdiction enhances the group's transactional flexibility and assists in establishing a robust offshore group structure. The IHC also serves to provide a means to centralize and manage international cash flows. It serves as a focal point to deploy one entity's earnings to other entities within the global enterprise.³⁹ These functions are not tax-related. The tax is an element that is considered and provided for in order to ensure that it does not make the achievement of the group's economic purpose more expensive than it should be. As a result, in practice, the decision to form an IHC is made by financial managers rather than tax managers.

Enhanced flexibility within a group caters for acquisitions, reorganisations, disposals, offshore listing, reducing the impact of exchange control rules and free flow of funds. As an addition to these benefits, the IHC can also offer a maximisation of after-tax fund flows. However, it should be noted that the goals of the group may necessitate the interposition of an IHC even if that would result in an increased tax liability for the group. In this case the benefit of interposing an IHC will be weighed against the additional tax liability. Depending on the specific functions required to be performed by the IHC, it is often beneficial to the group to incorporate the IHC in a jurisdiction where the operations of the group take place.

³⁷ See International Bureau of Fiscal Documentation (IBFD) "Introduction to Holding Activities" http://online2.ibfd.org/collections/hold/html/hold_introduction.html accessed on 22 September 2008 at par 1.1.

³⁸ The basis of the discussion on the functions of an IHC emanates from a discussion on this topic with Mr Serge de Reus, Partner/Director of Corporate International Tax at PricewaterhouseCoopers on 19 September 2008 in Sunninghill, Johannesburg.

³⁹ Global Strategies (Supplement – Energy 2002) *International Tax Review* <http://www.internationaltaxreview.com/?Page=17&PUBID=211&ISS=13174&SID=487921&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 12 November 2009.

The reasons often cited for the formation of a holding company include:⁴⁰

- the desire to consolidate the company's current (and future) foreign subsidiaries under one foreign holding company structure for management and reporting purposes;
- the creation of a platform for future business acquisitions, joint ventures and other business opportunities;
- to act as a gateway for growth and expanding business operations in new markets and regions; increased financial flexibility and the creation of an efficient vehicle for the redeployment of cash among foreign operations, thereby facilitating the use of internal funding of operations and expansion;
- improved treasury efficiency and financial risk management, by permitting foreign cash, foreign currency receipts and disbursements, and inter-company loans and other transactions to be consolidated, netted and managed within the holding and financing structure;
- facilitation of raising capital offshore thereby enhancing the enterprise's capital structure;
- positioning the company to more effectively reduce foreign income taxes through, e.g. internal financing and leveraging;
- to better manage and exploit intellectual property;

⁴⁰ IBFD "Introduction to Holding Activities" par 1.1.

- enabling access to the EC Directives and/or tax treaty networks reducing withholding taxes on dividend, interest and royalty flows; and
- facilitation of the preparation of a sub-consolidation of the combined foreign operations of the company for financial reporting purposes.⁴¹

Generally, IHCs are not engaged in commercial trade or business. Where their functions are extended, they would normally be for the purposes of reinvesting excess dividends at the level of the IHC to obviate the need to remit the dividends to the ultimate holding company or shareholders, where such action has tax and exchange control disadvantages.⁴²

2.6.1 Acquisitions

The credibility of a group depends to a very large extent on the balance sheet of the group. An IHC's balance sheet consists of its assets and those of its subsidiaries. By consolidating all these assets, the group is able to present a larger and credible financial statement to guarantee liquidity to both creditors and persons with whom the group conducts business. Raising finance through the use of the aggregate group assets as collateral is made easier by using the sum of all investments.

IHCs are also formed by partners in joint ventures. This helps the partners to streamline their investment into one company as opposed to individually investing in each individual subsidiary and thus having no management powers.

⁴¹ For a further discussion of the functions of an IHC in different country structures see Pfaar "Inbound Investment from a European Perspective" (2003) *International Tax Review* <http://www.internationaltaxreview.com/Default.asp?Page=17&PUBID=211&ISS=13163&SID=488044&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 28 October 2009.

⁴² Olivier and Honiball 297.

2.6.2 Management

Each company in a group has its own management personnel. The management personnel's responsibility is to manage the investments of that company. In order to synchronise the group objectives and ensure that each company works towards the achievement of such goals, a single senior management is placed in an IHC. This also assists where subgroups are tasked with achieving certain goals, including management and reporting.⁴³ Furthermore, this ensures that the ultimate investors have control of the management of the group and can implement the overall policy positions of the group in all subsidiaries.

2.6.3 Reorganisations

Reorganisations are a part of the life of groups of companies. Most often these are done to enable company groups to access some convenience or economy or business activities, for example moving a licensing company to the same subgroup as the operating companies that use the licence. Such reorganisations could require stringent regulatory requirements from the home country of the ultimate investors. Furthermore, an IHC is ideal where the subgroup is to be reorganised.

2.6.4 Disposals

Third-party investment becomes easier if the IHC is used as a single entry point for the (sub)group. Flexible third-party investment is a key consideration when an investor plans to acquire part of the group, where separate aspects of the business are conducted in separate subsidiaries. In this case, acquiring stock in a subsidiary or some of the subsidiaries could result in an inchoate investment that depends on the interaction with other entities. Thus an IHC enables the sale of a conglomerate where separate businesses are run in different subsidiaries.

⁴³ IBFD "Introduction to Holding Activities" par 1.1.

2.7 DISTINCTION BETWEEN AN IHC AND OTHER SIMILAR ENTITIES

In the discussion that follows, corporate forms that have substantially similar characteristics with IHCs at an international level are examined in order to draw clear distinctions between these corporate forms and IHCs.

2.7.1 International Holding Company

An international holding company is a company that controls one or more companies in jurisdictions other than the jurisdiction in which it is resident. Such company is generally accepted to be resident in a country where it is tax-resident in terms of the laws of that country after taking into account any treaties applicable. Where such company is incorporated in a country which has no tax treaties, or has no tax treaties with the investor's country and its subsidiaries' countries, double taxation problems may arise.⁴⁴ Similarly, where an IHC is not regarded as a resident in a country from which it operates and therefore cannot access tax treaty benefits, double taxation problems exist.

A pure international holding company is confined to managing and holding investments while a mixed international holding company also engages in other commercial activities. The latter helps global tax planning and may help defer payment of dividends to the home country.⁴⁵

The fundamental and foremost distinction between an international holding company and an IHC is that an international holding company can be an ultimate holding company of a group of companies whereas an IHC is interposed between operating subsidiaries and a company normally based in the investor's jurisdiction. An IHC could also only be held indirectly and ultimately by a company in the investor's jurisdiction.

⁴⁴ Holmes *International Tax Policy and Double Tax Treaties* (2007) 23.

⁴⁵ Rohatgi 238.

International holding companies are mostly used within multinational company groups to centralise the management of the group companies in a certain geographical area. In such cases they take the form of international management companies.⁴⁶

2.7.2 Offshore Holding Company

An offshore holding company is almost identical to an international holding company. The essential difference between the two is that the emphasis of an offshore holding company is that it is located outside the country of residence of the investor. It is not focused on holding controlling rights in companies in other jurisdictions. It also lacks the central location of control of multinationals that is a feature of IHCs.⁴⁷

Olivier and Honiball submit that “[t]he term ‘offshore holding company’ is usually used for holding companies incorporated in a tax haven”.⁴⁸ In this form, the main reason for removing the control of the company would be to benefit from the often lax tax system in the tax haven. Such use of the offshore holding company is probably minimal and limited as countries generally relentlessly enact provisions to combat the erosion of their tax bases in this way. Controlled foreign companies legislation and transfer pricing rules are examples of such provisions.

2.7.3 Foreign Financial Instrument Holding Company

A foreign financial instrument holding company is a purely South African domestic tax system creation. It is compared to an IHC in this thesis due to the fact that the IHC that forms the subject of this thesis is expected to be operating within South Africa. It is therefore important to distinguish the IHC from a foreign financial instrument holding company.

⁴⁶ <http://www.b2bfreezone.com/product-search/international-management-company.htm> accessed on 16 February 2008.

⁴⁷ Olivier and Honiball 297.

⁴⁸ See “Why Choose an Offshore Company?” <http://www.icsl.com/pages/why.html> accessed on 31 July 2008. See also Olivier and Honiball 297.

A foreign financial instrument holding company is defined in the Act for the purposes of the foreign business establishment exemption⁴⁹ in section 9D(1) and in section 41(1) for group reorganisation rules in section 42 to 47 of the Act.⁵⁰

A foreign financial instrument holding company is defined as “a foreign company as defined in section 9D where more than the prescribed portion of all the assets of that company, together with the assets of all its influenced companies in relation to that foreign company, consists of financial instruments...”⁵¹ Simply put, it is a foreign company where more than 50% of the market value or two-thirds of the actual cost of the company and all controlled group companies consist of financial instruments⁵² (subject to certain exclusions).⁵³ Thus, a foreign company would be a foreign financial instrument holding company if in aggregate all its assets together with those of all influenced companies consist of financial instruments.⁵⁴

In determining whether the prescribed portion consists of financial instruments the following are not taken into account:

- Firstly, financial instruments that consist of debts due to the foreign company, or to any controlled group company in relation to the foreign company, in respect of goods sold or services rendered by that foreign or controlled group company, as the case may be, where (a) the amount of the debt is or was included in either the foreign company or controlled group company; and (b) the debt is an integral part

⁴⁹ The business establishment exemption has been replaced by the foreign business establishment exemption by s 9(1)(a) of the Revenue Laws Amendment Act of 2006.

⁵⁰ The s 9D(1) of the Act definition refers to a foreign financial instrument holding company as defined in s 41.

⁵¹ See s 41(1).

⁵² Olivier and Honiball 357. See also the definition of “Foreign Financial Instrument Holding Company” in s 41 of the Act.

⁵³ See definition of “prescribed portion” in s 41(1).

⁵⁴ This allows the foreign holding company to escape the foreign financial instrument holding company even if it has assets that consist only of financial instruments, provided, when aggregated with those of its subsidiaries, the prescribed portion does not consist of financial instruments.

of a business conducted as a going concern by the foreign company or controlled group company.⁵⁵

- Secondly, any financial instrument arising from the principal activities of the foreign company or of a controlled group company in relation to the foreign company which is a bank, insurer, dealer or broker with a licence or registration that allows the foreign company or the controlled group company to operate in the same manner as a company that mainly conducts business with clients who are residents in the same country of residence as the foreign company. To qualify for the exemption, the foreign company or controlled group company has to either regularly accept deposits or premiums for the general public or effect transactions with the general public or derive more than 50% of its income or gains arising from principal trading activities with persons who are connected persons to the foreign company.⁵⁶
- Thirdly, any financial instrument held by a controlled group company in relation to the foreign company if the foreign company is a specified controlled group company.⁵⁷

In the calculation of the market value or actual cost of the assets, shares held in another company in the same group and inter-group financial instrument consisting of a loan, advance or debt are disregarded.

The foreign financial instrument holding company rules have been designed to curb tax avoidance. The tax treatment of a foreign financial instrument holding company excludes it from deriving the tax benefits that ordinary companies derive. Two disadvantages of qualifying as a foreign financial instrument holding company are worth mentioning. Firstly, section 64B of the Act, which provides for an exclusion of gains (or losses) from the disposal of any interest in the equity share capital of a foreign company where the

⁵⁵ Par (a) of the definition of “Foreign Financial Instrument Holding Company” in s 41.

⁵⁶ Par (b) of the definition of “Foreign Financial Instrument Holding Company” in s 41.

⁵⁷ Par (c) of the definition of “Foreign Financial Instrument Holding Company” in s 41.

disposing company holds more than 20% of the shares in the foreign company whose shares are disposed, does not apply where the company whose shares are disposed is a foreign financial instrument holding company.⁵⁸

Secondly, the net income of a foreign financial instrument holding company is not eligible for the foreign business establishment exemption in the hands of its South African resident shareholders in terms of section 9D(9)(b)(iii) of the Act.

A significant feature of a foreign financial instrument holding company that distinguishes it from an IHC is that while the assets of a foreign financial instrument holding company and its subsidiaries consist of financial instruments, assets of an IHC's subsidiaries do not consist of financial instruments. Subsidiaries of an IHC are mainly operating companies that carry on business other than holding and trading in financial instruments. Therefore, its assets would generally consist of tangible assets, such as plant and machinery.

2.7.4 International Headquarter Company

International headquarter companies are often formed where multinational groups of companies have significant economic interests in a region which is distant from its head office to oversee and co-ordinate the group's business interests in a particular region. "Such centres will usually provide the full range of administrative and management functions associated with a head office; for example, treasury and tax management, internal audit, public relations, market research and marketing, insurance and accounting."⁵⁹ It is, therefore, not infrequent that a group of companies would have multiple international headquarters each serving group companies in contiguous countries within a particular region.

The purpose of the IHC is not to provide management and administrative services to the group. Its role is limited to financial and structural functions. However, its functions can

⁵⁸ The exemption is subject to certain further requirements which are beyond the scope of this chapter.

⁵⁹ Ogley *Principles of International Tax: A Multinational Perspective* (1993) 137.

be combined with those of an international headquarter company. As Ogley⁶⁰ states, “[w]here a multinational holds overseas investments through an intermediate holding company, it makes good commercial sense to arrange for any regional co-ordination function to be undertaken by that company as this will lend substance and help demonstrate that it is indeed resident in that country.” Following Ogley, the fact that an IHC may undertake the regional co-ordination functions of a headquarter company demonstrates that the two are distinct entities.

2.7.5 Foreign Base Holding Company

The notion of a foreign base company emanates from the idea or existence of base countries. A foreign base company is an element in the concept of a base country.⁶¹ An ideal foreign base of incorporation is a country which imposes only negligible income or capital tax, or no taxes at all, on income or certain of the income of its domestic corporations derived from sources outside the base country.⁶² The purpose of such base companies is to conduct third-country operations. Third-country operations include conducting business through agents or branches with holding companies deriving passive income from foreign subsidiaries.⁶³

The essential element of a foreign base company is that it is used as a shareholder of companies conducting businesses outside the base country. “This business may either be outside the ‘home country’ where the shareholders or other beneficial owners live or are resident (in third countries other than the home country), or it may even be business within the home country”⁶⁴ of the shareholders or the beneficial owners.

⁶⁰ Ogley 137.

⁶¹ “Foreign Holding Company Income Changes. (International Taxation)” <http://www.nysscpa.org/cpajournal/old/07950850.htm> accessed on 28 July 2008.

⁶² See De Broe *International Tax Planning and Prevention of Abuse* (2008) 41–46. Gibbons *Tax Effects of Basing International Business Abroad* 1956 *Harvard Law Review* 1207.

⁶³ Rotterdam Institute for Fiscal Studies *International Tax Avoidance, Volume A, General and Conceptual Material* (1979) 50.

⁶⁴ Rotterdam Institute for Fiscal Studies 50.

The essential characteristics of a base company are as follows:⁶⁵

- Two or more interstate relationships;
- Legal or factual control; this can be control by two or more persons together;
- The economic interests lie wholly or mainly outside the base country. The (economic) function of the base is that of a circuit or at least a roundabout;
- A (very) advantageous fiscal climate;
- The tax factor dominates the choice of location;
- The base enterprise must have either a legal personality, or, at least, the capacity of being the owner of rights, like a *Liechtenstein Ansalt*, which may not have legal personality;
- Base enterprises should be a separate taxable subject. They must not be subjected to the worldwide taxation basis of another (high) tax jurisdiction;
- In principle, only those functions can be attributed to a base enterprise which could in an economic sense be a separate division or part, in country A, of a firm having its residence in the same country A.

In German literature a distinction is drawn between typical base companies (*typische Basisgesellschaften*), where foreign investment is involved, and atypical base companies (*atypische Basisgesellschaften*), where only home country investment is involved.⁶⁶ For South African purposes this distinction might have a serious effect on whether the income of the base company is attributable in terms of the CFC diversionary rules, if the base company is a CFC.⁶⁷

The Rotterdam Institute for Fiscal Studies states that “[t]he general conclusion is that, under the heading of these broad definitions, there are many possible kinds of base companies, some with a single function, some with several functions, and some which combine base-company functions with ‘normal’ industrial or commercial activities.”⁶⁸

⁶⁵ Rotterdam Institute for Fiscal Studies 51–52. See also De Broe 41–50.

⁶⁶ Rotterdam Institute for Fiscal Studies 51.

⁶⁷ The diversionary rules are contained in s 9D(9).

⁶⁸ Rotterdam Institute for Fiscal Studies 52.

The essential requirements of low tax and the fact that the tax factor dominates the choice of location might pose problems in many jurisdictions. Furthermore, the fact that the base country levies no or minimal taxes on the income of the base companies may result in the country being regarded as a tax haven and thus disadvantage the position of the base country.⁶⁹ Such are not essential elements of an IHC and are central to the distinction between base companies and IHCs. Furthermore, the IHC does not conduct its primary business through agents.

2.7.6 Foreign Group Finance Company

A foreign group finance company is a company located in a foreign jurisdiction for the purpose of controlling the finances of the group of companies. It can be referred to as the treasury of the group or the finance house. The main assets of the foreign group finance company are finances and financial instruments. This company can provide the group with finances from its own capital or may borrow and lend on the finances to group companies. In this way it intermediates between lenders and borrowers. It also serves for the transmission of loans from one country to another. Mostly foreign group finance companies have higher credibility to borrow and are located in jurisdictions where lending practices are not strictly regulated.⁷⁰

Referring to the foreign group finance company, Honiball and Olivier state that:

“[t]he fiscal purposes here are the payment of little or no tax on the interest receipts, entitlement of tax deductibility for interest paid in high-tax jurisdictions, and the reduction or annihilation of withholding taxes on interest through the operation of tax treaties.”⁷¹ The authors furthermore state as follows:

⁶⁹ See discussion in Chapter 6.

⁷⁰ Rotterdam Institute for Fiscal Studies 84.

⁷¹ Rotterdam Institute for Fiscal Studies 84.

Reasons for having such a centralised finance entity include funding and monitoring the fixed and floating capital requirements of group companies, providing centralised exchange rate and interest rate risk, financial management services to group companies, managing group liquidation through the use of specialised products like bonds, and managing the repatriation of funds throughout the group.⁷²

A foreign group finance company may be established as a fellow subsidiary to the group companies to which it provides treasury support or it can be the holding company of those companies. Where it is the holding company of some group companies (i.e. the foreign group holding finance company) some of its activities may resemble those of an IHC. However, the foreign group finance company does not have the purpose of providing transactional and organisational flexibility in a group of companies, something that is key to the functions of the IHC.

There are considerable similarities between a foreign group finance company and a foreign base holding company and a foreign financial service centre company.

2.7.7 Foreign Financial Services Centre Companies

Foreign financial services centre companies derive their name from the jurisdictions that provide for such entities, the foreign financial services centres. The objective of these centres is mostly to provide global financial services with tax benefits for transactions undertaken outside the country of residence of the financial services centre company.⁷³ Rohatgi⁷⁴ states that “[f]or example, [these centres] permit international investors to form tax-beneficial entities in their jurisdictions for various business objectives. These entities may act as holding companies managing overseas investments and activities of a multinational enterprise, or they may accumulate capital lawfully for reinvestment abroad.”

⁷² Olivier and Honiball 558.

⁷³ Rohatgi 4.

⁷⁴ Rohatgi 4.

Within the Southern African Development Community (“SADC”), Mauritius and Botswana are the most commonly used financial services centres. In Mauritius the concept of Global Business Licence (“GBL”) has been adopted to allow resident companies to conduct offshore business with non-residents of Mauritius and in currencies other than the Mauritian rupee. The GBL holders are taxable at the tax-incentive rate of 15% which, coupled with the deemed or presumed foreign tax credit of 80%, reduces the effective tax rate to 3% for these companies.⁷⁵

In Botswana, the Income Tax Act provides the Botswana Minister of Finance with the powers to provide for the establishment, marketing and operation of an international financial services centre company.⁷⁶ This empowers the Minister to issue a tax certificate certifying that the activities of a company are approved financial operations. The approved financial operations include banking and financing operations transacted in foreign currency, the broking and trading of securities denominated in foreign currency, investment advice, and accounting and financial administration.⁷⁷

The tax incentives available to the international financial services centre company are *inter alia* the following:⁷⁸

- Dividends received by the international financial services centre company in respect of qualifying foreign participation are exempt;
- An international financial services centre company is entitled to deduct interest on any loan including debentures or debenture stock;

⁷⁵ “Category 1 Global Business Company” <http://www.alliance-mauritius.com/gbl1.php> accessed on 22 June 2008. See a further discussion on the Mauritian corporate tax system in Chapter 8.

⁷⁶ Section 137(1) of the Botswana Income Tax Act 12 of 1995.

⁷⁷ Section 137(2) of the Botswana Income Tax Act 12 of 1995. The other operations are management and custodial functions in relation to collective investment schemes, insurance and related services, registrars and transfer agency services, exploitation of intellectual property, and other operations that the minister may declare by order from time to time to be approved financial operations for the purposes of section 137. See also <http://www.kpmg.co.za/content> accessed on 16 March 2008.

⁷⁸ “International Financial Services Centre Companies in Botswana Tax Law” http://www.armstrongs.bw//publications/docs/international_financial_services_centre.doc accessed on 17 March 2008.

- An international financial services centre company is entitled to deduct the amount of certain foreign exchange losses;
- An international financial services centre company is granted foreign tax credit on taxes paid in any other countries on income sourced outside Botswana against tax chargeable under the Botswana Income Tax Act; and
- There are no withholding taxes on any payment of interest, royalty or management or consulting fee by an international financial services centre company or dividends to a non-resident of Botswana.

The defining characteristics of these companies are that their countries modify their tax laws to create a fertile environment for an international financial services centre company to operate. Furthermore, these companies' main operations are financial services. This may coincide with other IHC operations and result in the IHC being a "mixed" IHC where such operations are undertaken by the IHC. However, it is the above defining characteristics that distinguish the foreign financial services centre companies from IHCs.

2.7.8 Intellectual Property Holding Company

The simplest way of defining an intellectual property holding company is that it is a holding company in which intellectual property or rights thereto are held. These are also often referred to as patent holding companies. "These companies have as their purpose and activity the acquisition, exploitation, licensing or sublicensing of patents, trademarks, copyrights, brand names, or other industrial property rights, like 'know-how' on technical or administrative matters."⁷⁹ The purpose of an intellectual property holding company is mainly to minimise or avoid the tax liability on royalty payments by usage of tax treaties and/or low rates in tax havens.⁸⁰

The essence of an intellectual property holding company is not to hold shares or controlling power in other group companies, but to hold intellectual property normally

⁷⁹ Rohatgi 87.

⁸⁰ See Rohatgi 87.

beneficial to the other group companies. In this guise it is therefore not a holding company in accordance with the use of the term in this thesis. It must be noted, however, that these function could be combined with IHC functions in a group of companies to achieve the ultimate tax savings.

2.7.9 Personal Holding Company

A personal holding company is generally a company owned by natural persons, normally a small number of individuals. It engages in investment activities in that it owns shares in other companies.⁸¹ It is used to defer tax by trapping dividends interest, rent and royalties where the tax burden for companies is less than that of individuals on receipt of such payment. It can either be resident in the country of residence of its shareholders or outside such country depending on the origin of the amounts on which tax is to be avoided.⁸²

What immediately distinguishes a personal holding company from an IHC is that a personal holding company is owned by individuals. Furthermore, a personal holding company does not form part of a group of companies with any other companies. On the other hand an IHC is owned by an ultimate holding company in a group of companies.

2.8 CONCLUSION

There are numerous similarities between IHCs and other forms of corporations as discussed above. The essential characteristic of an IHC is that it owns a substantial participation in the shares of other companies, usually operating subsidiaries, established outside the country in which the IHC is established even though the IHC may perform other functions and own other assets. Moreover, IHCs are more often formed to perform a conglomerate of functions – some of which are peculiar to certain of these other corporations. Still, the nature of an IHC should not be confused with these other entities.

⁸¹ *IBFD International Tax Glossary* definition of “Personal Holding Company”.

⁸² See <http://www.allbusiness.com/glossaries/foreign-personal-holding-company/4951392-1.html> accessed on 14 June 2009.

Confusing the IHC with other entities may result in misinformed decisions and attributions of the resulting assessments or expectations in different jurisdictions.

Entrepreneurs and tax practitioners alike spend considerable amounts of time and energy trying to design the best structures for international and local, but internationally assisted businesses. Often, it does not matter to the entrepreneur what the non-resident holding company is called or where it is incorporated. Mostly, it is the result that it brings to the companies' group that matters. In this sense the distinction might seem theoretical.

Due to the similarities in the nature of the IHC and the other company structures that have been discussed above, tax instruments that apply to IHCs inadvertently apply also to other companies. However, specific tax provisions can and do vary such application. The application of controlled foreign companies, dividends tax, thin capitalisation and exchange control generally apply similarly to holding companies irrespective of the unique features that may exist, such as the holding of intellectual property. However, there are additional instruments that might apply to some holding companies that do not apply to the rest. Once again, using the example of an intellectual property holding company, the tax provisions relating to royalties and the withholding of the tax thereon would apply to such companies (and others that might hold intellectual property as an ancillary function).

In choosing to interpose an IHC the investor needs to assess the circumstances and the needs of the group carefully. An IHC can...

...play a particularly damaging role if the operating subsidiary loses money, is sold at a loss or is abandoned, because an intermediary holding or finance company may serve to postpone or deny the deductibility of the loss. Consequently, tax planning to create a holding or finance company may be viewed as an exponential component-the structure can multiply

profits through deferral of tax or aggravate losses through denial of deductions.⁸³

Thus, although the formation of an IHC can be beneficial in some instances, it might not be beneficial in other instances. In fact, it could constitute a substantial burden to a global enterprise. A parent company may find it more difficult to deduct a failed equity investment where an IHC is used as opposed to where it is not used. For example, if a failing foreign subsidiary is owned through an IHC located in a country that exempts income related to foreign subsidiaries the write-off of an investment in the shares of the failed foreign subsidiary would not be deductible. The same rule would apply if a loss resulted from the sale of a foreign subsidiary's shares.⁸⁴

⁸³ “Global Strategies” (Supplement – Energy 2002) *International Tax Review*
<http://www.internationaltaxreview.com/?Page=17&PUBID=211&ISS=13174&SID=487921&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 09 November 2009.

⁸⁴ “Deductibility of Losses” (Supplement – Energy 2002) *International Tax Review*
<http://www.internationaltaxreview.com/?Page=17&PUBID=211&ISS=13174&SID=487922&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 08 November 2009.

CHAPTER 3

NON-TAX REASONS FOR FORMING AN IHC

3.1 INTRODUCTION

When it comes to investment, a lot of time is spent, both at the inception and during the operation of the investment, on planning. At the earliest stages, once the investors have defined what business they need (or would like) to undertake, they engage in a process of identifying the form that the business would take. It is trite business conduct that a company is the most preferred form as it carries the essential benefit of limited liability. There are, however, other forms of businesses, such as a trust and the limited liability partnership, that also offer limited liability but not to the level of satisfaction enough to attain as much popularity with investors as do companies.

The other consideration that goes into planning is the place of business. In the context of local investment in particular, in deciding where to locate their businesses, entrepreneurs consider the key determinants such as the availability of labour, the demand for goods or services to be provided, the availability of the material for production, safety and security, the legal system, the general production costs, language, communication network, transportation network, time zone and the residence of the investors. The tax system also plays a major role in this decision, but as will be seen, is by no means the only consideration.

As stated in Chapter 2,¹ an IHC is formed mainly to provide flexibility to the group structure. Its formation takes the form of a company. The choice of the location of an IHC is flexible and geared towards achieving the specific goals for which it is needed.

¹ Par 2.6.

Generally speaking, setting up and using an IHC are expensive. As tax laws may change one would generally not set up an IHC with the sole purpose of taking advantages of a specific tax regime. As McGonagle states, “[t]he location of choice for a [holding company] will depend both on tax and non-tax considerations; it should offer something more than merely a low rate of tax”.²

The financial costs of maintaining an international group structure can severely affect the profitability of the group. According to Finnerty,³ in most instances an optimised group structure involves multiple tiers of holding companies resident in one or more jurisdictions to address non-tax objectives as well as various tax objectives. In the setting up of such a structure consideration is given to various factors such as:

- Political and investment climate,
- Company or corporate law, the rule of law and the availability of reputable law, accounting and audit firms,⁴
- Treasury considerations, including monetary controls, foreign exchange and currency exposure,
- Administrative ease and the availability of reputable service firms,
- Existing operational substance, and
- Infrastructure and cost factors.⁵

When the decision is taken to interpose an IHC between the investor country and the operating subsidiaries’ country, the real economic benefits are usually non-tax in nature. The most common benefits are the following:⁶

² McGonagle “Ireland Aims to Attract Holding Companies (2004) *International Financial Law Review* <http://proquest.umi.com/pqdweb?did=783749051&Fmt=3&clientId=27625&RQT=309&VName=PQD> accessed on 22 October 2009.

³ Finnerty *Introduction – Holding Companies* http://online2.ibfd.org/collections/hold/html/hold_introduction.html, accessed on 18 August 2008.

⁴ For example, according to Shelton, one of the reasons why the Danish holding company regime was not successful in the late 1990s although the Danish infrastructure was extremely well-developed and functions well, was that one will not find many accountants, lawyers or bankers as familiar with the formation and administration of Danish intermediary holding companies as in a number of other jurisdictions (Shelton “Denmark Squares up for Holding Battle” (December 1998/January 1999) *International Tax Review* <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12655&SID=468670&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 13 November 2009.

⁵ See Finnerty, par 1.3.

1. Raising external finance;
2. Exchange controls;
3. Holding, with a combination of non-holding reasons;
4. Asset protection; and
5. Structural and group reorganisation.

What follows is an analysis of each of these non-tax reasons for setting up and operating an IHC.

It is noted that there are instances where IHCs are formed primarily for tax reasons.⁷ A deep analysis of the reasons for formation is beyond the scope of this thesis. Thus, whether IHCs are set up primarily for tax or non-tax reasons has no bearing on the suitability of the South African corporate tax regime for operation of an IHC.

3.2 RAISING EXTERNAL FINANCE

Financing a company or business operations generally takes the form of equity or debt.⁸ Equity instruments generally represent ownership interests entitled to dividend payments, when declared, but with no specific right to a return on capital. An issuer of an equity instrument generally does not receive a deduction for dividends paid and the holder generally includes such dividends in the calculation of taxable income.

⁶ See Rohatgi *Basic International Taxation* (2002) 238. See also Olivier and Honiball *International Tax, A South African Perspective* (2008) 299.

⁷ See Bergmann, Hirschler, Rödler and Kornberger “Tax Treatment of Holding Companies in Austria” (2004) *Bulletin for International Fiscal Documentation* 418.

⁸ Both of these types of financing can take different and varied forms. Each of these two categories presents a wide variety of rights, privileges and limitations that may be established by the issuing company. Debt financing refers to borrowing money to finance a business undertaking. The money is to be repaid over a period of time, usually with interest. The lender does not gain an ownership interest in the business and the obligations are limited to repaying the loan. Equity financing on the other hand describes an exchange of money for a share of business ownership.

For a further discussion on the distinctions between debt and equity, see Financing Basics: Debt vs. Equity http://www.toolkit.com/small_business_guide/sbg.aspx?nid=P10_2000 accessed on 10 June 2009.

Equity financing may be through an issue of shares either to the public or to the holding company and/or specific persons, such as current shareholders.⁹ As Rohatgi states “[t]he shares could be ordinary or preferred shares, redeemable or convertible preference shares, participating preference shares or deferred shares. The shares may be issued either at par or no par value. They may also have unequal rights on voting control, distribution of assets or management decisions.”¹⁰

Save for certain exceptions which are limited in their scope, debt instruments generally represent fixed obligations to repay a specific amount at a specified date in the future. This often coincides with an obligation to pay interest on the amount of the debt. However, there are debt instruments that are issued interest-free due to, *inter alia*, the relationship between the issuer and the holder. The issuer of a debt instrument may receive a deduction for accrued interest and the holder generally includes interest in taxable income, subject to certain limitations.¹¹

In respect of debt instruments the funds may be borrowed in the jurisdiction of the IHC (hereinafter referred to as “the host country”), the investor’s country of residence (hereinafter referred to as “the home country”) or even a third country. In this regard Rohatgi states the following:

The interest may be payable at regular intervals or on maturity. Again, the interest may be fixed or variable or dependent on profits under a participating loan. The loan may be unsecured, or guaranteed by the [holding] company directly or under a back-to-back arrangement. They may be denominated in the local currency of the borrower or a foreign

⁹ Rohatgi 456. For further reading on financing aspects, see Lyon A, *Taxation, Information Asymmetries, and the Financing Choice of the Firm* in Fiscal Incentives for Investment and Innovation (1995) Chapter 1.

¹⁰ Rohatgi 456.

¹¹ See *Debt and Equity Financing* http://www.lordalex.org/financialinfo/debt/Debt_and_Equity_Financing.html accessed on 20 November 2008.

currency. The borrower is usually obliged to comply with certain loan covenants under the agreement.¹²

Another form of financing is a combination of debt and equity. Actually, most companies are financed by a combination of debt and equity. This combination is generally dictated by economic and commercial considerations.¹³

Financing can also take the form of instruments that combine both debt and equity. These are called hybrid financing instruments. These instruments combine the flexibility and repayability of debt with the advantages of equity. They include convertible loans, *jouissance* rights,¹⁴ option loans, transferable bonds, subordinated loans, profit participating loans, etc, with varying elements of equity and debt. Generally, hybrids are capable of being treated as debt in one country and as equity in another, as well as where the tax law and commercial law of a country characterise the instruments differently. This characteristic enables hybrid instruments to be used to exploit the divergence in the application of tax laws of different jurisdictions either to avoid tax or to claim double benefits.¹⁵

For tax purposes, from the viewpoint of an investor debt is preferable to equity. Most tax regimes allow a deduction of the cost of financing a debt, i.e. the interest and other finance charges.¹⁶ Thus, part of the expenditure of the income-producing undertaking can be deducted from the income of the undertaking. There is no such offsetting deduction in relation to equity. As a result the decision to use debt would generally be based on tax

¹² Rohatgi 456.

¹³ Rohatgi 457.

¹⁴ *Jouissance* rights are participation certificates that provide security for creditors' claims. These rights are usually reserved for shareholders who are also creditors in the company. They would, for example, carry rights of participation in profits. Participation certificates do not give the bearer any voting rights. They are recorded as supplementary capital under certain circumstances

¹⁵ Rohatgi 562 states: "The tax benefits on hybrid instruments arise both from the classification conflicts and the timing differences on income or expense recognition. These advantages are often the result of the tax rate differences and the timing of the tax due on various payments such as dividends, interest, capital gains or even capital duties."

¹⁶ See Organisation for Economic Co-operation and Development, *Fundamental Reform of Corporate Income Tax No 16* (2007) 59.

reasons. However, the circumstances under which the debt financing is obtained are not tax in nature. The most common tax benefits of using debt are as follows:¹⁷

- The borrower can reduce its tax by financing through debt, as interest is paid from pre-tax profits as opposed to dividends that are paid from after-tax profits;¹⁸
- A loan may be obtained in any currency to minimise foreign exchange risks; generally, interest does not suffer from economic double taxation¹⁹ in the hands of the borrower and the lender; and
- It may be possible for different persons to claim a deduction for the interest costs if the holding company borrows at home to invest in a foreign subsidiary in a tax haven, which then grants a loan to a sister subsidiary in the host country.

As a result, tax advisors, bankers and lawyers devote significant time and effort to arbitraging the tax, particularly aiming to obtain some tax deduction with some credit from the rating agencies.²⁰ This begs the question: What are the commercial and other reasons for locating a company in the host country and not the home country? The most common reasons are country risk, currency risk and usage of group assets.²¹

3.2.1 Country Risk

Due to the political, social and economic status of a country, a country may be seen to be a higher risk in terms of lending money to residents of that country. This may also be due to the legal system that fails to effectively enforce the rule of law. In such a case it

¹⁷ Rohatgi 457.

¹⁸ This is subject to the application of thin capitalisation rules. See a discussion on thin capitalisation rules in Chapter 5 par 5.3.8.2.

¹⁹ Economic double taxation means the inclusion, by more than one state's tax administration, of the same income in the tax base when the income is in the hands of different taxpayers. This is contrasted with juridical double taxation, which refers to the imposition of income taxes in two (or more) states on the same taxpayer in respect of the same income. See Organisation for Economic Co-operation and Development *What is a tax Convention – Double Taxation – Juridical and Economic* available on http://www.oecd.org/document/15/0,3343,en_2649_33753_36156239_1_1_1_1,00.html accessed on 10 June 2009.

²⁰ See Hammer *How Should a Corporation Strategically Review its Capital Markets and Financial Activities in the United States?* Derivatives & Financial Instruments (2008) (Volume 10)10

²¹ See Olivier and Honiball 298–299.

becomes prudent for a group to locate its financial hub outside the home country, in a country with a higher regard of the rule of law. This is in light of the fact that the bulk of a pure IHC's functions are to acquire, manage and/or sell investments in domestic and/or foreign companies.²² Such transactions require certainty of the legal provisions and enforceability of the obligations arising from the contractual relationship.

3.2.2 Currency Risk

The differences in the currencies of the home country and the jurisdiction where the funding is sought may also be a hurdle to the financing of a company for a group. Financiers are generally reluctant to provide foreign borrowings or foreign currency borrowings due to the risk of repayment. The financial burden increases when the debtor's currency depreciates against the currency in which the debt is denominated.

This risk is reduced if the borrowed funds are denominated in the same currency as the income flows that service the use of funds. This makes it preferable for companies to maximise borrowings within their country of residence. The creditors' preference to denominate debt in their business currency results in most groups managing such risk by locating an IHC in a favourable jurisdiction for finance purposes.

It needs to be noted that where funding is sought in more than one country the IHC could be located in a central location suitable for all, or most, countries from which the finance is obtained. Alternatively a group may incorporate various IHCs in numerous countries to serve subgroups in the group structure.

3.2.3 Usage of Group Assets

Where a company requires finance by way of a loan, its assets may often serve as collateral for that loan. The provision of collateral often poses problems where the

²² Zimbabwe presently constitutes a good example of such a high-risk country.

company's position is precarious and such company fails to provide the financier with enough security for the loan. However, the usage of the IHC to acquire financing for such a company may yield quicker success as the IHC may be able to utilise the assets of all its subsidiaries or investments to provide security for the loans.

3.3 EXCHANGE CONTROLS

Exchange controls are used to regulate the influx and outflow of funds and investments into and from countries. Typically these controls permit and restrict certain financial movements in and out of the country. Transactions that are affected by exchange controls are subject to either prior government approvals or post-transaction reporting of income or capital flows.²³

Ordinarily, exchange controls may result in forced repatriation of profits where a resident invests in a country outside the exchange control free area (where there is one).²⁴ Exchange controls may also result in the trapping of profits where a non-resident invests in a country which has exchange controls. As a result, IHCs are sometimes incorporated outside an exchange control country in order to facilitate reinvestment and prevent forced repatriation of profits or the trapping of profits in an exchange control country.²⁵

Exchange controls are also used in some countries as anti-tax avoidance measures on cross-border transactions. However, due to their impact on international trade and commerce, exchange controls are not a suitable anti-avoidance measure for tax purposes.²⁶

²³ See Rohatgi 432.

²⁴ Exchange control free areas are areas within which no exchange control restrictions are in place on trade between residents of different countries. This often occurs as a result of proximity of the countries, usage of the same currency and the trade relationships (including the frequency of trade transactions) between countries.

²⁵ See Olivier and Honiball 533.

²⁶ Rohatgi 432.

3.4 ASSET PROTECTION

An essential aspect of entering into a trade or conducting a business is earning a profit. Such profits either increase the assets of the business or are passed on to the investor by way of dividends. In both cases these profits increase the net worth of the investor. It is therefore important that the assets of the business, which are ultimately the assets of the investor, are protected and safe.

Depending on the nature of the business undertaking, the nature of the protection of the assets of the undertaking would differ. The costs of insuring the assets may also differ. Irrespective of the nature of the assets, attendant upon conducting business of any nature is a responsibility to ensure that the assets of a business are secure.

3.4.1 What is an “Asset”?

In the context of the current discussion “asset” is used in a wide sense. It is used as property of whatever nature, whether movable or immovable, including tangible and intangible assets, corporeal or incorporeal, including rights or interests of whatever nature to or in such property.²⁷

3.4.2 What are the Dangers?

The dangers to asset security depend on the nature of the business. While land claims, for example, may be a threat to a mining company in many countries including South Africa, they may not be so for an IHC. An IHC primarily holds investments in its subsidiaries. The main threat to such assets is expropriation by the government of the country where the assets are located. This may not necessarily be the same country as the country in which the IHC is located.

²⁷ This wide definition is based on the nature of interests that a business undertaking may give to the investor. This is based on the definition of “asset” in paragraph 1 of the Eighth Schedule to the Act.

Expropriations generally happen as a result of changes in government policy. As a result countries that are politically unstable pose a bigger security threat to the assets of an IHC. Where investors are located in such a politically unstable country, the insecurity might necessitate a change of location to secure the assets. Thus, just as the political stability of a country encourages foreign direct investment, political instability drives investment away.²⁸

A further threat to the viability of an IHC could be brought by business regulations. Regulations could increase the costs of conducting business for example by requiring high and frequent fees for business licences and requiring companies to contribute a certain percentage of their proceeds or income to social development. Overregulation that is complemented by tough non-compliance penalties increases this level of threat to the economic profitability of the IHC and the group as a whole.

As a result of these dangers, a feasible business decision is to locate an IHC in a country where the risks are less. This often entails the relocation of the financial hub of the group from a country with high risk levels into a less risky country. In this way the assets of the group would escape the risk by the formation of the IHC in a different country.

3.5 GROUP REORGANISATION AND STRUCTURAL CONSOLIDATION

Reorganisation broadly refers to a transaction (or transactions) that effects significant changes in the legal or economic structure of companies. These take the form of mergers, divisions, asset acquisitions, share acquisitions and recapitalisations. In a consolidation, two or more companies transfer their assets and liabilities to a single newly established company.

The company laws of some countries allow structural consolidations and group reorganisations more readily. Where such consolidation or reorganisation is required for

²⁸ Expropriation loss is treated as a tax loss in some countries and is not taken into account in other countries. Also, insurance companies will generally exclude expropriation when determining the total risk to be insured.

economic purposes, directing the consolidation or reorganisation to a jurisdiction with flexible company laws is inevitable. Thus the prohibition or difficulties with consolidations and reorganisations do not necessarily only come from the fiscal side.²⁹ Even then, certain reorganisations are taxable while others are not. Income tax systems generally treat reorganisations in which the transferor company disappears as a taxable reorganisation or consolidation.³⁰ In line with group flexibility, IHCs are located in jurisdictions where reorganisation would attract the least regulatory and tax consequences.

3.6 HOLDING, WITH A COMBINATION OF NON-HOLDING REASONS

A group of companies sometimes prefers to centralise certain functions within the group. Thus, a group may have a reason, other than a holding reason, to set up a company outside its home country. The reason may be, for a distribution group, a central distribution point for the group either due to the close proximity of the host country to the contiguous target countries, or some other reason.

At times, the IHC functions are undertaken as ancillary to the business activities of an entity that was not set up as an IHC. Conversely, an entity may be set up as an IHC to perform both IHC functions and non-IHC functions. Generally, IHC functions are often combined with headquarter activities. Headquarter activities consist of administrative and general support activities for the group.

Pure headquarter companies do not own intangibles, make investments or carry on any of the business activities of the group companies. According to Olivier and Honiball, pure headquarter companies are “generally responsible for any or all of the services which are auxiliary to the multinational group’s main business or operational activities on a

²⁹ See Olivier and Honiball 299 and Rohatgi 238.

³⁰ Vanistendael “Taxation of Corporate Reorganizations” in (ed Thuronyi) *Tax Law Design and Drafting*, International Monetary Fund (1998) 908.

centralised basis. Examples of such services include accounting, legal, computer, marketing and scientific support services.”³¹

The functions of an IHC could be combined with the activities of other companies in order to comply with certain regulatory provisions. For example, utilising an IHC to perform headquarter activities for IHCs located in the European Union is generally to ensure that the IHC complies with the anti-avoidance provisions contained in the European Community Merger Directive,³² which requires that a holding company should have a *bona fide* commercial substance in the country in which it is located.³³

In recent years, company groups have preferred to share employees. According to this arrangement, a company would be set up within a group in a jurisdiction where some or most of the group companies are located. This company would employ people with different expertise. These would generally be people whose skills are required by the group companies on a regular, but not on a full-time³⁴ basis (therefore this excludes operational personnel). These members of staff would be deployed to each company as and when needed.

Where such an employee-sharing arrangement is already in place, certain management of the company, which might include the group’s operational management, may also be employed by the employment company.

Such operational management staff does not necessarily have to be deployed to any group company. The management may perform IHC functions, thus rendering the company an IHC in that jurisdiction. This combination only works in certain restrictive circumstances.³⁵

³¹ Olivier and Honiball 300.

³² *European Community Merger Directive* of 23 July 1990 (90/434/EEC).

³³ Olivier and Honiball 300.

³⁴ “Full-time” is used here in a loose and general sense: tax practitioners disagree as to whether it implies a permanent employment, eight-hour working day, etc.

³⁵ According to Olivier and Honiball 300 “[i]t may not always be possible, however, to combine investment holding activities with other types of business activities due to the restrictive laws of the particular holding

3.7 CONCLUSION

The reasons for the formation of an IHC are closely linked to the functions of the IHC. The group identifies what services it needs and the reasons why it needs such services. In some instances such services cannot be performed by a third party to the group. Where such services can be performed by a group member and fall within the functions of an IHC, the reason for the establishment of an IHC would have arisen. Thus, the reason for the formation of an IHC is focused on exactly what the group aims to achieve with the entity.

The real reasons why such companies are set up are economic in nature. The prevalence of such reasons in company groups results in the popularity of IHCs in large multinational groups. Choosing a jurisdiction is guided by such business and economic reasons.

This, however, does not mean that investors should be oblivious of the tax advantages and disadvantages of establishing the IHC in a particular jurisdiction.³⁶ As stated in Chapter 1,³⁷ tax reasons are important to the determination of where to set up an IHC.³⁸ In the chapter that follows, the tax reasons are explored in more detail.

company regime. For example, to receive the preferential tax benefits of the Luxembourg 1929 holding company, the company's activities must be restricted to investment holding, acquisition or sale."

³⁶ See Eynatten "European Holding Company Tax Regimes: A Comparative Study" (2007) *European Taxation* (Vol. 47 Issue 12) 562-570.

³⁷ Par 1.1.

³⁸ For example, where two jurisdictions grant a similar corporate environment, the investor would not be expected to choose a tax-adverse jurisdiction to preserve the essence of the IHC.