

CHAPTER 4

TAX REASONS FOR ESTABLISHING AN IHC

4.1 INTRODUCTION

Tax planning is one of the main considerations in any investment planning. As Graetz¹ States, “[a] deal done by very smart people that absent tax considerations, would be stupid”. Complementary to this, Lord Tomlin’s oft-quoted dictum in *IRC v Duke of Westminster*² that “[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be”,³ finds support from or is at least acknowledged by all sectors of business, revenue authorities, government treasury departments and academics as forming the cornerstone of any tax jurisdiction. Russo explains the principle as follows:⁴

A key determinant of shareholder value under current corporate reporting guidelines is earnings per share (EPS). An important element of EPS or the bottom line is tax. The net effect of having an [effective tax rate (“ETR”)] of 35% to 40% is that any earnings resulting from organic growth, acquisitions or other corporate initiatives, are diluted by 35% to 40%. It should thus be clear that ETR, as reported in [a multinational enterprise’s] financial statements, significantly impacts EPS and therefore has a direct impact on the shareholder value. In order to have a positive impact on EPS, however, tax savings must be sustainable.

Three main forms of tax saving and tax structuring are worth mentioning: tax avoidance, tax minimisation and tax evasion. Tax avoidance is the usage of legal ways to regulate

¹ See Graetz (Yale Law School) as quoted in Hager, *Treasury Targets Shelters Again*, *Washington Post* (1999) E3 in relation to tax planning using tax shelters.

² [1936] AC 1 at 19, [1935] All ER Rep 259.

³ At 267.

⁴ Russo *Fundamentals of International Tax Planning* (2007) 73.

one's affairs in such a way that one pays the minimum tax imposed by law rather than the maximum. Put differently, tax avoidance is the legitimate and legal process of protecting one's property from unnecessary erosion by taxation.⁵

Tax minimisation, on the other hand, involves no degree of cunning and no structures designed – just an application of the tax laws and interpretation to the particular facts and circumstances in order to pay the right amount of tax payable, with no prejudice suffered. Thus tax minimisation does not seek to take advantage of possible contentious loopholes in the tax system (as does tax avoidance) but applies the tax laws to the taxpayer's advantage as much as is possible. As can be seen, the distinction between tax avoidance and tax minimisation is very slight. In some interpretations the two overlap to a large extent.⁶

The third version, tax evasion, connotes the use of illegal and dishonest means to escape tax, for which penalties are normally prescribed. This can take many forms, from falsification of records to concealment of income or taxable events.⁷

These three methods of dealing with one's tax affairs are embarked upon locally as well as internationally. While an IHC is not necessarily formed to achieve tax savings, the decision regarding where it is formed is, to varying degrees, influenced by tax consequences. In this way, the decision to locate it within a particular jurisdiction does constitute at least an attempt to reduce the worldwide tax liability.

What follows is an appraisal of the main tax reasons why an investor may choose to form an IHC in a particular jurisdiction. It needs to be noted at the outset that investors would generally be more motivated to form an IHC where more than one reason exists – and,

⁵ Joubert and Faris (eds) *LAWSA* 6 (2000) 1 par 632

⁶ See LexisNexis "Objectives of Estate Planning" <http://butterworths/nxt/gateway.dll> accessed on 25 February 2008 where it is further stated that "[t]he conventional wisdom is that an estate plan should ensure that no income tax prejudice is suffered, but is unlikely to lead to income tax savings. If these do eventuate, well and good, but such savings should be neither promised nor expected.

⁷ See *CIR v Conhage (Pty) (Ltd)* 1999 (4) SA 1149 (SCA); *CIR v King* 1947 (2) SA 196 (A). See also Williams *Income Tax in South Africa – Law and Practice* (2006) 771.

still better, where there is a combination of the tax reasons and the non-tax reasons mentioned above.

4.2 DEFERRING TAX ON OPERATING INCOME

The operating income of a business activity is income produced by the business's operating activities. The International Financial Reporting Standards ("IFRS") define operating activities as the principal revenue-producing activities of an entity and other activities that are not investing or financing activities.⁸ Thus, according to the IFRS, the operating incomes of businesses would differ depending on the specific nature of business of a particular enterprise.⁹

Investing activities mean the acquisition and disposal of long-term assets and other investments not included in cash equivalents.¹⁰ Thus, the IFRS treatment would include in operating activities liquid investments convertible to cash, including dividends, rental and royalties.

From a tax point of view, operating income is akin to revenue income. Revenue receipt is the income which arises from a business activity or the employment of capital either by using it or by letting it. The classification is, however, subjective.

Investors mainly earn income from their equity investments by way of dividends. Investors may defer tax on operating income by trapping the dividends at the IHC level instead of remitting them to the home country. In circumstances where income is taxable or exempt, depending on its source, an IHC can be used to channel only exempt income

⁸IAS 14.8, *International Financial Reporting Systems including International Accounting Standards and Interpretations* as at 1 January 2006, International Accounting Standards Board, United Kingdom.

⁹ An apple-farming business would have the income from selling apples as its operating income, just as an audit firm's income would be derived from consulting services. Income from the sale of land would be operating income in the hands of a dealer in land.

¹⁰ Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. See *International Financial Reporting Systems including International Accounting Standards and Interpretations* as at 1 January 2006, International Accounting Standards Board IAS 14.8. United Kingdom.

back to the investor country.¹¹ This would be the case, for example, where there is a participation exemption on certain dividends.

Generally, this form of deferral is affected by the application of controlled foreign companies' (hereinafter referred to as "CFC") legislation in the home countries of the investors. CFC legislation generally attributes income of a foreign company that is substantially held by residents to its resident shareholders in proportion to their shareholding. The primary objective of CFC legislation is to tax residents on income shifted to low income jurisdictions with no business objective and on income that is trapped in foreign jurisdictions as a result of the foreign company not declaring dividends. CFC legislation achieves this by attributing the income to the resident shareholders of the CFC in the year that the income is earned.¹²

Legislative intervention to achieve these goals is constantly under intense scrutiny by taxpayers, who attempt to circumvent it. One of the ways of doing so is at the planning stages where investors ensure that investors in the home country hold less than the required percentage for the company to be a CFC. In this way, as most dividends would be subject to a participation exemption of, say, 25%, the investor can get the dividends free from withholding taxes and, possibly, without a tax on foreign dividends.¹³

An IHC can also be used to defer tax on a CFC's operating income. For example in Mexico, CFC legislation requires taxpayers to accrue into their Mexican taxable income the gross revenues realized by subsidiaries located or resident in low tax jurisdictions. They are required to accrue into their taxable income revenues derived not only by their first-tier subsidiaries, but also those accrued by lower-tier subsidiaries located in low tax

¹¹ Olivier and Honiball *International Tax, A South African Perspective* (2008) 302.

¹² Foreign companies that are controlled by residents of other countries are often used to keep their income in the foreign jurisdiction by the residents of the other countries by, in the exercise of their controlling powers, prohibiting the foreign company from declaring dividends. This is the reason why CFC legislation seldom subjects the income of non-controlling shareholders to attribution.

¹³ Interest, royalties and rental treatment as operating income do not fall within the scope of this discussion because companies that have such income as operating income would be financial instruments holding companies, intellectual property holding companies and rental companies, respectively. These, as discussed before, do not have the essential characteristics of an IHC.

jurisdictions. Moreover, contrary to the approach taken by other jurisdictions, the Mexican controlled foreign corporation (CFC) legislation does not grant Mexican taxpayers a deemed paid credit (ie an indirect credit) for income taxes paid by the low tax jurisdiction corporation. Taxpayers defer the recognition of the low tax jurisdiction company's earnings by interposing an IHC in a jurisdiction with CFC legislation, provided that the intermediary jurisdiction's CFC legislation is applicable to the intermediary foreign holding company.¹⁴

4.3 DEFERRING TAX ON CAPITAL GAINS

Both internationally and for South African tax purposes, the distinction between capital and revenue plays an important role in the decision to form and locate an IHC. Traditionally, most jurisdictions treat capital gains more favourably than ordinary income. For example, in South Africa the effective capital gains tax (“CGT”) rate for companies is half that of the normal income tax rate (due to the inclusion rate).¹⁵

A capital gain arises on the disposal of a capital asset. The determination of whether an asset is capital in nature (similar to whether an asset is a revenue asset) depends on the intention that the taxpayer has and how he or she deals with the asset. Most countries have a wealth of tax jurisprudence on the distinction between capital and revenue, as capital gains is generally more favourably treated than revenue gains.¹⁶

Capital assets of a company include the cash given in lieu of the shares and the assets that the company utilises to produce its income. Shares are capital assets in the hands of the shareholders, unless these shareholders hold such shares as trading stock. However,

¹⁴ See Solano, Alvarez, Fabregat and Santos “Mexico Bill: Tough on Tax Havens” (December 1997/January 1998) *International Tax Review*

<http://www.internationaltaxreview.com/Default.asp?Page=10&PUBID=35&ISS=12666&SID=468530&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 15 November 2009.

¹⁵ See par 10 of the Eighth Schedule to the Act. See also Olivier and Honiball 301; Wilcocks and Strydom “The Concept of ‘Disposal’ for the Purposes of Capital Gains Tax in South Africa” 2000 *Meditari Accountancy Research* 312; Davis *What You Must Know About Capital Gains Tax* (2001) 4; Geach *Capital Gains Tax in South Africa – The Essential Guide* (2001) 16.

¹⁶ See Ault *Comperative Income Taxation* (1997) 194–195.

shares that a company holds in another company are assets in the hands of the former company. Assets that a company uses as capital assets include intellectual property. Intellectual property is one asset the value of which generally increases as the enterprise becomes a successful undertaking.¹⁷

While tax on operating income is generally triggered by an accrual or a receipt, tax on capital gains is generally triggered by disposal or disposition. Disposal has a very broad definition and captures almost all instances in which an asset is alienated.¹⁸ The International Bureau of Fiscal Documentation¹⁹ defines disposal as follows:

The term is often given a broad meaning and may, depending on the country involved, cover sales, exchanges, gifts or bequests; leasing, surrender or forfeiture; the receipt of insurance moneys or other compensation; the receipt of a sum for exploration of an asset; the receipt of a sum for refraining from exercising rights; the destruction or abandonment of an asset; emigration of the taxpayer; and the transfer of the taxpayer's business property to his private property.²⁰

In addition to these and other forms of disposals in different jurisdictions, certain events that are strictly not disposals are deemed as disposals. As Whiteman²¹ observes, “[c]hargeable disposals fall into two categories: those events or transactions which can be

¹⁷ See Bently and Sherman *Intellectual Property Law* (2009) 1–11.

¹⁸ Haccius *Ireland in International Tax Planning* (2004) 19; “Capital Gains Tax Guide” <http://www.bizland.co.za/cgt.htm#triggers> accessed on 15 October 2008. HM Revenue & Customs “Capital Gains Tax” <http://www.hmrc.gov.uk/cgt/index.htm> accessed on 15 October 2008.

¹⁹ *IBFD International Tax Glossary* definition of “disposal”.

²⁰ Paragraph 11 of the Eighth Schedule to the Act. See also Wilcocks and Strydom 312. For South African purposes and subject to certain specific exclusions, a disposal is defined in the Act as follows: a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes (a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset; (b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset; (c) the scrapping, loss, or destruction of an asset; (d) the vesting of an interest in an asset of a trust in a beneficiary; (e) the distribution of an asset by a company to a shareholder; (f) the granting, renewal, extension or exercise of an option; or (g) the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement. See Geach 30–42; Davis 10–19; Williams *Capital Gains Tax – A Practitioner's Manual* (2005) 32.

²¹ See Whiteman *Whiteman and Wheatcroft on Capital Gains Tax* (1980) 23.

regarded as a ‘disposal’ within the ordinary meaning of that word...and those events or transactions which are treated as notional ‘disposals’ though no actual disposal takes place.” However, as a general rule a company does not dispose of an asset when it issues shares or when it grants an option to acquire a share or debenture in the company.

Investors would generally prefer to invest in countries with low or no capital gains tax. However, this is not easy to do, as tax, let alone CGT, cannot be the only motivation for investing in a particular country. With a wide range of activities deemed to be disposals, investors would rather invest in a country where there are fewer disposal events. In this way, although the CGT rate may be high, the CGT base is not broad and certain gains may escape taxation and therefore bring the effective CGT rate down.

Based on the foregoing, depending on the objectives of the group companies and what assets the companies hold, an investment decision is made on the location, influenced to a large extent, by the tax treatment. For example, a group that holds capital assets that are moved from one company to another or a group that envisages restructuring would prefer a jurisdiction that does not deem the movement of assets within the group as a disposal for CGT purposes.

The main problem that most groups experience is that even if CGT is avoided in the host country under a DTA, the home country may still have the right to levy CGT. Thus, where the home country deems a change in residence as a disposal, the CGT on all worldwide assets, subject to DTAs, is triggered. Therefore, the investor would rather move the residence of the company outside of the home country before the company acquires assets or where assets are already acquired, at the earliest stage before the assets appreciate much in value.²² Alternatively, it is preferable for assets to be owned by a company located in a jurisdiction where the change of residence would not trigger a disposal, thus necessitating the location of an IHC in such a country.

²² See Olivier and Honiball 301. Also see Ogley *Principles of International Tax: A Multinational Perspective* (1996) Chapter 9.

It is preferable that the country in which the investor locates the IHC should not tax capital gains on cessation of residence as that would jeopardise the chances of further relocation of residence should that be desired in the future.²³ Where cessation of residence is not a trigger in the investor country, the tax that would have been levied on relocation would be deferred. Even then, some investors prefer to be taxed once when the value of the gain is low and defer the rest of the gain such that they would allow a tax on capital gains on relocation from the home country with anticipation of a large increase in the value of the assets in the short term. Some countries have anti-avoidance measures that are specifically designed and intended to combat this type of avoidance.²⁴

4.4 MAXIMISING CREDIT FOR FOREIGN TAXES

Legislation in most countries allows the tax authorities to grant unilateral tax relief against double taxation by not taxing foreign income or allowing a tax credit on the foreign taxes paid, or deduction or exemption on the income in respect of which foreign taxes were paid, to a foreign government.²⁵ Tax treaties also offer such relief but the relief is not general as it is limited to countries which have DTAs with each other. In a discussion that follows, the main elements of these options are examined. The importance of these provisions for IHCs is that IHCs often receive amounts that have been taxed in the jurisdictions in which such amounts are sourced. These include dividends from their non-resident subsidiaries and capital gains on the sale of capital assets located offshore.

²³ The Netherlands and Mauritius are examples of jurisdictions that do not levy capital gains tax on cessation of residence. Switzerland does levy capital gains tax on cessation of residence and as a result the numbers of IHCs in that country have declined since the introduction of the capital gains tax in that country. South Africa also levies CGT on cessation of residence. See par 12(2)(a) of the Eighth Schedule.

²⁴ The USA is one of the countries that apply anti-avoidance measures in respect of intellectual property. In South Africa the anti-avoidance measure contained in s 23I was introduced in 2007 by the Revenue Laws Amendment Act 35 of 2007.

²⁵ McLure "Must Corporate Income be Taxed Twice?: A Report of a Conference Sponsored by the Fund for Public Policy Research and the Brookings Institution" 1979 *Fund for Public Policy Research, Brookings Institution* 79; See also "Foreign Tax Credit" http://www.taxalmanac.org/index.php/Foreign_Tax_Credit accessed on 14 October 2008.

4.4.1 No Tax on Foreign Income

One of the ways of avoiding double taxation is to apply the source-based tax purely and to tax only income sourced in the country applying the tax. This system is not popular at all as it is prone to tax avoidance and is not in line with the usual international norm of worldwide taxation of residents, rather than taxing on the basis of source.²⁶

4.4.2 Foreign Tax as an Allowable Deduction in Determining Taxable Income

A tax deduction is a mechanism to prevent juridical double taxation. In the deduction system, the tax payable or paid to foreign countries is deducted in the calculation of the taxable income of a resident. This method is used in some countries as a fallback from a foreign tax credit method where the credit may not be of use to the taxpayers. It is, however, not widely accepted as a method to be used on its own without being coupled with other methods available.²⁷

This method, compared with the others, yields less relief for taxpayers, as all that is deducted is the actual tax payable or paid. The benefit that the taxpayer derives is only the non-taxation of the amount of tax paid or payable. The formula is as follows:

$$A - B \times C = D$$

Where:

A is the taxable income;

B is the tax paid in the foreign country;

C is the local tax rate; and

D is the tax payable in the home country.

²⁶ See Vann *Tax Law Design and Drafting* (ed Thuronyi) (1998) 756. See also Davis *Principles of International Double Taxation Relief* (1985) Chapter 5.

²⁷ See Vann 757; Olivier and Honiball 315.

4.4.3 Tax Exemption

The exemption method exempts foreign-sourced income from tax in the home country. Thus, the foreign-sourced income is not included in the calculation of taxable income. Several jurisdictions apply this system subject to certain conditions.²⁸ Mainly the conditions relate to the fact that the income has actually been taxed (as opposed to tax that is payable or that the income is subject to tax) in the foreign country. Some systems place conditions on actual tax rates while others exempt income sourced in certain countries.²⁹

Certain exemptions are blatantly conditional, for example exemption on receipts and accruals of foreign ship or aircraft owners or aircraft or charterers if a similar exemption or equivalent relief is granted to the taxing country's residents by the country in which that person is resident.³⁰ In this regard Vann³¹ states:

If the exemption is unconditional and the exemption does not affect in any way the taxation of other income, then in substance the result is the same as a purely territorial system. Most countries using an exemption system adopt exemption with progression, under which the total tax on all income of a resident is calculated, and then the average rate of tax is applied to the income that does not enjoy the exemption.

Countries that apply the exemption method apply it only to certain specified items of income.³²

²⁸ Arnold and McIntyre *International Tax Primer* (2002) 33–34.

²⁹ South Africa, by the mechanism of s 9D(9)(a) of the Act exempted from the CFC attribution, income of a CFC located in “designated countries.” This provision has since been repealed by s 22(1) of Act 45 of 2003.

³⁰ For the South African equivalent provision, see s 10(1)(cG) of the Act.

³¹ Vann 757.

³² For example, South Africa applies the exemption method to certain foreign dividends (s10(1)(k)(ii)), income received by crew members of ships operating outside the South African territorial waters (s10(1)(o)) and royalties (s10(1)(m)).

Where income is exempt, the expenditure incurred in producing that income is generally not deductible in the hands of the resident. For example, in South Africa when the source-based system of tax was applicable, income from a non-South African source was not taxable in South Africa. Therefore, the interest incurred in producing that income was not deductible in South Africa. The same applies with foreign dividends. The interest incurred in producing exempt foreign dividends is not deductible while the interest incurred in producing taxable foreign dividends is deductible, but limited to the amount of the dividends.

The formula in this respect takes the following two simplified steps:

$$A - B = C$$

$$C \times D = E$$

Where:

A is the total income;

B is the tax paid in the foreign country;

C is the taxable income;

D is the local tax rate; and

E is the tax payable in the home country.

4.4.4 Tax Credits

This is the most popular form of unilateral double tax avoidance. This system gives a credit against total tax on worldwide income for foreign taxes paid or payable on foreign income by a resident.³³ In this system, the credit is given against the tax payable in the host country. Thus, while in the deduction method the deduction is given when determining the taxable income, the credit system gives the credit against the actual tax

³³ Arnold and McIntyre 36. See also “Taxes: what is the foreign tax credit?” http://www.essortment.com/home/taxesforeignta_smsr.htm accessed on 13 October 2008.

paid or payable.³⁴ The calculation starts by determining the taxable income and then the tax payable. Once the tax payable is determined, the tax paid in the foreign countries is deducted. The formula is as follows:

$$A - B = C$$

Where:

A is the tax payable before the credit is applied;

B is the tax paid in the foreign countries; and

C is the final tax payable.

This is therefore the most effective and practical unilateral method of avoiding double taxation in that the taxpayer's tax is effectively limited to the higher of the tax of either jurisdiction. The credit is normally limited to the tax payable in the host country. As Vann³⁵ states, "[t]his limit is designed to ensure that foreign taxes do not reduce the tax on domestic income of residents and is calculated by applying the average rate of tax on the worldwide income before the credit to the foreign-source income."

In South Africa a tax rebate applies in relation to the following:³⁶

- Revenue income or capital gain received by or accrued to a resident from any source outside South Africa which is not deemed to be from a South African source;
- Any proportional amount of income in terms of the CFC rules;
- Any foreign dividend;
- Any revenue income or capital gain deemed to have been accrued to a resident in terms of tax-back provisions in the Act.

³⁴ Russo *Fundamentals of International Tax Planning* (2007) 10.

³⁵ Vann 757.

³⁶ See s 6quat(1) of the Act.

The exemption method generally provides the best benefits for the taxpayers. However, where the tax rate in the source country is higher, the credit method provides equal relief to the exemption method. The use of these methods either on their own or in combination with the other methods is very effective for the elimination of double taxation. With the deduction method, one can only receive a credit where there has been a tax loss. Even then, tax systems generally ring-fence tax losses. As a result one would not be able to utilise the tax loss from a foreign country in one's home country.

4.5 REDUCING WITHHOLDING TAXES

Withholding tax is not a tax as such, but rather a method of tax collection employed by tax administrations to ensure payment of tax.³⁷ Before withholding can be applied, there has to be an underlying tax liability on the part of the taxpayer. The tax may be a tax on royalties, dividend tax, or even income tax. The terminology often extends to coupling the nature of the tax with the element of withholding like “a withholding tax on royalties”.³⁸

The obligation to withhold is on the person making the payment. Generally, the person receiving the amount has no right of recourse whatsoever against the person withholding the amount in respect of the amount legally withheld. However, a contractual arrangement between the parties may vary this general rule by allowing the payer to gross-up the amount.³⁹

Mostly, withholding taxes are in respect of royalties and dividends. However, in certain jurisdictions, for example Australia, withholding taxes are also imposed on interest

³⁷ See Arnold and McIntyre 169. “What is Withholding Tax?” <http://www.wisegeek.com/what-is-withholding-tax.htm> accessed on 13 June 2009.

³⁸ The most common example of these is in relation to tax on employees where employers are obliged to withhold the tax. Some laws also oblige debtors of sole proprietors to withhold the tax on payment.

³⁹ However, where there is a withholding tax in the country of the person making payment, the parties may agree on a royalty payment that takes into account that there would be tax payable thereon. See Olivier and Honiball 344.

payments to non-residents.⁴⁰ Withholding taxes are generally reduced by tax treaties. Thus, residents of a country with a high number of tax treaties may be in a more favourable position as opposed to their counterparts in countries with fewer treaties. As Olivier and Honiball⁴¹ observe:

The country of residence of the intermediary holding company may have negotiated a more favourable network of tax treaties than the investor country and this may result in the intermediary holding company being liable for lower withholding taxes in respect of dividends received. A situation where the relevant intermediary holding company jurisdiction does not levy a withholding tax on the payment of dividends will result in an overall reduction in tax. This withholding tax advantage is achieved only if the intermediary holding company itself is entitled to treaty benefits.

The benefit would arise from the fact that, while trading in the home country, the investor would not have the benefits of the treaties because the home country does not have a treaty with the countries where the ultimate investments are located. By interposing the IHC, the investment and other income that arise in the target countries would be collected at the IHC host country where they would derive the treaty benefits. Furthermore, it would be desirable for the home and the host countries to have treaties with each other. In this way the income or investments would take the otherwise unavailable treaty route.

As stated above, withholding taxes would be reduced by the use of an IHC. There is, however, a possibility that withholding taxes may be altogether eliminated depending on

⁴⁰ In South Africa, secondary tax on companies is payable on declaration of dividends by resident companies. Because this is a tax on the company declaring the dividend, it is not a withholding tax as it is paid by the person who is liable for the tax. The common factor about this type of tax is that the tax incidence is on the shareholder(s). It should be noted that the current tax will be replaced by a new dividend tax which should likely be effective only from the fourth quarter of 2009, at the earliest. South Africa also levies a withholding tax on royalties at a rate of 12% of the amount paid. See s 35.

⁴¹ Olivier and Honiball 301.

the content of the treaties⁴² and the participation exemptions available. As typical tax-haven jurisdictions generally do not have good treaty networks, their residents are not likely to benefit from this reduction or elimination of the taxes. An IHC located in such a jurisdiction could be at the disadvantage of not benefiting from the reduction or elimination of taxes.

4.6 GROUP TAXATION

4.6.1 Introduction

Perhaps one of the main tax reasons why an investor would like to form an IHC in a particular country is the fact that the tax systems of certain jurisdictions allow a group of companies to be taxed as one unit, thereby allowing the offset or consolidation of losses or income. This is premised upon the fact that losses in tax are of great use in reducing one's tax liability. Depending on what kind of relief the investor seeks and the countries of the ultimate investments, the investor chooses the location of the IHC by also considering this alongside other tax and non-tax motivation for the establishment of an IHC.

Group taxation is classifiable into three forms: fiscal unity, group contribution or group relief.⁴³ These general references can lead to an inaccurate classification, as the terms are often used to refer to group taxation in general as opposed to being used as descriptive of the nature of the particular group taxation system.

Group taxation comprises special rules that are applicable to members of a group of companies under which the group is broadly assimilated for tax purposes to a single

⁴² This is the case in relation to the treaty between South Africa and the Netherlands in relation to royalties. See Article 12 of the Convention between the Republic of South Africa and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital that entered into force on 28 December 2008.

⁴³ By way of an example, Finland, Norway and Sweden refer to it as group consolidation. The United Kingdom and Ireland refer to it as group relief and Denmark as joint taxation.

company or entity.⁴⁴ This assimilation is expounded by an adoption of special rules used to offset the losses and profits of companies within a group. These provisions avoid the need to operate as a single legal entity with divisions or branches for tax purposes. In order to further neutralise the taxation within the group of companies, the gain on transfer of capital assets is ignored and only accounted for in the tax system when the assets are transferred to persons who do not form part of that group.⁴⁵ Generally, most countries that apply these provisions allow tax consolidation for resident companies. However, some countries offer worldwide tax consolidation.

The South African tax dispensation does not provide for group taxation. However, as will be seen in Chapter 10, the tax provisions applicable to company restructuring provide some relief to a limited extent akin to group taxation.

4.6.2 Fiscal Unity System

Under this system the company group is treated as a single business entity for tax purposes. The group pools the profits and losses of the group members and files a joint and consolidated tax return.⁴⁶ According to Rohatgi “[g]enerally the losses incurred before the consolidation period by a company are not applied to offset joint profits within the tax group. However, such losses may be carried over by the particular company for offset against its own future profits.”⁴⁷

There are variations as to the treatment of gains and losses. For example, the fiscal unity option in Luxembourg does not lead to taxation of the group on its consolidated profits. “Rather, the tax base of each of the members of the fiscal group is calculated separately and includes transactions between members of the fiscal unity, which should be carried on under commercial conditions. Subsequently, the individually computed tax base of

⁴⁴ *IBFD International Tax Glossary* definition of “group treatment”.

⁴⁵ Rohatgi *Basic International Taxation* (2005) 256.

⁴⁶ Rohatgi 256.

⁴⁷ Rohatgi 256–257.

each member is added up and taxed at the level of the parent company.”⁴⁸ Due to the merging of companies’ tax liabilities into one, it is rare for non-resident companies to be allowed to participate in this system.⁴⁹

The benefits of a fiscal unity system include:⁵⁰

- A determination of consolidated tax statements on the basis of current rules. In this regard, an application of homogeneous calculation rules favoured by application to all subsidiaries in a group makes group taxation procedures easier and more accurate;
- Creation of a system of audits protecting the parent company or organisation in relation to joint liability for the fiscal data of the entities included in the consolidation area; and
- A reliable assessment of the tax benefits of including an entity or a number of entities in the consolidation area.

4.6.3 Group Contribution System

Also referred to as the intra-group contribution system, this system involves the contribution by profit-making companies in the group to one or more loss-making companies within the same group.⁵¹ Contributions so transferred are tax-deductible for the paying company and taxable for the receiving companies. Each company files its own tax return and pays its own taxes. Generally, the system requires that both the receiving and paying companies must be resident for tax purposes.⁵²

⁴⁸ “Inconsistency of Luxembourg Fiscal Unity Rules with Tax Treaties and EU Law” http://www.ey.com/GLOBAL/content.nsf/Luxembourg_E/Inconsistency_of_Luxembourg_fiscal_unity_rules_with_tax_treaties_and_EU_law accessed on 08 July 2008.

⁴⁹ See further in the “Country Examples” discussion below.

⁵⁰ http://www.finconsgroup.com/Offers/Proprietary_Solutions/Fiscal_Accounting.kl accessed on 02 July 2008.

⁵¹ Commission of the European Communities, *Communication from the Commission to the Council, The European Parliament and the European Economic and Social Committee, Tax Treatment of Losses in Cross-Border Situations* SEC (2006) 7.

⁵² See Rohatgi 257.

To the extent that the group contribution system is used to eliminate losses, it has the same economic effect as a group relief system described below.⁵³ The benefit of this system is generally that the profit-making companies reduce their taxable income by transferring some or all of it to loss-making companies. The loss-making companies offset the income against the losses made. Consequently, the tax on the group of companies is reduced.

4.6.4 Group Relief System

This system is the reverse of the group contribution system. In the group relief system a loss-making company surrenders its current losses to the profitable companies in the group.⁵⁴ The transferee company will then be able to utilise the transferred losses to offset against its taxable profits. Each company files its own tax return and pays its own taxes. The surrender of current losses can be done with a subvention payment or without such a payment. A subvention payment is an inter-company payment specifically made for the transfer of company losses for trading or other reasons.⁵⁵

4.7 FOREIGN EXCHANGE GAINS AND LOSSES

4.7.1 Introduction

Foreign exchange gains and losses arise when a financial obligation arises in a foreign currency, payment is made at a future date and there are currency fluctuations between the time the obligation arose and the time the obligation is discharged.⁵⁶ These gains and losses arise “in connection with assets and liabilities denominated in a currency other

⁵³ See Commission for European Communities 7. See also Äimä and Kiikeri *Direct tax rules and the EU fundamental freedoms: origin and scope of the problem; national and Community responses and solutions, Finland*, (2006) 5 <http://www.fide2006.org/TOPC1/Tax%20Kiikeri%20Finland.pdf> accessed on 02 July 2008.

⁵⁴ See Rohatgi 257. See also *Payments for Loss Transfers under the Group Relief System — the GST Angle* <http://www.lawgazette.com.sg/2003-8/Aug03-col.htm> accessed on 01 July 2008.

⁵⁵ *IBFD International Tax Glossary* definition of “subvention payment”.

⁵⁶ See Olivier and Honiball 575. See also *IBFD International Tax Glossary* definition of “foreign exchange gain and loss”.

than the currency in which a person's accounts are maintained, and are caused by fluctuations in the value of the two currencies relative to each other."⁵⁷ For example, in a contract of sale a South African buyer agrees to pay a seller US\$ 100 in twelve months' time and the exchange rate at the time of the conclusion of the contract is US\$ 1 = ZAR 7. If at the time of payment the rate is US\$ 1 = ZAR 6, the cost of the contract for the buyer would have decreased by ZAR 100, in which case the buyer would theoretically have made an exchange gain of ZAR 100. Should the currency take the opposite direction the buyer would have a foreign exchange loss in respect of the sale contract.

4.7.2 Tax Treatment of Foreign Exchange Gains and Losses

Different jurisdictions treat foreign exchange gains and losses (hereinafter referred to as "FEGGL") differently.⁵⁸ Certain jurisdictions do not tax or allow a deduction for FEGGL. Other jurisdictions tax the gains and allow the deduction of the losses. The other option is to tax the gains but not to allow the losses. This option is not popular with taxing jurisdictions.

There are a few other distinctions of treatment of FEGGL.⁵⁹ Based on the different treatment in different jurisdictions, an IHC can be used to obtain tax benefits where there are foreign exchange losses that reduce the negative tax consequences in relation to foreign exchange gains. Thus, depending on the tax treatment in the investor's residence country and the currency fluctuations, it might be prudent, from a tax point of view, for

⁵⁷ *IBFD International Tax Glossary* definition of "foreign exchange gain and loss".

⁵⁸ The United Kingdom, New Zealand, Ireland and Canada are examples of countries that foreign exchange gains and allow deductions for losses. Allen and Overy "Where are we now on foreign exchange gains and losses". See Haccius *Ireland in International Tax Planning* (1995) 546; CCH New Zealand Limited New Zealand Master Tax Guide (2007) 6:213 FBC "Foreign Exchange Losses are Deductible" http://www.fbc.ca/Keep_Current/Articles/articles02160502.asp accessed on 13 June 2009; <http://www.allenoverly.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&contentSubTypeID=7944&itemID=50601&prefLangID=410> accessed on 13 June 2009.

⁵⁹ For example, the taxation of foreign exchange gains and losses may not necessarily be the same as the underlying transaction, asset or liability. The timing of taxation of foreign exchange gains and losses often differs. The tax treatment may vary for monetary and non-monetary items or depend on the nature of the monetary item. The choice of method may or may not follow the accounting treatment. Certain exchange losses may be 'ring-fenced' and only offsettable against the profits from the same business activity. See Rohatgi 536.

an investor to move FEGL to a country where the transactional foreign exchange gains and losses will be recognised.

4.8 RE-CHARACTERISATION OF INCOME

One often finds, in international tax, instances where items of income are treated differently in different jurisdictions. The difference might be in the way one jurisdiction regards certain income derived in that jurisdiction differently from how the other(s) treat the same income. The other version is where income earned in one jurisdiction is treated in one way, but when it is received by a resident of another jurisdiction, that other jurisdiction treats it differently.

4.8.1 Income Paid and Received in the Same Jurisdiction

An IHC can be interposed in a jurisdiction apart from the jurisdiction of the investor where the group companies carry on business operations in order to receive the income arising out of the business operation in the host country. This would arise where, for example, the income earned by a branch in that host country is taxed at a higher rate than resident companies.

This situation arises where the investor has business operations in the host country and intends to utilise a different structure to benefit from the favourable treatment of income arising from the host country and earned by a resident.

4.8.2 Income Received from a Different Jurisdiction

The different ways in which income is classified often result in income earned in one country being treated differently from how it is treated in the recipient's country. This often occurs where dividends and interest are concerned. However, other instances are where the entities paying (or arguably even receiving) the income are not treated similarly in the different jurisdictions.

In the USA, for example, a Limited Liability Company (hereinafter referred to as “LLC”) has three tax options depending on whether it “checks the box” or not. The “check-the-box” system allows the LLC to be taxed variously as a Company, Partnership or S corporation.⁶⁰ When a dividend from such a corporation is declared to a non-resident a mismatch in treatment may arise where it “checked-the-box” and it is treated as a partnership but the investor country treats it as a company. This might result in higher effective tax rates as the host country would tax the income in the hands of the partner based on source and the investor’s country might tax the income as a dividend, with or without the application of a DTA. The converse might result in an avoidance of taxation with the application of a DTA.

For the South African circumstances Olivier and Honiball⁶¹ give the following example:

Company A, a South African resident investor, sets up an intermediary holding company, Company B, in Australia. Company A funds the investment with preference shares which have terms similar to a loan. Company B, in turn, sets up Company C in Australia. Company B uses the proceeds of the investment to make a loan to Company C, which is resident in Australia. Company B receives interest on the loan, which is taxable. However, Company B may deduct the preference dividends declared to Company A because the preference investment is regarded as a loan. Company A could be regarded as receiving an exempt dividend for

⁶⁰ An S corporation, for United States federal income tax purposes, is a corporation that makes a valid election to be taxed as a company or as a flow-through entity. S corporation status provides many of the benefits of partnership taxation and at the same time gives the owners limited liability protection from creditors. Generally, an S corporation is exempt from federal income tax other than tax on certain capital gains and passive income. On their tax returns, the S corporation's shareholders include their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of non-separately stated income or loss. See CCH Editorial Staff Publication, *Top Federal Tax Issues for CPE Course* (2006); Internal Revenue Service *S Corporations* available at www.irs.gov/businesses/small/article/0,,id=98263,00.html accessed on 11 June 2009. For a discussion of the taxation of S corporations see Perez *S Corporation Taxation* available at http://taxes.about.com/od/scorporations/qt/scorp_taxation.htm accessed on 11 June 2009. See CCH Editorial Staff Publication *US Master Tax Guide* (2008) par 301.

⁶¹ See Olivier and Honiball 303.

South African tax purposes, either because it is a foreign dividend received from a designated country which has been subject to tax at the qualifying statutory rate (until 2004), or from 2004, because it holds preference shares that have terms enabling the shareholder to participate to the extent of more than 25% in the total equity share capital of Company B and the other requirements of s 10(1)(k)(ii)(dd) ... Consequently, in these circumstances this particular preference share investment is a hybrid instrument ... However, it was not solely the preference share investment which caused the recharacterisation of the nature of the income for Company A, but also the interposition of Company B, the intermediary holding company. Of course, withholding taxes on the relevant income, such as the Australian withholding tax on interest, may reduce the overall tax benefit, where applicable.

4.9 UTILISATION OF A LIQUIDATION LOSS

Some tax regimes such as Japan,⁶² the Netherlands⁶³ and the United States of America⁶⁴ allow companies to deduct a certain amount of income as a liquidation loss. A liquidation loss occurs where a company liquidates its subsidiary that has realised only losses in its business ventures.⁶⁵ Therefore, where a group decides to venture into a risky business, it may be beneficial from a tax point of view to incorporate an IHC in a country where a liquidation loss is allowed to be deducted in the hands of the holding company. The IHC would then be able to use the loss to set off against the income of other subsidiaries or its own income.

The liquidation loss is normally limited to a certain amount, e.g. R100 million. In addition, the local rules may restrict the sale of an IHC, or not allow the deductibility of

⁶² See <http://ir.capcom.co.jp/english/news/pdf/e081217.pdf> accessed on 19 January 2009.

⁶³ See <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12602&SID=470125&TYPE=20> accessed on 19 January 2009.

⁶⁴ See <http://www.thefreelibrary.com/Fitch:+U.S.+CMBS+Loss+Severities+Vary,+But+Overall+Continue+To...-a0155655760> accessed on 19 January 2009.

⁶⁵ Based on a discussion with Mr Serge de Reus, Partner/Director of Corporate International Tax at PricewaterhouseCoopers on 19 September 2008 in Sunninghill, Johannesburg.

the losses where the IHC, or a certain percentage of its shareholding, is sold.⁶⁶ Furthermore, as is the case in the Finnish system, the holding company may not be allowed to deduct a loss where it does not carry on active business activities.

4.9 CONCLUSION

While tax is not the main reason why IHCs are used, inevitably and increasingly tax considerations play a major role in the decision as to the location of an IHC. The tax cost impacts on the general profitability of business enterprises.⁶⁷ The desirable situation is one where the taxes do not tremendously influence (either positively or negatively) the pure business and economic reasons on the setting up and conducting of business activities. Such an endeavour would, in any event, be sabotaged by the high cost of maintaining an IHC formed for no business reasons.

Certainly, an enterprise's cash flow and viability could be affected by poor tax planning. This results in tax decisions being part of business planning, as much as marketing strategies, corporate labour policies and management decisions. A distinction should be made between radical tax-planning strategies in terms of which enterprises are set up to take advantage of the tax system and where an investment idea is developed and tuned to take advantage of the available favourable tax regime. The former is tax-driven while the latter is business-driven.

It is, however, acknowledged that the dividing line gets thinner as specific scenarios are pondered. In the end, investors can use an IHC to take advantage of the tax system where its interposition in a certain jurisdiction would result in an overall tax saving for the company group. An example of this is where the IHC is formed to trap dividends in a host country which has a DTA with the countries of residence of the operating companies, and where the home country does not have a good treaty network.

⁶⁶ See Juusela "Finland: Court Decision on Liquidation Loss" (2009) *International Tax Review* <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=25471&SID=722231&SM=&SearchStr=%22holding%20company%22> accessed on 16 November 2009.

⁶⁷ See Eynatten "European Holding Company Tax Regimes: A Comparative Study" (2007) *European Taxation* (Vol. 47 Issue 12) 562-570.

There is no doubt that sometimes tax reasons play a role in the decision to form an IHC, especially where the tax system in the investor's home country is adverse to the business of the company group.⁶⁸ Whether the IHC was created for tax reasons or not does not have an impact on its status as an IHC. Put differently, the status of a company as an IHC is not changed by the fact that it was created to achieve certain tax purposes. It would only be the nature of the IHC's activities would change a company from being an IHC to one that is not an IHC.

As indicated above, where the activities of the IHC migrate into the activities of another form of business enterprise, such as an international headquarter company, its tax treatment in the home and host country will reflect the activities of an international headquarter company. This does not detract from the fact that the functions of the IHC may be mixed. The tax regime would determine the amount of non-IHC activities that would disqualify the purported IHC from functioning as such. Alternatively, the income of the IHC could be apportioned in accordance with the volume and nature of its activities.

Investors tend to design their businesses and construct the ideal environment for their investments prior to identifying such an environment. Once the non-tax and tax reasons for setting up an IHC have been identified, the next step is to identify a host country with such tax attributes. These relate to the characteristics of the tax regime and legal system, as well as the social and economic environment in the potential host country. It becomes important to consider a jurisdiction based on both the ease with which an IHC could be established and the tax characteristics of the host country, as these characteristics would impact on the economic viability of the IHC. In the chapter that follows, these two considerations are discussed.

⁶⁸ Discussion with Mr Frank Mosupa, Partner Corporate and International Tax, Bell Dewar Attorneys, Johannesburg on 24 April 2009.

CHAPTER 5

CHARACTERISTICS OF AN IDEAL LOCATION TO ESTABLISH AN IHC

5.1 INTRODUCTION

Once an investor has determined that the business structure of his or her investments require the establishment of an IHC to achieve some or all of the tax and non-tax objectives mentioned in the previous two chapters, the investor engages in identifying a jurisdiction with the infrastructure that would optimally enable the attainment of such objectives. Infrastructure presents itself in the characteristics, both tax and non-tax, of the particular jurisdiction. Easson, however, remarks that “[i]n many cases, a decision is made to invest abroad and, only then a shortlist is drawn up of suitable locations for that investment”.¹

In Chapters 3 and 4 the reasons for establishing an IHC were discussed. In this chapter the tax characteristics of an IHC jurisdiction and methods of establishing an IHC are examined. This chapter focuses on the suitability of a jurisdiction to host an IHC, thereby realising the objectives discussed in the previous two chapters.

The tax regime that applies in respect of a specific location is generally a key factor for determining the efficiency of an IHC and usually plays a role as far as a decision on the jurisdiction where the IHC should be established is concerned. It is important to examine the methods of setting up an IHC – particularly in view of the fact that the setting-up methods are not based only on the tax principles. An investor would need to identify the best possible method to be adopted in setting up an IHC, based on such investor’s peculiar needs. As such, this chapter also discusses the methods that are available to establish an IHC.

¹ Easson *Tax Incentives for Foreign Direct Investment* (2004) 17.

5.2 NON-TAX CHARACTERISTICS OF AN IHC JURISDICTION

An IHC requires infrastructure that is conducive to the performance of its operations and the achievement of its goals. Factors that affect the choice of location, locational determinants, in other words, will differ from one IHC to another, depending on the objectives of the investment. The more important non-tax factors include: economic and political stability; adequate physical, business, accounting and legal infrastructure; the absence (or limited presence) of bureaucratic obstacles; adequate communication channels; the ability to repatriate profits freely; an effective banking system; and the availability of an adequate dispute resolution mechanism.²

The social, economic and political stability and risk within different countries are major considerations in the decision-making especially where the need for the raising of finance is important.³ A factor that supplements the social, economic and political stability is the functionality of the country's legal system and rule of law. Thus, not only should the legal system be suitable for transacting but it should also be possible for legal subjects to enforce their legal rights (in light of the fact that the IHC would enter into legally binding agreements with residents). The alternative dispute resolution as a legal process is normally an expedient and cheap alternative to the often lengthy legal processes. Where available, it too should be dependable.⁴

The country's government should also respect the rule of law and ideally have an enshrined constitution that protects the rights of the country's subjects. As Olivier and Honiball⁵ observe, "... a combination of operational business activities with an intermediary holding company in a single legal structure could expose an operational

² See Udal and Cinnamon "How to select a Jurisdiction for Your Holding Company" (2004) *International Tax Review*
<http://proquest.umi.com/pqdweb?did=789908371&Fmt=3&clientId=27625&RQT=309&VName=PQD>
accessed on 19 October 2009.

³ Olivier and Honiball *International Tax – A South African Perspective* (2008) 304.

⁴ See further on the factors that make a jurisdiction suitable for investment Cinnamon "Tasty Regimes Tempt Holding Companies" (1999) *International Tax Review* (Vol. 10) 9-11.

⁵ Olivier and Honiball 305. See also Rohatgi *Basic International Taxation* (2002) 239; Udal and Cinnamon *International Tax Review*.

company's assets and investments to commercial risks. Stable laws and ease of compliance could assist in offsetting such risks".

The commercial language of the host country is also important. It is important that the language used is the same as the language of the investor (or at least a common language such as English or French). The importance of this factor is illustrated by the loss of popularity of the Danish holding company structure due to the requirement that compliance and reporting documentation had to be in Danish.⁶ Linked to the prevailing commercial language are reliable communication channels such as telecommunication, fax and email without which the management role would be particularly impaired.⁷

As it mainly deals with acquisition, management and disposal of investments for group companies (and the discharging of such services requires a high level of skill in financing and financing structures, economics, accounting and auditing), the IHC does not necessarily require employees to be stationed in the host country. The acquisition, management and disposal of assets in the operating companies can be done electronically or from a country other than the host country of the IHC.⁸

5.3 TAX CHARACTERISTICS OF AN IHC JURISDICTION

An ideal or beneficial IHC jurisdiction depends on the specific characteristics of that jurisdiction. The degree of flexibility required by a multinational group of companies is also paramount when juxtaposed with such a jurisdiction. The critical characteristics that must be met by a potential jurisdiction are discussed below.⁹

⁶ Olivier and Honiball 305.

⁷ See Cussons P and Bojkovic M "Where do I hold my company?" (1998) *Accountancy* (Vol. 122, Issue 1262) 124-125.

⁸ However, where it is not a pure intermediary company, employees may be required to carry out the extensions of its business.

⁹ See further on a summary of the essential characteristics, *Netherlands: Dutch Holding Companies*, <http://www.lowtax.net/lowtax/html/offon/netherlands/nethold.html> accessed on 21 August 2008.

5.3.1 A Favourable Capital Gains Tax Regime

In its purest form, the purpose of an IHC is to acquire, manage, or sell investments in domestic or foreign companies.¹⁰ However, sometimes the purpose of an IHC company is extended to the reinvestment of excess dividends at the IHC level to obviate the need to remit the dividends to the ultimate holding company, in cases where remitting the dividends to the ultimate holding company has tax or exchange control disadvantages.¹¹ If an IHC is to carry out an acquisition, the criteria for choosing a holding company venue would include the intermediary country's tax treatment of the subsequent sale of the target.¹²

Based on the above and given that an IHC holds the shares of the group companies, it is very important for the potential IHC jurisdiction to have a tax system that is lenient in respect of the taxation of capital gains. The burdensomeness or otherwise of a tax system on capital depends not only on the rate of tax charged on capital. To a very large extent it depends on the rules for determining the acquisition price of assets, realisation and recognition rules and rules for determining gain or loss on disposal.¹³

The contours of the concept of capital gains and losses vary considerably from country to country. This concept also plays a different role in different systems. Generally it refers to a non-recurring gain which is not part of the normal stream of income involved in a business or investment.¹⁴

¹⁰ IHCs operating in this form are referred to as a “pure intermediary holding companies”.

¹¹ Olivier and Honiball 297. See Evans “The Australian Capital Gains Tax: Rationale, Review and Reform” 14 *Australian Tax Forum* (1998) 287.

¹² See 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.

¹³ See Burns and Krever “Taxation of Income from Business and Investment” in *Tax Law Design and Drafting* (ed Thuronyi) (1998) 646.

¹⁴ Ault and Arnold *Comparative Income Taxation: A Structural Analysis* (1997) 194.

5.3.1.1 Determining the Acquisition Price

Acquisition price¹⁵ is generally the consideration given for the creation or acquisition of an asset.¹⁶ According to Burns and Krever¹⁷

[t]his should include any borrowed funds used to acquire the asset. Where the taxpayer has given consideration in kind for the asset, the market value of the in-kind consideration at the time of the acquisition should be included in the cost base of the asset. The cost base of an asset should include any ancillary costs incurred in the acquisition of the asset such as legal and registration fees relating to transfer of the ownership of the asset, transfer taxes, agent's fees, installation costs, and start-up expenses to make the asset operational. The cost base of an asset should also include any capital expenditures incurred to improve the asset and expenses incurred in respect of initial repairs.

Most jurisdictions follow this pattern, thus resulting in the definitions or classifications of base cost being manifold. Acquisition costs could extend to the costs of insuring the asset, cost of remuneration of advisors or consultants involved in the acquisition of the asset, costs of moving the asset, cost of any improvement or enhancement of the asset during the acquisition, etc. The broader the coverage of expenditure included in the definition of base cost, the more favourable the taxation of capital.¹⁸

5.3.1.2 Timing and Event for Realisation of Gain or Loss

The second important aspect is the event giving rise to the realisation of gain or loss. Capital gains, unlike revenue gains, are generally not realised on accrual or receipt but on

¹⁵ Acquisition price is also referred to as “base cost”, “basis”, “cost price”, “book value” or “cost base”

¹⁶ See par 20 of the Eighth Schedule to the Act. See also Burns and Krever *Tax Law Design and Drafting* 648.

¹⁷ Burns and Krever *Tax Law Design and Drafting* 648–649.

¹⁸ Where there is part disposal of an asset, the rules generally provide for apportionment of part of the cost of the original asset to the part of the asset sold.

the disposal of the asset or the cessation of ownership of the asset.¹⁹ “In its ordinary meaning, disposal covers all situations in which the ownership of the asset changes.”²⁰ Not only does it cover voluntary alienation of assets. It also covers, ordinarily or per deeming provisions, redemption, forfeiture, expiry, cancellation, renunciation, surrender, loss, destruction and abandonment.²¹

Deemed disposals increase the scope of the realisation events. In this regard Burns and Krever²² state that “[t]he effect of a deemed-disposal is to treat a particular event as giving rise to the disposal of an asset for a consideration that is equal to either the market value or the cost base of the asset at that time depending on the circumstances.” Therefore, the fewer the deeming rules in this case, the more attractive the capital tax system.

Systems provide for the disposal rules when the assets or shareholders of a company exit the tax system. Others provide also for a disposal when the residence of a company is changed.²³ These are major considerations for IHCs, as some or all of its assets may be itinerant. If the disposal events are vast, numerous and broad, the chances of business actions being taxable increase and this presents a disadvantage to the jurisdiction being considered for the location of an IHC.

5.3.1.3 Amount Included in Calculation of Taxable Capital Gains

The amount that is included in the calculation of taxable capital gains is the proceeds of the disposal less the base cost. This includes the market value of any asset given (or given in part) in return for the asset. Where the asset is disposed of for no consideration or a

¹⁹ Whiteman *et al* *Whiteman on Capital Gains Tax* (1980) 23.

²⁰ Burns and Krever *Tax Law Design and Drafting* 647. See also Boidman and Ducharme *Taxation in Canada, Implications for Foreign Investment* (1985).

²¹ See Burns and Krever *Tax Law Design and Drafting* 647.

²² Burns and Krever *Tax Law Design and Drafting* 648.

²³ Burns and Krever *Tax Law Design and Drafting* 647.

consideration that is less than the base cost, the seller would be in a capital loss situation.²⁴

These losses can be set off against all income or only against capital gains. It benefits the investors more where the losses are not ring-fenced as they can be set off immediately against the income as opposed to being deferred until the next capital gains event in which a gain is realised. The problem is exacerbated by the fact that most countries do not adjust tax losses for inflation, therefore eroding their value through the passing of time.

Special rules also apply to situations where an asset is involuntarily disposed of for a loss and compensation is received by the taxpayer in respect of that destruction (or loss). Generally no gain is recognised in so far as the compensation received does not exceed the base cost of the asset destroyed.

5.3.1.4 Disposals between Connected Persons

Connected persons²⁵ may choose to transfer assets *inter partes* to achieve various objectives, including minimising the recognition of gain to defer taxes, inflating gains to absorb losses that were carried forward, value shifting to transfer gains to a lower bracket or exempt taxpayer, etc.²⁶ Non-arms-length transactions are mostly subject to deeming provisions. The person disposing of the asset is deemed to have received a consideration equal to the market value of the asset at the time of the disposal. At the same time, the amount is treated as the base cost of the asset for the person acquiring the asset.²⁷ As

²⁴ Whiteman *Whiteman on Capital Gains Tax* (1988) 27.

²⁵ Connected person is a defined term in the South African tax legislation (see s 1 definition of “connected person”). Internationally a reference is made to “related party” and “associated person”. The definition differs from country to country and from situation to situation mainly depending on the purpose of the definition and the context in which it is used. Generally, such definitions include blood relatives, lineal descendants and ancestors, members of the same partnership, and a company, its controlling shareholders and other companies in the same group of companies. See IBFD International Tax Glossary definition of “connected person”.

²⁶ Burns and Kreyer *Tax Law Design and Drafting* 651.

²⁷ Burns and Kreyer *Tax Law Design and Drafting* 651.

IHCs are generally members of a group of companies, tax-free intra-group transfers are essential for the carrying out of the functions of the IHC.

5.3.1.5 Roll-Over Provisions

Roll-over provisions are rules that regulate the non-recognition (or ignorance) of the disposal of an asset in the year that the asset was disposed of.²⁸ This applies both to actual and deemed disposals. The tax system treats the disposal of the asset as if it was disposed of at cost or base cost and the acquirer to have acquired it for a consideration equal to the original cost.²⁹

Three main situations where roll-over provisions are relevant for IHCs are –

- Firstly, where the tax status of an asset changes, for example where an asset acquired as a business asset or an item of inventory is subsequently held as an investment asset or *vice versa*.
- Secondly, where an asset is disposed of with an intention to trigger a loss to countenance the gain made in respect of other assets that are disposed of, the tax systems often deny the loss recognition and impose a roll-over treatment.
- Thirdly, where an asset is disposed of involuntarily and a replacement asset is acquired, non-recognition rules apply.

These provisions normally apply on condition that the proceeds of the disposal (such as insurance payments) are used to acquire a replacement asset of a similar kind to the disposed asset within a specified time.³⁰

As the saying goes, “tax deferred is tax saved”, so investors are likely to be attracted to countries where there is an abundance of roll-over provisions.

²⁸ See *IBFD International Tax Glossary* definition of “rollover relief”. See also <http://www.ftomasek.com/RickKreverDraft.html> accessed on 28 October 2008.

²⁹ Burns and Krever *Tax Law Design and Drafting* 652.

³⁰ Burns and Krever *Tax Law Design and Drafting* 654.

5.3.1.6 Capital Gains Tax Rate

Generally, capital gains are given preferential treatment in tax.³¹ The rates are normally lower than the rates of income tax. Capital tax rates are usually the first issue addressed when the suitability of a jurisdiction to host an IHC is being considered. In effect the rate should not be that important because the effective rate is decisively affected by the rules outlined above. As is the case with income tax rates, capital tax rates can be represented by a low percentage (e.g. 2%), or a numerical division of a unit of currency (e.g. 2 cents in each Rand).

In addition to the aforesaid, they can, as is the case in South Africa, be further determined by usage of an inclusion rate. This method includes a certain percentage of the gain in the normal taxable income of the taxpayer and the amount is taxed at the normal tax rate applicable to that taxpayer.

5.3.2 Low Income Taxes

Income tax is the most important source of direct taxation for almost all countries. It is also referred to as normal tax and generally caters for all income, other than that specifically provided for like donations tax, estate duty and capital gains tax. As a result, a discussion on income tax in this context cannot be about the lack thereof, as that would be superficial. It is limited to the rate of tax and the chances of reducing the effective tax payable.

Some countries levy income tax on their residents and others on the income earned from a source within that country. Generally, the residence-based systems enjoy a broader tax base than the source-based ones. Therefore, most countries change their systems in favour of the residence basis. This move is not very favourable for IHCs, as the IHC could be taxed on its capital gains made from countries other than its country of residence in which its subsidiaries are located. However, a double tax treaty between the host

³¹ See Whiteman 27.

country and the country of the subsidiaries may significantly influence the countries' right to tax.

The effective income tax rate can be reduced by exemptions, deductions and allowances. It can also be reduced by tax incentives that a country may use to attract investors. Such incentives can be general such as tax holidays, investment allowances, tax credits, timing differences, tax rate reductions or incentives based on administrative discretion.³²

It should be noted that tax incentives have generally lost their popularity due to the fact that they do not achieve most of their purposes as investors exploit them and exit the country once the incentive ceases to benefit the taxpayer.³³

5.3.3 No or Low Tax on Dividends

The measure of a company's success is the amount of dividends that that company distributes to its shareholders alongside the appreciation of the value of the company (in the form of retained earnings that translate into the increase in the value of the shares). Each company's ultimate objective is to make enough profit and to pass on that profit to its shareholders as a dividend, unless such amounts are reinvested in the company. The company, at best, would like the value of its undistributed profits to translate into the amount of dividends received by its shareholders without, or with the least, liability for tax.

A low tax on dividends is an overarching statement that encapsulates both a numerically low amount of tax payable thereon or it can refer to a thin dividend tax base.

³² Incentives can also be special-purpose based such as those dedicated to famine relief, infrastructure development, employment creation, technology transfer and export promotion.

³³ See Bolnick *Technical Report on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region* (2004) (Unpublished report for the Southern African Development Community)

5.3.3.1 Numerically Low Amount of Tax on Dividends

This favourable type of low tax on dividends, which again can be represented by either a low percentage (e.g. 2%) or a numerical division of a unit of currency (e.g. 2 cents in each Rand), is frequently used to apply to dividends generally or specific forms of dividends, e.g. where a participation preference is granted. It also gives the impression that tax jurisdictions have attractive tax regimes, as the low percentage is at the forefront of the information on taxation of dividends.

5.3.3.2 Thin Dividend Tax Base

The effective dividend tax rate can be low though not represented by the tax rate applicable thereto but by the amounts that are included in the base of dividends. This may be by way of restrictive dividend definition, fewer or no inclusions in the definition of dividends, exceptions, exemptions etc. Some jurisdictions have broader dividend tax bases covering most distributions by companies while others have considerably limited bases. The South African secondary tax on companies system (“STC”) on the one hand and the Canadian dividend tax system, on the other hand, represent such extremes.

Examples:

South Africa: Although it does not necessarily tax dividends, the effect of the STC is a tax on dividends. It is a tax on the company declaring the dividend as and when it declares the dividend.³⁴ It is a tax calculated with reference to the amount of dividends distributed. The calculation is based on the concept of profit. STC can therefore only be calculated on the amount of profit in a company that is distributed to the shareholder. If the distribution does not come from the profit of the company no STC is payable. Taxpayers could, therefore, reduce the amount that emanates from profits by inflating the company’s share capital and share premium accounts and distributing therefrom.

³⁴ *Volkswagen of South Africa (Pty) Ltd v CSARS* (Gauteng High Court case 24201/2007)

South Africa is in the process of adopting a new dividend tax system in terms of which any transfer of value from a company to a shareholder by virtue of the latter's shareholding is a dividend, unless the amount transferred comes out of the company's contributed tax capital. Contributed tax capital is the amount received by the company as consideration for the issue of shares by that company less the amount transferred to the shareholder in relation to those shares.³⁵

Canada: The Canadian tax system is probably one of the broadest systems. Under this system any distributions other than liquidation distributions or distributions pursuant to authorised reduction of capital are taxed as dividends. However, dividends received by a Canadian company from another Canadian company are tax-deductible. As a result they are effectively only taxed when they reach the ultimate individual shareholder.³⁶

Canadian corporate law provides for a distribution of paid-up share capital.³⁷ Such a distribution is deemed to be made before profit distributions for tax purposes. The excess over paid-up capital reduction is taxable as a dividend. The transaction is deemed to be a disposal for capital gains tax purposes. Any distribution out of the capital account of a company is deemed to be a dividend.

Furthermore, any benefit conferred on the shareholder is included in taxable income, for example a loan not repaid within one year. Such benefits do not qualify for imputation credit nor do they qualify for inter-corporate dividend deduction. On liquidation, the taxpayer's share of paid-in capital is received tax-free. If the acquisition cost is less than paid-in capital, the difference is a capital gain. Thereafter any additional amount is a dividend.³⁸

³⁵ See section 1 of the Act definition of "contributed tax capital".

³⁶ See the *Canadian Master Tax Guide* (2008) par 6030; Ernst & Young *Worldwide Corporate Tax Guide* (2006) 136.

³⁷ For these purposes corporate law provides for a determination of the stated or paid-up capital and limitations within which the distributions can be made.

³⁸ *Canadian Master Tax Guide* par 6000; Ernst & Young 136 – 137.

There is a huge range of possibilities between these extremes. The more restricted the inclusion into the dividend tax base, the more suitable the jurisdiction for IHC purposes. Ideally for an IHC, a jurisdiction should have no tax on dividends – or, if it has any, it should have a restrictive definition of a dividend with a low dividend tax rate.

5.3.4 No or Low Withholding Tax on Dividends

As with the low tax on dividends, a determination of a withholding tax is mainly informed by the nature of amounts that constitute a dividend and the numerical rate attached to that withholding. A withholding tax is normally not an underlying tax. The terminology hinges on a two-step construction in terms of which the dividend tax is determined and a withholding obligation is imposed on the company declaring the dividend to a non-resident to withhold that amount of the tax. Therefore, a withholding tax is an administrative intervention. It is common on dividends declared to non-residents, as the tax authorities would otherwise not have the legal power or jurisdiction to collect the tax payable on dividends.

The amount withheld is determined by national legislation but often reduced by treaties. As a result the investor would prefer a jurisdiction where there is either low or no withholding tax – or, where there is a high rate of withholding, it is in a country that has a good treaty network which includes treaty relief against the withholding. Alternatively, the group's income distribution track could require only a treaty between the host country and the ultimate holding company's country that relieves the declaration of a dividend out of the IHC from taxation.

5.3.5 A Favourable Treaty Network

A favourable network of tax treaties which limit withholding taxes in general levied on payments by and to other investment countries is one of the features that make a country suitable to host an IHC.³⁹

³⁹ See Udal and Cinnamon *International Tax Review*.

A preliminary question may arise in this context: What do treaties achieve such that a quest is made for a fertile network of them? They are generally treaties for the avoidance of double taxation. In this context Loncarevic⁴⁰ states that “juridical double taxation may be broadly described as subjecting the same income derived by a taxpayer during the same period of time to comparable taxes under taxation laws of two different countries.” This situation is created, as Harris⁴¹ suggests, where there is a “concurrence of limited or unlimited fiscal liability among national fiscal categories such as double allegiance or dual residence of a taxpayer.” Double taxation can have crippling consequences for investors earning income in jurisdictions other than countries where they are resident.

Treaties have the advantage of promoting international trade and investment by preventing double taxation through assignment of taxing rights via tax exemption or credits and through agreements on maximum withholding tax and thus reducing the overall tax burden.⁴² Loncarevic⁴³ states that “[o]n the other hand restrictions on tax avoidance and tax evasion, anti-treaty shopping rules, as well as exchange of information between tax administrators may have negative effects on international movement of goods, services, persons and capital since these measures reduce possibilities of taxpayers to avoid taxes through transfer pricing, treaty shopping, etc.”

It is not only the number of the treaties that is important. Perhaps even more important is the content of the treaty. As Vanhaute⁴⁴ states:

In deciding on a suitable jurisdiction for the location of a holding company, the availability of a treaty network, and moreover the scope of such network and its specific features are, of course, as important as in any

⁴⁰ Loncarevic “Economic Relevance of Double Taxation Conventions” in *Tax Treaty Policy and Development* (eds Stefaner and Züger) (2005) 19.

⁴¹ Harris “Reduction and Elimination of Economic Double Taxation by Tax Treaties” in *Tax Treaty Policy and Development* (eds Stefaner and Züger) (2005) 40.

⁴² Loncarevic *Tax Treaty Policy and Development* 19. See Vogel *Klaus Vogel on Double Taxation Conventions* (1997) 1130. See also Ault and Arnold 385 – 403.

⁴³ Loncarevic *Tax Treaty Policy and Development* 20.

⁴⁴ Vanhaute *Belgium in International Tax Planning* (2008) 157.

other international tax planning scheme. In this respect, the relevant factors to be considered are:

- the scope of the tax treaty network (number of treaties, with which countries, etc.);
- the attractiveness of these treaties in terms of accessibility, and the average level of withholding tax on interest, dividend and royalty income which may accrue to the holding; and
- the impact of certain limitation of benefits (LOB) clauses.

Investors looking to invest could limit their exposure to dividend withholding tax and capital gains tax by placing an intermediary holding company in a jurisdiction which has a double tax arrangement that limits dividend withholding tax and tax on capital gains.⁴⁵ While the prevention of double taxation is the main purpose of DTAs, they are also not intended to facilitate tax avoidance and evasion.⁴⁶

DTAs avoid double taxation by using the exemption or credits methods as well as by awarding some taxing rights exclusively to one country. The methods vary according to the negotiations between the countries. The OECD Model Convention and the UN Model Convention, as guides, outline both methods.

5.3.6 Unilateral Avoidance of Double Taxation

Countries have systems of unilateral avoidance of double taxation. In these systems the countries independently exempt income that was taxed in a source country or give credit for taxes incurred in those countries in respect of the same income.⁴⁷ This is a system that investors also look at in determining the suitability of an IHC host jurisdiction.⁴⁸ Where a country has adequate unilateral tax double tax avoidance provisions the purpose of the

⁴⁵ Nelson "China: How to Prepare for Implementing Rules" (2007) *International Tax Review* <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=24353&SID=697470&SM=&SearchStr=%22intermediary%20holding%20company%22> accessed on 13 November 2009.

⁴⁶ Such prevention of tax avoidance and evasion is achieved by the exchange of information provisions in the DTAs. See Van Weeghel *The Improper Use of Tax Treaties* (1998).

⁴⁷ Vogel 1174.

⁴⁸ See Udal and Cinnamon *International Tax Review*.

DTA would be to supplement such provisions. As Loncarevic⁴⁹ states, “[a] tax treaty supplements the unilateral double tax relief provisions in the respective treaty partner countries’ domestic law and clarifies the taxation position of income flows between them”.

Unilateral tax avoidance measures fail to provide investors with the sense of certainty that taxpayers need for investment as countries can and do amend or cancel them unilaterally. The certainty provided by treaties is effective in attracting foreign investors, as treaties reassure investors in advance as to how they will be taxed on their offshore profits.⁵⁰ Countries generally hesitate to violate their treaty obligations and would not want to be seen to abandon their original treaty undertakings by suggesting amendments.⁵¹ A source of guarantee and certainty to investors which is also a downside of treaties from a tax policy point of view is that treaties take long to amend as the amendment process requires bilateral negotiations between the treaty partners.

5.3.7 The Absence of Controlled Foreign Company (“CFC”) Legislation

Countries generally tax both residents and non-residents on the domestic-source income derived from their tax jurisdiction.⁵² Some countries tax their residents on their worldwide income irrespective of the source. Other countries tax residents on their worldwide income and non-residents on income that is sourced domestically. Countries that tax on a residence basis supplement their taxing authorities by subjecting their residents to tax on income made by foreign corporations in which residents hold substantial shares. The system deems income of CFCs as dividends though they are not declared.

⁴⁹ Loncarevic *Tax Treaty Policy and Development* 19.

⁵⁰ Loncarevic *Tax Treaty Policy and Development* 22.

⁵¹ Testimony of Barbara Angus, *US Department of Treasury before the Senate Committee on Foreign Relations on Pending Income Tax Agreements*, 24 September 2004, <http://www.treas.gov/press/releases/js1952.htm> accessed on 25 February 2008.

⁵² This could be varied by the provisions of a double taxation agreement. See Vogel “Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I) (1998) *Intertax* 219. See also Forst “The Continuing Vitality of Source-Based Taxation in the Electronic Age” (1997) 15 *Tax Notes International* 1455; Udal and Cinnamon *International Tax Review*.

Tax systems define CFCs for their domestic purposes. These definitions differ from country to country. The main difference relates to the shareholding by the resident and connected persons in the foreign company. However, a CFC can broadly be described as a foreign company over which its resident shareholders have sufficient influence to determine when to pay the dividends, and therefore can use such influence in the foreign company to defer the declaration of dividends, thereby deferring the tax thereon.⁵³

The effect of the CFC rules on the shareholders is considerable. Under the normal tax rules a shareholder cannot be taxed on his or her underlying share of the profits of a company until it is distributed to him or her as dividends. Without remedial legislation domestic tax on foreign-source income can easily be deferred or postponed by establishing a foreign corporation to receive the income.⁵⁴

The absence of CFC legislation is therefore one of the characteristics that would render a jurisdiction an ideal one for hosting an IHC. It is therefore important for prospective investors to examine the main features and application of CFC legislation in potential jurisdictions to determine the extent to which the CFC legislation is applicable. What follows is an outline of the main features to consider in CFC legislation.

5.3.7.1 Definition of Controlled Foreign Company

In jurisdictions where CFC provisions are applicable, the provisions would be legislated to become part of law. The CFC provisions never apply as part of the common law of any country. In such tax law sources, the operation of CFC provisions begins with the definition of CFC. The defining characteristics of CFCs are their residence in the foreign country and the control of the CFC by resident shareholders. As Arnold and McIntyre state:

⁵³ Rohatgi 305.

⁵⁴ Rohatgi 305 states: “The CFC rules counter the deferral of taxation in such companies. Under its rules, the income earned by a CFC is attributed on a current basis to the shareholders on a pro rata basis even when not distributed to them.”

[m]ost CFC legislation applies only to foreign corporations that are controlled by certain domestic shareholders. Control generally means the ownership of more than 50 percent of the outstanding voting shares. Some countries extend the concept of control to include ownership of shares having a value equal to more than 50 percent of the total value of the outstanding shares. A few countries have rules that presume residents to control a foreign corporation if they own less than 50 percent of the voting shares. For example, the Australian and New Zealand rules deem a resident to control a foreign corporation if the resident owns 40 percent or more of the voting shares of the foreign corporation. No country has adopted a *de facto* control test because of the difficulty of determining control of a widely-held corporation. The rationale for the control requirement is fairness. It might be unfair to tax resident shareholders on the undistributed income of a foreign corporation if they do not have sufficient power or influence to require the corporation to distribute its income.⁵⁵

The determining holding requirement in the CFC definitions differs significantly. Some countries do not base it on the issue of control. In these countries the determination is based on the ownership interest.⁵⁶ Where a person's voting interest does not accurately reflect the shareholder's economic interest in the company, control may be determined based on "market value circumstance".⁵⁷ To avoid obvious tax avoidance schemes, control generally includes indirect control and/or ownership.

⁵⁵ Arnold and McIntyre 90.

⁵⁶ France, Portugal and Denmark are examples of this. See Arnold and McIntyre 90.

⁵⁷ In New Zealand, market value circumstance is heavily relied on where the shareholder interests are to be determined. Market value circumstance exists where a person's voting interest does not accurately reflect the shareholder's economic interest and the shareholder's percentage ownership is determined by reference to both voting interests and the market value interests held in the company. Market value circumstance takes into account the existence of debentures, shares, options and other arrangements which may affect the balance of interests within the company to such an extent that a simple examination of voting power may be misleading. Lindsay *New Zealand Master Tax Guide* (2008) par 16:170.

The important deciding factor is the amount of control or interest in the foreign company that makes it a CFC. Here too the range is broad. While in most countries a minimum of 50%⁵⁸ is required, some countries go as low as 25%.⁵⁹ This holding can be through one resident or more, either connected or unconnected persons. These constructive ownership rules are designed to prevent taxpayers from avoiding the CFC rules by fragmenting the ownership of the shares among connected persons.⁶⁰ In some countries, the CFC control requirement is satisfied if control is concentrated in a small number of resident shareholders.⁶¹

CFC rules also provide for holdings in terms of percentages which may not be taken into account in determining whether a company is a CFC or not. This ensures that where unconnected shareholders hold a minimum holding in a foreign company, such minimum holding does not change the treatment of the company. This is probably partly in order to acknowledge the control issues, as each shareholder has too little to determine the declaration of a dividend.

Furthermore, on the imputation of the income to the residents, certain minimum shareholdings do not attract attribution to the residents. In South Africa, where a person holds less than 10% of the shares in the CFC his or her pro-rata share is not attributed to him or her.⁶²

⁵⁸ In France the percentage holding required is 50%.

⁵⁹ The required percentage holding in Portugal and Denmark is 25%. See Ernst & Young 216 and 756.

⁶⁰ Where the holding requirement refers to connected or related persons the required holding per person is generally low.

⁶¹ For example, Australia (s 340 of the Income Tax Assessment Act of 1936), Canada (s 112 of the Income Tax Act) and New Zealand (s EX1(1) of the New Zealand Income Tax Act of 2004) require that for a foreign corporation to be a controlled foreign corporation five or fewer residents should control such a corporation. In other countries, even foreign corporations that are widely held by resident shareholders are considered to be controlled foreign corporations. The concentrated ownership requirement is related to the rationale for a control test. Whenever the shares of a foreign corporation are widely held by resident shareholders, those shareholders are unlikely to be able to exercise sufficient power over the corporation to require it to make distributions. The South African provision does not require that the residents be connected or related. Three residents each holding 17% of shares in a foreign company render the company a CFC. See section 9D definition of “controlled foreign company”.

⁶² See Proviso (A) to section 9D(2).

Investors would be more attracted to a jurisdiction where the holding in a foreign company needs to be high (for example 60%) for a company to be a CFC, where widely held foreign companies are treated differently from companies held by connected residents, where the minimum participation exemption for attribution is high and where the income is only attributable to persons holding a certain higher amount of shares. For IHC purposes the more limited the application of CFC legislation, the more the flexibility to structure the holding of the underlying investments with, for example, its ultimate holding company.

5.3.7.2 Computation of Attributable Income

It is also essential for the investors to know what constitutes attributable income in the potential jurisdiction as compared to other jurisdictions. The income is generally attributed to the resident shareholders and computed in accordance with domestic tax rules and in domestic currency.⁶³ In determining attributable income, two different approaches are adopted by countries, i.e. the entity and the transactional approach. Some countries adopt the entity approach while others adopt the transactional approach.

a. The entity approach

The entity approach looks at the fact that a foreign company is a CFC. Once that is determined the income of that entity is attributable to the resident shareholders irrespective of the source of that income or the nature of the transaction that the company would have entered into to generate that income. This approach entails an all-or-nothing inclusion mechanism.⁶⁴ According to Arnold and McIntyre, “[i]f a CFC does not qualify for any of the exemptions, all its income is attributable to its domestic shareholders. If, however, the CFC is exempt, none of its income, even passive income, is attributable to its domestic shareholders.”⁶⁵

⁶³ Arnold and McIntyre 96.

⁶⁴ There are, however, exceptions to the general rule.

⁶⁵ Arnold and McIntyre 94.

The entity approach attributes the net income of the CFC. This is so because attribution of the gross income would not take into account the cost of making business in the country where the CFC is resident. The residence country would then generally grant foreign tax relief.

b. The transactional approach

The transactional approach, on the other hand, attributes only certain kinds of “tainted income” to the resident shareholders. “Under the transactional approach, each transaction entered into by a CFC must be analysed to determine if it produces tainted or other income.”⁶⁶ Tainted income consists of passive investment income (dividends, rent, royalties, interest and capital gains) and base company income (income mainly derived from offshore transactions between the CFC and connected persons in relation to that CFC).⁶⁷ Only amounts that constitute tainted income would be attributable to the shareholders of the CFC and therefore be taxable.

5.3.7.3 Attributable Amount

The amount attributed to the shareholder is usually the proportion of the shareholder’s shareholding in relation to the entire shareholding in the CFC. Thus, in this calculation, it is the shareholder’s interest in the distribution that determines the proportion attributable to that shareholder. Any diversion from this general principle would be distortionary to the concept of attribution and its adverse implications would most definitely discourage investors from choosing such jurisdiction as suitable for an IHC.

⁶⁶ Arnold and McIntyre 94

⁶⁷ Arnold and McIntyre 94. See also *IBFD International Tax Glossary* definition of “base company”. The inclusion of income from transactions with related or connected parties in tainted income is usually intended to bolster a country’s transfer pricing rules.

Some countries have adopted a hybrid approach in which they would, for example, use the transactional approach but grant an exemption to a CFC whose tainted income is less than a specified percentage of its total income.⁶⁸

Whether the investor prefers the transactional or entity approach jurisdictions depends largely on the nature of the underlying investments that the operating companies engage in. For an IHC whose operating subsidiaries' business is market-orientated, for example in the manufacturing sector, the undertaking would qualify for the genuine business activities exemption.

Where the jurisdiction ignores the underlying activities of the operating subsidiaries and only considers the activities of the IHC, the entity approach could be prejudicial. The transactional approach would also be prejudicial, as all the activities of the IHC would fall short of genuine business activities that give rise to active income. The transactional approach would also be appropriate in certain of these activities, though in the previous example some income which could be ancillary to the business of the CFC may fall in the tainted income classification.

A hybrid system exists in between these two extreme approaches in terms of which entity income is attributed subject to exemptions, e.g. the genuine business activities exemption.

5.3.7.4 Exemptions

Exemptions play a significant relieving role in the taxation of CFCs. The most common exemptions are the *de minimis*, genuine business activities and distribution exemptions.

a. De minimis exemption

The *de minimis* exemption applies to the proportion of the tainted income in relation to the total income of the CFC. It exempts tainted income of a certain percentage to the

⁶⁸ Arnold and McIntyre 94.

extent that it is deemed to be negligible. This applies both to transactional and hybrid approaches. However, often the tainted income is excluded from the exemption with the end result that the genuine business would be exempt but still attribute the tainted income.⁶⁹

The amounts and values to which the *de minimis* rule applies differ. In some cases they are expressed in percentages and in others in amounts or both. For example, the Canadian *de minimis* exemption is available only if the tainted income of the CFC is CAN \$5,000 or less. The Australian exemption, on the other hand, applies if the tainted income of the CFC does not exceed the lesser of AUS \$50 000 and 5% of gross income.⁷⁰ The South African exemption applies to the extent that tainted income does not exceed 10% of the income and capital gains of the CFC.⁷¹

b. Genuine business activities exemption

This exemption basically recognises that, while CFC legislation is basically intended to curb tax avoidance by relocating the tax residence of an entity, there are certain circumstances under which genuine business activities are carried out in a different jurisdiction without an intention to avoid the tax. This exemption is granted under both the entity and transactional approaches. It is generally granted if the CFC is engaged in certain defined businesses, has a substantial presence in the foreign country and more than a certain percentage of its income is derived from sources in the foreign country or from transactions with unrelated parties.⁷²

Income that normally does not qualify for this exemption is income that cannot be

⁶⁹ The South African system is one such hybrid. See s 9D of the Act; see also the discussion in Chapter 9 par 10.3.

⁷⁰ Arnold and McIntyre 97.

⁷¹ See s 9D(9)(b)(iii).

⁷² Arnold and McIntyre 96–97.

attributed to the genuine business (i.e. mobile business income) and income arising from transactions where the possibility of price manipulation exists.⁷³

c. Distribution exemption

This is perhaps the least used exemption due to its vulnerability to abuse. In terms of this exemption CFCs that distribute their income to shareholders who are subject to domestic tax are exempt. This is normally coupled with a requirement that the distribution be made within a certain period from the end of the tax year. In the UK the exemption applies if 50% or more of the available profits of the CFC are distributed within 18 months of the year end.⁷⁴

5.3.8 Thin Capitalisation and Transfer Pricing Rules

The inherent purpose of a pure IHC is to acquire, manage and/or sell investments in domestic and/or foreign companies. These transactions happen between an IHC and its related parties or non-related parties. As a holding company and a subsidiary at the same time, an IHC funds the formation of its subsidiaries and is in turn also funded by its holding company.

Thin capitalisation rules regulate the taxation of amounts arising out of or incurred as a result of the international funding of related companies. Transfer pricing rules determine the taxation of amounts arising out of transactions between related parties at an international level.⁷⁵

⁷³ See Olivier and Honiball at 373–375. Also see Legwaila ‘The Business Establishment Exemption’ (2004 December) *De Rebus* 42–43.

⁷⁴ Arnold and McIntyre 97.

⁷⁵ In some countries, transfer pricing rules apply even to transactions entered into between related parties within the domestic sphere. This application is not adopted by many countries due to the fact that there would not be any depletion of the tax base, as the ultimate income would still be taxable in the particular country.

5.3.8.1 *Transfer Pricing*

Transfer pricing is an area of economics and tax law that is concerned with ensuring that prices charged between related parties or associated enterprises for the transfer of property, goods and services are not manipulated.

A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, if A Co manufactures goods in Country A and sells them to its affiliate, B Co, organised in Country B, the price at which the sale takes place is called a transfer price. A transfer price is usually contrasted with a market price, which is the price set in the market place for transfers of goods and services between unrelated persons.⁷⁶

The purpose of a multinational group setting the price at a transfer rate as opposed to a market rate would normally be to shift the tax losses to a high taxing jurisdiction and the profits to a low-tax jurisdiction or a jurisdiction with special tax features like tax holidays, or other industry-specific incentives.⁷⁷ As Vann states, “[t]he prices charged within the group for goods or services provided and the financing methods used between the members of the group simply serve as a means of moving funds around the group and do not in a commercial sense create profits for the group.”⁷⁸

Transfer pricing rules generally provide that where goods or services are supplied or rendered in terms of a cross-border transaction between connected persons at a price that does not represent an arm’s length consideration, an adjustment would be made on the pricing to reflect such arm’s length. Normally penalties are levied on amounts so adjusted.

⁷⁶ Arnold and McIntyre 55.

⁷⁷ See Olivier and Honiball 399.

⁷⁸ Vann “International Aspects of Income Tax” in *Tax Law Design and Drafting* (ed Thuronyi) (1998) 781.

a. *Cross-border transactions*

This is an agreement between a resident and a non-resident. It also covers agreements between two non-residents for the supply of goods or services in the country, and agreements between residents for the supply of goods or services outside the country.

b. *Connected persons*

The concept of connected persons seeks to cover affiliated or related persons.⁷⁹ These are persons who can transact with each other at any consideration without adversely affecting the interest of their ultimate shareholders. Vann confirms that “[f]or the group as a whole, all that matters at the end of the day is the after-tax profit of the group rather than of its individual members.”⁸⁰ Different jurisdictions use different yardsticks to determine to whom the transfer pricing rules apply. Certain countries apply it to company groups, which are also in turn differently defined. Others apply it to companies held at a certain percentage lower than what would generally qualify as a group. A higher amount of holding relaxes the rules and restricts application thereof.

It should be noted that in most jurisdictions transfer pricing rules do not apply to non-related persons. The logic behind this is that unrelated persons would not have an interest in shifting the profits of a transaction to one particular party to the transaction.

c. *Arm’s length*

Transfer pricing applies the so-called arm’s length principle as a generally recognised method to attribute profits made by related enterprises to enterprises operating in different countries.⁸¹ The arm’s length standard is met if the company sets its transfer

⁷⁹ See above at 5.3.1.4.

⁸⁰ Vann *Tax Law Design and Drafting* 781.

⁸¹ The attribution applies both to enterprises and parts or divisions of those enterprises. See Hamaekers “Arm’s Length – How Long?” in *International and Comparative Taxation, Essays in Honour of Klaus Vogel, Series on International Taxation* (ed Raad) (2002) 29.

prices in its dealings with its related persons so that those prices are the same as prices used in comparable dealings with unrelated persons.⁸²

Countries can either use the arm's length method or the formulary apportionment method.⁸³ However the arm's length method is accepted by almost all countries as it is theoretically correct because it most closely approximates the operation of the open market.⁸⁴

Investors naturally prefer countries with a more flexible system of choice by taxpayers of the arm's length methods to apply. A jurisdiction is even more attractive where it provides for advance pricing agreements in terms of which the taxpayer agrees with the revenue authorities regarding the transfer pricing method to be used by the taxpayer in the future.⁸⁵

A pure IHC manages the investments of the group. This is a function for which it should be paid. The main challenge is that the management services are rendered to related parties and the particular payment does not have any bearing to the earnings of the group. It makes no difference to the ultimate shareholders whether the payment has been made or not. As a result the temptation not to pay or to make a notional payment is high.

⁸² Rolfe *International Transfer Pricing* (1998) 6 – 23; Arnold and McIntyre 60.

⁸³ Olivier and Honiball 405.

⁸⁴ Hamaekers 38. Arnold and McIntyre 61 – 65. The following methods are used to determine whether a price is at arm's length or not: (a) Comparable Uncontrolled Price ("CUP") Method – establishes an arm's length price by reference to sales of similar products made between unrelated persons in similar circumstances; (b) the Resale Price Method – sets the arm's length price for the sale of goods between related parties by subtracting an appropriate mark-up from the price at which the goods are ultimately sold to unrelated parties; (c) the Cost Plus Method – uses the manufacturing and other costs of the related seller as the starting point in establishing the arm's length price. An appropriate amount of profit is added to these costs by multiplying the seller's costs by an appropriate profit percentage; (d) Profit-Split Method – the worldwide taxable income of related parties engaging in a common line of business is computed. The taxable income is then allocated among the related parties in proportion to the contribution they are considered to have made in earning the income; and (e) Transactional Net Margin Method (TNMM) – the taxpayer establishes, for itself or a related party, an arm's length range of profits on a set of transactions. If the tested party's reported profits on those transactions fall within that range, then its transfer prices will be accepted by the tax authorities.

⁸⁵ See Sawyer "Advance Pricing Agreements: A Primer and Summary of Developments in Australia and New Zealand" (2004) *Bulletin for International Fiscal Documentation* 556-565.

5.3.8.2 *Thin Capitalisation*

Thin capitalisation is the practice of excessively funding a related party, being a branch or subsidiary, with excessive interest-bearing loans (debt) from related parties rather than with share capital or equity.⁸⁶ Thin capitalisation rules are intended to combat tax avoidance by the relocation of interest from one jurisdiction to another. The relocation is normally made from a high to a low-tax jurisdiction, with a deduction being claimed as an allowance in the high jurisdiction country. Often the interest is subject to a reduced tax rate as a result of the application of tax treaties.⁸⁷ Vann states:

The fact that interest is usually deductible for the borrower and taxed to the nonresident lender at a low rate of withholding tax (or not at all in some cases) while in most cases company profits funding dividends are fully taxed makes the practice attractive taxwise to a nonresident investor. Although it is possible to deal with these problems under the arm's length principle, taxpayers and tax administrators often want more guidance on the level of permissible loan funding for a subsidiary than to be told that related party loans can be made up to the point and on the terms that an independent third-party lender would allow, having regard to the other liabilities of the subsidiary. Thin capitalization rules seek to deal with this problem by denying deductions for interest in defined cases (and possibly recharacterizing the payment of interest as dividends).⁸⁸

The application of thin capitalisation rules denies the deduction of the excessive part of the interest in the hands of the debtor. This makes the thin capitalisation rules an aspect of the tax jurisdiction that needs proper consideration with regard to planning the location of the IHC, as the IHC is often responsible for the formation of operating companies or specific operations in such companies. Furthermore, the IHC itself is formed as a subsidiary of a group member.

⁸⁶ Vann *Tax Law Design and Drafting* 785.

⁸⁷ See Arnold and McIntyre 83.

⁸⁸ Vann *Tax Law Design and Drafting* 784.

Thin capitalisation rules apply to loans by non-residents who own a substantial share of the borrowing company. The level of share ownership varies from 15% to 100% in the resident company.⁸⁹ This interest can either be held directly or indirectly through another resident or non-resident company. Countries differ in the way the denial of interest deduction is structured. Some countries use the ratios of loan capital to share capital beyond which interest deductions are denied (debt-equity rules) and others limit interest deductions by reference to a proportion of the income of the taxpayer (earning-stripping rules). The former is more common.⁹⁰

Where the excessive interest deduction is disallowed, the excessive interest can either be treated as a dividend or be carried forward and deducted in subsequent years.⁹¹ The methods and ease with which one gets caught by these rules as well as the consequences attached to excessive interest contribute to the suitability of a country as an IHC jurisdiction.⁹²

5.4 METHODS OF SETTING UP AN IHC

As discussed in Chapter 2,⁹³ an IHC in its nature is a company. Generally it would be set up in terms of the corporate laws of the host country.⁹⁴ The essential feature of corporate legal existence grants the shareholders of the IHC limited liability. The extent of the limitation differs depending on the jurisdiction chosen. The formation of an IHC can take the form of a new legal entity, converting the functions of an existing company in the host jurisdiction, migration, or moving the tax residence of an existing company to a jurisdiction other than the host country. These methods are catered for by the local

⁸⁹ Arnold and McIntyre 85.

⁹⁰ Among the countries using the debt-equity rules the ratios differ. The common range is between 1.5:1 and 3:1. The rules also provide for an application to the revenue authorities to allow a higher ratio. With the earnings-stripping rules, the rules are more permissive for financial institutions whose businesses consist in borrowing and lending and that typically operate at much higher debt levels than other businesses. Vann 785.

⁹¹ Arnold and McIntyre 86.

⁹² See Udal and Cinnamon *International Tax Review*.

⁹³ See par 2.2.

⁹⁴ Hansen "Practical Aspects of Setting up Holding Companies" (2000) *European Taxation* (Vol. 40 Issue 4) 130-131.

corporate statutes of the particular countries. The availability of the possible establishment options enhances the suitability of the country to host an IHC.

5.4.1 Incorporating a New Legal Entity

Setting up a new legal entity is the easier and therefore perhaps the most common way of creating an IHC in jurisdictions where the investor does not have a presence.⁹⁵ The formation of a new entity has the benefit of avoiding the risks of inheriting undisclosed liabilities such as guarantees and indemnities. The formation of the new entity generally takes the form of the investor(s) forming a company and the company issuing shares to the ultimate holding company in return for cash or assets.⁹⁶ The laws of the particular country may grant various options for the formation of a limited liability entity. Some such entities, though called companies, may not be capable or suitable to carry out IHC activities. Therefore the corporate laws of the host countries need to be analysed in light of the group intentions.

The following variations to incorporation of a new legal entity are available:

5.4.2 Changing the Shareholding of an Existing Entity in the Host Country

A variation of the incorporation of a new company is to change the holding structures of an existing entity in the host country to enable the movement of shares and income in and out of the host country. This method requires that there should be an existing company. Changing the shareholding of such company would happen, for example, where the investor has a presence in the host country but such presence is held directly by a company resident in a jurisdiction that is not suitable for direct holding company of an IHC. In this case the existing issued shares in the potential IHC would be sold to a company resident in a suitable direct holding company for an IHC. As an alternative, the

⁹⁵ See Hansen *European Taxation* 131.

⁹⁶ Olivier and Honiball 305.

existing company could buy back its shares and issue new shares to the company suitable for the group IHC functions.

5.4.3 Converting the Functions of an Existing Company in the Host Country

Where the investor has presence in the host country but the entity located in that country performs functions that are not, or are not suitable for, IHC functions, the investor can alter or convert such functioning accordingly. This normally does not necessitate a change in the structure of the company. There might be certain registration or deregistration requirements that would need to be fulfilled. For example, the IHC functions may constitute financial services in terms of the laws of the chosen jurisdiction thereby necessitating regulatory registration as a financial services provider.⁹⁷

5.3.4 Relocating the Tax Residence of a Company

As discussed in Chapter 2,⁹⁸ the residence of a company is determined by its incorporation, place of management or control or place of effective management. Place of management, control or effective management may be determined by the residence, nationality or citizenship of the company's officials or shareholders.

Domestic legislation is normally broader in its determination of whether a company is resident within a particular country.⁹⁹ However, DTAs limit this application. Where a company is tax-resident in two contracting states, the place where it is effectively managed is the tie-breaker.¹⁰⁰

⁹⁷ In South Africa, for example, financial services providers have to register in terms of section 8 of the Financial Advisory and Intermediary Services Act 37 of 2002. On the other hand an example of deregistration in South Africa is where a company would have been registered as a bank in terms of the s 11(1) of the Banks Act 94 of 1990. Once such company ceases to undertake banking activities, it is required to deregister as a banking institution.

⁹⁸ See Chapter 2 par 2.3.

⁹⁹ For example, in South Africa and most other jurisdictions, formation, establishment, incorporation or effective management qualifies a company as a resident. See section 1 definition of "resident" in the Act.

¹⁰⁰ See generally Article 4(3) of the OECD Model Convention. It should be noted that the OECD Model Convention is a guide for treaty design. Different countries still enter into treaties on different grounds depending on their own tax treaty policy informed by their economic activities in each other's territories.

Moving the residence of a company where the country from which the residence is purported to be moved to a different jurisdiction if the two countries do not have a DTA may prove to be a logistical disaster as the mere registration in a new jurisdiction may not necessarily cancel the residence of the company in the jurisdiction where it was initially incorporated. Where the two jurisdictions have a DTA in place, the matter becomes eased by the tie-breaker provisions.

The residence of a company can be moved to an ideal IHC jurisdiction where the investor already has a presence, say, in the form of a branch that has infrastructure for IHC functions. In this way a process similar to a conversion of the nature of the entity takes place. Certain registration requirements may need to be fulfilled. For example, in Australia the entity will become a company only when it is incorporated under the Australian Corporations Act 2001 and is registered with the Australian Securities and Investments Commission.¹⁰¹

Moving the residence of an existing company for IHC purposes would also entail the relocation of certain IHC activities where these activities were carried on elsewhere.

5.4.5 Migration

A migration is the actual movement of the entire legal entity for all intents and purposes. A migration differs from a change of tax residence in that a migration relocates the legal entity and all rights and obligations attendant thereto. Incorporation of a new resident company may be required. In a migration no contracts need to be ceded or assigned.

In New Zealand the Companies Act of 1955 required the liquidation and discontinuation of the legal personality of a company before it could be removed from the New Zealand register of companies. In contrast, the New Zealand Companies Act of 1993 allows a company to transfer its place of incorporation offshore and become a non-resident

¹⁰¹ http://www.business.vic.gov.au/BUSVIC/STANDARD//PC_50052.html accessed on 25 February 2008.

company without the need to liquidate, make a distribution and pay New Zealand income tax.¹⁰²

In South Africa there are no specific corporate migration rules. However, as indicated by Olivier and Honiball –

... s334 of the Companies Act 61 of 1973 allows an external company registered in terms of s332, which carries on its principal business within South Africa, to convert into a domestic company with the same assets and liabilities. The company is then deemed to be incorporated in South Africa in terms of the deeming provision contained in s335. These two sections have the effect of a corporate migration into South Africa but do not provide for overseas corporate law position.¹⁰³

5.4.6 Other Variations

Where the entity in the host country is not suitable for an IHC, the entity may be divided into two or more entities one of which can do IHC activities. Alternatively, where two or more entities exist but none performs enough activities to function properly as an IHC, such entities may be amalgamated into one entity capable of carrying on such activities holistically.

5.5 CONCLUSIONS

The structure of a country's tax system is a key factor to be considered as regards its suitability as a host country for IHCs. The legal system and the available options regarding the setting up of the IHC are also essential to the administrative tolerance of the investor in setting up the IHC. While the available setting up options and methods might not have any direct impact on the business operations of the IHC post the setting up, the

¹⁰² <https://www.ird.govt.nz/technical-tax/legislation/2006/2006-3/leg-2006-3-corp-migration.html> accessed on 25 February 2008.

¹⁰³ Olivier and Honiball 306.

difficulty in setting it up may discourage the investor from setting up in a particular jurisdiction.

On a more substantive basis, a tax on dividends is one of the major reasons why companies have huge accumulated profits on their books. A tax system with low or zero tax on dividends alleviates the concern of repatriating the income from the underlying investments of dividends. The DTA network of the potential host country and the contents of DTAs are crucial to the suitability of the jurisdiction. This is so because DTAs play a major role in exempting the dividends from tax or at the very least reducing the dividend tax rate applicable.

The taxation of capital gains can deplete the growth of the company and the group in general. Where there is a tax, the rate at which the gains are taxed is an essential aspect whose effect needs to be adequately assessed. Equally essential, however, is the rules for calculating the acquisition cost, determining the tax event, providing deferral opportunities and governing transactions between related parties.

The design of the CFC regime as an anti-avoidance measure results in CFC legislation containing strict provisions as opposed to instances where CFC legislation is seen as merely a taxing provision. This affects the imputation of the underlying investments to the shareholders of such underlying investments (the shareholder of the underlying investments in this case is the IHC). The extent of the application of these CFC provisions is also of great importance.

CFC regimes that apply the transactional approach are more favourable than those applying the entity approach. However, tax authorities find the entity approach administratively less burdensome to apply and police while unscrupulous taxpayers would prefer the transactional approach, as it is easier to manipulate. Available exemptions from the CFC regime reduce its ambit. While taxpayers structure their activities to qualify for the genuine business activities, passive income earners find it difficult to satisfy the stringent requirements.

Thin capitalisation provisions are also vital to the suitability of the jurisdiction. However, their importance is limited by the fact that they are restrictive mainly at inception when the enterprise requires start-up funding, and in the case of IHCs such funding may not consist of large amounts.

A jurisdiction with the above features favourable to setting up and conducting the business activities of an IHC would attract various other forms of investment. Such a jurisdiction would have the ability to manipulate and redirect the investment strategies of many investors. Whether it is intended and designed to do so or not, such jurisdiction would pose a serious threat to the tax bases of other countries not offering the same preferred tax and administrative treatment to investors.

CHAPTER 6

INTERNATIONAL ATTITUDE TOWARDS SYSTEMS SUITABLE FOR IHCs

6.1 INTRODUCTION

Depending on their stages in economic development, different countries view IHCs and jurisdictions that are conducive to IHCs operations differently. During the developmental stages most countries go to great lengths to attract foreign direct investment to their shores. Countries with adequate infrastructure have the benefit of attracting foreign direct investment through the availability of such infrastructure.

Fundamental determinants such as market size, access to raw materials and the availability of skilled labour are primary factors in attracting foreign direct investment. As was seen in Chapter 4, and as will be seen in Chapter 11, a suitable tax regime plays a secondary role in attracting foreign direct investment. The absence of fundamental determinants, and therefore adequate infrastructure, often results in countries relying on the tax system to attract investment.

Countries engaging in activities that are intended to attract development are constantly at the risk of crossing the Rubicon from what is seen to be fair competition to what is internationally deemed to be crude and unacceptable tax competition. Certain developed countries, in an attempt to broaden their tax bases, also engage in this unacceptable competition. Such unacceptable and unfair competition is referred to as harmful tax competition. This is practised broadly by tax havens and those countries whose tax regimes are harmfully preferential.¹

¹ Monaco, Liechtenstein and Guernsey are notable examples in this case.

6.2 HARMFUL TAX COMPETITION

According to Rohatgi, “[h]armful competition arises due to mismatches in the existing tax systems of countries that can be exploited by taxpayers. Such economic behaviour may be considered as unacceptable tax avoidance by certain countries since they believe that it undermines the integrity and fairness of their tax systems.”² The term “harmful tax competition” broadly refers to the tax practices that are adopted by countries to exploit the weaknesses in the international tax rules in other countries.³

It needs to be noted that by using the tax system to attract foreign investors, countries are exercising their right to fiscal sovereignty.⁴ In this regard it is acknowledged that tax competition cannot always be bad. It does have positive attributes. At the Commonwealth Finance Ministers’ Meeting held in Malta in September 2000 “[m]inisters recognised that tax competition could in fact be helpful, and not harmful, because it can further spur governments to create fiscal environments conducive to generating growth and employment”.⁵

In the same positive approach to tax competition Milton Friedman stated the following:⁶

Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them. Both lead to

² Rohatgi *Basic International Taxation* (2005) 85.

³ See Olivier and Honiball *International Tax – A South African Perspective* (2008) 575; OECD Report *Harmful Tax Competition, An Emerging Global Issue* (1998) 1-19. See also Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (LLD dissertation 2007 UNISA) 10–14.

⁴ “Fiscal sovereignty is a right which has been carefully guarded by sovereign states and protected in international law over hundreds of years; international fiscal disputes have provoked major international political upheavals...” Biswas *International Tax Competition: Globalisation and Fiscal Sovereignty* (2002) 1.

⁵ Commonwealth Finance Ministers Communiqué, September 2000. http://www.thecommonwealth.org/document/181889/34293/35232/152088/153876/commonwealth_finance_ministers_meeting_st_julians.htm accessed on 05 November 2008.

⁶ In a speech delivered by Emeritus Professor M Friedman of the University of Chicago, at the Hoover Institution, Stanford University, May 2001.

variety and innovation; to improvement in the quality of the goods and services and a reduction in their cost. A governmental cartel is not less damaging than a private cartel.

A contrary and more popular viewpoint is that tax competition is dreadful and appalling. The proponents of this view see tax competition as resulting in a destructive “race to the bottom”. This negative view is reflected by Ault⁷ as follows:

Tax competition causes ‘bidding wars’ in competing for mobile activities, ultimately resulting in no tax at all on mobile capital; it makes redistributive non-benefits-based income taxation impossible; it may require states to shift to other revenue sources, taxing less mobile activities and particularly [labour] more heavily, or it may force a reduction in public expenditures to a suboptimal level; it can prevent the implementation of democratically arrived at tax policy decisions as to tax mix and tax level, and generally leaves all countries worse off.

Tax competition is engaged in by tax havens and harmful preferential tax regimes at different levels and to greater or lesser extents. Less in the international spotlight, but seeking to achieve the same objectives, are the offshore financial centres. The two main types of tax competition will now be explored in more detail as well as the offshore financial centres and their impact.

6.2.1 Tax Havens

The term “tax haven” does not have any precise technical meaning.⁸ It could generally be defined as a country that levies lower effective rates of taxation than those generally

⁷ Ault “Tax Competition: What (If Anything) To Do About It?” in *International and Comparative Taxation, Essays in Honour of Klaus Vogel* (ed Van Raad) (2002) 2.

⁸ See Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) 9; Doerenberg *et al Electronic Commerce and Multi-jurisdictional Taxation* (2001) 91.

prevailing.⁹ In light of the fact that taxes are levied primarily to finance government expenditure, these countries are characterised, *inter alia*, by the ability to finance their public services with little or no income taxes, or some other kinds of taxes.¹⁰ Miller and Oats state that:

[t]he term ‘tax haven’ has been loosely defined to include any country having a low or zero rate of tax on all or certain categories of income, and offering a certain level of banking or commercial secrecy... The term ‘tax haven’ may also be defined by a ‘smell’ or reputation test: a country is a tax haven if it looks like one and if it is considered to be one by those who care.¹¹

The essential feature of a tax haven is that it has no or nominal taxes on income from mobile activities. In addition to this feature, tax havens also make themselves available to non-resident investors (to the exclusion of residents) for the avoidance of tax which would otherwise be paid at a relatively high rate.

According to Ginsberg¹² the term “tax haven” covers the following three classes of jurisdictions:

- Countries where there are no relevant taxes;
- Countries where taxes are levied only on internal taxable events, but not at all, or at very low rates, on profits from foreign sources (also referred to as foreign source exempt havens);¹³ and
- Countries where special tax privileges are granted to certain types of companies or operations.

⁹ See Olivier and Honiball 552; Glautier and Bassinger *A Reference Guide to International Taxation: Profiting from Your International Operations* (1987) 228.

¹⁰ Hadnum *The World’s Best Tax Havens* (2006) 2.

¹¹ Miller and Oats *Principles of International Taxation* (2006) 175.

¹² Ginsberg *International Tax Havens* (1997) 5.

¹³ See Hadnum 3.

In light of the attitude of the international tax community regarding tax havens,¹⁴ negative impressions have been attached over time to the term and countries try to steer clear of being regarded as such. Tax experts also tend to avoid usage of the term, particularly when referring to their own countries. Olivier and Honiball comment as follows in this regard:¹⁵

With the global increase in anti-avoidance measures and initiatives directed against tax havens, the use of the term ‘tax haven’ has become increasingly unpopular with both tax advisors and the authorities in the relevant jurisdictions themselves as it has come to imply the circumvention of another country’s tax laws. Increasingly, reference is being made to ‘low tax jurisdictions’ or ‘offshore financial centres’ with the hope that the more positive image of high tax countries with special tax concessions, such as the Netherlands, will rub off onto true tax havens such as the British Virgin Islands.

An unintended consequence of this unprecedented attempt to conceal this negative image is that a tax haven has become identifiable by one of the following characteristics:

- it does not exchange information effectively with other countries about taxpayers benefiting from the low-tax regime;
- it provides tax, legal, legislative and/or administrative benefits to taxpayers in a non-transparent fashion; or
- it does not require non-residents to engage in any substantial business activities in order to qualify for tax incentives.

These attributes provide a facility to achieve the goal of avoiding taxes and other regulatory mechanisms imposed by the countries of residence of investors.

¹⁴ Countries that are members of the Organisation for Economic Co-operation and Development (“the OECD”) generally subscribe to the negative regard of tax havens and these include rich countries upon which most countries depend for trade such as the United States of America, the United Kingdom, the Netherlands, Japan, France, Canada and Germany.

¹⁵ Olivier and Honiball 553.

One of the principal functions of tax havens is the avoidance of current and future taxes and exchange controls. According to Ginsberg,¹⁶ “[t]ax havens also serve to postpone the imposition of tax, thus permitting the more rapid development and consolidation of an undertaking. Furthermore, tax havens often provide an effective shield against the dangers of confiscation (such as nationalisation and other types of expropriation against inadequate compensation) and sanctions.”

Tax havens can generally be categorised into two types: those that levy no taxes and those that levy low or nominal taxes on all or some income, as the case may be. In international tax planning, tax havens that levy less tax are generally viewed by taxpayers more favourably than those that levy no tax at all.

These characteristics make more sense when juxtaposed with the common motivating factors and circumstances for residents of one country to prefer doing business in the other country. These negative features existing in the country of residence can be summarised as follows:

- High taxes in the country of residence;¹⁷
- The need for geographical expansion of multinational corporations;
- Transparency of financial information, particularly through the disclosure of banking accounts and shares;¹⁸ and
- Political considerations that inhibit businesses from holding wealth in their country of residence.

In pursuit of a suitable environment that would enable them to maximise their profits, investors often go to great lengths to exit a restrictive jurisdiction in favour of a more liberal one. However, this phenomenon is in most instances driven by business efficiency rather than the desire to avoid tax in their countries of residence.

¹⁶ Ginsberg 5.

¹⁷ According to Ginsberg 10 this is more a factor for residents of countries with progressive tax systems, as these systems mostly impact on those taxpayers at the high income tax brackets.

¹⁸ Secrecy may be desirable for reasons other than tax avoidance. An organisation may want to use a tax haven to develop new products or business ideas out of sight of its commercial competitors. Ginsberg 10.

Tax havens and harmful preferential tax regimes have similar basic characteristics. A harmfully preferential tax jurisdiction is a high or normal tax country that has aspects in its tax system that have the same harmful effects on mobile activities as traditional tax havens.¹⁹ What follows is a brief analysis of the basic characteristics of tax havens and of preferential tax regimes. This is in turn followed by a summary of the main differences between the two.

6.2.1.1 No or Nominal Taxes on Income from Mobile Activities

Tax havens levy no or nominal taxes on income from mobile business activities. Income from mobile activities is income that cannot be attributed to any genuine business activity. Mobile businesses can also generate passive income such as interest, royalties, dividends and annuities.²⁰

a. What is mobile business activity?

Mobile business activities are business activities that cannot be attributed to any fixed or substantial place of business. Mobile business produces mobile income which is basically income that as a factual matter can be shifted from one geographical location to another. Internationally, where an enterprise that is resident in one country carries on business in another country, the presence of sufficient business activities to constitute a permanent establishment determines whether that enterprise carries on mobile business activities in the other country.²¹

Given its general application, “permanent establishment” will be used here as a point of reference. A permanent establishment is defined in the OECD Model as “a fixed place of

¹⁹ Arnold and McIntyre *International Tax Primer* (2002) 140.

²⁰ See Murphy *What is a Tax Haven* <http://www.taxresearch.org.uk/Blog/2007/07/23/what-is-a-tax-haven/> accessed on 29 May 2009

²¹ According to Olivier and Honiball 447 mobile business income is income that cannot be attributed to a business establishment as defined in the South African Income Tax Act. Although Olivier and Honiball’s discussion is focused on the context of South African controlled foreign company legislation, the issues involved here are the same. For South African purposes, a business establishment produces income other than mobile, diversionary business, or mobile passive income.

business through which the business of an enterprise is wholly or partly carried on” and includes a place of management, branch, office, factory, workshop and mine.²² The definition incorporates numerous inclusions and exclusions which are beyond the scope of this thesis.²³

According to the OECD Commentary on the Definition of Permanent Establishment, this definition of permanent establishment contains the following conditions:²⁴

- “the existence of a ‘place of business’, i.e. a facility such as premises or, in certain instances, machinery or equipment;
- the place of business must be ‘fixed’, i.e. it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the state in which the fixed place is situated.”

Further, it does not follow that because in the wider context of the whole organisation a particular establishment has a productive character it qualifies as a permanent establishment.²⁵ The fact that the establishment must be fixed or permanent implies that it should have a certain degree of permanence and should not be of a blatantly temporary nature. This may be varied, however, in the context of the nature of the business undertaking. It would also depend on whether the business premises are fragmented or located in one location.

If a business activity does not satisfy these requirements of a permanent establishment, one could argue that it is mobile business. This is because the one element, i.e.

²² Article 5(1) and (2) of the OECD Model Convention.

²³ The specific provisions refer to building sites, construction and installation projects; preparatory, holding and ancillary facilities (excluded enterprises); dependent and independent agents and the rule on associated enterprises. For a further discussion on these provisions see Vogel *Klaus Vogel on Double Taxation Conventions* (1997) 271–353.

²⁴ OECD Committee on Fiscal Affairs *Commentaries on the Articles of the OECD Model Tax Convention* (July 2008) par 80.

²⁵ *OECD Commentary* par 80–81.

permanence, excludes the other, i.e. mobility. Business that is based on portfolio investment²⁶ is likely to fail the permanence test.

b. The tax on mobile income

A tax haven can tax the mobile income at normal or lower rates or not tax it at all. The tax can be low because the rate is low or because the base of the tax, relative to the instrument on question, is limited. Where the tax base is limited, the tax regime may exempt certain items of income due to the identity of the taxpayer or nature of business activity in which the particular taxpayer is engaged. This benefits taxpayers engaging in portfolio business in that the income will be technically subject to tax in the country where the activity takes place and as such the country of residence might exempt it on the basis that it has been so subjected or grant a tax credit on the tax that would have been paid.²⁷

The main source of avoidance of tax on portfolio investments is that taxpayers undertake the activities in other countries by using instruments that earn income by applying means other than physical activities located in a certain country. This generally takes the form of written contracts granting rights to intellectual property and dividends.²⁸

²⁶ Portfolio investment refers to investment that is held simply with a view to the appreciation in value of the underlying asset and the return to be expected from normal investment management. See *IBFD International Tax Glossary* (2005) definition of “portfolio investment”. Portfolio businesses include businesses that derive income from investment income. Investment income includes interest, royalties, rent, dividends and other forms of derivatives. Portfolio investment is investment that does not involve the running of a business. Derivatives are contractual rights or obligations the value of which is determined with reference to an underlying asset. According to Miller and Oats 174: “Tax havens are used mainly to shelter portfolio income and gains as opposed to profits and gains from foreign direct investment. This is mainly because portfolio income is more mobile and because most tax havens do not have the infrastructure to support or attract foreign direct investment such as manufacturing plants.”

²⁷ Most countries combat the avoidance due to the fact that income has been subjected to tax in the other jurisdiction by requiring that tax be paid or payable in respect of such income. The exemption will be granted to the extent that the tax has been paid or the credit will be equal to the amount of the tax paid or payable. In this regard it is noteworthy that income in respect of which tax is paid or payable refers to situations where a certain actual amount of tax has been paid, while income which is subject to tax implies that such income should fall within the tax net, and qualifies even though no actual tax is payable due to tax credits, deductions, exemptions or similar instruments.

²⁸ In terms of contract law, a contract is entered into where the offer is accepted (usually in a written contract by signature) and the source of income from a contract is the contract itself. See Christie *The Law of Contract* (2006) 28; Kerr *The Principles of the Law of Contract* (2002) 112; Van der Merwe *Contract* –

6.2.1.2 Availability to Non-Residents

The other feature of tax havens is that they make themselves available to non-residents for the avoidance of tax which would otherwise be paid at a comparatively high rate in the country of residence. In addition to the fact that tax practitioners research the availability and suitability of countries in which taxpayers could maximise their profits by paying the least tax, tax havens themselves advertise their availability to investors.

The tax regime of one country often benefits the economies of other countries. In this case it would not be strange for countries that stand to benefit to advertise the tax haven. For example, Country A (be it a tax haven, a preferential tax regime country or not) may advise residents of Country B to set up certain operations that produce mobile or passive income in Country C which income would be attributed to Country A. The income could be attributable to Country A due to the residence of the company undertaking the operations being located in Country A. This structure would benefit the investor where Country A and Country C have a DTA and neither of them has a DTA with Country B. In this elementary example, the investor might have to take up tax residence for convenience in Country A.

6.2.1.3 Ability to Fund National Expenditure without Income Taxes

In many instances tax havens are able to finance their government expenditure by using means other than income taxes. As a result, following the discussion above, they are able to brand themselves as no or low income tax jurisdictions. Income taxes constitute the primary tax base and source of revenue of most tax jurisdictions. Corporate income tax alone constitutes approximately 17% of the total tax collection in developing countries and approximately 10% in the OECD countries.²⁹ For example, in South Africa, of the

General Principles (2007) 68–76; *Cape Explosives Works Ltd v Lever Brothers (South Africa) Ltd* 1921 CPD 244 at 256–257. For tax purposes, however, most jurisdictions trace the underlying instrument in which the contractual rights originate.

²⁹ Keen “Presentation on Revenue Mobilisation: The Challenges in Corporate Taxation” 2008 *South African Tax Symposium* on 17 March 2008 in Pretoria.

total revenue of R571 billion collected in the 2007/2008 fiscal year, income taxes constituted R332 billion.³⁰ This represents more than 50% of total revenue.

Tax havens manage to finance their expenditure without income taxes often due to their smaller geographic sizes and low population. Most popular tax havens that have low income taxes are islands and they include the British Virgin Islands, the Cayman Islands, the Channel Islands, the Isle of Man and the Bahamas. In some instances these tax havens raise their revenue through high taxes on tourism and high transfer taxes on real estate.

Another group of taxes that generally generates significant revenue for tax havens is taxes on goods and services. This includes value-added tax, general or specific sales taxes, and excise duties (such as levies on fuel). These can be used by tax havens as alternative sources of revenue. These taxes are not a major concern for investors when making decisions on whether to invest in a country or not. Taxes on international trade and transactions and taxes on property are also supplementary.

Jurisdictions could also lower their government expenditures by privatising certain services. Furthermore, government could pass the cost of such services to the consumers. These would include medical, security, postal, road and other services. This absolution from certain responsibilities would often be augmented by an economy that is buoyant as opposed to a struggling economy with a high poverty rate.

6.2.1.4 Characterisation of Tax Havens

Tax havens perform the following three main types of functions:

1. They enable taxpayers doing business to produce goods and services;
2. They allow tax liability to be shifted among jurisdictions; and
3. They allow tax liability to be hidden.³¹

³⁰ See South African National Treasury's 2007 *Budget Review* 174.

³¹ Miller and Oats 176.

Most tax havens perform more than one of these functions but generally a tax haven should perform at least one of these.

Tax havens are also classified according to the functions they perform.³² Their classification still accords with the main functions that they perform. However, depending on the classification, the tax haven would not perform some of the functions, or even if it does, such functions would not be core to the structure or aims of the tax haven. The following are the main four forms of classification of tax havens:

a. Production havens

The utilisation of these forms of tax havens involves the transfer of real business activity to the tax haven, where products or things are made and tangible value is added.³³ While it is accepted that generally most tax havens do not have infrastructure to support or attract foreign direct investment such as manufacturing, those tax havens that have the infrastructure ensure the exploitation of such infrastructure to their benefit. Tax havens in this class would have facilities of proximity to markets and raw materials, suitable and adequate labour, political stability and transport links.³⁴

Due to the availability of infrastructure, these tax havens are more capable of attracting investment, as their capacity goes beyond catering for portfolio investment. Investors then prefer to shift their real economic activity to these low-tax jurisdictions. However, this form of tax haven accounts for a low percentage of tax havens in general. Countries with sufficient infrastructure to attract investment are unwilling to compromise their tax bases and credibility by engaging in tax haven activities.

³² Miller and Oats 176.

³³ Miller and Oats 176.

³⁴ Tax havens with sufficient infrastructure include stable countries such as Switzerland, Luxembourg, the Netherlands, Monaco, Liechtenstein, Channel Islands, Bermuda and Andorra.

b. *Base havens*

Base havens are also referred to as “sham havens”. They are more often small islands with few natural resources to exploit and limited labour. They levy very low or no tax on all business income.³⁵ This is the only way, practically, that they can attract investment. As Miller and Oats³⁶ state, “[t]he lack of labour, land and infrastructure generally rules out the location of manufacturing or large-scale distribution operations although there are notable exceptions, such as Specsaver plc’s extensive operations on Guernsey.”

Because of their low-tax or no-tax-on-all-income characteristic, these tax havens usually do not have good DTA networks.³⁷ This makes them unsuitable for hosting IHCs because payments to or out of the tax haven would incur high withholding and income taxes, as the case may be.³⁸ “Most base havens are also *secrecy havens* although some countries with substantive tax systems, such as Switzerland and Luxembourg, also act to some extent as secrecy havens.”³⁹

c. *Treaty havens*

Tax treaties are a very formidable form of tax reduction at an international level. Countries that achieve the most benefit from being tax havens need to have a good network of treaties, for the many reasons already dealt with and still to be explored in this thesis. Treaty havens have very favourable networks of DTAs, e.g. the Netherlands. “The benefits of treaty havens are low withholding taxes on money flowing into and out of the haven, often no tax while it remains there and no withholding tax when it flows back out again.”⁴⁰

³⁵ Miller and Oats at 176.

³⁶ Miller and Oats at 176.

³⁷ Base havens are usually colonies or former colonies. The *EU Code of Conduct on Tax Competition* (1997) found that more than seventeen of the tax havens associated with the UK are colonies or former colonies of onshore jurisdictions. See Miller and Oats at 176.

³⁸ Miller and Oats at 176; see also Olivier and Honiball 554.

³⁹ Miller and Oats at 176–177.

⁴⁰ Miller and Oats at 177.

These tax havens possess the essential feature for the ideal hosting of IHCs in light of the fact that, as opposed to the facilities available in production and base havens, IHCs are taxable on income that is generated other than through real activity or maximised by the taxation at low or zero tax.

d. Concession havens

Concession havens have startling similarities with preferential tax regimes. They have proper tax systems but offer particular tax incentives on certain forms of income, for example a certain rate on branches of companies resident in a particular jurisdiction. As can be seen, these will specifically target certain activities or countries. Also, some countries offer more and different incentives than others.⁴¹

A combination of the features of production, treaty, base and concession havens in one tax haven, where possible, would result in an immensely formidable tax haven.

6.2.1.5 Taxation in Tax Havens

Tax havens can generally be categorised into two categories as regards their systems of tax, i.e. those that levy no taxes and those that levy low or nominal taxes on all or some income, as the case may be. In certain limited circumstances tax havens that levy minimum taxes may be preferred over those that levy no taxes at all. The reasons for this preference are the following:

- Firstly, foreign-source income is often exempted from tax in the recipient's country of residence if and only if it has borne some tax in the source country.
- Secondly, there is often an advantage in routing dividends, interest, or royalties into a country that imposes some taxes, but that enjoys the benefit of a DTA that reduces the rate of tax at source.

⁴¹ Miller and Oats 177.

- Thirdly, the low-tax jurisdictions are viewed in a more favourable light and often host the foreign operations of well-established multinationals.⁴²

As has been seen, the tax system of a tax haven is purposefully geared towards offering generalised tax concessions. Tax havens can afford such concessions because they have the advantage of having no tax base to protect.

6.2.2 Harmful Preferential Tax Jurisdictions

A harmfully preferential tax jurisdiction is a high or normal tax country that has aspects in its tax system that have the same harmful effects on mobile activities as traditional tax havens.⁴³ While there are major similarities between tax havens and harmful preferential tax jurisdictions as outlined above, there are also crucial differences. According to Arnold and McIntyre, “[t]he essential difference between a tax haven and a preferential tax regime, according to the [OECD] Report, is that a tax haven has no base to protect and no interest in preventing harmful tax competition, whereas a country with a preferential tax regime does have a tax base to protect and an interest in preventing harmful tax competition.”⁴⁴

The essential features of a harmful preferential tax regime are as follows:⁴⁵

1. Low or no tax on certain (mainly mobile) income;
2. Ring-fencing of foreign income from the domestic economy;
3. No exchange of information; and
4. Lack of transparency.

According to the OECD Report, a preferential tax regime would be characterised by a combination of a low or zero effective tax rate and at least one of the above essential features.⁴⁶

⁴² Ginsberg 7.

⁴³ Arnold and McIntyre 140.

⁴⁴ Arnold and McIntyre 141. See also the OECD Report *Harmful Tax Competition, An Emerging Global Issue* (1998) par 60.

⁴⁵ OECD Report par 60.

6.2.2.1 Low or No Tax on Income

“A low or zero effective tax rate on the *relevant income* is a necessary starting point for an examination of whether a preferential tax regime is harmful” (my emphasis).⁴⁷ In this regard the lack of income taxes in a jurisdiction is rare, as income taxes account for most of the revenue of any country. Countries that are prepared to forgo this important source of revenue generally do so only in relation to certain forms of income and/or in relation to a certain group of taxpayers, as outlined below.

Generally, harmful preferential tax jurisdictions will have a low effective rate of income. This can be expounded by advertising a numerically low rate.⁴⁸ The effective income tax rate can also be reduced by exemptions, deductions and allowances. It can further be reduced by tax incentives on specific projects when a country employs such incentives to attract particular investors.⁴⁹

They can also be special-purpose incentives such as those dedicated to famine relief, infrastructure development, employment creation, technology transfer, export promotion, etc. It should be noted that most forms of tax incentives have generally lost their popularity due to the fact that they do not achieve most of their purposes, as investors exploit them and exit the country once the incentive ceases to benefit the taxpayer.⁵⁰

While tax competition often involves the imposition of lower or no income taxes, the fact that a country has low or no income taxes does not mean that such country does not raise its revenues through other taxes, such as indirect, consumption, customs, excise or other

⁴⁶ OECD Report par 60.

⁴⁷ OECD Report par 61

⁴⁸ This is, however, uncommon as it exposes the country to external criticism.

⁴⁹ Such incentives can be general, such as tax holidays, investment allowances, tax credits, timing differences, and tax rate reductions, or incentives based on administrative discretion.

⁵⁰ See Bolnick *Technical Report on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region* (2004); Easson *Tax Incentives for Foreign Direct Investment* (1992) 63–105; See also Holland and Vann “Income Tax Incentives for Investment” in *Tax Law Design and Drafting* (ed Thuronyi) 987–1019.

taxes. This aspect is often overlooked when an analysis of unfair tax competition is conducted.⁵¹

6.2.2.2 Ring-fencing of Foreign Income from the Domestic Economy

Another characteristic of preferential tax regimes is that they ring-fence foreign income from the domestic economy. Ring-fencing from the domestic economy in the preferential tax regime context refers to the inability of the domestic economy to access the preferential tax wholly, partly or directly. This may result in adverse implications for the tax bases of other countries. By limiting the application of the preferential regime, the jurisdiction limits the revenue loss to the amounts that could have been brought in by the foreign investors. At the same time, the investors would escape the tax net in their home countries, as the income would not be sourced in their home countries. The OECD Report states the following in this regard:⁵²

Since the regime's 'ring fencing' effectively protects the sponsoring country from the harmful effects of its own incentive regime, that regime will have an adverse impact only on foreign tax bases. Thus, the country offering the regime may bear little or none of the financial burden of [or loss resulting from] its own preferential tax legislation. Similarly, taxpayers within the regime may benefit from the infrastructure of the country providing the preferential regime without bearing the cost incurred to provide that infrastructure.

The total cost that preferential tax regimes incur for the mischief done to foreign tax bases is the past, present (and recurring) or future loss of the contribution to the tax base by foreign investors.

⁵¹ Biswas 3.

⁵² OECD Report par 62.

Two main forms of ring-fencing are identifiable. Firstly, the regime may only be available to non-residents. This can be done explicitly or implicitly. The more explicit indications increase the indication that the country is a preferential tax regime.⁵³ Countries do circumvent this explicitness by allowing residents limited access to the regime. For example, with regard to the regime applying to Belgian co-ordination centres, Belgian companies may participate in the creation of a co-ordination centre as shareholders and are included within the number of subsidiaries or the turn-over and capital criteria making the group eligible as the initiator of a co-ordination centre.⁵⁴

The second form, which also serves to insulate the domestic economy from the adverse effect of the regime, prohibits investors who benefit from the regime from accessing domestic markets. As such, no commercial transactions can be entered into between local enterprises and favoured entities.⁵⁵

6.2.2.3 Lack of Transparency

Lack of transparency arises from the way in which the legal regime is designed and administered, especially when legal requirements are applied by the tax administration in a lax and secretive way. This goes beyond the tax system and involves the entire legal system. As the OECD Report states:⁵⁶

[t]o be deemed transparent in terms of administrative practices, a tax regime's administration should normally satisfy both the following conditions: First, it must set forth clearly the conditions of applicability to taxpayers in such a manner that those conditions may be invoked against the authorities; second, details of the regime, including any applications thereof in the case of a particular taxpayer, must be available to the tax authorities of other countries concerned.

⁵³ See OECD Report par 62.

⁵⁴ See Malherbe J "Harmful Tax Competition and the Future of Financial Centres in the European Union in International and Comparative Taxation" in *Essays in Honour of Klaus Vogel* (ed Raad) (2002) 116.

⁵⁵ See Malherbe *Essays in Honour of Klaus Vogel* 116 – 117.

⁵⁶ OECD Report par 63.

Transparency can be undermined by the following:⁵⁷

1. Advance tax rulings. When these are done for a particular sector without disclosure of the conditions and without general applicability, they could turn into a factor that inhibits transparency;
2. Special administrative practices that are contrary to the fundamental procedures that underlie statutory laws – for example, where administrative practices and enforcement do not conform with the law or do not stipulate the conditions of applicability; or
3. Laws that are not enforced in line with domestic law – for example, where the tax authorities deliberately adopt a tax audit policy as an implicit incentive to taxpayers not to comply with the tax laws.

Perhaps the most destructive effect of the lack of transparency is the fact that if the country of residence does not have knowledge of the tax that is chargeable to its residents in the other country it is not able to take defensive measures against the taxpayer to correct the damage caused. Even worse, the country of residence might grant double tax relief in a situation where the income should have been taxable under the normal rules or controlled foreign company rules.

6.2.2.4 No Exchange of Information

Countries exchange information on their residents for various reasons. Initially it would seem that the motivation was to curb criminal activities. With economic development, it became essential for countries to access information on persons' economic activities in other countries in order, *inter alia*, to properly assess their tax liability in these other countries. This is essential both at national and international levels. Due to the increased regulatory environment in many areas such as banking, economics and accounting, the information to be exchanged is not limited to tax information.

⁵⁷ OECD Report par 63.

Financial information is normally used by both tax and other regulatory bodies in government. However, “[a] country may be constrained in exchanging information, for the purpose of the application of a treaty as well as for the application of national legislation, because of secrecy laws, administrative policies or practices that may impede the exchange of information.”⁵⁸ One of the reasons is the protection of trade secrets that may be compromised by the disclosure of financial information.

Against these constraints, the ability and willingness of a country to provide information to other countries remains one of the key factors in deciding whether the regime is a potentially harmful preferential tax regime. Factors that reflect difficulty in obtaining the information needed to enforce statutory laws include bank secrecy rules, the absence of an annual general audit requirement for companies, no requirement for a public register of shareholders and the use of shares and financial instruments issued in bearer form.⁵⁹

6.2.2.5 Other Features

In addition to the key features outlined above, there are other features that are characteristic of harmful preferential tax regimes. The extent to which a country has these features in addition to some or all of the key features mentioned above determines the extent to which a country’s preferential tax regime is harmful to other tax jurisdictions.

1. Artificial definition of the tax base – This arises where the tax base is generally defined but it contains instruments that modify such definition, for example, excessive tax credits, expenditure mark-ups (applying a margin to an expenditure) and deemed expenses. Where these instruments are not transparent and general

⁵⁸ OECD Report par 64; See also *Identifying Tax Havens and Offshore Finance Centres* http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf accessed on 16 September 2008.

⁵⁹ See Oguttu 20–23. See also Workman “The Use of Offshore Tax Havens for Purposes of Criminally Evading Income Taxes” 1982 *The Journal of Criminal Law and Criminology* 679; Westin *International Taxation of Electronic Commerce* (2000) 384.

- they result in companies in the same circumstances being subjected to tax at different effective rates.⁶⁰
2. Failure to adhere to transfer pricing principles – The transfer pricing principles are a key consideration in determining a multinational enterprise’s overall tax burden and the division of the tax base across countries.⁶¹
 3. Foreign-source income exemption – Pure territorial tax systems exempt income sourced from other countries. These are more attractive, as the exemption reduces the effective income tax rate and encourages the location of activities for tax purposes. Entities that exploit these regimes are often used as conduits or to engage in treaty shopping.⁶²
 4. Negotiable tax base or tax rate – This occurs where the country negotiates the rate with the investors or has different rates or bases depending on whether the taxpayer is resident or not, the nature of the activity and/or the country of residence of the investor. This becomes more complex where the regime is itself not transparent.⁶³
 5. Access to a wide treaty network – The main purpose of treaties is to avoid double taxation and evasion. They are also aimed at avoiding double dipping that may result from lack of exchange of information or transparency. Most harmful preferential tax regimes rely for their success on the existence of a wide treaty network. This is due to the fact that, without the treaties, the particular income that would be taxed at a lower rate in the harmful preferential tax regime could be

⁶⁰ See OECD Report par 69.

⁶¹ OECD Report par 71. Deviations from the application of the OECD 1995 Guidelines on transfer pricing and inappropriate use of advance tax rulings can have a massive impact on the allocation of income of a group of companies and cause investors to prefer one jurisdiction over others as a host of the operating or other company within the group. Such deviations may consist, *inter alia*, “in setting a level of profit which does not correspond to the functions actually performed by the entity in question or conversely, excess allocation of earnings to a firm that engages in no activity or in activity which, if not undertaken by a legally independent company, would not constitute a permanent establishment.”

⁶² OECD Report par 73. Treaty shopping is the use of a double tax agreement by a person who is not resident in either of the treaty countries, usually through the use of a conduit entity resident in one of the countries; see Olivier and Honiball 581.

⁶³ OECD Report par 74; See also *Identifying tax havens and Offshore Finance Centres*.

taxed also in the country of residence, which could result in a higher effective tax rate and thus nullify the effort to utilise the preferential tax regime.⁶⁴

6. Regimes promoted as tax minimisation vehicles – According to the OECD Report, some of the most successful preferential tax regimes are those that are widely promoted by, or with the acquiescence of, the offering country. This happens mostly when countries advertise or by other means make themselves known as tax minimisation regimes. The promotional descriptions used in the offerings generally indicate the country’s willingness to bend its tax laws to attract foreigners.⁶⁵

6.2.2.6 Assessing the Economic Effects of a Preferential Regime in terms of its Potential Harmfulness

As stated in the OECD Report, the economic effects of a certain regime influence the evaluation as to whether that regime is harmful or not.⁶⁶ Assessments of the regime either way are often hindered by the lack of transparency and reluctance to exchange information on taxpayers and investors.

The harmful part of preferential tax regimes is the fact that they harm the economies of other countries while shielding their own economies from similar or other harmful effects. The harm caused by preferential tax regimes is the attraction of foreign direct or portfolio investments while at the same time robbing the countries of residence of the investment in their jurisdictions. On the other hand, harmful preferential tax regimes shield their own economies from harmful effects by preventing the collection of taxes from their residents. The European Commission Code of Conduct for Business Taxation⁶⁷ acknowledges that in so far as the tax measures are used to support economic

⁶⁴ Girish *Offshore Financial Centres and Routing of Investments* <http://www.businessyan.com/content/view/199/430/> accessed on 21 September 2008; see also OECD Report par 76.

⁶⁵ Countries engaging in this kind of advertising are more likely not require much business activity for a taxpayer to qualify for the preferential regime. This exposes the country to being labelled a tax haven.

⁶⁶ OECD Report par 80.

⁶⁷ “The European Commission Code of Conduct for Business Taxation” *Resolution of the Council of Representatives of the Governments of the Member States* (1 December 1997).

development, an assessment should be made of whether the tax measures are in proportion to, and aimed at, the objectives sought.⁶⁸

The three primary and broad questions that have to be answered are the following:⁶⁹

1. Does the tax regime shift activity from one country to the country providing preferential tax treatment, rather than generate a significant new activity? – The issue here is whether the investor would relocate the business in order to exploit tax differentials or in order to benefit from the additional savings provided by lower taxes. This would involve an objective analysis of the tax and business environments of both countries and a subjective determination of the taxpayer's objectives in relocating (i.e. changing jurisdictions). In this analysis, the OECD Committee accepts that an investor may wish to move out of an unfavourable economic or political environment into a more business-friendly environment, regardless of tax incentives offered. Furthermore, the Committee accepted that certain domestic tax provisions may serve indirectly to discourage investment or to drive investment out, independent of the tax policies pursued in other countries.
2. Are the presence and level of activities in the host country commensurate with the amount of investment or income? – If the additional or alternative activities undertaken in the preferential tax regime are not commensurate with the amount of income attributable to the business in that country, the regime is likely to be harmful. Regardless of the existence of this proportionality, the international community would still be concerned about the harmful effects of tax regimes in other countries.
3. Is the preferential tax regime the primary motivation for the location of an activity? – In this evaluation, it is recognised that non-tax features also play a major role in the decision as to where the business activity should be located.

⁶⁸ *Resolution of the Council of Representatives of the Governments of the Member States Annex 2 G.*

⁶⁹ OECD Report par 80–81.

6.2.3 A Summary of the Differences between Tax Havens and Harmful Preferential Tax Regime Countries

As can be seen above, the similarities between tax havens and harmful preferential tax regime countries are quite significant. They resemble each other to such an extent that it takes an effort for one to distinguish between the two and they are often confused or the branding used interchangeably. In summary, the features that distinguish one from other are as follows:⁷⁰

1. Tax havens can fund their public expenditure without revenue from income taxes. This can arise due to the size of the country, the buoyant economy and/or the stable political and social status. On the other hand, harmful preferential tax regime countries require the revenue from income taxes to fund government expenditure.
2. Tax havens have low or no taxes on income in general, while harmful preferential tax regime countries tax normal income and do so at the normal or average rates. However, the harmful preferential tax regime countries have incentive features in their taxes for specific forms of income, mainly mobile business income, and either do not tax that particular income or tax such income at low effective rates.
3. Tax havens do not have a tax base to protect, while harmful preferential tax regime countries do have a sound tax base to protect.
4. Flowing from the foregoing, tax havens do not support the concerted efforts to curb tax competition and as such stimulate the “race to the bottom”⁷¹ as they do not have any base to protect.
5. Tax havens do not require any adequate business activity to take place in their jurisdictions. Harmful preferential tax regime countries do require such activities to exist in order to benefit from the regimes. This benefits their other objectives of foreign direct investment.

⁷⁰ OECD Report par 38–46. See also Oguttu 20; Spitz and Clarke *Offshore Service* (2002) OECD/3.

⁷¹ The “race to the bottom” refers to the situation of detrimentally lower tax rates brought about by countries competing to attract investors by lowering their tax rates and therefore depleting their tax bases.

6.2.4 Offshore Financial Centres

6.2.4.1 Introduction

Over time, negative impressions have been attached to the term “tax haven” and as a result tax jurisdictions avoid practices that could classify them as such. As mentioned above, more and more countries that qualify as tax havens refer to themselves as offshore financial centres.⁷² However, not all tax havens perform the services of offshore financial centres even though they prefer to be referred to as such. Below is a brief analysis of what offshore financial centres are and what they are designed to do.

6.2.4.2 Nature and Functions of Offshore Financial Centres

An offshore financial centre is a country where offshore finance is granted. It is a financial centre where offshore activity takes place. Offshore finance is the provision of financial services by banks and other agents to non-residents. It is usually a low-tax, carelessly regulated jurisdiction which specialises in providing the corporate and commercial infrastructure to facilitate the use of that jurisdiction for the formation of offshore companies and for the investment of offshore funds.⁷³

A more practical definition of an offshore financial centre is that it is a centre where the bulk of financial sector activity is offshore on both sides of the balance sheet, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents.⁷⁴

The International Monetary Fund characterises offshore financial centres as follows:⁷⁵

- Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;

⁷² See Oguttu 55–58.

⁷³ <http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1> accessed on 19 February 2008.

⁷⁴ <http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1> accessed on 14 March 2008.

⁷⁵ <http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1> accessed on 14 March 2008

- Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and
- More popularly, centres which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.

The distinction between offshore financial centres, tax havens and preferential tax regimes is by no means clear cut. Offshore financial centres range from centres such as Hong Kong and Singapore, with well-developed financial markets and infrastructure, and where a considerable amount of value is added to transactions undertaken for non-residents, to centres with smaller populations, such as some of the Caribbean centres, where value added is limited to the provision of professional infrastructure.⁷⁶

In addition to banking activities, other services provided by offshore centres include fund management, insurance, trust business, tax planning, and International Business Corporation (hereinafter referred to as “IBC”) activity.⁷⁷

IBCs normally operate in offshore financial centres. These are limited liability vehicles registered in an offshore financial centre. They are generally used to own and operate businesses, issue shares, bonds (including Eurobonds),⁷⁸ or raise capital in other ways. In many offshore financial centres the costs of setting up IBCs are minimal and they are generally exempt from all taxes.⁷⁹

⁷⁶ Adukia *International Financial Service Centre/Offshore Financial Centre* http://www.caclubindia.net/books/manual_sez_ftwz_ifsc/Ch%2022.asp accessed on 11 June 2009.

⁷⁷ See Oguttu 58–69 where she provides examples of offshore financial companies and their functions.

⁷⁸ Eurobonds are long-term bonds issued by companies and underwritten by an international banking syndicate and not bound by any country’s security laws. They are bearer instruments with fixed terms and are negotiable. See Miller and Oats 182.

⁷⁹ <http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1>, accessed on 14 March 2008 “Views of offshore financial centres tend to be polarised. Proponents suggest that reputable offshore financial centres play a legitimate and integral role in international finance and trade, offering huge advantages in certain situations for both corporations and individuals, allowing legitimate risk management and financial planning. Critics argue that they drain tax from wealthy (and not so wealthy) nations, are insufficiently regulated, and facilitate illegal activities such as tax evasion and money laundering while avoiding legal risk under corporate veil.”

An IHC's business structure allows it to fit any of these three modes of tax avoidance vehicles, i.e. tax havens, preferential tax regimes and offshore financial centres. The total lack of taxation in a tax haven means that the IHC would not incur any tax liability in such a jurisdiction. The favourable treatment of mainly passive mobile income in preferential tax regimes means that as the IHC would solely or mainly earn passive income, the IHC may not be liable income tax in such regimes. Finally, utilising an IHC to fund offshore operations in an offshore financial centre could also be an efficient tax-planning mechanism.

6.3 INITIATIVES AGAINST TAX HAVENS

The use of tax havens as a means to avoid taxes increased considerably in the latter part of the twentieth century.⁸⁰ This has resulted in more drastic focus on combating such usage in both national and international spheres. National government and the international tax community policies have been dramatically swayed and a lot of energy and resources directed at anti-haven practices.

The abuse of tax havens can be controlled by unilateral government initiatives or collectively by countries at an international level. Nationally, countries could enact anti-avoidance provisions and internationally they could follow the recommendations of the OECD in their tax treaties.⁸¹

⁸⁰ Miller and Oats 188.

⁸¹ See par 6.3.2. The Edwards Report and the KPMG Report, which were both commissioned by the British government, also recommended certain measures to curb harmful tax competition. For a further discussion on these reports see Diamond and Diamond *Tax Havens of the World* (Release No 108 Jan 2002) Intro 25–26; Bennet *International Initiatives Affecting Financial Havens* (2001) 37 Foreign and Commonwealth Office Partnership for Progress and Prosperity – British and Overseas Territories (17 March 1999) available on <http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1018028164839> accessed on 30 May 2009; Volaw Trust & Corporate Services Ltd, Channel Islands “The Edwards Report – 27 November 1998 available on <http://www.volaw.com/pg428.htm> accessed on 30 May 2009.

6.3.1 Unilateral Initiatives

In an effort to protect their tax bases, countries have a range of initiatives they can implement to restrict the detrimental use of tax havens. The means employed often depends on the kind of abuse the country is subjected to. These measures are found to be more efficient (both in substance and time), as, unlike collective measures, they do not require compliance with a host of administrative and bureaucratic formalities by more than one country. Individual country initiatives can also specifically target certain countries. However, certain general initiatives tend to be more effective against challenges of many kinds from many tax havens. The most common measures applied to achieve this goal are discussed below.

6.3.1.1 Controlled Foreign Company Legislation

In an attempt to combat international tax avoidance strategies, countries increasingly enact controlled foreign company (hereinafter referred to as “CFC”) legislation. This practice is consistent with recommendation 2 of the Harmful Tax Competition Report of the OECD.⁸² This is a very general and the most effective method of eliminating avoidance of tax by relocating the residence of a company.⁸³ The main purpose of CFC legislation is basically to prevent deferral of tax in the residence country due to the non-residence of the company and the non-distribution of dividends to shareholders. Because the deferral is more beneficial when the tax is low, tax havens present an even more serious problem in this regard. As Arnold and McIntyre state:⁸⁴

Absent remedial legislation, however, domestic foreign-source income can be deferred or postponed easily by establishing a foreign corporation or trust to receive the income. Because the foreign corporation or trust is generally considered to be a separate taxable entity, the controlling

⁸² See OECD Report par 101.

⁸³ See Miller and Oats 188.

⁸⁴ See Arnold and McIntyre 87.

shareholders of the corporation or the beneficiaries of the trust are not taxable until distributions from the corporation or trust are received.

CFC legislation combats the deferral of the tax by attributing the income of the CFC to its resident shareholders irrespective of the fact that the income has not been distributed to the shareholders. According to Miller and Oats, although the description of CFC “could equally apply to closely controlled subsidiaries in high tax countries, the phrase ‘controlled foreign company’ is only used to describe a subsidiary resident in a country where it pays little or no tax.”⁸⁵

Most CFC legislation is concentrated on definitions and the effectiveness of the system depends on how extensively the definitions apply. The most important of the definitions is the definition of CFC. Exclusions and exemptions for companies that qualify as CFCs are also important, the most important being the genuine business establishment exemption.⁸⁶

6.3.1.2 Transfer Pricing Rules

As a means of curbing or eliminating tax avoidance by usage of tax havens, a country may introduce transfer pricing rules into its tax regime. As indicated in Chapter 5, transfer prices are prices charged for goods supplied and services rendered to related or group companies. “‘Transfer pricing’ is the general term used to refer to the problem of allocating profits among the parts of a corporate group.”⁸⁷

A group of companies generally has the same ultimate shareholders. As the ultimate investor, the movement of prices and services within the companies does not affect the ultimate income of the shareholder, for example, where one company in a group is charged a price that is more than market value for goods and the profits are moved from that company to another company for ultimate distribution to the investor in both

⁸⁵ See Miller and Oats 189.

⁸⁶ For a further discussion on the exclusions and exemptions see Chapter 5 par 5.3.7.4.

⁸⁷ Vann *Tax Law Design and Drafting* 781.

companies. So, really, for the ultimate investor, or the group as a whole, it makes no difference where the income is earned or reserved.⁸⁸

For the country in which group companies are located, the view is different, as countries tax companies on the basis of their profits. Should companies freely shift profits from one country to another, the tax base of the one country would be depleted in favour of the other. Generally, for tax purposes profits are moved to companies located in countries with lower effective rates of tax. This is due to the fact that non-residents are taxed only on income sourced within the country.

Transfer pricing is a major issue in international commercial activities. In 2000, trade between companies in same multinational groups accounted for around US\$1.6 trillion per annum, or about one third of all world trade.⁸⁹ It will therefore be necessary to determine, by allocation, the profits attributable to a particular country.

According to Vann, the allocation can be effected in one of two ways.⁹⁰

A country can take the worldwide profits of the group and allocate some portion of those profits to a source in that country, thus bypassing the need to consider the pricing and nature of transactions within the group. Alternatively, the country can seek to determine the profits of a local branch or subsidiary separately from the rest of the group on the basis of the pricing and nature of transactions engaged in by the branch or subsidiary with the rest of the group.

The first method, based on formulary criteria such as relative assets, revenues and salaries, is the least preferred method and alongside the second method, got preferential

⁸⁸ “The prices charged within the group for goods or services and the financing methods used between the members of the group simply serve as means of moving funds around the group and do not in a commercial sense create profits for the group.” Vann *Tax Law Design and Drafting* 781.

⁸⁹ Miller and Oats 205.

⁹⁰ Vann *Tax Law Design and Drafting* 781

influence from the OECD and UN Model treaties.⁹¹ Central to the operation of this method is the so-called “arm’s length” principle.⁹²

6.3.1.3 Restriction of the Exemption Method on Certain Income

The third recommendation of the Harmful Tax Competition Report on how domestic jurisdictions can combat tax avoidance by usage of tax havens concerns restrictions on participation exemption and other systems of exempting foreign income in the context of harmful tax competition. It is recommended that countries that apply the exemption method to eliminate double taxation of foreign-source income should consider adopting rules that would ensure that foreign income that has benefited from tax practices deemed as harmful tax competition does not qualify for the application of the exemption method.⁹³

The exemption method is one of the methods used in eliminating double taxation of the same income in the hands of the same taxpayer.⁹⁴ In terms of the exemption method, the income that has been taxed in the hands of the taxpayer by a foreign jurisdiction is exempted from tax in the home jurisdiction. This method is commonly applied by countries that tax their residents on a territorial basis.

Applied in its purest form, the exemption method requires that the country of residence tax its residents on their domestic income and exempts them from domestic tax on all their foreign-source income. Not many countries apply the exemption method in its purest form.⁹⁵ Most countries limit the exemption method to certain types of income – most commonly, business income and dividends. In other countries the exemption is only

⁹¹ Vann *Tax Law Design and Drafting* 781. Most countries negotiate treaties based on the pricing and nature of transactions between the branch or group company with other members of the group.

⁹² For a discussion on the operation of the “arm’s length” principle see Chapter 5 par 5.3.8.1.

⁹³ OECD Report par 104.

⁹⁴ Other methods commonly used are the deduction method, in terms of which taxpayers are allowed to take a deduction for foreign taxes paid, and the credit method, in terms of which foreign taxes paid by resident taxpayers on foreign-source income reduce domestic taxes payable by the amount of the foreign tax.

⁹⁵ Hong-Kong is a prime example of a country that applies the exemption method in its purest form. See Arnold and McIntyre 32.

available if the foreign-source income is derived from a country that taxes income at certain minimum tax rates.⁹⁶ This restriction system could also be applied in relation to the credit and the deduction methods.

6.3.1.3 Addition of Anti-Avoidance Measures

On the basis that countries generally apply the exemption method to active business income, most passive income is taxable in the country of residence irrespective of its source. In addition to this, the Harmful Tax Competition Report advises that on the basis of the restrictions that already exist, additional minimum restrictions could be introduced and designed on further bases. The following bases of restriction are suggested:⁹⁷

a. Focus on the countries from which the foreign income originates

This restriction is direct. It focuses on certain countries determined according to the characteristics of those countries' tax systems. The OECD Report suggests that it could be decided that income originating from a country that is included in the list of tax havens or from listed harmful preferential tax regimes should not be granted exemption. In practice this could also be done through the country naming certain countries that it considers threats to its tax base.

As an alternative, the countries could use the white, grey and black lists to determine which income should be granted an exemption.⁹⁸ Some countries reverse the naming process by listing countries to which the exemption in respect of income arising

⁹⁶ See Arnold and McIntyre 33.

⁹⁷ OECD Report par 105.

⁹⁸ The white, grey and black lists are the lists of countries assessed in terms of their tax co-operation that were developed by the London G20 Summit in April 2009. The white list consists of countries that have implemented the internationally agreed tax standards. The grey list consists of countries that have committed to the internationally agreed tax standards, but have not yet substantially achieved such standards, such as tax havens and financial centres. The black list consists of countries that have not committed to the internationally agreed tax standards. See "What Next? – Tax Cooperation after the London G20 Summit" http://www.actionaid.org.uk/doc_lib/what_next.pdf accessed on 29 May 2009.

dividends paid would apply.⁹⁹ In this way, companies in countries other than those mentioned would not get the exemption, or would have to submit a special request to the revenue authorities for the exemption based on facts.

b. The type of income

Income that takes a form other than that of active business income generally benefits from the exemption. However, certain active business income, depending on how it arises, may be suspect. According to the OECD Report, foreign income that could clearly be attributed to practices constituting harmful tax competition should not be entitled to the exemption.

c. The effective rate of tax to which the income has been subjected

The determining factor as to whether the exemption is available could also be the rate of tax to which the income has been subjected. Where the income has been taxed at a lower rate the exemption could either be disallowed or an adjustment, similar to partial exemption, be applied. Where there is a *bona fide* business activity, the taxpayer is not made worse off by the fact that the tax is grossed up from the lower tax in the foreign jurisdiction to the tax that would have been paid had the taxpayer operated in his country of residence.

d. Foreign investment funds

CFC rules generally do not apply to mutual funds. A mutual fund is a form of investment where the investors collectively invest in a fund which in turn buys shares in various companies. In this scheme, the fund is the investor. Normally, due to the fact that the fund may not be a person on its own, the investment in the shares is looked-through to the

⁹⁹ South Africa had exemption of income from “designated countries” in section 9D(9)(a) of the Act. This list has been repealed by s22(1)(g) of the Revenue Laws Amendment Act 45 of 2003.

individual investors. This fragments the holding, making it difficult for the company, however held, to be a CFC.¹⁰⁰

As a supplement to the CFC legislation, countries adopt rules that are intended to eliminate the benefit of deferral for all passive investments in foreign entities. The rules used to eliminate the deferral or avoidance are broadly similar to those applicable to CFCs. When adopted, these rules “constitute an effective tool against regimes that offer favourable tax treatment in order to attract foreign passive investment from resident individual, rather than corporate, shareholders.”¹⁰¹

e. Transparency of rulings

The fifth recommendation in the OECD Report provides that where administrative decisions concerning the particular position of a taxpayer may be obtained in advance of planned transactions (advance rulings), the tax authorities of such country must make public the conditions for the granting, denying or revoking of such decisions.¹⁰²

This recommendation stems from the fact that, as a supplement to the tax rules applicable in any regime, tax jurisdictions often, in the interests of clarity and taxpayer certainty, carry out or apply the rules in terms of a so-called ruling system. In terms of the ruling system, taxpayers are able to submit to the tax authorities structures of planned transactions either before¹⁰³ or during implementation of the plan. The tax authorities would consider the plan against the applicable laws to determine the tax implications thereof. Often this consideration is guided by the taxpayer’s preliminary view of the tax implications.

In some jurisdictions rulings are only granted in relation to certain types of planned transactions rather than to all transactions. In this case, the tax authorities allow

¹⁰⁰ See OECD Report par 101.

¹⁰¹ See OECD Report par 102.

¹⁰² See OECD Report 108–110.

¹⁰³ The rulings granted prior to the planned transaction being implemented are generally referred to as advance rulings.

application for rulings due to the complexity of the rules applicable to such transactions.¹⁰⁴ Once such considerations have been made, the structure would be “approved” where the tax authority is of the same view as the taxpayer, or a ruling simply not granted where an adverse tax result is reached. This system applies on a case-by-case basis, although in rare circumstances a general ruling can be granted subject to exact essential facts existing in applicable cases.

The granting of advance rulings can mask harmful tax competition practices. This is because such rulings can be used to grant favourable tax treatment to certain transactions involving non-residents or generally favour non-residents in order to attract them to invest in the particular jurisdiction. This situation could be exacerbated by the confidentiality of such rulings and the lack of guidelines determining conditions in which the rulings would be granted.¹⁰⁵

It is therefore recommended that countries should be transparent in their rulings systems. This would achieve both the goals of equality within the tax system and combating tax avoidance by the use of tax havens. The latter would be ensured by considering the depletion of the tax base of a country where aggressive tax benefits are obtained by the lack of tax (or very low tax) in the foreign jurisdictions that cannot be sustained on a large scale.¹⁰⁶

¹⁰⁴ For example, in South Africa, with effect from 2006, rulings can be obtained in relation to controlled foreign companies’ provision of employees, equipment and facilities to sister CFCs where otherwise the lack of employees in sister CFCs would disqualify the sister CFCs from the foreign business establishment exemption. Other rulings provisions relate to sale of goods and performance of services, payment of royalties and business activities of banks, financiers, insurers and brokers. This is a specific provision applied in addition to the general rulings provision. Internationally, these rulings are common in transfer pricing, as the methods of determining arm’s length prices are complex.

¹⁰⁵ According to the OECD Report, “[t]he absence of details concerning certain administrative practices through which taxpayers’ positions are determined, in particular on issues such as the arm’s length value of certain services or the allocation of profits or losses between associated enterprises or between head offices and their permanent establishments, contributes to making a tax system not transparent.” OECD Report par 108.

¹⁰⁶ It should be noted in this regard that although this recommendation requires countries to unilaterally adopt the transparent attitude to rulings, its adoption would benefit countries on a reciprocal basis. This is due to the fact that, indirectly, the recommendation assists countries by ensuring that while these countries are attempting to combat the harmful effect of activities in tax havens they do not themselves become tax havens.

f. Foreign information reporting

The OECD Report recommends that countries adopt rules concerning the reporting of international transactions and foreign operations of resident taxpayers and that countries should exchange information obtained under those rules.¹⁰⁷ It is difficult for countries to obtain information concerning taxpayers' foreign activities because such information is located outside a country's jurisdiction. Yet tax authorities require this information in order to be able to administer the income tax system properly. Adopting this recommendation (in relation to obtaining information and sharing it) would assist countries in obtaining information about the foreign activities of their residents relevant for combating harmful tax practices.¹⁰⁸

The effectiveness of adopting this recommendation depends on countries working together towards combating tax avoidance.

g. Taxation of foreign dividends

The recommendations of the OECD contained in the report do not specifically deal with the issue of taxing foreign dividends by countries as a unilateral measure of combating the avoidance of tax. Foreign dividends are basically dividends declared by a non-resident company. They stem from a resident's investment in a foreign company. If these dividends are altogether exempt and none of the double tax elimination systems is applicable to them, investors would make a higher after-tax receipt by investing in tax havens and other countries that do not tax dividends or tax them at very low rates.

A country would eliminate this anomaly by imposing a tax on foreign dividends received by its residents. However, such taxation should be accompanied by a credit, exemption or deduction method of eliminating double taxation.¹⁰⁹ The objective in this instance is to

¹⁰⁷ Recommendation 4. See OECD Report par 106–107.

¹⁰⁸ See OECD Report par 106.

¹⁰⁹ The credit, exemption or deduction could be granted by the residence country other than in cases where such double tax relief should be denied in terms of the rule in par 6.3.1.3.

ensure that taxpayers do not pay more tax than they would have had they invested in the country of residence.

h. Access to banking information

Tax evaders have always used banking secrecy as a way of preventing tax authorities from knowing about their income and the sources thereof. This is also a feature that makes it attractive for cunning investors to invest in ‘uncooperative’ jurisdictions. In the OECD Report countries agreed that, while recognising the confidential nature of the relationship between a bank and its clients, provisions that unduly restrict access by tax authorities to banking information required for the assessment of taxes constitute a serious impediment to the fair and effective implementation of tax rules and may distort the allocation of financial flows between countries by providing an unfair competitive advantage to those financial centres that operate such provisions.

Of course the OECD report is concerned about the effect of banking secrecy at an international level. The provisions that override banking secrecy are mostly important for a tax jurisdiction in the administration of tax for both local and international income. Most countries have general provisions that could be interpreted to override the banking secrecy common law. For example, in South Africa, the Income Tax Act provides the revenue authorities with powers to require any person to divulge any information that the revenue authority may require.¹¹⁰ This (without consideration of any other legislation and interpretation thereof) gives the revenue authorities the power to elicit any information regarding any taxpayer from a banking institution or any other institution or person.

¹¹⁰ Section 74A of the Act provides that “The Commissioner or any officer may, for the purpose of the administration of this Act in relation to any taxpayer, require such taxpayer or any other person to furnish such information (whether orally or in writing) documents or things as the Commissioner or such officer may require.”

6.3.2 Treaty Measures

Countries may also prevent international tax avoidance by including in their treaties measures that counter harmful tax competition. The OECD Report sets out a series of recommendations by which countries can use tax treaties to counter harmful tax practices. These measures are, however, not as effective as the unilateral measures as they depend on the joint effort and dual interest of the contracting countries. Furthermore, in addition to the fact that treaties take a long time to negotiate, certain countries are still apprehensive about the protection of their tax residents and discouraging foreign investment.

Below is a brief outline of treaty measures that can be undertaken.

6.3.2.1 Greater and More Efficient Use of Exchanges of Information

The OECD Report recommends that countries should undertake programmes to intensify exchange of relevant information concerning transactions in tax havens and preferential tax regimes constituting harmful tax competition. The objectives and difficulties encountered in relation to this recommendation are similar to those encountered in respect of information exchanges discussed in unilateral measures above.¹¹¹

6.3.2.2 Restriction on Entitlement to Treaty Benefits

Countries could include in their treaties provisions that restrict the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax competition. The ninth recommendation of the OECD Report urges countries to consider

¹¹¹ The OECD Report (OECD Report par 114) states that “Information on foreign transactions and taxpayers is essential for certain domestic counteracting measures to work properly, but is notoriously difficult to obtain with respect to tax havens and certain harmful preferential tax regimes.”

how the existing provisions of their tax conventions can be applied for the same purpose.¹¹²

This recommendation is premised on the fact that a wide treaty network by countries that introduced harmful tax practices may have the unintended consequence of opening up the benefits of harmful preferential tax regimes offered by treaty partners.

Different countries have adopted measures to circumvent this practice.

In some cases, countries have been able to determine that the place of effective management of a subsidiary lies in the State of the parent company so as to make it a resident of that country either for domestic law or treaty purposes. In other cases, it has been possible to argue, on the basis of the facts and circumstances of the cases, that a subsidiary was managed by the parent company in such a way that the subsidiary had a permanent establishment in the country of residence of the parent company so as to be able to attribute profits of the subsidiary to the latter country. Another example involves denying companies with no real economic function treaty benefits because these companies are not considered as beneficial owner of certain income formally attributed to them.¹¹³

6.3.2.3 Status of Domestic Anti-Avoidance Rules and Doctrines in Tax Treaties

Countries should clarify the position of their domestic anti-avoidance rules. Ideally the domestic anti-avoidance rules should not be overridden by treaties, as these domestic anti-avoidance rules are countries' first line of defence against depletion of their tax

¹¹² In an effort to aid the inclusion of such measures, it was also recommended that the OECD Model Tax Convention be modified to include such provisions or clarifications as are needed to assist contracting states. See the OECD Report par 118.

¹¹³ See the OECD Report par 119.

bases.¹¹⁴ Ideally, the domestic and treaty anti-avoidance measures should apply together in combating tax avoidance.¹¹⁵

6.3.2.4 Synchronising Exclusions from Treaty Benefits

The OECD Report states that “[v]arious treaties include provisions denying specified entities or types of income the benefits of tax treaties. As these specific exclusion provisions vary considerably and different treaties treat similar entities or types of income differently, they show different ways to approach the same problems.”¹¹⁶

Should there be a uniform system where countries all exclude certain forms of income or entities, countries could then use the list as a reference point in negotiating treaties or amending provisions of treaties.¹¹⁷

6.3.2.5 Terminating Treaties with Tax Havens

Tax havens utilise their treaty networks to achieve non-taxation of income. This is achieved by treaties giving the tax haven taxing rights, with the residence country having an obligation to exempt the income taxed in the tax haven. When the income is subjected to tax in the tax haven but no tax is payable, the income would not be taxed at all.

In order to alleviate this problem, countries are urged to either terminate treaties with tax havens or amend such treaties to do away with provisions that are conducive to tax haven

¹¹⁴ For a further discussion on the interaction between domestic law and treaty law see Jones “The Interaction between Tax Treaty Provisions and Domestic Law” in *Tax Treaties and Domestic Law* (ed Maisto) (2006) 123–158; Arnold and Van Weeghel “The Relationship between Tax Treaties and Domestic Anti-abuse Measures” in *Tax Treaties and Domestic Law* (ed Maisto) (2006) 81–114.

¹¹⁵ The OECD Report (par 121), however, recommends that the Commentary on the OECD Model Convention be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the Model Tax Convention. This is an indirect route of achieving the objective of countries clarifying the position in their tax treaties, as the Model Convention is merely a guidance tool and contracting states are not compelled to follow it.

¹¹⁶ OECD Report par 126.

¹¹⁷ A co-ordinated system similar the one envisaged in the *Tax Co-operation: Towards a Level Playing Field – 2007 Assessment by the Global Forum on Taxation Report*, (see www.oecd.org/ctp/gftemplate) would be ideal. See OECD Report par 126.

activities or preferential tax regimes. There are, however, problems with terminations of treaties, as the OECD Report observes:¹¹⁸

Most countries recognise that termination of a treaty may raise significant political and diplomatic difficulties both for the countries concerned and possibly for other countries as well. It may also raise broader economic considerations. Experience has shown that it is usually very difficult to take such action alone, despite the fact that most tax treaties explicitly provide for the possibility of termination. While termination of a treaty is a matter to be decided by each party to that treaty, the possibility that many countries could adopt the same position vis-à-vis treaties entered into by a tax haven would increase the credibility of such action.

The OECD Report nevertheless recommends that countries should terminate such treaties and not enter into any fresh ones.¹¹⁹ “The recommendation implicitly requests countries to ensure that the territorial scope of their tax conventions does not extend to dependencies that constitute tax havens, whether these dependencies are their own or those of the countries with which they negotiate tax conventions.”¹²⁰

6.3.2.6 Other Recommendations of the OECD Report

It is further recommended in the OECD Report that countries should consider undertaking coordinated enforcement programmes, e.g. simultaneous examinations, specific exchange of information projects or joint training activities, in relation to income or taxpayers benefiting from practices constituting harmful tax competition. Furthermore, they should review the current rules applying to the enforcement of tax claims for other countries as well as generally intensifying international co-operation in response to harmful tax competition.¹²¹

¹¹⁸ OECD Report par 129.

¹¹⁹ OECD Report par 130.

¹²⁰ OECD Report par 132.

¹²¹ See OECD Report par 133–148.

6.3.3 OECD Developments since the 1998 Report

Since the Report in 1998, the OECD has continued its work focusing on combating tax avoidance and improving international tax co-operation. This includes work on “improving access to bank information, facilitating effective exchange of information, combating corruption, improving co-operation between tax and anti-money laundering authorities and countering harmful tax practices”.¹²² Items that are relevant to this thesis are developments with regard to the access to bank information, exchange of information and countering of harmful tax practices.

Access to bank information

In April 2002, the OECD’s Committee on Fiscal Affairs published a report entitled “Improving Access to Bank Information for Tax Purposes” which mandates OECD member states to permit tax authorities to have access to bank information for all tax purposes. The OECD considers that that access to bank information would enable authorities to fully discharge their responsibilities to raise revenue and to be able to engage in effective exchange of information.¹²³ In the aforementioned 2002 report the Committee on Fiscal Affairs encourages countries to:¹²⁴

1. “...undertake the necessary measures to prevent financial institutions from maintaining anonymous accounts and to require the identification of their usual or occasional customers...”
2. “...re-examine any domestic tax interest requirement that prevents their tax authorities from obtaining and providing to a treaty partner...information they are otherwise able to obtain for domestic tax purposes with a view to ensuring that such information can be exchanged by making changes, if necessary, to their laws, regulations and administrative practices...”

¹²² OECD *OECD’s Current Tax Agenda* (2008) 59.

¹²³ See OECD *Improving Access to Bank Information for Tax Purposes* (2000) 14 <http://www.oecd.org/dataoecd/3/7/2497487.pdf> accessed on 09 November 2009; OECD *OECD’s Current Tax Agenda* 62.

¹²⁴ OECD *Improving Access to Bank Information for Tax Purposes* 14-15.

3. "...re-examine policies and practices that do not permit tax authorities to have access to bank information, directly or indirectly, for purposes of exchanging such information in tax cases involving intentional conduct which is subject to criminal tax prosecution, with a view to making changes, if necessary, to their laws, regulations and administrative practices..."

Two progress reports have been published in July 2003 and July 2007 outlining the progress that have been made by both OECD member countries and non-member countries with regards to improving access to banking information. These reports show that there has been a lot of progress in some areas and little in others.¹²⁵

Effective Exchange of Information

Article 26 of the Model Convention provides for exchange of information in the context of a comprehensive bilateral income tax treaty. This article was revised in July 2004 to bring it in line with the current country practices. The revision further incorporates the work that the Committee on Fiscal Affairs has undertaken in developing the 2002 Model Agreement on Information Exchange on Tax Matters.¹²⁶

The 2002 Model Agreement on Information Exchange on Tax Matters is a model for tax information exchange agreements separate from the DTAs. It focuses on exchange of information on request. This model has been used as a basis of the 23 Tax Information Exchange Agreements that have been already signed.¹²⁷

¹²⁵ For the detailed contents of the reports see OECD *OECD's Current Tax Agenda* 62-63; OECD *Improving Access to Bank Information for Tax Purposes – The 2003 Progress Report* (2003) 5-17 <http://www.oecd.org/dataoecd/5/0/14943184.pdf> accessed on 09 November 2009; OECD *Improving Access to Bank Information for Tax Purposes – The 2007 Progress Report* (2007) 14-33 <http://www.oecd.org/dataoecd/24/63/39327984.pdf> accessed on 09 November 2009.

¹²⁶ OECD *Agreement on Exchange of Information on Tax Matters* <http://www.oecd.org/dataoecd/15/43/2082215.pdf> accessed on 09 November 2009.

¹²⁷ OECD *OECD's Current Tax Agenda* 60-61. See also ISLA *Tax Information Exchange Agreements are not always working* <http://www.isla-offshore.com/going-offshore/tieas-dont-always-work/> accessed on 09 November 2009.

Countering Harmful Tax Practices

Since 1998 when it was published, the OECD report on harmful tax practices was followed by four progress reports. The first report was issued in June 2000. This report outlined the progress made in curbing harmful tax practices and identified 47 potentially harmful regimes within the OECD and 35 jurisdictions that were found to have met the technical tax haven criteria. The second report¹²⁸ was released in 2001 and made modifications to the tax haven aspect of the 1998 report.¹²⁹ The third and fourth reports released in 2004 and 2006 respectively both focused on member country preferential regimes.¹³⁰

6.4 CONCLUSION

The main functions of an IHC involve the moving around of assets, receiving passive income and passing such passive income on to the ultimate holding company. The IHC often holds some of the investments for shorter durations and others for long durations. Certain income from the sale of investments could be taxable in the hands of the IHC as revenue. As a result the IHC would find itself subject to normal tax and capital gains tax.

Advanced forms of tax provisions affect IHCs far much more than the above-mentioned basic taxes, in terms of the complexities of the instruments and the far-reaching consequences of their application. The buying and selling of investments between the IHC and related parties subject the IHC to transfer pricing rules. Funding the setting up or operations of related companies further subjects the IHC to thin capitalisation provisions. Failure to comply with these provisions would generally subject the IHC to further taxes such as dividend taxes on the amounts deemed to be dividends. Where the functions of the IHC are combined with non-IHC functions further issues arise.

¹²⁸ OECD *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (2001) 8-12 <http://www.oecd.org/dataoecd/60/28/2664438.pdf> accessed on 09 November 2009.

¹²⁹ The second report provided that “ for purposes of determining which jurisdictions would be considered as uncooperative tax havens, commitments would be sought only with respect to the principles of effective exchange of information and transparency” (OECD *OECD's Current Tax Agenda* 66).

¹³⁰ OECD *OECD's Current Tax Agenda* 66.

Locating the IHC in a tax haven in order to avoid the potential of these consequences often prove to be more drastic than the actual consequences eventuating. Locating the IHC in a tax haven may also not yield any tax benefits, as the country of residence may tax the IHC as if it were located in the country of residence. As already stated, better tax results are attained where the IHC is located in a country that imposes taxes, albeit at lower rates.

The enticement of the no-tax characteristics of tax havens might also not directly benefit the IHC. The one-size-fits-all approach of the tax havens means that they are not custom-designed for holding structures, as they also benefit enterprises with active income. Preferential tax regimes, on the other hand, are more designed for the kind of income that IHCs earn: passive mobile income.

The legitimacy and appropriateness of the OECD's initiatives against harmful tax competition have been debated in the international arena.¹³¹ While the intention of protecting the tax bases of tax jurisdictions is noble, the attempts at synchronising the tax systems impacts substantially on the tax sovereignty of countries. To a very large extent it also ignores the depletion of resources in many countries as a remnant of the colonial past. As to whether the attempts by the OECD would succeed in rooting out tax avoidance by use of tax incentives, the pessimistic view is that tax avoidance "is like graffiti or pollution: if you want to get rid of it completely you will be disappointed."¹³² Having said that, if South Africa is to modify its tax system in order to accommodate or attract IHCs, such modification should be done in a way that does not fall foul of the international community's perception of fair tax competition.

¹³¹ Salinas "The OECD Tax Competition Initiative: A Critique of its Merits on the Global Market Place" (2003) 25 *Houston Journal of International Law* 550; Avi-Yonah "Tax Competition, Tax Arbitrage and the International Tax Regime" (2007) *Bulletin for International Taxation* 138-138. See also Oguttu 53.

¹³² Gumbel "The Storm over Tax Havens: Corporate Scandals have Boosted the Pressure on Offshore Havens to Open their Books: Some have done so – But Global Crackdown has a Long Way to Go" (2004) 16 *Time Magazine* 23.