

**AN EVALUATION  
OF HOW THE NEW HEADQUARTER COMPANY TAX PROVISIONS  
IN SOUTH AFRICA SHOULD BE AMENDED  
TO RESULT IN A DIRECT BENEFIT TO THE FISCUS**

by

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Submitted in partial fulfilment of the requirements for the degree

Magister Commercii in Taxation

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

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Date of submission:

**2012-11-07**

## **ABSTRACT**

### **AN EVALUATION OF HOW THE NEW ‘HEADQUARTER COMPANY’ TAX PROVISIONS IN SOUTH AFRICA SHOULD BE AMENDED TO RESULT IN A DIRECT BENEFIT TO THE FISCUS**

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During the past few years, South Africa established a competitive headquarter tax regime, which was implemented with the primary goal of encouraging foreign direct investment in South Africa. An important secondary goal was for South Africa to be used as a Holding Company location through which multinational entities can invest into sub-Saharan Africa.

Although the Headquarter Company regime was developed to prevent any direct losses to the fiscus, it did not create any direct benefits or advantages. Internationally, substance requirements have a two-fold purpose: to encourage resident tax entities to engage in active economic activities, and to prohibit income losses due to tax avoidance or evasion.

Some of the most important substance requirements are set out in a country’s policies on permanent establishment, beneficial ownership and transfer pricing. Another effective manner to encourage economic activity is to offer tax incentives to activities usually associated with Headquarter Companies. These activities include, but are not limited to active management, granting loans, leasing, and the provision of intellectual property. This research concludes that the inclusion of substance requirements in headquarter tax legislation will not only directly benefit the fiscus, but it will indirectly benefit the economy as a whole.

#### **KEY WORDS**

Headquarter Company regime  
Intermediary Holding Company  
Substance requirements

## **OPSOMMING**

### **‘N EVALUERING VAN HOE DIE HOOFKWARTIERMAATSKAPPY-BELASTINGVOORWAARDES IN SUID AFRIKA VERANDER BEHOORT TE WORD OM ‘N DIREKTE VOORDEEL TOT DIE FISKUS TOT GEVOLG TE HE**

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Gedurende die afgelope paar jaar het Suid Afrika daarin geslaag om ‘n kompeterende hoofkwartiermaatskappy-regime te vestig. Die regime was geïmplementeer met die primêre doel om direkte buitelandse beleggings te bevorder. ‘n Belangrike sekondêre doel is dat Suid-Afrika gebruik kan word as ‘n houermaatskappybasis, waardeur multinasionale entiteite beleggings kan maak in sub-Sahara Afrika.

Alhoewel die hoofkwartiermaatskappy-regime ontwikkel is met die doel om verliese aan die fiskus te voorkom, bied die regime ook geen direkte voordele aan die fiskus nie. Internasionaal word substansievereistes gebruik om twee redes: om ekonomiese aktiwiteite in entiteite aan te moedig en om inkomsteverliese as gevolg van belastingontduiking te beperk.

Van die mees belangrike en effektiewe substansievereistes word geïmplementeer deur ‘n land se belastingbeleid op permanente instellings, ekonomiese eienaarskap en oordragpryse. ‘n Ander effektiewe manier waardeur ekonomiese aktiwiteit bevorder kan word, is die toekenning van belastingvoordele aan aktiwiteite wat gewoonlik met hoofkwartiermaatskappye vereenselwig word. Hierdie aktiwiteite sluit in aktiewe bestuur, lenings, verhuring en die verskaffing van intellektuele eiendom.

Hierdie navorsing kom tot die gevolgtrekking dat die insluiting van substansievereistes in die hoofkwartier-regime nie net direkte voordele tot die fiskus tot gevolg sal hê nie, maar ook die ekonomie indirek sal bevoordeel.

## **SLEUTELWOORDE**

Hoofkwartiermaatskappy, Intermediêre Houermaatskappy, Substansievereistes

## TABLE OF CONTENTS

CHAPTER 1 .....	2
BACKGROUND .....	2
1.1 INTRODUCTION .....	2
1.2 RESEARCH PURPOSE .....	3
1.3 RESEARCH OBJECTIVES .....	4
1.4 DELIMITATIONS AND ASSUMPTIONS .....	4
1.4.1 Delimitations .....	5
1.4.2 Assumptions .....	5
1.5 DEFINITION OF KEY TERMS.....	6
1.5.1 Definitions.....	6
1.5.2 Abbreviations.....	6
1.6 CHAPTER OUTLINE .....	7
CHAPTER 2 .....	9
THE CURRENT HEADQUARTER REGIME OF SOUTH AFRICA.....	9
2.1 INTRODUCTION .....	9
2.2 TAX POLICIES .....	9
2.2.1 Explanatory Memoranda .....	10
2.2.2 Exchange controls .....	14
2.2.3 The intermediary holding company .....	16
2.3 OBJECTIVES AND ISSUES ADDRESSED DURING THE DEVELOPMENT OF THE NEW HEADQUARTER REGIME .....	16
2.3.1 Katz Commission.....	16
2.3.2 National Treasury .....	18
2.3.3 Other objectives of the South African Government .....	21
2.3.4 Organisation for Economic Co-operation and Development .....	22

2.4	COMPARATIVE RESEARCH ON EXISTING HOLDING COMPANY REGIMES .....	23
2.5	SUMMARY .....	24
CHAPTER 3.....		26
HEADQUARTER COMPANIES' SUBSTANCE REQUIREMENTS .....		26
3.1	INTRODUCTION .....	26
3.2	THE IMPORTANCE OF SUBSTANCE REQUIREMENTS.....	27
3.3	INTERNATIONAL POLICIES .....	29
3.3.1	The Netherlands.....	29
3.3.2	Mauritius.....	33
3.3.3	Cyprus .....	37
3.3.4	The United Kingdom.....	40
3.3.5	Other countries.....	44
3.4	CURRENT SOUTH AFRICAN LEGISLATION .....	48
3.4.1	Permanent establishment and beneficial ownership provisions.....	48
3.4.2	Participation exemption .....	49
3.4.3	Anti-abuse legislation .....	50
3.5	SUMMARY .....	51
CHAPTER 4.....		54
TAX INCENTIVES FOR TRADE ACTIVITIES UNIQUE TO HEADQUARTER COMPANIES.....		54
4.1	INTRODUCTION .....	54
4.2	INTERNATIONAL POLICIES .....	55
4.2.1	The Netherlands.....	55
4.2.2	Mauritius.....	55
4.2.3	Cyprus .....	56
4.2.4	United Kingdom.....	57
4.3	CURRENT SOUTH AFRICAN LEGISLATION .....	59

4.4	SUMMARY .....	61
CHAPTER 5 .....		64
INTERNATIONAL ORGANISATIONS .....		64
5.1	INTRODUCTION .....	64
5.2	ORGANISATION FOR ECONOMIC DEVELOPMENT AND CO- OPERATION.....	64
5.2.1	Beneficial ownership.....	65
5.2.2	Permanent establishment.....	68
5.2.3	Transfer pricing.....	69
5.3	EUROPEAN UNION .....	71
5.3.1	EU Directives.....	72
5.3.2	The Cadbury Schweppes Case.....	72
5.3.3	The Common Consolidated Corporate Tax Base Proposal .....	73
5.4	SUMMARY .....	76
CHAPTER 6 .....		77
ANALYSIS OF FINDINGS .....		77
6.1	INTRODUCTION .....	77
6.2	SUBSTANCE REQUIREMENTS.....	77
6.3	TAX INCENTIVES FOR TRADE ACTIVITIES.....	80
6.4	CONCLUSION.....	<b>ERROR! BOOKMARK NOT DEFINED.</b>
CHAPTER 7 .....		83
CONCLUSION .....		83
7.1	INTRODUCTION .....	83
7.2	PROBLEM STATEMENT AND RESEARCH OBJECTIVES .....	84
7.3	RECOMMENDATION AND FUTURE RESEARCH.....	85
LIST OF REFERENCES .....		87

## LIST OF TABLES

Table 1: Abbreviations used in this document .....	6
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# **AN EVALUATION OF HOW THE NEW ‘HEADQUARTER COMPANY’ TAX PROVISIONS IN SOUTH AFRICA SHOULD BE AMENDED TO RESULT IN A DIRECT BENEFIT TO THE FISCUS**

## **CHAPTER 1**

### **BACKGROUND**

#### **1.1 INTRODUCTION**

Headquarter Companies and Holding Companies are commonly used by multinational groups as an important element of group tax planning. To this end, Intermediary Holding Companies are often created to benefit from a particular country’s double tax agreement network, as well as other advantages offered by a country’s tax regime.

In certain instances, intermediary Holding Companies is created by a mere legal group restructuring, while the operational activities of such a group remain unchanged. These instances may lead to a “transparent” Holding Company that lacks any true economic substance.

To combat the establishing of such Holding Companies, certain countries encourage economic activities inside their own borders by incorporating substance requirements in the qualifying criteria for Holding Companies in their legislation. They also offer tax incentives for any trade activities performed by Headquarter Companies. Substance requirements became even more important after the Organisation for Economic Co-operation and Development (OECD) updated its principles on the transparency of a company.

In South Africa, the concept of a “Headquarter Company” was recently introduced into the Income Tax Act (58/1962) (hereafter referred to as the Act) by the Taxation Laws Amendment Act (7/2010) (hereafter referred to as TLA 2010). This Act came into effect on 1 January 2011 with a simultaneous relaxation in South Africa’s exchange controls.



Significant changes to the “Headquarter Company” tax policies came into effect on 10 January 2012 by the promulgation of the Taxation Laws Amendment Act (24/2011) (hereafter referred to as TLA 2011). This was done to reduce the risk of South Africa’s international policies acting as barriers to establishing international trade (National Treasury, 2012a:95).

National Treasury (2010:80) and the Department of Trade and Industry (2011:18) support the same ideal – to enhance foreign direct investment in Africa by developing South Africa into an ideal Headquarter Company location. The main intention of the recent Headquarter Company developments in South Africa is to enable multinational groups to establish headquarter locations in South Africa. This is done by making use of South Africa’s economic and political stability, as well as the relaxation in Headquarter Company policies, while establishing new trade agreements with other countries in Africa.

In evaluating the development of the new Headquarter regime in South Africa and the government’s objectives therein, the question arises whether the South African government considered its benefits to the fiscus. As shown throughout this research, the actual benefit to the South African economy of the introduction of the new Headquarter Company regime was minimal.

This research review further reveals that the benefits of including “substance requirements” and “incentives to trade activities” in the provisions of the Act addressing the Headquarter Company concept were not extensively researched. The firstmentioned two tax policies could provide South Africa with the leverage to not only encourage foreign direct investment in South Africa, but could also directly benefit the fiscus by encouraging international trade.

## **1.2 RESEARCH PURPOSE**

It is the main objective of this research to investigate how the new Headquarter Company tax provisions in South Africa should be amended with regard to substance requirements and tax incentives to trade activities to result in a direct benefit to the fiscus.

It is important to note that Legwaila (2011:10) correctly pointed out that there is a “dearth of literature” regarding the various aspects of South Africa’s new “Headquarter Company regime”. Other than the textbook of Olivier and Honiball, *International Tax: A South African Perspective*, there is no other single authority that deals extensively and comprehensively with this issue. Although various articles have been written on this subject, most articles merely scratch the surface by providing a summary of the actual regime or changes thereof.

### **1.3 RESEARCH OBJECTIVES**

The research objectives of this research are:

- To specifically explore and analyse the inclusion of “substance requirements” and “incentives to activities” currently incorporated in the provisions of the Act regulating the South African Headquarter Company regime. The objective is to determine the extent to which these concepts can be amended in the current tax provision to result in a direct benefit to the South African fiscus.
- To evaluate the Headquarter Company regimes of other countries. The aim is to identify tax policies unique to substance requirements and trade incentives for Headquarter Companies that can be successfully incorporated in the South African headquarter tax regime. Applicable tax policies will be identified and evaluated against the current South African tax regime to establish whether the application of similar tax policies will result in a direct benefit to the fiscus.
- To consider whether the identified substance requirements and trade incentives have a negative impact on the current Headquarter regime in South Africa, and to what extent they comply with the current international principles, as set out by bodies such as the OECD and the European Union (EU).

### **1.4 DELIMITATIONS AND ASSUMPTIONS**

### **1.4.1 Delimitations**

The proposed research contains several delimitations in respect of the context, constructs and theoretical perspectives of the research, namely:

- It is limited to the new tax policies relating to Headquarter Companies in South Africa. Although there are many elements or factors that may influence international trade and the South African fiscus, the full extent of the effectiveness of these policies is not researched in this study. The inclusion of these policies in this research is used to emphasise certain ideas or provide further proof, where necessary, and is subsequently purely incidental in this research. This research also does not aim to provide recommendations to any non-tax factors which may play a role in the establishment of a Headquarter Company.
- The international policies considered are limited to tax policies in respect of Headquarter regimes. The tax systems of each country and the subsequent incorporation of headquarter tax policies differ substantially and are not fully included in this research. The full extent of the tax system of each country used in the comparisons is not encumbered in this research.
- The research is limited to substance requirements and provisions in both domestic legislation and international policy. The full extent of benefits offered by Headquarter Company regimes is to be researched.

### **1.4.2 Assumptions**

This research is based on the assumption that the references used, especially from academic journals and articles, were written and reviewed by specialists in their relevant fields. Reliance is based on the conclusions drawn from these references.

## 1.5 DEFINITION OF KEY TERMS

### 1.5.1 Definitions

**Headquarter company** is defined as a centre of operations or administration (Free Dictionary Online, n.d.). Investopedia (n.d.) elaborates by stating it is “a place where a company’s executive officers and executives’ direct support staff are located.” Headquarter Companies usually charge management or administration fees as remuneration for their efforts.

**Holding company** is defined as: “a corporation that owns enough voting stock in one or more other companies to exercise control over them. A corporation that exists solely for this purpose is called a pure Holding Company, while one that also engages in a business of its own is called a holding-operating company. . .” (Encyclopaedia Britannica, n.d.).

**Conduit company** is usually a Holding Company formed for the main purpose of avoiding paying taxes on a certain income stream to more than one country. A conduit company “would serve as a pipeline for income from the subsidiary to the parent company” (Business Dictionary, n.d.).

### 1.5.2 Abbreviations

A list of abbreviations used throughout this document is set out in Table 1 below:

**Table 1: Abbreviations used in this document**

<b>Abbreviation</b>	<b>Meaning</b>
BRICS	Brazil, Russia, India, China and South Africa
CFC	Controlled foreign company
DTLAB 2012	Draft Taxation Laws Amendment Bill 2012
EU	European Union
FATF	Financial Action Task Force
FSF	Financial Stability Forum
HMRC	Her Majesty’s Revenue & Customs
IBFD	International Bureau of Fiscal Documentation

<b>Abbreviation</b>	<b>Meaning</b>
IHC	Intermediary holding company
JSE	Johannesburg Security Exchange
OECD	Organisation for Economic Cooperation and Development
PRC	People's Republic of China
SADC	Southern African Development Community
SARS	South African Revenue Service
TLA 2010	Taxation Laws Amendment Act. 7 of 2010
TLA 2011	Taxation Laws Amendment Act. 24 of 2011
UK	United Kingdom
USA	United States of America
the Act	Income Tax Act 58 of 1962

## 1.6 CHAPTER OUTLINE

This research study is divided into seven chapters, outlined as follows:

**Chapter 1 - Background:** This chapter consists of the background of the study, purpose statement, research objectives, delimitations and definition of key terms used throughout this research.

**Chapter 2 – The current Headquarter regime of South Africa:** This chapter provides the groundwork done during the process of theory development. It outlines the current research available, as well as the intention of the government regarding the incorporation of the Headquarter Company tax regime in South African legislation.

**Chapter 3 - Headquarter Companies' substance requirements:** This chapter outlines the importance of substance requirements regarding Headquarter Companies in South Africa. Substance requirements currently used by other countries were evaluated and compared with the relevant legislation in South Africa. These countries include, but are not limited to, Mauritius, the Netherlands, Cyprus and the United Kingdom.

**Chapter 4 - Tax incentives for trade activities unique to Headquarter Companies:** This chapter discusses the various activities usually associated with a Headquarter Company, as defined. An evaluation was done of tax incentives provided to Headquarter

Companies incorporated in other countries' Holding Company regimes. The aim is to establish whether they can be incorporated in South African legislation. These countries include Mauritius, the Netherlands, Cyprus and the United Kingdom.

**Chapter 5 - International organisations:** This chapter outlines the concerns and principles set out by the OECD and the EU.

**Chapter 6 - Analysis of findings:** This chapter analyses the findings of the research study. It provides proposals as to the tax provisions to be amended in the South African legislation to maximise the benefit derived from the current headquarter tax regime.

**Chapter 7 - Conclusion:** This chapter provides a summary of the research study and offer findings and proposes areas that justify further research.

## CHAPTER 2

### THE CURRENT HEADQUARTER REGIME OF SOUTH AFRICA

#### 2.1 INTRODUCTION

There are various reasons why companies select a specific country in which to establish a Headquarter or Holding Company. These reasons consist of both tax and non-tax factors.

A Holding Company location should be politically and economically stable; have an efficient tax and treasury system; be geographically well located; require low operational costs; have minimal reporting requirements; be respected in the international business community and have a tried and tested Holding Company regime (Finnerty, 2010).

South Africa's Headquarter regime was only implemented in January 2011; a very young regime compared to the established and successful Holding Company regimes of other countries, e.g. the Netherlands and Mauritius. An interview was conducted on 13 June 2012 with Mr C Makola, Director of International Taxes at National Treasury. He mentioned that, although South Africa previously had a similar regime, it failed as a result of qualifying companies not being allowed to make use of South Africa's vast double tax agreement network.

To meet the objectives of this research, it is necessary to understand the provisions of South Africa's current Headquarter regime – both tax and other factors – that contribute to the successful implementation and administration thereof. It is also necessary to establish the original intention of the Government in creating and promulgating the Headquarter Company regime as it is implemented on the date of this research.

#### 2.2 TAX POLICIES

It is of great importance to determine which issues and objectives were considered before the legislation on the new Headquarter regime, as it currently stands, was enacted to

Parliament. This can only be determined by evaluating the various proposals and changes to legislation during the past few years. The explanatory memoranda to the different amendment acts provide the best insight in the reasons for the implementation of the legislation, as well as any subsequent changes.

## **2.2.1 Explanatory Memoranda**

### **2.2.1.1 *Taxation Laws Amendment Act, No. 7 of 2010***

The tax proposals regarding the new Headquarter regime were introduced into the South African tax system in the Taxation Laws Amendment Act, No. 7 of 2010 (hereafter referred to as the TLA 2010).

The criteria for qualifying as a Headquarter Company were set out in the definition thereof in section 1 of the Act. Compliance to the following criteria is required from the incorporation date of the company:

- Each shareholder must hold at least 20% of the equity shares of that company and must hold voting rights.
- 80% of the assets of the company must consist of investments in foreign subsidiaries (including interest in equity, loans and intellectual property) in which the company hold a minimum of 20% equity shares and voting rights.
- 80% of the total receipts and accruals of the company must consist of income received from a foreign company in which the local company holds a minimum of 20% equity shares and voting rights.

Three tax rules were, however, identified as barriers that may prevent South Africa from encouraging the establishing of Headquarter Companies. These barriers are explained as follows:



- *Controlled foreign company (CFC) rules.* Firstly, the appropriateness of CFC rules are questioned when most of a Holding Company's income is received from abroad. Secondly, CFC rules may lead to an unnecessary administration burden, should the home country of foreign shareholders also have a CFC regime.
- *Tax on outgoing dividends.* During the time the explanatory memorandum of the TLA 2010 was published, secondary tax on companies was still levied at 10% on outgoing dividends from a South African resident company. Going forward, the new dividends tax would have impose a withholding tax of 15% on any dividends declared by such company.
- *Thin capitalisation rules.* The application of the rules set out in section 31 of the Act becomes problematic where the South African Holding Company receives funding from its foreign shareholders, and uses this funding to lend to foreign subsidiaries. This creates non-deductible interest payments in the hands of the South African Holding Company, with subsequent interest income from lending to be included in gross income for tax purposes.

It was therefore recommended that:

- Foreign subsidiaries of a Headquarter Company will not be treated as a controlled foreign company (CFC) merely as a result of the Headquarter Company's equity interest therein. This will be established by deeming the Holding Company as a foreign resident and will result in the CFC status of the foreign subsidiary being determined by the indirect ownership of the Holding Company's shareholders. Section 16 of the TLA 2010 accomplished this by specifically excluding a Headquarter Company from the definition of a CFC in section 9D of the Act.
- Dividends declared by a Holding Company will not be subject to secondary tax on companies (section 64B of the Act was amended by section 68 of the TLA 2010), or subsequently, the new dividends tax as was promulgated during April 2012. Once again, the Holding Company will be deemed to be a foreign resident for the purposes

of this recommendation, resulting in dividends potentially qualifying for the participation exemption.

- Headquarter Companies will not violate thin capitalisation rules merely as a result of the existence of back-to-back cross-border loans. For the purposes of transfer pricing rules, the Holding Company does not have to take into account any foreign loans obtained to on-lend to foreign subsidiaries in which at least 20% of the equity shares are held. However, the interest expense incurred as a result of the foreign loan is ring-fenced to the interest income earned from loans supplied to foreign subsidiaries. Sections 56 and 38 of the TLA 2010 amended the Act by exempting Headquarter Companies from the thin capitalisation rules in section 31 of the Act and inserting section 20C in the Act which provides for the ring-fencing of interest.
- Foreign creditors will be exempt from the pending withholding interest on back-to-back loans. Section 58 of the TLA 2010 inserted Part 1A in Chapter 1 of the Act allowing for the withholding tax on interest. Section 37K of the Act however, excludes interest payable by a Headquarter Company.
- Headquarter Companies will be deemed as foreign residents for the purposes of the reorganisation rollover rules and may subsequently not benefit from them. This was entered in an attempt to discourage companies from artificially qualifying as Holding Companies.

#### **2.2.1.2 Taxation Laws Amendment Act, No. 24 of 2011**

The most significant changes to the Headquarter Company regime were the insertion of section 9H in the Act by section 26 of the TLA 2011 and the deletion of the definition of a Headquarter Company from section 1 of the Act (as explained above) which moved to a new section 9I in the Act (section 27 of the TLA 2011). This section deals with the new Headquarter Company regime and contains qualifying criteria as follows:

- *Minimum participation by shareholders.* The minimum participation threshold required from each shareholder was reduced to from 20% to 10% of the total equity shares and voting rights, in line with amendments regarding all residents holding foreign shares.
- *Asset test.* The 10% will also be extended to the asset test. Subsequently, 80% of the assets of a prospective Headquarter Company must consist of investments in which that company holds at least 10%. By determining the 80% asset value, cash or deposits payable on demand must be excluded, as it may distort the original intention of the Headquarter Company.
- *Receipts and accruals test.* Firstly, the minimum 10% participation test will be extended to the receipts and accruals test. Secondly, this test was seen as a “backstop” to the asset test and can be relaxed to 50%. Therefore, 50% of the income of a Headquarter Company must be derived from foreign subsidiaries in which the Headquarter Company holds at least 10% as the use of receipts and accruals did not reflect the true intention of the legislator as a benchmark, as it was broad in nature and created uncertainties. Income derived from a foreign subsidiary will include fees, interest, royalties, dividends, sale proceeds and lease payments. Also, to provide flexibility in this provision with respect to new companies in the start-up process, a safe harbour will exist for a Headquarter Company with a gross income of less than R5 million.

Further changes included the following:

- *Election and annual reporting.* A qualifying Headquarter Company must elect to form part of the Headquarter regime every year by submitting a prescribed form to SARS. Qualifying Headquarter Companies who elect to form part of this regime must submit annual information to National Treasury in the manner and form prescribed by the Minister of Finance (section 9I(3) of the Act).
- *Participation exemption.* The reduced participation threshold will be extended to the capital gains participation exemption. Although the holding period of foreign equity shares will remain 18 months, the restriction of the buyer of the Headquarter

Company's foreign interests will be lifted. As a result of this advantageous position, the participation exemption will no longer apply to shares held in the Headquarter Company by South African residents.

- Section 9H was inserted in the Act with the main objective of prohibiting existing companies from falling within the new Headquarter Company regime. In terms of this section a company that becomes a Headquarter Company by selection, or ceases to be a resident of the Republic as defined in section 1 of the Act, will be required to sell all its assets (subject to certain exceptions) at market value immediately before the change in residency or nature occurs. Immediately thereafter, the company will then be required to acquire these assets at market value.

### **2.2.2 Exchange controls**

Exchange controls and tax are inseparable when it comes to international tax planning. Although exchange controls in themselves do not impose tax and are mostly used to discourage money and assets from leaving a country, it is also used as a “backstop” to prohibit certain tax-efficient transactions (Legwaila, 2011:13).

It is preferable to incorporate an intermediary holding company's (IHC) outside jurisdictions with exchange controls. This will ease the process of reinvesting the profits and funds from the IHC to the investor. It will also help preventing the profits of the IHC being “trapped” or repatriated. (Olivier & Honiball, 2011:691).

The process of exchange controls was brought into effect during the Second World War, protecting the foreign exchange reserves of South Africa. It was reintroduced in 1961 and is controlled by the Currency and Exchanges Act, No. 9 of 1993. Although the Minister of Finance is responsible for the exchange control policy, the president is empowered by this Act to make regulations regarding currency, banking or exchange provisions. (Reserve Bank of South Africa, 2011).

Previous Finance Minister, Trevor Manuel, indicated in his 1995 budget speech that his Department was in the process of gradually getting rid of all exchange controls. However,

17 years passed and the exchange controls are yet to be abolished. It must also be noted that the restrictions placed by the current exchange control regime have been significantly reduced since then. (Verhoef, 2012).

A company incorporated in South Africa is seen as a resident for exchange control purposes. Due to certain relaxations in exchange control restrictions in terms of the Exchange Control Circulars No. 37/2010 (issued 27 October 2010) and No. 2/2011 (issued 25 January 2011), a Headquarter Company is deemed to be a non-resident for exchange control purposes, other than for the reporting obligations. Subsequently, Headquarter Companies may transfer funds internationally without exchange control approval (Olivier & Honiball, 2011:706,709).

The aforementioned relaxation was done with the primary objective of granting South African companies opportunities to expand their operations into Africa and the rest of the world. Current Finance Minister, Pravin Gordhan (2010:18) confirmed in his Medium-term Budget Policy Statement in 2010 that his Department wants to extend the relaxation in exchange controls to international investors setting up regional headquarters in South Africa.

The exchange control requirements for a Headquarter Company differ from the requirements in terms of section 9I of the Act. Companies that comply with the following requirements may register for approval with the Financial Surveillance Department to have unrestricted access to offshore investments:

- All shareholders must, whether alone or together with other group companies, hold at least 20% of the shares and voting rights of the Holding Company.
- The Holding Company's shares/debt may not be listed on the Johannesburg Stock Exchange (JSE). None of the shares of the Holding Company may be held by a shareholder who is listed on the JSE.
- South African residents may not, directly or indirectly, hold more than 20% of the shares to the Holding Company.

- The Holding company's assets must consist of at least 80% foreign assets at the end of each financial year. Cash, cash equivalents and debt with a term of less than one year must not be taken into account (Reserve Bank of South Africa, 2011).

### **2.2.3 The Intermediary Holding Company**

During the interview conducted with Mr C Makola, Director of International Taxes at National Treasury on 2012-06-13, he indicated that the intention of the new Headquarter regime was the establishment of IHCs in South Africa. Olivier and Honiball (2011:689) define an IHC as a Holding Company that is not incorporated in the same country as the residence of the investor. Such an IHC is also commonly referred to as an offshore Holding Company, a foreign base company or an international Holding Company. Legwaila (2011:20) correctly indicated that the tax residence status of an IHC does not only depend on the country of incorporation, but also on the place of effective management. The new Headquarter regime was intended to encourage an IHC as a South African tax resident and not necessarily just an IHC incorporated in South Africa.

An IHC is an entity with a double identity – it is both a Holding Company of underlying subsidiaries and a subsidiary of an ultimate Holding Company of a group. As indicated by Legwaila (2011:22), a Holding Company is a company that owns the shares or voting rights of a subsidiary to such an extent that the Holding Company can exercise power or control over that subsidiary and a subsidiary is a company over which another company has control. It can therefore be concluded that the ultimate Holding Company of a group will be distinguished by its shareholders consisting of mostly individuals or trusts. Accordingly, the fact that the ultimate company will not be controlled by another company is its main distinguishing factor.

## **2.3 OBJECTIVES AND ISSUES ADDRESSED DURING THE DEVELOPMENT OF THE NEW HEADQUARTER REGIME**

### **2.3.1 Katz Commission**

During 1997, with the objective to evaluate and analyse South Africa's tax system, the Katz Commission created the Fifth Interim Report of the Commission of Inquiry, reporting on certain aspects of the Tax Structure of South Africa. Hereby, recommendations were given to reform South Africa's tax system to favourably compare with international tax practices. These recommendations included the creation of tax policies that would encourage Holding Companies, Headquarter Companies and Finance Companies to relocate to South Africa.

The Katz Commission (1997: par 3.1.4) concluded with the recommendation to change the levy of tax on income derived from international activities to the residence principle. However, it was noted by the Katz Commission (1997: par 3.1.4) that the current source-based tax system at that time was a positive step towards encouraging international investments.

The source-based system did, however, fail to encourage international investments as a result of:

- strict exchange controls;
- a hostile investment climate;
- constant fear of the introduction of a residence-based tax system; and
- certain income streams of Headquarter Companies being taxed on source principles (Katz Commission, 1997: par. 7.1.2).

The Katz Commission (1997: par 7.1.4) listed various attributes of a tax system ideal for the creation of Headquarter Companies:

- a good double tax agreement network
- exemption of foreign dividend income
- exemption of other foreign income
- absence of capital gains tax
- absence of withholding taxes on dividends paid to shareholders
- an efficient tax rulings system

The Katz Commission (1997: par 7.1.6) compared the South African tax system to that of various European and Asian companies, including certain tax havens that will always remain competitors. After taking into account “South Africa’s geographic proximity, regional superiority as regards infrastructure, and common cause with Africa . . . in addition to fiscal factors”, it was concluded that South Africa is a favourable location in which to establish Headquarter Companies with operations throughout Africa, especially in sub-Saharan Africa.

## **2.3.2 National Treasury**

### **2.3.2.1 *Discussions with Charles Makola, Director: International Tax***

An interview was held on 13 June 2012 with Mr C Makola, Director of International Taxes at National Treasury. The primary purpose was to discuss the objectives of the new Headquarter regime of South Africa with its subsequent benefit to the South African economy. During this interview, the research already conducted by National Treasury, as well as other alternative considerations yet to be incorporated into the law, were also discussed. All the information below was gathered during this interview; no additional resources were added.

Makola indicated that the previous Headquarter Company regime failed mainly as a result of Holding Companies not being entitled to make use of South Africa’s vast double taxation agreement network. Therefore, allowing qualifying Holding Companies to still make use of the advantages offered by South Africa’s treaty network was one of the main objectives of this new regime. This was accomplished by treating Holding Companies as South African residents for tax purposes, with certain exceptions as indicated in the explanatory memoranda above.

The new Headquarter regime was incorporated with the main objective of encouraging international investment in South Africa and, subsequently, sub-Saharan Africa by establishing IHCs in South Africa. The main benefit of any Headquarter regime remains vested in the ultimate Holding Company. However, the lack of international trust in the



South African Government, paired with constant political instability, do not provide the most favourable location to establish an ultimate Holding Company.

The regime was designed to incorporate political sensitivity and to simultaneously ensure that the South African *fiscus* will not suffer monetary loss as a result of Headquarter Companies being established. The qualifying criteria of a Headquarter Company, as discussed in detail in the aforementioned chapters, incorporates the normal participation exemption of 10% used in the current CFC regime. The benefits provided via the treaty network with respect to withholding taxes on interest, dividends, royalties and certain other fees are available to all tax residents of South Africa. Most of the other rules were incorporated to prevent existing companies from entering into the Headquarter regime, as the intention of this regime was the establishing of new companies in South Africa.

The ultimate benefit to be gained by the South African *fiscus* is minimal and cannot be quantified. Although South Africa does not suffer any loss to the *fiscus* as a result of this regime, it does not gain any monetary value from the regime either. The only direct benefit, other than foreign direct investment, will be an increase of improvement in money flowing through the country.

The new Headquarter Company regime does not incorporate any substance requirements for Holding Companies established in South Africa. Other countries with successful Headquarter regimes require, for instance, that directors, offices or certain equipment be located in that country to benefit from their Headquarter regime. Subsequently, the new Headquarter Company regime does not provide any indirect benefit to the South African *fiscus* by way of job creation, immigration of knowledge, or participation in business activities.

The research already been conducted by the relevant authorities at the time of the creation of the new Headquarter Company regime included a study of successful international Headquarter Company regimes. It especially used information supplied by the International Bureau of Fiscal Documentation (IBFD). During this research process, the incorporation of a private equity Headquarter Company regime was also considered. Refer to paragraph 2.3.2.2 below for a brief explanation of this regime.

To date, no research was conducted by National Treasury on the benefits offered to trade or to the business activities of Headquarter Companies by extending the new Headquarter regime. Benefits could be the exclusion of certain management fees received by the Headquarter Company from taxable income, or incorporating certain substance requirements in the qualifying criteria of a Headquarter Company. It is, however, important to incorporate the guidelines on harmful tax practices provided by the OECD in any proposals to extend the new Headquarter regime.

### **2.3.2.2 *Private Equity Headquarter Regime***

Mr C Makola, Director of International Taxes at National Treasury indicated at the interview held on 13 June 2012 that the private equity Headquarter regime is aimed at easing the tax anomalies usually associated with the establishing of an equity fund in South Africa. The private equity fund is set up to operate as a limited partnership, dedicating 80% of its investments to South African operations, with the remaining 20% aimed at sub-Saharan investments. The main concern of the private sector is that, even after the change in legislation discussed below, a private equity is seen as a permanent establishment in a country, prohibiting the passive income from being eligible for treaty benefits.

This legislation was brought into effect on 1 January 2012. The new set of rules with respect to a private equity fund is not a regime as such, but was incorporated in the new source rules introduced by the TLA 2011. These new rules are set out in sections 9(2) (j), 9(2) (k) (ii) and 9(2) (l) (ii) of the Act. The effect of these rules is that private equity funds will not be taxed on trading gains from a South African trading manager, subject to certain exceptions.

The benefits provided by this new private equity fund regime are also aimed at increasing foreign direct investment in South Africa. Together with the current Headquarter regime, no further benefits are derived to increase the South African economy. Both the new Headquarter regime and the private equity fund rules contain no substance requirements and are also not set up to encourage international trade.

### **2.3.3 Other objectives of the South African Government**

In his 2011 State of the Nation address, President Zuma (2011) emphasised the importance of the African continent as a prime factor in economic development and regional integration. Regional integration in the Southern African Development Community (SADC) is currently being pursued by the Department of Trade and Industry. Their ultimate intention is the expansion of the South African market and its developmental objectives through the existence of free trade areas among regional economic communities in Africa (Portfolio Committee on Trade and Industry, 2011).

Africa is home to 70 % of the world's fastest growing economies. Africa has recently become even more popular with investors, as the developed economies have lost their lustre and the major emerging economies are struggling with a recession. It is a continent plagued by diseases, poverty corruption and wars, but it is a hidden gem for investment, with a rising middle class and rapidly growing technological sectors. (KPMG Debate Panel, 2011; Urmson, 2012).

The continued growth of Africa is dependent on the discovery of more natural resources and the commercialisation of its abundant selection of unused agricultural land (Collier, 2011:18). A few critical components are, however, still missing and need to be put in place before Africa can bridge the gap to become a developed continent. For investors to provide funds for infrastructure and construction strategies, political stability, education and lower levels of corruption are required.

Other factors are the large size of Africa and its diversity – it is a continent of many different peoples and scenarios and consists of 54 countries with various levels of economic maturity. Thus, the implementation of a single strategy is not sufficient to effectively address the missing components, or to provide sufficient investments and resources for the ultimate goal of economic development. (Urmson, 2012).

According to Kahn (2011: 38), South Africa is the only African country of sufficient scale and substance to be successful as a gateway to trade in Africa. However, certain negative

factors need to be addressed before this can be achieved. These include, but are not limited to, chronic political instability, Africa's importance to the United States, and global financial constraints.

South Africa's invitation to join BRICS is not just essential in the ultimate development of its economy, but also to expand its trade (Portfolio Committee on Trade and Industry, 2011). To China, South Africa is a "pivotal state on the continent that must be given due weight in its broader African engagement strategy" (Beeson, Soko & Yong, 2011:1381). According to Neubig and Kinrade (2012:44), the United Nations' World Investment Report points out how Holding Companies situated in BRICS countries are expanding and are continuously searching for new markets.

The Government of South Africa's priorities, aligned with the strategic objectives of the Department of Trade and Industry, are set out in the Medium-Term Strategic Plan 2011 – 2014 (2011:18,19). As indicated in this document, one of the main objectives of the South African Government is to pursue "African development and enhanced international co-operation". The subsequent Department of Trade and Industry strategic objective in this regard is to "build mutually-beneficial regional and global relations, advance South Africa's trade, industrial policy and economic development objectives". These priorities and objectives are supported by the implementation of tax and other policies, creating a new Headquarter regime for South Africa to enhance international trade.

#### **2.3.4 Organisation for Economic Co-operation and Development**

During 1998, the OECD approved a report entitled Harmful Tax Competition, An Emerging Global Issue, which addressed issues directly related to harmful tax policies (OECD, 1998). This report provided criteria by which a harmful tax regime can be identified:

- low or no tax on certain income streams
- lack of transparency
- lack of effective exchange of information policies
- the regime is ring-fenced from the rest of the domestic economy (OECD, 2006:3)

It is important to note that the low or no tax criteria on certain income streams is a mere tool to determine which tax practices may be construed as harmful. On its own, this practice will almost never be sufficient to label a tax regime as harmful. Also, the 1998 OECD Report was limited to only certain mobile services and did not cover industries like manufacturing. (OECD, 2006:3).

One of the main objectives of the 2006 Update on Progress in Member Countries (OECD, 2006) was to evaluate the progress of the 47 potentially harmful tax regimes originally identified in the 1998 OECD Report. It was found that 18 regimes had been abolished and 14 amended to remove any potentially harmful features. The only tax regime that was still deemed as harmful was the 1929 Luxembourg Holding Company regime. This regime was found to be harmful, even after amendments had been made to it, as it constituted state aid not compatible with the common market. Luxembourg disputes this classification, as the European Commission, after political analysis, declared the regime no longer harmful. (OECD, 2006:4).

The principles of transparency and exchange of information were enforced by all the OECD countries and non-OECD countries were encouraged to also abide by these principles. These two principles form the basis for creating an environment in which both OECD and non-OECD countries, with or without income tax systems, can “compete freely and fairly thereby allowing economic growth and increased prosperity to be shared by all” (OECD, 2006:3).

In Article 26 of the OECD Model Tax Treaty, the importance of exchange of information among countries to correctly apply the domestic tax policies of various countries is discussed. The OECD especially encourages countries to conclude Tax Information Exchange Agreements with one another in which they do not have a double tax agreement. (Olivier & Honiball, 2011:703).

## **2.4 COMPARATIVE RESEARCH ON EXISTING HOLDING COMPANY REGIMES**

Internationally, various jurisdictions offer benefits to the establishment of a Holding Company. The two most popular jurisdictions for Holding Companies are Luxembourg and

the Netherlands. This is as a result of their vast treaty network with subsequent reductions in withholding taxes, as well as granting participation exemptions in respect of dividends received from foreign operating subsidiaries. Both these countries also enjoy the benefits of the EU parent-subsidiary directive and the EU directive on interest and royalties. These directives eliminate the burden of withholding taxes on payments among companies organised in the EU, subject to certain ownership and holding period requirements. (Tuerff, Sierra, Trump & Narayan, 2011).

Legwaila (2011) did an extensive comparison between the South African Headquarter regime – before the changes effected in the TLA 2011 – and the successful Holding Company regimes of the Netherlands and Mauritius. He used the characteristics of an ideal Holding Company regime set out by the Katz Commission in their 1997 report to establish whether South Africa's new Headquarter regime is competitive in the international market, and to identify areas of the regime that can be improved to make the regime more competitive.

## **2.5 SUMMARY**

This chapter sets out the existing research already conducted on Headquarter Companies. Various resources were analysed to identify the original objective of the Headquarter Company regime. It was found that the Headquarter Company regime, including but not limited to the tax provisions, were created and incorporated into law with the main intention of attracting foreign direct investment into South Africa. The possibility of South Africa being created as a conduit for investment into Africa was a mere secondary objective.

The government's objective to enhance the economic growth of South Africa using the Headquarter Company regime is supported by the relaxation of the exchange controls and the specific tax regime promulgated. However, there is a lack of research conducted by both the Government and third parties with regard to the benefit offered by the Headquarter Company regime. No entity or body, including the Government, has considered changing the policies revolving around Headquarter Companies to result in any kind of benefit to the South African economy.

Both substance requirements and trade incentives to activities usually associated with Headquarter Companies were identified as two possible tax policies or regimes that could be incorporated into the Headquarter Company tax regime that should lead to a direct benefit to the South African *fiscus*. These two tax policies will therefore be further investigated in the next two chapters. This will be accomplished by analysing existing Headquarter Company regimes internationally and identifying policies which can be successfully incorporated into South African law.

## CHAPTER 3

### HEADQUARTER COMPANIES' SUBSTANCE REQUIREMENTS

#### 3.1 INTRODUCTION

“Substance” is a term used by businesses and tax authorities. It refers to a company’s level of activity and the responsibility or risks undertaken in a particular country. The substance of a company, either activity based or as a result of asset ownership, is directly linked to the profitability of a company. (Deloitte, n.d.).

During the past few years’ economic recession, governments started implementing various measures to combat the ever increasing budget deficits experienced. These measures include tax rate increases, enhanced reporting requirements and creating new tax policies that may stop the abuse of certain tax benefits, in particular in-country substance with related tax treaty abuse. (Taggart & McAneny, 2010:4).

Several countries located in the EU, including Luxembourg, France and Portugal, increased their corporate tax rates to decrease the effect of the economic recession (Koven, Kagalwala & De La Mettrie, 2010:7). As South Africa did not increase its corporate tax rate, its economy must be stimulated by means of other policies.

During this chapter the importance of substance requirements in a country’s Holding Company tax regime will be explored. This will be accomplished by evaluating the various substance requirements currently found in the tax regimes of certain countries. These substance requirements, or lack thereof, will then be compared to that of South Africa’s tax legislation in order to identify any areas for improvement.

Certain countries that are already successful and popular jurisdictions used for African investments will be used as comparisons to establish whether substance requirements are really necessary in South African tax legislation. These countries include Cyprus, the Netherlands and the United Kingdom (Brown, 2012). Mauritius is currently a very successful Holding Company location for investments in Africa and, as a result of its



proximity to other African countries, is an important country with which to compare South Africa's new Headquarter Company tax regime.

### **3.2 THE IMPORTANCE OF SUBSTANCE REQUIREMENTS**

Tax planning usually consists of legal restructuring of a group company, while the operational activities of the said group remain unchanged. These structures usually do not have any economical substance (Sanders, 2011). Tax schemes that are devoid of substance and economic justification are usually construed as abusive business practices (Tirard, 2009).

“Treaty shopping” is a term used to describe entities incorporated with the sole intention of getting undue treaty benefits. It usually occurs when two countries do not have a double tax agreement, or the double tax agreement is less favourable than others. A conduit company will then be created in a country with which both the aforementioned countries have favourable treaties. To avoid treaty shopping in their jurisdiction, governments employ various anti-avoidance measures. One such measure is the beneficial ownership provisions in treaties, whereby treaty benefits are only made available to the beneficial owner of the specific income. (Yiolitis, 2012).

Internationally, an increase in general anti-avoidance rules is experienced as an effort by Governments to prohibit the abuse of their Holding Company policies or double tax agreement network. Substance requirements are usually determined by the country in which the assets of a company is situated and not necessarily where said company is established or registered. As substance requirements usually depend on the domestic law of a country, it is difficult to establish a guideline of what exactly the substance of a company entails (Teunissen, Groenen, Mehra & Noordhuis, 2010:14). Over the years, the OECD published various documents indicating their policy on substance (refer to chapter 5).

The first consideration of governments in the assessment of a company's economic substance is the place of effective management. This is determined by either domestic legislation, or a specific treaty, if applicable. Where the legal set-up of the company and

the facts and circumstances in certain transactions do not coincide, general anti-abuse rules must provide for a substance-over-form approach. According to the judgment of *Laerstate BV V. Revenue & Customs* (2009), the place of effective management is influenced by the location where the decisions are taken, whether by management or by the directors of a company. If the decision-making lies with the directors, the place of effective management will usually be where the board meetings are held. High level decisions may also be taken by management. Should this be the case, it must be considered who the management is and where the decisions are taken. Simultaneously, the beneficial ownership of the IHC must also be considered. (Kellerman, 2011).

Another very effective anti-abuse rule is a country's CFC legislation. This legislation is usually used by governments to tax the profits of a foreign company that mainly receives passive income in the hand of its shareholders, should the shareholders of a specific country hold more than 50% of that company's shares (Kellerman, 2011).

Exemptions of anti-abuse rules must exist to prohibit double taxation of a certain income. Many countries, e.g. Switzerland, exempts a company (holding assets in the form of intellectual property) from its anti-abuse legislation if that company employs at least one qualified employee other than for the passive management or administration of a company's assets. (Kellerman, 2011).

During 2010, PriceWaterhouseCoopers completed a substance survey for real estate investment companies established in Luxembourg. This study was based on 230 real estate investment entities located in Luxembourg and concluded that "low relative substance is quite limited". This report, however, indicated that substance of companies established in Luxembourg became more important after the OECD's new developments. It also indicated that substance should not necessarily be measured by ways of ticking elements on a list, but should be about creating an environment with true economic activity. However, the substance requirements most used by certain countries can be set out as follows:

- senior decision-making staff;
- employees;

- office facilities;
- documentation;
- Board of Directors and shareholders' meetings; and
- profits or financing (PriceWaterhouseCoopers, 2010).

According to Kellerman (2011), the following substance requirements are usually used by countries to establish economic substance of IHCs:

- payroll requirements;
- minimum capital requirements;
- minimum revenue thresholds;
- reporting requirements; and
- requirements in relation to activities/number of activities.

### **3.3 INTERNATIONAL POLICIES**

Concluding from the aforementioned, substance requirements are not usually specified as such in a country's legislation, but are included in the provisions dealing with permanent establishments, beneficial ownership and participation exemptions. Anti-abuse legislation usually contains many stipulations that require an indication of substance. Therefore, all these factors will be considered in establishing the extent of substance requirements in each of the countries discussed below.

#### **3.3.1 The Netherlands**

Internationally, the Netherlands is a well-respected country, has a relatively well trained work force and a stable tax climate. With additional factors such as a good infrastructure, political and social stability and main ports, the Netherlands is an important option when it comes to decisions as to where the head offices of multinational entities should be established. Currently, the Netherlands is in the top 10 countries of the Fortune Global 500 business locations and is ranked as the number one location for investments in the USA. It is estimated that, during 2010, more than 13% of US foreign direct investment, or \$521.4

billion, was invested through the Netherlands. (Bilars, Laawman, Vermeulen & Vreman, 2012, Geuze & Rebergen, 2011).

Foreign direct investment is important to the Dutch government. Accordingly, they have established a 'Top Team Head Offices' committee in February 2011, consisting of representatives from various business sectors, knowledge institutes and the government. The objectives of this committee are to identify the most positive traits of the current tax regime in the Netherlands and to expand it to ensure an efficient use of current and future tax policies. (Bilars et al, 2012).

According to Legwaila (2012:192), the flexibility of the corporate tax systems provides an optimal environment for multinational companies to establish a Holding Company. IHCs incorporated in the Netherlands can be used for many functions; can be listed on the stock exchange, which provides a better way of funding; is a perfect environment in which to set up a joint venture.

Multinational group structures make use of the Netherlands as a Holding Company location, mostly as a result of the Dutch's vast treaty network, both double tax agreements and bilateral investment treaties. Recent research indicates that the Netherlands is home to many "mailbox companies" without any economic substance in the Netherlands. These companies have no employees and no real activity within the borders of the Netherlands. Concerns have been raised that the Dutch treaties are responsible for the establishing of over 20 000 mailbox companies in the Netherlands. Currently, the Dutch government does not perceive this to be a problem. (Knottnerus & Van Os, 2011).

### **3.3.1.1 Corporate and legal requirements**

Corporate service providers located in the Netherlands are usually required to provide a local address, directors or employees who are Dutch residents and be compliant in keeping all necessary documentation such as annual accounts, tax returns and trade register filings, up to date (Geuze & Rebergen, 2011).

### **3.3.1.2 The participation exemption**

Certain tax exemptions apply should the company hold at least 5% of the equity shares or voting rights of a subsidiary. These exemptions apply to dividends and capital gains derived as a result of the holdings in a subsidiary. In order for the participation exemption to apply, the following requirements must be met:

- The subsidiary is not held as a portfolio investment, but should be operational.
- The subsidiary is taxed at a reasonable, effective rate in the country of residence, based on principles laid out by the tax authorities of the Netherlands.
- Tax losses should be carried forward indefinitely.
- Passive assets should not comprise more than 50% of the total asset value (calculated using fair values) of the subsidiary (Deloitte, 2012e).

### **3.3.1.3 *Permanent establishment, residence and beneficial ownership requirements***

For tax purposes, all companies incorporated in the Netherlands, as well as companies with their place of effective management in the Netherlands, are regarded as Dutch residents (Deloitte, 2012d).

In *Prevost Car Inc. v Her Majesty the Queen*, 2009 FCA, 57 [2010] F.C.R 65, the court was requested to verify whether Prevost Car Inc. (Prevost) was privy to the benefits offered by the double tax agreement between Canada and the Netherlands. Prevost, a Canadian resident, paid dividends to its Holding Company, Prevost Holding BV, located in the Netherlands. In turn, Prevost Holdings BV declared a dividend of a similar amount to its shareholders in accordance with its shareholders' agreements, which provided for the distribution of at least 80% of the profits made by Prevost Holdings BV and Prevost respectively. Prevost Holdings BV has two shareholders, one resident in Sweden and the other in the UK.

The Canadian government held the view that Prevost Holdings BV was not the "beneficial owner" of the dividends received by Prevost, but rather that the shareholders of Prevost Holdings BV were the beneficial stakeholders.

The judgment gave recognition to the international meaning and interpretation of ‘beneficial owner’. According to the judge, Prevost Holdings BV was not a mere conduit of the dividends on behalf of its two shareholders. He also said Prevost Holdings BV was “a statutory entity carrying on business operations and corporate activity in accordance with Dutch law” and enjoyed the ultimate use of the dividends.

#### **3.3.1.4 Anti-abuse legislation**

The Netherlands does not have specific CFC rules by which to govern the taxation of profits of foreign subsidiaries. However, general anti-abuse provisions may apply in prohibiting the participation exemption from apply in to low taxed portfolio investments. Also, general provisions require the re-assessment of shareholdings of 25% or more in low-taxed companies with passive assets comprising more than 90% of its balance sheet value. (Deloitte, 2012d).

The Netherlands require inter-group transactions to be at arm’s length. Further, thin capitalisation provisions disallow inter-group interest to the extent that it exceeds the 3:1 debt equity ratio (Deloitte, 2012d).

Previously, a cooperative (a certain type of legal entity incorporated in the Netherlands) would not have been subject to a dividend withholding tax, as the nature of the cooperative’s capital is not such that it can be divided into shares. The Dutch tax authorities amended the Dutch Dividend Withholding Tax Act of 1965 to specifically deem the cooperative to have capital divided into shares. Entities will subsequently be responsible to withhold tax on dividends declared, should the following requirements be met:

- The main purpose for the incorporation of the company/structure is tax avoidance.
- The member is not party to active trade or business activities to which the rights in the cooperative can be allocated (Gerritsen & Kuipers, 2012).

In the explanatory memorandum of the amendment, the Dutch authorities indicated that they mainly target wholly artificial arrangements. In order to establish whether structures are wholly artificial, the legal form of the structure must support the economic reality thereof. Subsequently, the substance of that company will be analysed, establishing whether the entity is effectively managed in the Netherlands, whether it incurs real risk and whether it has employees on its payroll. (Gerritsen & Kuipers, 2012).

### **3.3.1.5 Summary**

In contrast to other countries, the Netherlands have limited substance requirements in its legislation, as well as provisions in its double tax agreements. A company incorporated in the Netherlands does not need a significant presence in the Netherlands to gain the advantages offered by either legislation or double tax agreements. This is as a result of the Netherlands allowing these benefits to any Dutch incorporated entity, whether it has local presence in the Netherlands or not (Geuze & Rebergen, 2011). It seems that, in this instance, the lack of major substance requirements create an incentive for group structures to use the Netherlands as a location in which to establish either an IHC, or an ultimate Holding Company.

### **3.3.2 Mauritius**

Mauritius is the ideal country with which to compare South Africa's Headquarter Company regime, as both countries are located in sub-Saharan Africa. Mauritius is also the only country in Africa that has a successful, favourable and proven Holding Company tax regime. Both countries strive to be a gateway through which other countries invest in the rest of Africa.

According to Jain (2008), "Mauritius has all the characteristics of a good Holding Company jurisdiction, including political stability, ease of administration, availability of reliable administrators, a good treaty network, favourable exchange controls, a sound legal system, certainty in tax and legal frameworks and ease of winding-up operations."

Legwaila (2011:213) indicate that, according to his comparisons, Mauritius is the most beneficial Holding Company regime in the world as a result of the following:

- A corporate tax rate of 15% (the lowest in the world). In addition, special tax rates apply for certain industries and a 3% tax rate for Category 1 Global Business Licences (GBC 1) companies.
- Dividends and capital gains are not subject to tax.
- Tax losses are carried forward indefinitely.
- The tax-exempt status of Category 2 Global Business Licence (GBC 2) incorporated companies.

### **3.3.2.1    *The Mauritius-India tax treaty***

During the interview on 13 June 2012, with Mr C. Makola, Director of International Taxes at National Treasury, he indicated that the main reason for the Holding Company regime of Mauritius being so popular is its double tax agreement with India. He also stated that if this treaty be significantly changes, it might very negatively affect their Holding Company regime.

This treaty allows for capital gains on the sale of shares of a company held in India to be exempt for tax purposes. In addition, domestic legislation in Mauritius, determines that tax is not levied on capital gains. As a result, companies based in Mauritius are not taxed at all on their investments in companies situated in India. This creates the perfect location for international group structures to invest in India. To combat the controversy around this treaty, Mauritius tightened its tax residency requirements and signed a Memorandum of Understanding with India that provides for effective exchange of information principles. (Jain, 2008).

It is estimated that approximately 42% of the foreign direct investment in India is sourced from Mauritius. In essence, the treaty between Mauritius and India provides that the transfer of shares of an Indian company by a non-resident of India is subject to capital gains in Mauritius only (Ernst & Young, 2011:2). The case of *Vodafone International Holdings BV v. Union of India* (2008) 175 Taxman 300 (Bom HV) (the Vodafone case)



created great controversies internationally regarding the substance of a company, as well as treaty benefits. This case dealt with the charging of capital gains tax in India regarding the transfer of shares in an Indian based company through various Holding Companies.

In a recent advanced ruling case confirming the international disapproval of the current Mauritius-India treaty is that of *E\*Trade Mauritius Ltd*. The Indian tax authorities denied the capital gains exemption in terms of the treaty. According to them, the Mauritius based company lacked sufficient substance and was effectively controlled by its parent company based in the United States of America (USA). Although the capital gains tax exemption was later upheld and confirmed by the Authority for Advance Rulings, the court case represents the current mind-set of various international tax authorities (Teunissen et al, 2010:13). It can therefore be suspected that tax authorities will not hesitate to take an aggressive stance towards conduit companies or special purpose vehicles without any, or with limited economic substance. At the time this research was written, the appeal had not yet been finalised.

The most recent case scrutinising this treaty, is the case of *Tata Industries Limited v. DDIT. (Mum)((2011) 2 Taxmann.com 141)*. A Mauritian entity – a wholly owned subsidiary of a company located in the USA – held shares in an Indian company. When the Mauritian entity sold its shares in the Indian company, it wanted the capital gains to be subject to the provisions of the Mauritian-India double tax agreement, being exempt from taxes on the capital gains. Various agreements between the parties, including a joint venture agreement, indicated the true substance of the arrangement among the various parties. The court found that the Mauritian entity was not the beneficial owner of the shares, as it merely held the shares on behalf of the company located in the USA. The capital gains on the sale of shares would therefore not be privy to the benefits of the double tax agreement between Mauritius and India.

### **3.3.2.2    *Legal nature and residency status of entities***

A resident of Mauritius can, for tax purposes, either be a company incorporated in Mauritius, or a company with its central management and control in Mauritius (Deloitte, 2012a).

International companies can either be registered as GBC 1 companies, or as GBC 2 companies. A GBC 1 company may, in terms of the Finance Act, 2010:

- conduct business within the borders of Mauritius;
- have dealings with entities located in Mauritius, as well as with GBC 2 companies; and
- hold shares or other interests in a company incorporated in Mauritius (Hamzaoui, 2012:2).

The preferential Holding Company regime in Mauritius is specifically applicable to GBC 1 companies. To establish a GBC 1 company in Mauritius and to make use of the vast treaty network of Mauritius, it is required that at least two directors are Mauritian residents and that all board meetings are chaired from Mauritius. The main advantage of a Mauritian Holding Company is that GBC 1 companies are entitled to foreign tax credits, which may result in a maximum effective tax rate of 3%. (Deloitte, 2012a).

For tax treaty purposes GBC 2 companies are deemed to be non-residents and will subsequently not have access to Mauritius's vast treaty network. These companies are also not allowed to conduct business with Mauritian residents, make public offerings, or conduct their business in the Mauritian currency. (Hamzaoui, 2012:2).

### **3.3.2.3 *Anti-abuse legislation***

Mauritius does not have specific transfer pricing, thin capitalisation, or CFC legislation. The Director General has the power to adjust inter-group transactions, should they not be conducted at arm's length. Mauritian legislation, however, makes no reference to how the arm's length principles must be calculated or implemented. (Hamzaoui, 2012:12).

The general anti-abuse legislation of Mauritius is not very extensive. It merely provides for the Director General to, in his own discretion, disallow any tax benefits to the Mauritian resident, should it become apparent that the transaction was merely entered into for the

purpose of tax avoidance. In order to ascertain whether he should deny any benefits, the following factors must be considered by the Director General:

- the manner in which the transaction was entered into
- the form and substance of the transaction
- the provision of their Income Tax Act and the difference as a result of taxation
- the change in financial position of the entity as a result of the transaction
- a change in the financial position of any related parties of the entity, which may have resulted from the transaction
- whether the provisions of the transaction allowed for the creation of rights or obligations that are usually associated with a transaction of a similar nature
- the participation of each entity that is party to the transaction (Hamzaoui, 2012:12).

#### **3.3.2.4 Summary**

Currently there is no guidance as to what the Mauritian authorities constitute as sufficient “substance” for a resident. Although they require company directors to be Mauritian residents, it is not sufficient to prevent increasing concern regarding conduit companies. However, as can be seen from the court cases revolving around its treaties, the concepts of “beneficial ownership” and “permanent establishments” have been well established. In all these cases, certain degrees of substance were considered to determine the true nature and reasons for the existence of conduit companies in Mauritius.

#### **3.3.3 Cyprus**

In January 2003, the Holding Company tax regime in Cyprus underwent significant changes, creating an “effective and transparent tax system ... that is fully EU, OECD, FATF and FSF compliant” (Focus Business Services, n.d.).

As a result of the recent approach of the OECD towards transparency and exchange of information, economic substance became an extremely important issue in the Holding Company regime of Cyprus. To gain the benefits of Cyprus’ Holding Company regime, a

Holding Company must prove that its management and control are exercised from Cyprus to ensure true justification for its existence. (Damianou & Zambartas, 2011).

Due to its good infrastructure, its low corporate tax rate of 10% and its network of over 40 double tax agreements, Cyprus has been a successful Holding Company jurisdiction for the past few years. As Cyprus is not deemed to be a low-tax jurisdiction, as opposed to many other countries in the EU, Cyprus is not in danger of being scrutinised as a tax haven. (Damianou & Zambartas, 2011).

As previously mentioned, Cyprus is a favoured location for treaty shopping. Recently, it also became a popular location for a new trend, directive shopping. The EU directives do not have specific anti-abuse clauses and allow for a certain measure of freedom in this regard. Cyprus requires no minimum holding period for shares, stipulates a minimum of 1% shareholding in the subsidiary, and uses the exemption method regarding dividends. (Yiolitis, 2012).

### **3.3.3.1 *Residency, permanent establishment and beneficial ownership provisions***

For tax purposes, a company is deemed as a resident if it is managed or controlled in Cyprus. Incorporation is not a decisive factor (Deloitte, 2012c).

Cyprus does not currently have any guidance as to what management or control in Cyprus entails. Companies are, however, encouraged to have as much substance as possible. According to Damianou and Zambartas (2011), the following are good guidelines for substance:

- most of the directors of the company should be residents of Cyprus
- the decision-making process must mostly occur in Cyprus
- the hHeadquarter Company must be situated in Cyprus
- a real presence must be sustained in Cyprus
- the company must be registered as an employer with either full-time or part-time employees

- the company must have registered telephone lines, email addresses and a domestic website address
- at least one bank account must be opened at a Cyprus bank

The provisions for beneficial ownership are not specified in Cypriot legislation. Although it has many beneficial ownership clauses in its treaties, the treaties do not define what beneficial ownership entails. It seems the Cypriot government mostly relies on the OECD and on other international interpretations of the term. (Yiolitis, 2012).

### **3.3.3.2 *Anti-abuse legislation***

Transfer pricing rules provide for the application of the arm's length principle, as well as for all intra-group transactions occurring on normal commercial terms. The Commissioner of Income Tax has the power to disregard any transactions he may deem as artificial or fictitious. (Deloitte, 2012c).

Cyprus does not have any thin capitalisation or CFC rules in its domestic legislation. The only measure Cyprus has against Holding Companies using foreign investment vehicles as a tax avoidance vehicle is that the exemption on dividends under the special contribution for defence law is only available if the following requirements are not met:

- the foreign subsidiary is engaged in 50% or more activities which give rise to investment income; and
- the subsidiary is subject to a significantly lower corporate tax rate than a similar entity in Cyprus (Taliotis & Markou, n.d.:27,34).

A significantly lower corporate tax rate refers to a tax rate of at least 50% lower than the Cypriot corporate tax rate of 10% (Taliotis & Markou, n.d.:34).

Generally, Cyprus does not include any anti-abuse provisions in its treaties, especially not regarding thin capitalisation and the deduction of interest (Taliotis & Markou, n.d.:28, 35).

### **3.3.3.3 *Summary***

Although it seems the importance of substance is recognised by the Cyprus authorities, Cyprus still has very few substance requirements and no anti-abuse legislation, whether domestic or incorporated in treaties. The advantages the Cypriot government offers to Holding Companies, whether tax or otherwise, establish Cyprus as a major player in the race for Holding Company jurisdictions.

### **3.3.4 The United Kingdom**

The UK, as a member of the EU, allows companies to benefit from the directives of this organisation (refer to Chapter 6). It is currently the ideal to create the UK as the best location in the EU in which to locate a Holding Company. The UK Government has already taken many steps to promote the return of companies who had previously migrated from the UK, as well as the incorporation of new companies. (KPMG, 2011:2).

During the past few years, the UK government has been in the process of improving its Holding Company regime to make it a valuable asset. This is based on the fact that various group structures are currently using the UK as base for its Holding Companies, especially as a result of the UK's vast double tax agreement network – it currently holds over 100 signed, active treaties. The UK government is therefore developing its tax system into a more territorial system, already granting exemption of dividends in most instances, as well as tax relief on loans granted for foreign investment. The next much anticipated step is the reform of the UK's CFC regime. (Sanger, 2011:2-3).

#### **3.3.4.1 Substantial shareholding exemption**

This participation exemption allows for the exemption of capital gains or losses on the disposal of shares in a company. Although this exemption is only available for commercial operations, it is not restricted to the disposal of foreign shareholdings. It is also available on the capital gains/losses made on the disposal of domestic shareholdings. This makes it an extremely attractive measure in encouraging foreign direct investment. To take advantage of the benefits offered by this shareholding exemption, the following requirements must be met:

- the Holding Company must hold shares of 10% or more in the subsidiary for a continuous period of 12 months during the two years prior to the disposal of the shareholding;
- the Holding Company must engage in active operating business activities, or be a member of a group engaging in such activities for a period of 12 months immediately before and after the disposal of the shareholding; and
- the subsidiary must either be the Holding Company of a group, or engage in active business operations for a period of 12 months immediately before and after the disposal of the shareholding (KPMG, 2011:3).

#### **3.3.4.2 *Permanent establishment provisions***

Her Majesty's Revenue & Customs (HMRC) has domestic legislation governing the concept of "permanent establishment". These principles are similar to the guidelines provided by the OECD. The HMRC defines a permanent establishment as an entity that:

- has a fixed place of business through which the business operations are carried out, whether wholly or partly; and
- acts as an agent on behalf of a company that usually exercises authority on behalf of that company (Hill, n.d.).

The domestic legislation provides further guidance as to what a "fixed place of business" entails. It provides a list similar to that of the OECD and includes an office, branch, place of management, factory, workshop, mine and building site. Furthermore, HMRC-published documents provide requirements or characteristics of a fixed place of business as follows:

- There must be a geographic place of business, including an office or machinery and equipment.
- The geographic location must have a certain degree of permanence.
- Business activities must be carried on through this geographical location. This characteristic usually requires the entity to have personnel on site (Hill, n.d.).

### **3.3.4.3 Beneficial ownership and residency provisions**

In the court case of *Indofood International Finance Ltd. V. JP Morgan Chase Bank N.A., London Branch* (2006) EWCA Civ 158, the Court of Appeal in the UK was requested to rule on the concept of beneficial ownership and residence. Although this was not a tax case, principles were established relevant to these two important concepts. The main principles of this case will be summarised below.

Indofood International Finance Limited is a special purpose vehicle incorporated in Mauritius with the main purpose of issuing loan notes and is the wholly owned subsidiary of PT Indofood Sukses Makmur Tbk Incorporated in Indonesia. This arrangement was created as a result of the Mauritius-Indonesia double tax agreement whereby interest was not subject to a withholding tax. This treaty was, however, terminated on 1 January 2005, resulting in the interest paid from the Mauritian company to the Indonesian company to become subject to a withholding tax. To avoid any withholding taxes, a new company was created in the Netherlands (Newco) as an intermediary between the Mauritian company and the Indonesian company.

The Dutch company was obliged by contract to distribute most of its profits or earnings to the Indonesian company. As a result, the court ruled that the Dutch company is not the beneficial owner of the interest received from the Mauritian company. The judges consulted the principles set out by the OECD and concluded that the concept of “beneficial ownership” should be interpreted using the international meaning of that term and not the domestic meaning allocated by domestic legislation. The judges concluded that Newco did not have the right to use and enjoy the interest received and could subsequently not benefit from the provisions of the Mauritius-Netherlands double tax agreement.

The question whether Newco would qualify as a tax resident of the Netherlands was also addressed. In order to establish this, the provisions of the Netherlands-Indonesian double tax agreement were considered. The double tax agreement determined that the country of residence would be where the place of effective management of a company would be. Although Newco complied with all the corporate and legal requirements of a company incorporated in the Netherlands, as well as with all the further tax requirements of



“substance and risk”, the place of management – the place where the board of directors of Newco gathered to make key decisions – was located in Indonesia. Subsequently, Newco would be a tax resident of Indonesia and not of the Netherlands.

#### **3.3.4.4 Anti-abuse legislation**

The UK adopted a very interesting method of incorporating treaty benefits into their policies of substance. Should a borrower in the UK pay interest to a non-resident lender, the non-resident lender must apply for treaty clearance from HMRC before the treaty benefits can be applied to the interest payment. If HMRC decides that the transaction was based solely on getting undue treaty benefits, the HMRC will deny the treaty benefits. HMRC’s decision will mainly be based on the recent decision of *Indofood International Finance v. JP Morgan Chase Bank*. (Teunissen et al, 2010:14).

The UK has extensive CFC rules that can be used as deterrents in the decision-making process of establishing a Holding Company there. However, as previously mentioned, the government is in the process of re-inventing this regime with a scheduled amendment date of July 2012 (KPMG, 2011:4). According to Stern (2012), the new CFC rules came into effect in March 2012 and will apply to companies with financial year-ends after January 2013.

Under the old CFC regime, a company in the UK with an interest of 25% or more in a foreign subsidiary would have been taxed on the profits of that subsidiary, should it have been:

- controlled by residents of the UK; and
- subject to a low level of taxation. A low level of taxation would have occurred where the subsidiary would have been subject to 75% or less of the tax that should have been paid if it were a UK resident (Deloitte; 2012b).

The new CFC regime is intended to target group structures used to artificially divert profits made in the UK to countries with a lower tax rate. The effect thereof will be that only the profits to be deemed artificially diverted from the UK will be taxed in the UK.

Subsequently, this regime will not be a “blanket” regime that automatically applies to all foreign controlled companies. This ideal to keep the competitiveness of the regime intact was important to the government. The definition of a CFC remains the same, but the regime contains many exemptions to fulfil its previously mentioned ideals. (KPMG, 2011:4).

#### **3.3.4.5 Summary**

The provisions made by the UK in their domestic legislation are to a large extent sufficient to force companies located in the UK to have acceptable substance. Their anti-avoidance legislation is extremely well constructed to prohibit the loss of income to the UK government. It would be expedient for the SARS and National Treasury to strive to implement a similar system. That way, the loss of income from tax avoidance structures could be minimised.

#### **3.3.5 Other countries**

The countries below recently amended their anti-abuse legislation to the point where extensive substance requirements were put in place. The substance requirements of these countries are discussed as a mere reference to the current internationally available substance requirements, not because their legislation and international policies are closely related to that of South Africa.

##### **3.3.5.1 China**

In 2009, the People’s Republic of China published two documents pertaining to non-residents claiming undue tax benefits. Notice 124 mainly deals with administrative measures regarding treaty benefits claimed by non-residents. Circular 601, however, deals with the availability of treaty benefits to owners and indirectly addresses the problem of treaty shopping by international group structures. Taking into account the People’s Republic of China tax legislation and double tax agreement provisions, tax treaty benefits relating to sourced income, e.g. dividends interest and royalties, may only be taken advantage of by the owner who benefits from such income. (KPMG, 2009).

According to Circular 601, the following requirements must be met before an entity can be a beneficial owner:

- The entity must own or control the income, assets or rights from which the income is generated.
- The entity is part of substantive operational activities.
- The entity is not an agent or a conduit company (KPMG, 2009).

Circular 601 identifies a conduit company by the following characteristics:

- The company was set up with the main purpose of avoiding, reducing or deferring tax liabilities.
- The company is registered in another country and barely meets the organisational requirements, if any, of the local country.
- The company does not engage in substantive operational activities (White & Case, 2009).

Below is a summary of additional factors to be considered in establishing whether an entity can qualify as the beneficial owner of source income, as set out in Circular 601. They establish the “substance-over-form” principle adopted by the People’s Republic of China (PRC):

- The non-resident is under obligation to distribute at least 60% of its income to a resident of a different country.
- The non-resident has any further business activities apart from holding assets or rights that facilitate the receipt of the source income.
- The size of the assets, operation and staff in relation to the amount of income generated.
- The extent to which the non-resident has the right of control or disposal over the assets or rights from which the income is generated.
- The income earned is either exempt, or taxed at a low rate in the non-resident’s country of residence.

- Rights to use IP and loans into the PRC are a result of back-to-back arrangements with an offshore lender or IP provider (KPMG, 2009).

The provisions set out in Circular 601, together with the administrative measures set out in Notice 124, provide the PRC with sufficient substance requirements to successfully combat “treaty shopping”. However, the strict requirements and factors in Circular 601 pose a threat to legitimate IHCs, who have sufficient operation and employees, but may not necessarily have any decision-making authorities. (KPMG, 2009).

### **3.3.5.2 Germany**

Dividends in Germany are usually subject to a withholding tax and solidarity surcharge with a combined taxation rate of 26,375%. Before the amendment, foreign shareholders were exempt from these taxes (other than as a result of the EU Parent-Subsidiary Directive of 23 July 1990), if the following criteria were fulfilled:

- the IHC has economic or other substantial reasons for being incorporated;
- the IHC participates in general commerce and participated in adequate business operations to fulfil its business purpose (the substance test); and
- the IHC’s gross income is mostly derived (90% or higher) from its own business operations (the 10%-revenue test).

The last requirement, the 10%-revenue test, was abolished on 25 November 2011 by the German Federal Council. Instead, the active income test applies whereby the tax benefits are only available to the extent of the IHCs own business activities. This amendment became effective on 1 January 2012. (Shearman & Sterling, 2011).

Active income includes dividends received from subsidiaries the IHC manages. The German tax authorities deem these dividends as active business income. (Shearman & Sterling, 2011).

### **3.3.5.3 Luxembourg**

The Luxembourg tax authorities recently published two circulars addressing the financial activities and transfer pricing principles applicable to Holding Companies. One of the main changes in these circulars is that they require a Holding Company to assume risk and that they have sufficient equity to cover any risks. Luxembourg companies granting loans to other group companies must assume a risk of at least 1% of the financing volume, or EUR two million. It is, however, important to note that, should the Luxembourg companies assume more risk than the 1% or EUR 2 million, the capital should be increased to cover the risk assumed. (Fernandez, n.d.).

The transfer pricing now requires the functions of a company to be analysed in accordance with its activities and responsibilities, as well as its economic importance in the structure of the group (Fernandez, n.d.).

International groups in want of advance tax clearance from the Luxembourg tax authorities were given clear guidance in the two new circulars as to the requirements set out by the Luxembourg tax authorities. The Luxembourg tax authorities now require a Holding Company to have an actual presence in Luxembourg, by taking the following into account:

- The majority of board members or managers of a company must either be Luxembourg residents, or non-residents who exercise a professional activity in Luxembourg. The board members or managers are taxable on at least 50% of the gross income relating to one of the first four net-income categories.
- The aforementioned must possess the necessary skills and knowledge to perform their relevant tasks.
- The aforementioned must also have the power to legally bind the Holding Company and to ensure that all transactions are properly performed.
- The Holding Company must have sufficient personnel, whether employed or outsourced, to perform and record activities. The Holding Company must also be able to supervise these functions.
- All key decision-making activities must be done in Luxembourg.
- The Holding Company must hold at least one bank account in Luxembourg.
- The Holding Company's entity must be sufficient to address the business operations, as well as the level of risk assumed (Schmitt, Mössner & Labusch, n.d.).

### **3.4 CURRENT SOUTH AFRICAN LEGISLATION**

As indicated in chapter 2.1.3, both South African incorporated companies and foreign companies effectively managed in South Africa can qualify as Headquarter Companies envisaged in section 9I of the Act. Currently, in South Africa, effective management is determined by taking into account the location where the day-to-day business activities of a company are conducted and whether the decisions made by senior management are exercised. SARS is, however, currently in the process of changing its view on effective management to merge its policies with that of the OECD, which considers itself more with the location of where senior management takes the business decisions. (Brown, 2012:5).

#### **3.4.1 Permanent establishment and beneficial ownership provisions**

The concept of “permanent establishment” is not specifically incorporated in South African tax legislation. As the purpose of this concept or term is to establish the extent of profits derived from activities performed in South Africa and whether they are to be included in the gross income of an entity, the source of this concept is from double tax agreements. This term is defined in most double tax agreements by the definition granted to it by the OECD (refer to chapter 6). Double tax agreements are brought into effect in terms of section 108 of the Act. According to this section, the provisions and definitions of a double tax agreement carry the same weight as domestic legislation. (Horak, n.d.).

Currently, there is no universal definition or meaning allocated to “beneficial ownership” in South African legislation. The only current reference or definition is found in section 64D of the Act, which governs the new dividends tax of South Africa. According to this definition, “beneficial owner” refers to the “person entitled to the benefit of the dividend attaching to a share”. One can however, hardly use this definition as a universal policy that also governs the intention of South African international agreements (including double tax agreements). As South Africa is not currently party to a double tax agreement that specifically defines the term “beneficial owner”, there is limited guidance as to what meaning must domestically be allocated to this term. During the past few years, South Africa has also not

established a fixed principle through case law and opted to rather use the international meaning allocated to this term. (Du Toit & Hattingh, n.d.).

From the aforementioned it is clear that South African domestic legislation does not specifically provide meaning or even interpretation of these concepts. The international direction in this regard is mostly followed. As this is normal for most countries – even those discussed earlier in this research – it does not raise great concern. However, as will be discussed in Chapter 6, the international meaning of these concepts is currently being questioned. Internationally, direction is sought as to the domestic implementation of these concepts.

### **3.4.2 Participation exemption**

South Africa has a very extensive participation exemption regarding Headquarter Companies. As previously indicated, three requirements must be fulfilled before a company qualifies to benefit from the advantages offered by the new Headquarter Company regime. These three requirements encompass four elements, which are summarised as follows:

- The Headquarter Company must have at least 10% voting rights or ownership in a subsidiary.
- 80% or more of the Headquarter Company's assets must relate to its subsidiary in which the first requirement was met.
- 50% or more of the Headquarter Company's revenue must consist of income from its subsidiary in which the first requirement was met.
- The Headquarter Company's shareholders must each own at least 20% of the voting rights or shareholding of such Headquarter Company. This is not necessarily a participation requirement. It was inserted more as a control requirement (section 9l of the Act).

South Africa's participation exemption further allows for the exemption of capital gains, should the aforementioned requirements be met and the shares held for at least 18 months before the date of sale (National Treasury, 2012a).

These provisions regarding participation are, in a sense, unique to South Africa. No other country has as extensive requirements for participation as the aforementioned. These participation requirements are very strict but do not *per se* ensure the economic substance of a qualifying Headquarter Company; they are merely for anti-avoidance.

The participation requirements would be the easiest to change, should one want to incorporate substance requirements into this regime. As the participation requirements are mostly found in the definition of a Headquarter Company, additional requirements can easily be incorporated to ensure that Holding Companies have sufficient substance and are engaged in economic activities.

### **3.4.3 Anti-abuse legislation**

The current anti-abuse legislation of South Africa, with subsequent substance requirements, are summarised as follow:

- *General anti-abuse legislation* – the general anti-avoidance legislation was re-invented during 2006 – 2007 in section 80A – 80L of the Act. The main changes resulted in the anti-avoidance provisions being applicable to only part of a transaction. As a consequence, should a transaction have commercial reason or substance for the most part, the anti-avoidance provisions can still apply on the part of the transaction SARS deems to be for tax avoidance. Further, the new provisions may be applied to transactions or arrangements that “lack commercial substance”. This concept was described to include an “avoidance arrangement would result in a significant tax benefit for a party, but the arrangement does not have any significant effect upon either the business risks or net cash flows of that party”. This concept is very broad, but specifically includes round-trip financing, a tax-indifferent party, an arrangement that has extensive off-setting characteristics, as well as arrangements where the legal substance does not agree with the legal form. (Mazansky, 2007:162).



- *CFC legislation* – in determining whether the subsidiary of a qualifying Headquarter Company is a CFC, the shareholders of the subsidiary will be ignored in favour of the shareholding of the qualifying Headquarter Company. Subject to certain exemptions, a foreign subsidiary will be deemed as a CFC, should a South African resident shareholder of the qualifying Headquarter Company hold indirectly 50% or more of the equity shares or voting rights in the foreign subsidiary. For a qualifying Headquarter Company to be exempt from the South African CFC rules, it must be predominately owned (50% or more) by foreign shareholders. (National Treasury, 2012a).
- *Transfer pricing and thin capitalisation provisions* – these provisions rely on the arm's length principle and deem connected persons to be any person or entity with a shareholding of at least 20% in a company (Hattingh, n.d.). Currently, Headquarter Companies will not be subject to South Africa's extensive transfer pricing or thin capitalisation provisions. The new Headquarter regime specifically allows for the elimination of tax on back-to-back interest and dividends earned. Although there is currently no specific benefit to royalties, it has been proposed by National Treasury that the same benefits be extended to the holding of IP. (National Treasury, 2012b:122).

Taking the aforementioned into account, South Africa's current anti-avoidance legislation is sufficient to combat group structures created with the intention of tax evasion, avoidance or even deferral. In cases where there is not sufficient evidence of a company's substance within the borders of South Africa, the exemption rules that apply to these anti-avoidance provisions for Holding Companies may, in certain instances, create concern. Once again, the importance of substance and the current lack of provisions governing the economic substance of companies are highlighted.

### **3.5 SUMMARY**

Conduit companies or special purpose vehicles are often used by group companies to receive treaty benefits to which they are not truly entitled. Governments currently try and prohibit conduit companies or special purpose vehicles from benefitting from their Holding

Company regimes and double tax agreement network by incorporating various substance requirements in their tax legislations. Substance requirements can take various forms. They can be included in the actual Holding Company's tax policies; requirements can be incorporated in the definition of beneficial owner; they can be permanently established in either the legislation or treaties; substance can be enforced by anti-abuse legislation. Anti-abuse legislation can be general policies incorporated into the tax legislation, or it can take a specific form, such as CFC legislation, or transfer pricing requirements.

The most common specific substance requirements found in other countries can be set out as follow:

- payroll requirements
- physical presence
- minimum revenue thresholds
- reporting requirements
- risk assumption
- specific activities, or level of activities, to be performed

Most of the countries discussed in this chapter rely on a participation exemption or certain participation rules to ensure Headquarter companies have sufficient substance. The South African participation exemption appears to be very strict compared internationally. This provision will, however, be the easiest to change. It would be the most beneficial and easiest to administrate should any of the aforementioned substance requirements be incorporated into the definition of a Headquarter Company, i.e. the participation exemption provision as set out in section 9I of the Act.

The beneficial ownership and permanent establishment principles are developed in very few countries, leaving South Africa on par with the rest of the world which mostly rely on the principles set out by international organisations (refer to chapter 5). The only country as discussed that actually incorporated principles with regard to “permanent establishments” into its domestic legislation, is the UK. These principles are only successful in prohibiting tax avoidance or evasion to the extent that it is incorporated with

their special CFC legislation and unique manner in which certain treaty benefits are granted to foreign companies.

Internationally very few countries with successful Headquarter Company regimes rely on substance requirements to either provide a benefit to their economy or prevent tax avoidance, even if they recognise the importance thereof. Most countries, it seems, deem substance requirements to be a negative factor in any type of tax regime and rely on the lack of substance requirements to act as an incentive to attract the incorporation of Headquarter Companies. These countries include but are not limited to, Cyprus, the Netherland and Mauritius.

However, these countries rely on “substance-over-form” provisions or principles in guiding them as to the substance of entities in specific circumstances. This principle is especially relied on by the People’s Republic of China with regards to the new “beneficial ownership” provisions as discussed earlier in this chapter.

After taking into account the above, the cost of complying with a country’s specific substance requirements may be substantial. It is therefore important for that country to provide sufficient benefits that will outweigh these costs for its Holding Company regime to be successful. These benefits may include the reduction of taxes, a strong economy, good economic infrastructure and tax authorities providing sufficient guidance on certain tax issues.

As indicated earlier in this research, the intention of the South African Headquarter Company tax regime was mainly to provide benefits to Headquarter Companies without any losses to the South African *fiscus*. This resulted in limited benefits being offered to Headquarter Companies.

Earlier in this research two possible tax provisions were identified that could result in a direct benefit to the *fiscus*. This chapter has already discussed the benefits and different types of substance requirements currently being implemented by other countries. The next chapter will analyse the trade incentives provided by these countries with regards to the activities usually associated with Headquarter Companies.

## CHAPTER 4

# TAX INCENTIVES FOR TRADE ACTIVITIES UNIQUE TO HEADQUARTER COMPANIES

### 4.1 INTRODUCTION

Where the IHC does more than merely holding subsidiaries and providing management or other services to such subsidiaries, tax treaty protection becomes advantageous, should the group not want to create a tax presence in the countries of the subsidiaries (Brown, 2012:2).

The main functions of an IHC are to “acquire, manage and sell investments in group companies, mainly its subsidiaries and in general to provide transactional and organisational flexibility in a group of companies” (Legwaila, 2011:26). Other functions should also include financing, treasury or cash management, factoring and leasing (Finnerty, 2010).

Questions may still arise as to the actual use of an intermediary company as, in essence, it has the same function as the ultimate Holding Company of a group. Mintz and Weichenrieder (2008:7) believe an important reason is to split central operations and management of unrelated markets to minimise administration difficulties. It would subsequently be appropriate to create various IHCs within a big multinational entity to manage operations or investments on a regional basis.

Therefore, it is safe to assume that the main purpose of an IHC is to be a Holding Company as defined. However, there is also a definite need for these IHCs to perform administrative activities usually identified with Headquarter Companies. As indicated by Olivier and Honiball (2011:692), Headquarter regimes are mostly set up by other countries to attract companies with operational activities, as it may lead to an increase in employment and provide further economic and commercial benefits.

It is common for groups to structure their entities in such a manner that the intellectual property of a group is situated in an IHC. It is important to distinguish between intellectual

property and IHC profit centres and mere investment centres. An investment centre is a pure conduit company that only receives royalties from subsidiaries. A profit centre receives other income as well, usually associated with the management of said intellectual property. (Kellerman, 2011).

## **4.2 INTERNATIONAL POLICIES**

The principles mentioned below do not necessarily take into account provisions of double tax agreements concluded with these countries. The corporate tax provisions are discussed under normal tax legislation and circumstances. Specific treaty provisions are not discussed, unless the principles are uniform in all the country's double tax agreements, or the provision requires special mention.

### **4.2.1 The Netherlands**

Dividends in the Netherlands are usually subject to a withholding tax of 15%, unless the participation requirements have been fulfilled (refer to chapter 3.2.1). No withholding taxes are levied on interest, royalty fees or even technical service fees, also known as management fees. (Deloitte, 2012d).

Dividends received by a Holding Company, as well as the capital gains in terms of sales of shares in a subsidiary, are exempt if the participation exemption, as previously discussed, is met. Otherwise, a foreign tax credit is available to offset taxes already internationally paid due to the entity's tax liability. (Deloitte, 2012d).

### **4.2.2 Mauritius**

Should a resident company in Mauritius receive a dividend from a non-resident and the resident holds at least 5% of the equity shares or voting rights of that non-resident, the foreign credit available for offset against the resident's tax liability in Mauritius will not only include the withholding tax paid on dividends received, but also any corporate taxes paid. This is also the case where the dividends paid by the non-resident results from a dividend

received from a company in which it holds at least 5% of the equity shares or voting rights. (Hamzaoui, 2012:10).

Interest payments to non-residents are usually subject to a withholding tax of 10%, unless one of the following exemptions applies:

- A GBC 1 company pays interest to a non-resident.
- A GBC 2 company pays interest to a non-resident.
- A bank pays interest to a non-resident from the gross income derived from business operations conducted with non-residents and GBC companies (Hamzaoui, 2012:11).

A withholding tax of 15% is applicable to royalties paid to non-residents. The following exemptions are, however, available when:

- a GBC 1 company pays royalties to a non-resident from its foreign sourced income;
- a GBC 2 company pays royalties to a non-resident;
- a bank pays royalties to a non-resident from the gross income derived from business operations conducted with non-residents and GBC companies; or
- a trust pays royalties to a non-resident (Hamzaoui, 2012:11).

Payments to non-residents in exchange for service fees are mostly either subject to a 10% withholding tax, or subject to a provisional withholding tax of 3%, with a final tax of 15% when the return is submitted. Management fees by subsidiaries are not usually subject to a withholding tax as it is deemed that the management services were not conducted in Mauritius. GBC 2 companies do not have to deduct withholding taxes on any rent, compensation, or any other amounts paid to non-residents. (Hamzaoui, 2012:11).

#### **4.2.3 Cyprus**

No withholding tax is applicable in Cyprus in respect of the payment of interest to non-residents, whether intra-group or not (Taliotis & Markou, n.d.:28).

Usually, interest is not deductible for income tax purposes, should it be incurred for the acquisition of a non-trading asset. Investments in shares or bonds are specifically included in the definition of non-trading assets. However, the Commissioner of Income Tax issued Circular 2012/6, allowing the deduction of interest in the acquisition of a Cypriot subsidiary. This special deduction will only be allowed if the subsidiary acquired does not own any assets not used in its business activities. Otherwise, the interest deduction will be limited to the assets actually used in the business activities of such subsidiary. (Taliotis & Markou, n.d.:28.)

Dividends received by a Holding Company in Cyprus are generally exempt from income tax, especially when it is received from a foreign resident. However, the dividend received may not necessarily be exempt from the special contribution under defence (refer to chapter 3.2.3.2). Dividends will not be seen as investment income if it is received from a subsidiary actively engaged in trading activities. No withholding taxes are levied on dividends paid. (Taliotis & Markou, n.d.:30).

Dividends paid to a foreign resident will not be subject to the special contribution for defence (Taliotis & Markou, n.d.:29).

From 2003 onward, gains derived from the sale of securities will be fully exempt from income tax, whether capital or revenue in nature. This exemption allows a Holding Company to restructure its group without any negative tax implications (Taliotis & Markou, n.d.:32). However, capital gains will be charged at 20%, if the shares being sold are of a company holding immovable property. (Deloitte, 2012c).

Royalties paid to a foreign resident for the use of intellectual property in Cyprus are subject to a withholding tax of either 5% or 10%, dependent on the nature of the rights. Technical fees paid to a foreign resident are subject to a withholding tax of 10%. (Deloitte, 2012c).

#### **4.2.4 United Kingdom**

No withholding tax on dividends paid is applicable to residents or non-residents of the UK. Dividends received from other entities, however, enjoy a significant system of relief. A

distinction is drawn by assessing whether the Holding Company is part of a small or large group structure (Isla, n.d.). The rules for these exemptions differ and are set out below.

A small group has less than 50 employees and a turnover or balance sheet value of less than EUR 10 million. Dividends from subsidiaries are exempt if the following criteria are met:

- The subsidiary is a resident of the UK, or is resident in a country with which the UK has a valid double tax agreement that contains a specific non-discrimination article.
- The payment does not contain any element of interest, even if treated as dividends for tax purposes.
- The dividends paid are not deducted for tax purposes by the subsidiary.
- The dividends do not result from a scheme created purely for tax purposes (Isla, n.d.).

Any other Holding Company may exempt the receipt of dividends based on the following criteria:

- The payment does not contain any element of interest, even if treated as dividends for tax purposes.
- The dividends paid are not deducted for tax purposes by the subsidiary.
- The dividends fall within one of the following 'exempt classes':
  - dividends from controlled companies (companies: 51%; joint ventures: 40%);
  - the dividends result from the holding of non-redeemable ordinary shares;
  - portfolio dividends with shareholding of less than 10%;
  - the dividends do not result from a scheme created purely for tax reasons; or
  - the dividends in respect of shares are treated as loans.

Both interest and royalties are subject to a withholding tax of 20%, should they be paid to non-residents (Deloitte, 2012b).

In 2011, the UK implemented a new regime whereby the profits of a company's foreign branches (permanent establishments) are exempt from tax in the UK. When the election is made to use this regime, the profits of foreign branches are not taxed in the UK. However,



losses made by such foreign branch may also not be offset against UK profits. This regime is based on OECD principles and will be brought in line with the new CFC rules as soon as they are promulgated. (KPMG, 2011:5).

### 4.3 CURRENT SOUTH AFRICAN LEGISLATION

One of the requirements that needs to be fulfilled before a company can take advantage of South Africa's Headquarter Company regime, is that, in terms of section 9I, should a company have a gross income exceeding ZAR 5 million a year, 50% or more of said gross income must consist of one of the following:

- rentals, dividends, interest, royalties or service fees paid or payable by qualifying companies; and
- proceeds from the disposal of qualifying foreign shares.

These requirements refer to participation requirements, which, *per se*, is a type of substance control with regards to Headquarter Companies.

From the above it is clear that the current legislation recognises the various activities usually associated with a Headquarter Company, as defined. However, no benefits are granted to IHCs who conduct these activities. This does not directly encourage IHCs to deliver such services within the borders of South Africa. This, in itself, also prohibits IHCs from having more economic substance in South Africa.

According to Brown (2012:5), the taxability of the more common activities of an IHC can be set out as follows:

- *Foreign dividends received.* Foreign dividends are usually included in the gross income of a company and subsequently taxed at the normal corporate tax rate of 28% (15% after April 2012). A qualifying Headquarter Company complying with all the requirements set out in sections 9H and 9I of the Act is not taxed on foreign dividends received if it holds more than 10% of the equity shares or voting rights of the paying

subsidiary. This is because the dividend received by a qualifying Headquarter Company from a foreign subsidiary is deemed as a foreign dividend.

- *Interest received.* Any interest received by a company must be included in its gross income and will subsequently be taxed at the corporate tax rate of 28%. No additional benefits are granted to a qualifying Headquarter Company in respect of foreign interest accrued or received from loans, or financing granted to foreign subsidiaries. A tax credit in terms of section 6quat is available for any foreign taxes paid as a result of the other country's source rules.
- *Royalties received.* Royalties received from foreign subsidiaries are included in the qualifying Headquarter Company's gross income as a result of South Africa's source rules and is subsequently taxed at 28%. No specific relief is granted in the Headquarter Company regime for royalties received from foreign subsidiaries. SARS is currently in the process of re-negotiating all standing double tax agreements to include a royalty withholding tax of at least 10%. The tax credit available under section 6quat may apply in certain circumstances. As a result of the new withholding tax policy on royalties, South Africa is not currently the ideal location to license intellectual property.
- *Management fees received.* Management fees must be included in the gross income of a qualifying Headquarter Company. However, a tax credit is available for any foreign taxes payable as a result of the source rules of the subsidiary's home country, even if the management fees are provided in South Africa. This creates a very beneficial environment for IHCs, even if the tax credit sometimes contradicts the double tax agreement rules. This benefit, in itself, promotes economic substance in the IHC, as the benefit encourages IHCs to deliver services using South African resources.
- *Capital gains / losses realised on disposal of shares.* A participation exemption is available to a qualifying Headquarter Company in terms of section 9I of the Act should it hold more than 10% of the equity shares or voting rights of the subsidiary. This participation exemption fully exempts the capital gains or losses incurred by a Holding

Company from its gross income. National Treasury proposed an amendment to the headquarter tax regime, whereby all capital gains and losses be excluded from the gross income, whether the participation requirements are met or not. Normally, capital gains or losses are included at a rate of 66,67% in the gross income of a company and, accordingly, are taxed at an effective rate of 18.67%.

- *Foreign exchange gains/losses.* Unrealised gains and losses from exchange items are disregarded for income tax purposes, should these gains or losses occur as a result of loans to and from foreign connected entities (including CFCs). The foreign exchange gains or losses are only included in the qualifying Headquarter Company's gross income and subsequently taxed at 28% if they are realised.

From the above it is clear that limited benefits are granted to trade activities of Headquarter Companies.

In the recent case *Oilwel v Protec*, 295/10 (2011) ZASCA 29, it was decided by the highest court that intellectual property could never be regarded as 'capital', as defined for exchange control purposes. The effect thereof is that, should intellectual property be transferred to a non-resident, pre-approval from the South African Reserve Bank would not be required.

In July 2012, National Treasury amended the definition of "capital" in the Exchange Control Regulations to specifically include intellectual properties (Margo Attorneys, n.d.). Before the amendment, the fact that pre-approval was not necessary to relocate intellectual properties within a group, would have been an excellent incentive for group companies to be based in South Africa. It would have resulted in group companies effortlessly moving assets and re-organising group structures without complying with too much 'red tape'. However, the fact that pre-approval is required before transferring the IP to a non-resident, may force current IHCs located in South Africa to have economic substance to internationally make use of that intellectual property.

#### **4.4 SUMMARY**

The typical activities of a Headquarter Company were firstly identified in this chapter to include administrative, financial and various other activities. In an effort to identify the current trend internationally with regard to tax incentives offered to Headquarter Companies, the current tax policies of Headquarter Company regimes in various countries were analysed.

Internationally, this method of encouraging economic activities is not very popular. The risk of providing tax benefits that may be construed as harmful by the rest of the world may be too high and do not cover the benefit derived from this type of regime or policy. Also, providing tax benefits to Holding Companies with foreign investment not normally available to Holding Companies with mostly local investments may create an unfair tax system or regime. This can have a negative impact on the one thing this regime was developed to encourage, namely foreign investment.

Linking tax incentives to certain trade activities of a Headquarter Company may be harmful to a country's *fiscus* and economy. It could be detrimental if sufficient substance policies are not in place to successfully combat group structures specifically created for fiscal evasion or tax avoidance. Once again, the importance of sufficient substance requirements in a country's tax policies is highlighted.

The direct tax benefits to activities usually associated with a Headquarter Company is minimal. Most Holding Company regimes rely on the exemption from withholding taxes and certain anti-avoidance provisions, as well as a relaxation in exchange control regulations.

South Africa is no different in this regard. South Africa relies on the benefits provided to foreign companies through double taxation agreements, exchange control relaxations and domestic legislation. These benefits are, however, minimal and are not truly an incentive for a group to establish an operating Headquarter Company within the borders of South Africa.

Trade incentives to activities of a Headquarter Company can indirectly be interpreted to be a type of substance measure. Should South Africa decide to implement tax incentives to

Headquarter Company trade activities, substance will be created, resulting in a direct benefit to the South African economy.

The two possible tax policies that could result in a benefit to the fiscus were discussed extensively during the two previous chapters by way of comparison with international tax policies. However, should South Africa decide to implement either of these tax policies, the impact on the international policies in this regard should be considered. The following chapter will analyse the policies of both substance requirements and trade incentives from the perspective of both the OECD and the EU.

## **CHAPTER 5**

### **INTERNATIONAL ORGANISATIONS**

#### **5.1 INTRODUCTION**

International juridical double taxation is defined as “the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods”. The aim of the OECD’s Model Tax Convention on Income and Capital (the Convention) is to provide States with guidance to settle universal problems arising from double tax agreements. The main purpose of double tax agreements is to prohibit double taxation as previously defined, but it is also used to prevent tax avoidance or evasion by reducing the risk of abuse. The most common way of abusing a country’s double tax agreement, is to establish an entity through which international trade is conducted, especially for the benefits provided by that country’s double tax agreements. (OECD, 2010:3, 37).

OECD member countries are obliged to comply with the provisions of the Convention. South-Africa is not currently a member of the OECD but strive to comply with their policies as far as possible. As a result, the tax policies and definitions ascribed to certain terms by the OECD will have a major impact on the decisionmaking process involving tax policies by the South African Government.

The EU’s policies do not carry the weight of that of the OECD, but considering the fact that most of the countries used for comparison purposes in this research are EU members, it is important to know what the EU’s view is on the concepts of substance requirements and trade incentives for tax purposes.

In light of the above, it is of great importance to analyse the view and policies of these two international organisations or bodies before any changes to the South African tax legislation can be proposed.

#### **5.2 ORGANISATION FOR ECONOMIC DEVELOPMENT AND CO-OPERATION**

According to Kellerman (2011), the OECD's view on substance can be summarised as follows:

- *Control over risk* - it is important for an IHC to have control over the management of its assets, as well as to have the financial capability to manage the risks associated with these assets. Management does not necessarily have to be done by the IHC itself, but proof must be had for governments to assess the nature and extent of the specific out-sourced functions. Should the management of business activities or financial risk not be successfully proven by an IHC, governments must immediately assess the nature of substance of such an IHC.
- *Significant people functions* mainly calculate the profit attribution of group companies between head offices, branches and other related parties. This is directly related to the functions usually associated with the active decision-making processes in the day-to-day activities in a group or company. The main idea behind this structure is that the profits attributable to certain assets and risks be allocated to the specific entities in which the assets are located, or that the activities are performed. This measure is extremely important in quantifying the economic substance of entities in a group where profit attributions do not seem to coincide with the legal reality. Transfer pricing rules are directly linked to risk allocation among related entities, as it measures the value of transactions among related parties.

## **5.2.1 Beneficial ownership**

### **5.2.1.1 *Income and Capital Model Convention***

The OECD deems the inclusion of the concept of “beneficial owner” in Articles 10 - 12 of the Income and capital Model Convention to be anti-abuse provisions regarding treaty shopping. It also provides guidance where treaty benefits should be denied in cases where subsidiary companies are established in tax havens or jurisdictions with harmful preferential regimes. In these instances, a country should prove that the place of effective management of a subsidiary lies within the resident country of its parent company, effectively making the subsidiary a resident of the parent company's country of residence.

Part of, or even all of the subsidiary's profits are then attributable to that country of residence. (OECD, 2010:38).

Income received by an agent nominee or even by a pure conduit entity should not be party to the advantages offered by double tax agreements, as this would directly frustrate the purpose of the Convention. The agent or nominee should not be regarded as the beneficial owner of the income if the conduit company has limited powers to put this income to use. These are conclusions drawn by the Double Taxation Convention on the Use of Conduit Companies Report, which was established to address the ever-growing problem of using conduit companies for treaty shopping. (OECD, 2010:126).

#### **5.2.1.2 Discussion draft on the meaning of 'beneficial ownership'**

The discussion draft on the meaning of 'beneficial ownership' sets out potential changes to be made to the commentaries of Articles 10, 11 and 12 of the Convention. It explains that the intention for the addition of the concept of "beneficial owner" to the Convention was for it to be interpreted in this context only. It was not intended to be interpreted by taking into account the meaning or definition allocated to it by domestic legislation or any other means. However, this document clearly states that the meaning ascribed to the beneficial owner of income in domestic legislation should not be entirely ignored (OECD, 2011:3).

The proposals regarding dividends, interest and royalties are much the same. It deems the "beneficial owner" of dividends, interest or royalties received by a subsidiary to be the entity that has the end-control over this income. This means the entity has the right of use and enjoyment of the income. Should the recipient of the income be constrained in any manner, including being obliged to pay over the income in part or wholly, either by contract or law, that recipient will not be deemed to be the beneficial owner of such income (OECD, 2011:4).

Treaty benefits should not, however, be granted to the recipient of income just because it is deemed as the beneficial owner of such income. Other anti-avoidance measures must also be fulfilled to fully qualify for the advantages offered by a specific double tax



agreement. Some of the most common anti-abuse legislation includes substance-over-form and economic substance measures (OECD, 2011:4).

In April 2011, comments were received by the OECD regarding the draft issued. Currently, the decision is awaited on the final changes to the Convention regarding beneficial ownership, therefore a few of these commentaries that are most applicable to this research will be considered.

According to Ng (2011:4), the new interpretation of “beneficial ownership” coincides with the judgment given in the Indofood case (refer to chapter 3.2.4.3). This remedies the confusion currently reigning among the various countries and provides overall guidance as to the implication of the concept of “beneficial ownership”.

This is confirmed by Kim and Chang (2011) in their response to the draft on “beneficial ownership”. According to them, there is currently no “substantive guidance in domestic laws and tax treaties”. During the past few years, certain jurisdictions applied beneficial ownership provisions as a type of substance-over-form test, whereby double tax agreement benefits were denied on the grounds of companies either being mere conduits for certain types of income, or incorporated for the sole purpose of tax avoidance. In these instances, pure Holding Companies without any physical substance (only holding shares in other companies) were deemed as artificial and subsequently did not qualify as the beneficial owner of income. This creates great concern as, according to their knowledge, the OECD never intended for economic substance to be a requirement when establishing whether an entity is the beneficial owner of certain income, or not.

Kim and Chang (2011) also indicate that it is preposterous to maintain that a Holding Company *per se* cannot be the beneficial owner of income. They refer to the Double Taxation Conventions and the Use of Conduit Companies Report and indicate that the OECD recognises the fact that Holding Companies (whether ultimate Holding Companies or IHCs) can be created for reasons other than tax avoidance or evasion.

It is further contended by Kim and Chang (2011) that the concept of “beneficial ownership” should only be used to a limited extent as an anti-avoidance measure. It should also not

be as widely used as “substance-over-form”, or “limitation of benefits” doctrines and, in some instances, should also be applied totally separately from the general anti-abuse measures.

This is, to some extent, supported by the view of the City of London Law Society. Phillips (2011:1) mentions in his letter to the OECD that the concept of “beneficial owner” should neither be defined in the Convention, nor be used as an anti-avoidance tool. The concept should merely allow countries to decide whether these provisions and concepts should be incorporated to their respective double tax agreements. Phillips (2011:3) also indicates that the concept of “full right to use and enjoy” might be too strict and lead to double taxation of certain passive income.

## **5.2.2 Permanent establishment**

### **5.2.2.1 *Income and Capital Model Convention***

The permanent establishing of a company is dealt with in Article 5 of the Convention. Effectively, a permanent establishment is “a fixed place of business, through which the business of an enterprise is wholly or partly carried on”. Paragraph 1 of Article 5 specifically requires the place of management, an office, branch, factory, workshop or mine to be included in the definition of a permanent establishment. (OECD, 2010:59).

The definition of a permanent establishment does not necessarily require a business to have a productive character; it merely requires a geographical location from which the business is conducted with a certain degree of permanency. It does not matter whether the area is owned, rented or occupied illegally, the business should merely have a space available from which to conduct its business operations. (OECD, 2010:59-60).

The operations of a business are usually conducted by its employees, whether formally or otherwise employed and includes any person receiving instructions from the enterprise. Whether the person or employee has the authority to make decisions or bind the business to a contract has no real significance. (OECD, 2010:63).

Usually, the mere existence of a subsidiary in a country, does not necessarily lead to a permanent establishment. The subsidiary will remain its own entity, even if managed by the parent company, and it operates as an extension of that parent company's business operations. As a result, the operations of a subsidiary in a certain country do not necessarily lead to the parent company having a permanent establishment in that country. The management services offered to a subsidiary also do not necessarily result in the permanent establishment of the parent company as a result of source rules and legislation. (OECD, 2010:71).

It is, however, important to take into account the provisions of place of effective management in this regard.

### **5.2.2.2 Profit attribution to permanent establishments**

In July 2010, the OECD published The 2010 Report on the Attribution of Profits to Permanent Establishments. This report enhances the focus on economic substance and mainly follows the principles already set out by the OECD's Transfer Pricing Guidelines.

The first step in allocating profits to a permanent establishment is to perform the 'functional and factual analysis'. This step requires that the activities and responsibilities undertaken by the permanent establishment be considered in comparison and in relation to the economic activities and risks assumed by the parent company, or the group as a whole. The second step is to evaluate the pricing structure among the relevant parties to establish whether the principles of Article 9 of the Convention should be applied. Accordingly, the permanent establishment will be treated as a separate entity conducting its own business operations. (OECD, 2010:13).

## **5.2.3 Transfer pricing**

### **5.2.3.1 Income and Capital Model Convention**

Article 9 of the Convention defines the general principles for assessing the validity of intra-group transactions. It allows for the adjustment of profits, should it be established that

these transactions are not at arm's length. The Article recognises that a probability exists that certain profits may be double-taxed as a result of these adjustments. Accordingly, it advises the two countries party to the double tax agreement to establish which country will make adjustments and relent on income. (OECD, 2010:123).

The provisions regarding transfer pricing were extensively researched. Subsequently, the OECD published their concerns and principles in a document called Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. This report is briefly discussed below.

### **5.2.3.2 *Transfer Pricing Guidelines***

During the past few years there have been extensive developments on the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines). Most of these developments relate to business restructurings and the importance of economic substance.

Paragraph 165 of the Guidelines provides for two occasions where it would be appropriate for tax authorities to disregard the transaction's structure. These two occasions are:

- “where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance; and”
- “where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price”( OECD, 2010a:51).

Paragraphs 1.48 – 1.65 of the Guidelines are the most important regarding economic substance. According to these paragraphs, a tax authority should consider whether the substance of a transaction corresponds to its legal form. It also suggests that tax authorities consider the risk allocation of a transaction or arrangement, as this might be

imperative to determine the substance of a transaction. Another factor to be considered is whether the outcome of a transaction should occur at arm's length, especially relating to risk allocation. This is because risk is usually allocated to the specific part of the transaction over which the relevant parties have the most control. (OECD, 2010a:46).

The OECD (2010a:243) defines 'risk' as the capacity to make decisions relating to the acquisition and management of risk. Therefore, for a company to have control over risk it is assumed that the company has personnel, whether employees or directors, with the necessary authority, skill and knowledge to effectively perform the tasks. The fact that a company hires another company or person to perform the actual day-to-day functions is not sufficient to transfer control over risk. To be in control of the assumed risk, a company needs to assess the outcome of the functions performed by the other company or person.

Paragraph 9.170 perfectly states the OECD's view on transfer pricing and economic substance, namely that "[t]he economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including functions performed, assets used and risks assumed by them". (OECD, 2010a:293).

During June 2012, the OECD released yet another discussion draft on proposed changes to the Guidelines. This draft mainly focuses on the functions, assets and risks utilised in the establishment of intellectual property. It also deals with the entitlement of returns generated by intellectual property. The new draft provides three criteria to be taken into account to establish the entity entitled to the returns of intellectual property. However, as indicated by this new draft, these three criteria merely form the starting point of the process. Where it is determined that the legal terms of the contract do not align with the actual activities of the parties, the returns will be allocated to the party who performs the functions and bears the risks and costs associated to the intellectual property. (Ernst & Young, 2012:3).

### **5.3 EUROPEAN UNION**

Other than the relevant directives, court cases and documents already discussed, the following further highlights the importance of substance and trade benefits in a country's tax legislation.

### **5.3.1 EU Directives**

Member countries or states of the EU have access to the very advantageous EU directives. As previously indicated, 'directive shopping' is a new trend and is becoming an important factor in international tax planning. The three directives currently available are discussed below.

#### **5.3.1.1 *The EU Parent-Subsidiary Directive***

The main features of this directive are the exemption of distributed profits (dividends) from a subsidiary in the hands of the parent company, as well as the exemption of these profits from any withholding taxes (De Wilde, 2011).

#### **5.3.1.2 *The EU Interest and Royalties Directive***

The purpose of this directive is the elimination of withholding taxes on interest and royalty payments between two member countries (De Wilde, 2011).

#### **5.3.1.3 *The EU Merger Directive***

This directive is the "common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchange of shares concerning companies of different Member States and to the transfer of the registered office ... between Member States" (De Wilde, 2011).

### **5.3.2 The Cadbury Schweppes Case**

The European Court of Justice delivered a judgment in the *Cadbury Schweppes plc & Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue* (2006) C-

196/04 case. It answers the question whether CFC legislation should restrict the freedom envisaged by the EU directives on the establishing of group companies in countries with a lower tax rate.

The opinions of the UK, Danish, German, French, Portuguese, Finnish and Swedish governments were highlighted in this judgment. According to these governments, the main intention of CFC legislation is to “counter a specific type of tax avoidance involving the artificial transfer by a resident company of profits” from one country to another.

The judgment further highlights that when a group establishes a subsidiary in a country with a low tax rate, it cannot immediately be assumed that the subsidiary was created with the intention of tax avoidance or evasion. The circumstances of each case must be scrutinised to establish the economic reality of the establishment of that subsidiary. The objective of a group can be measured by the economic activity carried on by the subsidiary in the country in which it was established. Should the subsidiary be engaged in active, legitimate business operations and have sufficient substance, including an office and employees, it cannot be argued that the subsidiary was created wholly for tax avoidance or evasion purposes. Paragraph 54 of the judgment points out that “the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period”.

The judgment concludes that CFC legislation should not be applied where a subsidiary was created for legitimate business purposes. CFC legislation should, however, apply where it is found that the arrangement is wholly artificial and was created for the sole purpose of tax avoidance or evasion.

### **5.3.3 The Common Consolidated Corporate Tax Base Proposal**

The final proposal for the Common Consolidated Corporate Tax Base was published on 16 March 2011. Panyani (2012:256) evaluated the anti-abuse provisions and its compatibility with current EU legislation and case law.

The latest Common Consolidated Corporate Tax Base draft proposes that associated companies will consist of permanent establishments and their head offices, as well as any structure that allows direct or indirect participation in the management or control of another entity, whether in the same group or not. The following thresholds are described by Panyani (2012:266):

- *control* – 50% or more of the voting rights
- *participation* – 20% or more ownership
- *management* – should have significant influence and control in the management processes of the entity

General anti-abuse provisions in the Common Consolidated Corporate Tax Base will only be applicable should specific anti-abuse rules not apply to a certain transaction. Certain anti-abuse legislation, like CFC, switch-over and thin capitalisation rules will only apply to non-member countries. (Panyani, 2012:259).

#### **5.3.3.1 CFC legislation and switch-over rules**

The Common Consolidated Corporate Tax Base provides for two anti-abuse legislations regarding outbound investments:

- a CFC regime;
- switch-over rules that provide a credit if the exemption is not justified as a result of low local taxation rates on foreign profits.

The business sector of the EU is not partial to CFC rules. However, discussions with member states concluded that CFC rules should only apply to certain income streams and that mostly passive income streams should be affected. Income from real economic activities should not be affected by these new rules (Panyani, 2012:260). This complies with the principles set out in the European Court of Justice judgment of the Cadbury Schweppes case discussed above. The currently proposed CFC rules do not, however, contain any test for economic activities or commercial justification. (Panyani, 2012:262).



The CFC provisions will apply if the subsidiary in a non-member country complies with various requirements. One of these requirements stipulates that 30% of the subsidiary's income should consist of "tainted income". Tainted income can be described as certain listed types of income mostly (more than 50%) derived from group entities. Losses made by CFCs will not be allowed as a deduction from the member country's tax liability. (Panyani, 2012:261).

The switch-over rule was incorporated in the Common Consolidated Corporate Tax Base with the intention of discouraging the inflow of revenues from low-taxed non-member countries. This rule taxes profit distributions, capital profits and other income earned from low-taxed non-member countries and then provides a tax credit for taxes already paid. A low-taxed non-member country is a country whose tax rate is 40% lower than that of the member country. The switch-over rules do not, however, have any clauses that cater for true economic activities. (Panyani, 2012:260).

### **5.3.3.2 Thin capitalisation rules**

For loans between member countries, the interest deductibility will not be an issue, as the intra-group income and expenses will be netted for consolidation purposes. Subsequently, thin capitalisation will only apply to interest earned or paid to a non-member country (Panyani, 2012:264). The thin capitalisation rules stipulate that interest is not deductible from taxable income in respect of a loan received from an associated company resident in a low-taxed, non-member country. A low-taxed non-member country will have the same meaning as set out above by CFC rules. (Panyani, 2012:264).

Thin capitalisation provisions were intended to cover both "definitive influence and control, i.e. the freedom of establishment", as well as the "free movement of capital". However, interest will still be deductible, should it be paid to an associate non-member company who, in its normal course of business, supplies similar loans to third parties. Article 81(3) (c) of the draft Common Consolidated Corporate Tax Base directive indicates that it should be "an independent economic enterprise carried on for profit and in the context of which officers and employees carry out substantial managerial and operational activities".

## 5.4 SUMMARY

The OECD has extensive policies with regard to “permanent establishments”, “transfer pricing” and “beneficial ownership”. Although these concepts are currently being re-visited, they are used as the benchmark for all similar policies internationally.

In essence, the OECD deems the beneficial owner of certain income streams to be the entity or person who has control over that income (reaps the benefits from that income stream) and deems the permanent establishment of an entity to be a fixed place of business with only a certain degree of permanency. It is important to note that the OECD deems a subsidiary to be a whole separate entity from its parent company with regard to the establishment of that parent company’s permanent establishment in a certain country.

In the transfer pricing draft documents discussed earlier, the OECD highlighted the importance of group companies’ economic substance as well as “substance-over-form” principles embedded in a country’s domestic tax legislation as measures to combat tax avoidance or evasion. The transfer pricing document also highlights the importance of entities to have sufficient control over their risks and obligations. These views are confirmed with the drafts issued on both “permanent establishments” and “beneficial owners”.

Many entities and countries have responded with valid comments on the drafts issued by the OECD on the aforementioned matters. These comments mostly highlighted the fact that it would be unfair for the OECD to create policies where IHC’s will not be deemed beneficial owners of certain income streams.

The EU, on the other hand, is responsible for creating an advantageous Headquarter Company location to all its members as a result of the benefits to be reaped from its various directives. The EU also mainly relies on the judgment of the Cadbury Schweppes Overseas Ltd case to provide guidance on the economic substance and intention of certain group companies.

## **CHAPTER 6**

### **ANALYSIS OF FINDINGS**

#### **6.1 INTRODUCTION**

During the previous chapters, the various types of substance requirements and tax incentives for certain trade activities were analysed from an international perspective. The benefits of these policies were briefly discussed throughout these chapters,

Below a summary of the various policies and conclusions drawn throughout this research will be analysed to effectively support the conclusion drawn in chapter 7.

#### **6.2 SUBSTANCE REQUIREMENTS**

During the past few years, the economic substance of companies has become a controversial issue. Although not a new concept to governments, tax authorities or specialists, the policy thereof is still unclear. As indicated throughout this research, the extent to which substance requirements were considered and researched during the development of South Africa's current Headquarter regime is very limited.

International organisations, including but not limited to the OECD, published various documents that discuss the problems relating to companies without sufficient substance and provide guidance on the most important factors of this concept. Many countries, including Mauritius and Cyprus, follow these principles. However, to date, very few countries amended domestic legislation to provide guidance regarding their views on economic substance, but choose to rely on international principles or case law.

The OECD considers the degree of "control over risk" and "people functions" employed in a certain country as the main indicators of substance. Lack of transparency and exchange of information are deemed to go hand in hand with substance requirements to combat fictitious or transparent group structures. The 1998 OECD Report, as discussed in chapter 2.2.4, dealt extensively with these issues.

Substance requirements do not necessarily have to be specifically included in domestic legislation as shown in chapter 3. The economic substance of a company can be ensured by sufficient legislation regarding anti-avoidance, beneficial ownership, residence or permanent establishments. Many of the countries discussed in this research document have favourable Holding Company regimes, but neglected to ensure sufficient substance of these Holding Companies.

Many countries rely on a participation requirement before the benefits of a Holding Company regime can be reaped. Most of these participation provisions require a certain measure of shareholding or voting rights in a subsidiary. South Africa has a similar provision. However, the participation requirement is extended to the assets used and revenue earned by the IHC. Although these additional requirements were set in place to prohibit abuse of the new Headquarter regime, it is doubtful whether they contribute to the economic substance of an IHC. These additional requirements merely indicate the minimum revenue and assets an IHC needs to hold in order to qualify, but they do not demand any other economic business operations by such IHC.

South Africa also does not have any specific legislation governing its principles on permanent establishment, or beneficial ownership. The international principles in this regard, as well as the provisions in double tax agreements are used as guidance should any dispute arise. Internationally, this is not uncommon. As can be derived from previously mentioned international comparisons, very few countries have specific domestic legislation governing these two principles.

The UK incorporated permanent establishing principles in their domestic legislation. These principles, however, were almost directly copied from the OECD. The UK's general treatment regarding Holding Companies is the regime South Africa should strive to implement. The UK provides sufficient guidance in their domestic legislation for all parties to reach consensus on the treatment of various transactions. The UK is also currently trying to implement substance in these policies. This can be seen in their policy that requires a Holding Company to engage in operating activities for a period of 12 months before it can take advantages of benefits offered to Holding Companies.

The PRC, however, is on the forefront of ensuring economic substance by incorporating a strict policy on beneficial ownership. Even Luxembourg, a country deemed to be a tax haven, incorporated regulations that define their policy on economic substance. In Luxembourg, the importance of a company in relation to its group is measured by its capability to assume risk. South Africa, in this regard, is behind in establishing clear and logic principles.

Compared to international standards, the anti-abuse provisions in South African legislation are very well constructed. However, the fact that qualifying Headquarter Companies are able to circumvent certain anti-abuse provisions, may create some concern. Anti-abuse legislation is created for the specific purpose of prohibiting companies from distorting tax policies and to subsequently receive undue tax benefits or advantages.

There is currently international concern regarding the meaning of “beneficial ownership” and its subsequent use as an anti-abuse measure. However, South Africa could prevent abuse of its new Headquarter regime by establishing specific policies regarding this concept. These policies must be able to prohibit the unnecessary outflow of income or funds from the country as a result of undue tax benefits. It can therefore be concluded that the concept of beneficial ownership is of great importance in ensuring economic substance of group companies created in South Africa.

The requirement to have resident directors or to ensure that key decisions are made in the country of tax residence is also not found in South African legislation. Although the policy on permanent establishment will ensure that no company receives tax benefits, should it not be a tax resident, these policies do not encourage substance located in South Africa. National Treasury may find it advantageous to include substance provisions like these in the Headquarter regime.

It was hoped that the proposed amendments to the Headquarter Company definition in section 9I of the Act in the Draft Taxation Laws Amendment Bill 2012 (DTLAB 2012) would have addressed this issue. However, this was not the case, as the DTLAB 2012 merely looked at relief for dormant or “shelf” companies qualifying as Headquarter Companies, as

well as the exclusion of back-to-back royalties to withholding taxes. Charles Makola, Director: International taxes at National Treasury indicated during his interview on 13 June 2012 that a specific regime should not be significantly changed shortly after it was incorporated, but that a sense of trust and reliability in this regime should first be established. However, with an issue as important as substance, an exception to this approach is justified.

Interpretation of the substance of a company is no longer purely a legal consideration, but also entails the substance-over-form principle. Countries should strive to implement a substance-over-form approach when it comes to intra-group transactions. This approach is followed by most tax authorities in the EU.

The economic substance of a company has a two-fold function. Firstly, it ensures that a company does not receive tax advantages or benefits to which it is not truly entitled. Secondly, it encourages the economic growth of a company. By requiring an office, employees, bank account or any other substantive operational activity, legislation will automatically force entities incorporated in South Africa to conduct actual economic business operations. Subsequently, this encourages a benefit to the *fiscus*.

### **6.3 TAX INCENTIVES FOR TRADE ACTIVITIES**

Chapter 4 provided a brief analysis of the activities usually associated with an operating Headquarter Companies. These activities include the provision of finance, management services, management or holding of intellectual property, leasing of assets and many more. One way to encourage an entity to be party to these activities is to provide tax incentives for these activities. The current South African Headquarter regime was created for Holding Companies, as defined. However, the activities usually conducted by a Headquarter Company could create a platform whereby economic growth and expansion can be encouraged.

Internationally, the provision of tax incentives to actual economic activities is minimal. Most Holding Company regimes rely on the exemption from withholding taxes and certain anti-avoidance provisions, as well as a relaxation in exchange control regulations. South Africa

is no different in this regard. Although many countries still require that a withholding tax on technical fees or management fees be paid to parent companies, South Africa already provides a benefit in this regard by not requiring withholding taxes on these fees through normal domestic legislation provisions.

Allowing exemptions from withholding taxes does not directly or indirectly encourage economic activity or growth to the *fiscus*. Allowing certain payments to be exempt from income tax encourages multinational groups to direct foreign investment through a certain country. This merely encourages cash flow and foreign direct investment. Although this was the original intention of National Treasury when the South African Headquarter regime was developed, no further research has been done on how headquarter activities can benefit the South African *fiscus*.

Certain countries offer incentives by exempting certain income streams from subsidiaries from corporate taxation. Cyprus allows a special deduction of interest regarding finance acquired to purchase shares in a subsidiary. This deduction is usually not allowed under normal rules, as the subsidiary is unlikely to result in taxable income. Cyprus further allows an exemption on gains made from the sale of shares, whether capital or income by nature. This type of exemption allows groups to restructure without any adverse tax effects. Another country allowing special exemptions is the UK, who allows dividends received and profits made by foreign branches to be exempt from UK corporate tax. These new tax policies comply with the principles set out by the OECD.

South Africa already allows incentives to certain income streams. Although no special tax benefits are established for the receipt of royalties, rent or interest, the South African Headquarter regime allows for the exemption of foreign dividends from corporate taxation. It also allows for the deduction of tax credits regarding management fees received, even if the source is deemed to be in South Africa. These benefits in themselves create a reason for foreign direct investment. However, these incentives do not encourage Holding Companies to engage in economic activities.

A major difficulty regarding tax incentives to certain actual economic activities is that the substance of transactions may be distorted for entities to get the most beneficial results.

The provision of tax incentives may also encourage group structures to use conduit companies for the purpose of tax avoidance. Subsequently, this regime will not have a positive outcome on the *fiscus*, should the South African tax regime not have sufficient and air-tight economic substance policies in place.



## CHAPTER 7

### CONCLUSION

#### 7.1 INTRODUCTION

The South African *fiscus* can benefit in two ways from the new Headquarter regime. Firstly, the encouragement of actual operational activities in every company located in South Africa will lead to an increase in employment, knowledge transfer, work creation and trade. This will, in turn, inevitably lead to an increase in economic activities and growth. Secondly, the South African *fiscus* will benefit where undue tax benefits granted to group structures will no longer lead to a loss of income. These benefits reconcile with President Zuma's objective of increasing economic development (Zuma, 2011).

The inclusion of substance requirements will not only be of great assistance in the aforementioned, but it will also help South Africa comply with current international trends. It is clear from the research conducted that substance is no longer an option, but rather a requirement for all tax policies dealing with international Headquarter Company group structures. As a result, if South Africa formulates an extensive view on economic substance, whether by policy or legislation, it will put South Africa on the forefront of these new developments.

By evaluating the literature on the development of the current Headquarter regime in South Africa, it became clear that the regime was created with the main objective to use South Africa as a strategic place for business organisations to invest in Africa. It was created with the objective of encouraging multinational entities to establish Headquarter Companies, as defined, in South Africa and to use these companies to subsequently expand their trade into the rest of Africa. These objectives were potentially met by creating tax policies and relaxing exchange controls to facilitate an environment where funds can freely flow among group companies and to prevent profit from being trapped in one specific country.

It also became clear that the benefit to the South African *fiscus*, associated with the establishing of Headquarter Companies in South Africa, was not considered.

The main question remains whether the new 'Headquarter Company' tax provisions in South Africa can be amended to result in a direct benefit to the *fiscus* in South Africa. A Holding Company would benefit from the current tax policies in the new Headquarter regime, but it will not encourage international trade. By encouraging the establishing of Headquarter Companies in South Africa, direct benefit to the South African economy is encouraged. Headquarter Companies provide substance in a country in the form of products, skilled and unskilled labour and increased economic activity.

## **7.2 PROBLEM STATEMENT AND RESEARCH OBJECTIVES**

It was the main objective of this research to establish how the Headquarter Company regime should be amended by way of substance requirements as well as tax incentives to certain trade activities in order to result in a direct benefit to the South African *fiscus*.

This was accomplished by firstly analysing the various substance requirements and specific tax incentives to Headquarter Companies currently being implemented successfully internationally throughout chapters 3 and 4 of this research. Countries that were extensively researched included Mauritius, the Netherland, Cyprus and the UK. Other countries with recent development with regards to changes in policy which affected their provisions with regards to economic substance, included Luxembourg, China and Germany. During this research, certain substance requirements and tax incentives to trade activities were identified that are used more commonly in these countries.

Thereafter, the current Headquarter Company tax provisions with a direct focus on substance requirements and other tax incentives were analysed and compared with the results found in the aforementioned chapters. The analysis and comparisons were done in both the summaries of chapters 3 and 4 as well as chapter 6.

During the aforementioned processes, certain substance requirements were identified that could be implemented successfully in the South African legislation. These substance

requirements were identified by firstly selecting the most commonly found substance requirements and secondly selecting substance requirements that are both cost effective for group companies as well as providing the optimum benefit to the *fiscus*. The substance requirements identified are discussed in chapter 7.3 where further research is suggested.

The international principles established by the OECD and EU were also considered to ensure that the selected substance requirements do not fall within a tax regime that might be construed as harmful. It was however found that the international organisations deem the economic substance of Headquarter Companies to be an important factor. The inclusion of substance requirements would not result in the Headquarter Company tax regime of South Africa to clash with any of these organisations.

### **7.3 RECOMMENDATION AND FUTURE RESEARCH**

The world of holding companies is highly competitive. South Africa has already made a positive step by entering this world by creating a competitive headquarter company regime. This regime however, offers no benefit to the *fiscus*. By including substance requirements with subsequent trade benefits to certain headquarter activities the regime will become even more competitive.

Further research on this topic is necessary to identify specific substance requirements that can be successfully implemented in South African legislation. It is also important to weigh up the cost factor against the benefits provided by a Holding Company regime. Including specific substance requirements may inadvertently lead to expenses to the group as a whole. The benefits offered by a country's Headquarter regime should outweigh these costs.

The research should be concentrated on the establishment of concepts such as "permanent establishment" and "beneficial ownership". South Africa should follow in the footsteps of the UK in this regard and take the initiative, unlike many other countries, to incorporate such principles into its domestic legislation.

It would also be beneficial to research the economic impact of adjusting the definition and participation exemption of the Headquarter Company as set out in section 9I of the Act, to include specific substance requirements. The most common substance requirements were summarised in paragraph 3.5. Of these requirements, the following might provide substantial enough benefits to be incorporate into domestic legislation:

- Physical presence must be demanded within the borders of South Africa. Certain guidelines may be provided as to what extent o physical presence might be acceptable as this requirement could be quite broad.
- It should be required from all IHC's to have sufficient control over both its income received from subsidiaries as well as the risks and liabilities incurred by such IHC.
- Headquarter companies should have actual business activities performed within South Africa.
- A certain percentage or amount of employees must be resident in South Africa. These employees should cover a broad spectrum of the work force within the group as a whole.

The aforementioned are mere guidelines as to the possibilities of substance requirements. Other than these, the Government could consider a vast variety of requirements. Another method that could be considered is the creation of a “substance-over-form” policy with regard to the economic substance of IHC's resident in South Africa.

It should however also be said that, although the inclusion of substance requirements could provide substantial benefits and growth opportunities to the South African economy, one must consider the competetiveness of the Headquarter Company tax regime before any final decisions is taken. As mentioned earlier in this research, the lack of substance requirements is deemed by many countries to be an incentive rather than a tax deficiency.

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