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A COMPARISON OF THE TAX EFFICIENCY OF DIRECT VERSUS INDIRECT INVESTMENT INTO SOUTH AFRICA

by

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ABSTRACT

Multinational enterprises are continuously in search of investment opportunities to grow their businesses. For over two decades South Africa, being one of the economic powerhouses of Africa, has been one such target for global investors. A company planning to invest in South Africa will attempt to identify the most appropriate way to do so, for tax and non-tax reasons. However, tax consequences are one of the main factors influencing the decision of an investor.

While certain companies choose to invest directly into the target country, the majority choose to set up a holding company outside of the investor country. Such a company is known as an intermediary holding company and is defined as a company which is interposed between a shareholder and its foreign subsidiary.

The main purpose of this study is to investigate the best manner, for tax purposes, in which a foreign company would invest into South Africa, either directly or indirectly through an intermediary holding company. Should the intermediary holding company option be selected, the company will then need to select the country in which to base its intermediary holding company. Tax havens are commonly used as a base for intermediary holding companies, however, these may not be the most advantageous option in all cases.

Literature on intermediary holding companies and tax havens is reviewed and thereafter the study analyses and compares the tax efficiency of a hypothetical UK company investing into South Africa using different options. The options available to the UK Company which are compared, include investing directly into South Africa or investing indirectly through an intermediary holding company based in either Cyprus, Mauritius or the Netherlands, all of which are commonly used as bases for intermediary holding companies.

The comparative study on the different intermediary holding company options is performed based on the domestic tax laws of each country as well as the effects of the double tax agreements in force between these countries and other tax jurisdictions. Thereafter, the most tax efficient intermediary holding company option is compared to the tax efficiency of direct investment by the UK Company and a conclusion is reached on which is the best manner for such a company to invest into South Africa, for tax purposes.

KEY WORDS: intermediary holding company, direct investment, indirect investment, tax haven, tax efficiency comparison, cross-border investment, Cyprus, Mauritius, the Netherlands

OPSOMMING

Multi-nasionale ondernemings is voortdurend op soek na nuwe beleggingsgeleenthede ten einde besigheidsgroei te bewerkstelling. Internasionale beleggers sien Suid-Afrika nou al vir meer as twee dekades as ŉ toetreepunt tot geleenthede in Afrika, vanweë Suid-Afrika se status as een van die ekonomiese reuse in Afrika. Maatskappye wat beplan om in Suid-Afrika te belê sal ondersoek doen om die beste moontlike beleggings manier te vind. Talle besigheidsredes, waarvan belastingimplikasies een van die hoofoorwegings is, sal die faktore wees wat ŉ potensiële belegger se besluitneming beïnvloed.

Terwyl sommige maatskappye verkies om direk in die beleggingsland te belê sal die meeste maatskappye eerder in ŉ houermaatskappy buite die beleggingsland belê. So ŉ maatskappy staan bekend as ŉ intermediêre houer maatskappy en word gedefinieer as ŉ "tussenganger" maatskappy wat as geleibuis optree tussen die aandeelhouer en die buitelandse filiaal.

Die hoofdoel van hierdie studie is om ondersoek in te stel na die beste metode, vanuit ŉ belastingoogpunt, vir ŉ buitelandse maatskappy om in Suid-Afrika te belê. Dit kan óf direk óf indirek deur middel van ŉ intermediêre houer maatskappy gedoen word. Indien die intermediêre houer maatskappy opsie gekies word, moet die maatskappy ook die land kies waarin die intermediêre houer maatskappy opgerig gaan word. Lande wat bekend is as belastingtoevlugsoorde word dikwels gekies om intermediêre houer maatskappye op te rig. Dit is egter nie in alle gevalle die mees voordeligste metode nie.

Literatuur oor intermediêre houer maatskappye en belastingtoevlugsoorde word nagevors, waarna hierdie studie die belastingeffektiwiteit van ŉ hipotetiese Britse maatskappy, wat in Suid-Afrika belê, ondersoek deur gebruik te maak van verskillende opsies. Die opsies wat beskikbaar is en ondersoek sal word sluit in, direkte belegging in Suid-Afrika en belegging deur van ŉ intermediêre houer maatskappy gebruik te maak in Cyprus, Mauritius of Nederland. Al die vooraf genoemde lande is algemeen bekend daarvoor dat dit gebruik word om intermediêre houer maatskappye op te rig.

Die verskillende intermediêre houer maatskappy opsies word met mekaar vergelyk, deur die belastingimplikasies van plaaslike belastingwetgewing van elke land, asook enige dubbele belastingooreenkomste van krag tussen hierdie lande en ander regsgebiede, te oorweeg. Die mees effektiewe intermediêre houer maatskappy opsie word dan vergelyk met die belastingeffektiwiteit van direkte belegging deur die Britse maatskappy. ’n Gevolgtrekking word gemaak oor die metode wat die mees effektiefste belastinggevolge inhou vir ‘n Britse maatskappy wat in Suid-Afrika belê.

SLEUTELWOORDE: intermediêre houer maatskappy, direkte belegging, indirekte belegging, belastingtoevlugsoorde, belasting effektiwiteits vergelyking, oorgrensbelegging, Cyprus, Mauritius, Nederland

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

According to Alfaro (2012), the demand for multinational groups of companies is currently rising at a rapid rate due to the large amount of international investments and trading transactions taking place daily. In 2011, Africa attracted $55bn in Foreign Direct Investment (United Nations Conference on Trade and Development, 2011) indicating that Africa does have great potential to receive international investments. Furthermore, African countries were of the few countries which were able to avoid slipping into recession during 2008 and 2009 when growth in most of the developed world halted (PricewaterhouseCoopers, 2009:2).

Within Africa, South Africa has recently been identified as the economic powerhouse (SAinfo Reporter, 2012) and has been a major target for global entities. In addition, the country's Gross Domestic Product (GDP) accounts for 30% of the continent's GDP further highlighting South Africa's potential for international investors (Department of Trade and Industry, 2011).

A company planning to invest in countries with rapidly growing economies will attempt to identify the most appropriate way to do so, for tax and non-tax reasons. While certain companies choose to invest directly into the target country, the majority choose to set up a holding company outside the investor (or home) country. Such a company is known as an intermediary holding company (IHC) and according to Olivier and Honiball (2011:689) is defined as 'a holding company situated in a foreign jurisdiction … that is interposed between the foreign subsidiary and the resident shareholder (investor) of a multinational group of companies'.

1.2 PROBLEM STATEMENT

For almost two decades, foreign corporations have been investing into South Africa. Due to the interest in South Africa, an increasing number of companies will thus be faced with the task of deciding how to go about investing into South Africa. Would investing directly or indirectly into South Africa be more advantageous?

Various tax jurisdictions are utilised as bases for IHCs for tax and non-tax reasons (Olivier & Honiball, 2011:668). Selecting the most appropriate jurisdiction to base the IHC is a vital decision for the investor. Olivier and Honiball (2011:666) noted that tax havens are generally used in tax planning as a base for an IHC. However, Olivier and Honiball (2011:668) also noted that: ‘Tax havens are generally not suitable for intermediary holding company purposes because they seldom have tax treaty networks’. This statement questions the use of tax havens as the best jurisdictions to incorporate IHCs.

According to Eden and Kudrle (2005:124): ‘The literature on effectiveness of international regimes is still in its infancy. In addition, the jury is still out on whether the Organisation for Economic Co-operation and Development’s (OECD’s) attempt to define and neutralize harmful tax practices by “naming and shaming” tax havens as renegade states in the international tax regime will be successful. Studying tax havens is therefore likely to prove a fertile ground for theory development for international political economy scholars over the next few years.’

While research has been conducted by Botha (2010) and Legwaila (2010) on the use of South Africa as a base for an IHC, little is known about using other countries as a base for an IHC and a vehicle to invest into South Africa. Various studies on low tax jurisdictions such as the studies by Christensen (2011) and Eden and Kudrle (2005) were noted, however, none with particular reference to investment into South Africa. South Africa has double tax agreements (DTAs) in place with 75 other countries (as at 6 June 2012) and there is a lack of knowledge with regard to how these DTAs could be used to benefit the investor company in question.

1.3 PURPOSE STATEMENT

The main purpose of this study is to investigate the best manner, for tax purposes, in which a foreign company could invest into South Africa, either directly or indirectly through an IHC.

A foreign company will have to decide on whether to invest directly into South Africa or to set up an IHC in another country and invest into South Africa via that country. Should the IHC option be selected, the company will then need to select the country to base its IHC.

Substantial tax savings can be made by selecting the most appropriate jurisdiction to base an IHC. Tax consequences are one of the main factors influencing the decision of an investor (Harris & Oliver, 2010:389). This study will aim to assist such investors planning to invest into South Africa as previous studies have not made particular reference to investing into the country.

1.4 RESEARCH OBJECTIVES

The study will aim to discuss the following research objectives:

- To analyse the tax effects of direct investment into South Africa by a company based in the United Kingdom (UK).
- To analyse the tax effects of indirect investment via specific IHC jurisdictions by the UK Company to determine the most tax efficient jurisdiction to invest through.
- To critically analyse and compare the above options and conclude what would be the most tax efficient option of investing into South Africa.

1.5 DELIMITATIONS

The study has several delimitations related to the context in which it is performed. Firstly, investment into South Africa is limited to investment by a foreign company or foreign Multi-National Enterprise (MNE) and does not relate to investments by resident entities nor does it relate to individuals, whether resident or not.

Furthermore, the investment is limited to investing into South Africa as described in chapter 3 and does not relate to investments such as purchasing listed shares, property and other passive investments. Also, the study relates only to inbound investments and not outbound investments from South Africa.

The study acknowledges the existence of legislation affecting cross border investment such as transfer pricing, anti-avoidance provisions, exchange controls and controlled foreign company (CFC) rules, amongst others, but will not discuss these rulings and their consequences in detail.

Lastly, only taxation as an influencing factor for investors will be discussed. All other factors relating to the decision of direct versus indirect investment as well as the factors relating to the decision of the specific jurisdiction to base an IHC, will be deemed neutral.

1.6 DEFINITION OF KEY TERMS

The key terms used in this study are defined below:

Capital duty: A duty payable on creation and increases of a company's share capital as well as on issuance of shares (Olivier & Honiball, 2011:706).

Capital gain: A gain made on the disposal of a capital asset (Eighth schedule of the Income Tax Act). Capital gains tax (CGT) is payable on such gains.

Controlled foreign company (CFC): A foreign company controlled by a resident or residents up to a specific percentage shareholding, or where a resident or residents participate(s) in the profits of a foreign company up to a specific percentage, which specified percentage varies from country to country (Olivier & Honiball, 2011:839).

Country risk: The economic, political and other risks associated with investing in a foreign country.

Double taxation: When income is subject to taxation both in the country of residence (due to a residence based tax system) as well as the country in which the taxable transaction took place (due to a source based tax system) (Koekemoer, 2010:552).

Exchange controls: Restrictions imposed by a country regarding the purchase and sale of foreign exchange and cross-border transactions.

Foreign Direct Investment (FDI): Investment into a company in a foreign country that is likely to provide the foreign investor with substantial managerial influence over that company (Olivier & Honiball, 2011:841).

Intermediary holding company (IHC): 'A holding company situated in a foreign jurisdiction, whether or not it is a tax haven, that is interposed between the foreign subsidiary and the resident shareholder (investor) of a multinational group of companies' (Olivier & Honiball, 2011:689).

Multinational Enterprise (MNE): 'A group of companies with business establishments in more than one country' (Olivier & Honiball, 2011:846).

Resident: A person who has sufficiently close connections to a country to be liable for tax there on worldwide income (Olivier & Honiball, 2011:849).

Tax avoidance: 'The deferral, avoidance or reduction of tax by lawful means' (Olivier & Honiball, 2011:850).

Tax credits: Credits against tax payable, which may be claimed due to some form of tax already incurred on the specific taxable income.

Tax evasion: 'The reduction of tax by illegal means, usually involving fraudulent non-disclosure or wilful deceit' (Olivier & Honiball, 2011:850).

The Republic: The Republic of South Africa.

Thin capitalisation: The funding of a company with debt instead of capital in order to maximise the interest deductibility (Olivier & Honiball, 2011:850).

Transfer pricing: 'The adjustment of intergroup prices of goods and services charged by affiliated companies in order to take advantage of the different tax rates found in different countries' (Olivier & Honiball, 2011:851).

Treaty network: Various double tax (treaties) agreements (DTAs) signed by a country.

Withholding tax: A tax levied by the source country on payments made by residents to non-residents of that country, which is collected and paid to the government by the resident payer.

Abbreviations used in this document are included in Table 1.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
CFC	Controlled Foreign Company
CGT	Capital Gains Tax
DTA	Double Taxation Agreement
EU	European Union
FDI	Foreign Direct Investment
GBL	Global Business Licence
GDP	Gross Domestic Product
HMRC	Her Majesty's Revenue and Customs
IHC	Intermediary Holding Company
MNE	Multi-National Enterprise
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
SPV	Special Purpose Vehicle
UK	United Kingdom
UN	United Nations
VAT	Value Added Tax

1.7 DESCRIPTION OF INQUIRY STRATEGY AND BROAD RESEARCH DESIGN

Non-empirical studies refer to studies where questions regarding the meaning of scientific concepts, trends in scholarship or the nature of existing theories or theoretical perspectives are answered without collecting new data or re-analysing existing data (Babbie & Mouton, 2001:75). In this study the existing theories related to using IHCs and tax havens to invest into South Africa will be reviewed, critically analysed and questioned. Furthermore, the DTAs between specific countries will be analysed, thus no new data will be collected but rather existing data will be analysed.

The above reasoning further supports the qualitative strategy of inquiry followed as the type of research undertaken is of a qualitative (textual) nature. This choice is supported by previous studies that have also used qualitative approaches to study the various DTAs entered into by a country (Botha, 2010; Legwaila, 2010).

The research will be carried out initially through a review of literature available on means used in order to invest into South Africa. To further the study, a comparison will be made of the effective tax rates and other tax considerations applicable to a company based in one of South Africa's biggest trading partners, the UK, when investing through various jurisdictions as well as when choosing to invest directly into South Africa. This in-depth analysis will take into account the various tax laws and applicable DTAs affecting the transactions under the different options.

The UK was selected as the base of the investor company as according to the Department of Trade and Industry (2012), the UK is one of South Africa's leading trading partners. Furthermore, the Western Cape attracted 80 international FDI projects with a total value of R30.1 billion between June 2009 and June 2012 and the UK was the biggest contributor to this FDI (Western Cape Provincial Government, 2012).

1.8 OVERVIEW OF CHAPTERS

Various literature on related topics are reviewed in chapter 2. In chapter 3 the scenario of the foreign company investor is placed into context, the tax consequences of direct investment into South Africa are analysed and the three IHC options are introduced. The domestic tax laws and the applicable DTAs of the three IHC countries are analysed and compared in chapter 4. A summary of findings is discussed in chapter 5 as well as how the research objectives of the study were addressed. Thereafter, a conclusion is reached on whether the UK Company should invest directly or which country should be selected as a base for an IHC, followed by recommendations and future research to be performed.

CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

Firstly, the relationship between globalisation and taxes as well as the concept of international tax is discussed. Thereafter, the options of investing into South Africa as noted in the literature reviewed are mentioned i.e. investing directly or indirectly through an IHC. IHCs are then further discussed and various literature is reviewed relating to why a company should use an IHC, how to choose a location for an IHC and the challenges facing a company when using an IHC.

An important aspect of international tax, DTAs, is then explained. Finally, the planned research to further the study is noted.

2.2 GLOBALISATION AND TAX

Cross-border activity is now fundamental to many businesses and is often seen as the key to their growth (Ellingsworth, 2009:273). According to Cockfield (2010:4), globalisation refers to 'the tying together of nations through economic and other activities'. As mentioned earlier, MNEs are looking to increase shareholder wealth through globalisation. The main relevant features of globalisation from the perspective of the taxation of international investments as noted by Cockfield (2010:4) are:

- the increasing activity of MNEs;
- the internationalisation of the way in which these companies organise their business;
- the increasing number of countries that act as both importers and exporters of investment capital;
- the increasing complexity of cross-border transactions; and
- the shrinking of geographical constraints on international business activities as a result of the information and communication technology revolution.

From the points above it seems that taxation and globalisation are so closely linked that the taxation of a global transaction can greatly affect the structuring of the transaction. Also, Harris and Oliver (2010:389) noted that one of the main factors influencing the decision of an investor is the tax consequence of an investment.

2.2.1 International tax

The term 'international tax' can be confusing as it may appear that there is some sort of international tax act that levies a tax on international transactions. This is not the case as global tax laws do not exist. The following, according to Koekemoer (2010:544) must, however, be considered during the study of international tax:

- The domestic principles of the relevant country must be considered to the extent that they regulate the taxation of international transactions.
- The impact of a DTA must also be considered.

The taxation of MNEs is one of the areas where international conflicts are inevitable between nation states. As domestic tax systems are set up for domestic purposes, they are poorly designed to handle the international activities of MNEs. These MNEs are likely to disagree with tax authorities regarding the appropriate tax the enterprise should pay at a domestic level. (Eden & Kudrle, 2005:103).

Several international institutions have been mobilizing for change to international taxation arrangements. As noted by Koivusalo (2011:7), '... the Tax Justice Network calls for the initiation of a democratic global forum, comprising representatives from citizen groups and governments across the world, that should engage in widespread debate on taxation with the possibility of implementing policies such as the following: (1) developing systems of unitary taxation for multinationals to stop the entirely false shifting of profits to countries with low or no taxes; (2) harmonizing tax rates and policy for capital (that is currently highly mobile); and (3) cooperation among states to reduce the destructive effects of tax competition.'

Due to the absence of a global set of tax laws as discussed above, the affected countries' domestic tax laws and the DTAs in place will be considered in the study on whether to invest directly or indirectly via an IHC.

Below, how and why IHCs and tax havens are used for investing is discussed based on various literature. The problems and challenges of using an IHC and a tax haven as discussed below can be taken as advantages of investing directly into South Africa.

2.3 IHCs

A company that chooses not to invest directly into a country will use an IHC. MNEs set up IHCs in various jurisdictions to hold shares in and manage investments in companies in a foreign country. Such an IHC is referred to as a 'pure' holding company (Rohatgi, 2002:238) whereas a 'mixed' holding company may engage in other commercial activities.

2.3.1 Why use an IHC?

An MNE with a tax residence in a country that has a residence-based tax system risks being subject to international double taxation on income generated in a country that imposes tax based on the source of the income. Thus, by setting up an IHC and strategically choosing its location in order to avoid any international double taxation, MNEs stand to benefit (Huizinga & Voget, 2009:1217).

There are, however, multiple non-tax reasons for using an IHC that companies may deem more important. Olivier and Honiball (2011:690-692) identify the following:

- *Exchange controls*: In order to facilitate reinvestment and prevent forced redistribution or trapping of profits, an IHC can be incorporated outside the exchange control area in the case where the investor is situated in a country which imposes exchange controls.
- *Raising external finance*: Finance may be more easily obtainable based on the balance sheet of the IHC as it holds the investment. Also country risk is reduced as the IHC is located outside the country of the investor and the underlying investments.

- *Structural consolidation and group reorganisation*: An IHC may be set up in order to have centralised legal control for a geographical area or for flexibility in group reorganisation, for example, in a jurisdiction with more flexible company laws than the investor country.
- *Asset protection*: An IHC could assist in the reduction of the risk of expropriation by retaining profits outside the investor country in a politically safe jurisdiction.
- *Combination with non-holding reasons*: Along with holding the investment in the foreign country, the IHC can be used as a centralised unit which provides headquarter activities such as accounting, legal, marketing and other administrative services.

Apart from the above non-tax reasons, numerous other reasons for incorporating an IHC were noted. A few pertinent ones were preferential time differences, expertise and quality of work of potential employees in the intermediary country, political stability, company incorporation legislation, accounting and audit requirements, economic stability, and ease of accessibility and communication.

According to Olivier and Honiball (2011:693) and Rohatgi (2002:238) an IHC may be formed for the following tax reasons:

- *Reducing withholding tax*: The jurisdiction in which the IHC is located, may have a more favourable network of DTAs than the investor country and this may result in the IHC being liable for lower withholding taxes in respect of dividends received.
- *Deferring Capital Gains tax*: The intermediary country may impose more favourable treatment to capital gains. This may include relaxed deemed disposals laws and deferrals of capital gains.
- *Deferring tax on operating income*: The IHC may enable the investor to defer tax by not remitting dividends received to the investor country and accumulate dividends and reinvest income instead.
- *Optimising credits for foreign taxes*: Depending on the tax legislation in the investor country, tax credits from the intermediary country may have the effect of pooling of foreign income and thus eliminating wasted tax credits or increasing the average rate of tax credits claimed.
- *Foreign exchange gains and losses*: An IHC can also be used to obtain tax benefits from foreign exchange gains/losses.

- *Re-characterisation of income*: Through an IHC, the nature of income can be changed, for example, from interest to dividends.

One can derive from the reasons above, that the location of the IHC is crucial in obtaining the tax benefits, however, a company may choose a location less suitable for tax but with greater benefits related to the non-tax reasons, or *vice versa*.

2.3.2 How to choose the location for an IHC and challenges thereof

When selecting the location of an IHC, Rohatgi (2002:238) mentions the following aspects which should be considered:

- A wide and appropriate treaty network to minimise the withholding and other taxes in the host countries on the income and gains of the subsidiaries.
- The availability of foreign tax credits in the holding company for the taxes paid by the subsidiaries, unless the income is not subject to tax.
- A nil or low effective corporate tax on the foreign income received, and on the other income earned in the jurisdiction. No capital taxes, stamp duties on capital issues and transfers, and no net worth taxes.
- The ability to make tax free reorganisations through the sale or liquidation of foreign subsidiaries or branches. For example, no capital gains tax on the sale or liquidation of the subsidiaries in either the holding or the host jurisdiction.
- The deductibility of interest payments on the funds borrowed to finance the subsidiaries against the income received from them, and the deductibility of their losses.
- No withholding tax on the dividend and other payments made by the holding company to the home country.
- Stable tax laws and treaties, the ease of compliance requirements and a favourable attitude of the tax authorities. No anti-avoidance provisions, such as anti-treaty shopping, transfer pricing, thin capitalisation and CFC rules.

In addition to the benefits obtained from setting up an IHC there are challenges and problems that the investor may be faced with in selecting the most appropriate jurisdiction.

One particular jurisdiction that satisfies all the above criteria will be close to impossible to locate thus the investor may have to deal with the following potential challenges:

- CFC or other anti-avoidance legislature in the investor country may eliminate potential tax advantages.
- Costs in setting up an IHC as well as other administrative costs relating to restructuring and consolidation may be very high.
- Investor country may not grant foreign tax credits.
- Exchange controls may limit the choice of re-investment of income.

The investor will be tasked with weighing up the costs and benefits of each potential location in order to find the most suitable one. Other aspects that the investor should keep in mind include the type of intermediary – whether it is a pure intermediary or a mixed intermediary. This will be determined by the nature of repatriation of profits to the investor, which will affect the tax consequences.

2.4 TAX HAVENS

From the 1950s taxpayers have shifted their operating bases from place to place in search of tax efficiency (Oguttu, 2010:175). Over 50 years later, it is increasingly clear that tax havens have become major players in the global financial markets: over half of all international bank lending and approximately one-third of FDI is routed via tax havens and 50% of global trade is routed on paper via tax havens even though they only account for some 3% of the world GDP (Christensen, 2011:178).

Although a tax haven cannot be clearly defined, it is generally a country or state which has a relatively lower rate of taxation than other countries or states (Olivier & Honiball, 2011:667). According to the OECD[1] (1998:22), a tax haven is identified through the following characteristics:

- The jurisdiction imposes no or only nominal taxes.

[1] The OECD has not released an updated report on Harmful Tax Competition, thus the source used is the latest version of the report by the OECD.

- Laws or administrative practices are in place which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction.
- Lack of transparency.
- The absence of a requirement that the activity carried on by the taxpayer be substantial.

The use of a suitable tax haven has become a characteristic feature of modern tax planning and is frequently an essential element of an effective international set-up. According to Ginsberg[2] (1990:5), '... the object of choosing the most suitable tax haven is not to minimise taxes per se, but to maximise net after-tax income'. Thus an entity planning to solely avoid tax may not simply do so by incorporating a company in a tax haven and expect to minimise its tax burden, but there is in-depth planning needed before it can effectively maximise its post-tax income.

To illustrate, a company cannot merely be incorporated in a tax haven and operate in another country in attempt to pay nominal or no taxes, as the country where the company is managed (the place of effective management) may render the company a resident and tax the company based on its tax laws. Thus board meetings and management decisions will have to be made in the tax haven and not in the residence country to avoid being taxed in the residence country.

Therefore a company setting up a presence in a tax haven should ensure that such a presence has commercial substance and a detailed cost-benefit analysis should be undertaken in order to determine whether the location will be beneficial.

2.4.1 Why use a tax haven

Tax efficiency is not the only reason for using a tax haven. A number of other reasons given by Ginsberg (1990:7), for using tax havens by individuals or corporations are:

- inheritance provisions in the country of residence;

[2] This source was used as it is regarded as the primary research on Tax Havens by this author. Later authors also refer to this source, for example, Olivier and Honiball (2011) whose research is regarded as very prominent in South Africa.

- anonymity and secrecy – whether it relates to keeping the use of bank accounts from governments or development of business products/ideas from commercial competitors;
- political reasons in the country of residence;
- accumulating of income prior to emigration on retirement;
- geographical expansion by MNEs; and
- protection of assets from seizure or ex-spouses.

2.4.2 Problems with using a tax haven as a base for an IHC

Despite the above reasons for using a tax haven, many problems can be faced by a company that uses a tax haven country, such as those challenges faced by a company when incorporating an IHC as previously discussed . Apart from this, a more concerning problem is the continued action against tax havens.

Furthermore, as stated by Olivier and Honiball (2011:668), a tax haven is generally not a suitable jurisdiction for an IHC as tax havens seldom have treaty networks. DTAs are, however, an integral part of international tax.

2.4.3 Types of havens

According to Rohatgi (2002:229), there are three types of tax havens:

- *Base havens*: Jurisdictions with nil or very low tax on corporate or business income and a few or no DTAs.
- *Treaty havens*: Countries with reasonable domestic tax rates but with special tax regimes that allow the use of their treaty network for offshore activities. They also generally levy no taxes or very low taxes on source-based profits.
- *Special concession havens*: Countries with special incentives or benefits that may be exploited for a particular international transaction or activity to gain a tax or non-tax advantage, usually with the help of DTAs.

Base haven countries are generally used for accumulation of income subject to low or no tax as well as for group administration activities. Treaty havens are more suitable for intermediaries and conduit companies as the favourable treaties allow for minimal or no withholding taxes on inbound income and outbound payments. On the other hand special concession havens provide exemptions or relief for certain types of business. Selecting the most appropriate tax haven thus depends on various factors including the type of income to be repatriated to the host country. Various factors which may be considered when choosing a tax haven are discussed below.

2.4.4 How to choose a tax haven

Although there are differing opinions on whether a tax haven would be the most ideal location for an IHC, the factors discussed above in selecting the location of an IHC can also be used to select a tax haven. However, the following additional considerations are noted by Ginsberg (1990:9):

- Political and economic stability.
- Secrecy of information.
- The conducting of active business in the tax haven country itself.
- Degree of physical presence in the country.
- Adequate banking and professional facilities as required by the operations in the country.

2.4.5 Initiatives against tax havens

There is widespread international resistance against tax havens. Among the many reasons for this resistance is that tax havens rob poorer countries of tax revenue. Due to tax havens providing the opportunities for tax evasion and tax avoidance the tax burden of corporations and wealthy individuals are thus shifted to the rest of the population and this curbs development in developing countries (Koivusalo, 2011:7).

Tax havens also make it difficult to clearly identify where the debt and equity of a company lies (The Economist, 2011:2). Thus debt is granted based on the strength of the company’s asset base but the risk of the company is hidden through special purpose vehicles (SPVs) or debt/equity held in a foreign country in relation to its operations.

Tax havens provide an important channel for tax evasion and encourage money laundering and fraud. Thus they constitute a significant reason why many corporations pay little, or even no, income tax. Economic activity is not recorded where it actually takes place but instead often declared as occurring in places where taxes are low. Because transfer pricing transactions occur within the company, this creates opportunity to trade at arbitrary prices instead of market-related ones and to disguise profits and report losses that attract no fiscal obligations. According to Koivusalo (2011:7), developing countries are estimated to lose revenue far greater than the annual inflow of economic aid through schemes such as transfer pricing.

However, arguments for tax havens state that due to MNEs using tax havens and intricate tax planning through tax havens, it results in cheaper goods and services. This occurs through structuring which keeps costs as low as possible as well as by increasing global competition for goods, and thus ultimately benefits poorer countries.

Another argument against the clamp down on tax havens is that offshore jurisdictions also provide the tax and regulatory competition that keep governments and officials in check (The Economist, 2011:2). Furthermore, the belief of some, centre around the rationale that even if a company's profits, as a result of using a tax haven, are higher, that money will flow out and eventually be taxed, for example as dividends when it reaches shareholders.

A number of international initiatives have been attempted to control the activities of tax havens, but with remarkably little success (Christensen, 2011:178). Among them is the OECD report on harmful taxation which is probably the most well-known.

2.4.6 The OECD

The OECD is an international organisation comprising of the major countries of the world and currently has 34 member countries (OECD, 2012). The organisation’s aim is to achieve the highest sustainable economic growth and employment, to contribute to sound economic expansion in member as well as non-member countries and to contribute to the expansion of world trade on a multilateral, non-discriminatory basis (OECD, 1998:2).

Numerous OECD countries have enacted domestic tax rules in order to reduce the attractiveness of tax avoidance and evasion through tax havens (Eden & Kudrle, 2005:115). In 1998, the OECD released a report on harmful tax competition, arguing that tax haven countries had diverted substantial amounts of FDI and taxable income away from OECD member countries (OECD, 1998:2).

The OECD report’s emphasis is on the exchange of information, transparency, and non-discrimination between domestic and foreign activities. It also urges its member states to make abuse of their own tax codes more difficult and specific suggestions were to tax the haven income of a state’s own CFCs immediately at the full home-country rate and pay strict attention to transfer price manipulation (Eden & Kudrle, 2005:120).

As a result of the OECD initiative many member countries have done away with their harmful preferential tax regimes. Furthermore, a large number of tax haven jurisdictions have agreed to cooperate with the OECD and implement transparency and exchange of information standards (Oguttu, 2010:184).

However, Addison (2009:716) states that through this report the OECD raised global awareness but did ‘little to reduce tax evasion and the use of tax havens’. He further states that this was evident by the increasing amount of lost tax revenue due to tax havens. The reason for this was due to the lack of incentives offered to tax havens to change their practices. While some countries decided to comply with the report after being pressurised by the OECD, this merely pushed business elsewhere.

A crucial aspect when selecting a tax haven or a base for an IHC is the treaty network of the relevant country and the study of the applicable articles of the DTAs between the relevant countries. The importance, purpose and status of DTAs are discussed below.

2.5 DOUBLE TAX AGREEMENTS (DTAs)

Due to the fact that there are no global tax laws in existence, double taxation may take place. Relief from double taxation can take the form of unilateral relief – where one of the countries grants tax credits for taxation already paid on the income; or bilateral relief – where two countries enter into a DTA (Koekemoer, 2010:552). An important step in the study of international tax is to consider any DTAs between the two countries affected by the international transaction, once the residency of a company is determined and the domestic laws applicable to the international transaction are applied.

DTAs are agreements signed by two or more contracting states in order to avoid and reduce the burden of double taxation. Their primary objective is to limit the taxes that can be levied by each contracting state under its domestic tax law and to provide tax relief on double taxation. Through a DTA, the states agree to share the tax costs of double tax avoidance (Rohatgi, 2002:2-3).

In order to standardise the treaties around the world, model DTAs were drawn up by international organisations in order for countries to use as templates for their own treaties (Olivier & Honiball, 2011:268). Among them the most commonly used are the OECD and the United Nations (UN) model tax treaties. Thus many DTAs between countries are based on these model DTAs and amended as and where agreed upon.

The applicable articles in the DTAs will be analysed in detail in this study, when comparing possible jurisdictions to be used when investing into South Africa. Thus the study of the relevant DTAs and its effect on the international transactions is pertinent. The purposes and effects of DTAs will be looked at in detail below.

2.5.1 Status of DTAs

While a country has a right to establish its own tax rules it does not have a right to enforce these rules over other jurisdictions. According to international law a country is only permitted to enforce its laws within its legislative jurisdiction (Rohatgi, 2002:20). However, DTAs create contractual obligations between the contracting states and are binding on the tax authorities and the taxpayers once they become part of domestic law. Through these DTAs sharing of tax-related information is permitted which allows the prevention of tax evasion and fraud.

To emphasize the fact that a DTA is not enforceable unless implemented by domestic legislation, Olivier and Honiball (2011:270) state that ‘the OECD is a legal person with no law-making powers.' Thus should a state adopt the OECD model DTA, a decision by the OECD will not affect the state (even if it is an OECD member state) unless the decision is implemented by domestic legislation.

2.5.2 Purpose of DTAs

The primary objective of DTAs is to avoid and reduce any double taxation. DTAs are generally known not to impose tax on income that is not taxable under the relevant domestic law (Olivier & Honiball, 2011:273). To put this in simple terms, Olivier and Honiball (2011:273) illustrate this as follows: '... where a treaty may provide for a maximum withholding tax on royalties of 10%, the investor has a guarantee that as long as the treaty is in force, the maximum tax that will be imposed is 10%. However the possibility still exists that the tax may be imposed at a lower rate.'

The position, however, may be different depending on the laws of a country. For example, French domestic law provides that where a DTA imposes tax where it is not provided for under domestic law, the DTA provision will become domestic law.

DTAs are not only entered into in order to avoid or reduce double taxation, but according to Olivier and Honiball (2011:278), they are entered into, among others, for the following ancillary objectives:

- To facilitate international trade.
- To eliminate discrimination based on nationality.
- To prevent tax evasion and collect taxes through *inter alia* exchange of information.
- To achieve harmonisation and simplification of rules governing international taxation.
- To remove administrative obstacles to international business and investment.
- To provide certainty to taxpayers regarding taxes faced by them.
- To reduce withholding taxes.

Therefore, for an MNE, a DTA will be of particular importance as it contributes to the economic development of the contracting states in which the MNE intends to operate irrespective of whether the DTA prevents double taxation.

2.5.3 Status of DTAs in South Africa

According to section 108(2) of the Income Tax Act, no. 58 of 1962, read with section 231(4) of the Constitution of the Republic of South Africa 1996 (Act No. 108 of 1996), once a DTA has obtained approval by parliament and is published in the Government Gazette, it becomes part of domestic law. Thus such a DTA will have the same legal effect as any other provision in the Income Tax Act.

As DTAs aim to prevent double taxation which may be imposed by the Income Tax Act, conflicting provisions are very likely to occur. In South Africa the DTA (once approved and Gazetted) and domestic law have an equal ranking (Olivier & Honiball, 2011:306). However, Koekemoer (2010:553) states that in such a case the DTA provision will override the Income Tax Act. Olivier and Honiball (2011:308) further state that the above cannot be the case in South Africa as South African law does not state that DTAs will override domestic law as in the case of certain countries.

Although South Africa is not a member of the OECD and does not use the OECD model tax treaty to base its DTAs on, but rather its own model tax treaty, should a treaty provision be in conflict with domestic law, the OECD commentary can be used to interpret them (Olivier & Honiball, 2011:314).

South Africa has a very wide treaty network. At 6 June 2012 there were 75 DTAs in force between South Africa and other countries (South African Revenue Services, 2012). Specific articles of the applicable DTAs will be analysed in detail in this study to determine the tax efficiency of an IHC located in that particular jurisdiction.

‘In an attempt to eliminate the erosion of the domestic tax bases, DTAs are not usually entered into with countries known as tax havens. However, South Africa has entered into DTAs with several countries that are regarded as tax havens, such as the DTAs with Cyprus, Malta, Mauritius, Singapore, Seychelles and Luxembourg’. (Olivier & Honiball, 2011:293). Thus, despite the fact that tax havens seldom have DTA networks, South Africa seems to have DTAs with a few of them and these will be considered in the furtherance of the study as mentioned above.

2.6 CONCLUSION

‘Among the most commonly used company structural modifications internationally are IHCs’ (Legwaila, 2010:1). From the literature reviewed it can be seen why this is the case not only from a tax perspective but also from various other perspectives. Using a tax haven as a base for an IHC may be found suitable by a company but the possibility of its benefit being lost is always there.

Despite action from the leading countries of the world, tax haven activity is still on the rise. Tax havens will continue to be an integral part of MNEs’ tax planning and this will continue until these jurisdictions have sufficient incentive to amend their practices. The lack of DTAs between tax havens and other countries may be one of the practices which needs to be amended.

Taking all the above into account, the scene of the investor company is set out in the next chapter and the analysis of tax consequences of different means of investing into South Africa is performed thereafter.

CHAPTER 3

SETTING THE SCENE

3.1 INTRODUCTION

Foreign investment into South Africa has been on the rise in the past two decades. Based on the level of investment of the UK in South Africa and the relationship between these two trading partners, a hypothetical UK investor company, planning to invest into South Africa was set up. The tax laws affecting this company and its South African investment are analysed in this chapter.

3.2 THE INVESTOR COMPANY

3.2.1 UK economic background and tax law

The UK comprises of Great Britain (England, Wales and Scotland) and Northern Ireland. According to Deloitte (2011b:1) the UK is one of the largest economies in the world. It is a European Union (EU) member state as well as a member of the OECD. According to UK tax law, a company is a UK resident if it is incorporated in the UK or its place of central management and control is in the UK (similar to the residency laws in South Africa). A UK resident company is subject to corporation tax on worldwide profits and gains, with credits given for overseas taxes.

The current corporate tax rate is 24%. Other relevant taxes and rates affecting the UK Company include VAT at 20% (standard rate) and capital gains at the full rate (included in taxable income and taxed at the corporate rate of 24%). According to UK tax laws, most dividends including foreign dividends are exempt (Deloitte, 2012b:11).

The UK has one of the largest network of treaties, covering 126 countries (Her Majesty's Revenue and Customs, 2012). There are no exchange controls nor are there any currency considerations which may affect the remittance of profits, interest, dividends or royalties.

However, the UK's tax authorities, Her Majesty's Revenue and Customs (HMRC), may question and investigate suspicious transfers for possible tax evasion (Deloitte, 2011b:11).

3.2.2 The type of investment

To take advantage of the improving South African economy, the investment to be made by the UK Company will be one in which the entity will directly benefit from. The investment will thus not be one in which the entity will purchase immovable property or listed shares. The investment will rather be a shareholding in a South African company, conducting business there, wherein the foreign entity will earn dividends from shares owned in the company and interest on loans to the company. However, a controlling share in a local company is not looked at due to the CFC and other anti-avoidance legislation which may be triggered.

Once the type of investment has been identified as above, the UK Company needs to decide on the manner in which it would go about making the investment. As mentioned previously, there are various advantages for investing directly as well as indirectly through an IHC. However, the tax consequences of the investment will be the only deciding factor for the purposes of this study.

3.2.3 IHC options available to the company

The UK had DTAs with 126 countries in force on 18 August 2012 (Her Majesty's Revenue and Customs, 2012). This increases the options where an IHC can be based. Furthermore, many of the countries with whom South Africa has DTAs in place also have DTAs in place with the UK. Keeping this in mind, the three countries selected as options for an IHC are Cyprus, Mauritius and the Netherlands. All three countries have DTAs with both the UK and South Africa and all three countries or jurisdictions are also commonly used for indirect investment into South Africa.

Cyprus is regarded as a tax haven by the OECD (Eden & Kudrle, 2005:122). Tax havens are generally used to base IHCs due to their low tax rates. Furthermore, Cyprus is an EU member and as it is based in Europe, it may be a convenient and familiar location through which the UK Company can invest into South Africa.

The Netherlands was also selected based on its geographical position which may be an advantage to the UK Company. The Netherlands is amongst the world's most advanced countries and is an EU member and OECD member state (OECD, 2012). Although the Netherlands is often used as a base for an IHC, it is not a tax haven. Therefore, this will provide a good comparison between the two European country options.

Lastly, Mauritius as a location for an IHC will be analysed due to it being one of the most commonly used countries for IHCs closest to South Africa. This will be a good option to look at as it may provide convenience for the UK Company in the sense that it is situated closer to the investment. Also, Mauritius is a developing country and considered a tax haven (Eden & Kudrle, 2005:122) thus it will add a further attractive option for the UK Company.

A comparison of the various tax rates and tax laws in the above countries as well as the effects of the DTAs between them and South Africa and the UK will be analysed and discussed below. However, before the UK Company chooses a country to base its IHC it must first determine whether investing directly into South Africa may be more tax efficient.

3.3 INVESTING DIRECTLY INTO SOUTH AFRICA

Investing directly into South Africa can save a company a lot of time, administration and it is convenient. The investor company will, however, be looking for the most tax effective and cost-efficient way to invest. The UK company will thus need to undertake a detailed tax plan in order to determine if it should invest via an IHC or not, and which tax jurisdiction should be selected to base the IHC in.

3.3.1 UK taxes affecting the investor

The UK tax rate of 24% mentioned previously is the main rate applied to companies with taxable profits (calculated in terms of the Corporation Tax Act of 2010) above £1,500,000

(PricewaterhouseCoopers, 2012a:31). Companies with smaller taxable profits may qualify for tax at a lower rate. However, for the purposes of this study the main rate of 24% will be applied to the UK Company.

The UK Company will receive dividends from its investment in shares in the South African Company. Almost all dividends received by corporate shareholders are exempt from tax in the UK. Thus the dividends received by the UK Company will be tax exempt in the UK. There may, however, be withholding tax consequences resulting from the DTA between South Africa and the UK.

Another type of income that may be received by the UK Company from its investment in South Africa is interest on loans to the South African Company. The interest paid by the South African Company may require it to withhold tax from the UK Company (see discussion below on DTA between South Africa and the UK).

According to UK tax law, unilateral relief from double taxation is provided through the credit method which allows foreign taxes paid as a deduction from the local tax payable on a source by source basis or an item by item basis (PricewaterhouseCoopers, 2012a:31). A company may also elect not to apply the credit method and instead deduct the foreign taxes paid when calculating its taxable profits.

CFC legislation in the UK results in the income of a foreign company that is controlled by UK residents to be included in the UK residents' taxable profits. This only applies should the foreign company be controlled by UK residents and an interest of at least 25% in the foreign company is held by a UK resident. However, in this case a 20% interest in the South African Company is held by the UK Company and is thus not controlled by UK residents. The CFC legislation therefore does not apply.

3.3.2 South African taxes affecting the investor

South Africa applies a residence-based tax system i.e. residents are taxed on world-wide income. Non-residents are taxed on South African-sourced income and on capital gains arising from the disposal of immovable property and assets of a permanent establishment in South Africa (Deloitte, 2012a:1).

Thus the investor will be subject to tax in South Africa on the dividends, interest and other income received from the South African business. This tax will be at the corporate tax rate applicable in South Africa of 28% of a company's taxable income (calculated in terms of the Income Tax Act, no. 58 of 1962).

Furthermore, the following withholding taxes may be levied on the investor company (Deloitte, 2012a:1):

- *Dividends:* 15% withholding tax as from 1 April 2012.
- *Interest:* None. However, a rate of 10% will be levied from 1 January 2013.
- *Royalties:* 12% withholding tax.

The above withholding tax rates are, however, subject to the UK DTA with South Africa.

3.3.3 DTA between South Africa and the UK

From the discussion above, it is clear that the investor will be taxed in the UK due to its residency there as well as in South Africa due to the South African-source income. However, in conjunction with the domestic tax laws of the countries, the DTA between the two countries will be looked at in order to provide relief from double taxation.

According to article 10(2) of the Convention between the Government of the Republic of South Africa and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains (hereafter referred to as the DTA between South Africa and the UK), any dividends paid by a company which is a resident of one state to a company resident in the other state will attract withholding taxes at the following rates:

- 5% of the gross amount of the dividends if the beneficial owner is a company which holds at least 10% of the capital of the company paying the dividends;
- 15% of the gross amount of the dividends paid by a property investment company; or

- 10% of the gross amount of the dividends in all other cases.

The dividends paid by the South African Company comply with the term ‘dividends’ as defined in article 10(3) of the DTA between South Africa and the UK, and as the UK Company’s interest in the South African Company is a 20% shareholding, withholding tax at a rate of 5% will be levied by the South African Company.

In terms of articles 11(1) and 12(1) of the DTA between South Africa and the UK, interest and royalties paid by a company which is a resident of one state to a company resident in the other state will only be taxed in the country of the company receiving the interest or royalties.

Furthermore, article 7 relating to the taxation of business profits in the investor country will not apply as the shares held by the UK Company do not meet the definition of a ‘permanent establishment’ as defined in article 5. Similarly, as no permanent establishment in South Africa exists in this case, articles 10(4); 11(3) and 12(3) relating to the exemptions of dividends, interest and royalties respectively, will not apply.

3.4 CONCLUSION

In summary, the UK Company will be subject to withholding taxes of 5% on dividends in South Africa. Dividends received will be tax exempt in the UK and any royalties and interest received will be taxed in the UK at a rate of 24%.

To compare these rates against the rates applicable when investing through an IHC, the applicable tax laws and the DTAs between the relevant countries will be analysed and compared in the following chapters.

CHAPTER 4

IHC OPTIONS

4.1 INTRODUCTION

The three IHC location options to be analysed are Cyprus, Mauritius and the Netherlands. In order to determine the most tax efficient IHC option, the articles of the applicable DTAs and other tax considerations are analysed and discussed in this chapter.

4.2 CYPRUS AS A BASE FOR AN IHC

The first country to be analysed as a possible country in which to base an IHC, is Cyprus. Cyprus is the third largest island in the Mediterranean and is situated in the north-eastern basin of the Mediterranean Sea. It is a long established International Finance Centre and has been a member of the EU since 2004 (PricewaterhouseCoopers, 2010).

According to Saunders (2010:103), Cyprus has developed as an important financial centre in the Middle East and a preferable investment landscape for European corporations due to the following aspects:

- The strategic geographical position of the country.
- The excellent infrastructural facilities.
- The favourable tax incentives.
- The European standard of living.

4.2.1 Economic background and tax law

Companies that are tax residents in Cyprus are taxed on income from all sources in Cyprus and abroad. Non-residents are taxed on income sourced in Cyprus or derived from a permanent establishment in the country. A company is regarded as resident in Cyprus if it is managed and controlled in Cyprus. (PricewaterhouseCoopers, 2010).

The current corporate income tax rate is 10% and the standard rate of VAT is 17% (15% before 1 March 2012). CGT is imposed at a rate of 20% of the gain on disposal of immovable property in Cyprus (including shares in a company which owns such immovable property). Other taxes which may be imposed on a company resident in Cyprus are stamp duty, immovable property tax and capital duty. Dividends are exempt in the hands of a corporate recipient. (PricewaterhouseCoopers, 2012c).

As at June 2012, Cyprus had DTAs in place with 43 other countries (PricewaterhouseCoopers, 2012c). Cyprus is a very attractive location to base an IHC in, as according to Deloitte (2012d), there are no substance requirements for a holding company set up in Cyprus nor are there any restrictions on its activities. Also, there is no CFC or equivalent legislation nor are there any thin capitalisation limits or restrictions on interest deductibility. Other tax laws which may attract MNEs to Cyprus include the exemptions from tax of profits on sale of securities and dividends as well as the full deductibility of donations to approved charities.

4.2.2 Receipts by the IHC from South Africa

The Cypriot IHC will be wholly owned by the UK Company and the IHC will hold the investment (shares) in the South African Company from which it will receive income. Similar to the case of direct investment, the types of income that could be received by the IHC are interest, dividends or royalties.

Without taking the DTAs into account, due to the IHC's residence in Cyprus (through its management and control in Cyprus), it will be taxed on its income from all sources. According to Cypriot law, the dividends will be tax exempt in the IHC. No such exemptions exist for interest and royalties and thus the IHC will be taxed at the corporate tax rate of 10% on these.

Withholding taxes levied by the South African Revenue Service (SARS) on the above payments by the South African Company will be at the following rates (Deloitte, 2012a:1):

- *Dividends:* 15% withholding tax as from 1 April 2012.
- *Interest:* None. However, a rate of 10% will be levied from 1 January 2013.

- *Royalties:* 12% withholding tax.

Thus the Cypriot IHC will be taxed on the interest and royalties at 10% in Cyprus and taxes will be withheld in South Africa on the dividends and royalties at 15% and 12% respectively. However, relief from double taxation is provided by the Agreement between the Republic of South Africa and the Republic of Cyprus for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital (hereafter referred to as the DTA between South Africa and Cyprus).

According to articles 10(1), 11(1) and 12(1) of the DTA between South Africa and Cyprus, dividends, interest and royalties, respectively, paid by a company which is a resident of one state to a company resident in the other state will only be taxed in the country of the company receiving the dividends, interest or royalties. Therefore, the withholding taxes in South Africa will not apply.

Furthermore, article 7 relating to the taxation of business profits in the investor country will not apply as the shares held by the Cypriot company do not meet the definition of a 'permanent establishment' as defined in article 5. Similarly, as no permanent establishment in South Africa exists in this case, articles 10(4); 11(3) and 12(3) relating to the exemptions of dividends, interest and royalties respectively, will not apply.

According to the UK CFC legislation, a foreign company is a CFC if:

- it is non-resident of the UK;
- it is controlled by UK residents; and
- it is subject to a lower level of tax - less than 75% of the tax it would have paid had it been a UK resident (Deloitte, 2011b:13).

As the UK Company holds a 100% interest in (and thus controls) the Cypriot IHC and tax paid in Cyprus would generally meet the requirement of a 'lower level of tax', this will cause the UK CFC legislation to apply. The effect of the CFC legislation will be to tax the UK Company on its share (100%) of the chargeable profits of the CFC. Thus, the UK Company will be taxed on dividends, interest and royalties which the IHC received from the South African investment. Tax credits will, however, be granted for the taxes paid on this income in Cyprus.

For the purposes of this study, the detailed effects of the CFC legislation will not be taken into account in the comparison of the IHC countries. Furthermore, according to section 748(1)(d) of the Income and Corporation Taxes Act, an exemption to the CFC rules apply if the CFC's chargeable profits do not exceed the *de minimus* level of £50,000 in an accounting period. The chargeable profits will exclude the dividends received from the South African Company as these dividends are exempt in the UK and thus the interest and royalties received will need to exceed £50,000 for the CFC rules to apply. For the purposes of this study it is accepted that the chargeable profits will not exceed £50,000 and thus the exemption to the CFC rules will apply. Therefore, the IHC will not be regarded as a CFC and there will no impact of this legislation on the IHC.

In summary, the Cypriot IHC will not be subject to any withholding taxes and will be taxed on the interest and royalties in Cyprus at a rate of 10%.

4.2.3 Amounts paid by the IHC to the UK Company

The income received by the Cypriot IHC will for the purposes of this study be repatriated to the UK Company. Also as the UK Company sets up an IHC in Cyprus in this option and does not hold the investment itself, a loan is made to the IHC to purchase the investment in the South African Company and interest is charged on this loan. Therefore, interest on the loan will be paid as well as the income from the investment in the form of dividends will be distributed to the UK Company.

Cypriot domestic tax laws do not impose withholding tax on interest, dividends and royalty payments (when the right/asset is used outside Cyprus) made to non-Cypriot resident recipients (Saunders, 2010:126). However, the DTA between the two countries will have to be looked at as the UK Company will be taxed on the above amount in Cyprus based on its source and in the UK based on its residency there.

According to the relevant articles of the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Cyprus for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (hereafter referred to as the DTA between the UK and Cyprus), the following rules will apply:

- *Dividends paid by the IHC:* The dividends will be exempt from tax in Cyprus and no withholding taxes will be levied on the dividends in Cyprus.
- *Interest paid by the IHC:* The interest may be taxed in Cyprus at a rate not exceeding 10%, however, no withholding taxes are levied in Cyprus according to domestic tax laws.

Therefore, the dividends will not attract any taxes as no withholding taxes are levied and they are exempt in Cyprus as well as in the UK. The interest will also not be subjected to withholding tax in Cyprus but will be taxed in the UK at a rate of 24%.

Table 2 summarises the withholding tax rates levied on the cross-border payments made when using Cyprus as a base for an IHC, as noted from the relevant DTAs:

Table 2: DTA withholding tax rates for Cyprus as a base for an IHC

	Dividends %	**Interest %**	**Royalties %**
Received in Cyprus from South Africa	Nil	Nil	Nil
Paid in Cyprus to the UK	Nil	Nil	N/A

Therefore, no withholding taxes will be levied (Table 2). Taking into account the various domestic tax laws discussed previously, the only cross-border payments that will attract tax are the interest and royalties which are received by the Cypriot IHC and are taxed at 10% in Cyprus and the interest paid by the IHC to the UK Company which is taxed at 24% in the UK. This, along with other tax factors discussed, will be compared to that of the other IHC country options.

4.3 MAURITIUS AS A BASE FOR AN IHC

Mauritius is an island east of Madagascar off the south-east coast of Africa. The country has attracted considerable foreign investments and thus has become one of Africa's highest per capita incomes. Up to June 2012 it had attracted more than 32,000 offshore entities, many aimed at commerce in India, South Africa and China (PricewaterhouseCoopers, 2012b).

4.3.1 Economic background and tax law

Saunders (2010:1081) describes Mauritius as '... a middle income developing economy strategically situated in the Indian Ocean, serving as a gateway to the emerging economies of Africa, India and China.' He also noted that the country has been rated as the easiest place to do business in Africa in the World Bank's Doing Business 2009 rankings.

The Mauritian basis of tax is the same as South Africa i.e. residents are taxed on their worldwide income while non-residents are taxed on their Mauritian-source income. Corporations are residents if they are incorporated in Mauritius or its central management and control is in Mauritius (Deloitte, 2012c:1).

In 2006 Mauritius introduced a simplified uniform tax regime of 15% on personal income tax and corporate tax. This played a vital role in creating a conducive business environment for foreign investors (Saunders, 2010:1081). However, companies holding a Category 1 Global Business Licence (GBL1) are entitled to a foreign tax credit equivalent to the greater of either 80% of the Mauritius tax charge or the actual tax suffered abroad in respect of foreign-source income, and thus will pay tax at a maximum effective tax rate of 3% (PricewaterhouseCoopers, 2012b). Companies holding a Category 2 Global Business Licence (GBL2) are exempt from tax (Saunders, 2010:1082).

For the purposes of this study the IHC to be set up will be a company holding a GBL1 licence as the company will satisfy the substance and residency requirements in order to obtain this licence. Furthermore, a GBL2 licensed company will not be considered for the

IHC as a GBL2 licensed company is not regarded as a resident of Mauritius and will not have access to the country's treaty network (Saunders, 2010:1082).

The VAT rate in Mauritius is 15% and there is no tax on capital gains. Certain capital gains are taxed as ordinary trading income if the Mauritius Revenue authority deems it to be of a trading nature. An alternative minimum tax, equal to the lower of 7.5% of accounting profits or 10% of dividends declared for the relevant year, is imposed on certain companies. GBL1 licensed companies are, however, exempt from this tax (Deloitte, 2012c:1).

4.3.2 Tax consequences of income received by the Mauritian IHC

As in the case of the Cypriot IHC, the Mauritian IHC will be wholly owned by the UK Company and the IHC will hold the investment (shares) in the South African Company from which it will receive income. The nature of the income to be received by the Mauritian IHC from its South African investment is dividends, interest and royalties.

According to the domestic tax laws in Mauritius the IHC will, due to its residency there, be taxed on the above income. Dividend income received by a GBL1 licensed company from abroad is taxed in Mauritius (PricewaterhouseCoopers, 2012b). The IHC will thus be taxed on the dividends received at an effective tax rate of 3%. However, a credit against Mauritius tax payable can be claimed for any taxes withheld in South Africa. Similarly, interest and royalties received will be taxed at an effective rate of 3% and tax credits are granted to provide relief from double taxation.

The following withholding taxes will be levied in South Africa on the payments made to the IHC (Deloitte, 2012a:1):

- *Dividends:* 15% withholding tax as from 1 April 2012.
- *Interest:* None. However, a rate of 10% will be levied from 1 January 2013.
- *Royalties:* 12% withholding tax.

The Mauritian IHC will thus be taxed on the dividends, interest and royalties at 3% in Mauritius and taxes will be withheld in South Africa on the dividends and royalties at 15% and 12% respectively. However, relief from double taxation is provided by the Agreement between the Government of the Republic of South Africa and the Government of the Republic of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (hereafter referred to as the DTA between South Africa and Mauritius).

According to article 10(2) of the DTA between South Africa and Mauritius, any dividends paid by a company which is a resident of one state to a company resident in the other state will attract withholding taxes at the following rates:

- 5% of the gross amount of the dividends if the beneficial owner is a company which holds at least 10% of the capital of the company paying the dividends;
- 15% of the gross amount of the dividends in all other cases.

The dividends paid by the South African Company comply with the term ‘dividends’ as defined in article 10(3) of the DTA between South Africa and the UK, and as the Mauritian company’s interest in the South African Company is a 20% shareholding, withholdings tax at a rate of 5% will be withheld by the South African Company.

As in the case of the DTA between the UK and Cyprus, articles 7, 10(4), 11(3) and 12(4) of the DTA between the UK and Mauritius relating to permanent establishments will not apply. Similarly, it is accepted that the exemption to the CFC rules will apply to the Mauritian IHC as for the purposes of this study its chargeable profits will not exceed the £50,000 *de minimis* level and therefore will not be considered a CFC.

In summary, the Mauritius IHC will be subjected to withholding taxes of 5% on the dividends received and the tax credits of the withholding taxes will effectively reduce the tax on the dividends in Mauritius to nil. The interest and royalties received will only be taxed in Mauritius at an effective rate of 3%.

4.3.3 Amounts paid by the Mauritian IHC to the UK Company

The nature of payments to be made by the Mauritian IHC to the UK Company will be dividends (distribution of income received from South Africa) and interest payments on the loan from the UK Company to purchase the investment (as in the case of the Cypriot IHC).

Mauritius tax laws do not impose withholding taxes on payments made by a GBL1 licensed company to non-residents not carrying out any business in Mauritius (PricewaterhouseCoopers, 2012b). The UK Company and the Mauritius IHC meets this requirement and thus no withholding taxes are imposed. However, the DTA between the two countries may provide differing rules and this is analysed below.

According to the relevant articles of the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains (hereafter referred to as the DTA between the UK and Mauritius), the following rules will apply:

- *Dividends paid by the IHC:* The dividends will be exempt from tax in the UK and no withholding taxes will be levied on the dividends in Mauritius.
- *Interest paid by the IHC:* No maximum rate is specified by the DTA between the UK and Mauritius.

Therefore, the dividends will not attract any taxes as no withholding taxes are levied and they are exempt in the UK. The interest will only be taxed in the UK at a rate of 24% and no withholding taxes will be withheld in Mauritius.

Table 3 summarises the withholding tax rates levied on the cross-border payments made when using Mauritius as a base for an IHC, as noted from the relevant DTAs:

Table 3: DTA withholding tax rates for Mauritius as a base for an IHC

	Dividends %	Interest %	Royalties %
Received in Mauritius from South Africa	5	Nil	Nil
Paid in Mauritius to the UK	Nil	Nil	N/A

Taking into account the DTA withholding tax rates (Table 3) the only withholding tax levied is the withholding tax of 5% on the dividends paid by the South African Company to the Mauritian IHC. Furthermore, from the various domestic tax laws discussed previously, the other cross-border payments that will attract tax are the interest and royalties received by the Mauritian IHC which are taxed at the 3% effective tax rate in Mauritius and the interest paid by the IHC to the UK Company which is taxed at 24% in the UK. These taxes, along with other tax factors discussed, will be compared to that of the other IHC country options.

4.4 THE NETHERLANDS AS A BASE FOR AN IHC

The Netherlands is located mainly in North-West Europe with some islands in the Caribbean. The country's business climate, tax regime and advance tax ruling policy has made it an attractive jurisdiction for international businesses over the last 30 years (Saunders, 2010:389).

4.4.1 Economic background and tax law

The Netherlands role as an important European transportation hub and its strong economy makes it a likely choice as a base for an IHC of an MNE. The Dutch basis of tax is the same as South Africa i.e. residents are taxed on their worldwide income while non-residents are taxed on income from a source in the Netherlands. Any company which has its management in the Netherlands or is incorporated under Dutch civil law is regarded as a Dutch resident (Deloitte, 2012e:1).

The Dutch corporate income tax rate is 20% on the first €200,000 of taxable profits and 25% of taxable profits exceeding €200,000. For the purposes of this study and for the comparison between jurisdictions a rate of 25% is used. The standard VAT rate in the Netherlands is 19% and capital gains are taxed at the same 25% (Deloitte, 2012e:1).

Although the Netherlands is a high-tax country, international holding and finance companies have become common due to its attractive tax system (Graham, 2002:328). According to Deloitte (2012e:1) this system includes the following tax benefits:

- *A wide treaty network*: Rates negotiated in the DTAs are generally lower than that of other European countries.

- *No withholding taxes on interest and royalties*: Taxes are not withheld on interest and royalties paid domestically and abroad, irrespective of whether the recipient country has a DTA with the Netherlands.
- *The participation exemption*: Dividends and capital gains will be exempt if they are derived from shareholdings of at least 5% provided that (1) the shareholding is not held as a portfolio investment; or (2) the subsidiary is subject to a reasonable effective tax rate based on Dutch rules; or (3) less than 50% of the assets of the subsidiary consist of passive assets (assets earning investment income).
- *Advanced tax rulings*: Where there is any doubt relating to the application of the participation exemption or any other laws, an advance ruling from a Dutch tax inspector can be obtained. This attracts foreign investors by providing certainty on the tax effect of corporate structures prior to investing in the Netherlands.

4.4.2 Tax consequences of income received by the Dutch IHC

The Dutch IHC will be wholly owned by the UK Company and the IHC will hold the investment (shares) in the South African Company from which it will receive income. The nature of the income to be received by the Dutch IHC from its South African investment is dividends, interest and royalties.

Dutch domestic tax law will cause the Dutch IHC to be taxed on the above income, due to its residency. Dividend income received by a Dutch resident company will be exempt if the participation exemption applies. The interest and royalties received will be taxed at 25%.

The following withholding taxes will be levied in South Africa on the payments made to the IHC (Deloitte, 2012a:1):

- *Dividends:* 15% withholding tax as from 1 April 2012.
- *Interest:* None. However, a rate of 10% will be levied from 1 January 2013.
- *Royalties:* 12% withholding tax.

The Dutch IHC will qualify for the participation exemption for the following reasons:

- The 20% shareholding in the South African Company is greater than 5%.
- The shares are not held as a portfolio investment.

- The South African Company will be subject to tax in South Africa at a rate of 28% which is deemed to be a reasonable effective tax rate in comparison to the Dutch tax rate of 25%.
- As the South African Company will be operating a business and not an investment company, it is accepted that 50% of its assets will not be passive assets.

Thus the dividends received from the South African Company will be exempt. The Dutch IHC will only be taxed on the interest and royalties at 25% in the Netherlands and taxes will be withheld in South Africa on the dividends and royalties at 15% and 12% respectively. However, relief from double taxation is provided by the Convention between the Republic of South Africa and the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital (hereafter referred to as the DTA between South Africa and the Netherlands).

According to article 10(2) of the DTA between South Africa and the Netherlands, any dividends paid by a company which is a resident of one state to a company resident in the other state will attract withholding taxes at the following rates:

- 5% of the gross amount of the dividends if the beneficial owner is a company which holds at least 10% of the capital of the company paying the dividends;
- 10% of the gross amount of the dividends in all other cases.

The dividends paid by the South African Company comply with the term ‘dividends’ as defined in article 10(5) of the DTA between South Africa and the Netherlands, and as the Dutch company’s interest in the South African Company is a 20% shareholding, withholding tax at a rate of 5% will be withheld by the South African Company.

As in the cases of the DTA between the UK and Cyprus and the DTA between the UK and Mauritius, articles 7, 10(6), 11(4) and 12(4) of the DTA between the UK and the Netherlands relating to permanent establishments will not apply.

According to the UK CFC legislation, a foreign company is a CFC if:

- it is non-resident of the UK;
- it is controlled by UK residents; and

- it is subject to a lower level of tax - less than 75% of the tax it would have paid had it been a UK resident (Deloitte, 2011b:13).

As the UK Company holds a 100% interest in the Dutch IHC, the criteria relating to a non-resident controlled by UK residents is met. However, as the Dutch company is subject to tax at a rate of 25% in comparison to the tax at 24% which it would have paid had it been a UK resident, the company is not subject to a lower level of tax and does not meet the definition of a CFC. Thus, no share of the Dutch IHC's profits will be included in the UK Company's taxable profits.

In summary, the Dutch IHC will be subjected to withholding taxes of 5% on the dividends received and no foreign tax credit will be received by the company for this withholding taxes as the participation exemption applies (Deloitte, 2011a:12). The IHC will be taxed at 25% on the interest and dividends received.

4.4.3 Amounts paid by the Dutch IHC to the UK Company

The Dutch IHC will pay dividends (as a distribution of income received from South Africa) and interest (on the loan from the UK Company to purchase the investment) to the UK Company. Dutch tax laws do not impose withholding taxes on interest payments. A withholding tax of 15% is levied on dividends paid to residents or non-residents. However, the DTA between the two countries may provide differing rules and this is analysed below.

According to the relevant articles of the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains (hereafter referred to as the DTA between the UK and the Netherlands), the following rules will apply:

- *Dividends paid by the IHC:* No withholding taxes will be levied if the beneficial owner of the dividends owns at least 10% of the shares of the company paying the dividends. In other cases, 10% will apply.
- *Interest paid by the IHC:* No withholding tax is levied and the interest will be taxed in the country of the recipient company.

Therefore, the dividends will not attract any taxes as no withholding taxes are levied and they are exempt in the UK. The interest will only be taxed in the UK at a rate of 24% and no withholding taxes will be withheld in the Netherlands.

Table 4 summarises the withholding tax rates levied on the cross-border payments made when using the Netherlands as a base for an IHC, as noted from the relevant DTAs:

Table 4: DTA withholding tax rates for the Netherlands as a base for an IHC

	Dividends %	**Interest %**	**Royalties %**
Received in the Netherlands from South Africa	5	Nil	Nil
Paid in the Netherlands to the UK	Nil	Nil	N/A

Taking into account the DTA withholding tax rates (Table 4) the only withholding tax levied is the withholding tax of 5% on the dividends paid by the South African Company to the Dutch IHC. Furthermore, from the various domestic tax laws discussed previously, the other cross-border payments that will attract tax are the interest and royalties received by the Dutch IHC which are taxed at 25% in the Netherlands and the interest paid by the IHC to the UK Company which is taxed at 24% in the UK. These taxes, along with other tax factors discussed, will be compared to that of the other IHC country options.

4.5 SUMMARY OF FINDINGS

Through the analysis of the effects of the various countries' domestic tax laws and the relevant DTAs, Table 5 presents a comparative summary of the rates at which the transactions are taxed as well as the other taxes affecting an IHC in each of the countries as well as in the UK (for direct investment).

Table 5: Summary of tax rates affecting an IHC in each country and the UK

IHC Country	Cyprus	Mauritius	The Netherlands	The UK
Tax paid on amounts received from the South African investment:				
• Dividends	0%	5%[3]	5%[4]	5%[5]
• Interest	10%	3%	25%	24%
• Royalties	10%	3%	25%	24%
Tax in the UK on amounts paid by IHC:				
• Dividends	0%	0%	0%	N/A[6]
• Interest	24%	24%	24%	N/A[7]
Effective Tax Rate	10%	3%	25%	24%
CGT Rate	20%[8]	0%	25%	24%
VAT Rate	17%	15%	19%	20%

From the summary (Table 5) it is noted that the repatriation of profits from the IHC to the UK Company through dividends distributions will be exempt in the UK irrespective of where the source is. Similarly the interest paid on the loan from the UK Company will be taxed in the UK at 24%, irrespective of where the IHC is located. However, the income received from the investment in South Africa is taxed at different rates due to the countries' differing tax rates and the DTAs in place between them and South Africa.

[3] In Mauritius the dividends received from the South African Company are exempt. This 5% represents withholding tax in South Africa on the dividends paid by the South African Company to the Mauritian IHC and not taxes paid in Mauritius.

[4] In the Netherlands the dividends received from the South African Company are exempt due to the participation exemption applying. This 5% represents withholding tax in South Africa on the dividends paid by the South African Company to the Dutch IHC and not taxes paid in the Netherlands.

[5] In the UK dividends received from the South African Company are exempt, however, the 5% represents withholding tax in South Africa on the dividends paid by the South African Company to the UK Company and not taxes paid in the UK.

[6] Not applicable as the UK Company will receive the dividends, interest and royalties directly from the South African investment and an IHC will not be used if a direct investment by the UK is made.

[7] Not applicable as the UK Company will receive the dividends, interest and royalties directly from the South African investment and an IHC will not be used if a direct investment by the UK is made.

[8] The CGT rate of 20% only applies to gains on disposal of immovable property in Cyprus (including shares in a company which owns such immovable property).

Interest and royalties received in Mauritius and Cyprus are taxed at a significantly lower rate than in the Netherlands. Both Mauritius and Cyprus also compare favourably against the Netherlands in terms of their CGT rates and VAT rates. As noted above, CGT in Cyprus only applies to immovable property there. For the purposes of this study the IHC will not hold such property, thus along with the Mauritian IHC, the Cypriot IHC will also not be subject to any CGT, while a rate of 25% applies to capital gains made by the Dutch IHC.

The tax rates applying to direct investment by the UK Company discussed in detail in the previous chapter and summarised above (in Table 5) will be compared to that of the most tax efficient IHC option, once determined.

Other tax aspects which may affect the decision of the location of an IHC also need to be considered. These factors and the way in which it could affect the decision are:

- *Exchange controls*: The IHC country may have restrictions on the purchase and sale of foreign exchange and other cross-border transactions.
- *Advanced tax rulings*: Advanced tax rulings will allow the UK Company to approach the tax authorities of an IHC country to discuss and negotiate the tax consequences prior to the actual incorporation of the IHC.
- *Taxes on disposals*: The tax effect of the disposal of the South African investment in the IHC as well as the tax effect of the disposal of the IHC may differ in each country.
- *Anti-avoidance legislation*: CFC, thin capitalisation and other anti-avoidance legislation may eliminate the benefit of the IHC to the UK Company.
- *Capital duty*: Capital duty is payable in certain countries on the authorisation and issuing of share capital of an IHC.
- *Substance requirements*: Should the IHC not have a certain degree of substance in accordance with a country's laws it may not be treated as a separate legal person.
- *Restriction of activities*: Certain countries may restrict the activities of an IHC. These restrictions may include the repatriation of profits and the freedom of borrowing.
- *Deductibility of interest*: As the IHC will pay interest to the UK Company on the loan to purchase the investment in South Africa, these interest payments may or may not be tax deductible.

Table 6 compares the above factors for each IHC option:

Table 6: Other tax factors to be considered

IHC Country	Cyprus	Mauritius	The Netherlands
Are there exchange controls in place?	No	No	No
Are advanced rulings available?	Yes, in certain cases	Yes	Yes
Is tax payable in IHC country on disposal of IHC shares by the UK Company?	No[9]	No	Yes
Does CFC or similar legislation apply?	No	No	No
Are there thin capitalisation limits?	No	No	Yes
Is capital duty payable?	Yes[10]	No	No
Are there restrictions on the IHC activities?	No	No	No
Are there substance requirements for the IHC?	No	Yes[11]	No
Is interest on loans to purchase the investment tax deductible?	No	Yes	Yes
Is the gain on disposal of the South African investment taxable?	No	No	No

Source: Adapted from Deloitte (2012f)

Despite the tax rates being in favour of Mauritius and Cyprus, the other tax factors above also need to be taken into account. Due to the capital duty in Cyprus being so insignificant, this will in all likelihood not affect the decision of the investor. Also as the Mauritian substance requirements relate to the criteria for a GBL1 company which would be met easily by the IHC, these two factors along with most of the other factors are the same in the three countries compared. The factors which differ between the countries are the thin capitalisation rules applied in the Netherlands, the non-deductibility of interest paid to the

[9] CGT of 20% will only be payable if the IHC held immovable property in Cyprus.

[10] Capital duty in Cyprus is an amount of €102,52 (once–off) plus 0,6% on the value of the authorised share capital. For issuing of shares a flat rate of €17,09 is payable.

[11] The substance requirements in Mauritius relate to the criteria that need to be met in order to obtain a GBL1 licence.

UK Company in Cyprus and the tax payable in the Netherlands on the disposal of the IHC shares.

4.6 CONCLUSION

From the above analysis it is noted that the Netherlands may not be as tax efficient as Mauritius and Cyprus due to its exposure to higher tax rates. Furthermore, as the interest and royalties received from the South African investment will be taxed in the hands of the IHC in all three cases, the UK investor will want to reduce the tax paid by the IHC and thus select a country where the deductibility of interest paid to the UK Company is allowed. The tax systems in Mauritius and the Netherlands allow this interest deduction.

Therefore, as Mauritius' tax rates as well as other tax rules seem to be the most tax efficient from the three options compared, should the UK Company elect to invest via an IHC, Mauritius should be selected.

CHAPTER 5

CONCLUSION

5.1 INTRODUCTION

South Africa's growing economy attracts MNEs throughout the world looking for cross-border investment opportunities. MNEs looking to capitalise on such opportunities spend large amounts of money structuring these FDI projects. One of the main areas of focus when planning these transactions is the tax consequences thereof.

The problem statement noted in chapter one relates to how a company would go about identifying the different available options when investing into South Africa and after analysing their tax consequences, implement the most tax efficient option.

The purpose of this study was to assist a company based in the UK, to select the most tax efficient manner of investing in South Africa. The company could choose to either invest directly by purchasing and holding the investment itself or to set up an IHC in another country and benefit from the investment through the IHC.

5.2 RESEARCH OBJECTIVES

The research objectives of the study, as set up in chapter one are:

- To analyse the tax effects of direct investment by a UK company into South Africa.
- To analyse the tax effects of indirect investment via specific IHC jurisdictions by the UK Company to determine the most tax efficient jurisdiction to invest through.
- To critically analyse and compare the above options and conclude what would be the most tax efficient option of investing into South Africa.

5.3 ANALYSIS OF FINDINGS

The study of international tax does not relate to a global set of tax laws but rather a combination of domestic tax laws of certain countries and DTAs between them. In order to lower the taxes paid throughout the world, the use of IHCs has become a common component in multinational corporate structures. The careful selection of the location of an IHC can benefit an MNE in tax related as well as other aspects. Tax havens may be possible locations for these ‘conduit’ companies but may not be the best solution due to the negativity connected with tax havens globally.

Through the review of international tax practices, domestic tax laws of the relevant countries, the DTAs in force and effects thereof on the transactions of the UK Company and its investment, the tax effects of the UK Company investing directly into South Africa were examined. Through a similar process, the countries selected as options in which to base an IHC were compared.

Direct investment by the UK Company will cause the company to be taxed on the royalties and interest received from the South African Company, at a rate of 24% in the UK. Also, from the analysis of the DTA between the UK and South Africa, it was noted that 5% tax will be withheld from the dividends paid by the South African Company.

For indirect investment, Mauritius was found to be the most tax efficient of the three IHC options as the tax rates that the IHC would be subjected to in Mauritius are significantly lower than that of the other two countries. Mauritian tax law also allows the deductibility of interest paid to the UK Company and no CGT is imposed in Mauritius. These advantages along with other tax aspects considered (in Table 6) led to Mauritius being selected as the most tax efficient country to base an IHC over two other jurisdictions. Therefore, to determine the most tax efficient option of the UK Company investing into South Africa the tax effects of direct investment are compared to that of using a Mauritian IHC.

In comparison to the case of the Mauritian IHC, the UK Company will be subject to tax on the royalties and interest at a rate of 24% while the Mauritian IHC will be taxed at only 3%. Withholding taxes of 5% will be levied on the dividends in both cases. Regarding the interest received by the UK Company, the tax position would be the same in both cases as the interest paid by the Mauritian IHC will be deductible in Mauritius and the interest received by the UK Company will be taxable in the UK, while no such loan will exist in the case of direct investment. Furthermore, should the UK Company dispose of its investment in South Africa the gain will be taxed at a rate of 25% in the UK whereas the gain on the disposal of the Mauritian IHC will also be the only tax payable due to there being no CGT in Mauritius.

5.4 CONCLUSION

From the above analysis it is noted that the UK investor will be neutral on various tax aspects when looking to invest directly or indirectly. However, the 3% tax rate at which the income from the investment will be subjected to will be more favourable than the 24% in the UK. Based on this, the UK Company should choose to invest indirectly through Mauritius in order to take advantage of the various tax benefits available to a Mauritian IHC.

To further support this selection, Mauritius was noted to have several tax advantages besides its attractively low tax rate. These include the absence of CGT, thin capitalisation and CFC rules. Also there are no exchange controls or restrictions on the activities of an IHC. It is for the above reasons that Mauritius has seen an enormous influx of foreign investment, has been rated one of the easiest countries to invest in and now has been selected as the most tax efficient jurisdiction through which a UK company can invest into South Africa.

Concerns about tax havens not having vast treaty networks are common reasons for selecting a non-tax haven country to base an IHC. However, Mauritius had 34 DTAs in force at 30 June 2012 (Deloitte, 2012f). This may not be as many as the UK or South Africa, but included in these 34 are DTAs with major EU, African and Asian countries. Therefore, the country’s treaty network is not seen as a disadvantage in selecting it as a base for an IHC over the other countries considered. Indirect investment using a Mauritian IHC would thus be the most tax efficient option for the UK Company to invest into South Africa.

5.5 RECOMMENDATIONS

Despite the analysis performed as the basis of selection of the Mauritian IHC above, an investor should also take into account the continued action against tax havens by the OECD and other international organisations and its effect on the sustainability of the tax advantages of Mauritius in the long term. This may steer the UK investor to invest directly or to select a country like the Netherlands which is not considered a tax haven by the OECD.

As tax laws are continuously being amended, tax avoidance measures being put into place and DTAs being re-negotiated, it is no longer a simple task to set up a multinational structure that will be the most tax efficient over a long period of time. Thus, taxpayers are advised to perform extensive research on the latest developments and continuously seek professional advice before implementing any international structure.

5.6 FUTURE RESEARCH

Various sources reviewed during this study indicated a strong global financial interest in South Africa. There may be many situations wherein an MNE may want to invest into South Africa not only by purchasing a share in a South African business, as in the case of this study, but rather through expanding its existing business by setting up a presence in South Africa.

Various types of entities can be used by a foreign company to conduct a business in South Africa such as a branch of the foreign company, a local subsidiary, a partnership or even a trust. As these legal entities are taxed differently according to South African tax law, an opportunity for future research lies in analysing their tax consequences to provide a foreign investor with the most tax efficient option.

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