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# The Suitability of the South African Corporate Tax Regime for the Use of South African Resident Intermediary Holding Companies

by

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# ABSTRACT

An Intermediary Holding Company ("IHC") is a company that is interposed between an ultimate holding company and the operating subsidiaries of a group of companies. The IHC operates at an international level such that either its holding company or its subsidiaries or both are located in a country foreign to the IHC. Its main functions are to acquire, manage and dispose of the assets of the group of companies and to facilitate structural flexibility of a group of companies. Investors have tax and non-tax reasons for conducting business using an IHC, and, depending on the reasons, they determine the location of the IHC based on the characteristics of potential host countries.

This thesis analyses the suitability of the South African corporate tax regime for the use of South African-resident Intermediary Holding Companies. The South African government has the objective of promoting South Africa as a gateway for investment in Africa and for this reason the present research is important. Such an objective could be adversely affected by a corporate tax regime that is not suitable for the operations of an IHC. Furthermore, the Katz Commission recommended in 1997 that South Africa should consider introducing a regime that is suitable for the location of holding companies.

In discharging its functions the IHC attracts liability for corporate income tax, capital gains tax, controlled foreign company tax and dividends tax. It also exposes itself to anti-avoidance measures such as thin capitalisation and transfer pricing provisions. The existence of such taxes and anti-avoidance measures in the tax system of a country may deter investors from locating an IHC in such country. Exchange control regulations could also adversely affect the ability of the IHC to perform its functions effectively, as their purpose is to restrict the movement of capital out of the country.

The South African legal system contains all these taxes and anti-avoidance measures as well as exchange control provisions. However, it also contains tax instruments that alleviate the tax burden on an investor using an IHC such as the participation exemption, advance tax rulings and a network of tax treaties. Against this background this thesis

analyses the South African corporate tax system to determine whether it is suitable for locating an IHC. In the analysis, a comparative study is done of the tax systems of two of the most effective IHC host countries, namely the Netherlands and Mauritius. In addition, a brief discussion of the special features contained in the tax systems of Belgium, Ireland and the United Kingdom outlines why these jurisdictions are not necessarily successful in attracting IHCs.

The thesis also discusses harmful tax practices and the attitude of the international community towards countries that engage in harmful tax competition in order to determine the limits to which a country should use the tax system to attract investment. Finally, the thesis makes recommendations as to what adjustments could be made in order to enhance the suitability of South Africa to host an IHC. The thesis recommends a special dispensation as regards corporate income tax and exchange control that would apply to wholly-owned South African companies that own foreign subsidiary shares and loans that consist of 80% of the gross asset total of these companies.

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***CHAPTER 1***

# INTRODUCTION

## 1.1 BACKGROUND

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

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

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

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

## 1.2 PURPOSE

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

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

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

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

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

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

Acknowledging the benefits that the IHCs would bring to South Africa, the South African government has clearly pronounced its objective to promote South Africa as a gateway for investment elsewhere in Africa. This objective requires that the tax system be reviewed and where possible revised to ensure that it does not inhibit the operation of holding companies in South Africa. In 1997 the Katz Commission[2] recommended an adjustment of the corporate tax system in order to appropriately accommodate the IHC and its operations. The benefits of having a suitable regime for IHCs and recommendations of the Commission and the South African government's response as regards policy in this regard are outlined below.

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

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

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

### 1.2.1 Advantages to the South African Economy of hosting IHCs

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

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

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

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[3] Weigel *et al Foreign Direct Investment* (1997) 14.
[4] See a discussion on the functions of an IHC in Chapter 2, par 2.6.

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

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

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

IHCs would also assist in retaining skilled labour within the country. As the Katz Commission observed, the formation of IHCs in South Africa would positively contribute to the overall economic activity in the country by retention and importation of skills.[6] The exodus of educated professionals would be reduced by IHCs offering such professionals interesting, challenging and high-salaried jobs. As Musgrave[7] avers, "[t]he loss of educated people is in fact a loss of human capital, often accumulated at public expense through publicly financed education." Being employed in an IHC would ordinarily

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

[6] Katz Commission par 7.1.1.

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

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

### 1.2.2 South African Government's Objectives

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

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

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

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

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

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

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

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

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

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

The financial centre for Africa strategy is aimed at positioning South Africa as a significant competitor to other financial centres, such as London. The previous Minister of Finance[15] hoped that, once the strategy is implemented, "companies will have the choice of conducting business in London or Johannesburg, and the choice will depend on how competitive South Africa's financial sector is relative to others". Should this competitive goal be achieved, African companies and countries will be able to access many options in terms of sources of capital.

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

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

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

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

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

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

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

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

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

### 1.2.3 Katz Commission Recommendations

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

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

[16] See http://www.treasury.gov.za/publications/other/MinAnsw/2004/epifr_fsp_na.pdf accessed on 06 October 2008.
[17] See http://www.treasury.gov.za/publications/other/MinAnsw/2004/epifr_fsp_na.pdf accessed on 06 October 2008.
[18] Morekwa and Schoeman *Empirical Analysis of Progressivity of the Tax System in South Africa*, paper presented to the Essa Conference held in Durban South Africa on 7 September 2005 available on http://www.essa.org.za/download/2005Conference/Morekwa.pdf accessed on 08 June 2009.

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

The Katz Commission[20] identified the following as the key fiscal attributes of a regime conducive to the formation of international holding companies:

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

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

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

[19] Katz Commission *Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* par 7.1.1.
[20] Katz Commission par 7.1.4. and 7.1.5.
[21] Katz Commission par 7.1.8.

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

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

## 1.3 METHODOLOGY

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

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

[22] Katz Commission par 7.1.2.

## 1.4 A COMPARATIVE STUDY OF HOLDING COMPANY REGIMES

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

### 1.4.1 The Netherlands

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

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[23] *Tax Planning Through The Netherlands* http://www.icsl.com/pages/jurisdic/nether.html accessed on 22 June 2008.
[24] See http://www.anglo-legal.com/index.php?id=86 accessed on 08 June 2008
[25] See http://www.dboffshore.com/offshore/html/location/netherlands.shtml accessed on 08 June 2008.
[26] See http://www.anglo-legal.com/index.php?id=86 accessed on 08 June 2008.

### 1.4.2 Mauritius

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

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

### 1.4.3 Other Jurisdictions

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

## 1.5 THE RELEVANCE OF EXCHANGE CONTROL

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

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

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

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

## 1.6 SCOPE OF THE STUDY

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

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

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

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

The European Union[31] and the Group of Eight Industrialised Countries[32] have also embarked on initiatives that are intended to curb harmful tax practices.

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

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

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

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

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

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

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

## 1.7 REFERENCE TO THE TAX ACT

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

***CHAPTER 2***

# INTERMEDIARY HOLDING COMPANIES DEFINED AND DISTINGUISHED FROM OTHER SIMILAR ENTITIES

## 2.1 INTRODUCTION

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

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

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

In this chapter, the characteristics of entities similar to the IHC are identified and where necessary the tax treatment applicable to those entities is briefly mentioned. These entities operate at an international level and therefore this section is not reliant on the definitions used in any specific countries.

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

## 2.2 AN IHC AS A COMPANY

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

## 2.3 TAX RESIDENCE OF AN IHC

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

[1] See *IBFD International Tax Glossary* (2005) definition of "company".
[2] As to the nature of a company see further *Salomon v Salomon & Co* 1897 AC 22*; Stellenbosch Farmers' Winery v Distillers Corporation* 1962 (1) SA 458 (A); *S v De Jager* 1965 (2) SA 616 (A); *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530.
[3] See definition of "company" in s 1 of the Act and s 1 of the Companies Act 61 of 1973. Once the new Companies Bill comes into effect the IHC would be required to comply with the provisions of the new law.
[4] See the comprehensive definition of holding company in 2.4 below.

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

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

For South African income tax purposes a resident in relation to a company is defined in section 1 as "any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic".[7] Interpretation Note 6 defines the "place of effective management" as[8] –

> "the place where the company is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised or where the board or directors meets. Management by these directors or senior managers refers to the execution and implementation of policy and strategy decisions made by the board of directors. It can also be referred to as the place of implementation of the entity's overall group vision and objectives."

[5] See *IBFD International Tax Glossary* definition of "holding company".
[6] See Article 4(3) of the Organisation for Economic Cooperation and Development Model Tax Convention. See also Vogel *Klaus Vogel on Double Taxation Conventions* (1999) 259–270.
[7] See s 1.
[8] The South African Revenue Service ("SARS"), *Practice Note 6*, issued on 26 March 2002.

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

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

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

[9] See Article 4(3) of the OECD Model Tax Convention and OECD Model Tax Convention Commentary (2003) to Article 4(3) par 21–24.
[10] See Collinson & Tiley *Tiley and Collinson UK Tax Guide 2006 – 2007* (2006) par 33. See also Miller and Oats *Principles of International Taxation* (2006) 52.
[11] Article 4(3) of the OECD Model Tax Convention.
[12] Article 5(1) of the OECD Model Tax Convention.
[13] OECD Model Tax Convention Commentary (2008) to Article 5(1) par 4.

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

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

## 2.4 AN IHC AS A HOLDING COMPANY AND A SUBSIDIARY

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

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

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

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

In the South African context, "holding company" is not directly defined for purposes of the corporate law. The Act also does not define holding and subsidiary companies. The Companies Act[18] defines a holding company thus: "a company shall be deemed to be a holding company of another company if that other company is its subsidiary."[19] In terms of the new Companies Bill[20] a holding company, "in relation to a subsidiary, means a juristic person or undertaking that controls that subsidiary".[21] In terms of both these pieces of legislation, it is, therefore, the definition of subsidiary that determines what constitutes a holding company.

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

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

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[15]IBFD International Tax Glossary definition of "holding company".
[16] See Connell 'Holding Companies to Account: The Expense Apportionment Conundrum' 2004 *South African Law Journal* 117.
[17] http://www.trueblueauctions.com/Auction_Terms.html accessed on 17 September 2008.
[18] The Companies Act 61 of 1973 (hereinafter referred to as "the Companies Act").
[19] See s 1(4) of the Companies Act.
[20] Companies Bill 61D of 2008. The South African company law is currently being amended by the introduction of the new Companies Bill. The new law is expected to come into effect in 2010.
[21] Section 1 of the Companies Bill definition of "holding company".
[22] Olivier and Honiball *International Tax, A South African Perspective* (2008) 297.

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

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

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

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

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

[23] See s 1(3)(a)(i) of the Companies Act; s 3(1) of the Companies Bill.
[24] See s 1(3)(a)(iii) of the Companies Act.
[25] See s 1(3)(a)(ii) of the Companies Act.
[26] Kunst, Delport and Vorster *Henochsberg on the Companies Act* (2008) 14
[27] See Kunst, Delport and Vorster 14.
[28] See Kunst, Delport and Vorster 14. See also Haydock "The Effect of the Amendments to the Definition of a Subsidiary in the Companies Amendment Act 82 of 1992" 1993 *South African Mercantile Law Journal* 166–180.

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

### 2.4.1 Company groups

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

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

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

> "group of companies" means two or more companies in which one company (hereinafter referred to as the "controlling group company") directly or indirectly holds shares in at least one other company (hereinafter referred to as the "controlled group company"), to the extent that—
>
> (*a*) at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one

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[29] IBFD *International Tax Glossary* definition of "holding company".
[30] "Glossary of Terms" http://www.veoliaenvironmentalservices.co.uk/pages/pack_glossary.asp accessed on 12 December 2009.
[31] Definition of "group of companies" in s 1.
[32] See definition of "group of companies" in s 1.

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

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

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

## 2.5 THE INTERMEDIARY NATURE OF AN IHC

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

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

[33] See Article 5 of the OECD Model Convention, read with Article 7 of the OECD Model Convention and the commentaries in respect thereof.
[34] Olivier and Honiball 297.

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

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

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

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

### 2.6 FUNCTIONS OF AN IHC

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

[35] Hornby *Oxford Advanced Learner's Dictionary of Current English* (2006) Seventh Edition definition of "intermediary".
[36] Olivier and Honiball 297.

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

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

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

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

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

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

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

- the desire to consolidate the company's current (and future) foreign subsidiaries under one foreign holding company structure for management and reporting purposes;

- the creation of a platform for future business acquisitions, joint ventures and other business opportunities;

- to act as a gateway for growth and expanding business operations in new markets and regions; increased financial flexibility and the creation of an efficient vehicle for the redeployment of cash among foreign operations, thereby facilitating the use of internal funding of operations and expansion;

- improved treasury efficiency and financial risk management, by permitting foreign cash, foreign currency receipts and disbursements, and inter-company loans and other transactions to be consolidated, netted and managed within the holding and financing structure;

- facilitation of raising capital offshore thereby enhancing the enterprise's capital structure;

- positioning the company to more effectively reduce foreign income taxes through, e.g. internal financing and leveraging;

- to better manage and exploit intellectual property;

[40] IBFD "Introduction to Holding Activities" par 1.1.

- enabling access to the EC Directives and/or tax treaty networks reducing withholding taxes on dividend, interest and royalty flows; and

- facilitation of the preparation of a sub-consolidation of the combined foreign operations of the company for financial reporting purposes.[41]

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

### 2.6.1 Acquisitions

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

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

[41] For a further discussion of the functions of an IHC in different country structures see Pfaar "Inbound Investment from a European Perspective" (2003) *International Tax Review* http://www.internationaltaxreview.com/Default.asp?Page=17&PUBID=211&ISS=13163&SID=488044&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 28 October 2009.
[42] Olivier and Honiball 297.

### 2.6.2 Management

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

### 2.6.3 Reorganisations

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

### 2.6.4 Disposals

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

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[43] IBFD "Introduction to Holding Activities" par 1.1.

## 2.7 DISTINCTION BETWEEN AN IHC AND OTHER SIMILAR ENTITIES

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

### 2.7.1 International Holding Company

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

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

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

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[44] Holmes *International Tax Policy and Double Tax Treaties* (2007) 23.
[45] Rohatgi 238.

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

### 2.7.2 Offshore Holding Company

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

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

### 2.7.3 Foreign Financial Instrument Holding Company

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

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[46] http://www.b2bfreezone.com/product-search/international-management-company.htm accessed on 16 February 2008.
[47] Olivier and Honiball 297.
[48] See "Why Choose an Offshore Company?" http://www.icsl.com/pages/why.html accessed on 31 July 2008. See also Olivier and Honiball 297.

A foreign financial instrument holding company is defined in the Act for the purposes of the foreign business establishment exemption[49] in section 9D(1) and in section 41(1) for group reorganisation rules in section 42 to 47 of the Act.[50]

A foreign financial instrument holding company is defined as "a foreign company as defined in section 9D where more than the prescribed portion of all the assets of that company, together with the assets of all its influenced companies in relation to that foreign company, consists of financial instruments…"[51] Simply put, it is a foreign company where more than 50% of the market value or two-thirds of the actual cost of the company and all controlled group companies consist of financial instruments[52] (subject to certain exclusions).[53] Thus, a foreign company would be a foreign financial instrument holding company if in aggregate all its assets together with those of all influenced companies consist of financial instruments.[54]

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

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

[49] The business establishment exemption has been replaced by the foreign business establishment exemption by s 9(1)(a) of the Revenue Laws Amendment Act of 2006.
[50] The s 9D(1) of the Act definition refers to a foreign financial instrument holding company as defined in s 41.
[51] See s 41(1).
[52] Olivier and Honiball 357. See also the definition of "Foreign Financial Instrument Holding Company" in s 41 of the Act.
[53] See definition of "prescribed portion" in s 41(1).
[54] This allows the foreign holding company to escape the foreign financial instrument holding company even if it has assets that consist only of financial instruments, provided, when aggregated with those of its subsidiaries, the prescribed portion does not consist of financial instruments.

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

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

- Thirdly, any financial instrument held by a controlled group company in relation to the foreign company if the foreign company is a specified controlled group company.[57]

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

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

[55] Par (a) of the definition of “Foreign Financial Instrument Holding Company” in s 41.
[56] Par (b) of the definition of “Foreign Financial Instrument Holding Company” in s 41.
[57] Par (c) of the definition of “Foreign Financial Instrument Holding Company” in s 41.

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

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

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

### 2.7.4 International Headquarter Company

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

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

[58] The exemption is subject to certain further requirements which are beyond the scope of this chapter.
[59] Ogley *Principles of International Tax: A Multinational Perspective* (1993) 137.

be combined with those of an international headquarter company. As Ogley[60] states, "[w]here a multinational holds overseas investments through an intermediate holding company, it makes good commercial sense to arrange for any regional co-ordination function to be undertaken by that company as this will lend substance and help demonstrate that it is indeed resident in that country." Following Ogley, the fact that an IHC may undertake the regional co-ordination functions of a headquarter company demonstrates that the two are distinct entities.

### 2.7.5 Foreign Base Holding Company

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

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

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[60] Ogley 137.

[61] "Foreign Holding Company Income Changes. (International Taxation)" http://www.nysscpa.org/cpajournal/old/07950850.htm accessed on 28 July 2008.

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

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

[64] Rotterdam Institute for Fiscal Studies 50.

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

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

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

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

[65] Rotterdam Institute for Fiscal Studies 51–52. See also De Broe 41–50.
[66] Rotterdam Institute for Fiscal Studies 51.
[67] The diversionary rules are contained in s 9D(9).
[68] Rotterdam Institute for Fiscal Studies 52.

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

### 2.7.6 Foreign Group Finance Company

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

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

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

[69] See discussion in Chapter 6.
[70] Rotterdam Institute for Fiscal Studies 84.
[71] Rotterdam Institute for Fiscal Studies 84.

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

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

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

### 2.7.7 Foreign Financial Services Centre Companies

Foreign financial services centre companies derive their name from the jurisdictions that provide for such entities, the foreign financial services centres. The objective of these centres is mostly to provide global financial services with tax benefits for transactions undertaken outside the country of residence of the financial services centre company.[73] Rohatgi[74] states that "[f]or example, [these centres] permit international investors to form tax-beneficial entities in their jurisdictions for various business objectives. These entities may act as holding companies managing overseas investments and activities of a multinational enterprise, or they may accumulate capital lawfully for reinvestment abroad."

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[72] Olivier and Honiball 558.
[73] Rohatgi 4.
[74] Rohatgi 4.

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

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

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

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

[75] "Category 1 Global Business Company" http://www.alliance-mauritius.com/gbl1.php accessed on 22 June 2008. See a further discussion on the Mauritian corporate tax system in Chapter 8.
[76] Section 137(1) of the Botswana Income Tax Act 12 of 1995.
[77] Section 137(2) of the Botswana Income Tax Act 12 of 1995. The other operations are management and custodial functions in relation to collective investment schemes, insurance and related services, registrars and transfer agency services, exploitation of intellectual property, and other operations that the minister may declare by order from time to time to be approved financial operations for the purposes of section 137. See also http://www.kpmg.co.za/content accessed on 16 March 2008.
[78] "International Financial Services Centre Companies in Botswana Tax Law" http://www.armstrongs.bw//publications/docs/international_financial_services_centre.doc accessed on 17 March 2008.

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

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

### 2.7.8 Intellectual Property Holding Company

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

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

[79] Rohatgi 87.
[80] See Rohatgi 87.

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

### 2.7.9 Personal Holding Company

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

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

## 2.8 CONCLUSION

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

[81] *IBFD International Tax Glossary* definition of “Personal Holding Company”.
[82] See http://www.allbusiness.com/glossaries/foreign-personal-holding-company/4951392-1.html accessed on 14 June 2009.

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

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

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

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

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

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

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

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[83] "Global Strategies" (Supplement – Energy 2002) *International Tax Review* http://www.internationaltaxreview.com/?Page=17&PUBID=211&ISS=13174&SID=487921&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 09 November 2009.
[84] "Deductibility of Losses" (Supplement – Energy 2002) International Tax Review http://www.internationaltaxreview.com/?Page=17&PUBID=211&ISS=13174&SID=487922&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 08 November 2009.

***CHAPTER 3***

# NON-TAX REASONS FOR FORMING AN IHC

## 3.1 INTRODUCTION

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

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

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

[1] Par 2.6.

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

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

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

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

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

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

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

[5] See Finnerty, par 1.3.

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

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

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

## 3.2 RAISING EXTERNAL FINANCE

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

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

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

[8] Both of these types of financing can take different and varied forms. Each of these two categories presents a wide variety of rights, privileges and limitations that may be established by the issuing company. Debt financing refers to borrowing money to finance a business undertaking. The money is to be repaid over a period of time, usually with interest. The lender does not gain an ownership interest in the business and the obligations are limited to repaying the loan. Equity financing on the other hand describes an exchange of money for a share of business ownership.
For a further discussion on the distinctions between debt and equity, see Financing Basics: Debt vs. Equity http://www.toolkit.com/small_business_guide/sbg.aspx?nid=P10_2000 accessed on 10 June 2009.

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

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

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

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

[9] Rohatgi 456. For further reading on financing aspects, see Lyon A, *Taxation, Information Asymmetries, and the Financing Choice of the Firm* in Fiscal Incentives for Investment and Innovation (1995) Chapter 1.
[10] Rohatgi 456.
[11] See *Debt and Equity Financing* http://www.lordalex.org/financialinfo/debt/Debt_and_Equity_Financing.html accessed on 20 November 2008.

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

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

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

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

[12] Rohatgi 456.
[13] Rohatgi 457.
[14] *Jouissance* rights are participation certificates that provide security for creditors' claims. These rights are usually reserved for shareholders who are also creditors in the company. They would, for example, carry rights of participation in profits. Participation certificates do not give the bearer any voting rights. They are recorded as supplementary capital under certain circumstances
[15] Rohatgi 562 states: "The tax benefits on hybrid instruments arise both from the classification conflicts and the timing differences on income or expense recognition. These advantages are often the result of the tax rate differences and the timing of the tax due on various payments such as dividends, interest, capital gains or even capital duties."
[16] See Organisation for Economic Co-operation and Development, *Fundamental Reform of Corporate Income Tax No 16* (2007) 59.

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

- The borrower can reduce its tax by financing through debt, as interest is paid from pre-tax profits as opposed to dividends that are paid from after-tax profits;[18]
- A loan may be obtained in any currency to minimise foreign exchange risks; generally, interest does not suffer from economic double taxation[19] in the hands of the borrower and the lender; and
- It may be possible for different persons to claim a deduction for the interest costs if the holding company borrows at home to invest in a foreign subsidiary in a tax haven, which then grants a loan to a sister subsidiary in the host country.

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

### 3.2.1 Country Risk

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

[17] Rohatgi 457.
[18] This is subject to the application of thin capitalisation rules. See a discussion on thin capitalisation rules in Chapter 5 par 5.3.8.2.
[19] Economic double taxation means the inclusion, by more than one state's tax administration, of the same income in the tax base when the income is in the hands of different taxpayers. This is contrasted with juridical double taxation, which refers to the imposition of income taxes in two (or more) states on the same taxpayer in respect of the same income. See Organisation for Economic Co-operation and Development *What is a tax Convention – Double Taxation – Juridical and Economic* available on http://www.oecd.org/document/15/0,3343,en_2649_33753_36156239_1_1_1_1,00.html accessed on 10 June 2009.
[20] See Hammer *How Should a Corporation Strategically Review its Capital Markets and Financial Activities in the United States?* Derivatives & Financial Instruments (2008) (Volume 10)10
[21] See Olivier and Honiball 298–299.

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

### 3.2.2 Currency Risk

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

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

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

### 3.2.3 Usage of Group Assets

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

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

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

## 3.3 EXCHANGE CONTROLS

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

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

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

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[23] See Rohatgi 432.
[24] Exchange control free areas are areas within which no exchange control restrictions are in place on trade between residents of different countries. This often occurs as a result of proximity of the countries, usage of the same currency and the trade relationships (including the frequency of trade transactions) between countries.
[25] See Olivier and Honiball 533.
[26] Rohatgi 432.

## 3.4 ASSET PROTECTION

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

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

### 3.4.1 What is an "Asset"?

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

### 3.4.2 What are the Dangers?

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

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

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

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

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

## 3.5 GROUP REORGANISATION AND STRUCTURAL CONSOLIDATION

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

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

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

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

### 3.6 HOLDING, WITH A COMBINATION OF NON-HOLDING REASONS

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

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

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

[29] See Olivier and Honiball 299 and Rohatgi 238.
[30] Vanistendael "Taxation of Corporate Reorganizations" in (ed Thuronyi) *Tax Law Design and Drafting*, International Monetary Fund (1998) 908.

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

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

In recent years, company groups have preferred to share employees. According to this arrangement, a company would be set up within a group in a jurisdiction where some or most of the group companies are located. This company would employ people with different expertise. These would generally be people whose skills are required by the group companies on a regular, but not on a full-time[34] basis (therefore this excludes operational personnel). These members of staff would be deployed to each company as and when needed.

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

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

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[31] Olivier and Honiball 300.
[32] *European Community Merger Directive* of 23 July 1990 (90/434/EEC).
[33] Olivier and Honiball 300.
[34] "Full-time" is used here in a loose and general sense: tax practitioners disagree as to whether it implies a permanent employment, eight-hour working day, etc.
[35] According to Olivier and Honiball 300 "[i]t may not always be possible, however, to combine investment holding activities with other types of business activities due to the restrictive laws of the particular holding

## 3.7 CONCLUSION

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

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

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

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

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

[37] Par 1.1.

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

***CHAPTER 4***

# TAX REASONS FOR ESTABLISHING AN IHC

## 4.1 INTRODUCTION

Tax planning is one of the main considerations in any investment planning. As Graetz[1] States, "[a] deal done by very smart people that absent tax considerations, would be stupid". Complementary to this, Lord Tomlin's oft-quoted dictum in *IRC v Duke of Westminster*[2] that "[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be",[3] finds support from or is at least acknowledged by all sectors of business, revenue authorities, government treasury departments and academics as forming the cornerstone of any tax jurisdiction. Russo explains the principle as follows:[4]

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

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

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[1] See Graetz (Yale Law School) as quoted in Hager, *Treasury Targets Shelters Again, Washington Post* (1999) E3 in relation to tax planning using tax shelters.
[2] [1936] AC 1 at 19, [1935] All ER Rep 259.
[3] At 267.
[4] Russo *Fundamentals of International Tax Planning* (2007) 73.

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

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

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

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

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

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

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

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

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

## 4.2 DEFERRING TAX ON OPERATING INCOME

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

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

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

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

[8]IAS 14.8, *International Financial Reporting Systems including International Accounting Standards and Interpretations* as at 1 January 2006, International Accounting Standards Board, United Kingdom.
[9] An apple-farming business would have the income from selling apples as its operating income, just as an audit firm's income would be derived from consulting services. Income from the sale of land would be operating income in the hands of a dealer in land.
[10] Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. See *International Financial Reporting Systems including International Accounting Standards and Interpretations* as at 1 January 2006, International Accounting Standards Board IAS 14.8. United Kingdom.

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

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

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

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

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[11] Olivier and Honiball *International Tax, A South African Perspective* (2008) 302.
[12] Foreign companies that are controlled by residents of other countries are often used to keep their income in the foreign jurisdiction by the residents of the other countries by, in the exercise of their controlling powers, prohibiting the foreign company from declaring dividends. This is the reason why CFC legislation seldom subjects the income of non-controlling shareholders to attribution.
[13] Interest, royalties and rental treatment as operating income do not fall within the scope of this discussion because companies that have such income as operating income would be financial instruments holding companies, intellectual property holding companies and rental companies, respectively. These, as discussed before, do not have the essential characteristics of an IHC.

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

### 4.3 DEFERRING TAX ON CAPITAL GAINS

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

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

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

[14] See Solano, Alvarez, Fabregat and Santos "Mexico Bill: Tough on Tax Havens" (December 1997/January 1998) *International Tax Review* http://www.internationaltaxreview.com/Default.asp?Page=10&PUBID=35&ISS=12666&SID=468530&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 15 November 2009.

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

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

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

While tax on operating income is generally triggered by an accrual or a receipt, tax on capital gains is generally triggered by disposal or disposition. Disposal has a very broad definition and captures almost all instances in which an asset is alienated.[18] The International Bureau of Fiscal Documentation[19] defines disposal as follows:

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

In addition to these and other forms of disposals in different jurisdictions, certain events that are strictly not disposals are deemed as disposals. As Whiteman[21] observes, "[c]hargeable disposals fall into two categories: those events or transactions which can be

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

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

[19] *IBFD International Tax Glossary* definition of "disposal".

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

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

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

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

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

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

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

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

## 4.4 MAXIMISING CREDIT FOR FOREIGN TAXES

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

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

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

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

#### 4.4.1 No Tax on Foreign Income

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

#### 4.4.2 Foreign Tax as an Allowable Deduction in Determining Taxable Income

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

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

A – B x C = D

Where:
A is the taxable income;
B is the tax paid in the foreign country;
C is the local tax rate; and
D is the tax payable in the home country.

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[26] See Vann *Tax Law Design and Drafting* (ed Thuronyi) (1998) 756. See also Davis *Principles of International Double Taxation Relief* (1985) Chapter 5.
[27] See Vann 757; Olivier and Honiball 315.

### 4.4.3 Tax Exemption

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

Certain exemptions are blatantly conditional, for example exemption on receipts and accruals of foreign ship or aircraft owners or aircraft or charterers if a similar exemption or equivalent relief is granted to the taxing country's residents by the country in which that person is resident.[30] In this regard Vann[31] states:

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

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

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[28] Arnold and McIntyre *International Tax Primer* (2002) 33–34.
[29] South Africa, by the mechanism of s 9D(9)(a) of the Act exempted from the CFC attribution, income of a CFC located in "designated countries." This provision has since been repealed by s 22(1) of Act 45 of 2003.
[30] For the South African equivalent provision, see s 10(1)(cG) of the Act.
[31] Vann 757.
[32] For example, South Africa applies the exemption method to certain foreign dividends (s10(1)(k)(ii)), income received by crew members of ships operating outside the South African territorial waters (s10(1)(o)) and royalties (s10(1)(m)).

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

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

A – B = C
C x D = E

Where:
A is the total income;
B is the tax paid in the foreign country;
C is the taxable income;
D is the local tax rate; and
E is the tax payable in the home country.

### 4.4.4 Tax Credits

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

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

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

A – B = C

Where:

A is the tax payable before the credit is applied;
B is the tax paid in the foreign countries; and
C is the final tax payable.

This is therefore the most effective and practical unilateral method of avoiding double taxation in that the taxpayer's tax is effectively limited to the higher of the tax of either jurisdiction. The credit is normally limited to the tax payable in the host country. As Vann[35] states, "[t]his limit is designed to ensure that foreign taxes do not reduce the tax on domestic income of residents and is calculated by applying the average rate of tax on the worldwide income before the credit to the foreign-source income."

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

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

[34] Russo *Fundamentals of International Tax Planning* (2007) 10.
[35] Vann 757.
[36] See s 6*quat*(1) of the Act.

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

## 4.5 REDUCING WITHHOLDING TAXES

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

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

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

[37] See Arnold and McIntyre 169. "What is Withholding Tax?" http://www.wisegeek.com/what-is-withholding-tax.htm accessed on 13 June 2009.
[38] The most common example of these is in relation to tax on employees where employers are obliged to withhold the tax. Some laws also oblige debtors of sole proprietors to withhold the tax on payment.
[39] However, where there is a withholding tax in the country of the person making payment, the parties may agree on a royalty payment that takes into account that there would be tax payable thereon. See Olivier and Honiball 344.

payments to non-residents.[40] Withholding taxes are generally reduced by tax treaties. Thus, residents of a country with a high number of tax treaties may be in a more favourable position as opposed to their counterparts in countries with fewer treaties. As Olivier and Honiball[41] observe:

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

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

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

[40] In South Africa, secondary tax on companies is payable on declaration of dividends by resident companies. Because this is a tax on the company declaring the dividend, it is not a withholding tax as it is paid by the person who is liable for the tax. The common factor about this type of tax is that the tax incidence is on the shareholder(s). It should be noted that the current tax will be replaced by a new dividend tax which should likely be effective only from the fourth quarter of 2009, at the earliest. South Africa also levies a withholding tax on royalties at a rate of 12% of the amount paid. See s 35.
[41] Olivier and Honiball 301.

the content of the treaties[42] and the participation exemptions available. As typical tax-haven jurisdictions generally do not have good treaty networks, their residents are not likely to benefit from this reduction or elimination of the taxes. An IHC located in such a jurisdiction could be at the disadvantage of not benefiting from the reduction or elimination of taxes.

## 4.6 GROUP TAXATION

### 4.6.1 Introduction

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

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

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

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

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

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

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

#### 4.6.2 Fiscal Unity System

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

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

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[44] *IBFD International Tax Glossary* definition of "group treatment".
[45] Rohatgi *Basic International Taxation* (2005) 256.
[46] Rohatgi 256.
[47] Rohatgi 256–257.

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

The benefits of a fiscal unity system include: [50]

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

### 4.6.3 Group Contribution System

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

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[48] "Inconsistency of Luxembourg Fiscal Unity Rules with Tax Treaties and EU Law" http://www.ey.com/GLOBAL/content.nsf/Luxembourg_E/Inconsistency_of_Luxembourg_fiscal_unity_rules_with_tax_treaties_and_EU_law accessed on 08 July 2008.
[49] See further in the "Country Examples" discussion below.
[50] http://www.finconsgroup.com/Offers/Proprietary_Solutions/Fiscal_Accounting.kl accessed on 02 July 2008.
[51] Commission of the European Communities, *Communication from the Commission to the Council, The European Parliament and the European Economic and Social Committee, Tax Treatment of Losses in Cross-Border Situations* SEC (2006) 7.
[52] See Rohatgi 257.

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

### 4.6.4 Group Relief System

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

## 4.7 FOREIGN EXCHANGE GAINS AND LOSSES

### 4.7.1 Introduction

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

[53] See Commission for European Communities 7. See also Äimä and Kiikeri *Direct tax rules and the EU fundamental freedoms: origin and scope of the problem; national and Community responses and solutions, Finland*, (2006) 5 http://www.fide2006.org/TOPC1/Tax%20Kiikeri%20Finland.pdf accessed on 02 July 2008.
[54] See Rohatgi 257. See also *Payments for Loss Transfers under the Group Relief System — the GST Angle* http://www.lawgazette.com.sg/2003-8/Aug03-col.htm accessed on 01 July 2008.
[55] *IBFD International Tax Glossary* definition of "subvention payment".
[56] See Olivier and Honiball 575. See also *IBFD International Tax Glossary* definition of "foreign exchange gain and loss".

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

### 4.7.2 Tax Treatment of Foreign Exchange Gains and Losses

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

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

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

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

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

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

## 4.8 RE-CHARACTERISATION OF INCOME

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

### 4.8.1 Income Paid and Received in the Same Jurisdiction

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

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

### 4.8.2 Income Received from a Different Jurisdiction

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

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

For the South African circumstances Olivier and Honiball[61] give the following example:

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

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

[61] See Olivier and Honiball 303.

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

## 4.9 UTILISATION OF A LIQUIDATION LOSS

Some tax regimes such as Japan,[62] the Netherlands[63] and the United States of America[64] allow companies to deduct a certain amount of income as a liquidation loss. A liquidation loss occurs where a company liquidates its subsidiary that has realised only losses in its business ventures.[65] Therefore, where a group decides to venture into a risky business, it may be beneficial from a tax point of view to incorporate an IHC in a country where a liquidation loss is allowed to be deducted in the hands of the holding company. The IHC would then be able to use the loss to set off against the income of other subsidiaries or its own income.

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

[62] See http://ir.capcom.co.jp/english/news/pdf/e081217.pdf accessed on 19 January 2009.
[63] See http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12602&SID=470125&TYPE=20 accessed on 19 January 2009.
[64] See http://www.thefreelibrary.com/Fitch:+U.S.+CMBS+Loss+Severities+Vary,+But+Overall+Continue+To...-a0155655760 accessed on 19 January 2009.
[65] Based on a discussion with Mr Serge de Reus, Partner/Director of Corporate International Tax at PricewaterhouseCoopers on 19 September 2008 in Sunninghill, Johannesburg.

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

## 4.9 CONCLUSION

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

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

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

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

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

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

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

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

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

***CHAPTER 5***

# CHARACTERISTICS OF AN IDEAL LOCATION TO ESTABLISH AN IHC

## 5.1 INTRODUCTION

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

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

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

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

## 5.2 NON-TAX CHARACTERISTICS OF AN IHC JURISDICTION

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

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

The country's government should also respect the rule of law and ideally have an enshrined constitution that protects the rights of the country's subjects. As Olivier and Honiball[5] observe, "… a combination of operational business activities with an intermediary holding company in a single legal structure could expose an operational

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[2] See Udal and Cinnamon "How to select a Jurisdiction for Your Holding Company" (2004) *International Tax Review* http://proquest.umi.com/pqdweb?did=789908371&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 19 October 2009.
[3] Olivier and Honiball *International Tax – A South African Perspective* (2008) 304.
[4] See further on the factors that make a jurisdiction suitable for investment Cinnamon "Tasty Regimes Tempt Holding Companies" (1999) *International Tax Review* (Vol. 10) 9-11.
[5] Olivier and Honiball 305. See also Rohatgi *Basic International Taxation* (2002) 239; Udal and Cinnamon *International Tax Review*.

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

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

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

## 5.3 TAX CHARACTERISTICS OF AN IHC JURISDICTION

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

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[6] Olivier and Honiball 305.
[7] See Cussons P and Bojkovic M "Where do I hold my company?" (1998) *Accountancy* (Vol. 122, Issue 1262) 124-125.
[8] However, where it is not a pure intermediary company, employees may be required to carry out the extensions of its business.
[9] See further on a summary of the essential characteristics, *Netherlands: Dutch Holding Companies*, http://www.lowtax.net/lowtax/html/offon/netherlands/nethold.html accessed on 21 August 2008.

### 5.3.1 A Favourable Capital Gains Tax Regime

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

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

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

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[10] IHCs operating in this form are referred to as a "pure intermediary holding companies".
[11] Olivier and Honiball 297. See Evans "The Australian Capital Gains Tax: Rationale, Review and Reform" 14 *Australian Tax Forum* (1998) 287.
[12] See Global Strategies (Supplement – Energy 2002) *International Tax Review* http://www.internationaltaxreview.com/?Page=17&PUBID=211&ISS=13174&SID=487921&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 12 November 2009.
[13] See Burns and Krever "Taxation of Income from Business and Investment" in *Tax Law Design and Drafting* (ed Thuronyi) (1998) 646.
[14] Ault and Arnold *Comparative Income Taxation: A Structural Analysis* (1997) 194.

#### *5.3.1.1 Determining the Acquisition Price*

Acquisition price[15] is generally the consideration given for the creation or acquisition of an asset.[16] According to Burns and Krever[17]

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

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

#### *5.3.1.2 Timing and Event for Realisation of Gain or Loss*

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

[15] Acquisition price is also referred to as "base cost", "basis", "cost price", "book value" or "cost base"
[16] See par 20 of the Eighth Schedule to the Act. See also Burns and Krever *Tax Law Design and Drafting* 648.
[17] Burns and Krever *Tax Law Design and Drafting* 648–649.
[18] Where there is part disposal of an asset, the rules generally provide for apportionment of part of the cost of the original asset to the part of the asset sold.

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

Deemed disposals increase the scope of the realisation events. In this regard Burns and Krever[22] state that "[t]he effect of a deemed-disposal is to treat a particular event as giving rise to the disposal of an asset for a consideration that is equal to either the market value or the cost base of the asset at that time depending on the circumstances." Therefore, the fewer the deeming rules in this case, the more attractive the capital tax system.

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

#### *5.3.1.3 Amount Included in Calculation of Taxable Capital Gains*

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

[19] Whiteman *et al Whiteman on Capital Gains Tax* (1980) 23.
[20] Burns and Krever *Tax Law Design and Drafting* 647. See also Boidman and Ducharme *Taxation in Canada, Implications for Foreign Investment* (1985).
[21] See Burns and Krever *Tax Law Design and Drafting* 647.
[22] Burns and Krever *Tax Law Design and Drafting* 648.
[23] Burns and Krever *Tax Law Design and Drafting* 647.

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

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

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

#### *5.3.1.4 Disposals between Connected Persons*

Connected persons[25] may choose to transfer assets *inter partes* to achieve various objectives, including minimising the recognition of gain to defer taxes, inflating gains to absorb losses that were carried forward, value shifting to transfer gains to a lower bracket or exempt taxpayer, etc.[26] Non-arms-length transactions are mostly subject to deeming provisions. The person disposing of the asset is deemed to have received a consideration equal to the market value of the asset at the time of the disposal. At the same time, the amount is treated as the base cost of the asset for the person acquiring the asset.[27] As

[24] Whiteman *Whiteman on Capital Gains Tax* (1988) 27.
[25] Connected person is a defined term in the South African tax legislation (see s 1 definition of "connected person"). Internationally a reference is made to "related party" and "associated person". The definition differs from country to country and from situation to situation mainly depending on the purpose of the definition and the context in which it is used. Generally, such definitions include blood relatives, lineal descendants and ancestors, members of the same partnership, and a company, its controlling shareholders and other companies in the same group of companies. See IBFD International Tax Glossary definition of "connected person".
[26] Burns and Krever *Tax Law Design and Drafting* 651.
[27] Burns and Krever *Tax Law Design and Drafting* 651.

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

### *5.3.1.5 Roll-Over Provisions*

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

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

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

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

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

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[28] See *IBFD International Tax Glossary* definition of "rollover relief". See also http://www.ftomasek.com/RickKreverDraft.html accessed on 28 October 2008.
[29] Burns and Krever *Tax Law Design and Drafting* 652.
[30] Burns and Krever *Tax Law Design and Drafting* 654.

#### *5.3.1.6 Capital Gains Tax Rate*

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

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

### 5.3.2 Low Income Taxes

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

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

[31] See Whiteman 27.

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

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

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

### 5.3.3 No or Low Tax on Dividends

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

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

[32] Incentives can also be special-purpose based such as those dedicated to famine relief, infrastructure development, employment creation, technology transfer and export promotion.
[33] See Bolnick *Technical Report on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region* (2004) (Unpublished report for the Southern African Development Community)

#### *5.3.3.1 Numerically Low Amount of Tax on Dividends*

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

#### *5.3.3.2 Thin Dividend Tax Base*

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

***Examples:***

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

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

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

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

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

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

[35] See section 1 of the Act definition of "contributed tax capital".
[36] See the *Canadian Master Tax Guide* (2008) par 6030; Ernst & Young *Worldwide Corporate Tax Guide* (2006) 136.
[37] For these purposes corporate law provides for a determination of the stated or paid-up capital and limitations within which the distributions can be made.
[38] *Canadian Master Tax Guide* par 6000; Ernst & Young 136 – 137.

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

### 5.3.4 No or Low Withholding Tax on Dividends

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

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

### 5.3.5 A Favourable Treaty Network

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

[39] See Udal and Cinnamon *International Tax Review.*

A preliminary question may arise in this context: What do treaties achieve such that a quest is made for a fertile network of them? They are generally treaties for the avoidance of double taxation. In this context Loncarevic[40] states that "juridical double taxation may be broadly described as subjecting the same income derived by a taxpayer during the same period of time to comparable taxes under taxation laws of two different countries." This situation is created, as Harris[41] suggests, where there is a "concurrence of limited or unlimited fiscal liability among national fiscal categories such as double allegiance or dual residence of a taxpayer." Double taxation can have crippling consequences for investors earning income in jurisdictions other than countries where they are resident.

Treaties have the advantage of promoting international trade and investment by preventing double taxation through assignment of taxing rights via tax exemption or credits and through agreements on maximum withholding tax and thus reducing the overall tax burden.[42] Loncarevic[43] states that "[o]n the other hand restrictions on tax avoidance and tax evasion, anti-treaty shopping rules, as well as exchange of information between tax administrators may have negative effects on international movement of goods, services, persons and capital since these measures reduce possibilities of taxpayers to avoid taxes through transfer pricing, treaty shopping, etc."

It is not only the number of the treaties that is important. Perhaps even more important is the content of the treaty. As Vanhaute[44] states:

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

[40] Loncarevic "Economic Relevance of Double Taxation Conventions" in *Tax Treaty Policy and Development* (eds Stefaner and Züger) (2005) 19.
[41] Harris "Reduction and Elimination of Economic Double Taxation by Tax Treaties" in *Tax Treaty Policy and Development* (eds Stefaner and Züger) (2005) 40.
[42] Loncarevic *Tax Treaty Policy and Development* 19. See Vogel *Klaus Vogel on Double Taxation Conventions* (1997) 1130. See also Ault and Arnold 385 – 403.
[43] Loncarevic *Tax Treaty Policy and Development* 20.
[44] Vanhaute *Belgium in International Tax Planning* (2008) 157.

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

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

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

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

### 5.3.6 Unilateral Avoidance of Double Taxation

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

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

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

[47] Vogel 1174.

[48] See Udal and Cinnamon *International Tax Review.*

DTA would be to supplement such provisions. As Loncarevic[49] states, "[a] tax treaty supplements the unilateral double tax relief provisions in the respective treaty partner countries' domestic law and clarifies the taxation position of income flows between them".

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

### 5.3.7 The Absence of Controlled Foreign Company ("CFC") Legislation

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

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[49] Loncarevic *Tax Treaty Policy and Development* 19.
[50] Loncarevic *Tax Treaty Policy and Development* 22.
[51] Testimony of Barbara Angus, *US Department of Treasury before the Senate Committee on Foreign Relations on Pending Income Tax Agreements*, 24 September 2004, http://www.treas.gov/press/releases/js1952.htm accessed on 25 February 2008.
[52] This could be varied by the provisions of a double taxation agreement. See Vogel "Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I) (1998) *Intertax* 219. See also Forst "The Continuing Vitality of Source-Based Taxation in the Electronic Age" (1997) 15 *Tax Notes International* 1455; Udal and Cinnamon *International Tax Review*.

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

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

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

#### *5.3.7.1 Definition of Controlled Foreign Company*

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

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

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

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

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[55] Arnold and McIntyre 90.

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

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

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

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

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

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[58] In France the percentage holding required is 50%.
[59] The required percentage holding in Portugal and Denmark is 25%. See Ernst & Young 216 and 756.
[60] Where the holding requirement refers to connected or related persons the required holding per person is generally low.
[61] For example, Australia (s 340 of the Income Tax Assessment Act of 1936), Canada (s 112 of the Income Tax Act) and New Zealand (s EX1(1) of the New Zealand Income Tax Act of 2004) require that for a foreign corporation to be a controlled foreign corporation five or fewer residents should control such a corporation. In other countries, even foreign corporations that are widely held by resident shareholders are considered to be controlled foreign corporations. The concentrated ownership requirement is related to the rationale for a control test. Whenever the shares of a foreign corporation are widely held by resident shareholders, those shareholders are unlikely to be able to exercise sufficient power over the corporation to require it to make distributions. The South African provision does not require that the residents be connected or related. Three residents each holding 17% of shares in a foreign company render the company a CFC. See section 9D definition of “controlled foreign company”.
[62] See Proviso (A) to section 9D(2).

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

### *5.3.7.2 Computation of Attributable Income*

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

*a. The entity approach*

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

[63] Arnold and McIntyre 96.
[64] There are, however, exceptions to the general rule.
[65] Arnold and McIntyre 94.

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

*b. The transactional approach*

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

#### ***5.3.7.3 Attributable Amount***

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

[66] Arnold and McIntyre 94

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

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

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

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

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

#### *5.3.7.4 Exemptions*

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

*a. De minimis exemption*

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

[68] Arnold and McIntyre 94.

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

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

*b. Genuine business activities exemption*

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

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

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[69] The South African system is one such hybrid. See s 9D of the Act; see also the discussion in Chapter 9 par 10.3.
[70] Arnold and McIntyre 97.
[71] See s 9D(9)(b)(iii).
[72] Arnold and McIntyre 96–97.

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

*c. Distribution exemption*

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

### 5.3.8 Thin Capitalisation and Transfer Pricing Rules

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

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

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[73] See Olivier and Honiball at 373–375. Also see Legwaila ‘The Business Establishment Exemption’ (2004 December) *De Rebus* 42–43.
[74] Arnold and McIntyre 97.
[75] In some countries, transfer pricing rules apply even to transactions entered into between related parties within the domestic sphere. This application is not adopted by many countries due to the fact that there would not be any depletion of the tax base, as the ultimate income would still be taxable in the particular country.

#### *5.3.8.1 Transfer Pricing*

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

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

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

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

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[76] Arnold and McIntyre 55.
[77] See Olivier and Honiball 399.
[78] Vann "International Aspects of Income Tax" in *Tax Law Design and Drafting* (ed Thuronyi) (1998) 781.

*a. Cross-border transactions*

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

*b. Connected persons*

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

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

*c. Arm's length*

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

[79] See above at 5.3.1.4.
[80] Vann *Tax Law Design and Drafting* 781.
[81] The attribution applies both to enterprises and parts or divisions of those enterprises. See Hamaekers "Arm's Length – How Long?" in *International and Comparative Taxation, Essays in Honour of Klaus Vogel, Series on International Taxation* (ed Raad) (2002) 29.

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

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

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

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

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[82] Rolfe *International Transfer Pricing* (1998) 6 – 23; Arnold and McIntyre 60.
[83] Olivier and Honiball 405.
[84] Hamaekers 38. Arnold and McIntyre 61 – 65. The following methods are used to determine whether a price is at arm's length or not: (a) Comparable Uncontrolled Price ("CUP") Method – establishes an arm's length price by reference to sales of similar products made between unrelated persons in similar circumstances; (b) the Resale Price Method – sets the arm's length price for the sale of goods between related parties by subtracting an appropriate mark-up from the price at which the goods are ultimately sold to unrelated parties; (c) the Cost Plus Method – uses the manufacturing and other costs of the related seller as the starting point in establishing the arm's length price. An appropriate amount of profit is added to these costs by multiplying the seller's costs by an appropriate profit percentage; (d) Profit-Split Method – the worldwide taxable income of related parties engaging in a common line of business is computed. The taxable income is then allocated among the related parties in proportion to the contribution they are considered to have made in earning the income; and (e) Transactional Net Margin Method (TNMM) – the taxpayer establishes, for itself or a related party, an arm's length range of profits on a set of transactions. If the tested party's reported profits on those transactions fall within that range, then its transfer prices will be accepted by the tax authorities.
[85] See Sawyer "Advance Pricing Agreements: A Primer and Summary of Developments in Australia and New Zealand" (2004) *Bulletin for International Fiscal Documentation* 556-565.

#### *5.3.8.2 Thin Capitalisation*

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

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

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

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[86] Vann *Tax Law Design and Drafting* 785.
[87] See Arnold and McIntyre 83.
[88] Vann *Tax Law Design and Drafting* 784.

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

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

## 5.4 METHODS OF SETTING UP AN IHC

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

[89] Arnold and McIntyre 85.
[90] Among the countries using the debt-equity rules the ratios differ. The common range is between 1.5:1 and 3:1. The rules also provide for an application to the revenue authorities to allow a higher ratio. With the earnings-stripping rules, the rules are more permissive for financial institutions whose businesses consist in borrowing and lending and that typically operate at much higher debt levels than other businesses. Vann 785.
[91] Arnold and McIntyre 86.
[92] See Udal and Cinnamon *International Tax Review.*
[93] See par 2.2.
[94] Hansen "Practical Aspects of Setting up Holding Companies" (2000) *European Taxation* (Vol. 40 Issue 4) 130-131.

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

### 5.4.1 Incorporating a New Legal Entity

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

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

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

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

[95] See Hansen *European Taxation* 131.
[96] Olivier and Honiball 305.

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

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

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

### 5.3.4 Relocating the Tax Residence of a Company

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

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

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

[98] See Chapter 2 par 2.3.

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

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

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

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

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

### 5.4.5 Migration

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

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

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

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

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

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

### 5.4.6 Other Variations

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

## 5.5 CONCLUSIONS

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

[102] https://www.ird.govt.nz/technical-tax/legislation/2006/2006-3/leg-2006-3-corp-migration.html accessed on 25 February 2008.
[103] Olivier and Honiball 306.

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

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

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

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

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

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

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

***CHAPTER 6***

# INTERNATIONAL ATTITUDE TOWARDS SYSTEMS SUITABLE FOR IHCs

## 6.1 INTRODUCTION

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

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

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

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

## 6.2 HARMFUL TAX COMPETITION

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

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

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

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

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[2] Rohatgi *Basic International Taxation* (2005) 85.
[3] See Olivier and Honiball *International Tax – A South African Perspective* (2008) 575; OECD Report *Harmful Tax Competition, An Emerging Global Issue* (1998) 1-19. See also Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (LLD dissertation 2007 UNISA) 10–14.
[4] "Fiscal sovereignty is a right which has been carefully guarded by sovereign states and protected in international law over hundreds of years; international fiscal disputes have provoked major international political upheavals…" Biswas *International Tax Competition: Globalisation and Fiscal Sovereignty* (2002) 1.
[5] *Commonwealth Finance Ministers Communiqué*, September 2000. http://www.thecommonwealth.org/document/181889/34293/35232/152088/153876/commonwealth_finance_ministers_meeting_st_julians.htm accessed on 05 November 2008.
[6] In a speech delivered by Emeritus Professor M Friedman of the University of Chicago, at the Hoover Institution, Stanford University, May 2001.

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

A contrary and more popular viewpoint is that tax competition is dreadful and appalling. The proponents of this view see tax competition as resulting in a destructive "race to the bottom". This negative view is reflected by Ault[7] as follows:

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

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

### 6.2.1 Tax Havens

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

[7] Ault "Tax Competition: What (If Anything) To Do About It?" in *International and Comparative Taxation, Essays in Honour of Klaus Vogel* (ed Van Raad) (2002) 2.
[8] See Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) 9; Doerenberg *et al* *Electronic Commerce and Multi-jurisdictional Taxation* (2001) 91.

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

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

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

According to Ginsberg[12] the term "tax haven" covers the following three classes of jurisdictions:

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

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[9] See Olivier and Honiball 552; Glautier and Bassinger *A Reference Guide to International Taxation: Profiting from Your International Operations* (1987) 228.
[10] Hadnum *The World's Best Tax Havens* (2006) 2.
[11] Miller and Oats *Principles of International Taxation* (2006) 175.
[12] Ginsberg *International Tax Havens* (1997) 5.
[13] See Hadnum 3.

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

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

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

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

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

[14] Countries that are members of the Organisation for Economic Co-operation and Development ("the OECD") generally subscribe to the negative regard of tax havens and these include rich countries upon which most countries depend for trade such as the United States of America, the United Kingdom, the Netherlands, Japan, France, Canada and Germany.
[15] Olivier and Honiball 553.

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

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

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

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

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

[16] Ginsberg 5.
[17] According to Ginsberg 10 this is more a factor for residents of countries with progressive tax systems, as these systems mostly impact on those taxpayers at the high income tax brackets.
[18] Secrecy may be desirable for reasons other than tax avoidance. An organisation may want to use a tax haven to develop new products or business ideas out of sight of its commercial competitors. Ginsberg 10.

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

#### *6.2.1.1 No or Nominal Taxes on Income from Mobile Activities*

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

*a. What is mobile business activity?*

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

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

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

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

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

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

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

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

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

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

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

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

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

[25] *OECD Commentary* par 80–81.

permanence, excludes the other, i.e. mobility. Business that is based on portfolio investment[26] is likely to fail the permanence test.

*b. The tax on mobile income*

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

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

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

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

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

### *6.2.1.2 Availability to Non-Residents*

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

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

### *6.2.1.3 Ability to Fund National Expenditure without Income Taxes*

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

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

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

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

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

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

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

#### *6.2.1.4 Characterisation of Tax Havens*

Tax havens perform the following three main types of functions:

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

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[30] See South African National Treasury's *2007 Budget Review* 174.
[31] Miller and Oats 176.

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

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

*a. Production havens*

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

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

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[32] Miller and Oats 176.
[33] Miller and Oats 176.
[34] Tax havens with sufficient infrastructure include stable countries such as Switzerland, Luxembourg, the Netherlands, Monaco, Liechtenstein, Channel Islands, Bermuda and Andorra.

*b. Base havens*

Base havens are also referred to as "sham havens". They are more often small islands with few natural resources to exploit and limited labour. They levy very low or no tax on all business income.[35] This is the only way, practically, that they can attract investment. As Miller and Oats[36] state, "[t]he lack of labour, land and infrastructure generally rules out the location of manufacturing or large-scale distribution operations although there are notable exceptions, such as Specsaver plc's extensive operations on Guernsey."

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

*c. Treaty havens*

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

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35 Miller and Oats at 176.
36 Miller and Oats at 176.
37 Base havens are usually colonies or former colonies. The *EU Code of Conduct on Tax Competition* (1997) found that more than seventeen of the tax havens associated with the UK are colonies or former colonies of onshore jurisdictions. See Miller and Oats at 176.
38 Miller and Oats at 176; see also Olivier and Honiball 554.
39 Miller and Oats at 176–177.
40 Miller and Oats at 177.

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

*d. Concession havens*

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

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

#### *6.2.1.5 Taxation in Tax Havens*

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

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

[41] Miller and Oats 177.

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

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

### 6.2.2 Harmful Preferential Tax Jurisdictions

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

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

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

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

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[42] Ginsberg 7.
[43] Arnold and McIntyre 140.
[44] Arnold and McIntyre 141. See also the OECD Report *Harmful Tax Competition, An Emerging Global Issue* (1998) par 60.
[45] OECD Report par 60.

#### *6.2.2.1 Low or No Tax on Income*

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

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

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

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

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[46] OECD Report par 60.
[47] OECD Report par 61
[48] This is, however, uncommon as it exposes the country to external criticism.
[49] Such incentives can be general, such as tax holidays, investment allowances, tax credits, timing differences, and tax rate reductions, or incentives based on administrative discretion.
[50] See Bolnick *Technical Report on the Effectiveness and Economic Impact of Tax Incentives in the SADC Region* (2004); Easson *Tax Incentives for Foreign Direct Investment* (1992) 63–105; See also Holland and Vann "Income Tax Incentives for Investment" in *Tax Law Design and Drafting* (ed Thuronyi) 987–1019.

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

#### *6.2.2.2 Ring-fencing of Foreign Income from the Domestic Economy*

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

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

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

[51] Biswas 3.
[52] OECD Report par 62.

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

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

#### *6.2.2.3 Lack of Transparency*

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

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

[53] See OECD Report par 62.
[54] See Malherbe J "Harmful Tax Competition and the Future of Financial Centres in the European Union in International and Comparative Taxation" in *Essays in Honour of Klaus Vogel* (ed Raad) (2002) 116.
[55] See Malherbe *Essays in Honour of Klaus Vogel* 116 – 117.
[56] OECD Report par 63.

Transparency can be undermined by the following: [57]

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

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

#### *6.2.2.4 No Exchange of Information*

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

[57] OECD Report par 63.

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

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

#### *6.2.2.5 Other Features*

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

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

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

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

they result in companies in the same circumstances being subjected to tax at different effective rates.[60]

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

[60] See OECD Report par 69.
[61] OECD Report par 71. Deviations from the application of the OECD 1995 Guidelines on transfer pricing and inappropriate use of advance tax rulings can have a massive impact on the allocation of income of a group of companies and cause investors to prefer one jurisdiction over others as a host of the operating or other company within the group. Such deviations may consist, *inter alia*, "in setting a level of profit which does not correspond to the functions actually performed by the entity in question or conversely, excess allocation of earnings to a firm that engages in no activity or in activity which, if not undertaken by a legally independent company, would not constitute a permanent establishment."
[62] OECD Report par 73. Treaty shopping is the use of a double tax agreement by a person who is not resident in either of the treaty countries, usually through the use of a conduit entity resident in one of the countries; see Olivier and Honiball 581.
[63] OECD Report par 74; See also *Identifying tax havens and Offshore Finance Centres*.

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

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

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

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

The harmful part of preferential tax regimes is the fact that they harm the economies of other countries while shielding their own economies from similar or other harmful effects. The harm caused by preferential tax regimes is the attraction of foreign direct or portfolio investments while at the same time robbing the countries of residence of the investment in their jurisdictions. On the other hand, harmful preferential tax regimes shield their own economies from harmful effects by preventing the collection of taxes from their residents. The European Commission Code of Conduct for Business Taxation[67] acknowledges that in so far as the tax measures are used to support economic

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

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

[66] OEDC Report par 80.

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

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

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

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

[68] *Resolution of the Council of Representatives of the Governments of the Member States* Annex 2 G.
[69] OECD Report par 80–81.

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

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

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

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[70] OECD Report par 38–46. See also Oguttu 20; Spitz and Clarke *Offshore Service* (2002) OECD/3.
[71] The "race to the bottom" refers to the situation of detrimentally lower tax rates brought about by countries competing to attract investors by lowering their tax rates and therefore depleting their tax bases.

### 6.2.4 Offshore Financial Centres

#### *6.2.4.1 Introduction*

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

#### *6.2.4.2 Nature and Functions of Offshore Financial Centres*

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

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

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

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

[72] See Oguttu 55–58.
[73] http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1 accessed on 19 February 2008.
[74] http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1 accessed on 14 March 2008.
[75] http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1 accessed on 14 March 2008

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

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

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

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

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[76] Adukia *International Financial Service Centre/Offshore Financial Centre* http://www.caclubindia.net/books/manual_sez_ftwz_ifsc/Ch%2022.asp accessed on 11 June 2009.
[77] See Oguttu 58–69 where she provides examples of offshore financial companies and their functions.
[78] Eurobonds are long-term bonds issued by companies and underwritten by an international banking syndicate and not bound by any country's security laws. They are bearer instruments with fixed terms and are negotiable. See Miller and Oats 182.
[79] http://www.internationalmonetaryfund.com/external/np/mae/oshore/2000/eng/back.htm#table1, accessed on 14 March 2008 "Views of offshore financial centres tend to be polarised. Proponents suggest that reputable offshore financial centres play a legitimate and integral role in international finance and trade, offering huge advantages in certain situations for both corporations and individuals, allowing legitimate risk management and financial planning. Critics argue that they drain tax from wealthy (and not so wealthy) nations, are insufficiently regulated, and facilitate illegal activities such as tax evasion and money laundering while avoiding legal risk under corporate veil."

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

## 6.3 INITIATIVES AGAINST TAX HAVENS

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

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

[80] Miller and Oats 188.

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

### 6.3.1 Unilateral Initiatives

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

#### *6.3.1.1 Controlled Foreign Company Legislation*

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

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

[82] See OECD Report par 101.
[83] See Miller and Oats 188.
[84] See Arnold and McIntyre 87.

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

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

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

### *6.3.1.2 Transfer Pricing Rules*

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

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

[85] See Miller and Oats 189.
[86] For a further discussion on the exclusions and exemptions see Chapter 5 par 5.3.7.4.
[87] Vann *Tax Law Design and Drafting* 781.

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

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

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

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

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

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

[88] "The prices charged within the group for goods or services and the financing methods used between the members of the group simply serve as means of moving funds around the group and do not in a commercial sense create profits for the group." Vann *Tax Law Design and Drafting* 781.
[89] Miller and Oats 205.
[90] Vann *Tax Law Design and Drafting* 781

influence from the OECD and UN Model treaties.[91] Central to the operation of this method is the so-called "arm's length" principle.[92]

*6.3.1.3 Restriction of the Exemption Method on Certain Income*

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

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

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

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[91] Vann *Tax Law Design and Drafting* 781. Most countries negotiate treaties based on the pricing and nature of transactions between the branch or group company with other members of the group.
[92] For a discussion on the operation of the "arm's length" principle see Chapter 5 par 5.3.8.1.
[93] OECD Report par 104.
[94] Other methods commonly used are the deduction method, in terms of which taxpayers are allowed to take a deduction for foreign taxes paid, and the credit method, in terms of which foreign taxes paid by resident taxpayers on foreign-source income reduce domestic taxes payable by the amount of the foreign tax.
[95] Hong-Kong is a prime example of a country that applies the exemption method in its purest form. See Arnold and McIntyre 32.

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

#### *6.3.1.3 Addition of Anti-Avoidance Measures*

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

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

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

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

[96] See Arnold and McIntyre 33.
[97] OECD Report par 105.
[98] The white, grey and black lists are the lists of countries assessed in terms of their tax co-operation that were developed by the London G20 Summit in April 2009. The white list consists of countries that have implemented the internationally agreed tax standards. The grey list consists of countries that have committed to the internationally agreed tax standards, but have not yet substantially achieved such standards, such as tax havens and financial centres. The black list consists of countries that have not committed to the internationally agreed tax standards. See "What Next? – Tax Cooperation after the London G20 Summit" http://www.actionaid.org.uk/doc_lib/what_next.pdf accessed on 29 May 2009.

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

*b. The type of income*

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

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

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

*d. Foreign investment funds*

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

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

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

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

*e. Transparency of rulings*

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

This recommendation stems from the fact that, as a supplement to the tax rules applicable in any regime, tax jurisdictions often, in the interests of clarity and taxpayer certainty, carry out or apply the rules in terms of a so-called ruling system. In terms of the ruling system, taxpayers are able to submit to the tax authorities structures of planned transactions either before[103] or during implementation of the plan. The tax authorities would consider the plan against the applicable laws to determine the tax implications thereof. Often this consideration is guided by the taxpayer's preliminary view of the tax implications.

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

[100] See OECD Report par 101.
[101] See OECD Report par 102.
[102] See OECD Report 108–110.
[103] The rulings granted prior to the planned transaction being implemented are generally referred to as advance rulings.

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

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

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

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

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

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

*f. Foreign information reporting*

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

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

*g. Taxation of foreign dividends*

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

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

[107] Recommendation 4. See OECD Report par 106–107.
[108] See OECD Report par 106.
[109] The credit, exemption or deduction could be granted by the residence country other than in cases where such double tax relief should be denied in terms of the rule in par 6.3.1.3.

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

*h. Access to banking information*

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

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

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

### 6.3.2 Treaty Measures

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

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

#### *6.3.2.1 Greater and More Efficient Use of Exchanges of Information*

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

#### *6.3.2.2 Restriction on Entitlement to Treaty Benefits*

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

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

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

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

Different countries have adopted measures to circumvent this practice.

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

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

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

[112] In an effort to aid the inclusion of such measures, it was also recommended that the OECD Model Tax Convention be modified to include such provisions or clarifications as are needed to assist contracting states. See the OECD Report par 118.
[113] See the OECD Report par 119.

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

#### *6.3.2.4 Synchronising Exclusions from Treaty Benefits*

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

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

#### *6.3.2.5 Terminating Treaties with Tax Havens*

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

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

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

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

[116] OECD Report par 126.

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

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

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

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

#### *6.3.2.6 Other Recommendations of the OECD Report*

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

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[118] OECD Report par 129.
[119] OECD Report par 130.
[120] OECD Report par 132.
[121] See OECD Report par 133–148.

### 6.3.3 OECD Developments since the 1998 Report

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

***Access to bank information***

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

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

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[122] OECD *OECD's Current Tax Agenda* (2008) 59.
[123] See OECD *Improving Access to Bank Information for Tax Purposes* (2000) 14 http://www.oecd.org/dataoecd/3/7/2497487.pdf accessed on 09 November 2009; OECD *OECD's Current Tax Agenda* 62.
[124] OECD *Improving Access to Bank Information for Tax Purposes* 14-15.

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

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

***Effective Exchange of Information***

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

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

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

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

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

***Countering Harmful Tax Practices***

Since 1998 when it was published, the OECD report on harmful tax practices was followed by four progress reports. The first report was issued in June 2000. This report outlined the progress made in curbing harmful tax practices and identified 47 potentially harmful regimes within the OECD and 35 jurisdictions that were found to have met the technical tax haven criteria. The second report[128] was released in 2001 and made modifications to the tax haven aspect of the 1998 report.[129] The third and fourth reports released in 2004 and 2006 respectively both focused on member country preferential regimes.[130]

## 6.4 CONCLUSION

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

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

[128] OECD *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (2001) 8-12 http://www.oecd.org/dataoecd/60/28/2664438.pdf accessed on 09 November 2009.
[129] The second report provided that " for purposes of determining which jurisdictions would be considered as uncooperative tax havens, commitments would be sought only with respect to the principles of effective exchange of information and transparency" (OECD *OECD's Current Tax Agenda* 66).
[130] OECD *OECD's Current Tax Agenda* 66.

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

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

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

[131] Salinas "The OECD Tax Competition Initiative: A Critique of its Merits on the Global Market Place" (2003) 25 *Houston Journal of International Law* 550; Avi-Yonah "Tax Competition, Tax Arbitrage and the International Tax Regime" (2007) *Bulletin for International Taxation* 138-138. See also Oguttu 53.
[132] Gumbel "The Storm over Tax Havens: Corporate Scandals have Boosted the Pressure on Offshore Havens to Open their Books: Some have done so – But Global Crackdown has a Long Way to Go" (2004) 16 *Time Magazine* 23.

*CHAPTER 7*

# THE NETHERLANDS

## 7.1 INTRODUCTION

The Netherlands is ranked 26 out of 181 economies in terms of ease of doing business.[1] The Dutch economy has changed significantly in the last 20 years mainly due to its perspectives on international business and open market policies.[2] The Netherlands has been very successful in attracting international business, mainly in the form of IHCs from all over the world, including within the European Union. This is largely due to the tax regime it applies to IHCs, which contains tax instruments that ease the tax burden for IHCs.[3] IHCs located in the Netherlands hold investments in operating companies in the Netherlands, within the European Union and all over the world.

These attributes make the Netherlands an ideal country to study in order to determine how the South African tax regime could be designed in order to provide a suitable tax environment for the location of IHCs. The ability to route investment from all over the world through the IHCs located in a country is the attribute that the South African government seeks to achieve by making South Africa a financial centre for Africa.

[1] See World Bank *Doing Business 2009 – Country Profile for Netherlands* http://www.doingbusiness.org/Documents/CountryProfiles/NLD.pdf accessed on 25 May 2009.
[2] Koninkrijk der Nederlanden *Doing Business in the Netherlands* available at http://www.netherlands-embassy.org/printerfriendly.asp?articleref=AR00002251EN accessed on 25 May 2009.
[3] See ABAB Accountants, Tax Consultants and Lawyers Doing Business in the Netherlands available at http://www.abab.nl/downloads/DOINGBUSINESSEN.pdf accessed on 25 May 2009.

## 7.2 BACKGROUND

The Netherlands is situated west of Germany and north of Belgium along the North Sea coast. It has a total area of 41 526km$^2$ and a population estimated (in 2008) at 16.6 million. This makes the Netherlands the most densely populated country in Europe.[4]

The Netherlands is one of the most stable European countries. It is a full member of the European Union (commonly referred to as the EU) and one of the original co-founders of the former European Economic Community (the EU's predecessor). The official language is Dutch but English, German and French are widely spoken in the business community.[5] The monetary unit of the Netherlands is the Euro.[6] The Netherlands political system is a parliamentary system with a constitutional monarchy.

The Netherlands is a country within the Kingdom of the Netherlands, which further consists of the Netherlands Antilles (the Dutch Caribbean Islands of Bonaire, Curaçao, Saba, St. Martin and St. Eustatius, with the exception of Aruba) and Aruba (which is geographically part of the Netherlands Antilles, but has a special legal status within the Kingdom).[7] Each of the parts of the Kingdom has its own tax legislation.[8] This chapter addresses the tax legislation of the Netherlands as a country within the Kingdom.

For centuries, the Netherlands has encouraged an entrepreneurial spirit, an international perspective to business and open market policies. These historical factors, along with the country's secure political and economic climate, make it a near perfect environment for

[4] *Tax Planning Through The Netherlands* http://www.icsl.com/pages/jurisdic/nether.html accessed on 02 June 2009.
[5] See *Tax Planning Through The Netherlands, supra.*
[6] Prior to 1999 the monetary unit was the Dutch Guilder (or Florin), which was divisible into 100 cents. The Guilder was freely convertible and was one of Europe's strongest and most stable currencies.
[7] Lambooij and Portengen *Netherlands – Holding Companies* (2008) par 1.1 http://online2.ibfd.org/collections/hold/html/hold_nl.html accessed on 19 August 2008.
[8] "The relationship between the three parts of the Kingdom (the Netherlands (European territory), the Netherlands Antilles (with the exception of Aruba) is regulated by the Tax Arrangement of the Kingdom of the Netherlands, which has the same function as a bilateral tax treaty. Currently, there are far-reaching discussions with the parts that together form the Netherlands Antilles on their future. It is likely that Bonaire, Saba, St Martin and St Eustatius will become part of the Netherlands in the form of a municipality or a special type of entity in the course of the coming years. It is at present unclear what the consequences will be for the applicable tax legislation." Lambooij and Portengen par 1.1.

international tax planning for investors from all over the world. This environment is further enhanced by the Netherlands's network of double tax agreements with virtually every significant financial territory in the world, as well as the benefits that can be gained from basing intermediary holding companies in the Netherlands and within the Netherlands Antilles.[9] The Netherlands has one of the largest tax treaty networks in the world. This makes the Netherlands attractive for tax planning by companies from all over the world.[10]

Historically, the Netherlands played a key role in international tax planning.[11] Currently it is still a major player in international corporate structuring. It offers a wide range of facilities that allow both non-resident corporate and individual clients a broad range of tax advantages.[12]

> For decades The Netherlands have been the pilot country in facilitating tax driven structures as a result whereof many foreign enterprises hold their investments abroad through Dutch 'tax planning' companies. Not only are there several supporting technical arguments to do so, like the beneficial and flexible tax and legal regime, but it also has to do with emotions. Simply stated, the Netherlands are stable and reliable and therefore a safe place to do business and apart from that, it is a country worth visiting.[13]

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[9] http://www.dboffshore.com/offshore/html/location/netherlands.shtml accessed on 08 June 2008.

[10] http://www.anglo-legal.com/index.php?id=86 accessed on 08 June 2008. See also Kriek and Drijer "Cypriot Companies go Dutch for Tax Planning" (2007) *International Tax Review* http://proquest.umi.com/pqdweb?did=1379442051&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 17 October 2009.

[11] Boon R "The Holding Regime in the Netherlands" (1992) *The International Tax Journal* (Vol. 18 Issue 4) 48-73; Bayliff and Teves "Using the Netherlands as an Operational Base" (1985) *International Financial Law Review* (Vol. 4) 31-35; Turkenburg "The Netherlands Woos Foreign Investors" (1993) *International Tax Review* 31-32. Boudewijn "Using a Dutch Intermediary Company to Help Manage and Control an Organization's Worldwide Tax Liabilities" (1994) *The International Tax Journal* http://proquest.umi.com/pqdweb?did=7645136&Fmt=2&clientId=27625&RQT=309&VName=PQD accessed on 17 November 2009.Brood "Dutch Credit for Foreign Withholding (1995) *International Tax Review* (Vol. 6) 20-22; De Jong "The Netherlands" (1995) *International Tax Review* 30-38; Jenner and De Koning "Dutch Law Offers Mixed Blessings(1996) *International Tax Review* (Vol. 7) 21-24; Van der Donk "Dutch Boost for Multinationals" (1996) *International Tax Review* (Vol. 7) 31-33;

[12] See Van der Laan and Papen "About Netherlands Finance Centres and More" (1996) *International Tax Review* 210.

[13] http://www.taxci.nl/read/using_netherlands_tax_planning, accessed on 08 June 2008.

According to the Royal Dutch Embassy in Washington DC, United States "the Netherlands has an abundance of sales agents, importers and distributors experienced in international trade. People are internationally oriented and largely multilingual, moreover education level is high. In addition, the cultural climate is convenient, innovativeness is stimulated and people are open-minded."[14]

## 7.3 THE DUTCH CORPORATE TAX SYSTEM

### 7.3.1 General

The Netherlands tax system is based on a number of laws some of which date back many years.[15] In the Netherlands, corporate income tax is levied on both resident and non-resident companies. Resident companies are taxable on their worldwide income and non-resident companies, primarily branch offices of foreign companies doing business in the Netherlands, are taxable only on income derived from a source within the Netherlands. Resident companies are companies incorporated under the Dutch Civil Law[16] and foreign incorporated companies that are effectively managed in the Netherlands.[17]

### 7.3.2 Corporate Income Tax

Dutch companies are subject to a corporate income tax at the rate of 26.9% (20% on the first EUR 41 000) for the 2008 tax year.[18] The standard tax year is the calendar year. However, a company is allowed to use its financial year as its tax year. As opposed to common practice, the Netherlands is one of the few countries where, in calculating taxable income, no distinction is made between ordinary income and capital gains.

[14] See Koninkrijk der Nederlanden *Doing Business in the Netherlands* available at http://www.netherlands-embassy.org/printerfriendly.asp?articleref=AR00002251EN accessed on 25 May 2009.
[15] Spenke and Lier *Taxation in the Netherlands* (1992) 1.
[16] Resident companies include subsidiaries of foreign companies and European companies (*Societas Europaea* or SEs) established in the Netherlands even if their management and statutory seats are located abroad.
[17] See Ernst & Young, *Worldwide Corporate Tax Guide* (2006) 635.
[18] The standard corporate tax rates have been systematically reduced over the years. For 2006 the standard corporate tax rate was 29.6% (with 25.5% applying to the first EUR 22 689) and for 2007 it was reduced to 27.4% (with 20% applying to the first EUR 41 000); see Ernst & Young 635.

Taxable profits are calculated in Euro, although a corporation can elect to determine its taxable profits in its functional currency. [19]

Non-resident corporates and individuals are subject to corporate or individual income tax, respectively, at the normal rates applicable to Dutch residents. This liability arises if the shareholder has a substantial interest in the Netherlands holding company and such interest cannot be allocated to the assets of the enterprise.[20]

### 7.3.3 Capital Gains Tax

As indicated above,[21] in the Netherlands no distinction is made between capital gains and other income. Capital gains, like other income, are taxed at the corporate tax rate. In this regard Lambooij and Peelen state that "[c]onsequently, dividends received and capital gains realized on the shares of a Netherlands holding company, as well as interest on loans to such a company, [are] subject to the Netherlands individual and corporate income tax at the normal rates."[22]

### 7.3.4 Dividend Tax

The standard dividend tax rate in the Netherlands is 25%. Where the participation exemption applies, dividends paid by resident companies to other resident companies are usually tax-free.[23]

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[19] Lambooij and Peelen "The Netherlands Holding Company – Past and Present" *Bulletin for International Taxation* (2006) 4.1. According to the Dutch system profits are determined on the principles of sound business practice and in a consistent manner. See also http://www.minfin.nl/en/subjects,taxation/corporate-income-tax/Tax-base-and-tax-rates.html accessed on 20 August 2008.

[20] See Lambooij and Peelen *Bulletin for International Taxation* 7. A shareholder has substantial interest if he or she directly or indirectly owns at least 5% of the shares, a specific class of shares or rights over shares.

[21] See par 7.3.2.

[22] Lambooij and Peelen *Bulletin for International Taxation* 7.

[23] See Müller *The Netherlands in International Tax Planning* (2005) 10. See the discussion on participation exemption in par 7.5.1.

### 7.3.5 Controlled Foreign Company Provisions

The Netherlands does not have controlled foreign company legislation. Instead it has limited measures to prevent residents from accumulating passive income in non-resident entities.[24] The participation exemption provides relief from this anti-avoidance measure. In this regard Sandler[25] states as follows:

> A corporate taxpayer that holds an interest of at least 25 per cent in a non-resident company or other entity whose assets are more than 90 per cent portfolio investment must value the interest at its fair market value. Any increase or decrease in the value of the interest is included annually in the taxpayer's income unless the participation exemption applies. A special flat rate of 15 per cent applies to the first revaluation gain that results from the application of these rules.

The application of these provisions is limited in its nature. Furthermore, the participation exemption plays a major role in ensuring that IHC investors are generally excluded from the application of these anti-avoidance measures.

### 7.3.6 Transfer Pricing

The Dutch tax law applies transfer pricing provisions for transactions between connected persons. Article 8b(1) of the Dutch *Wet op de Vennootschapsbelasting*[26] provides that -

> *Indien een lichaam, onmiddellijk of middellijk, deelneemt aan de leiding van of het toezicht op, dan wel in het kapitaal van een ander lichaam en tussen deze lichamen ter zake van hun onderlinge rechtsverhoudingen voorwaarden worden overeengekomen of opgelegd (verrekenprijzen) die afwijken van voorwaarden die in het economische verkeer door*

[24] See article 29a of the Individual Income Tax Act 1964 (IB 1964)
[25] Sandler *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries* (1998) 48.
[26] *Wet op de Vennootschapsbelasting* 1969.

*onafhankelijke partijen zouden zijn overeengekomen, wordt de winst van die lichamen bepaald alsof die laatstbedoelde voorwaarden zouden zijn overeengekomen.*[27]

The transactions between connected persons should be documented. Such documentation should include the nature of the relationship between the entities, the description of the terms of the transactions involved and a thorough analysis of the comparability factors.[28] The documentation should also establish how the prices were determined and provide a basis for determining whether the terms of the transactions would have been adopted if the parties were not connected.[29] If such information is not available, the taxpayer bears the burden of proof that the prices are at arm's length and failure to discharge this burden of proof could expose the taxpayer to non-compliance penalty charges.[30] Taxpayers can use the transfer pricing regulations[31] for guidance as to the allowable pricing. These regulations are based on the Organisation for Economic Co-operation and Development (hereinafter referred to as "the OECD") transfer pricing guidelines and merely provide

[27] This provision is translated into English in *Netherlands Transfer Pricing Country Profile* http://www.oecd.org/dataoecd/19/58/38415233.pdf accessed on 06 February 2009 as follows: "[w]here an entity participates, directly or indirectly, in the management, control or capital of another entity, and conditions are made or imposed between these entities in their commercial and financial relations (transfer prices) which differ from conditions which would be made between independent parties, the profit of these entities will be determined as if the last mentioned conditions were made."

[28] See Doets and Van Dam "Transfer Pricing in the Netherlands – The 'Rules of the Road'" (2006) *Bulletin for International Taxation* 345-346.

[29] Article 8b(3) of the *Wet op de Vennootschapsbelasting* provides as follows: "*De in het eerste en tweede lid bedoelde lichamen nemen in hun administratie gegevens op waaruit blijkt op welke wijze de in dat lid bedoelde verrekenprijzen tot stand zijn gekomen en waaruit kan worden opgemaakt of er met bettrekking tot de totstandgekomen verrekenprijzen sprake is van voorwaarden die in het economische verkeer door onafhankelijke partijen zouden zijn overeengekomen.*" The Netherlands Transfer Pricing Country Profile translates it as follows: "The entities referred to in paragraphs 1 and 2 should include in their records information that shows in which way the transfer prices referred to in paragraph 1 were established, and from which can be determined whether – with respect to these transfer prices – conditions were made to which third parties would have agreed."

[30] Spoelder and Bosch "Transfer Pricing Developments in the Netherlands" (2004) *Bulletin for International Fiscal Documentation* 159-160.

[31] *Besluit verrekenprijzen* IFZ 2001/295

the Dutch version thereof.[32] The OECD transfer pricing guidelines are discussed in Chapter 6.[33]

### 7.3.7 Thin Capitalisation

Thin capitalisation rules were introduced in the Netherlands in 2004 and apply to any financial years starting on or after 1 January 2004. Under these rules interest expenses with respect to connected party loans may be disallowed if the taxpayer is part of a group of companies. The interest will be disallowed if the debt exceeds three times the equity of the debtor company. Thus, the regime has a maximum debt-to-equity ratio of 3:1. However, the excess debt is considered excessive if it exceeds EUR 500 000. The regime considers debt to be the difference between the taxpayer's outstanding loan liabilities and its outstanding loan receivables.[34] The interest that is not deductible "must be due to a related party and is calculated as a pro rated part of the total net interest payments of the taxpayer".[35]

### 7.3.8 Foreign Tax Credit

The Dutch resident taxpayers receive a credit against corporate income tax for dividends, interest and royalties from sources outside the Netherlands that are included in their taxable income. The credit applies if the dividends, interest and royalties have been subject to income tax in the source state. Furthermore, the credit is only available if the taxpayer is deemed to be the beneficial owner of the dividend, interest or royalties. The amount of the credit is the lower of the amount of tax levied by the source country and

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[32] See Oosterhoff "Transfer Pricing Landscape: Legislation and Guidance" in *The New Netherlands Transfer Pricing Regime* (ed Betten) (2002) 3–4. See also Ernst & Young *Worldwide Corporate Tax Guide* (2006) 647–648.
[33] See par 6.3.1.2. For a further discussion on the Dutch transfer pricing system see Van Dam "Transfer Pricing Rules and Practice in the Netherlands – An Overview" 2006 *Tax Management International Journal* 443–458; Kamphius, Gillis and Diakonova "Group Financial Services Companies: Tax and Transfer Pricing Policy" in *The New Netherlands Transfer Pricing Regime* (ed Betten) (2002) 29–58.
[34] See Müller 86; Ernst & Young 646.
[35] Müller 86.

the amount of tax which would have been due under the Dutch tax law had the credit not been applicable.[36]

### 7.2.9 Exchange Control

The Netherlands law does not contain exchange control provisions. Therefore there are no restrictions imposed on the movement of funds into and out of the Netherlands.[37]

## 7.4 THE DUTCH HOLDING COMPANY

### 7.4.1 Defining a Holding Company

The Dutch civil, corporate and tax laws do not contain the concept of a holding company as such. Thus there are no provisions in these legal instruments that specifically provide for Dutch holding companies.[38] Accordingly, a holding company is subject to normal company law.[39]

Dutch corporate law comprises a closed system of legal entities. In terms of this system, no new types of legal entities can be created by the will of the parties.[40] The legal entities provided for in the Dutch Civil Code are the association, co-operative, mutual insurance society, limited liability company, public company and the foundation. A limited liability company is a closed company with limited liability referred to in Dutch as *Besloten Vennootschap met beperkte aansprakelijkheid* and abbreviated as "BV".[41]

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[36] Müller 155.
[37] Ernst & Young 646.
[38] Lambooij and Portengen par 1.1.1.1.
[39] See Book 2 of the Dutch Civil Code.
[40] Lambooij and Portengen par 1.1.1.1.
[41] See http://www.tax-consultants-international.com/read/How_to_incorporate_a_BV, where it is further stated that "[i]n comparison to other jurisdictions the BV can be seen as the equivalent of the German 'GmbH', the American 'LLC', or the English 'Ltd'. The BV has legal personality and it has an equity divided into shares. A BV can only have registered shares, and shares are always not freely transferable. The shareholders of a BV are in general not personally liable for acts performed in the name or on behalf of the B.V., nor can they be compelled to make more funds available than that part of the capital for which they have subscribed."

For tax purposes, a Dutch holding company is an ordinary company. A European company with its seat in the Netherlands can also be used as a Dutch holding company.[42] As with any other company, the Dutch holding company is subject to the normal tax system and files the same tax returns as any other corporate taxpayer.[43]

In practice the legal form of the co-operative (*coöperatie*, abbreviated as coop) is also used in specific situations. Commonly the co-operative is chosen as an IHC or for personal holding companies. The main reason for the prevalence of co-operatives being used as IHCs is that, as a matter of law, distributions of a co-operative are not subject to any Dutch dividend withholding tax. It is essential that a co-operative is indeed factually and formally treated as a true co-operative for tax purposes, and cannot be considered, *de facto*, to have its capital divided into shares. If the capital is so divided, the distributions of the co-operative will be subject to the dividend withholding tax.[44]

In specific tax-planning situations, the limited partnership (*Commanditaire Vennootschap*), abbreviated as "CV" (or internationally as "Dutch CV") is sometimes used to fulfil the role of a holding company. A CV which fulfils certain criteria as to the transferability of partnership interests is subject to corporate income tax.[45] This form is only used in specific tax-planning situations and is therefore not as widely used as a BV.[46]

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[42] Lambooij and Portengen par 1.1.1.1. Incorporating a holding company in the form of a European company with a seat in the Netherlands is not a commonly used structure.
[43] Lambooij and Peelen *Bulletin for International Taxation* par 4.1. See also *Netherland Holding Company Overview* http://www.ocra.com/solutions/eu_holding/Netherlands.asp accessed on 06 July 2008.
[44] *The Dutch co-operative in international tax planning* http://www2.asiaoffshore.org/html/articles01/JimmievanderZawwn_2008-05_id7592.pdf accessed on 06 July 2008. See also Lambooij and Portengen par 1.1.3.
[45] A limited partnership or CV which fulfils the criteria as to the transferability of partnership interests is generally referred to for corporate income tax purposes as an "open CV".
[46] Lambooij and Portengen par 1.1.3.

Generally, holding companies are incorporated as BVs. The BV is regulated by Dutch corporate law, which in comparison to the corporate laws of other countries is quite flexible. The specific relevant attributes of a holding company are as follows:[47]

- Dividends can be paid at the end of the year or, if the proper provisions are included in the articles of incorporation of the BV, during the year as an interim dividend. The general limitation for paying a dividend is that the company has sufficient "free reserves".
- Equity can be contributed to the company as a payment on shares or as a share premium without the issuance of shares or as a combination of these two. The contribution of share premium and the repayment of share premium can be achieved through a shareholders' decision which allows an easy and quick transit of funds.
- There are no special limitations for foreign shareholders or directors.

The provisions in the Dutch Civil Code regarding the BV are currently being reviewed.[48] The objective of the review is to create a more flexible legal form. A preliminary text of a legislative proposal was published by the Dutch Ministry of Justice for consultation in three separate sections in 2005 and 2006. These have led to a number of reactions from various experts on corporate law.

The legislative amendments relate to the structuring of the BV from a company law perspective and not the tax status of the BV. As a result, the changes are not expected to affect the tax treatment of the BV and therefore would not affect the context in which the BV is used as a holding company for tax purposes. Due to their specific functions and the rarity of their use, the tax implications where the co-operative and the CV are used as holding companies will not be further discussed here, unless if absolutely necessary or relevant.

[47] *The Dutch Holding Company* www.atrium-incorporators.com/Dutch%20Holding%20Companies.htm accessed on 31 July 2008.
[48] See Fernández and Olffen *Regulation and application of LLP and LLC* (2007) 1–3 available on http://www.wodc.nl/images/1423_summary_tcm44-81289.pdf. accessed on 8 June 2009.

### 7.4.2 Various Uses of the Dutch Holding Company

The Dutch holding company can be used for holding reasons both within the Netherlands and outside the Netherlands, including outside the Kingdom of the Netherlands and the European Union. Both for local and international purposes, the Dutch holding company can be used for various purposes.

In international tax structuring the Dutch holding company is commonly used for the following purposes:

- It is more popularly used as an IHC, acting as the head of a regional or functional group or subgroup of subsidiaries. This function is usually coupled with the function of reducing the overall dividend withholding tax costs or converting capital gains into dividends for parent companies;[49]

- Where the group intends to list on a stock exchange, the Dutch holding company is often used as a top holding company the shares of which are or will be traded on a stock or securities exchange. Listing on an exchange has several advantages. The main advantages are: firstly, it is often cheaper to raise equity capital rather than to rely on debt finance to fund the expansion of a company's business, and a listed company is more able to raise such equity capital. Secondly, a listing better enables the company to obtain other forms of finance, such as bank loans. A listing enhances the status of the company. Prospective providers of finance may take some comfort from the fact that its financial information and actions will be subject to the rules and regulations of the stock exchange and public scrutiny. Thirdly, a listing enables a company to use its shares to fund acquisitions, as sellers are more likely to accept listed shares as consideration.[50]

[49] http://www.freemontgroup.com/eng/jurisdicties/cyprus.php accessed on 10 November 2008.
[50] See http://www.jse.co.za/docs/listings/guidelines.pdf accessed on 1 June 2008.

- A Dutch holding company is also used when two or more investors from different countries wish to set up a joint-venture company. This is due to the combination of the flexible corporate law system of the Netherlands and the tax regime applicable to the Dutch holding company.

- A Dutch holding company is also commonly used as an acquisition vehicle for acquisitions on the Netherlands domestic market. This is because the Dutch holding company can set off interest expenses against the tax base of the target company by forming a fiscal unity or by merging with the target entity.[51]

- In addition to holding shares in operating subsidiaries, the functions of the Dutch holding company are often combined with management and control functions over the subgroup that it heads.[52] As Lambooij and Peelen state, "[t]he combination with a group financing function (both group financing and treasury functions) is also feasible. This function can be carried out within the holding company or in a separate finance subsidiary."[53] The holding company could also perform other functions such as group audit, group consolidation, business development and information technology services.[54]

## 7.5 TAX ASPECTS THAT MAKE THE NETHERLANDS POPULAR

From a tax perspective the Netherlands is a very popular jurisdiction for multinational structures. Mainly this is due to the structure of three tax instruments, i.e. the

[51] Lambooij and Peelen *Bulletin for International Taxation* par 2.2. "Both scenarios are subject to several limitations. If the acquiring group already has a company with a Netherlands taxable base, this company can be used as an acquisition vehicle, and it can set off, within the thin capitalization limitations, financing expenses against the Netherlands taxable base. Specific loss carry-over restrictions may apply in these cases" Lambooij and Peelen at 2.2 footnote no 8.
[52] Lambooij and Peelen *Bulletin for International Taxation* par 2.3.1. Transfer pricing rules apply in relation to the pricing of these services.
[53] Lambooij and Peelen *Bulletin for International Taxation* par 2.3.2.
[54] Lambooij and Peelen *Bulletin for International Taxation* par 2.3.3.

participation exemption, the double taxation agreement network and the advance tax rulings system.[55]

Dating back from the provisions of the Business Tax Act of 1893, the Dutch participation regime exempts dividend payments and capital gains payments by subsidiary companies to holding companies from the Dutch corporate income tax in the hands of the holding company.[56] The rationale for this exemption is that profits should not be taxed twice in the corporate tax sphere and that a group of companies should be treated as one whole.[57]

The Netherlands has, and has for a long time had, an extensive network of DTAs which provide for a zero withholding tax for dividends, interest and royalties. By preventing double taxation these treaties stimulate trade and investment between the Netherlands and its treaty partners. The first treaty was signed in 1933 with Belgium. Currently, the Netherlands has treaties with more than 80 countries.[58]

The Dutch system of advance tax rulings is a system in terms of which the taxpayer can provide the tax authorities with a planned structure prior to implementation. The taxpayer would also provide the tax authorities with the tax implications of such structure as the taxpayer understands it. If the tax authorities agree with the application of the tax code to the structure, an agreement is reached to the effect that the tax authorities would impose the tax as per the agreement. Thus, advance tax rulings are agreements with tax authorities on how much will be taxed, given the specific method of calculation. They provide upfront certainty regarding the tax consequences of planned transactions.[59]

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[55] See Van der Voort "Tax Planner's Guide to Holding Companies" (1998) *International Tax Review* http://proquest.umi.com/pqdweb?did=35146916&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 14 November 2009.

[56] Spenke and Lier 79.

[57] Van Dijk, Weyzig and Murphy *The Netherlands: A Tax Haven?* http://somo.nl/html/paginas/pdf/netherlands_tax_haven_2006_NL.pdf accessed on 15 July 2008.

[58] See Van Dijk, Weyzig and Murphy par 4.2.3.

[59] See Van Dijk, Weyzig and Murphy par 4.2.3; see also Ernst & Young 636.

In addition to the advance tax ruling system and as an alternative to the usage of the tax treaties and the participation exemption, tax residents of the Netherlands have the added facility of the European Union Parent-Subsidiary Directive.[60] This specifically deals with the tax treatment of distributions by a subsidiary to its parent or holding company located in another EU member state. It aims to promote the creation of an internal market for dividend flows between group companies incorporated within the member states of the EU.

In terms of the Parent-Subsidiary Directive the member state in which a holding company is established must refrain from taxing profitable distributions the parent company receives. As an alternative such member state must grant relief for the tax the subsidiary's member state levies on the profit from which the dividend was distributed. On the other hand, the subsidiary's member state must exempt profits distributed by the subsidiary from withholding taxes.[61]

### 7.5.1 The Participation Exemption

#### *7.5.1.1 The Nature of the Participation Exemption*

The participation exemption is one of the main features which make the Netherlands tax regime attractive as a means of avoiding taxation.[62] Participation exemption is defined as synonymous with "affiliation privilege" which is in turn defined as "tax relief accorded to a company in respect of distributions it receives from, or (in some cases) capital gains it realizes on certain shareholdings on another company, typically where the shareholding exceeds a certain minimum percentage or acquisition cost. A minimum holding period

[60] European Union Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.
[61] See KPMG Parent-Subsidiary Directive available at http://www.meijburg.com/advisory_services/european_union/directives_on_direct/the_directives/parents_and accessed on 10 June 2009.
[62] See Van Dijk, Weyzig and Murphy par 4.2.1.

may also be required."[63] As its name indicates, this affiliation privilege takes the form of an exemption.[64]

The justification for a participation exemption is to eliminate double taxation of income when transferred to shareholders. In an accounting period, a company may pay corporate income tax on its taxable profit which reduces the amount of post-tax profit available for a dividend distribution to shareholders. In the absence of a participation exemption, or other form of tax relief, shareholders may be taxed on the amount of dividend income received. This results in double taxation of the same income if the dividend is paid out of profits previously taxed in the hands of the company.[65]

A participation exemption typically provides that certain types of dividends on income taxed in the hands of the company are not taxable in the hands of shareholders. In addition, many participation exemption regimes provide that capital gains on shares are not taxable to the extent that the share capital portion to which the gain relates has been held for a specified period. A participation exemption may apply to qualifying shareholdings in both foreign companies and domestic companies.[66]

#### *7.5.1.2 Application of the Dutch Participation Exemption*

The Dutch participation exemption was introduced with respect to dividends as early as 1893. This makes it one of the oldest participation exemption regimes. Due to its long existence, there are substantial sources and precedents in the form of case law, administrative decisions, rulings and literature. These sources make it such that most technical concerns and questions arising from specific situations can be answered with a reasonable degree of certainty.[67]

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[63] *IBFD International Tax Glossary* definition of "participation exemption". See also Arnold and McIntyre *International Tax Primer* (2002) 35.
[64] Internationally, the affiliation relief does not only take the form of an exemption. In certain cases the relief can also take the form of a deduction and, theoretically, a credit.
[65] Spenke and Lier 80.
[66] See Arnold and McIntyre 35.
[67] Lambooij and Peelen *Bulletin for International Taxation* par 1. Bakker "Netherlands: Changes to Dutch Participation Exemption are postponed" (December 2000/January 2001) *International Tax Review*

The Dutch participation exemption is laid out in Article 13 of the Corporate Income Tax Act of 1969 (*Wet op de vennootschapsbelasting* 1969). Lambooij and Portengen[68] state the following:

> Under the participation exemption, qualifying elements of the profit are excluded from the taxable profit. Under this system, these elements (in general dividends, capital gains, certain costs and losses, certain currency exchange results) are included in the normal profit calculation and subsequently are excluded from the taxable profit. Therefore, in contrast to jurisdictions such as Belgium and Switzerland where the participation exemption results in a reduction of the tax payable, the Dutch system functions as a full exemption system.

The participation exemption excludes all benefits received from or realised on qualifying participations from the taxable profit of the recipient. The full exemption implies that in computing the taxable profit from the commercial profit, the full amount of the exempt elements is subtracted. The fact that the exempt elements are excluded from the calculation of the taxable profits applies not only to positive elements, but also to negative elements. Thus, profits, as positive elements, and losses and costs, as negative elements, are treated as neutral for tax purposes. The result is that losses and costs attributable to exempt elements are not deductible.[69]

According to the Dutch Ministry of Finance the main features of the participation exemption are as follows: [70]

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http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12634&SID=468288&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 12 November 2009.

[68] Lambooij and Portengen par 1.3.1.

[69] See the European Court of Justice's decision in *Bosal Holding BV v Staatssecretaris van Financiën* Case C – 186/01: referred by Supreme Court of the Netherlands *(Hooge Raad der Nederlanden)* 11 April No 35 729. See also Lambooij and Portengen par 1.3.9; Wattel "Pending Cases Filed by Dutch Courts in Direct Taxation" *Recent ECJ Developments* (ed Lang) (2003) 153.

[70] *Corporate Income Tax, Participation Exemption* http://www.minfin.nl/en/subjects,taxation/corporate-income-tax/Participation-exemption.html accessed on 19 August 2008.

> [a]ll benefits gained from shareholdings are exempt. In principle, the term 'benefits' covers profits and losses. Profits comprise dividends and hidden profit distributions. Exempt returns also cover the profit realised on the sale of a participation. However, losses realised are not deductible. If the value of a participation decreases as a result of losses suffered, its write-down by the parent company is in principle not deductible either. The costs associated with a shareholding are deductible. Losses arising from liquidation of a shareholding may be set off under certain conditions.

In principle if the participation exemption applies, the following elements are excluded from the taxable base: [71]

- All forms of dividends (whether in cash or dividends *in specie*) including constructive or deemed dividends;[72]
- Capital gains;
- Refunds of foreign tax credits and refunds of foreign withholding taxes;
- Losses on subsidiaries;
- Currency exchange results realised on instruments used to cover exchange risks on qualifying participations; and
- Certain types of hybrid loan granted to qualifying subsidiaries, under such conditions that the loan *de facto* has the function of equity.

*a.* *Qualifying participations*

The participation exemption is available to the Dutch holding company if (i) the Dutch holding company owns a minimum of 5% of the share capital of the subsidiary; (ii) the subsidiary has capital that is divided into shares; and (iii) the Dutch holding company

[71] See Lambooij and Portengen par 1.3.9; Bakker *International Tax Review*.

[72] This requirement goes further: it requires that the dividend should result in a benefit for the participation exemption to apply. "Purchased dividends are generally booked off from the cost price of the participation and, therefore, are generally not included in the profit and loss account. Consequently, the participation exemption does not apply, but the purchased dividends are not effectively taxed." Lambooij and Portengen par 1.3.9.

does not hold the shares in the subsidiary as inventory. Additional conditions apply where the subsidiary is not resident in the Netherlands.

(i) Ownership of at least 5%

The participation exemption applies to income derived by a Dutch holding company from an investment in a subsidiary, either resident in the Netherlands or resident elsewhere. It is required that for the participation exemption to apply the Dutch holding company should hold at least 5% of the nominal paid-up share capital of such subsidiary.[73]

The low participation percentage makes the Netherlands a particularly attractive jurisdiction in which to base an IHC, offshore holding company or international holding company. Similar regimes in other countries require much higher percentage shareholdings if the company is to qualify for favourable tax treatment. For example, Belgium[74] and Luxembourg[75] require a holding of at least 10% while Switzerland[76] requires a minimum holding of 20%. Furthermore, most jurisdictions require that the company be a proper holding company in the sense that its sole economic activity should be to hold shares in subsidiaries. In the Netherlands, by contrast, a company which trades but also happens to own shares in another corporate entity can be deemed a holding company for the purposes of the participation exemption rules.[77]

This rule is subject to three exceptions where the Dutch holding company owns less than 5% of the shares of the subsidiary. Firstly, the Dutch holding company should not hold the shares in the company declaring the dividend as a portfolio investment. In determining whether the shares are held as a portfolio investment the criterion is whether the shareholding in the foreign subsidiary has the nature of a portfolio investment from the perspective of the Netherlands holding company. What is relevant in this

[73] Spenke and Lier 80. Bakker *International Tax Review*.
[74] Vanhaute *Belgium in International Tax Planning* (2008) 153.
[75] See http://www.investors.oriflame.com/files/Oriflame_dividend_withholding_tax.pdf accessed on 10 November 2008.
[76] *Taxation in Switzerland* http://www.swissprivacy.com/swiss_taxes.htm accessed on 10 November 2008.
[77] *Netherlands: Dutch Holding Companies* http://www.lowtax.net/lowtax/html/offon/netherlands/nethold.html accessed on 21 August 2008.

determination is the purpose of the shareholding in the enterprise by the Dutch holding company and not the activities of the company declaring the dividend.

> The purpose of the shareholding in the enterprise of the Netherlands holding company (or parties related to it) is relevant, rather than the activities of the subsidiary on a stand-alone basis. Elements that are relevant for determining whether [the shareholding is a portfolio investment or not] are: the size of the shareholding, the control of the shareholder over the subsidiary, the activities of the subsidiary in relation to the activities of the shareholder or related parties (the 'business link' test), the marketability of the shares, and the shareholder's expressed motives for acquiring and owning the shares. As a general test, shares are held as a portfolio investment if the holding of shares in the subsidiary is aimed at obtaining an increase in value and a yield that could be expected in the case of normal, active asset management (i.e. without a specific 'business link' interest).[78]

The second exception applies where the Dutch holding company holds less than 5% of the nominal paid-up share capital and a company related to that holding company owns at least 5% of the shares in the subsidiary. Companies are generally deemed to be related in the case of a direct or indirect interest of one third or more (i.e. generally direct and indirect subsidiaries, parent companies and sister companies are covered).[79]

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[78] Lambooij and Peelen *Bulletin for International Taxation* par 5.2.2.

[79] The related party position is different from a group position. "In general, a group is a parent company with all its subsidiaries, provided that the subsidiary is 'controlled' by the parent company. 'Control' is generally described as the power to govern the financial and operating policies of an enterprise so as to obtain the benefits from its activities. It is presumed to exist when the parent company owns more than half of the voting rights in the subsidiary." Sunderman "Netherlands, Thin Capitalization Rules Introduced" *Bulletin for International Taxation* (2004) 40. Lambooij and Portengen par 1.3.2. state that '[u]nder the participation exemption rules that applied before 1 January 2007, a taxpayer with an interest below 5% of the nominal paid-in capital could nevertheless apply for the participation exemption if the participation was in line with the normal exercise of the taxpayer's enterprise, or if the acquisition of the participation served a public interest. The possibility for smaller holdings to qualify had been generally interpreted in a restrictive way by case law. In more recent case law, however, the Supreme Court had relaxed its restrictive position. In this respect, the Supreme Court decided that as long as the shareholding was not held as portfolio investment (i.e. for passive investment purposes) the participation would apply." Sunderman *Bulletin for International Taxation* par 1.3.2. See SC 14 March 2001, 95/9695, BNB 2001/210; SC 5

Thirdly, the participation exemption would apply if the Dutch holding company does not hold the shares in the subsidiary as trading stock or inventory (i.e. the holding company does not hold the shares for sale in the ordinary course of business). This requirement does not exclude the application of the participation exemption by companies that trade in shares. The exemption is available for these share traders on shares that they hold as an investment and not as trading stock.

Contrary to the position in other countries, the minimum shareholding in a subsidiary is not linked to a minimum holding period.[80] Thus, if at the time that the investment is realised the holding company holds the required percentage, the participation exemption would apply. This makes it possible for the shareholding to be increased to coexist with the realisation of the investment, after which the shareholding could be reduced to below 5% depending on the business requirements. The minimum holding period applies in the special cases where the holding company holds less than 5% and the participation exemption applies.

The participation exemption only applies to companies which are subject to normal corporate income tax. Companies that benefit from a special tax regime cannot access the participation exemption.[81]

(ii) Subsidiary's capital divided into shares

For the participation exemption to apply, it is required that the subsidiary should have capital that is divided into shares. This requirement exhibits a strong linkage with the 5% holding requirement. As a general rule, all corporate taxpayers in the Netherlands have capital that is divided into shares. The common forms of corporations such as the BV and NV have capital divided into shares.[82]

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November 1997, VN 1997/4393 and 5 November 1997, VN 1997/4399. Participations that qualified under the pre-2007 rule prior to 31 December 2006 are deemed to meet the 5% shareholding threshold until 1 January 2010. See Lambooij and Portengen par 1.3.2. Bakker *International Tax Review*.

[80] The minimum holding period in Luxembourg and Belgium is one year.

[81] Lambooij and Peelen *Bulletin for International Taxation* par 5.2.1. Bakker *International Tax Review*.

[82] See http://www.ftc.nl/holland/ftctrust-legalas.html accessed on 22 January 2009.

Different rules apply to specific forms that are not as common as the BV and the NV. For example, as Janssen[83] states, a cooperative association

> may only be considered to have a capital divided into shares if the membership is based on a participation in the equity of the cooperative association; which is the case if the cooperative association issues shares, certificates of ownership or similar instruments that are separate and distinct from the membership interests, or where the membership interests, either with or without the shares, certificates of ownership or similar instruments, can be transferred without the prior consent of all other members.

(iii) Shares not held as trading stock

The participation exemption will apply if the Dutch holding company does not hold the shares in the subsidiary as trading stock. Shares are held as trading stock or inventory if the following conditions are met: [84]

1. The holding company holds the shares with the intention to sell those shares and the shares constitute part of the holding company's floating assets;
2. The subsidiary in which the holding company holds the shares is not, or is no longer engaged in active trade or business; and
3. The subsidiary has no assets or virtually no assets other than cash or assets that, immediately and without any significant loss, can be converted into cash.

[83] See Janssen "Repurchase transactions in the Netherlands" *International Financial Law Review* (2008) http://www.iflr.com/includes/supplements/PRINT.asp?SID=515115&ISS=16382&PUBID=213 accessed on 16 August 2008.
[84] Lambooij and Peelen *Bulletin for International Taxation* par 5.2.1.

(iv) Additional requirements for foreign subsidiaries

As mentioned earlier, the participation exemption is available for holding companies income from investments in both resident and non-resident subsidiaries. The above requirements apply where the subsidiary is resident in the Netherlands. Where the subsidiary is a foreign company the following two additional requirements should be met for the exemption to apply: [85]

1. The subsidiary must be subject to tax on its profits levied in the subsidiary's residence country. This "subject to tax" requirement does not imply that there must be a tax payable. Furthermore, there is no requirement as to the level of such tax, e.g. that it should be reasonably similar to the Dutch corporate income tax.
2. The Dutch holding company must not hold the shares in the subsidiary as a portfolio investment.

### 7.5.2 Advance Tax Rulings

An advance tax ruling (hereinafter referred to as "an ATR") is a procedure in terms of which a taxpayer may obtain confirmation of the related tax consequences from the tax authorities in advance of entering into a transaction.[86] The Dutch Ministry of Finance considers an ATR to be an agreement on the tax characterisation of international corporate structures, such as advance certainty on the application of the participation exemption.[87] The ATRs are mere interpretations of the Dutch law. They do not offer any privileges or concessions to taxpayers.[88] Their purpose is to take away the uncertainty in tax areas where uncertainty exists, such as where there is little or no case law, in new

[85] Lambooij and Peelen *Bulletin for International Taxation* par 5.2.2.
[86] See the *IBFD International Tax Glossary* definition of "advance ruling." "In some countries an advance ruling will bind the tax authorities if the taxpayer uses the ruling. In other countries an advance such rulings cannot be obtained for hypothetical cases.
[87] Kröner and Van Doorne "Legal Aspects of Tax Rulings in the Netherlands" in *International Tax Planning* (ed Campbell) (1995) 149. Jansen "Netherlands: New APA and ATR Policy, and Transfer Pricing Guidelines" (2001) *International Tax Review* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12630&SID=468493&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 12 November 2009.
[88] Van Herksen "New and Improved: Advance Pricing Agreements" in *The New Netherlands Transfer Pricing Regime* (ed Betten) (2002) 109–113.

areas and in areas where certain income must be reported within a certain range.[89] Rulings may be issued in respect of matters relating to holding companies, future companies, royalty or intellectual property holding companies, permanent establishments, foreign sales companies and transfer pricing matters.[90]

The tax administration has a dedicated team called the ATR team or Ruling Team specifically dealing with the tax ruling requests. The Ruling Team is located in the Rotterdam branch of the Rijnmond Tax Administration department in the inspectorate for Large Enterprises.[91] The purpose of this centralisation is to avoid each tax inspectorate in the different branches having to expend time and expertise discussing and agreeing on tax subjects with a major financial impact.[92]

> The Ruling Team is under no obligation to actually issue an ATR. They have full liberty to not agree to any tax analysis made by a tax adviser on which he bases his ATR request. The Ruling Team may also decide that although they do not see fault with the tax analysis, to refuse issuing an ATR if they believe that granting one would upset the tax authorities of other countries and might cause drawbacks to the willingness of other countries to enter into tax treaties with the Netherlands or into treaty renegotiations. The Ruling Team may also decide that an ATR request was made 'to test the boundaries of tax law', cases which they do not want to bless with advance certainty to the tax payer.[93]

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89 *Advance Pricing Agreement and Advance Tax Ruling* http://www.minfin.nl/en/subjects,taxation/international-aspects-of-taxation-in-the-netherlands/Advance-Pricing-Agreement-and-Advance-Tax-Ruling.html accessed on 22 August 2008.

90 See Jonker and Loos "Tax Rulings in The Netherlands and The Netherlands Antilles" in *International Tax Planning* (ed Campbell) (1995) 151; Jansen *International Tax Review*.

91 This team works in conjunction with the APA team, which is the Advance Pricing Agreement team. An "Advance Pricing Agreement entails providing advance certainty on the fiscal acceptability of the price (transfer pricing) that the Dutch group company pays to or receives from a foreign group company for receiving or delivering a service or goods." See *Advance Pricing Agreement and Advance Tax Ruling*.

92 See http://www.royaltytax.com/merlyn.asp?p=35 accessed on 08 June 2008.

93 http://www.royaltytax.com/merlyn.asp?p=35 accessed on 8 June 2008. The request for the issue of an ATR is addressed to the competent tax inspector. In order to ensure the co-ordination of the practice, the tax inspector will submit the request to the Ruling Team for a binding advice. Where necessary, the Ruling Team consults with the relevant knowledge groups to secure a uniform policy, both in principle and in practice. Because the Ruling Team is represented in all of the relevant knowledge groups, this form of

The ATR is an agreement with the tax authorities and the particular taxpayer based on the given circumstances. Should the taxpayer proceed with the transaction in question with altered facts, the ruling may not be applied to such transaction. Furthermore, the ruling cannot be applied by a different taxpayer against the tax authorities even if the circumstances are identical.[94] However, the previous ruling would be a persuasive instrument to command a similar tax treatment or a treatment that is suitable for the taxpayer. Correspondingly, the ruling does not form a precedent. However, it may establish an unenforceable but persuasive trend for treating certain specific transactions. A ruling is valid only for a period of no more than four years from the moment on which the activities to which it applies have commenced in the Netherlands.[95]

The ATR system is a very attractive tool for international investors hoping to access the participation exemption through the use of a holding company.[96] Its use is relatively extensive.[97] Be that as it may, there is normally no need to obtain an ATR since sufficient comfort can often be obtained from case law, policy statements and precedents.[98]

### 7.5.3 Treaty Network

The purpose of a tax treaty is the avoidance of double taxation. According to Holmes,[99] "[f]rom their inception the *raison d'être* of DTAs has been the avoidance of double taxation."[100] The solution to the problem of double taxation involves taxing income only

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consultation can take place during the assessment process, thereby helping to ensure that the request is dealt with both swiftly and efficiently. Dutch Policy for Advance Tax Rulings; See http://www.tax-consultants-international.com/read/Dutch_policy_for_advance_tax_r accessed on 11 June 2008.

94 See Jansen *International Tax Review*.

95 Kröner and Van Doorne *International Tax Planning* 153.

96 See Jansen *International Tax Review*. For more on advance tax rulings see Van Dam and Jacobs "Advance Tax Rulings in *The New Netherlands Transfer Pricing Regime* (ed Betten) (2002) 119–130.

97 By way of comparison, Shelton applauds the Dutch advance tax rulings system by stating that "although Denmark has a system of advance rulings, it is not nearly as useful as the Dutch system" (Shelton N "Denmark Squares up for Holding Battle" (December 1998/January 1999) *International Tax Review* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12655&SID=468670&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 13 November 2009).

98 Lambooij and Peelen *Bulletin for International Taxation* par 5.2.2.

99 Holmes *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (2007) 54.

100 Holmes 54. *Raison d'être* is a phrase borrowed from French where it means simply 'reason for being'; in English use it also comes to suggest a degree of rationalisation, as the claimed reason for the existence of

once and that leads to consideration of which country will have the taxing right. The determination of which country will have the taxing right is customarily contained in the DTAs.

The Dutch treaties provide persons to whom the treaties apply with additional treaty benefits in two forms, namely, the high number of treaties and the elimination of certain taxes payable by Dutch residents.

Generally, Dutch DTAs contain articles that award the taxing rights on dividends, interest and royalties to the Netherlands or to the other contracting state. The Dutch treaties often result in dividend withholding tax on dividends paid to the Netherlands holding company being reduced to zero. This is a special feature of the Dutch tax treaties emanating from the Dutch government's policy on tax treaties. In most countries' treaties the dividend withholding tax is usually set at a rate between 5% and 15%.[101] The Dutch treaties also reduce the tax rates for dividends paid by a Dutch holding company to its parent from 25% to a maximum of 15%.

Treaties also eliminate the withholding tax on interest and limit withholding tax on royalties to a maximum of 15% on interest and royalties paid to the Netherlands. On the other hand, in terms of the Dutch domestic law withholding tax from the Netherlands is always zero on interest and royalties, irrespective of the target country. A combination of these attributes establishes the Netherlands as an ideal jurisdiction to host a variety of companies in multinational structures. As Van Dijk, Weyzig and Murphy observe, "[t]his makes it especially attractive for foreign companies to establish a conduit company in The Netherlands to route royalty, licence or patent payments, tax international markets and intermediate in group financing structures."[102]

The Netherlands has concluded treaties with over 80 countries. This is a favourable treaty network for a vast number of investors from all over the world. Quite importantly, the

something or someone; see http://tiscali.co.uk/reference/dictionaries/difficultwords/data/d0010875.html accessed on 19 November 2008.

[101] Van Dijk, Weyzig and Murphy par 4.2.2.

[102] Van Dijk, Weyzig and Murphy par 4.2.2.

Netherlands has concluded treaties with the world's financial strongholds, including, the United States of America, the United Kingdom, China, Germany, Japan and France. Save for France and the United Kingdom (with about 90 and 100 treaties respectively), the Netherlands has more treaties that any of these countries.

### 7.5.4 Parent-Subsidiary Directive

The Parent-Subsidiary Directive ("the directive") is a multilateral agreement between the European Union ("EU") member states contained in the European Union Council Directives.[103] It specifically deals with the tax treatment distributions by a subsidiary to its parent or holding company located in a foreign EU member state. It aims to promote the creation of an internal market for dividend flows between group companies incorporated in the EU. Dividend distributions to non-EU shareholders do not qualify for the parent-subsidiary directive treatment.[104]

Since the directive was adopted in July 1990 it has had the most immediate effect on cross-border business transactions in Europe. It has proven to be of great help to countries with poor treaty networks in the EU, either because they are considered to be tax havens[105] or because of their limited cross-border business relations.[106] Without a tax treaty, investors in these countries had to rely on the unilateral tax relief provided by their home countries.[107] The directive deals with these issues that were previously exclusively dealt with in bilateral tax treaties.

The directive is based on two basic premises contained in its preamble. Firstly, when the holding company receives a distribution of profits from the subsidiary, the state of the holding company should refrain from taxing such profits or tax such profits while

[103] EU Council Directive (90/435/EEC) of 23 July 1990. See Schonewille "Some Questions on the Parent-Subsidiary Directive and the Merger Directive" (1992) *International Tax Review* 13-20.
[104] Peters "National Report Netherlands" in *WTO and Direct Taxation* (eds Lang, Herdin and Hofbaner) (2005) 506.
[105] An example of a country with few tax treaties because it is considered to be tax haven is Cyprus.
[106] Bulgaria and Estonia are examples of limited cross-border relations countries.
[107] Thömmes and Nakhai *Introduction to the Parent-Subsidiary Directive*, http://online2.ibfd.org/data/ectl/cm/CM-CH-06.doc.p0005.html accessed on 29 August 2008.

authorising the holding company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits.[108] Secondly, the profits which a subsidiary distributes to its holding company should be exempt from withholding tax in the hands of the holding company.[109]

The status of a holding company to which the directive applies is attributed to a company resident in a member state which has a minimum holding of 10% in the capital of a company of another state.[110] This minimum holding requirement was reduced from 15% on 1 January 2009. For the directive to apply –

(i) the holding company and the subsidiary must be companies in the nature of NV, BV, or SE, i.e. entities whose capital can be divided into shares;[111]
(ii) the subsidiary should not, under the terms of a bilateral tax treaty concluded with a third state, be resident for tax purposes outside the EU;[112] and
(iii) the holding company and the subsidiary must be subject to corporate income tax.[113]

The directive allows member states to set minimum periods for which shares must be held. However, such period may not exceed two years. Under this provision, the Netherlands prescribed a minimum period of one year. This requirement was abolished in January 2007.[114] The abolition of the one-year minimum holding period was to align the application of the directive with the participation exemption. Certain investors' circumstances would have been better suited to apply the participation exemption over

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108 Preamble and Article 6 of the EU Council Directive.
109 Preamble and Article 6 of the EU Council Directive. The exemption from withholding tax on the subsidiary is directed at ensuring fiscal neutrality. Germany and Greece, by reason of the particular nature of their corporate tax systems, and Portugal for budgetary reasons are authorised to temporarily maintain a withholding tax.
110 Article 3 of the EU Council Directive. Prior to 1 January 2007 the minimum holding percentage was 20% and was reduced to 15% on that date. The gradual reduction of the minimum holding percentage was brought by the amendment to the directive by Council Directive 2003/123/EC of 22 December 2003 to improve the directive's practicality.
111 Article 2(1)(a) of the EU Council Directive.
112 Article 2(1)(b) of the EU Council Directive.
113 Article 2(1)(c) of the EU Council Directive. See also *Parent-Subsidiary Directive* http://www.meijburg.com/advisory_services/european_union/directives_on_direct/the_directives/parents_and accessed on 28 August 2008.
114 Corporate Income Tax Act of 2007.

the directive, thus placing EU investors in an adverse tax position where there is no tax treaty between the Netherlands and the investor's home country.

Due to its multilateral nature, the directive provides broader tax relief than bilateral treaties. As Thömmes and Nakhai observe,

> … even in a tax treaty situation, the benefits of the Parent-Subsidiary Directive significantly outweigh the benefits granted by bilateral tax treaties. On the one hand, the criteria under the Parent-Subsidiary Directive are uniform for all Member States (even though some countries were granted special transition periods and certain details of the application may vary in different countries). On the other hand, the benefits granted by the Parent-Subsidiary Directive are usually more far-reaching than the ones granted by individual tax treaties which usually only provide for a reduction of withholding tax but not for a complete elimination of withholding taxes. Last but not least, the fact that the application and interpretation of the Parent-Subsidiary Directive by the individual Member States is subject to the jurisprudence of the European Court of Justice (ECJ) proved to be another significant advantage for taxpayers over the past years.[115]

Because the EC law prevails over bilateral agreements between individual member states, the directive overrides a bilateral tax treaty if and to the extent that provisions in that treaty which differ from those of the directive are less favourable to the companies affected than the directive's position. Conversely, if a bilateral treaty grants more benefits than the directive or requires less stringent conditions to be met than the directive in order to obtain the same benefits under both regimes, the bilateral treaty provisions cannot be

[115] Thömmes and Nakhai par 4.

objected to as an infringement of EC law.[116] The directive's benefits may be limited under the member state's anti-tax abuse legislation.[117]

For purposes of the directive, "withholding tax" does not cover an advance payment or prepayment of corporation tax to the member state of the subsidiary which is made in connection with a distribution of profits to its holding company.[118] Furthermore, the directive does not affect the application of domestic or provisions contained in any agreement designed to eliminate or lessen economic double taxation, in particular provisions relating to the payment of tax credits to the recipient of dividends.[119]

### 7.5.5 Comparison between the Directive and the Participation Exemption

The directive and the participation exemption apply in the same circumstances and in relation to the same nature of transactions. However, the directive is limited to member countries. In relation to the distributions by Dutch companies, there is no dividend withholding tax in both cases. The requirements for the exemption from the dividend withholding tax are the same.

With regard to distributions to Dutch companies, even prior to the implementation of the directive the Netherlands already refrained from taxing such distributions by using the participation exemption. The requirements under the directive and the participation exemption are the same. The difference exists with regard to the minimum holding percentage, which is 5% for the participation exemption and 10% for the directive. It has to be noted that this difference has been marginally reduced since prior to 2006, when it was 25%.

[116] Thömmes and Nakhai par 5.
[117] Article 2.2 of the EU Council Directive.
[118] Article 7(1) of the EU Council Directive.
[119] Article 7(2) of the EU Council Directive.

## 7.6 PROPOSALS FOR THE DUTCH CORPORATE TAX REFORM

The Dutch State Secretary of Finance issued a consultation document on 15 June 2009 containing proposals for changes to the Dutch corporate tax regime.[120] If implemented this regime would allow foreign operations to be leveraged from and through the Netherlands without incurring significant Dutch tax burden. The main changes that would enhance the position of the Netherlands as a holding location are the following:

- Interest box regime – Interest income would be taxed at an effective rate of 5%. Interest expenditure would be equally deducted at 5%. The regime would be mandatory to intragroup interest income and expenditure.
- Participation exemption regime – The participation exemption is to be applicable if the participation is not held as a portfolio investment. The intention of the taxpayer is decisive in determining whether the holding is portfolio or not.
- Carry back of losses – It is proposed that the tax loss carry back period be extended from 1 year to 3 years.
- Limitation of interest deductions – In the Netherlands it is possible to deduct interest expenditure on financing of qualifying participations while the income on such participations is exempt under the participation exemption. It is proposed that the thin capitalisation rules be abolished and the transaction based anti-avoidance rules be expanded to address this anomaly.[121]

## 7.7 CONCLUSION

As has been seen in this analysis of the aspects of the Dutch tax system that apply to holding companies, the Netherlands is a very suitable tax jurisdiction for the hosting of

[120] Ernst & Young *Dutch Government Issues Consultation Document on Tax Reform* http://www.ey.com/Publication/vwLUAssets/N_Dutch_International_Tax_Alert,_June_12_2009/$FILE/N_Dutch%20International accessed on 11 January 2010; Ruijten and De Vries *Dutch State Secretary Issues Discussion Paper Regarding Tax Treatment of Interest and Relaxation of Participation Exemption Rules* http://www.bakernet.com/BakerNet/Resources/Publications/Recent+Publications/AmsterdamDiscussionPaperTaxCAJun09.htm accessed on 11 January 2010

[121] See Ruijten and De Vries; Ernst & Young.

an IHC. It allows access to tax relief to a wide range of investors with different countries of origin. Its corporate and tax law systems are flexible. Furthermore, as has been observed, the corporate law is currently under review with a view to making it even more flexible.

Entities whose identity is the same as those of a conventional company can access the tax attributes of the Dutch system that makes it popular. These forms are common and investors are familiar with their nature, operation, uses and the risks they involve. In its very nature an IHC is a company that is a subsidiary of some company in a group of companies. Its shares can either be held by sister-subsidiaries, a holding company that is a subsidiary of a company within the group or the ultimate holding company. The shareholding in the IHC by any of these group companies generally exceeds 50% in order to allow control of the IHC, thus the 5% holding requirements are exceeded.

Once formed, the IHC in the Netherlands can be used for multiple functions. The uses that the Dutch holding company can be put to are common functions in the financial industry. It is more popularly used as an IHC, acting as the head of a regional or functional group or subgroup of subsidiaries, coupled with the function of reducing the overall dividend withholding tax costs or converting capital gains into dividends for parent companies.

With the benefits of listing on a stock exchange, the Dutch holding company is often used as a top holding company whose shares are or will be traded on a stock exchange. With listing it is often cheaper to raise equity capital rather than to rely on debt finance, and the company is therefore able to raise equity capital more readily. A listing better enables the company to obtain other forms of finance, such as bank loans. A listing also enables a company to use its shares to fund acquisitions.

A Dutch holding company is also used when two or more investors from different countries wish to set up a joint-venture company. It is also commonly used as an acquisition vehicle for acquisitions on the Netherlands domestic market. Besides the holding of shares in subsidiaries, the function of the Dutch holding company is often combined with management and control functions over the subgroup it heads.

The IHC would access the benefits of the participation exemption and the directive where the group operates within the EU as soon as it is formed, due to the fact that there is no minimum holding period in the Netherlands, on application of either the participation exemption or the directive. This is essential for a group where the group has accumulated profits that should be distributed but could be eroded by the tax system of the ultimate holding company.

As indicated in the discussion on group taxation,[122] the Netherlands applies the fiscal unity system of group taxation in terms of which a Dutch holding company is allowed to file a consolidated tax return with its resident domestic subsidiaries.[123] Because fiscal unity is allowed for companies that are tax-resident in the Netherlands it includes foreign incorporated subsidiaries which are tax-resident in the Netherlands due to the place of effective management being the Netherlands.

The Dutch fiscal unity regime allows group companies to pool their profits and losses and to transfer the assets within the group without a capital gains tax liability. Thus, losses of one subsidiary may be offset against profits of other members of the group. Furthermore, reorganisations have no direct tax consequences. Added to the inherent relief provided by the Dutch tax system as discussed, this fiscal unity system further enhances the Netherlands as the ultimate holding company regime.

The Netherlands holding company regime indisputably provides an ideal environment for investors to set up IHCs to perform their functions in the Netherlands without the tax regime eroding the finance base of the group.

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[122] See Chapter 4 at 4.6.
[123] See Spenke and Lier 87.

***CHAPTER 8***

# MAURITIUS

## 8.1 INTRODUCTION AND BACKGROUND

In this chapter the Mauritian tax system applicable to holding companies is discussed with a view to identifying the tax attributes that could be adopted by South Africa in enhancing South Africa's suitability to host IHCs. As mentioned in Chapter 1, Mauritius is similar to South Africa in key respects. Like South Africa (i) it is an African country; (ii) it is a developing country; and (iii) it is a member of the Southern African Development Community. Furthermore, Mauritius is successfully being used by multinational investors as a gateway to invest in countries in Africa and around the world. Mauritius has adjusted its tax system specifically to attract interposition of companies for investment elsewhere. These features make Mauritius the ideal country to study in order to assess and enhance the suitability of South Africa to host IHCs.

Mauritius is a small multi-cultural island situated in the southern Indian Ocean to the east of Madagascar. It comprises four islands: Mauritius, Rodrigues, Saint Brandon, and Agalega. With the exception of its coral reefs and beaches, the land area of 1,865km$^2$ is of volcanic origin. The other islands comprise another 175km$^2$ of land area. Sugar cane farming is prevalent in Mauritius. About 90% of the Mauritian cultivated land area is devoted to sugar cane.[1]

The population of Mauritius is approximately 1.28 million[2] of which about 150 000 live in the capital city, Port Louis. The official language is English, although Creole, French,

[1] *Mauritius: Country and Foreign Investment Regime*, http://www.lowtax.net/lowtax/html/jmucfir.html accessed on 13 March 2008.
[2] This estimate is the population estimate of July 2008.

Hindi, Urdu, Hakka and Bojpoori are also spoken. The Mauritian currency is the rupee (MR).[3]

It gained independence from Britain in 1968 and became a republic in 1992. Mauritius is a multi-party democracy and a sovereign state within the British Commonwealth of Nations. The head of state is the President of the Republic who is elected by the National Assembly.[4]

Mauritius is a dynamic economy with a well-developed communications infrastructure to enable the operation of business activities. The Mauritian government actively encourages foreign investment and discourages residents from actively pursuing offshore activities. To this end the Board of Investment and the Mauritius Offshore Business Activities Authority (MOBAA) were created. The MOBAA has been replaced with the Financial Services Commission in 2001. These bodies regulate such matters as foreign direct investments, trust services, trading and pooled or mutual fund programmes.[5] As a result of the keen interest in foreign investment, there is a very clear distinction between the onshore and offshore sectors. Foreigners need specific permission from the Prime Minister's office before they can own shares in an onshore company, while Mauritian residents are generally prohibited from taking part in offshore activities.[6]

Since 1991 Mauritius has developed at a fast pace. It has attracted considerable foreign investment and now has one of Africa's highest per capita incomes. In order to attract prospective investors Mauritius offers a wide range of attractive investment incentives. The focus of these incentives is to improve the Mauritian financial sector and the various

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[3] *Mauritius: Country and Foreign Investment Regime;* see also *Currency in Mauritius* http://wwp.greenwichmeantime.com/time-zone/africa/mauritius/currency.htm accessed on 3 February 2009.

[4] http://www.gov.mu/ accessed on 13 March 2008; See also *Mauritius: Country and Foreign Investment Regime.*

[5] *About Mauritius…Our World Tax Haven Director,* http://www.ascotadvisory.com/Incorporations_Directory/Mauritius.html accessed on 02 March 2008.

[6] *Mauritius Offshore Company Formation. Which Type is Best for You* http://www.content4reprint.com/finance/financial-planning/mauritius-offshore-company-formation.-which-type-is-best-for-you.htm accessed on 13 March 2008.
See also *Mauritius: Country and Foreign Investment Regime.*

services provided by it with the objective of making Mauritius offshore company formation an attractive and suitable option for investors all over the world.[7] According to the Central Intelligence Agency[8] there are about 32 000 offshore entities in Mauritius.[9]

Since independence in 1968, Mauritius has developed from a low-income, agriculturally based economy to a middle-income diversified economy with growing industrial, financial services and tourist sectors. The Mauritian government strategy centres on industrialisation (with a view to modernisation and to exports), agricultural diversification and tourism.[10] Banking and other financial services form the most rapidly growing economic sector. Due to its focus on the tourism industry, the transportation and communication networks and accomodation facilities are very well developed.[11] Mauritian politics are characterised by coalition and alliance building as well as a commitment to democracy.[12]

With English being an official language, communication is not a barrier for business in Mauritius. Mauritius is ranked 24 out of 181 countries in terms of ease of doing business.[13] From a political and socio-economic perspective Mauritius is a safe country for offshore investment because of its vibrant democracy and political and economic stability.[14]

Mauritius has a relatively sophisticated banking sector, with more than eleven domestic banks and twelve offshore banks. The offshore banks are engaged in a wide range of internationally based business, including private banking, foreign exchange trading and fund management. The central bank, the Bank of Mauritius, carries out the supervision and regulation of all banks as well as those non-bank financial institutions that are

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[7] *Mauritius Offshore Company Formation. Which Type is Best for You?*
[8] Central Intelligence Agency "Mauritius" *The World Factbook* accessible on https://www.cia.gov/library/publications/the-world-factbook/geos/mp.html accessed on 03 February 2009.
[9] See http://www.taxhavenco.com/mauritius.html accessed on 22 March 2008.
[10] Oleynik *Mauritius Tax Guide* (2006) 12.
[11] Oleynik 12.
[12] Oleynik 19.
[13] World Bank *Doing Business 2009 - Country Profile for Netherlands* http://www.doingbusiness.org/ExploreEconomies/?economyid=125 accessed on 28 May 2009.
[14] *Mauritius Offshore Company Formation. Which Type is Best for You?*

authorised to accept deposits.[15] Mauritius offshore company formation and handling of other company affairs is regulated under the Companies Act 2001.[16]

Mauritian corporate law is derived from English law. Many Mauritian lawyers and attorneys have been trained in the United Kingdom. However, the primary legal system is founded on French civil law.[17]

The Mauritian tax system is constantly being adjusted in order to make Mauritius an even more attractive country to invest in. The constant adjustment is regularly influenced by tax and economic experts from all over the world recommending incentives that would be more suitable for investors from outside Mauritius.[18]

## 8.2 MAURITIAN CORPORATE INCOME TAX

Mauritius has a global system of corporate income tax (i.e. it is a residence-based tax system). The taxation of resident companies is governed by the Income Tax Act 1995, which is, as is the case with corporate laws, also substantially based on the equivalent law in the United Kingdom. A company is treated as resident in Mauritius if it is incorporated in Mauritius or if it is managed and controlled from Mauritius. According to Joory: [19]

> In determining whether a company's central management and control is exercised in Mauritius, the tax authorities will look at the decision-making process to ascertain whether the key decisions are taken in Mauritius. The fact that the board of directors of a company normally meet in Mauritius is

[15] "Mauritius Financial Overview". http://www.sovereignsociety.com/Default/MauritiusFinancialOverview/tabid/1678/Default.aspx accessed on 15 May 2008.
[16] *Mauritius Offshore Company Formation. Which type is Best for You?*
[17] See Central Intelligence Agency *The World Factbook.*
[18] Discussion with Professor Peter Harris, Director – Centre for Tax Law, University of Cambridge on 20 March 2009 at the University of Cambridge.
[19] Joory D, *International Taxation of Low-Tax Transactions*, International Financial Services Limited 2008, Ebene, Mauritius, at II/63, http://books.google.co.za/books?id=prLYMAwtTcC&pg=PT52&lpg=PT52&dq=Mauritius accessed on 04 September 2008.

> *prima facie* evidence that the company's central management and control is in Mauritius.

A resident company is taxed on its worldwide taxable income. The worldwide taxable income includes foreign-source income. A non-resident company carrying on business through a branch in Mauritius is subject to tax on the income of the branch.[20] Mauritius does not have a controlled foreign company regime. Non-resident companies not carrying on business in Mauritius, even though they may be wholly-owned subsidiaries of a Mauritian holding company, will not be taxed in Mauritius. In this regard Joory comments as follows:

> Foreign enterprises carrying on business in Mauritius are subject to tax only on their Mauritian-sourced income. When business is carried on through a registered branch, income is determined on the basis of the local activity of the branch. Deductions are allowed for reasonable head office expenses incurred in relation to the branch operations. A branch is liable to tax at the same rate and in the same manner as a local corporation. There is no additional tax on the transfer of branch profits.[21]

Taxable income includes rents, dividends, royalties and interest. However, dividends paid by "tax incentive" companies, companies listed on the stock exchange, and companies which are fully taxable in Mauritius are exempt from tax in the hands of the receiving shareholder, whether resident or not. Capital gains are not generally subject to tax in Mauritius. However, in certain instances capital gains arising from the disposal of land are taxed. All other capital gains are not included in taxable income.[22]

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[20] *Mauritius: Domestic Corporate Taxation*, http://www.lowtax.net/lowtax/html/jmudctx.html accessed on 16 March 2008.
[21] See Joory D II/55.
[22] *Mauritius: Domestic Corporate Taxation.* See also *Mauritius: Country and Foreign Investment Regime.*

### 8.2.1 Rates of Tax

The rate of normal corporate income tax in Mauritius is currently 15% on taxable income, having been reduced from 25% as of 1 July 2007. Corporate profits are calculated by application of the ordinary principles of commercial accounting, subject to the rules contained in the tax legislation. In the 2007/2008 budget the Mauritian treasury introduced a Special Levy on the banking sector that applies only to profitable banks. The Special Levy combines the features of a turnover tax and a tax on profits. It is calculated at 0.5% of the turnover and 1.7% of the profits made.[23]

The 2007/2008 budget also introduced an Advance Payment System (commonly known as "APS") for companies. In terms of this system companies are required to effect quarterly provisional tax payment on the basis of the taxable income of the preceding tax return. Final reconciliation of tax liability will be done when the annual tax return for that year is submitted.[24] Furthermore, all companies with an annual turnover of above R30 million or having more than 50 employees are required to submit their income tax and VAT returns electronically.

### 8.2.2 Alternative Minimum Tax

Since 2004 Mauritius has also applied the alternative minimum tax (hereinafter referred to as "the AMT") system. The AMT is designed to ensure that taxpayers pay at least some tax, whatever the level of deductions. It applies if a company declares a dividend or distributes any shares instead of dividends and if the tax payable is less than 5% of that company's book profits.[25]

The AMT is payable by companies whose normal tax payable in an income year is less than 7.5% of its book profit. The tax payable under the AMT equals the lower of 7.5% of

[23] *Mauritius: Domestic Corporate Taxation.*
[24] To avoid double tax payment in the first year the tax due for the previous year is spread over three years, in equal instalments. The first quarterly payment was required from large companies as from financial year starting 1 July 2008. See *Mauritius: Domestic Corporate Taxation, supra.*
[25] See http://www.gov.mu/portal/sites/mra/efile.htm accessed on 12 November 2008.

the book profit[26] or 10% of dividends declared for that year and any amounts distributed instead of dividends. The tax payable is the higher of the AMT or the tax payable under the normal corporate tax rules. Book profit is reduced by the amount of exempt dividends from resident companies and profits and/or gains from the sale of fixed assets or securities and is increased by disallowed expenditure incurred in the production of such exempt income.[27]

The AMT does not apply to companies that are exempt from normal corporate tax. Furthermore, due to the method of calculating the normal tax (i.e. multiplying the tax rate applicable to a company by its taxable income and deducting tax credits other than foreign tax credits) most companies that are owned by non-residents normally fall outside the scope of the AMT.[28]

### 8.2.3 Other Tax Instruments

The Mauritian tax system does not contain most of the anti-avoidance provisions that are found in developed tax systems. There are no transfer pricing and thin capitalisation provisions, controlled foreign company provisions, exchange controls or withholding taxes.[29]

## 8.3 TAX ASPECTS THAT MAKE MAURITIUS POPULAR

From a tax point of view, Mauritius is a popular jurisdiction for multinational structures. As Joory[30] states, “Mauritius is a low tax jurisdiction, as well as a no-tax jurisdiction for certain offshore entities (referred to as Global Business Companies). Low taxation and

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[26] Book profit is calculated in terms of the generally accepted accounting principles. For purposes of the AMT calculation, capital gains and losses on revaluation of fixed assets, dividends received from resident companies and trading profits and losses from the sale or revaluation of securities are excluded in the computation of book profit. Ernst & Young, *Worldwide Corporate Tax Guide* (2006) 581.
[27] See Joory D II/53. See also Ernst & Young 580.
[28] Joory II/53.
[29] Oleynic (ed) *Mauritius Tax Guide* (2006) 25; Ernst & Young 584.
[30] Joory D II/51.

tax exemption on sale of securities, coupled with a wide network of tax treaties makes Mauritius an attractive jurisdiction for cross-border business activities."

The nil income tax rate on total net income before distributions applies not only to companies holding Global Business Licence 2[31] (hereinafter referred to as "GBL2 companies") but also to headquarter companies, companies licensed to carry out activities in a Freeport zone and offshore trusts electing non-residence status, among others.

In addition to GBL2 companies and the other companies that are not taxed, Mauritius imposes a low tax of 15% on approximately 40 types of enterprises referred to as tax-incentive companies. The more prominent examples of these types of companies are: companies holding a Global Business Licence 1 (hereinafter referred to as "GBL1 companies"); unit trusts; authorised mutual funds; venture capital funds; manufacturing and export service companies; companies operating in priority sectors such as hotels, housing, export service and small and medium-sized industries; and internet and network service providers.

Relative to its geographical size, low-tax system and international exposure, Mauritius has an extensive treaty network. It has a network of 33 treaties with eight awaiting ratification and six more being negotiated.[32] Besides this significant number, the Mauritian tax treaty policy includes a preference for a tax sparing[33] clause and minimum (often zero) withholding taxes.

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[31] See par 8.3.1 below.

[32] *Mauritian Revenue Authority, Double Taxation Agreements* http://www.gov.mu/portal/sites/mra/dta.htm accessed on 10 September 2008.

[33] A tax sparing clause is a tax treaty provision in terms of which a contracting state agrees to grant relief from residence taxation with respect to source taxes that have not actually been paid (taxes that have been 'spared' or hypothetical taxes) in the other contracting state. See *Tax Sparing – A Reconsideration* http://www.oecd.org/dataoecd/10/48/2090389.pdf accessed on 16 September 2008. See discussion on tax sparing credit below at par 8.3.1.1 (b)(ii).

### 8.3.1 Companies Holding Global Business Licences

The Mauritian government provides for Global Business Licences for Mauritian incorporated companies owned by foreigners. Companies holding Global Business Licences are very popular for foreign investment into Mauritius. The special tax regime for these companies was intended at attracting foreign direct investment into Mauritius. Two kinds of Global Business Licences are on offer: the GBL1 and the GBL2.[34]

There are specific rules applicable to both GBL1 and GBL2 companies. Both kinds may only conduct offshore business activities with persons who are not resident[35] in Mauritius and in currencies other than the Mauritian rupee. They are not allowed to hold any immovable property in Mauritius, or certain securities in Mauritian corporation or any account in a bank in Mauritian currency.[36]

An additional benefit provided by the Mauritian Financial Services Development Act of 2001 (hereinafter referred to as "the FSDA") to bodies regulated by it, including GBL1 and GBL2 companies, is that of secrecy and confidentiality. No person or body is authorised to disclose information or present documentation to any court, tribunal, committee of inquiry or other authority in Mauritius unless ordered to do so by a court of law on application by the Director of Public Prosecution. The order can only be made for inquiry into the trafficking of narcotics and dangerous drugs, arms trafficking or money laundering. With the permission of the FSC, disclosure of information may be made to

[34] Oleynik 43–44.
[35] For purposes of determining residency in respect of individuals in Mauritius, a "resident" is an individual who is domiciled in Mauritius unless his/her permanent place of abode is outside Mauritius, has been present in Mauritius in that income year, for a period of, or an aggregate period of, 183 days or more; or has been present in Mauritius in that income year and the two preceding tax years, for an aggregate period of 270 days or more. See *Mauritius, Taxation of International Executives* http://www.kpmg.com/SiteCollectionDocuments/TIES/MAURITIUS_2007_TIES.pdf accessed on 24 March 2008.
[36] Section 21(1) of the Financial Services Development Act of 2001. Specific securities that may not be held are "any share, debenture, security or any interest in any company incorporated or registered under the Companies Act 2001 or in any société or partnership under the *Code Civil Mauricien* or the *Code de Commerce*, or in any body corporate or association formed or registered under any enactment in force in Mauritius, other than in a corporation holding a Category 1 Global Business Licence." Section 21(1)(b) of the Financial Services Development Act of 2001.

the shareholders of the company but such information is not available for public inspection.[37]

As stated in Chapter 2,[38] an IHC is incorporated as a company. It is interposed between the operating subsidiaries and the ultimate holding company. This formation accords with the nature of the companies holding Global Business Licences in Mauritius. An IHC can be formed in Mauritius as a company holding a Global Business Licence, as it does not conduct any business and does not have to hold any immovable property directly.

#### *8.3.1.1 Taxation of GBL1 Companies*

A GBL1 company is a company engaged in qualified global business that is carried on from within Mauritius with persons who are all resident outside Mauritius and where business is conducted in a currency other than the Mauritian rupee.[39] The FSDA provides that no person shall conduct any qualified global business unless that person holds a category 1 Global Business Licence.[40] A qualified global business for purposes of a GBL1 company is any business or other activity specified in the Second Schedule to the FSDA which is carried on from within Mauritius. The Second Schedule lists the following activities: aircraft financing and leasing; assets management; consultancy services; employment services; financial services; funds management; information and communication technology services; insurance; licensing and franchising; logistics and/or marketing; operational headquarters; pension funds; shipping and ship management; and trading.

The GBL1 company is the recommended structure for individuals, body corporate, trust or partnership including limited liability partnership or a *société* for investment.

[37] *Category 1 Global Business Company* http://www.alliance-mauritius.com/gbl1.php accessed on 11 September 2008.
[38] See par 2.2 above.
[39] See *Category 1 Global Business Company*; Oleynik 44.
[40] See s 20(1)(a) of the Financial Services Development Act of 2001.

*a. Tax residence of a GBL1 company*

A GBL1 company is required to be a tax resident of Mauritius. Such a company should obtain a Tax Residence Certificate (TRC). The TRC is issued by the Commissioner of Income Tax. To be tax-resident, the company must demonstrate that the effective management and control thereof is in Mauritius. To satisfy the residence test the GBL1 company must satisfy the following six requirements:[41]

1. The company must have at least two resident directors in Mauritius;

2. The board meetings of the company must be initiated and chaired from within Mauritius. This requirement does not necessarily require that the meetings should be held in Mauritius. Where the meetings are held by way of, for example, tele-conferencing, the chairperson of such meeting should be located in Mauritius;

3. The company must open and maintain an account with a local bank through which funds must flow;

4. The registered office of the company must be situated and all statutory records of that company must be stored in Mauritius;

5. The company's qualified company secretary must be resident in Mauritius; and

6. The company must have a local auditor.

Where an investor plans to incorporate an IHC as in the form of a GBL1 company such investor would need to ensure that the above requirements are met. Failure to comply with these requirements could result in the IHC being disqualified as a GBL1 company and consequently face higher taxes. The investor might also be faced with more serious consequences in the home country.

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[41] *Mauritius GBC I Company (Tax Resident – Treaty Access)* http://www.ocra-mauritius.com/local/resident.asp accessed on 15 September 2008. See also *Category 1 Global Business Company***.**

*b. Tax treatment of a GBL1 company*

GBL1 companies are taxed at a flat rate of 15% on their taxable income. Prior to June 2006, this tax rate for GBL1 companies was seen to be a tax incentive rate. However, in 2007 the normal corporate tax rate was also reduced to 15%, putting it on par with the tax rate for GBL1 companies. However, to some extent companies have retained their tax incentive status as a result of the availability of tax relief provisions that apply only to GBL1 companies.

The Mauritian Income Tax Regulations of 1996 allow for foreign tax credits on the foreign-source income of a Mauritian resident. In drafting these regulations, the Mauritian approach has been to be as generous as possible to the taxpayer with regard to foreign tax credit, making the tax regime for GBL1 companies as attractive as possible.

Three forms of credits are on offer. Two of the credits apply to the actual tax paid or payable by the taxpayer and the other is a notional, presumed tax credit. The following tax credits are available:

(i) Underlying Tax Credit

An underlying or foreign tax credit is a mechanism used to reduce or eliminate double taxation when the same income is taxed in more than one country. In terms of this method of eliminating double taxation, foreign taxes paid by a resident taxpayer on foreign-source income generally reduce domestic taxes payable by the amount of foreign tax.[42] The underlying tax credit is granted in the residence country (i.e. Mauritius). The foreign tax credit can be provided by unilateral means, where the country provides for the credit in its tax laws or by virtue of the tax treaty.

[42] Arnold and McIntyre, *International Tax Primer* (2002) 36.

Foreign tax credit in Mauritius is granted through a unilateral provision contained in the tax law. Section 77 of the Mauritian Income Tax Act provides as follows:

> Credits in respect of foreign tax
>
> (1) Where a taxpayer derives income which is subject to foreign tax, the amount of foreign tax so paid shall be allowed as a credit against income tax payable in Mauritius in respect of that income.
> (2) The credit in respect of foreign tax shall, in the case of a dividend, include credit for any foreign tax imposed on the profits out of which that dividend is directly or indirectly paid.
> (3) The Minister may, by regulations, provide for the implementation of the provisions of this section and for the granting of credit for foreign tax in such manner and on such conditions as he thinks fit.[43]

The foreign tax credit is granted on the amount taxable in Mauritius to the extent that such amount has been taxed in a foreign jurisdiction. The foreign tax credit will also, in the case of dividend income and where the shareholding is not less than 5%, include any foreign tax imposed on the profits out of which that dividend has directly or indirectly been paid.[44]

(ii) Presumed Tax Credit

A presumed tax credit, like the tax sparing credit, is not based on actual taxes paid. It is based on a presumed tax paid. The presumed tax credit applies as an alternative to the foreign or underlying tax credit. In order to apply for the foreign tax credit the taxpayer must have actually paid the tax or be liable to pay such tax. However, with regard to the

[43] Section 77 of the Income Tax Act of 1995.
[44] See The Income Tax (Foreign Tax Credit) Regulations 1996GN 80 of 1996 - 20 July 1996 Regulation 7.

presumed tax credit, a certain amount of tax is presumed to have been paid, where the taxpayer produces no records of such payment or liability.[45]

The Mauritian tax legislation provides for a presumed tax credit of 80% of the Mauritius tax chargeable in case no documentary evidence is produced in support of the payment of foreign tax at the same rate as Mauritius.[46]

The Mauritian presumed tax credit presumes that 80% of the income has been taxed in the source state. The presumption is not that the income was taxed at 80%. If the latter were the case, all foreign-source income would not be taxed in Mauritius as according to the tax credit rules, the maximum tax payable in the residence country is payable. In this case, the maximum tax payable in Mauritius is 15%. As a result, only 20% of the income is taxable at a rate of 15% resulting in an effective rate of 3%.

(iii) Tax Sparing Credit

Tax sparing is a tax treaty provision in terms of which a contracting state agrees to grant relief from residence taxation with respect to source taxes that have not actually been paid (taxes that have been 'spared' or hypothetical taxes) in the other contracting state.[47] It is typically provided by way of a tax sparing credit. Put differently, it is a credit granted by the country of residence of the taxpayer for foreign taxes that for some reason were not actually paid to the source country but would have been paid under the source country's normal tax rules.[48] The credit is normally granted in respect of notional source country taxes of a certain kind, e.g. dividends, interest and royalties or to all income arising in the source state.[49]

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[45] Campbell *International Taxation of Low-Tax Transactions* (2007) II/61.
[46] The presumed tax credit was reduced by the Finance Act of 2000 from 90% to 80% in 2002.
[47] See Shannon "Tax Incentives and Tax Sparing" (1992) *International Tax Review* 84-96; *Tax Sparing – A Reconsideration* http://www.oecd.org/dataoecd/10/48/2090389.pdf accessed on 16 September 2008.
[48] Arnold and McIntyre 50.
[49] Olivier and Honiball *International Tax – A South African Perspective* (2008) 333 outline the different forms that tax sparing provisions may take as follows: (i) the state of residence may allow as a deduction or credit the amount of tax which the state of source could have imposed in accordance with its general

A distinction may be made between tax sparing and matching credit. In tax sparing the notional foreign tax represents the tax forgone by the source country under special measures that are more often than not designed to encourage foreign investment. Matching credit on the other hand operates as a kind of exemption that is not linked to the level of source country tax or any reduction thereof.[50] Without a tax sparing provision in the treaty, the actual beneficiary of the tax incentive provided by a source country to attract foreign investment would be the residence country instead of the foreign investor, or the residence country.[51]

The standard Mauritian tax sparing clause provides that for the purposes of the normal tax credit granted by Mauritius's treaty partner "the tax payable in Mauritius shall be deemed to include the amount of tax which would have been paid if the tax had not been reduced in accordance with laws designed to promote economic development in Mauritius…"[52]

The practical application of the Mauritian tax sparing provision is that where the Mauritian laws provide for the imposition of a lower rate of tax, or the exemption of income from tax, the treaty partner's tax authorities should allow a sparing tax credit for the tax which would have been chargeable in Mauritius had those incentive provisions not been enacted. This ensures that the effective tax rate of the investor is limited to the tax that would have been payable in Mauritius.

legislation; (ii) the state of residence may allow as a deduction the amount of tax as limited by the tax treaty for a specific type of income e.g. dividends, royalties and interest; (iii) the state of residence may allow a deduction against its own tax of a specified amount fixed at a higher rate; or (iv) the state of residence exempts the income which has benefited from tax incentives in the source state. The Mauritian policy of tax sparing takes the first form.

[50] *IBFD International Tax Glossary*, definition of "Tax Sparing Credit."

[51] Arnold and McIntyre 50.

[52] See Article 23(2) of the Double Tax Agreement between Mauritius and South Africa.

(iv) Application of the Credits

A combination of the foreign tax credit or presumed tax credit and the tax sparing provisions provide a significant tax relief measure for GBL1 companies.

The Mauritian tax credit presumes that 20% of the foreign-source income has not been taxed. As a result the 20% is taxed at a tax rate of 15%, resulting in an effective rate of 3%. For example, if a GBL1 company earns MR 200 million of foreign income, a presumed tax credit for MR 160 million will be granted and the MR 40 million will be taxed at 15% resulting in an effective tax amount of MR 6. In the same circumstances, if the taxpayer chooses to apply the foreign tax credit option on all income taxed in the source country, there would not be any tax in Mauritius, unless the source country taxes income at less than a 15% rate.

Based on the aforegoing, the presumed tax credit option operates more efficiently than the foreign tax credit in circumstances where the underlying investment is located in a tax haven. According to this functional structure, investors from foreign tax partner countries wanting to invest in a tax haven or preferential tax regime are incentivised to set up a GBL1 company in Mauritius. Such company would benefit from the Mauritian tax treaties. The GBL1 company would then set up operations or a subsidiary in a tax haven. No or low lax will be levied in the tax haven. The income will be earned in Mauritius or brought in as a dividend.

The country of residence will not be able to tax because the company will be effectively managed in Mauritius. Any dividends accruing to the shareholders resident in the country of residence would be subject to a tax sparing clause, granting 15% credit of the amount of the dividend received. The effective rate would depend on the tax rate in the resident country. Assuming all dividends are declared, as per the previous example a GBL1 company earns MR 200 of foreign income, a presumed tax credit for MR 160 is granted and the MR 40 will be taxed at 15% resulting in an effective tax amount of MR 6. If the shareholders of the GBL1 company are resident in a country with a flat tax rate of 35%, the tax sparing clause will apply to the effect that a credit of MR 30 will be granted. The shareholder's home country will levy a tax of MR 70 less the MR 30 notionally paid in Mauritius. This will result in an overall effective rate of 20% as opposed to 35% that would have been effectively levied but for the tax sparing clause.

(v) The Benefits of GBL1 Licence for an IHC

The tax treatment of GBL1 companies in Mauritius is advantageous for IHCs. This is due to the fact that the IHC can be incorporated as a GBL1 company and access the benefits of the tax sparing credit and either the underlying tax credit or the presumed tax credit. Where the foreign-source income is taxed at a rate of 15% or more applying the underlying tax credit would result in no tax in Mauritius. However, where the tax is lower than 15%, a presumed tax credit will result in an effective rate of 3% in Mauritius.

In addition, where Mauritius has a tax treaty with the country of residence of the ultimate holding company,[53] the tax sparing credit would grant a credit for the 15% tax that would have been paid in Mauritius but for the GBL1 company incentive. In effect, therefore, the effective tax rate for the company would be the sum of the higher of 3% Mauritian tax or the source-based tax levied on subsidiaries and the difference between the 15% tax that should have been levied in Mauritius and foreign dividend tax rate levied in the residence country of the ultimate holding company.

#### *8.3.2.1 GBL2 companies*

A company can qualify as a GBL2 company if it is wholly owned by persons who are not resident in Mauritius and should operate exclusively outside Mauritius. In addition, a company may only carry on business activities as a GBL2 company if it satisfies the following criteria:[54]

[53] Mauritius has tax treaties containing tax sparing credit provisions with the following countries: China, Croatia, India, Kuwait, Lesotho, Malaysia, Mozambique, Namibia, Nepal, Oman, Pakistan, Rwanda, Seychelles, Singapore, Swaziland, Sweden, Thailand, Uganda and Zimbabwe.
[54] Section 19(2) of the FSDA.

1. It must be a private company incorporated or registered under the Companies Act of 2000;
2. It should not conduct business with persons resident in Mauritius;
3. It should not conduct any dealings in Mauritian currency, the rupee; and
4. It should have obtained the GBL2 licence issued by the Financial Services Commission.[55]

The legislative regime for GBL2 companies is more flexible than that of GBL1 companies.[56] A GBL2 company may be set up either by direct incorporation or by way of continuation. Alternatively, a GBL1 company may be converted into a GBL2 company. A GBL2 company may either be limited by shares or by guarantee or limited by shares and guarantee or simply unlimited. GBL2 company may also be registered as a Limited Life Company. It must at all times have a registered agent (an Offshore Management Company) and a registered office in Mauritius where all statutory books and records are to be kept. The purpose of the registered agent is to communicate with the Mauritian authorities and ensure that the company complies with statutory requirements.[57] Unlike GBL1 companies, GBL2 companies do not have to hold board meetings in Mauritius or have them set up or chaired in Mauritius. The GBL2 company board meetings can be held anywhere in the world.

GBL2 companies are generally used to carry on activities that include non-financial consultancy; information technology services; logistics; marketing; shipping; ship management; non-financial trading, passive investment holding; and once-off transactions using a special purpose vehicle. In addition the Financial Service Commission has the power to approve any additional activities upon application by the GBL2 company.[58]

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[55] The Financial Services Commission may refuse to license a company with a GBL2 if, in its view, the impact of the company's affairs on third parties is such that it needs to be subject to a higher degree of supervision. See *International Financial Consulting* http://www.ifcconsult.com/services_GBL2.asp accessed on 11 September 2008.
[56] See Ernst & Young 580.
[57] See *International Financial Consulting.*
[58] *Category 2 Global Business Company* http://www.alliance-mauritius.com/gbl2.php accessed on 15 September 2008.

*(a) Taxation of GBL2 companies*

A GBL2 company is tax-exempt as it does not fall within the purview of the Mauritian tax law. It does not pay any tax on its worldwide income to the Mauritian authorities. It does not pay any withholding tax on dividends nor is any capital gains tax levied on a GBL2 company. In effect the tax cost of a GBL2 is effectively the foreign tax suffered. Because of its tax-exempt status, a GBL2 company does not have access to the Mauritian tax treaties.[59]

The fact that the GBL2 companies are not taxable in Mauritius means that when a GBL2 company earns foreign-source income such income will be fully taxed in the foreign country and when it distributes dividends to its shareholders, such dividends will be taxable in the home country of the shareholders without any tax relief. This limits the tax benefits derivable from using a GBL2 company and subjects the company to the same difficulties experienced by the erstwhile international headquarter company in South Africa.[60] As a result of these limitations, a GBL2 company (or a company of its nature) would not be ideal to use as an IHC.

### 8.3.2 Advance Tax Rulings

The Mauritian tax system allows taxpayers to obtain tax rulings from the Director-General of the Mauritian Revenue Authority in respect of the application of the tax law to income that such person derives or may derive.[61] The Mauritian provision is drafted in a wide form, to the extent that "any person" may apply in relation to "any income". Practically, however, only persons that are liable to tax in Mauritius have an interest in obtaining such rulings. The ruling is not in respect of the transaction as is the case with the rulings in the Netherlands and in South Africa.[62] According to the Income Tax Act, the ruling is in relation to the income. In determining the application of the Income Tax

[59] Oleynik 44.
[60] See Chapter 10 par 10.3 on the South African International Headquarter Company.
[61] See s 159(1) of the Income Tax Act 1995 read with s 1 definitions of "Director-General" and "Authority".
[62] See par 7.3.2 with regards to the Netherlands and par 10.8 with regards to South Africa.

Act to the income, the Director-General would rely on the nature of the transaction giving rise to the income.

An application for a ruling should include "full details of the transaction relating to the income together with all documents relevant to the transaction"[63] and "specify precisely the question as to which the ruling is required".[64] Upon application of the tax ruling, the applicant is required to give a statement setting out the opinion of the applicant as to the taxation of such income.[65] The tax ruling is binding on the Director-General.[66] Thus, the taxpayer will be entitled to be taxed on the income in the manner in which the Director-General indicated the tax implications of such income to be.[67] However, the ruling would not be binding on the Director-General if there is any material difference between the facts relating to the transaction and the details contained in the application.[68]

## 8.4 CONCLUSION

The Mauritius tax system is one of the most attractive tax systems in the world for holding companies. The corporate income tax rate of 15% is one of the lowest compared to the corporate tax rates of most African countries.[69] Despite this low rate of tax, there are special low rates for companies undertaking certain business activities, including exporting and construction companies and companies in the financial services sector. The effective tax rate of 3% on GBL1 companies is a main attraction to use Mauritius as a host for an IHC.

The fact that dividends and capital gains are not subject to tax further enhances Mauritius as an ideal tax jurisdiction for most kinds of businesses. This is in light of the fact that no

[63] S 159(2)(a) of the Income Tax Act 1995.
[64] S 159(2)(b) of the Income Tax Act 1995.
[65] S 159(2)(c) of the Income Tax Act 1995.
[66] S 159(4) of the Income Tax Act 1995.
[67] S 159(7) of the Income Tax Act 1995.
[68] S 159(5) of the Income Tax Act 1995.
[69] The worldwide average corporate tax rate for 2008 was 25.9%. See KPMG *Corporate and Indirect Tax Rate Survey* (2008) 14 available on http://www.kpmg.com/SiteCollectionDocuments/Corporate-and-Indirect-Tax-Rate-Survey-2008v2.pdf accessed on 02 February 2009.

special circumstances need to exist in order for the dividends or capital gains to receive tax-free treatment. Furthermore, tax losses can be offset against future income for an indefinite period of time, with no monetary limit applying to such losses. In addition, where the alternative minimum tax applies, it limits the tax compliance cost and liability for the eligible companies.

Besides these positive general tax attributes, Mauritius achieved and maintains its attraction as a host for IHCs through the special tax dispensation that was designed to invite and draw foreign investment. The tax-exempt status of GBL2 companies makes these vehicles quite attractive in a group business structure. The fact that the GBL2 companies do not have access to the Mauritian tax treaty network severely diminishes the tax benefits of this entity. However, it is the GBL1 companies that yield the most tax benefits. The combination of the tax sparing clause in the DTAs and the presumed tax credits give the GBL1 company a major competitive tax advantage over structures that countries worldwide offer to investors.

***CHAPTER 9***

# SPECIAL FEATURES IN OTHER TAX REGIMES

## 9.1 INTRODUCTION AND BACKGROUND

As was seen in Chapters 7 and 8, the Dutch and Mauritian tax systems make these countries ideal as the location of an IHC. The purpose of this chapter is to highlight special features in the tax systems of other countries that have special tax regimes for holding companies that are intended to attract IHCs to their shores. This chapter is also intended to expose the reasons why some countries are not necessarily successful, despite having specific legislation to attract IHCs. In this context the tax systems of three countries, namely Belgium, Ireland and the United Kingdom (hereinafter referred to as "the UK"), will be discussed briefly.

This section focuses on special features in different tax jurisdictions that are beneficial to, and could result in the attraction of, IHCs. The general corporate tax systems of these jurisdictions are briefly outlined in order to contextualise the application of the special features concerned. That is followed by a detailed analysis of the special features of each system.

Belgium, Ireland and the UK are all members of the European Union (hereinafter referred to as "the EU"). The EU's Parent-Subsidiary Directive applies to dividends declared by companies resident within the EU to companies resident in these countries.[1] The result of the application of the Parent-Subsidiary Directive is that when the holding company receives a distribution of profits from the subsidiary, the country of the holding company should refrain from taxing such profits or should tax such profits while authorising the holding company to deduct from the amount of tax due that fraction of the corporation

[1] Council Directive of 23 July 1990, Parent-Subsidiary Directive 90/435/EEC. See a detailed discussion of the Parent-Subsidiary Directive in par 7.5.4 and sources referred to therein.

tax paid by the subsidiary which relates to those profits.[2] Furthermore, the profits which a subsidiary distributes to its holding company should be exempt from withholding tax in the hands of the holding company.[3]

## 9.2 BELGIUM

### 9.2.1 Introduction

Belgium is located in Western Europe bordering the North Sea. It is located between France and the Netherlands. It has a population of about 10 million people. Dutch, French and German are the official languages, although less than 1% of the population speak German. The Belgian currency is the Euro and the capital city is Brussels.[4] In the 2009 Doing Business report from the World Bank, Belgium was ranked 64th out of 181 countries in relation to the ease of paying taxes.[5]

### 9.2.2 Corporate Income Tax

In Belgium resident companies are subject to tax on their worldwide income and non-residents on their Belgian-sourced income. A company is resident in Belgium if it is registered, or its central management is exercised, in Belgium.[6] The corporate income tax rate is 33.99%.[7]

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[2] Preamble and Article 6 of the EU Council Directive.

[3] Preamble and Article 6 of the EU Council Directive. The exemption from withholding tax on the subsidiary is directed at ensuring fiscal neutrality. Germany and Greece, by reason of the particular nature of their corporate tax systems, and Portugal for budgetary reasons are authorised to temporarily maintain a withholding tax.

[4] Central Intelligence Agency "Belgium" The World Factbook accessible on https://www.cia.gov/library/publications/the-world-factbook/geos/be.html#top accessed on 02 November 2009.

[5] See *Doing Business* http://www.doingbusiness.org/documents/paying_taxes_2009.pdf accessed on 15 October 2009.

[6] See Vanhaute *Belgium in International Tax Planning* (2008) 94. See also Ernst & Young *Worldwide Corporate Tax Guide* (2006) 85.

[7] Deloitte *Holding Companies in Belgium* http://www.deloitte.com/dtt/cda/doc/content/Holding%20Companies%20in%20Belgium.pdf accessed on 22 October 2009.

Foreign tax relief is only available through treaty application.[8] Capital gains are treated as ordinary company profits and are therefore subject to tax at the standard corporate income tax rate. However, as is discussed below, capital gains on shares are fully exempt.[9] Belgium has a tax treaty network covering some 88 countries.[10] A general advance tax ruling system was introduced on 1 January 2003.[11] There is no restriction of inward and outward movement of capital through exchange controls.[12]

### *9.2.2.1 CFC Legislation*

There is no specific controlled foreign company (hereinafter referred to as "CFC") legislation, although general anti-avoidance measures may achieve the same effect as CFC legislation would have achieved.[13] In terms of Article 344 § 2 of the Belgian Income Tax Code, the *Wetboek van de Inkomstenbelastingen* (hereinafter referred to as "the ITC"), certain transfers on income-producing assets, such as shares, receivables, debt instruments, intellectual property rights and cash to a foreign entity subject to a privileged tax treatment can be disregarded by the tax authorities. The transfer could be valid for tax purposes if the taxpayer is able to prove that the transaction was entered into for genuine business or financial purposes, or when the transferred assets produce taxable income.[14]

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[8] Ernst & Young 89; Schoonvliet "Unilateral and Treaty Measures in Belgium for the Avoidance of Double Taxation" (2008) *Bulletin for International Taxation* 430.
[9] Vanhaute 101.
[10] Deloitte *Comparison of European Holding Company Regimes* https://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/dtt_tax_holdcomatrix_europe_072309.pdf accessed on 22 October 2009.
[11] The Belgian advance tax ruling "is legally binding on the [Federal Public Service for Finance] vis-à-vis the taxpayer that requested the advance tax ruling, provided that the situations or transactions materialize in accordance with their description by the taxpayer. However, there is no obligation on the part of the taxpayer to carry out the transactions that are the subject of the ruling request" (Vanhaute and Huygens *Belgium: Holding Companies* (2009) par 8.4.1.4. http://online2.ibfd.org/hold/ accessed on 06 November 2009). See also PricewaterhouseCoopers *Belgium's Advance Ruling Practice: A Powerful Risk Management Instrument in Tax Planning* http://www.doingbusiness.pwc.be/index.html?page=117 accessed on 22 October 2009; Ernst & Young 87.
[12] Ernst & Young 91. For statistical purposes, the Belgian financial institutions are required to report all transactions with foreign countries to the National Bank of Belgium.
[13] Deloitte *Comparison of European Holding Company.*
[14] See Vanhaute 209.

#### *9.2.2.2 Transfer Pricing*

The Belgian tax regime contains transfer pricing rules. Most significant and relevant to this thesis is the principle which provides that all abnormal and gratuitous advantages granted by a Belgian enterprise are added to the taxable income of that Belgian enterprise. This transfer pricing rule does not apply if the advantages are part of the income of the recipient that is taxable in Belgium.[15]

The Belgian transfer pricing rules apply to transactions between connected persons as a general rule. However, the rules also apply to transactions with "unrelated foreign persons that are not subject to income tax in their residence state or are subject to an income tax regime that is substantially more beneficial than the normal income tax regime in Belgium".[16]

#### *9.2.2.3 Notional Interest Deduction*

The Belgian tax regime provides companies with an annual notional interest deduction, a fictitious interest deduction which is calculated as a percentage of the company's risk-bearing adjusted net equity.[17] The percentage is equal to the interest rate applicable to ten-year Belgian government bonds. By way of example, for the 2008 financial year, the percentage was 3.701%.[18]

The purpose of the notional interest deduction is to reduce the tax discrimination between debt financing and equity financing. This is because interest on borrowed funds is deductible and dividends on risk-bearing capital are not deductible.[19] According to Bird

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[15] Art 26 of the ITC. See also Feinschreiber *Transfer Pricing International – A Country-by-Country Guide* (2002) par 19.3; Vanhaute 191; Ernst & Young 91.
[16] Osterweil and Quaghebeur "Taxation of Companies under Belgian Income Tax Law" (2008) *Bulletin for International Taxation* 350.
[17] Art 205*bis*-205*novies* of the ITC. Adjusted equity consists of net equity, including capital, reserves and retained earnings, but does not include equity invested in shareholdings; see Haelterman and Verstraete "The 'Notional Interest Deduction' in Belgium" (2008) *Bulletin for International Taxation* 365; Vanhaute 228.
[18] See Vanhaute 158.
[19] Vanhaute and Huygens *Belgium: Holding Companies* par 3.4.2.1.4.

and Bird, "[t]his deduction is considered compensation for the economic cost of equity and is not subject to any condition of reinvestment or employment and may be carried forward for seven years".[20]

#### *9.2.2.4 Dividend Withholding Tax*

Dividends paid by a Belgian company are subject to a 25% withholding tax. The withholding liability arises when the dividend is paid. The withholding liability extends to foreign-sourced dividends that are paid through the intervention of a Belgian intermediary. Where there are multiple Belgian intermediaries, the first Belgian intermediary who intervenes in the payment has the liability to withhold.[21]

Dividends paid by a Belgian company to a company resident in an EU member state are subject to a zero per cent withholding in terms of the EU Parent-Subsidiary Directive.[22] Similarly, dividends paid to a company resident in a tax treaty partner country where that treaty contains an exchange of information clause are subject to a zero per cent withholding.[23] In both the cases of EU member state and treaty country, the following conditions must be met in order for the zero per cent rate to apply:[24]

1. the company receiving the dividend must hold a participation of at least 25% of the share capital of the dividend distributing company for a period of at least 12 months;

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[20] See Bird & Bird *Belgian Holding Company Rules* (2008) http://springael.com/Documents/HOLD_BB_20080601.pdf accessed on 28 October 2009.
[21] Vanhaute and Huygens *Belgium: Holding Companies* par 4.2.1.1. See also Hinnekens and Drijkoningen "Belgium's Holding Company Regime – The Dividends-Received Deduction and Capital Gains Exemption for Shares" (2001) *Bulletin for International Taxation* 358–359.
[22] See Art 106(5) of the ITC.
[23] See Van Stappen "Belgium: Dividend Withholding Tax Exemption Improves Code" *International Tax Review* http://www.internationaltaxreview.com/Default.asp?Page=10&PUBID=35&ISS=23172&SID=668625&TYPE=20 accessed on 29 October 2009.
[24] See Vanhaute 155; Vanhaute and Huygens *Belgium: Holding Companies* par 4.2.3.1.

2. the company receiving the dividend must have its corporate seat within the EU and must not also be resident in a non-EU country in terms of a double tax treaty (hereinafter referred to as "a DTA") (no dual residence); and
3. the company receiving the dividend must be subject to corporate income tax or to similar tax without benefiting from a regime that deviates from the normal regime.

With regard to the 12-month holding period, the European Court of Justice in the *Denkavit*[25] case held that the exemption also applies even if the minimum 12-month holding period has not yet expired provided that the Belgian company submits a certificate indicating an undertaking to keep the minimum 25% participation for at least 12 months.[26] The second requirement stated above disqualifies dividends that are paid to companies that are not resident in an EU country from the exemption. Thus, only Belgian IHCs with ultimate investors that are resident in the EU can benefit from this exemption.

### 9.2.3 Special Features in the Belgian Tax System

The Belgian tax system contains three special tax features that are intended to make Belgium particularly attractive as a location for a holding company. These features are the dividend received deduction, the tax exemption for capital gains realised on shares and a liberal thin capitalisation regime.

#### *9.2.3.1 Dividends Received Deduction*

Ordinarily, dividends received by a Belgian company become part of taxable income and are therefore taxable at the 33.99% corporate income tax rate. In terms of the dividends received deduction, 95% of the dividends received by a Belgian company are deducted

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[25] EU Court of Justice C-283/94 and C-292/94, 17 October 1996.
[26] For a further discussion of this case see Jakoben and De Haan "European Union: Why Withholding Taxes are under Threat" (2005) *International Tax Review* http://www.internationaltaxreview.com/Default.asp?Page=10&PUBID=35&ISS=20909&SID=596447&TYPE=20 accessed on 06 November 2009.

from taxable income.[27] The remaining 5% is taxable but costs and expenses, such as interest, are deductible therefrom.[28] The dividends received deduction applies where the shareholding by the Belgian company in the company paying the dividends meets the following conditions:[29]

1. The Belgian company must hold at least 10% of the share capital of the company declaring the dividend, or must have obtained the shareholding for acquisition value of at least EUR 1.2 million;
2. The participation must be held (or there should be a commitment to hold the participation) in full property for an uninterrupted period of at least 12 months;
3. The participation must qualify as a "fixed financial asset";[30] and
4. The company paying the dividend must satisfy the subject-to-tax requirement.

In terms of the subject-to-tax requirement the dividends will not benefit from the dividends received deduction if they are distributed by certain treasury, financing and investment companies and/or distributed by companies located in low-tax jurisdictions or tax havens.[31]

The dividends received deduction is not available if the dividends are paid by: (i) a company that is not subject to tax in Belgium or to a similar foreign corporate income tax; (ii) a company that is established in a country where the normal tax regime is substantially more advantageous than the normal Belgian tax regime; (iii) a finance, treasury or investment company that is subject to a tax regime that deviates from the normal tax regime; (iv) a company receiving non-dividend income that is subject to a

[27] Art 205 § 2 of the ITC. See also Hinnekens and Drijkoningen *Bulletin for International Taxation* 355; Deloitte "Changes Introduced to Taxation of Dividends" (2005) *Belgium Tax Alert* http://www.mdseminars.be/files/articles/FIS-A-87.pdf accessed on 23 October 2009.
[28] See Bird & Bird *Belgian Holding Company Rules*.
[29] See Art 205(ter)(1) of the ITC.
[30] As to what constitutes a "fixed financial asset" the Belgian tax law refers to the accounting legislation, i.e. Art 95 of the Royal Decree of 30 January 2001. According to Dierckx the "fixed financial asset" requirement in principle requires that at the time the dividend is payable the participation must be considered to be a long-term investment (Dierckx "Belgium's Holding Company Regime – Past, Present and Future" (2008) *Bulletin for International Taxation* 404.
[31] Deloitte *Holding Companies in Belgium.*

separate tax regime deviating from the normal tax regime in the country of residence of the company declaring dividends; (v) a company that realises profits through foreign branches (to itself) subject to a tax assessment regime that is substantially more advantageous than the Belgian regime; (vi) an intermediary distributing or redistributing dividend income of which items (i)-(v) apply to 90% of the dividend concerned.[32]

The dividends received deduction is applicable only to the extent that there is sufficient taxable income available from which the deduction can be made. The taxable income can be from any source. If the company receiving the dividends does not have sufficient taxable income, or has losses, all or part of the 95% may be lost.[33]

In April 2003, the Court of First Instance of Brussels in Belgium ruled that the application of the dividends received deduction is in violation of the EU Parent-Subsidiary Directive because the EU Parent-Subsidiary Directive requires that member states should refrain from taxing qualifying dividends in the country of the company receiving dividends or to provide for a full foreign tax credit.[34] Pursuant to this the Minister of Finance announced that the dividends received deduction would be amended to be brought in line with the EU Parent-Subsidiary Directive in respect of dividends received from companies resident in the EU member states.[35] Irrespective of remedial action taken by Belgium, the ECJ ruled on 12 February 2009 in the *Cobelfret v Belgium*[36] case that Belgium has not correctly implemented the Parent-Subsidiary Directive in the dividends received deduction regime.

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[32] See De Neef and Malvaux "New Belgian Rules on Dividend Income Taxation and Capital Gains Exemption" (1997) *International Tax Review* 290–295. See Vanhaute 153; See also http://www.ing.be/xpedio/groups/ingbe/@public/@bbl/@risk_management/documents/other/262169_en.pdf accessed on 29 October 2009.
[33] See Deloitte *Holding Companies in Belgium.*
[34] Brussels Court, 25 April 2003, *F.J.F.* 2003, p. 812. See KPMG "Dividends Received Deduction and Withholding Tax: Partial Adjustment to European Legislation" (2005) *e-Tax Flash* accessible on http://kpmgbe.lcc.ch/dbfetch/52616e646f6d49562cdd4cc78bc61c14eb773c6c7c5f5b79/implementation_new_parent-subsidiary_directive.pdf accessed on 09 November 2009.
[35] See Deloitte *Belgium Tax Alert*. See also Dierckx *Bulletin for International Taxation* 409–410; Deloitte *Holding Companies in Belgium.*
[36] *Cobelfret v Belgium* (C-138/07) European Court of Justice. See also Isenbaert "Belgium Dividend Received Deduction Regime Found Contrary to the Parent-Subsidiary Directive by the ECJ in the Cobelfret Case" (2009) *Client Alert* http://www.bakernet.com/NR/rdonlyres/8332E9A5-EF15-4EFB-BC77-5DB3F7FAA2F8/0/belgium_colfretcase_ca_feb09.pdf accessed on 18 November 2009.

The dividends deduction is not available for dividends distributed by an intermediary company unless that intermediary company is an investment company which redistributes dividends from "contaminated" participators.[37] It is only under certain circumstances that the dividends deduction would remain available with respect to dividends received from EU-based finance companies, Belgian companies and certain listed companies, and companies that have been effectively taxed in Belgium on the redistributed dividends.[38]

In this regard Dierckx[39] states that the dividends received deduction will be allowed "for dividends from a direct shareholding in an EU-resident intermediary financial company if it can be demonstrated that the shareholding meets legitimate financial needs and the financial company's taxed reserves on the first day of its financial year plus its paid up capital on the last day of its financial year do not exceed 33% of its liabilities".

For the purposes of the dividend deduction, an "investment company" is defined as a company the purpose of which is to collectively invest pooled funds in the nature of a collective investment scheme such as a SICAV[40] and similar entities.[41] An IHC is not an investment scheme or similar to an investment scheme. Furthermore, it does not even carry out business activities similar to those carried out by an investment scheme. This means that the dividends received deduction does not apply to an IHC as it is not an "investment company" as defined.

The dividends received deduction is a great tax-reduction tool in the operation of a holding company. However, in effect, it does not apply to IHCs located in Belgium. This deprives Belgium of one of the main attractions of locating an IHC in the country.

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[37] Vanhaute and Huygens *Belgium: Holding Companies* par 4.1.3.2.5. For purposes of this provision, dividend income from "contaminated" participations refers to dividends of which, if distributed directly to the Belgian beneficiary, at least 90% would have been excluded from the dividend deduction under one of the exclusions.
[38] Vanhaute and Huygens *Belgium: Holding Companies* par 4.1.3.2.5.
[39] Dierckx *Bulletin for International Taxation* 408.
[40] A SICAV, *Societe d'Investissement*: A Capital Variable is "an open-ended collective investment scheme that derives its value by the number of participating investors (more investors means more available capital)"; see http://www.investorwords.com/6672/SICAV.html# accessed on 06 November 2009.
[41] Vanhaute and Huygens *Belgium: Holding Companies* par 4.1.3.2.5.

#### *9.2.3.2 Tax Exemption for Capital Gains Realised on Shares*

As stated above,[42] capital gains are treated as ordinary company profits and are therefore subject to the standard corporate income tax rate. With regard to shares, the net gain[43] realised by Belgian companies on the disposal of shares in non-resident companies is exempt from Belgian corporate income tax if the shares relate to participations that meet the "subject-to-tax" requirement as discussed under the dividend received deduction regime above.[44] The other requirements (i.e. the minimum shareholding, fixed financial asset and holding period) do not apply.[45]

The subject-to-tax requirement is not met if the company whose shares are disposed of is resident in a low-tax country.[46] This means that the tax exemption for capital gains on shares will be available only in limited cases where the company whose shares are disposed of is resident in a high-tax country.

#### *9.2.3.3 Thin Capitalisation*

The Belgian tax regime contains thin capitalisation provisions. The debt-to-equity ratio is effectively 7:1.[47] Deloitte[48] summarises the application of the thin capitalisation provisions as follows:

> When the holding company issues debt to a tax exempt company or a company at the level of which interest income is subject to a tax regime substantially more advantageous than in Belgium, the debt is regarded as

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[42] See par 9.2.2.
[43] "Net gain" is gain after the deduction of the alienation costs e.g. bank fees, commissions, consultancy costs, notary fees and publicity costs (Vanhaute 154).
[44] Vanhaute 154. See also Tahon and Bogaerts "Belgium: Amendments to the Participation Exemption Regime" (2002) *European Taxation* (Vol. 42 Issue 12) 513–515.
[45] See Bird & Bird *Belgian Holding Company Rules*.
[46] See par 9.2.3.1; Art 205(ter)(1) of the ITC; Decleir "Belgian Budgetary Income Tax Measures of 1997: Major Changes for the Participation Exemption and Introduction of Thin Capitalization Rules" (1998) *The International Tax Journal* (Vol. 24 Issue 1) 60–67.
[47] See Art 198(1)(11) of the ITC.
[48] Deloitte *Comparison of European Holding Company Regimes*.

> "tainted", with the following consequences: i) interest payments related to tainted debt are only tax deductible when HoldCo proves that the debt relates to real and sincere transactions and that the conditions of the debt are not abnormal, and ii) in any case, the interest deduction will be denied to the extent that the total tainted debt exceeds seven times the equity. The part of the interest payments exceeding the market rate are not tax deductible. Interest payments on debt issued to individual shareholders and to directors (individuals and corporations other than European corporations) will be recharacterised as dividends to the extent that the total debt exceeds the company's equity and to the extent the normal market rate is exceeded.

The 7:1 limitation "can apply to foreign-based beneficiaries as well as to beneficiaries resident in Belgium who benefit from a substantially more advantageous tax regime as compared to the generally applicable regime. Accordingly, the [7:1] limitation could potentially apply to interest paid by a Belgian debtor to a Belgian coordination centre or any other not or low-taxed entity."[49] The Belgian thin capitalisation regime is liberal in its application and is thus convenient for the financing of foreign subsidiaries.[50]

Although the Belgian thin capitalisation provisions are liberal there are established methods of avoiding the application of these provisions. In this regard Vanhaute and Huygens state as follows:[51]

> The [7:1] debt/equity ratio could be avoided by using an intermediate finance company which is subject to a tax regime which is not considered to deviate substantially from the Belgian tax regime. Depending on the debt/equity ratios which may apply in the finance company's own country, the latter could be highly leveraged so that its taxable basis is substantially

[49] Vanhaute and Huygens *Belgium: Holding Companies* par 3.4.2.3.2.
[50] Hinnekens and Drijkoningen *Bulletin for International Taxation* 359; Decleir *The International Tax Journal* 66–67
[51] Vanhaute and Huygens *Belgium: Holding Companies* par 3.4.3.4.

eroded. Suitable jurisdictions for the location of such finance company would be the Netherlands and Luxembourg.

### 9.2.4 Conclusion

The Belgian corporate tax regime contains some features that make Belgium suitable for the operation of an IHC. These are mainly that Belgium does not have exchange control regulations and has an advance tax ruling system and a notional interest deduction system. Furthermore, there is an exemption on capital gains realised on shares (although it applies in limited cases) and liberal thin capitalisation provisions, for the avoidance of which there are established methods.

However, dividend withholding tax is a main concern for many investors. The exemption therefrom would suit investors whose home country is located in the EU, or those that are willing to interpose another company within the EU. However, the cost of such interposition might extinguish the tax benefit derived from the exemption from the dividend withholding tax.

On the other hand, the Belgian tax system also contains tax instruments that are not suited for a jurisdiction that hosts IHCs. Among these the following deserve to be mentioned: the high 33.99% corporate income tax that also applies to capital gains, the lack of foreign tax credits other than on application of a treaty as well as the presence of CFC-like legislation. The availability of the dividends received deduction, on the face of it, is a positive feature. Unfortunately, the fact that it is not available for IHCs makes the dividends received deduction useless for enhancing Belgium's position as a preferable host for IHCs.

## 9.3 IRELAND

### 9.3.1 Introduction

Ireland is located in Western Europe and occupies five-sixths of the island of Ireland in the North Atlantic Ocean, west of Great Britain. It has a population of about four million people. English is the official language that is generally used while Irish is an official language that is spoken mainly along the western coast of Ireland. The Irish currency is the Euro. The capital city is Dublin.[52]

Ireland has been at the forefront of fiscal inventive innovations for many years.[53] Currently it is seen as an attractive location for business, with a tax regime that ranks very competitively against other economies.[54] Its appeal derives from a low rate of corporation tax coupled with an educated workforce and an advanced industrial infrastructure.[55] In the 2009 Doing Business report from the World Bank, Ireland was ranked 6th out of 181 countries in terms of the ease of paying taxes, the highest in the European Union.[56]

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[52] Central Intelligence Agency "Ireland" *The World Factbook* https://www.cia.gov/library/publications/the-world-factbook/geos/ei.html accessed on 14 October 2009.
[53] Loughlin "Ireland Offers Limited Opportunities" 1993) *International Tax Review* 37.
[54] Diamond "Maintaining Ireland's Advantages as a Location for FDI" (2008) *Accountancy Ireland* (Vol. 40 Issue 5) 80–82.
[55] McGonagle "Ireland Ranks Highly as a Location for Business" (2009) *International Tax Review* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=25377&SID=719831&TYPE=20 accessed on 19 October 2009. McGonagle "Ireland Aims to Attract Holding Companies" (2004) *International Financial Law Review* http://proquest.umi.com/pqdweb?did=783749051&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 22 October 2009.
[56] See *Doing Business* http://www.doingbusiness.org/documents/paying_taxes_2009.pdf accessed on 15 October 2009. McGonagle "Ireland Attracts HQs and Holding Companies" (2004) *International Tax Review* http://proquest.umi.com/pqdweb?did=783742491&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 16 November 2009.

### 9.3.2 Corporate Income Tax

Ireland has a global system of corporate income tax (i.e. it is a residence-based tax system). The Irish income tax provisions are contained in the Tax Consolidation Act of 1997 (hereinafter referred to as "the TCA 1997").[57] A company is treated as resident in Ireland if it is incorporated in Ireland or if its central management and control is located in Ireland.[58] Foreign companies are taxable on Irish-sourced income.

Ireland imposes corporate tax on profits or gains at two varying rates. Trading income is taxed at 12.5% while income other than trading income is taxed at 25%. The 25% rate applies to non-trading income, rental and investment income, and foreign income unless the income is part of an Irish trade.[59] In relation to holding companies, the 12.5% rate applies where the holding company's trade is carried on in Ireland. Where the holding company's trade is carried on offshore as a foreign trade, the 25% rate applies.[60]

Until 24 December 2008 capital gains tax (hereinafter referred to as "CGT") was levied at a flat rate of 20% on chargeable gains.[61] In an attempt to deal with the global and economic downturn, the Irish Minister of Finance increased the CGT rate by 2% to 22%.[62] Residents are liable to CGT on the gain accruing to that resident from the alienation of any asset regardless of where that asset is situated.[63] A non-resident company is subject to CGT on its chargeable capital gains from the disposal of land and buildings (as well as unquoted shares deriving the majority of their value from land and

[57] The TCA 1997 levies all three forms of taxation: income tax, capital gains tax and corporation tax.
[58] See s 23A(2) of the TCA 1997; *De Beers Consolidated Mines Ltd vs Howe* 5 TC 198, 213; *San Paulo (Brazilian) Railway Co vs Carter* 3 TC 407, 410.
[59] See ss 21(A)(3), 25, 26(1) and 76 of the TCA 1997.
[60] Deloitte *Comparison of European Holding Company Regimes* https://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/dtt_tax_holdcomatrix_europe_072309.pdf accessed on 19 October 2009.
[61] See s 28 of the TCA 1997. See also Haccius *Ireland in International Tax Planning* (2004) 17.
[62] McGonagle "Welcome Changes in Finance (no 2) Act 2008" (2009) International Tax Review http://www.internationaltaxreview.com/default.asp?Page=10&PUBID=35&ISS=25283&SID=716805 accessed on 19 October 2009.
[63] See s 29(2) of the TCA 1997.

buildings) and assets used in a business carried on in Ireland through a branch or agency.[64]

### 9.3.3 Special Features in the Irish Tax System

Ireland does not prescribe any corporate form for a holding company. This flexible system allows the holding entity to be incorporated with limited or unlimited liability.[65] Ireland does not have CFC or equivalent legislation. It also does not impose foreign exchange controls, except in very limited circumstances at the discretion of the Minister of Finance.[66] There are no thin capitalisation provisions in Ireland provided that the rate of interest charged does not exceed a reasonable rate.[67] However, interest payments to 75% non-resident affiliated companies may be treated as distributions of profit and are consequently not deductible.[68]

In addition to the above, the features that make Ireland attractive as an IHC host country are its low corporate tax rate, exemption from capital gains tax on disposal of qualifying shareholdings, a unilateral foreign tax credit system, an onshore pooling of excess foreign credit and withholding tax exemptions.[69] Ireland also has a system of group taxation in the form of group contribution. On the other hand, Ireland does not have a participation exemption. It also does not have an advance tax rulings system.[70]

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[64] See s 29(3) of the TCA 1997; Haccius 532–534.
[65] Cunningham "Ireland's New Holding Company Regime" (2004) *Bulletin for International Fiscal Documentation* 545.
[66] Ernst & Young *Worldwide Corporate Tax Guide* (2006) 421.
[67] See *Irish Holding Companies* http://www.byrnemccall.ie/byrnemccall/Main/HoldingCompanies2006-5.htm accessed on 13 October 2009.
[68] Ernst & Young 421.
[69] See Phelan "Holding Companies: the New Regime" (2005) *Accountancy Ireland* (Vol. 37 Issue 3) 44–45; Connell and O'Meara "Ireland: Ireland's New Rules on the Taxation of Dividend Income – Some Practical Considerations" (2008) *International Tax Review* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=24924&SID=710730&TYPE=20 accessed on 14 October 2009.
[70] See Deloitte *Comparison of European Holding Company Regimes.*

#### *9.3.3.1 Low Corporate Tax Rate on Dividends*

In terms of the Irish corporation tax system, dividends received from non-Irish subsidiaries are taxed at the corporation tax rate. Prior to 24 December 2008, Irish-resident holding companies were subject to Irish corporation tax at a rate of 25% on dividends received from foreign subsidiaries. The Finance Act (no. 2) of 2008 reduced the tax rate to 12.5% for dividends paid to the Irish holding company out of trading profits of companies resident in a European Union member state or country with which it has a DTA.[71] According to Connell and O'Meara:

> Broadly, the provisions operate by providing that a dividend paid out of trading profits of a company resident in a relevant territory is treated as trading profits in the hands of the recipient company. This allows for trading profits to be traced up through a chain of companies to the top Irish holding company.

The rules require that the dividend be paid out of trading income. However, trading is not defined. Three rules are used to determine whether the lower rate of 12.5% applies. Firstly, dividends received from portfolio investment automatically qualify. Portfolio investment refers to shareholding of less than 5%. Secondly, the amount of the dividend will be deemed to be wholly paid from trading profits where at least 75% of the total profits of the company paying the dividend comprise trading profits, and at least 75% of the aggregate value of the assets of the Irish holding company relates to assets used for trading purposes.[72] Thirdly, in all other cases, only the proportion of the dividend that represents trading income will qualify for the 12.5% rate.[73]

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[71] See Connell and O'Meara *International Tax Review*. See also Hickson "Ireland" (2009) *International Tax Journal* (Vol. 35 Issue 2) 33–34.

[72] The assets of the Irish holding company in this case include assets of its 5% held companies in the foreign country. Furthermore, assets exclude the shareholdings themselves as inter-company loans between those companies.

[73] See Connell and O'Meara *International Tax Review*.

These provisions could reduce the tax burden on the IHC where its subsidiaries operate in EU member states or in countries with which Ireland has a DTA. However, if the subsidiaries operate in non-EU member states which do not have DTAs with Ireland, these provisions do not apply. In that case, the IHC would be taxed on the dividend receipts as if Ireland does not have a special tax regime for holding companies. In light of the fact that Ireland has only 46 tax treaties, compared to the Netherlands with 81 and the United Kingdom at 112, the beneficial application of these provisions is considerably restricted.[74]

### *9.3.3.2 Exemption from CGT on Disposal of Qualifying Shareholdings*

In 2004 Ireland introduced an exemption from CGT on disposals by an Irish company of a shareholding in another company.[75] The exemption applies if the following conditions are met:

1. The company whose shareholding is disposed of must be resident in Ireland, in another EU member state or in a country with which Ireland has a DTA at the time of the disposal;
2. The Irish company must have held at least 5% of the shares in the company whose shareholding is disposed of for a period of at least 12 months ending in the previous 24 months. The 5% shareholding can be direct or indirect; and
3. The company whose shares are being disposed of must be wholly or principally a trading company. Alternatively, the company disposing of the shareholding together with its 5% group and the company whose shareholding is disposed of must be wholly or principally a trading group.[76]

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[74] See Deloitte *Comparison of European Holding Company Regimes.*
[75] See "Ireland's Holding Company Regime is Legal" (2004) *International Tax Review* http://proquest.umi.com/pqdweb?did=783743651&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 16 November 2009; Cullen and Forde "Ireland Moves Ahead as a Holding Company Location" (2004) *International Tax Review* http://proquest.umi.com/pqdweb?did=609359621&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 16 November 2009.
[76] See Ernst & Young 410. In Germany 95% of a capital gain from the sale of shares in a foreign or German company is exempt from tax when received by a company taxable in Germany (see Germany Income Taxes and Tax Laws http://www.worldwide-tax.com/germany/germany_tax.asp accessed on 29 October 2009).

As can be seen, the first requirement limits the application of this exemption to EU member states and countries with which Ireland has DTAs. The disposals of shareholding in companies that are not resident in the EU and that do not have DTAs with Ireland would be taxed as if Ireland did not have a special tax treatment for holding companies.

#### *9.3.3.3 Tax Credit System*

Ireland provides for a tax relief against foreign taxes on dividends received by an Irish holding company from foreign shareholdings. This is hailed as one of the main features that make the Irish tax system suitable for holding company operations.[77] This relief is granted in terms of the tax treaty credit relief and unilateral credit relief. The credit relief applies to dividends received from shareholdings of at least 5% in a foreign company. In addition there could be "a drilldown to lower level subsidiaries where the relationship is at least 5% and the Irish company controls at least 5% of the lower tier company".[78] This relief applies to dividends from all countries and not just EU member states or countries with which Ireland has a DTA.[79]

A tax credit system is a mechanism to eliminate double taxation. It is generally not a tax incentive or a feature that is included in the tax system to encourage investment. Without the elimination of double taxation, international business activity could be significantly hampered. As Arnold and McIntyre[80] aver:

> If income tax rates are low, as they were in the early years of the 20th century, the inefficiencies and unfairness caused by double taxation are modest enough to be bearable. But when the tax rates reach the levels that

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[77] See McGonagle "Ireland Attracts HQs and Holding Companies" (2004) *International Tax Review* http://www.internationaltaxreview.com/includes/magazine/PRINT.asp?SID=470485&ISS=12595&PUBID=35 accessed on 13 October 2009.
[78] A&L Goodbody *Ireland – A Holding Company for European Acquisitions* http://docs.google.com/gviewa=v&q=cache:8YaNsZcYUjMJ:www.algoodbody.ie accessed on 13 October 2009.
[79] See Cunningham "Ireland's New Holding Company Regime" (2004) *Bulletin for International Taxation* 544; Tivnan and Lewis "Foreign Dividends: Irish HoldCo Gains Momentum" (2008) *Accountancy Ireland* (Vol. 40 Issue 3) 61–63.
[80] See Arnold and McIntyre *International Tax Primer* (2002) 27.

> now prevail, double-tax burdens can become onerous and interfere substantially with international commerce. The necessity for relief is clear on the grounds of equity and economic policy.

Elimination of double taxation is therefore an essential feature of any tax system. Without a system of elimination of double taxation, Ireland's tax system would be adverse to international business in general and not only to holding companies. Therefore, the introduction of a tax credit system merely brings Ireland into line with best practice.

#### *9.3.3.4 Pooling of Tax Credits*

Normally, an optimal IHC location would have a participation exemption which results in a complete exemption from tax on dividends received. Ireland does not have a participation exemption. Instead, it operates a credit system. As McGonagle[81] states

> *Finance Act 2004* introduced a system of onshore pooling of tax credits to deal with the situation where foreign tax on some dividends exceeds the Irish tax payable while on other dividends the foreign tax is below the Irish tax liability. Previously, any credit that exceeded the Irish tax liability attributable to that particular dividend would be lost. The new provisions allow excess so-called "credit" to be offset against Irish tax on other foreign dividends received in the accounting period concerned.

Practically, this pooling system would not be beneficial where all the subsidiaries of the IHC operate in countries with lower tax rates than Ireland or those with higher tax rates than Ireland. It would be of benefit where some subsidiaries operate in higher tax jurisdictions and others in lower tax jurisdictions than Ireland and the average tax rate is equivalent to that of Ireland.

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[81] See McGonagle *International Tax Review*.

The pooling system could offset, to a limited extent, the adverse tax implications on dividends received from non-EU member states that do not have DTAs with Ireland.

#### *9.3.3.5 Group Taxation*

Ireland has a system of group taxation in the form of group contribution. In terms of this system, members of a group may surrender current-year trading losses, excess charges on income, and excess management expenses to other members of the group.[82] Two companies are members of a group if one is a 75% subsidiary of the other or both are 75% subsidiaries of a third company. Group relief is available to Irish companies, subject to certain conditions, in respect of trading losses incurred by their non-Irish subsidiary companies that are resident in EU Member States and European Economic Area states with which Ireland has a DTA. Loss relief is limited to losses incurred in a business carried on by a company that is subject to corporation tax in Ireland.

### 9.3.4 Conclusion

The main tax attractions in Ireland are restricted in application to companies that are resident in the EU and countries with which Ireland has a DTA. The low corporate tax rate of 12.5% is in practice not applicable to dividends received from non-EU member states and countries with which Ireland does not have DTAs. Similarly, the trading of losses in terms of the Irish group taxation system is not available to non-EU member states and countries with which Ireland does not have DTAs. The availability of a unilateral double tax relief is not something that could be hailed as an attraction to do business. It is an essential feature of any tax system that ensures equity.

The pooling of foreign tax credits could offset the adverse implications on dividends received from non-EU member states that do not have DTAs with Ireland. However, due to the limited circumstances under which this is most beneficial (i.e. where some

[82] Revenue Irish Tax and Customs *Groups* http://www.revenue.ie/en/tax/ct/groups.html accessed on 18 October 2009.

subsidiaries operate in higher tax jurisdictions and others in lower tax jurisdictions than Ireland and the average tax rate is equivalent to that of Ireland) its impact is not likely to persuade an investor to choose Ireland as a host for an IHC. In addition, with only 46 tax treaties, the Irish tax treaty network is not large enough to attract investors from most countries. Similarly, the treaty network is not large enough to encourage investment through Ireland to most countries.

The remaining features that might attract IHCs to Ireland are the absence of CFC, transfer pricing and liberal thin capitalisation provisions. Without a capital gains and dividend tax relief mechanism that applies to disposals and distributions, respectively, and that is not limited to subsidiaries in EU member states and Ireland's DTA partners only, Ireland's favourable holding company tax regime will not in itself appeal to investors worldwide.

## 9.4 UNITED KINGDOM

### 9.4.1 Introduction

The United Kingdom (UK) is located in Western Europe. It comprises four countries: England, Scotland, Wales, and Northern Ireland. It includes the northern one-sixth of the island of Ireland between the North Atlantic Ocean and the North Sea and is to the northwest of France. It has a population of approximately 61 million people. English is the official language, while Welsh and Scottish are also generally spoken by the populations of Wales and Scotland respectively. The capital city is London. Although the UK is a member of the EU, it presently still retains the Pound Sterling as its currency.[83]

In the 2009 Doing Business report from the World Bank, the UK was ranked 16th out of 181 countries in terms of the ease of paying taxes.[84]

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[83] Central Intelligence Agency "Ireland" *The World Factbook – United Kingdom* https://www.cia.gov/library/publications/the-world-factbook/geos/uk.html#top accessed on 20 October 2009; Doing Business in the UK http://www.kwintessential.co.uk/etiquette/doing-business-uk.html accessed on 20 October 2009.

[84] See *Doing Business* http://www.doingbusiness.org/documents/paying_taxes_2009.pdf accessed on 15 October 2009.

### 9.4.2 Corporate Income Tax

The UK has a global system of corporate income tax (i.e. it is a residence-based tax system). Resident companies are subject to corporation tax on their worldwide profits. Corporation tax, as opposed to income tax, covers both income and capital gains.[85] A company is resident in the UK if it is incorporated in the UK or if the company's central management and control is exercised in the UK. Foreign companies are taxable on UK-sourced income.[86]

The UK imposes corporation tax at a rate of 28%. This rate was reduced from 30% in 2008.[87] There is no CGT for companies. Instead, companies are subject to corporation tax on chargeable gains at the same rate as income.[88]

The UK does not have a system of advance tax rulings. However, the UK tax authorities "will give advice on the interpretation of the law (including in relation to a proposed transaction) if the query relates to (i) legislation passed in the last four Finance Acts; (ii) older legislation where the uncertainty is of commercial significance to the business; (iii) the application of tax treaties; or (iv) areas of major public interest".[89]

[85] Collinson and Tiley *Tiley and Collinson UK Tax Guide* 2006–2007 (2006) par 25:01.
[86] Collinson and Tiley par 25:01. See also Laing *British Master Tax Guide 2006/2007* (2006) 644–645.
[87] Watterson *Corporation Tax 2008/2009* (2008) 49. In this regard a UK tax authority spokesperson said: "At 28%, the UK's corporation tax rate is now at its lowest ever level. The UK continues to have the lowest corporation tax rate of the major G7 economies. See "UK Taxpayers Fear Corporate Tax Hike" *International Tax Review* http://www.internationaltaxreview.com/?Page=9&PUBID=210&ISS=25473&SID=722572&SM=&SearchStr=%22UK%20corporation%20tax%22 accessed on 21 October 2009.
[88] See Watterson 499.
[89] See Deloitte *Comparison of European Holding Company Regimes* https://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/dtt_tax_holdcomatrix_europe_072309.pdf accessed on 19 October 2009.

#### *9.4.2.1 Capital Gains Exemption*

An exemption exists from corporation tax on chargeable gains on the disposal of shareholdings in other companies.[90] In order for a company to benefit from the exemption, the following three requirements must be fulfilled:

1. The company disposing of the shares must hold at least 10% of the share capital of the company whose shares are disposed of for a period of 12 continuous months within the two years prior to the disposal ;
2. The company disposing of the shares must be a trading or holding company by itself during the period of 12 continuous months within the two years prior to the disposal; and
3. The company whose shares are disposed of must be a trading company or a holding company of a trading group for period of 12 continuous months within the two years prior to the disposal.[91]

#### *9.4.2.2 Tax Credits*

The UK also provides for a tax credit for corporate taxes paid by foreign countries against UK corporation tax. The claim may be made under a DTA or under the unilateral tax relief mechanism. The credit cannot exceed the UK corporation tax.[92] "The only credit available for overseas dividends is withholding tax unless the UK company owns more than 10% of the overseas company's equity."[93]

[90] See Kavanagh "New U.K. Participation Exemption for Capital Gains on Substantial Shareholdings" (2002) *Journal of International Taxation* (Vol. 13 Issue 8) 24–29.
[91] See Ocra Worldwide *UK Holding Company Information* http://www.ocra.com/solutions/eu_holding/uk.asp accessed on 20 October 2009.
[92] See Deuchar and Van Hulsen "What next for UK mixers?" (2001) *International Tax Review* (Vol. 12) 48–51; Watterson 375.
[93] Watterson 375.

#### *9.4.2.3 Controlled Foreign Company Legislation*

*(a) Application*

The UK legislation contains CFC legislation. The control provisions of the UK CFC legislation are contained in section 755D of the Income and Corporation Taxes Act of 1988 (hereinafter referred to as "the ICTA 1988"). A foreign company is a CFC if UK residents hold more than 50% of the interest in that foreign company.[94] Furthermore, where UK residents hold more than 40% of the interest in a foreign company and a non-UK resident holds at least 40% of the interest in that foreign company, such company would be a UK CFC.[95]

The UK CFC rules also contain provisions which attribute certain rights and powers to persons in establishing whether or not they have control.[96] In terms of this rule, in determining whether a person has control consideration is given to the rights and powers which can be acquired in the future, those belonging to UK-connected persons and those exercised in accordance with the person's wishes (or jointly with someone else) in establishing whether that person has control.[97]

The income of the CFC is imputed to shareholders who hold 25% or more of the interest in the CFC. [98]

Certain CFCs are exempt from CFC taxation. The main companies that are exempt are:

(i) companies that distribute 50%[99] of their available profits within 18 months after the end of the accounting period to which the income relates;[100]

[94] See s 755D(1) of the ICTA 1988.
[95] See s 755D(3) and (4) of the ICTA 1988.
[96] See s 755D(5) of the ICTA 1988. See Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (LLD dissertation 2007 UNISA) 249–253.
[97] See s 755D(5) of the ICTA 1988; see also Gordon-Brown *Controlled Foreign Companies*.
[98] Ernst & Young 997
[99] The percentage increases to 90% if the CFC is not a trading company.

(ii) the CFC has a business establishment in the territory in which it is resident;

(iii) the activities of the CFC are carried out for *bona fide* commercial reasons. In order satisfy this requirement, "a company must show that neither the main purpose of the transactions which gave rise to the profits of the CFC nor the main reason for the CFC's existence was to achieve a reduction in UK tax by means of the diversion of profits".[101] The UK tax authorities' practice with regard to the motive test is unclear *inter alia* as to whether a company that is set up to avoid foreign tax passes this test.[102]

(iv) a minimum of 35% of the voting shares of the CFC are listed and traded in a recognised stock exchange; or

(v) the CFC is resident in an excluded country.[103]

*(b) Analysis*

The UK CFC rules are very complicated, and are among the toughest in the world when compared with other CFC regimes.[104] As KPMG reported, the prevailing UK CFC rules are hugely unpopular with investors. KPMG states as follows:[105]

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[100] See Leegaard "CFC legislation – Recent Changes to the Acceptable Distribution Policy Exemption" (2001) *European Taxation* (Vol. 41 Issue 7) 293–296.

[101] Lee *UK Finance Bill Introduces New CFC Rules.*

[102] See Gordon-Brown *Controlled Foreign Companies* http://www.tax.org.uk/showarticle.pl?id=93&n=379 accessed on 05 November 2009.

[103] See Laing 817; Ernst & Young 996–997. It should be noted that the UK CFC rules are being reviewed. See "UK Taxpayers Fear Corporate Tax Hike" *International Tax Review* http://www.internationaltaxreview.com/?Page=9&PUBID=210&ISS=25473&SID=722572&SM=&SearchStr=%22UK%20corporation%20tax%22 accessed on 21 October 2009. The UK authorities maintain a list of excluded countries divided into two. The first list contains countries which are excluded provided that income and gains derived outside that country do not exceed the greater of 10% of the company's income and gains or £50 000. The second list contains countries which are excluded subject to the additional requirement that none of the specified exemptions or relief measures are available to the overseas company. See FL Memo Ltd *FL Memo Tax 2006–2007* (2006) 260.

[104] See Gordon-Brown *Controlled Foreign Companies*. Frankly, the UK had difficulties with attracting investors for a long time. In this regard see Berner "Where the UK Falls Short" (1993) *International Tax Review* 24–26.

[105] KPMG Cadbury Schweppes Case – *Advocate General says Locating Operations on the Basis of a Low Tax Rate is Legitimate* http://www.kpmg.co.uk/news/detail.cfm?pr=2508 accessed on 05 November 2009. See also Lee *UK Finance Bill Introduces New CFC Rules* http://www.tax-news.com/archive/story/UK_Finance_Bill_Includes_New_CFC_Rules_xxxx26909.html# accessed on 05 November 2009.

> In a survey conducted on behalf of KPMG [in 2006], two-thirds of respondents said that UK tax rules had hindered cross-border investment for their groups. Asked about which specific rules were to blame, the CFC regime was the most commonly cited, affecting over half of the companies concerned. The companies questioned commented that they would like to see changes to the CFC legislation because it was unfair and complex, they felt that it was difficult for them to understand where they stood, it made normal business transactions difficult and that companies could be caught up by the rules even when they had a true commercial purpose.

As a result of the stringent UK CFC rules, a number of companies made "public declarations about moving out of the UK, and a number have gone to Ireland … Some have gone to the Netherlands."[106]

The UK CFC legislation has also come under scrutiny at the level of the European Court of Justice (hereinafter referred to as "the ECJ") when the UK tax authorities applied the CFC legislation to Irish companies on the basis that they were established and operated in order to avoid tax. In the *Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*[107] the EJC held that such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that controlled company is actually established in the host EU member state and carries on genuine economic activities there.[108] In this regard it was the view of the ECJ that the UK's motive test went beyond what is necessary to achieve the objective of preventing wholly artificial arrangements intended to avoid UK national tax.[109]

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[106] See http://www.strategicrisk.co.uk/story.asp?storycode=380661 accessed on 03 November 2009; Oguttu 271–273.
[107] Judgment of the Court (Grand Chamber) of 12 September 2006 (reference for a preliminary ruling from the Special Commissioners, London — United Kingdom) — Cadbury Schweppes plc, *Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* Official Journal of the European Union C 281/5.
[108] See Tran "*Cadbury Schweppes plc v. Commissioners of Inland Revenue*: Eliminating a Harmful Tax Practice or Encouraging Multinationals to Shop around the Bloc?" http://ilr.lls.edu/issues/30/documents/Article330.1Tran.pdf accessed on 04 November 2009.
[109] See Dodwell and Sarrau "*Cadbury Schweppes*: the ECJ Decides" (2006 November) *Tax Adviser* 26. The *Cadbury Schweppes* case had an impact on other tax systems and resulted in some countries amending their

Currently, the UK is considering a review of its CFC legislation as it considers that CFC legislation goes "to the heart of the taxation regime for UK multinationals and raise[s] issues regarding the competitiveness of the UK as a holding company location".[110]

### 9.4.3 Special Features in the UK Tax System

The UK does not have statutory thin capitalisation provisions. However, highly leveraged non-resident companies are closely scrutinised by the tax authorities. This may result in interest deductions being disallowed on the grounds that "based on all of the circumstances, the loan would not have been made at all, or that the amount loaned or the interest rate would have been less, if the lender was an unrelated party acting at arm's length".[111]

The UK does not have exchange control regulations (these were abolished in 1979), and it also has one of the largest treaty networks in the world, with 112 concluded tax treaties.[112]

#### *9.4.3.1 No Withholding Tax on Dividends*

The UK further provides incentives that are intended to encourage the location of holding companies in the UK. It does not impose any withholding tax on dividends distributed by resident companies to UK non-resident shareholders, irrespective of their residence.

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CFC rules to bring them in line with the ECJ ruling, for example see Brenfield "Sweden's New CFC Regime after Cadbury Schweppes – Comments and Analysis" (2008) *Bulletin for International Taxation* 295–301; Malherbe *et al* "Controlled Foreign Corporations in the EU after Cadbury Schweppes" (2007) *Tax Management International Journal* 607–650.

[110] See "UK throws out Controlled Foreign Companies Regime" (2008) *International Tax Review* http://proquest.umi.com/pqdweb?did=1456135201&Fmt=3&clientId=27625&RQT=309&VName=PQD accessed on 16 November 2009.

[111] Ernst & Young 997; Laing 813.

[112] Deloitte *Comparison of European Holding Company Regimes*.

### *9.4.3.2 No CGT on Sale of UK Subsidiary*

CGT is not levied on non-residents. As a result no tax is levied on the sale of shares of a UK subsidiary of a non-resident parent company.[113]

### *9.4.3.3 Group taxation*

The UK tax law provides for group taxation in the form of group relief. The aim of the UK group relief system is to ensure the fiscal neutrality of the effects of the creation of a group of companies.[114] A group of companies comprises the UK parent company and all UK-resident subsidiaries that are owned directly or indirectly by a percentage of 75% or more by a holding company, unless the shares are held as inventory. In this regard Collinson and Tiley[115] state the following:

> Group relief enables current trading losses, capital allowances, a non-trading deficit on loan relationships, excess management expenses of investment companies and excess charges on income to be surrendered by one company (the surrendering company) to another (the claimant company) enabling the latter to put the other company's loss against its total profits. Both companies must satisfy the group or consortium tests throughout their respective accounting period but need not be members of the same group or consortium when the claim is made.[116]

[113] Ocra Worldwide *UK Holding Company Information.*
[114] Walton and Stone *Marks & Spencer: UK group relief rules at risk*, http://tax.practicallaw.com/1-200-6684 accessed on 10 July 2008.
[115] Collinson and Tiley *Tiley and Collinson UK Tax Guide 2006–07* (2006) par 28:05 and references contained therein.
[116] In Barbados, resident companies may elect to surrender only the current, not past, eligible trading losses within a group. Eligible trading losses exclude depreciation allowances, and any inter-group expenses that are claimed as expenses but not included in the taxable income for the receiving company in the same fiscal year. See Rohatgi *Principles of International Taxation* (2002) 194. In Trinidad and Tobago the taxpayer cannot reduce its tax liability by more than 25% through the tax losses of the surrendering company. See Rohatgi (2002) 194.

Foreign incorporated subsidiaries may be included, provided they are tax-resident. Thus, non-resident companies do not benefit from the group relief.[117] Where the loss arises in a group member that is not resident in the UK, group relief is available only if the surrendering company is resident in another member state of the European Economic Area (or has a permanent establishment in another European Economic Community) and the loss is not relievable in that other member state.[118]

### 9.4.4 Conclusion

Technically, the UK does not have a special regime for holding companies.[119] The UK tax system merely contains certain features that can alleviate the tax burden on holding companies operating in the UK. The most important of these features are the absence of withholding tax on dividends, the absence of capital gains on the sale of a UK subsidiary and the presence of group taxation as well as an extensive treaty network.

"The use of the UK as a holding company location has been fraught with difficulties over the years."[120] The failure of the UK tax system to attract IHCs can be attributed to the fact that while the UK has an adverse CFC regime, it does not have any special tax attributes that could offset the adversity of the CFC regime. The offsetting features could be a special tax regime for IHCs similar to the Mauritian taxation of GBL1 companies, or a conglomerate of tax relief features such as a combination found in the Dutch tax system.

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[117] See Foster "Losses for Companies Mean Losses for Governments" http://www.dlapiper.com/hu/global/publications/detail.aspx?pub=1412 accessed on 28 September 2009. The group relief system applicable in Ireland is analogous to the UK provisions in that it restricts loss relief to Irish companies and branches.

[118] Tiley and Collinson par 28:05.

[119] Deloitte *Comparison of European Holding Company Regimes*.

[120] Shelton N "Denmark Squares up for Holding Battle" (December 1998/January 1999) *International Tax Review* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12655&SID=468670&SM=&SearchStr=%22intermediary%20holding%20company%22 accessed on 13 November 2009.

In addition to the complex CFC legislation, the 28% corporate tax rate and the absence of advance tax rulings system, as well as the seemingly discretional disallowance of interest on highly leveraged non-resident companies, could deter potential investors to the UK.

## 9.5 CONCLUSION

As indicated in the introduction to this chapter, the three countries discussed in this chapter have the benefit of the Parent-Subsidiary Directive. However, the Parent-Subsidiary Directive only benefits investors on dividend payments within the EU.

For the UK the problem is clear: the UK CFC legislation is expansive and complex. This in itself repels investors from the UK, and illustrates that one significantly adverse aspect in the tax system has the potential to sabotage concerted efforts to promote a country as an ideal host for IHCs. In the UK this is exacerbated by the fact that the UK does not have abundant special features that are favourable for IHCs.

Ireland, on the other hand, does have numerous features that make the Irish tax system ideal for the operation of an IHC. However, most of the features are available for optimal use only by investors from EU countries and those resident in countries with which Ireland has a DTA. This restricts the suitability of Ireland as an IHC host country to a limited number of investors. This limitation is exacerbated by the relatively small number of DTAs that Ireland has concluded. This illustrates the point that the suitability of a country as a host for IHCs can be curtailed by the limited or focused applicability of enabling tax provisions.

With regard to Belgium, the factors that inhibit the ability of Belgium to attract IHCs are two-fold. The one is the high corporate income tax rate that also applies to capital gains, the lack of foreign tax credits other than on application of a treaty as well as the presence of CFC-like legislation. The other is that the dividends received deduction is not available to IHCs. This basically makes the dividends received deduction useless for enhancing Belgium's position as a preferable host for IHCs. This illustrates the point that the application of highly effective tax instruments could be rendered worthless by excluding from their application entities that are commercially essential for operating in a country.

***CHAPTER 10***

# SOUTH AFRICAN TAX PROVISIONS APPLICABLE TO IHCs

## 10.1 INTRODUCTION

This chapter outlines the aspects of South African tax law that have a direct impact on South Africa as a suitable jurisdiction for hosting an IHC. These aspects have both positive and negative attributes and are analysed in this chapter with regard to that impact. Focus is placed on the attributes of the South African tax system that are the same as or mirror those that make the Netherlands and Mauritius suitable jurisdictions for holding companies.

The usefulness of IHCs can be limited or completely annihilated by a tax regime that is too rigid. This strictness of the tax regime depends to a large extent on a country's adherence to the capital import neutrality and capital export neutrality principles.[1] A country that is adverse to capital outflow would subject income earned by its residents from foreign countries to high taxes. This is mirrored by the presence of dividend taxes, transfer pricing rules, thin capitalisation and controlled foreign company (hereinafter referred to as "CFC") legislation.

As indicated in Chapter 1, this thesis examines the suitability of South Africa, given its tax system, as a location from which IHCs could operate. It should be noted that, in light of the fact that the reasons for incorporating an IHC are generally not to avoid tax, the South African tax laws can only be seen to be adverse if they would subject the IHC to

[1] The capital export neutrality principle advocates neutrality of the tax system so as not to encourage or discourage the outflow of capital. On the other hand, the capital import neutrality principle advocates neutrality of the tax system so as not to encourage or discourage the inflow of capital. See Holmes *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (2007) 6–14.

harsher tax treatment than other investment vehicles. It could also be regarded as not suitable if it is, on average, more burdensome than other tax regimes around the world. The examination of the South African tax system in this chapter is followed by a comparative analysis in which the South African tax system is compared to the tax systems of its main trading partners.

## 10.2 OUTLINE OF SOUTH AFRICAN CORPORATE INCOME TAXATION

Since 2001, South Africa has been taxing on a residence basis.[2] In terms of this system companies that are incorporated in South Africa or that have their place of effective management in South Africa are taxable in South Africa on their worldwide income.[3] The corporate income tax rate is 28%. Capital gains are taxable at the rate of 14% for resident companies. Non-resident companies are only liable for capital gains tax on the disposal of assets that are attributable to immovable property located in South Africa, subject to DTA provisions.[4]

On declaration of dividends, companies are liable to secondary tax on companies at the rate of 10%.[5] The secondary tax on companies is a tax on the company declaring dividends and not on the shareholder receiving the dividend.[6] The secondary tax on companies is being abolished and replaced with a dividend tax system in terms of which the shareholder will be liable for the tax.[7] The new dividend tax system will come into

[2] See s 1 definition of “gross income”.
[3] See s 1 definition of “gross income” read with definition of “resident”. For a detailed discussion of the residence requirements for companies in South Africa see South African Revenue Service *Interpretation Note No 6: Resident: Place of Effective Management (Persons Other Than Natural Persons)* (2002) par 3; Silke and Stretch “Residence and Persons Other Than Natural Persons” 2002 (Issue No 5) *Taxgram* 6–7.
[4] See Mazansky “South Africa and its Worldwide Tax Regime: Have we (Almost) Come Full Circle?” (2004 ) *Bulletin for International Fiscal Documentation* 151.
[5] See s 64B(2).
[6] See s 64B(2).
[7] See National Treasury *Budget Review* (2007) 67; National Treasury *Media Statement Revised Taxation of Distributed Profits* (20 February 2008) 1 available at http://www.treasury.gov.za/comm_media/press/2008/2008022001.pdf accessed on 05 February 2009. National Treasury *Budget Review* (2008) 61–62; National Treasury *Budget Review* (2009) 64. The provisions of the new dividend tax have been enacted in ss 64D-L but have not yet come into effect.

effect once the South African treaties that limit the withholding tax on dividends have been revised.[8]

In addition to the above-mentioned tax instruments, the South African tax system contains provisions that impose a tax on CFCs[9] and on foreign dividends.[10] Furthermore, the South African tax system contains anti-avoidance measures in the form of transfer pricing[11] and thin capitalisation.[12]

Similar to the tax regimes in the Netherlands and Mauritius, the South African tax regime grants credits for foreign taxes levied by source countries and has an advance tax ruling system in terms of which taxpayers may obtain the tax authorities' view on the application of the tax laws to proposed transactions. [13]

The focus of this thesis is IHCs that are tax-resident in South Africa. Thus such IHCs would have to be incorporated or effectively managed in South Africa.[14] Once tax-resident in South Africa, ordinarily, the IHC would be taxable at the corporate tax rate, capital gains tax rate and the secondary tax on companies or dividend tax rates mentioned above. Furthermore, other tax implications applicable to South African companies will be applicable to the IHC, including the benefit of the South African tax treaty network.

[8] See National Treasury *Media Statement Revised Taxation of Distributed Profits* 2. The tax treaties at issue are the treaties with Australia, Cyprus, Ireland, Kuwait, the Netherlands, Oman, Seychelles, Sweden and the United Kingdom. At the time of the publication of this media statement, it was envisioned that the treaty revision process would be completed by the end of 2009.
[9] See s 9D.
[10] See s 5 read with para (k) of the definition of "gross income".
[11] See s 31(2).
[12] See s 31(3)
[13] See s 6quat and ss 76B-76S; Bakker "Netherlands: Changes to Dutch Participation Exemption are Postponed" (January 2001) *International Tax Review* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12634&SID=468288&TYPE=20 accessed on 05 February 2009. See also section 159 of the Mauritian Income Tax Act 1995 accessible on http://www.gov.mu/portal/sites/mra/download/ITax1995updated081108.pdf accessed on 05 February 2009; Kröner and Van Doorne "Legal Aspects of Tax Rulings in the Netherlands" in *International Tax Planning* (ed Campbell) (1995) 149.
[14] Where the IHC is incorporated in South Africa but effectively managed in another country with which South Africa has a double taxation agreement, such IHC may not be tax resident in South Africa in terms of that double taxation agreement.

### 10.2.1 Corporate Income Tax Rate

The South African corporate income tax rate is 28%. Table 1 below outlines South Africa's main trading partners and their corporate tax rates.

**TABLE 1**

| Countries Globally | CIT% | African Countries | CIT% |
|---|---|---|---|
| Australia | 30 | Botswana** | 5 – 15 |
| Belgium | 33.3 | Mauritius | 15 |
| China | 25 | Mozambique | 32 |
| France | 33.3 | Nigeria | 30 |
| Germany | 15 | Zambia | 35 |
| India | 30 | Zimbabwe | 30 |
| Israel | 27 | | |
| Italy | 27.5 | | |
| Japan | 30 | | |
| Korea | 25* | | |
| Netherlands | 26.9 | | |
| Spain | 30 | | |
| Switzerland | 17 – 30 | | |
| United Kingdom | 28 | | |
| United States | 15 – 35 | | |

Source: Ernst & Young (2006) *Worldwide Corporate Tax Guide*

*Korea has a two-step tax rate system in terms of which the tax rate is 13% for the first 100 million KRW and 25% on amounts in excess of this.

** Botswana, US and Switzerland have special dispensations in terms of which the tax rates could be reduced to the lower rate indicated in the table.

As has been seen in Chapter 8,[15] the Mauritian corporate tax rate is 15%. This rate is one of the lowest of all of South Africa's main trading partners. It was seen in Chapter 7,[16] that the Dutch corporate tax rate is 26.9%, which is lower than the majority of the other trading partners of South Africa. At 28% the South African rate is also lower than 13 of the 20 trading partners to which it is compared.

## 10.3 CFC LEGISLATION

### 10.3.1 General

The CFC regime was introduced in South Africa in 1997 by the introduction of section 9D of the Act as a mechanism to impose tax on investment income.[17] The introduction of the residence basis of taxation in 2001 broadened the application of the CFC regime from applying only to investment income. In terms of the CFC regime, coupled with the introduction of the residence basis of taxation, all income, including investment income and capital gains accrued to or received by a CFC for years of assessment commencing on or after 1 January 2001, is attributed to the South African resident.

### 10.3.2 Content of the South African CFC Regime

The charging subsection of the CFC regime requires residents holding participation rights in a CFC to include a proportional ownership percentage of the net income earned by the CFC in their South African income.[18] Commentators generally view the South African CFC legislation as an anti-avoidance measure.[19] However, it might not be so. It is submitted that the South African CFC legislation subjects to tax income that was not subject to tax before. The effect is the same as was the case with the introduction of

[15] See Chapter 8 par 8.2.1.
[16] See Chapter 7 par 7.3.2.
[17] See Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (LLD dissertation 2007 UNISA) 111–112; Olivier and Honiball 430. The CFC rules were introduced by s 9 of the Income Tax Act 28 of 1997.
[18] See s 9D(2).
[19] See Olivier and Honiball 430; Huxham and Haupt *Notes on South African Income Tax* (2008) 367.

capital gains tax.[20] Thus, it is submitted, the South African CFC legislation is in effect a tax base broadening item. The fact that it was also intended at combating certain income tax avoidance schemes should not give it the general character of an anti-avoidance measure. The perception of provisions being anti-avoidance in nature could result in broader interpretation in a court deciding a tax case on interpretation of such provisions.

In conjunction with the charging provisions, the crux of the operation of the CFC legislation is contained in the definitions subsection.[21] The effect of the charging provision contained in section 9D(2) is that the net income of a CFC is attributed to the resident who holds participation rights in the CFC in proportion to that resident's shareholding in the CFC. For the purposes of section 9D the terms "participation rights" and "controlled foreign company" are defined. Other key terms are "attributable amount" and "net income". The CFC provisions exclude certain amounts from attribution. These key terms and exclusions are discussed below in outlining the CFC provisions.

#### *10.3.2.1 Participation Rights*

The term "participation rights" is defined as follows:

> 'participation rights' in relation to a foreign company means –
>
> (a) the right to participate directly or indirectly in the share capital, share premium, current or accumulated profits or reserves of that company, whether or not of a capital nature; or
>
> (b) in the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company.[22]

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[20] For example, the introduction of CGT in 1962 as an income tax on short-term gains was essentially seen as a tax that was created to prevent what was deemed to be a socially unacceptable way of avoiding tax on a form of wealth realisation. See Miller and Hardy *Taxation of Company Reorganisations* (2007) 11.

[21] The definitions for purposes of s 9D are contained in s 9D(1).

[22] See s 9D(1) definition of "participation rights". The original definition of "participation rights" did not include the rights to exercise voting rights in the company. This was included with effect from 2 November 2006 and is applicable in respect of any year of assessment ending on or after that date. See Jooste 473.

This broad definition of "participation rights" has the effect that where a resident has any conceivable ownership interest in a foreign company such interest would constitute a participation right. As will be seen below,[23] a certain level of holding of participation rights is required both for the company to constitute a CFC and for the income of such CFC to be attributable to the resident. The definition of participation right is in relation to a foreign company. A foreign company is defined as a company that is not resident.[24]

### *10.3.2.2 Controlled Foreign Company*

A company is a CFC if it is not resident and more than 50% of its participation rights are held, or 50% of its voting rights are exercisable, by one or more residents. A natural person is resident in South Africa if he/she is ordinarily resident in South Africa or he or she satisfies the physical presence test.[25] A company is resident if it is incorporated in South Africa or has its place of effective management in South Africa.[26] The requirement that the participation rights be held or voting rights be exercisable by residents does not imply that the residents should hold such participation rights or have rights to exercise such voting rights in collusion or jointly.[27] Thus, a company will be a CFC even if the

[23] See par 2.2.2 below.
[24] See s 9D(1) definition of "foreign company". See also Oguttu 113–115.
[25] A natural person's ordinary residence is a country to which he would naturally and as a matter of course return from his wanderings. When contrasted with other countries, this country might be called his usual or principal residence and it would be described most aptly in relation to other countries as his real home. See *Cohen v CIR* 1946 AD 183–187 and *CIR v Kuttel* 1992 (3) SA 242 (A) 246–250. Where a person's ordinary residence is in one place and it is part of the ordinary and regular course of his life to live elsewhere for a period of time each year with a degree of permanence sufficient to characterise his physical presence there as more than that of a mere bird of passage, he will be resident (but not ordinarily resident) in such other place. See *H v COT* 1960 (2) SA 695 (SR). See further Emslie, Davis and Hutton *Income Tax Cases and Materials* (2001) 949–950**.** If a natural person is not ordinarily resident but is physically present in South Africa for a period or periods exceeding 91 days in aggregate during a year of assessment, as well as for a period or periods exceeding 91 days during each of the five years of assessment preceding that year of assessment and for a period or periods of 915 days in aggregate during those five preceding years of assessment, such person is resident in South Africa. See section 1 definition of resident. See further Williams *Income Tax in South Africa, Law and Practice* (2006) 32 – 36.
[26] See Meyerowitz *Meyerowitz on Income Tax* (2008) par 5.19, see also Van der Merwe 'Residence of a Company – the Meaning of Effective Management' *South African Mercantile Law Journal* (2002) 79. Place of effective management is an international tax term used in double taxation agreements following the OECD Model Convention.
[27] See Jooste 2001 *SALJ* 475–476.

persons holding such rights are not related, or do not even know any one or more of the other person or persons also holding rights.[28]

In the determination of whether a foreign company is a CFC, voting rights in a foreign listed company are ignored. Furthermore, if the voting rights in a foreign company are exercised indirectly through a listed company, such voting rights are equally ignored.[29] Any voting rights in a foreign company which can be exercised directly by any other CFC in which a resident (or a resident together with any connected person[30] in relation to that resident) can directly or indirectly exercise more than 50% of the voting rights are deemed for purposes of this definition to be exercisable by that resident.

If a resident holds less than 5% of the participation rights in a CFC which is a listed company (or a foreign company in which participation rights are held indirectly through a listed company) such person is deemed to be not a resident for purposes of determining whether a company is a CFC.[31] Where more than 50% of all the voting or participation rights in the foreign company are held by connected persons, such foreign company will be a CFC irrespective of the fact that it is listed and regard will be had to all shareholders, irrespective of the fact that they may hold less than 5% of the participation rights.[32]

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[28] It needs to be noted here that further to the objective of taxing active income, where the shareholding in the foreign company is substantial, the shareholders would at the very least be aware of other persons holding substantial interests in the company. Some confusion existed with the original version of section 9D, which defined a CFC as a foreign company in which any resident or residents held rights individually or jointly. The question was whether that implied that residents should hold the rights in concert or with a common purpose. See Jooste 2001 *SALJ* 475–476.

[29] See 9D(1) proviso (a) to the definition of "controlled foreign company".

[30] "Connected person" is defined in s 1 of the Act by way of reference to the definition of "group of companies" in section 1. In terms of these definitions two companies would be connected to another if there is a 50% or more holding by the one company in the other company. A company will also be connected to another company if that company owns at least 20% of the equity share capital of another and no shareholder holds the majority voting rights of such company. Companies which are controlled by connected persons are connecter persons.

[31] See s 9D(1) proviso (c)(i) and (ii) to the definition of "controlled foreign company". Holdings in collective investment schemes are also ignored if the resident holds less than 5% of the participation or voting rights therein.

[32] See Wilson "International Tax X" 2004 *Tax Planning* 115–117.

#### *10.3.2.3 Attributable Amount*

The amount to be included in the income of the resident is an amount equal to:

> …where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day.[33]

The attributable amount is pro rated to the percentage of the participation rights of the resident. Therefore, a resident who holds 25% of the participation rights would have only 25% of the income of the CFC attributed to that person. This applies where the CFC was a CFC for the entire foreign tax year. However, if the foreign company became a CFC during the foreign tax year, the amount to be included in the income of the resident will be an amount equal to an amount which bears to the proportional amount pro rated to the percentage of the participation rights, the same ratio as the number of days during that foreign tax year that the foreign company was a CFC bears to the total number of days in that foreign tax year.[34]

Alternatively, at the option of the resident taxpayer the amount included could be the proportional amount, pro rated to the percentage of the participation rights (as if the day that foreign company commenced to be a CFC was the first day of its foreign tax year), of the net income of that company for the period commencing on the day that the foreign company commenced to be a CFC and ending on the last day of that foreign tax year.[35]

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[33] S 9D(2)(a)(i).
[34] S 9D(2)(a)(ii). See also Mitchell *et al* "Controlled Foreign Companies" 2008 *Income Tax Reporter* 153–157.
[35] S 9D(2)(a)(ii)*(aa)*.

If the foreign company ceased to be a CFC at any stage during the year of assessment before the last day of the foreign tax year of that controlled foreign company, the amount to be included in the resident shareholder is determined similarly to where the foreign company became a CFC during the foreign tax year. This is also at the option of the resident shareholder.[36]

Attribution does not apply where the resident holds less than 10% of the participation rights in the foreign company.[37] The provision exempts the resident shareholders from attribution where the resident (or the resident together with any connected person in relation to that resident) does not hold more than 10% of the participation rights in the CFC at the end of the last day of the foreign tax year of the CFC, or in the case of a CFC that ceased to be such during the foreign tax year, immediately before that foreign company ceased to be a CFC. Furthermore, there is no attribution to the extent that the resident holds the participation rights through a company which is a resident.[38] The attribution in relation to the indirect holding would be in relation to the company holding the shares directly.[39]

Having determined that a company in which connected persons hold more than 50% of the participation rights will be a CFC irrespective of the holding, the income of the CFC will be attributed to the shareholder if that shareholder holds more than 10% of the participation rights. If the shareholder holds less than 10% but a connected person in relation to him or her also has a holding which if combined exceed 10% the net income of the CFC would be attributed to both such shareholders in relation to their respective sub-10% holdings. It is not required that the connected person shareholder should be a South African resident for their shareholding to be considered in determining the CFC status of the foreign company or the attributability of the income.

[36] S 9D(2)(a)(ii)*(bb)*.
[37] Proviso (A) to s 9D(2). Mitchell *et al* "Controlled Foreign Entities" 2001 *Income Tax Reporter* 30.
[38] Proviso (B) to s 9D(2).
[39] Burt "Apportionment under s 9D" 2004 *Tax Planning* 110 – 112.

#### *10.3.2.4 Net Income*

For the purpose of the CFC provisions, the net income of a CFC is determined in accordance with the provisions of the Act as if that CFC is a resident and taxpayer in South Africa.[40] The allowances, deductions and any assessed losses to the resident in respect of the income of the CFC are ring-fenced to the income of the CFC.[41] Losses are carried forward to the immediately succeeding foreign tax year and are deemed to be a balance of the assessed loss that may be set off against the income of such CFC.[42]

Deductions are not allowed in respect of interest, royalties, rental, foreign exchange loss or income of a similar nature that arose as a result of transactions between the CFC and another CFC. This applies unless the CFC elects to divest itself of the available exemptions or the income from the items listed above has been included in the income of the other CFC.[43]

The net income of the CFC is determined in the currency used by that CFC for purposes for financial reporting. Such amount is translated to the South African Rand by applying the average exchange rate for the year of assessment concerned.

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[40] S 9D(2A). See also Meyerowitz, Emslie and Davis "Controlled Foreign Entity" *The Taxpayer* (2000) 186. See also Olivier and Honiball 443.
[41] Proviso (a) to section 9D(2A). See also Boltar "Law of Taxation" *Annual Survey of South African Law* (2000) 815; Boltar and Monteiro "Law of Taxation" *Annual Survey of South African Law* (2001) 815.
[42] Proviso (b) to s 9D(2A). See also Olivier and Honiball 443.
[43] Proviso (c) to s 9D(2A). The other provisions applied in determining the net income of a CFC relate to the capital gains tax ("CGT") where the foreign company becomes a CFC after the effective date of the CGT regime in South Africa. In this case the valuation date for CGT purposes is deemed to be the date on which that foreign company becomes a CFC. See proviso (e) to s 9D(2A). Where the resident shareholder is a natural person, special trust or insurer in respect of its individual policyholder fund, the taxable capital gain of the CFC will be 25% of that company's net capital gain for the relevant foreign tax year. See proviso (f) to s 9D(2A). These aspects will be dealt with where they become directly relevant to the discussion.

#### *10.3.2.5 Exclusions / exemptions*

The CFC regime exempts or excludes[44] certain receipts and accruals of the CFC in the determination of the net income of a CFC imputable to a South African resident. The main exemptions are the following:

1. Income that has already been taxed;[45]
2. Income arising from a CFC that has a foreign business establishment;[46]
3. Dividend income from a related CFC;[47] and
4. CFC interest, rents and royalties.[48]

Prior to 2003, in addition to the above exemptions, the Act contained an exemption of income of CFCs located in certain countries (the so-called "designated countries"). The purpose of this exemption was to exclude the receipts and accruals of a CFC that is subject to foreign income taxes comparable in amount to those imposed in South Africa.[49] That exemption was repealed in 2003.[50]

*(a) Income that has already been taxed*

Where the income of a CFC has been, or will be, taxed in South Africa in terms of other provisions of the Act and will not be exempt or taxed at a reduced rate as a result of the application of a DTA, such income will not be imputed to the resident shareholder's

[44] It is not clear whether these items are excluded (disregarded) or exempt (still to be accounted for) from the application of the CFC provisions. Olivier and Honiball 446 submit that even though the South African legislature attempted to provide clarity in 2005 there is still no certainty in this regard. For a discussion of this aspect see Olivier and Honiball 446.
[45] S 9D(9)(e).
[46] S 9D(9)(b).
[47] S 9D(9)(f).
[48] S 9D(9)(fA).
[49] See Jooste 484. The designated countries as per GN 866 of 1 September 2000 were the following: Algeria, Australia, Austria, Belgium, Canada, Croatia, the Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Italy, Japan, Korea, Lesotho, Malawi, Namibia, the Netherlands, Norway, Poland, Romania, Slovakia, Swaziland, Thailand, Tunisia, the United Kingdom, the Unites States of America, Zambia and Zimbabwe.
[50] The designated country exemption was repealed by s 22(1)(g) of the Revenue Laws Amendment Act 45 of 2003 with effect from 1 June 2004. For more on how the designated country exemption applied see Jooste 484 – 486; Kolitz "Designated Countries and Foreign Dividends" 2005 *Tax Planning* 19.

income.[51] The basis of this provision is that certain income of the CFC may be taxed or taxable in South Africa by application of the source rules. Without this exemption, the income of the CFC that would have been taxed by application of the source rules would also be imputed to the resident shareholders, resulting in economic double taxation of the same income.[52]

Certain income could be subject to tax in South Africa but as a result of the application of the DTA between South Africa and the country of residence of the CFC, such income is not taxable in South Africa. Where this is the case, the exemption does not apply. In this regard Jooste[53] states that "[i]t follows that South African residents cannot avoid tax on South African income by operating through [CFCs] located within the South African treaty network. This is equitable because the income would have been taxed if earned directly by the South African residents."

This exemption would only apply to an IHC where the subsidiaries of the IHC source their income in South Africa.

*(b) Dividend income from a related CFC*

The provision relating to the dividend income is somewhat complicated. In terms of this exemption, in determining the net income of a CFC the amount that is excluded is any amount which is attributable to any foreign dividend declared to that CFC by any other CFC in relation to the resident to the extent that the foreign dividend does not exceed the aggregate of all amounts which have been or will be included in the income of the resident in terms of section 9D which relate to the net income of the company declaring the dividend.[54]

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[51] See s 9d(9)(e). See also Meyerowitz, Emslie and Davis *The Taxpayer* 187 – 188.
[52] Economic double taxation is taxation that results in the same income being taxed twice in the hands of different taxpayers. On the other hand, juridical double taxation is the double taxation of the same income in the hands of the same taxpayer.
[53] Jooste 498.
[54] Mitchell *et al* "Controlled Foreign Entities" 2001 *Income Tax Reporter* 37.

This aggregate amount is to be reduced by the amount of any foreign tax payable, in respect of the amounts so included in that resident's income; and so much of all foreign dividends received by or accrued to that controlled foreign company as was excluded from the application of this section 9D and previously not included in the income of that resident by virtue of any prior inclusion in terms of section 9D.[55]

This provision applies in relation to dividends declared by one CFC in relation to the resident to another CFC in relation to the same resident (hereinafter referred to as "sister CFCs"). The amount exempted is the amount of the dividend that is less than (does not exceed) the sum of amounts includable in the hands of the resident in any year of assessment. However, the amount exempted and the amounts includable relate to the net income of the sister CFC declaring the dividend reduced by foreign taxes payable, exempt foreign dividends and amounts that have been included in terms of source rules.

*(c) The foreign business establishment ("FBE") exemption*

Originally referred to as the "business establishment" exemption, the foreign business establishment (hereinafter referred to as "FBE") exemption is intended to apply only if the income of the CFC concerned does not pose any threat to the South African tax base.[56] The generation of income elsewhere would pose a threat to the South African tax base where such income could be earned in South Africa; thus, the business producing such income could be conducted from South Africa. This is often explained in terms of a business in respect of which there is no real economic reason, other than tax, to locate in the other jurisdiction.[57]

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[55] See Boltar *Annual Survey of South African Law* 815.

[56] See Oguttu 128 – 130; Olivier and Honiball 447 – 460 for a detailed discussion of the business establishment exemption. The terminology from "business establishment" to "foreign business establishment" was changed by s 9(1)(b) of the Taxation Laws Amendment Act 8 of 2007 with effect from 2 November 2006.

[57] See Legwaila "The Business Establishment Exemption" 2004 (December) *De Rebus* 42; National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* (2002) 9 available at http://www.treasury.gov.za/divisions/epifr/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf accessed on 12 January 2009.

Section 9D accounts for the genuine business concerns by exempting all foreign business establishment income other than that which qualifies as mobile foreign business income,[58] diversionary foreign business income[59] and mobile foreign passive income.[60]

(i) Definition of an FBE

The point of departure with the application of the FBE exemption is the definition of an FBE. The general definition of an FBE requires locational permanence, economic substance and business purpose.[61] The FBE is also defined in respect to specific business activities. These are prospecting and exploration operations for natural resources;[62] construction or installation of items such as buildings and bridges;[63] agricultural activities[64] and transportation.[65] These specific definitional references are beyond the scope of this thesis.

[58] Mobile foreign business income is income from shell businesses that lack any economic substance to attract taxable income. Generally, these businesses only maintain a post office address, telephone or fax line or a website.

[59] Diversionary foreign business income is income derived by the CFC arising out of transactions involving artificial transfer pricing. It is income that is diverted to the CFC through transactions between the CFC and connected South African residents. See s 9D(9)(b)(i) – (ii). See Oguttu 130.

[60] Mobile foreign passive income is income arising from assets that can be shifted around easily and consists mainly of income from portfolio investments (for example, interest, royalties, dividends, rental, annuities and insurance premiums). See s 9D(9)(b)(iii); Also Jooste 497 – 498; Oguttu 135.

[61] S 9D(9). See Clegg "Business Establishments" 2004 *Tax Planning* 60. The definition of business establishment received minor cosmetic changes by s 9(1)(c) of the Revenue Laws Amendment Act 20 of 2006 which in effect have no impact on the application of the definition.

[62] Any place outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that CFC carries on those prospecting, exploration, mining or production operations. S 9D(1) para (b) of the definition of "foreign business establishment".

[63] A site outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects of a comparable magnitude which lasts for a period of not less than six months, where that controlled foreign company carries on those construction or installation activities. See s 9D(1) para (c) of the definition of "foreign business establishment".

[64] Agricultural land in any country other than the Republic used for *bona fide* farming activities directly carried on by a CFC. S 9D(1) para (d) of the definition of "foreign business establishment".

[65] A vessel, vehicle, aircraft or rolling stock used for the purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by a CFC or by any other company that has the same country of residence as that CFC and that forms part of the same group of companies as that CFC. See s 9D(1) para (e) of the definition of "foreign business establishment".

(ii) Locational permanence

An FBE is broadly defined as a place of business with an office, shop, warehouse or other structure which is used by the CFC for not less than one year whereby the business of the CFC is carried on.[66] The use requirement can be satisfied by ownership or leasing.[67] In this regard it is noteworthy that the place of business would not be an FBE if it is not the CFC that carries on its business in such a place. However, the CFC does not have to be the sole user of such place of business. Thus, theoretically several CFCs can use the same place of business and still retain the status of an FBE. The importance of this aspect for IHCs is that an IHC may have various CFCs that use the same premises for their business activities without losing their FBE status.

(iii) Economic substance

In terms of the definition of an FBE, the place of business should be suitably equipped with on-site operational management, employees, equipment and other facilities for conducting the primary operations of that business.[68] This provision attempts to ensure that a business does not qualify as a foreign "business establishment" purely on the basis of the form that is presented. It excludes a business involving purely paper-based transactions, or a business that is conducting passive income-generating activities which are disguised as a more substantial undertaking.[69]

(iv) Business purpose

It is required that the business must have a *bona fide* non-tax reason for operating abroad rather than in South Africa. This criterion involves a subjective enquiry into the purpose of locating the business activities outside South Africa.[70] In this regard the enquiry is whether there are business reasons for the business to operate in the location where it

[66] S 9D(1) definition of "foreign business establishment".
[67] See the National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 9.
[68] See s 9D(1) definition of "foreign business establishment".
[69] See Jooste 488.
[70] Jooste 489.

operates.[71] Should there be genuine business reasons why the operations are conducted from a jurisdiction outside South Africa, this requirement will be met. The fact that the jurisdiction may also offer a favourable tax regime would not disqualify the availability of the FBE exemption.[72] However, should it be found that no business reasons, or sufficient business reasons exist to justify the relocation (irrespective of the presence of tax reasons), the FBE exemption will not apply.

Where the investor has an option of locating the operating companies in one of two or many identified jurisdictions for a valid business reason or reasons, the investor should be allowed to choose the one where the tax consequences would be minimal. By so doing, the taxpayer would not lose the FBE exemption merely because of such tax planning.[73]

(v) Application of the FBE

In determining the net income of a CFC any amount that is attributable to an FBE of the CFC is not taken into account. Amounts that arise from the disposal or deemed disposal of any assets forming part of the FBE are also disregarded, otherwise they would be included in calculating the capital gains tax attributable to the resident shareholders.[74]

[71] The original provisions referred to the usage of the place of business "solely or mainly" for a *bona fide* business purpose. This raised uncertainty as to the proportion of the tax reasons to the business purposes. For example, Jooste op cit indicates that "[i]t is not clear whether or not the criterion is satisfied only if the sole purpose is a *bona fide* non-tax purpose, or whether or not it suffices if it is the main purpose. In other words, if the foreign location is attractive mainly because of its favourable business prospects but also, to a lesser extent, because of its favourable business dispensation, is the criterion satisfied?" See Jooste at 489.

[72] The example given in the National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 10 is as follows "Facts: South African Company owns all the share of multiple foreign subsidiaries, including [CFC]. [CFC] is a resident of Tax Haven, a Mediterranean Country which imposes income tax at a 10% statutory tax rate. [CFC] leases a large warehouse within Tax Haven. [CFC] operates as a central delivery point for products shipped to customers located in Southern Europe and the Middle East. [CFC] hires managers and 5 employees that handle all storage and shipment contracts. [CFC] hires independent contractors for trucking and airline transportation. The Tax Haven location was chosen partly due to its convenient delivery location and partly due to its low tax rate. *Result*. The warehouse operations qualify as a business establishment. Even though the choice of location provides tax savings over the South African rate, the location has a *bona fide* non-tax business purpose because the location offers significant shipment cost advantages over locating in South Africa." See National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 10.

[73] A similar line of thought was followed by Hefer JA in *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd* 1999 (4) SA 1149 (SCA) with regard to the application of the anti-avoidance provisions then contained in s 103(1).

[74] S 9D(9)(b).

This implies that where the South African IHC has participation rights in operating subsidiaries that undertake business activities outside South Africa, the FBE would apply so as to exempt the income of such subsidiaries from attribution to the IHC. There are amounts accrued or received by the CFC that would, however, be attributed to the resident shareholders irrespective of the fact that the CFC qualifies as an FBE. These amounts are outlined below.

(aa) Amounts arising from non-arm's length transactions with residents

If a CFC derives any income from any transaction with a connected person who is a resident relating to the supply of goods or services by or to that CFC, such amounts would be imputed to the income of such CFC's resident shareholders.[75] However, if the consideration charged for that supply of goods or services reflects an arm's length consideration, the FBE exemption would not disallowed. This provision is aimed at transactions that divert income from South Africa by using transfer pricing.

This anti-diversionary rule involves an increased and concerted effort to stamp out transfer pricing through the operation of two strategies. In this regard Jooste states, "[f]irstly, the rule creates a deterrent by effectively increasing the penalty for transfer pricing. Secondly, the rule requires a higher business activity standard than that imposed by the 'business establishment' exemption when the [CFC] engages in sales or services transactions with connected South African residents."[76]

This higher business activity standard places a burden on the South African resident shareholder, once amounts are derived by the FBE from transactions relating to supply of goods or services, to prove that the consideration paid for the goods or services reflect an arm's length consideration.[77]

[75] Wilson "International Tax XI" 2004 *Tax Planning* 125.
[76] Jooste 490.
[77] According to Jooste, "[t]he strategy also recognizes that sales and services transactions between a [CFC] and connected South African residents involve a close link with South Africa, which calls into question whether there are not tax reasons for conducting them offshore. …[T]he 'business establishment' exemption does not take this into account by excluding from its ambit the income of a [CFC] if it is not

(bb) Sale of goods by a CFC to a resident connected person

If a CFC sells goods to a connected South African resident a higher business activity level is required. This would apply where the CFC of an IHC sells goods to a South African subsidiary of an IHC. The higher business activity requirement would be met if the sale falls into one of the following three categories:

i. The CFC purchased those goods within the country of residence of the CFC from any person who is not a connected person in relation to that CFC.[78]

ii. The creation, extraction, production, assembly, repair or improvement undertaken by the CFC amount to more than minor assembly, packaging, repackaging and labelling of the goods.[79]

iii. The CFC sells a significant quantity of goods of the same or similar nature to persons who are not connected persons in relation to that CFC at comparable prices (after accounting for the level of the market, volume discounts and cost of delivery). The rationale is that chances of transfer pricing occurring are reduced by the availability of the outside pricing.[80]

iv. The CFC purchases the goods or similar goods mainly within the country of residence of the CFC from persons who are not connected persons in relation to that CFC. This late inclusion ensures that the CFC does not have to purchase all of the goods from its country of residence. Furthermore, it ensures that the CFC could buy similar goods and modify them prior to the sale to the resident.[81]

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attributable to a place of business utilized outside South Africa for a [*bona fide*] business purpose other than a tax purpose. However, it seems that the 'business establishment' test is not regarded as stringent enough in a situation involving sales and services transactions between a [CFC] and connected South African residents, and that is why, in such circumstances, the higher business activity threshold is imposed." See Jooste 491; Wilson "International Tax XI" 2004 *Tax Planning* 125.

[78] See s 9D(9)(b)(ii)(aa)(A). This physical location of the goods purchased establishes that the [CFC] has an economic nexus to the country of residence, and the country of residence most likely has a sufficiently good infrastructure to produce the goods. Countries with a good infrastructure typically do not tax their local sales at artificially low tax haven rates. These factors indicate that the [CFC] is most likely purchasing and reselling the goods at a convenient location for non-tax reasons, and that the [CFC] is not over-inflating the price on resale to a related South African resident.

[79] S 9D(9)(b)(ii)(B). Whether foreign production activities are significant is a facts and circumstances test which takes into account many factors such as how the production costs compare to the total cost of goods sold or whether special skills are employed in order to provide value. See National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 13.

[80] S 9D(9)(b)(ii)(aa)(C).

[81] S 9D(9)(b)(ii)(aa)(D).

(cc) Sales to unconnected South African residents

This provision aims to prevent loop sales from benefiting from the FBE exemption. These are transactions where the goods are initially purchased by the CFC from a connected South African resident and are on-sold to South African residents.[82] This transaction would have the effect of reassigning the ultimate income to the CFC, which income should have been earned and taxed in South Africa. This happens where the connected South African resident sells the goods to the CFC at a low margin, or a loss, and the CFC sells the goods to the resident unconnected person at market value. In this way the income would be earned in the country of residence of the CFC.[83] Transfer pricing could apply in this case. However, the onus of proof is on the FBE or the South African resident shareholder to prove one of the following four cases in order for the FBE exemption to apply: [84]

i. Those goods or tangible intermediary inputs thereof purchased from connected persons who are residents amount to an insignificant portion of the total goods or tangible intermediary inputs of those goods;
ii. The creation, extraction, production, assembly, repair or improvement of goods undertaken by that CFC amount to more than minor assembly or adjustment, packaging, repackaging and labelling;
iii. The products are sold by that CFC to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of that CFC; or
iv. Products of the same or similar nature are sold by that CFC mainly to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of that CFC.

[82] S 9D(9)(b)(ii)(bb).
[83] See Wilson "International Tax XI" 2004 *Tax Planning* 125.
[84] S 9D(9)(b)(ii)(bb)(A)-(D). See Wilson "International Tax XI" 2004 *Tax Planning* 125

(dd) Services performed to connected residents

The fourth category of amounts that would not qualify for the FBE exemption are amounts arising from the performance of services by the CFC to a connected person who is resident. Such amounts would only be exempt if the service is performed outside South Africa and one of the following conditions is met:

i. The service relates directly to the creation, extraction, production, assembly, repair or improvement of goods utilised within one or more countries outside South Africa;
ii. The service relates directly to the sale or marketing of goods of a connected person in relation to that CFC who is a resident and those goods are sold to persons who are not connected persons in relation to that CFC for physical delivery to customers' premises situated within the country of residence of the CFC;
iii. The service is rendered mainly in the country of residence of the CFC for the benefit of customers that have premises situated in that country; or
iv. To the extent that no deduction is allowed of any amount paid by the connected person to that CFC in respect of that service.

Before applying these provisions to the operations of the business of the IHC, the focus should be placed on the key aspect of these provisions (i.e. sale of goods by a CFC to a resident connected person; sales to unconnected South African residents; and services performed to connected residents). The key aspect here is the dealing with "goods". "Goods" are generally commodities that are tangible, usually movable, or articles of commerce.[85] Commodities themselves are articles of commerce.

The above provisions would apply to the transactions between the subsidiaries of the IHC located outside South African borders. Depending on specific circumstances these

[85] See the *Collins Concise Dictionary* (1995) definition of "goods".

provisions could deny the IHC the FBE exemption and therefore result in full imputation of the income.

(ee) Mobile passive income

Passive CFC receipts and accruals attributable to an FBE do not qualify for the FBE exemption. These include amounts received in the form of capital gains, foreign currency gains, dividends, interest, royalties, rental, annuities and insurance premiums. These amounts are fully subject to tax because no direct competitiveness concerns are at stake if no active business is involved.[86] Two exceptions exist which, if satisfied, would mean that the FBE exemption would apply to the income. The exceptions are the *de minimis* exception and an exception for banking, insurance financial service and rental businesses.

i. *De minimis* exception

The *de minimis* exception is intended to prevent the CFC provisions from applying when the CFC earns trivial amounts of income from passive investments. This rule is created for administrative convenience. The rule initially applied to amounts that do not exceed 5% of the total income and capital gains of the CFC. It has, however, been increased to 10%.[87] This rule is not an "all-or-nothing" rule. If passive income exceeds the 10% level, then the part of passive income that exceeds the 10% would be subject to imputation.[88] The National Treasury[89] states that "[p]assive capital gains are similarly part of the *de minimis* calculation. These gains are measured in terms of gains (not total proceeds) with capital losses ignored. Capital gains are measured for purposes of both the numerator and the denominator."

[86] National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 17.
[87] See proviso (A) to s 9D(2). The original 5% provision was amended by s 14(1)(d) of the Revenue Laws Amendment Act 31 of 2005 and deemed to have come into operation on 8 November 2005. The amendment is applicable in respect of any foreign tax year which commenced on or after 8 November 2005. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2005, the change from the 5% rule to the 10% rule was "consequential upon the introduction of the voting right test to determine whether a foreign company qualifies as a controlled foreign company." See http://www.sars.gov.za/home.asp?pid=2631 accessed on 09 February 2009.
[88] See Jooste 478 – 479.
[89] National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 18.

ii. Banking, financial services, insurance and rental business exception

Passive income may be exempt from CFC imputation if it arises from the principal trading activities of a bank, financial services, insurance and rental business.[90] The purpose of exempting this form of income is to avoid stunting the international competitiveness of CFCs that are principally involved in such services. A set of anti-avoidance provisions apply. Firstly, CFC receipts and accruals from connected persons who are residents or residents who hold at least 5% in the CFC or in any company that holds shares in the CFC are not exempt. Secondly, amounts received by a CFC which is a foreign financial instrument holding company at the time it receives the amounts are also not exempt.

iii. Disposal of intangible assets

Amounts that arise from the disposal of intangible assets that formed an integral part of the business of the CFC or the asset was disposed of as part of the disposal of the CFC together with all assets which are necessary for carrying on the business of the CFC are exempt from CFC imputation. This exemption provision would apply to the CFCs of the IHC.

*(d) CFC interest, rents and royalties*

Amounts attributable to interest, royalties, rental or similar income which is payable to a CFC by any CFC in the same group of companies are exempt from attribution in the hands of the resident shareholders.[91] This is because the CFC paying such income is not allowed to deduct the payment where it pays the amount to a CFC in the same group.[92] However, the CFC may elect to have the exemption waived so that the income is attributed.[93] Where such election is made, the interest, royalties, and rental paid to the other CFC in the same group of companies would be allowed as a deduction in the hands

[90] S 9D(9)(b)(iii)(bb). See National Treasury *Detailed Explanation to Section 9D of the Income Tax Act* 19.
[91] S 9D(9)(fA)
[92] S 9D(2A)(c).
[93] S 9D(12).

of the CFC paying such amount. Thus, such income arising out of transactions between the IHC and its CFCs would be exempt.

#### *10.3.2.6 Special Rulings Provisions*

The CFC provisions provide for ruling provisions in relation to the application of the exemption provisions. These rulings relate to fulfilment of the definition of CFC,[94] sale of goods or performance of services,[95] receipt or accrual of royalties[96] and the place where the income of a banker, financier, issuer or broker originates.[97]
As was seen in Chapters 7[98] and 8,[99] the Netherlands and Mauritius do not have CFC legislation.

[94] S 9D(10)(a)(i). The ruling in this regard may deem a place of business of a CFC as fulfilling the requirements of the definition of a CFC by taking into account the utilisation of employees, equipment and facilities of any company that has the same country of residence as that CFC where that other company forms part of the same group of companies as the CFC.
[95] S 9D(10)(a)(ii). The ruling may disregard the application of subsec (9) (*b*) (ii) in respect of the sale of goods or performance of services by a CFC where the foreign business establishment of that CFC situated in that company's country of residence mainly serves as a central location for the sale or performance of identical or similar goods or services in at least two countries that are contiguous to the country of residence of that company. Furthermore, in terms of s 9D(10)(a)(iv) the ruling may disregard the application of subsec (9)(b)(ii) or (iii) where the Commissioner is satisfied that the income from the sale of goods or performance of services will be subject to tax on income by any sphere of government of countries other than the Republic; and the amount of tax on income contemplated in item (*aa*) will equal at least two-thirds of the normal tax that would otherwise arise in connection with that income if subsec (9) (*b*) (ii) or (iii), as the case may be, were to apply in respect of that income after taking into account any applicable agreements for the prevention of double taxation, and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and any assessed losses.
[96] S 9D(10)(a)(iii). The ruling may disregard the application of subsec (9)(b)(ii) to royalties received by or accrued to a CFC where that company directly and regularly creates, develops, substantially upgrades or adds value to (or provides substantial support services in respect of) intangibles giving rise to those royalties.
[97] S 9D(10)(a)(v). The ruling would disregard the business activities of a bank or financier, insurer or broker of a CFC arising in any country other than that company's country of residence where (1) that business is conducted through a permanent establishment in that other country; (2) the income from that business is subject to tax on income by that other country by virtue of that permanent establishment; and (3) the rate of tax imposed by that other country will at least equal the rate of tax that would otherwise be imposed by the country of residence had the income arisen within that country.
[98] See Chapter 7 par 7.3.5.
[99] See Chapter 8 par 8.2.3.

## 10.4 TAXATION OF DIVIDENDS

As noted in Chapter 2, an IHC is a company that is interposed between two or more companies. In this way it is a subsidiary of one, and a holding company of the other or others. Thus, the IHC would typically receive dividends from its subsidiaries and in turn pay dividends to its holding company. As a recipient of dividends from non-resident subsidiaries, the taxation of foreign dividends impacts on the cash flow of the IHC and the entire company group arising from the operations of foreign subsidiaries.

The South African system of taxation of dividends is currently undergoing change. The secondary tax on dividends (hereinafter referred to as "STC") system is being replaced by a dividend tax system.[100] Under the STC system the company distributing the dividend is subject to tax on the net amount of dividends distributed.[101] Under the new dividend tax system, the shareholder receiving the dividend would be subject to tax on the amount of dividends received. This change also has an impact on the definition of a dividend.[102]

A foreign dividend is defined as a dividend received by or accruing to any person from a foreign company.[103] Thus, what distinguishes a foreign dividend from a dividend is the fact that the foreign dividend is distributed by a foreign company.

South African companies are currently taxed at 10% on the net amount of dividends they declare. In terms of the new dividends tax systems, shareholders will be taxed at 10% of the amount of dividends paid by South African companies. Save for the United Kingdom, as shown in Table 2 South Africa's dividend tax rate ranks among the lowest of its trading partners. In general, the rates are reduced by treaties. On average, the rates are reduced to 5% by the treaties. The difference between the low rate and the rate reduced

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[100] National Treasury *Budget Review* (2007) 67–68; National Treasury *Budget Review* (2008) 61–62. Refer to budget Review for 2008. See also Mitchell *et al* "Secondary Tax on Companies" 2008 *Income Tax Reporter* 48.
[101] On the nature of STC as a tax on the company and not on dividends or the shareholder see the 2008 decision in *Volkswagen of South Africa (Pty) Ltd v CSARS* 70 SATC 195; Silke and Stretch "High Court: STC not a Tax on Dividends" 2008 (Issue No 9) *Taxgram* 9–10.
[102] See Silke and Stretch "From STC to a Shareholder Dividends Tax" 2008 (Issue No 4) *Taxgram* 3–4.
[103] See s 1 definition of "foreign dividend".

by treaties is that South Africa, with a low rate irrespective of the treaties, has a competitive advantage over its trading partners as regards investment from non-treaty countries, in the same way as European countries have an advantage regarding fellow European Union countries without treaties.

Table 2 shows the dividend tax rate of South Africa’s main trading partners and the withholding rates as reduced by treaties.

**TABLE 2**

| **Countries Globally** | **WHT%** | **Treaty rate** | **African Countries** | **Div tax%** | **Treaty rate%** |
|---|---|---|---|---|---|
| Australia | 30 | 15 – 20 | Botswana | 20 | 5 – 15 |
| Belgium | 20 | 15 – 25 | Mauritius | 15 | 0 |
| People's Republic of China | 20 | 0 – 10 | Mozambique | 20 | 0 – 15 |
| France | 25 | 0 – 20 | Nigeria | 10 | 7.5 |
| Germany | 20 | 0 – 20 | Zambia | 15 | 0 – 15 |
| India | 20 | 0 | Zimbabwe | 20 | 5 – 20 |
| Israel | 25 | 5 – 15 | | | |
| Italy | 20 | 5 – 15 | | | |
| Japan | 20 | 0 – 25 | | | |
| Korea | 25 | 0 – 15 | | | |
| Netherlands | 25 | 0 – 25 | | | |
| Spain | 15 | 0 – 15 | | | |
| Switzerland | 35 | 0 – 15 | | | |
| United Kingdom | 0 | 0 | | | |
| United States | 30 | 0 – 30 | | | |

Source: Ernst & Young (2006) *Worldwide Corporate Tax Guide*

### 10.4.1 General

In order for the distributions paid to the South African shareholders of the IHC to be subject to tax in South Africa, such distributions should constitute a dividend. The definition of dividend is quite lengthy and cumbersome to understand. It contains a general provision, inclusions and exclusions. For purposes of this paper a brief analysis of the general provision and the inclusions should suffice.

### 10.4.2 Definition of Dividend under the STC Regime

A dividend is generally defined as any amount distributed by a company to its shareholders.[104] This general provision covers all payments made by a company to its shareholders. Its wide scope is limited by the presence of specific inclusions to the effect that where a specific form of distribution is not included in the specific inclusions discussed below. This is according to the longstanding statutory interpretation maxim *inclusio unius est exclusio alterius*, which literally translated means that to include one is to exclude another.[105]

The effect of the maxim is that if the legislature specifically included a thing or transaction in legislation, it is assumed that the intention was to exclude other related or similar things or transactions. Thus, the inclusion of specific transactions without expressing that such inclusion does not limit the application of the general rule results in, at the very least, an interpretative ambiguity. A comparison in this regard is made with the definition of gross income in section 1 where the specific inclusions are preceded by the phrase "without in any way limiting the scope of this definition".

Furthermore, this broad definition tends to also include transactions that should not be included in the definition of dividend. In this regard it is should be noted that the objective of taxing a dividend is to tax the accretion in the wealth of the shareholder. However, theoretically the dividend definition would also tax as a dividend payments made by the company to a shareholder as consideration for assets purchased by the company from the shareholder, say as trading stock. Such could not have been intended.

[104] See s 1 definition of "dividend". This definition is subject to change in the next amendments to the Act as it does not squarely define what a dividend should be.
[105] See *Consolidated Diamond Wines of SWA Ltd v Administrator, SWA* 1958 (4) SA 512 (A) 622. See also *Ex Parte Lancashire: In re Paruk v Patel* 1943 NPD 356; *Parkes v Parkes* 1932 SR 74.

It is submitted that a different construction similar to the United States tax law construction that refers to a "distribution made by a corporation to a shareholder with respect to its stock"[106] would be more appropriate. A similar construction is found in the capital gains provisions where a distribution is defined as any "transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder"[107] would eliminate the uncertainty.

Be that as it may, the definition of dividend includes specific transactions. The inclusions are imported by extending the expression "amount distributed". Case law has held that "amount distributed" is so general as to include amounts that have been apportioned, appropriated, allocated or applied towards a goal.[108] The following specific cases are included:

#### *10.4.2.1 Liquidation Dividends*

Where a company is being wound up, liquidated or deregistered or its corporate existence is otherwise finally terminated, any profits which are distributed, whether in cash or otherwise during such process, constitute a dividend.[109] As can be seen, the amount of dividend in this regard is limited to the profits of the company. This part of the definition should be read with sub-para (v) of the first proviso to the definition. The combined effect of these provisions is that it must first be determined whether the company at the commencement of the corporate termination had profits available for distribution. If the company had such profits, a portion of such profits may be deemed to be a dividend distributed to shareholders.[110] Subject to certain exceptions, any amounts paid out from

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[106] See s 301(a) of the US Federal Income Tax Code.

[107] See par 74 of the Eighth Schedule. It is expected that the National Treasury will consider changing the definition to eliminate the ambiguity in due course.

[108] See *CIR v Legal and General Assurance Society Ltd* 1963 (3) SA 876 (A) at 886.

[109] S 1 para (a) of the definition of "dividend". This inclusion excludes capital profits earned before the process of terminating the existence of the company before the capital gains tax regime was introduced in South Africa in 2001. A provision is also made for the calculation of the base cost of an asset acquired by the company prior to 2001 and sold afterwards. See Stein "Liquidation distributions and STC" 2005 *Tax Planning* 19.

[110] See Williams 450–451; Silke and Stretch "STC – Nature of Liquidation Dividend" 2005 (Issue No 10) *Taxgram* 9.

the share capital or share premium accounts of the company would not be a dividend as they represent return of the capital (or base cost) of the shareholders.[111]

### *10.4.2.2 Going-Concern Dividends*

In relation to an operating company declaring dividends, the dividend is any profits distributed, whether in cash or otherwise, whether of a capital nature or not. This provision also specifically includes an amount equal to the nominal value of any capitalisation shares,[112] bonus debentures or securities awarded to shareholders. Any distribution of profit is a dividend and the revenue or capital nature of the profit is immaterial.[113]

This definition is to be read with para (e) of the definition of dividend.[114] Under para (e) of the definition of "dividend" an award of capitalisation shares out of the share premium account will not be an "amount distributed" and hence will not be a dividend. If capitalisation shares are awarded out of an unrealised profit they are excluded from the definition of dividend.[115]

As can be seen, for a distribution to constitute a dividend, such distribution should be made out of the profits of the company. South African companies have been avoiding the payment of the STC by ensuring that their distributions are not made out of profits.[116] This has resulted in various anti-avoidance provisions being enacted.[117]

[111] See s 1 para (f) of the definition of "dividend". See also Meyerowitz par 15.4
[112] Capitalisation shares are shares issued by a company paid up from the company's reserves (including share premium) or unrealised profits. Such issue may constitute a dividend where the profits are so applied. However, if the payment is made by application of amounts from the reserves, generally it is not a dividend and no tax would be paid thereon.
[113] Meyerowitz par 15.9.
[114] In terms of para (e) the definition of dividend does not include the nominal value of any capitalisation shares awarded to a shareholder to the extent to which such shares have been paid up by means of the application of the whole or any portion of the share premium account of a company.
[115] See s 1 para (h) of the definition of "dividend". In terms of para (h) the definition of dividend excludes the nominal value of any capitalisation shares awarded to shareholders as part of the equity share capital of a company. The rationale for this treatment is that the issue of capitalisation shares does not result in the transfer of any asset from the company to the shareholder. See also Williams 451.
[116] See further on this aspect Kolitz "Capitalised Profits" 2007 *Tax Planning* 56.
[117] See first proviso to the definition of dividend.

#### *10.4.2.3 Partial Reduction or Redemption of Capital or Share Buy-Backs*

Para (c) of the dividend definition provided for situations where there is a reduction or redemption of the capital of a company. It also applied where there is a share buy-back by the company of its own shares.[118] In this case, the extent to which the cash or the value of the asset given exceeds the cash equivalent of the amount by which the nominal value of the shares of that shareholder is reduced or the nominal value of the shares so acquired from such shareholder, as the case may be, is a dividend.

This provision has been deleted in the 2007 Revenue Laws Amendment Act because it has been deemed to be obsolete.[119] However, it raised issues pertaining to whether an ordinary redemption without any excess payment constitutes a dividend, capital gain or an ordinary gain. The determination of this aspect is beyond the scope of this thesis.

#### *10.4.2.4 Company Reconstructions*

The Act determines that in the case of a reconstruction of a company, so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the nominal value of the shares held by him or her before the reconstruction shall be a dividend. Reconstruction occurs where the undertaking of a company is maintained in an altered form to allow the same persons carrying it out to continue to carry it on.[120]

### 10.4.3 New Definition of Dividend

Contemporaneous with the replacement of the STC with the new dividend tax, the definition of dividend has been substituted. The Revenue Laws Amendment Bill[121] substituted the definition of dividend and the Act now defines a dividend as “any amount transferred by a company to a shareholder in relation to a share held by the shareholder,

[118] The share buy-back is provided for in section 85 of the Companies Act 61 of 1973.
[119] S 5(1)(f) of the Revenue Laws Amendment Act 35 of 2007.
[120] See Williams 452.
[121] Revenue Laws Amendment Bill 80 of 2008.

to the extent that the amount transferred *(a)* does not result in a reduction of contributed share capital; and *(b)* does not constitute shares in that company".[122] Contributed tax capital is the consideration received by or accruing to a company for the issue of shares.[123]

This definition is broad, as it includes all amounts transferred to the shareholder, irrespective of the availability of profits in the distributing company. It is expected that the 2009 amendment to the Act will include consequential adjustment to the application of the dividend definition to company structuring provisions and deemed dividend provisions.[124]

### 10.4.4 Tax Treatment of Foreign Dividends

A dividend is any amount distributed by a company to its shareholders. The definition of a company includes "any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law."[125] This implies, therefore, that distributions by a non-resident company constitute a dividend.[126]

The tax residence of a recipient shareholder creates a tax nexus between the dividend and the tax system. A foreign dividend is a dividend declared by a company that is not incorporated in South Africa and whose place of effective management is not in South Africa.[127]

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[122] S 1 definition of "dividend".
[123] S 1 definition of "contributed tax capital".
[124] See further on the introduction of the new dividend tax system and the dividend definition Clegg "Aye, There's the Rub" 2007 *Tax Planning* 63; Mazansky "From STC to a Dividend Tax" 2007 *Tax Planning* 78.
[125] S 1 definition of "company".
[126] Since neither the definition of dividend nor the definition of company is linked to the residence of the shareholders, or the company distributing the dividends, theoretically a distribution by any company in the world to its shareholders constitutes a dividend for South African tax purposes. However, this does not confer upon South Africa the right to tax such dividends unless such dividends have a source or residence connection with South Africa.
[127] See Wilson "International Tax – XIV" 2005 *Tax Planning* 63.

Foreign dividends fall into gross income in terms of para (k) of the definition of gross income. The definition of gross income includes the following, without in any way limiting the scope of the definition:

> (k) any amount received or accrued by way of a dividend: Provided that where any foreign dividend declared by a foreign company—
>
> (i) is received by or accrues to a portfolio of a collective investment scheme referred to in paragraph *(e)* (i) of the definition of "company"; and
>
> (ii) is distributed by that portfolio by way of a dividend, or a portion of a dividend, to any person who is entitled to that dividend by virtue of being a holder of any participatory interest in that portfolio…
>
> that foreign dividend shall, to the extent that it is declared to that person as contemplated in subparagraph (ii), be deemed to have been declared by that foreign company directly to that person and to be a foreign dividend which is received by or accrued to that person . . .

Foreign dividends, where taxable, are included in the taxpayer's gross income and taxable at the personal income tax rates or corporate tax rate, as the case may be. There is no STC in relation to non-resident companies, as South Africa does not have a taxing right. The determination of whether a payment or distribution of a foreign company to a resident is a dividend is made by sole reference to the tax laws of South Africa. The fact that the nature of the distribution is categorised in the foreign country as anything other than a dividend generally does not affect the status of the payment for South African tax purposes.

Certain foreign dividends are exempted from South African tax.[128] The importance of the South African tax treatment of foreign dividends for IHCs is that the IHC would

[128] S 10(1)(k)(ii).

generally receive dividends from its non-resident subsidiaries. The South African tax system could have an impact on the amount of dividend finally received by the IHC.

### *10.4.4.1 Exemptions*

While foreign dividends are generally taxable in South Africa, the Act provides for exemptions of certain foreign dividends received or accrued to residents. The exemptions are based on the nature of the dividend, the foreign tax treatment of the dividend, the nature of the company declaring the dividend and the influence that the resident shareholders have on the control of the company.[129]

*(a) Dividends from taxable amounts*

An exemption is provided for foreign dividends accrued to or received by a resident where the amount of the dividend has been or will be subject to tax in South Africa.[130] Amounts earned and distributed by a foreign company could be subject to tax in South Africa where such amounts are sourced in South Africa. Such a situation arises where a foreign company carries on business in South Africa through a permanent establishment or the income is otherwise sourced in South Africa.[131] The income of a permanent establishment would be taxable in South Africa.[132]

The exemption does not apply where the amounts concerned are subject to tax in South Africa but are exempt or will be taxed at a reduced rate in South Africa as a result of the application of a double taxation agreement between South Africa and the country of

[129] See Mitchell "Foreign Dividends" 2007 *Tax Planning* 70.
[130] See s 10(1)(k)(ii)(aa)(A); Olivier and Honiball 153.
[131] For more on permanent establishment in the South African context see Olivier "The 'Permanent Establishment' Requirement in an International and Domestic Taxation Context: An Overview" 2002 *South African Law Journal* 866.
[132] Companies carrying on business in South Africa through permanent establishments are required to register as external companies and are subject to a 34% income tax rate. However, such companies are not subject to STC. Permanent establishment is a concept used to determine when a company has enough connection with a country to subject such company to tax on the income attributable to such permanent establishment. This generally includes branches of companies and other fixed establishments through which companies carry on business in foreign countries.

residence of the foreign company.[133] A double taxation agreement can allocate the ultimate taxing rights in relation to income to any of the contracting states. It can also reduce the rate at which the taxing country may tax certain amounts, subject to the provisions of the DTA.[134]

*(b) Amounts arising from resident company dividends*

Where dividends distributed by a non-resident company arise directly or indirectly from dividends declared by a resident company, such foreign dividend would not be taxable in South Africa.[135] This is due to the fact that the amount of the dividend would have been subject to tax in South Africa. This occurs for example where a South African company declares dividends to a non-resident company whose shareholders are resident in South Africa. The South African company would have been subject to the corporate tax and the STC on the amount of the dividend declared to the non-resident. The chances of tax avoidance would have thereby been eliminated.

*(c) Dividends declared by listed companies*

Foreign dividends declared by listed companies are exempt from tax.[136] A listed company is any company listed on the Johannesburg Stock Exchange or any stock exchange in any foreign country that is recognised by the Minister by notice in the *Gazette*.[137] In addition to the requirement that the company has to be a listed company for the dividend to be exempt, more than 10% of the equity share capital of that listed company should, at the time of the declaration, be held collectively by residents. The residents holding the equity share capital do not have to be the residents to whom the dividends are declared.[138] As

[133] See s 10(1)(k)(ii)(aa)(A); Olivier and Honiball 153.
[134] See Olivier and Honiball 153–154.
[135] See s 10(1)(k)(ii)(aa)(B).
[136] See s 10(1)(k)(ii)(bb).
[137] See s 1 definition of “listed company” read with para 1 of the Eighth Schedule definition of “recognised exchange”.
[138] S 10(1)(k)(ii)(bb) requires that for the dividend to be exempt, the company should comply with the requirements of paragraphs (a) and (b) of the definition of “listed company”. This is surely unintended as it implies that the company has to be a dual-listed company.

Williams states, "[f]or a shareholder to qualify for the exemption, there is no requirement that he must own any particular percentage of the foreign company's shares; the only requirement is that South African residents must, collectively, hold more than 10% of the shares in the foreign company."[139]

*(d) CFC dividends*

Where the income of a CFC has been or will be attributed to its South African shareholder, the dividend declared by the CFC to the shareholder to the amount attributed or attributable would be exempt.[140] This is an exemption for the South African shareholder. The essence of this exemption is that if a calculation is being made of the net income of a CFC, relief cannot be sought under this provision in respect of dividends received by the CFC from other foreign companies because the CFC is not a resident and is not deemed to be a resident. This exemption prevents the taxing of the same profits twice in the hands of the company and the shareholder.[141]

The amount attributed could be the net income of the company declaring the dividend or any other company that is a further tier CFC.[142] These attributed amounts are reduced by any foreign tax payable on the amounts included in the income of the South African resident and so much of all foreign dividends derived by such resident as were exempt from tax or were not previously included in the income of that resident.[143]

[139] Williams 460. For a company to be listed on the Johannesburg Securities Exchange such company has to be a public company. Thus, the shares of that company should be available to the general members of the public. Listed public companies are heavily regulated in terms of the administration, management and governance. In order for a private company to be listed it has to first convert into a public company and make an initial public offering of shares to the public.

[140] See s 10(1)(k)(ii)(cc).

[141] S 9D(9)(e). See also http://adl.ukzn.ac.za/Uploads/56b34556-b394-4e1a-bf2039a4f43b0a65/CFCs_LectRnd4.doc accessed on 05 December 2008.

[142] S 10(1)(k)(ii)(cc)(A) and (B).

[143] See s 10(1)(k)(ii)(cc)(AA) and (BB). This exemption is available on a cumulative basis year by year dating back to 1997 or the date when the CFC was formed, whichever is later.

*(e)* *Participation exemption*

This is perhaps the most reliable and widely used exemption that investors worldwide rely on in planning their affairs. This exemption determines a percentage holding in a foreign company beyond which the dividends would be exempt from tax. In addition to popularity, this is also one of the simplest and effective exemptions to apply. Structuring to benefit from this exemption is also fairly easy.

The participation exemption applies where the shareholder receiving the dividend holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend.[144] Where the recipient shareholder is a company, the 20% holding could be by such shareholder together with any other company in the same group of companies as that recipient shareholder.[145] There are two provisos intended at ensuring that the shareholding must be of genuine equity shares. These provisos prevent deductions being generated by shifting payments offshore, followed by the tax-free return of these funds in the form of exempt foreign dividends. The provisos state as follows:

Provided that—

(A) in determining the total equity share capital of a company, there shall not be taken into account any share which would have constituted a hybrid equity instrument, as contemplated in section 8E, but for the three year period requirement contained in that section; and

(B) this exemption does not apply in respect of any foreign dividend which forms part of any transaction, operation or scheme in terms of which any amount received by or accrued to any person is exempt from tax while any

[144] The holders of equity share capita generally have an unlimited right to participate in the dividends declared by the company and in the capital of the company on liquidation or deregistration. Preference shares on the other hand generally do not qualify as equity share capital because they would typically have fixed dividend and repayment terms. See Olivier and Honiball 156; Silke and Stretch "Removing Tax on Certain Foreign Dividend Repatriations" 2003 (Issue No 3) *Taxgram* 8; Legwaila "The New Treatment of Foreign Dividends" 2004 (October) *De Rebus* 47

[145] S 10(1)(k)(ii)(dd). See Mazansky *South Africa: Participation Exemption Rules Eased* (2 November 2005) http://www.mondaq.com/article.asp?articleid=35862 accessed on 12 January 2009.

> corresponding expenditure (other than expenditure for the delivery of any goods, including electricity) is deductible by that person or by any connected person in relation to that person in determining the liability for tax of that person or connected person, as the case may be, in terms of this Act . . .

The first proviso disregards in the determination of the 20% equity share holding any share which would have constituted a hybrid equity instrument in terms of the Act but for the three-year requirement. The second proviso turns off the exemption in relation to any dividend which forms part of any transaction operation or scheme in terms of which any amount received is exempt while any corresponding expenditure is deductible.[146]

A South African IHC would generally hold majority voting rights in foreign subsidiaries in order to control and manage those subsidiaries and any underlying investments of those subsidiaries. As a result, as a matter of course, the dividends declared by the foreign subsidiaries would be exempt from tax in South Africa in the hands of the IHC. It should be noted that in most cases where this requirement is satisfied in relation to the IHC and its subsidiaries, such foreign subsidiaries would be CFCs whose income would have been attributable to the resident (unless they have foreign business establishments) and would therefore qualify for the exemption on two grounds.

#### *10.4.4.2 Deductibility of Expenditure Incurred in Producing Foreign Dividends*

Expenditure incurred in the production of foreign dividends is deductible in the determination of the taxable income of a shareholder.[147] However, in terms of section 11C, such deduction is limited to interest expenditure.[148] There is no deduction available for other expenditure like professional fees, brokers' commission, agency fees, etc

[146] See Joubert "Participation Exemption" 2002 *Tax Planning* 98–101.
[147] See Mitchell *et al* "Interest Incurred on Earning Foreign Dividends" 2001 *Income Tax Reporter* 71.
[148] It should be noted that expenditure incurred in the production of South African dividends is not deductible. This is because South African dividends are exempt from tax in the hands of the shareholder. At the time of writing it was not yet clear as to whether, with the STC flip to a shareholder tax, the proposed classical system of taxing dividends would allow deductions for interest incurred in the production of South African dividend income.

incurred in the production of dividends. The deduction is available where the interest is incurred in the production of income by way of foreign dividends. Save for this specific provision the expenditure incurred in the production of foreign dividends would not satisfy the general deduction formula[149] because the earning of foreign dividends would not constitute the carrying on of trade unless the taxpayer was a share-dealer.[150]

The deduction of the interest is ring-fenced. It is only available to the extent of the foreign dividends which are included in the income of the person during the year of assessment concerned. As a result, the interest paid on a loan which was used to purchase the shares which produced the foreign dividend will qualify for the deduction, subject to the ceiling.[151] The interest that was incurred in the previous year is not deductible unless it has been carried forward in terms of section 11C(3).

Section 11C(3) provides for the excess interest, i.e. the amount by which the interest exceeds the amount of the foreign dividend, to be reduced by amount of tax-exempt foreign dividends derived by the taxpayer during that year. The balance is to be carried forward to the immediately succeeding year of assessment and is deemed to be an amount of interest actually incurred by that taxpayer during that succeeding year of assessment in the production of foreign dividends. The taxpayer can elect that the amount of foreign taxes paid be deducted from his or her foreign dividend income.[152]

This provision encourages the preference by investors to fund their investments by debt as opposed to equity. Where the purchase of the shares is by equity there would not be a corresponding tax benefit or relief for such funding. As a result, where an IHC is formed by South African residents, it makes an effective tax-planning scheme to fund such company by debt subject to the thin capitalisation rules of the host country.

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[149] The general deduction formula is contained in s 11(a) read with section 23(g).
[150] See Williams 461.
[151] Section 11C(2). See also Williams 461.
[152] If the taxpayer does not make the election, the rebate in respect of foreign taxes would be available to the taxpayer for the foreign withholding tax in respect of those foreign dividends, if those foreign dividends were not exempt from tax in South Africa. See Williams 461.

As has been seen in Chapter 7,[153] dividends are taxable in the Netherlands but the participation exemption provides for a broad relief of tax on dividends. It was also seen in Chapter 8[154] that in Mauritius dividends paid by tax incentive companies, companies listed on the Mauritian stock exchange, and companies that are fully taxable in Mauritius are exempt from tax in the hands of the receiving shareholder, whether resident or not.

## 10.5 REBATE IN RESPECT OF FOREIGN TAXES ON INCOME

### 10.5.1 General

The South African tax system provides for a rebate in respect of foreign taxes on income.[155] This provision applies ancillary and supplementary to many other provisions of the Act, such as CFC income,[156] foreign dividends[157] and foreign capital gains.[158] Basically, this rebate is granted to residents for non-recoverable income taxes payable to a foreign country on income from a foreign country or on CFC income. The rebate in respect of foreign taxes is a unilateral tax relief aimed at providing relief against double taxation. The rebate is deducted from the income tax payable of a resident in whose taxable income is included the above-mentioned and other specific categories of income.[159]

The relevance of this rebate for IHCs is that the IHC is provided with relief on the taxes paid by the subsidiary in the foreign country. Thus, where the foreign subsidiary incurs some tax liability in the foreign country such liability would be offset against the income

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[153] See Chapter 7 par 7.3.4 and par 7.5.1.
[154] See Chapter 8 par 8.2.
[155] The provisions are contained in s 6*quat* of the Act. See Silke and Stretch "Interpretation Note No 18: Rebate for Foreign Taxes and Natural Persons" 2003 (Issue No 6) *Taxgram* 5.
[156] See s 6*quat*(1)(b) of the Act. See Mitchell *et al* "Controlled Foreign Entities" 2001 *Income Tax Reporter* 39.
[157] See s 6*quat*(1)(d) of the Act; Mitchell *et al Income Tax Reporter* 39.
[158] See s 6*quat*(1)(e) of the Act; Meyerowitz par 19.3. See also Mitchell *et al* "Rebate or Deduction of Foreign Taxes" 2008 *Income Tax Reporter* 137.
[159] See Dachs "Foreign Taxes Levied" 2006 *Tax Planning* 138. The rebate applies in relation to foreign-source income. In relation to income earned in South Africa taxpayers get a deduction for the expenditure incurred in the production of income in terms of s 11(a) read with s 23(g). See also South African Revenue Service *Draft Interpretation Note 18* (2009) par 3.1.

that the IHC receives from the foreign subsidiary. Without such relief the ultimate income of the IHC would be diluted by taxation, as it would be taxed in the foreign country and in South Africa. For example, a Congolese subsidiary would be subject to the corporate tax rate of 38% and when it declares dividends to a South African IHC such income would be taxed at the marginal rate of 40%, resulting in a net income after tax of 37% of the gross income received by the Congolese company, i.e. an overall effective rate of 63%.

The rebate is limited to the amount which bears to the total normal tax payable the same ratio as the total taxable income attributed to the specific category of income in respect of which the rebate may be claimed bears to the total taxable income.[160] The wording of the provision is so wide that, arguably, it would cover not only normal taxes paid in the foreign country but also regional taxes like the Swiss Cantonal taxes and the United States's state taxes.[161]

Where the sum of the foreign taxes proved to be payable exceeds the rebate as determined, the excess amount may be carried forward to the immediately succeeding year of assessment and shall be deemed to be a tax on income paid to the government of any other country in that year. The excess may then be set off against the normal tax payable in that succeeding year.[162] What follows is an overview of the amounts in relation to which the foreign tax rebate may be claimed.

### 10.5.2 Foreign-Source Income

In order to qualify for the rebate, the foreign taxes must be payable in respect of income derived from a foreign source.[163] Foreign-source income is income that is not sourced in South Africa. Source is not defined in the Act but it has been held that source is not a legal concept, but something that an ordinary man would regard as a real source of

[160] See s 6*quat*(1B) of the Act. See also Meyerowitz par 19.5.2.
[161] See Olivier and Honiball 322.
[162] See s 6*quat*(1B)(a)(ii). See also Olivier Honiball 322–324.
[163] See s 6*quat*(1A); South African Revenue Service *Interpretation Note 10* (2003) par 2.3.1; South African Revenue Service *Draft Interpretation Note 18* (2009) 3.4.

income.[164] The court in *CIR v Lever Brothers and Unilever Ltd*[165] stated as follows regarding the source of income:

> [The source of income]…is not the quarter whence they come, but the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital by using it to earn income or by letting its use to someone else. Often the work is some combination of these.[166]

Due to the fact that in certain instances income may have multiple originating causes, its case law requires that the dominant cause be established.[167] For South African tax law purposes there are no apportionment rules for the source of income. Due to the different nature of amounts of income, different rules have been created for specific types of income. The forms of income that are relevant for IHCs are interest, shares, dividends and business income.

The source of business income is the place where the business is carried on or where the capital is employed, whichever is dominant. The source of a dividend is the place where the register of the share in respect of which the dividend is paid is located.[168] The source of interest is not the debt but the granting of the credit or the transfer of the lender's right to credit to the borrower, the granting of credit normally being situated where the

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[164] See *Rhodesia Metals Ltd (In Liquidation) v COT* 1938 AD 282.
[165] 1946 AD 441.
[166] At 450.
[167] See *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441 at 449–450; *CIR v Black* 1957 (3) SA 536 (A) at 542–543.
[168] See *Boyd v CIR* 1951 (3) SA 525 at 528. See also Emslie, Davis and Hutton *Income Tax Cases and Materials* (1995) 111.

creditor's business is located.[169] Deeming provisions in relation to interest deem interest to be received or accrued from a South African source where such interest is derived from the utilisation or application in South Africa by any person of funds or credit obtained in terms of an interest-bearing arrangement.[170]

Where the South African resident earns income that is sourced from a foreign country and is not deemed to be sourced from South Africa, the foreign tax credit will be applied in relation to the amount of that income that is included in the taxable income of the resident.[171] If income is deemed to be from a South African source, the rebate cannot be applied in relation to such income.[172]

#### *10.5.2.1 CFC Income Attributable to the Resident*

Where income of a CFC is attributable to a resident and foreign taxes have been paid in relation to that income, the rebate will be applied to the amount so attributed in calculating the taxable income of the resident.[173]

#### *10.5.2.2 Foreign Dividends*

Where the taxable income of a resident includes a foreign dividend in relation to which foreign taxes have been paid, the rebate will be applied to the amount of that dividend in calculating the taxable income of the resident.[174]

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[169] See *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441; *First National Bank of Southern Africa v C: SARS* 64 SATC 253. See also Silke and Stretch "New Test for Source of Interest?" 2001 (Issue No 7) *Taxgram* 6.

[170] See Tsatsawane "Interest Income from a Source Within, or Deemed to be Within, South Africa" *Juta's Business Law* (2000) 178.

[171] See Dachs 138–139.

[172] Deeming provisions apply in relation to certain specific forms of income including royalties, mining income, pensions and capital gains. See s 9.

[173] S 6*quat*(1)(b).

[174] S 6*quat*(1)(d); South African Revenue Service *Draft Interpretation Note 18* (2009) par 3.2.

#### *10.5.2.3 Capital Gains*

If the taxable income of a resident includes a capital gain from a source outside South Africa which is not deemed to be from a source within South Africa in relation to which foreign taxes have been paid the rebate will be applied to the amount of that capital gain in calculating the taxable income of the resident.[175]

As a general rule, capital gains tax ("CGT") in South Africa is payable only by residents. Non-residents are not subject to CGT unless the asset being disposed of is immovable property or attributed to immovable property or to a permanent establishment located in South Africa. Residents pay CGT on their worldwide capital gains. The implication of these CGT provisions is that where a resident holds shares or assets outside South Africa and the country in which the assets or shares are situated taxes the capital gain on the sale of such assets or shares, the resident would receive a section 6*quat* credit on the tax payable in South Africa on income that includes such capital gain. This would apply to IHCs where the IHC disposes of its interests in the foreign subsidiary.

The amount of gains or losses arising from the currency fluctuations on the consideration payable for the disposal of an asset in foreign currency is taxable or deductible in terms of par 86 of the Eighth Schedule.

As was seen in Chapter 7,[176] the Dutch system of foreign tax credit is similar to the South African system. It was also seen in Chapter 8[177] that the Mauritian tax system provides for a foreign tax credit and presumed tax credit for GBL1 companies. In certain instances, the tax treaties entered into by Mauritius provide for a tax sparing credit. A combination of the foreign tax credit or the presumed tax credit and the tax sparing credit provide a significant tax relief measure for GBL1 companies.

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175 South African Revenue Service *Draft Interpretation Note 18* (2009) par 3.2 and 3.3.
176 See Chapter 7 par 7.3.8.
177 See Chapter 8 par 8.3.1.1.

## 10.6 EXCHANGE CONTROL

### 10.6.1 Introduction

The South African government's general policy approach to exchange control is one of prohibition to deal in foreign exchange except with the permission of and on the conditions set by the South African Reserve Bank (hereinafter referred to as "the SARB"). As the SARB explains, "[t]he economic policy underlying exchange control is, however, not totally prohibitive, since such an approach would not be conducive to the conduct of normal international trade and payments."[178]

### 10.6.2 Purpose of Exchange Control

According to the Exchange Control Manual,[179] the main purposes of exchange control are as follows:

- To ensure the timeous repatriation into the South African banking system of certain foreign currency acquired by residents of South Africa, whether through transactions of a current or of a capital nature; and

- To prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa.

The Exchange Control Manual furthermore states that, based on the above, exchange control "constitutes an effective system of control to these ends by monitoring the movement of financial and real assets (money and goods) into and out of South Africa,

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178 The South African Reserve Bank *Exchange Control Manual* Part E accessible on http://www.reservebank.co.za/internet/Publication.nsf/LADV/8A3852676EBE6C26422573FC0053E76E/$File/E.pdf accessed on 12 June 2008.
179 *Exchange Control Manual* Part (E).

while at the same time avoiding interference with the efficient operation of the commercial, industrial and financial systems of the country."[180]

### 10.6.3 Application of Exchange Controls in South Africa

South African exchange control provisions apply to residents and non-residents.[181] What further determines whether the regulations apply is mainly the nature and context of the transactions entered into as opposed to the identity of the persons to whom the regulations apply. In practice the application of these regulations is discretionary and based on policy and procedure which are not available to the general public.[182]

The exchange control applies to capital movements in and out of the Common Monetary Area ("CMA"). The CMA consists of South Africa, Lesotho, Swaziland and Namibia. These are neighbouring countries the currencies of which (Maloti, Lilangeni and Namibian Dollar, respectively) are based on the South African Rand and trade on the Johannesburg Securities Exchange on the back of the Rand. The CMA Agreement provides that the exchange controls of the other CMA countries should be as strict as the South African exchange controls.[183]

For ease of administration, the exchange control regulations are administered by authorised dealers in foreign exchange acting for and on behalf of the South African Reserve Bank. Authorised dealers are persons authorised by the Treasury to deal in gold

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[180] *Exchange Control Manual* Part E.
[181] *Exchange Control Manual* Part (D8)
[182] See Olivier and Honiball 524.
[183] *Exchange Control Manual* Part D7 available on http://www.reservebank.co.za/internet/Publication.nsf/LADV/C708879B5724E5A6422574570033B459/$File/D.pdf accessed on 23 July 2008.

or foreign exchange.[184] Most of South Africa's commercial and merchant banks are authorised dealers.[185]

#### 10.6.4 Restriction on Export of Currency and Import of South African Rand

Probably the most important part of the regulations in relation to IHCs is the regulations that govern the export of currency. This is because the setting up of a South African IHC requires a transfer of some value or consideration to be made into South Africa. Conversely, the setting up of a foreign subsidiary by the South African IHC or residents requires expatriation of funds. This may take the form of buying shares in the foreign company from existing shareholders or buying newly issued shares in a newly formed company.[186] In terms of para 3 of the regulations the following acts are prohibited unless authorised or exempted by an authorised dealer or the Treasury: [187]

a) Taking or sending out of South Africa any bank notes or foreign currency;
b) Sending, consigning or delivering any bank notes or foreign currency within South Africa with the purpose of removing such bank notes or foreign currency out of South Africa. This prohibition applies to foreign currency or bank notes irrespective of the fact that it has not yet been removed from South Africa;
c) Taking, sending or consigning any South African bank notes into South Africa;
d) Making payments to, in favour of or on behalf of a person resident outside South Africa, or place any sum to the credit of such person;
e) Drawing or negotiating any bill of exchange or promissory note, transferring any security or acknowledging any debt, so that a right (whether actual or contingent) on the part of such person or any other person to receive a payment in the

[184] See definition of "authorised dealer" in Para 1 of the Schedule to Exchange Control Regulations 1961, Government Notice R1111 of December 1961 (hereinafter referred to as "the Regulations") available on http://www.reservebank.co.za/internet/Publication.nsf/LADV/E2B2440F192F118342257134004A9935/$File/Regulations.pdf accessed on 23 July 2008.
[185] See Incompass *Exchange Control* http://www.incompass-financial-services.com/exchange-control-South-Africa.html accessed on 09 February 2009.
[186] For a detailed discussion on the methods of establishing an IHC see Chapter 5 par 5.3.
[187] See para 3(1)(a)–(f) of the Regulations. See Fisher Hoffman PKF *South African Exchange Control Guide* (2004) 3 available on http://www.pkf.co.za/publications/pdf/exchangebrochure4.pdf accessed on 15 December 2008.

Republic is created or transferred as consideration for the receiving by such person or any other person of a payment or the acquisition by such person or any other person of property, outside South Africa; or for a right (whether actual or contingent) on the part of such person or any other person to receive a payment or acquire property outside South Africa; or making or receiving any payment as such consideration.

f) Granting of financial assistance[188] to a person who is not resident or to an affected person. Affected person is defined as "a body corporate, foundation, trust or partnership operating in the Republic, or an estate, in respect of which –

(i) 75% or more of the capital, assets or earnings thereof may be utilised for payment to, or to the benefit in any manner of, any person who is not resident in the Republic; or

(ii) 75% or more of the voting securities, voting power, power of control, capital, assets or earnings thereof, are directly or indirectly vested in, or controlled by or on behalf of, any person who is not resident in the Republic."

**10.6.5 Rules Applicable to Subsidiaries of South African Companies**

South African residents are required to obtain approval to set up subsidiary companies in foreign countries within limits for approved investments.[189] However, residents are not required to obtain approval to set up companies within the CMA.

Since 1995 the quantitative requirements have undergone evolution, and this has resulted in their being more relaxed in recent years.[190] Prior to 2004, the limits were R2 billion for

[188] Financial assistance includes the lending of currency, the granting of credit, the taking up of securities, the conclusion of a hire purchase or a lease, the financing of sales or stocks, discounting, factoring, the guaranteeing of acceptance of credits, the guaranteeing or acceptance of any obligation, a suretyship, a buy-back and a leaseback, but excludes the granting of credit by a seller in respect of any commercial transaction directly involving the passing of ownership of the goods sold from seller to purchaser; and the granting of credit solely in respect of the payment for services rendered.
[189] See Exchange Control Manual par F 6.1.2.
[190] See National Treasury *Budget Review* (2004) 32. According to the National Treasury *Budget Review* (2007) 30, the "gradual process of exchange control relaxation has enabled an orderly process of global

each new and approved African investment and R1 billion for each new and approved investment elsewhere in the world. On application, a further 20% of excess costs of a new investment (as opposed to an improvement on an already existing investment) could be funded by cash holdings if the investment limit had been utilised.[191]

Until 27 October 2007 resident companies were allowed to transfer amounts up to R50 million per year for investment offshore investment from South Africa for each new and approved foreign investment.[192] Should a resident company need to transfer any amount in excess of the R50 million, such company should obtain approval from the SARB.[193] This limit has been increased by Finance Minister Pravin Gordhan in the 2009 Medium Term Budget Policy Statement delivered on 27 October 2009 to R500 million.[194] The SARB reserves the right to stagger capital outflows relating to very large foreign investment in order to manage any potential impact on the foreign exchange market.[195]

Furthermore, as stated in the Exchange Control Manual

> "South African companies are allowed, without prior approval from Exchange Control, to expand their existing offshore business via the existing/newly established offshore entity, through the acquisition of further assets/equity interests offshore, provided such acquisitions are in the same line of business and an enhanced benefit to South Africa (other than dividends) can be demonstrated."[196]

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reintegration, encouraging South African companies to expand from domestic base and allowing South African residents to diversify their portfolios through domestic channels."
See further on the relaxation of exchange controls Webber Wentzel *Investing in South Africa - Exchange Control* http://www.webberwentzel.com/wwb/view/wwb/en/page2015#relax accessed on 17 April 2009.

[191] See Olivier and Honiball 533.

[192] Exchange Control Manual par F 6.1.2.2.

[193] Exchange Control Manual par F 6.1.2.3.

[194] See National Treasury *Medium Term Budget Policy Statement* (2009) 26; Exchange Control Circular 13 of 2009 accessible on http://www.reservebank.co.za/internet/Publication.nsf/LADV/C5C3ADD965CE179F4225765C004F8AF4/$File/Circ+No+13+2009.pdf accessed on 11 January 2009.

[195] Exchange Control Manual F 6.1.2.5.

[196] Exchange Control Manual F 6.1.2.5.

The requests made by corporates to invest abroad are considered in the light of national interest. The Exchange Control Manual[197] lists the following conditions and policy principles that are applicable to approved investments exceeding R50 million:

(1) Whilst there are no exchange control limits on new outward foreign direct investments by South African companies, Exchange Control reserves the right to stagger capital outflows relating to very large foreign investments so as to manage any potential impact on the foreign exchange market.

(2) On application, foreign finance may be raised on the strength of the applicant company's South African balance sheet to finance foreign acquisitions.

(3) Companies wishing to invest in countries outside the CMA may apply to Exchange Control to engage in corporate asset or share swap transactions in order to fund such investments or to repay existing offshore debt. Similarly, requests for share placements and bond issues offshore by locally listed companies will also be considered.

(4) Companies which have existing approved subsidiaries abroad are allowed to expand such activities without prior Exchange Control approval, provided that such expansion is financed by foreign borrowings, without recourse to South Africa, or by the employment of profits earned by that subsidiary, subject to the expansion being in the same line of business and that benefit to South Africa can be demonstrated. The local parent company is required to place their proposed plans for the expansion of the investment on record with Exchange Control within 30 days.

[197] Exchange Control Manual par F 6.1.2.3.

Where dividends to the South African parent/holding company are not declared, the retention of any balance of the profits earned would, bearing in mind the provisions of Regulation 6, have to be negotiated with Exchange Control at the time of the normal annual report back.

(5) Dividends repatriated from abroad by South African companies during the period 2003-02-26 to 2004-10-26 (dividend credits) automatically form part of domestic funds and may be allowed to be retransferred abroad for the financing of approved foreign direct investments or approved expansions, but may not be transferred abroad for any other purpose.

Dividends declared by offshore subsidiaries of South African companies after 2004-10-26 may be retained offshore and used for any purpose, without any recourse to South Africa. Such dividends repatriated to South Africa after 2004-10-26 may be retransferred abroad at any time and used for any purpose, provided that there is no recourse to South Africa.

Resident companies establishing subsidiaries abroad are required to submit financial statements on these operations to the Exchange Control annually. There are, however, certain instances where the Exchange Control requires regular progress reports in addition to the annual reports.

Prior to 2004, corporates were not allowed to retain foreign dividends offshore. This resulted in forced repatriation that made it extremely difficult for South African residents to utilise IHCs as investment vehicles. This position has changed only for companies. Foreign companies owned by South African residents are not allowed to hold investments within the CMA. The loop structures in terms of which residents hold interests in foreign companies who in turn hold investments in South Africa are undesirable both from an exchange control point of view and from a tax point of view and measures are in place to deal with such structures.[198]

The exchange control regulations would require that when a South African IHC sets up operating subsidiaries outside the CMA, or purchases the shares of companies outside the CMA and the value of such investment exceeds R50 million in any particular year, the IHC would have to obtain approval from the SARB. As stated above, investments of over R50 million would be allowed subject to the conditions stated above. In essence, this approval process is not prohibitive, but ensures that large investments made outside South Africa are economically beneficial to South Africa.

#### 10.6.6 Local Borrowing Restrictions

The South African exchange control provisions impose a general restriction on amounts or financial assistance that may be received by resident countries that are controlled by non-residents.

Regulation 3(1)(e) and (f) provide as follows[199]

> Subject to any exemption which may be granted by the Treasury or a person authorised by the Treasury, no person shall, without permission granted by the Treasury or a person authorised by the Treasury and in accordance with such conditions as the Treasury or such authorised person may impose -
>
> (e) grant any financial assistance to any person in the Republic, where as security for such financial assistance, the person granting the

[198] The Exchange Control Manual states at par F 6.1.2.3 that funds for which approval has been obtained "may under no circumstances be utilised to fund investments/loans into the CMA and SADC, for any purpose whatsoever, through a 'loop structure'". It states with regard to dividends resulting from such funds that "dividend proceeds may…under no circumstances be used to fund investments/loans into the CMA and SADC, for any purpose whatsoever, through a 'loop structure'."
[199] Exchange Control Regulation 3(1)(e) and (f).

financial assistance in turn relies on any security, guarantee, undertaking or financial assistance, directly or indirectly furnished by (i) any person resident outside the Republic; or (ii) an affected person…

(f) grant any financial assistance to any person in the Republic, where such person (i) is not resident in the Republic; or (ii) is an affected person.

An affected person is defined as a body corporate, foundation, trust or partnership operating in the Republic, or an estate, in respect of which -

"(i) 75 per cent or more of the capital, assets or earnings thereof may be utilised for payment to, or to the benefit in any manner of, any person who is not resident in the Republic; or (ii) 75 per cent or more of the voting securities, voting power, power of control, capital, assets or earnings thereof, are directly or indirectly vested in, or controlled by or on behalf of, any person who is not resident in the Republic."[200]

The regulations contain a definition of financial assistance. It provides as follows:[201]

"'financial assistance' includes the lending of currency, the granting of credit, the taking up of securities, the conclusion of a hire purchase or a lease, the financing of sales or stocks, discounting, factoring , the guaranteeing of acceptance of credits, the guaranteeing or acceptance of any obligation, a suretyship, a buy-back and a leaseback but excluding (a) the granting of credit by a seller in respect of any commercial transaction directly involving the passing of ownership of the goods sold from seller

[200] Exchange Control Regulation 1 definition of "affected person".
[201] Exchange Control Regulation 1 definition of "financial assistance".

to purchaser; and (b) the granting of credit solely in respect of the payment for services rendered"

The rules provide for an exemption within the limits of a stipulated formula in terms of which an affected person may only borrow funds from local and CMA sources up to a percentage of its effective capital.[202] The exemption creates a local borrowings formula of a debt-to-equity ratio of 3:1. [203]

Generally the ultimate holding company of the IHC would be resident outside South Africa. Most of the financing of the IHC would be obtained from the ultimate holding company. The IHC, as a subsidiary of the ultimate holding company would satisfy the requirements of an affected person. Thus any borrowing by the IHC from local sources should not exceed the 3:1 debt-to-equity ratio.

The local borrowing restrictions have been abolished with effect from 27 October 2009. The purpose of the abolition of this restriction is in order to improve access to domestic credit in the financing of local foreign direct investment. This relaxation does not apply to portfolio investment by non-residents.[204]

### 10.6.7 Dividends

Dividend distributions are freely remittable to non resident shareholders. Distributions by companies that are not listed require the company paying the dividend to "provide an authorised dealer with an auditor's certificate that confirms that the amount transferred arises from realised profits arising in the normal course of business and payable toa non-resident who has not previously been resident.[205] With regards to the distribution of capital profits the certificate should indicate how the profit arose and that the

[202] "Effective capital is the net worth of the company, together with approved shareholders' loan funds, which are regarded as investment funds because of their permanence" (Olivier and Honiball 543).
[203] See Olivier and Honiball 543.
[204] National Treasury Medium *Term Budget Policy Statement* (2009) 26.
[205] See s F2.2.3.1 of the Exchange Control Manual. See also Olivier and Honiball 540-541.

consideration paid for the sale was at arm's length.[206] These provisions do not impose cumbersome requirements on the IHC.

#### 10.6.8 Interest on Foreign Loans

Interest on loans form non-residents is freely remittable abroad. However, the loan facility and the interest rate must be approved by the SARB. The interest rate cannot exceed the base rate of the currency in which the loan is raised plus 2% or prime rate plus 3% if the loan is denominated in the South African rand.[207]

#### 10.6.9 Management and Administrative Fees

Payment of management and administrative fees may be paid to a non-resident service provider without intervention of the SARB. Authorised dealers are given the authority to approve these payments upon production of documentary evidence confirming the amount involved, and that the amount is reasonable in relation to the services provided.[208]

#### 10.6.10 The 2009 Developments

The South African government has been and continues to relax exchange controls with a view to lowering the cost of doing business in South Africa.[209] National Treasury Announced further relaxation of exchange controls in the 2009 Medium Term Budget Policy Statement. In addition to the abolition of the local borrowing restrictions and the increase in the outward investment limit numerous provisions of exchange controls have generally been relaxed. Of importance to IHCs are the following: [210]

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[206] See s F2.2.3.1 of the Exchange Control Manual; Olivier and Honiball 541.
[207] See s F6.1.7 of the Exchange Control Manual; Olivier and Honiball 541.
[208] See s F2.2.3 of the Exchange Control Manual. See also Olivier and Honiball 542.
[209] See Cronje "Changes to Income Tax and Exchange Control in South Africa" (1997) *International Tax Review* 319-321.
[210] National Treasury Medium *Term Budget Policy Statement* (2009) 26. See also Exchange Control Circular 13 of 2009 accessible on http://www.reservebank.co.za/internet/Publication.nsf/LADV/C5C3ADD965CE179F4225765C004F8AF4/$File/Circ+No+13+2009.pdf accessed on 11 January 2009.

- Section B2B(iii) of the Exchange Control Manual restricted loop structures into the South African Development Community member countries in terms of which South African residents would invest in SADC member countries though a foreign intermediary. This restriction has been removed in order to promote regional integration. However, the relaxation excludes investment in SADC member countries that are part of the CMA.
- The regulations required that South African companies should convert their foreign exchange into the South African Rand within 180 days of acquiring such currency. This requirement has been removed.
- South African companies will be allowed to open foreign bank accounts for permissible purposes without prior approval, subject to reporting obligations.

The National Treasury vowed to continue to improve the exchange control regulatory framework for improving investments and undertook to announce key proposals that will form part of the modernised approach in the 2010 Budget Review.[211]

As was seen in Chapters 7[212] and 8,[213] the Netherlands and Mauritius do not have exchange control provisions.

## 10.7 CAPITAL GAINS TAX IN SOUTH AFRICA

### 10.7.1 Introduction

Capital gains tax (hereinafter referred to as "CGT") was introduced in South Africa in 2001.[214] Prior to its introduction only income of a revenue nature was taxable, unless specifically included in the definition of "gross income". Capital gains of most kinds

[211] National Treasury Medium *Term Budget Policy Statement* (2009) 26
[212] See Chapter 7 par 7.2.9.
[213] See Chapter 8 par 8.2.3.
[214] See Silke and Stretch "Capital Gains Tax Bill Introduced" 2001 (Issue No 3) *Taxgram* 1–2.

were exempt from income tax.[215] Gross income was defined in section 1 to exclude receipts or "accruals of a capital nature."[216] Courts were inundated with the task of determining the capital or revenue nature of amounts received by taxpayers. An amount could either be capital or revenue and thus exempt or taxable, respectively. There was no mid-point between the two ends.[217] This tax treatment resulted in taxpayers recharacterising revenue income as capital income.

When it was introduced in South Africa, the National Treasury and the South African Revenue Service justified the need to introduce CGT as follows: [218]

> The absence of a CGT creates many distortions in the economy, by encouraging taxpayers to convert otherwise taxable income into tax-free capital gains. The South African Revenue Service has observed that sophisticated taxpayers have engaged in these conversion transactions, thereby eroding the corporate and individual income tax bases. This erosion reduces the efficiency and equity of the overall tax system. A CGT is, therefore, a critical element of any income tax system as it protects the integrity of the personal and corporate income tax bases and can materially assist in improving tax morality.

CGT is applicable to disposals on or after 01 October 2001. The basic principle of the CGT is that if a gain is made from the disposal of a capital asset, such gain is taxable.[219]

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215 In 1969 the Franzsen Commission recommended a limited form of CGT on immovable property and marketable securities – see Franzsen Commission *Taxation in South Africa: First Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa* (November 1968), printed for the Government Printer, Pretoria by Cape and Transvaal Printers TD, Cape Town B932/5,000 at 48.The Katz Commission also recommended that CGT should not be introduced in South Africa due to its complexity and the capacity of the tax administration in South Africa. See Katz Commission *Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (1995) http://www.treasury.gov.za/publications/other/katz/4.pdf Accessed on 08 April 2008.

216 Section 1 of the Act definition of "gross income" as at 30 September 2001.

217 See *Tuck v CIR* 1988 (3) SA 819 (A); *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A).

218 Guide to Capital Gains Tax http://www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf accessed on 01 April 2008. See further on the need for capital gains tax in South Africa Meyerowitz, Emslie and Davis "Why Capital Gains Tax" *The Taxpayer* (2001) 228.

219 See s 26A read with Part II of the Eighth Schedule.

On the other hand, if the asset is sold at a loss, the loss can be set off against other capital (not revenue) profits.[220] The excess is carried over to the next tax year.[221] The capital gain raised is included in the taxable income of the taxpayer at a rate applicable to such taxpayer. The inclusion rate for individuals and trusts is 25% while for corporate taxpayers it is 50%. The included amount is taxed at the normal personal income tax marginal rate (at a sliding scale) of 40% and corporate tax rate of 28% respectively.[222]

The trigger for the CGT is a disposal of a capital asset by a taxpayer. Certain disposals are disregarded. In some cases the disposal is tax-free because the disposal event is exempt and in other cases the tax is deferred or rolled-over to the purchaser.[223] The following key terms are central to the operation of the CGT system in South Africa: (i) capital gain; (ii) asset; (iii) base cost; and (iv) disposal. Furthermore, the CGT system is applicable to residents. It is only applicable to non-residents in certain circumstances. Certain gains are excluded from the application of the CGT system. The key terms, persons liable for the tax and available exclusions are discussed below.

### 10.7.2 Key Terms, Taxpayer and Exclusions

#### *10.7.2.1 Capital Gain and Asset*

A person's "capital gain" for the year in which the asset was disposed of is defined as the amount by which the proceeds accruing in respect of the disposal during that year of an asset exceed the base cost of the asset.[224] The proceeds from the disposal of an asset are the amount received by or accrued to a person in respect of the disposal in a year of

[220] See Williams *Capital Gains Tax – A Practitioner's Manual* (2005) 21–22. Silke and Stretch "CGT: Limitation of Capital Losses" 2001 (Issue No 7) *Taxgram* 5.
[221] See Huxham and Haupt *Notes on South African Income Tax* (2008) 693.
[222] In Divaris and Stein's words, "[t]here is no separate capital gains tax (CGT) in South Africa. A person's taxable capital gain for a year is included in his or her taxable income and subjected to normal tax. This means that taxable capital gains are subject to normal tax rather than a separate CGT." See Divaris and Stein *South African Income Tax Guide* (2007) 394.
[223] See par 52-64B and par 65-67C of the Eighth Schedule; see also the capital gains flowchart in Davis *What You Must Know About Capital Gains Tax* (2001) 20.
[224] Par 3(a) of the Eighth Schedule. See Divaris and Stein 395.

assessment.[225] This specifically includes the amount by which any debt owed by a person has been reduced or discharged[226] and any amount received by or accrued to a lessee from the lessor of property for improvements effected to that property.[227]

An "asset" is defined as including property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum.[228] An asset also includes a right or interest of whatever nature in an asset as stated above.[229]

### *10.7.2.2 Base Cost*

The base cost of an asset is deducted from the proceeds of the disposal of that asset.[230] In general terms the base cost is the sum of all amounts that the seller incurred in acquiring and keeping the asset.[231] Par 20 describes it as the sum of the following salient aspects relevant to this study: [232]

*(a)* the expenditure actually incurred in respect of the cost of acquisition or creation of that asset;

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[225] Par 35(1) of the Eighth Schedule.
[226] Par 35(1)(a) of the Eighth Schedule.
[227] See Boltar and Monteiro *Annual Survey of South African Law* 809–810; par 35(1)(b) of the Eighth Schedule to the Act. In terms of par 35(3) the proceeds from the disposal of an asset by a person must be reduced by (a) any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain; (b) any amount of the proceeds that has been repaid or has become repayable to the person to whom that asset was disposed of; or (c) any reduction, as the result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event, of an accrued amount forming part of the proceeds of that disposal.
[228] Par 1(a) of the Eighth Schedule definition of "asset". See Swart "Interpreting Some Core Concepts Governing the Taxation of Capital Gains" 2005 *South African Law Journal* 2–3.
[229] Par 1(a) of the Eighth Schedule definition of "asset". For a further discussion on the meaning of "asset" see Olivier "Determining a Taxable Capital Gain or an Assessed Capital Loss: Some Problems" (2007) *Meditari Accountancy Research* Vol 15 No 1 35 at 37–40.
[230] See par 20 of the Eighth Schedule to the Act. See also Boltar and Monteiro *Annual Survey of South African Law* 810.
[231] Kolitz "Listed Share Valuations – A Closer Examination of the Three Options for the Base Cost of an Asset Available to Taxpayers" 2002 *Tax Planning* 2.
[232] See par 20(1) of the Eighth Schedule to the Act. See also Olivier *Meditari Accountancy Research* 42.

*(b)* the expenditure actually incurred in respect of the valuation of the asset for the purpose of determining a capital gain or capital loss in respect of the asset;

*(c)* the following amounts actually incurred as expenditure directly related to the acquisition or disposal of that asset namely—

(i) the remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered;

(ii) transfer costs;

(iii) stamp duty, transfer duty or similar duty;

(iv) advertising costs to find a seller or to find a buyer;

(v) the cost of moving that asset from one location to another;

(vi) the cost of installation of that asset, including the cost of foundations and supporting structures;

(vii) in the case of a disposal of an asset by a person by way of a donation, so much of any donations tax payable by that person in respect of that donation;

(viii) if that person acquired that asset by way of a donation and the donations tax levied in respect of that donation was paid by that person, so much of the donations tax which bears to the full amount of the donations tax so payable the same ratio as the capital gain of the donor determined in respect of that donation, bears to the market value of that asset on the date of that donation; and

(ix) if that asset was acquired or disposed of by the exercise of an option (other than the exercise of an option, the expenditure actually incurred in respect of the acquisition of the option;

*(d)* the expenditure actually incurred for purposes of establishing, maintaining or defending a legal title to or right in that asset;

*(e)* the expenditure actually incurred in effecting an improvement to or enhancement of the value of that asset, if that improvement or enhancement is still reflected in the state or nature of that asset at the time of its disposal;

*( f )* if that asset was acquired or disposed of by the exercise on or after valuation date of an option acquired prior to the valuation date, the valuation date value of that option, which value must be treated as expenditure actually incurred in respect of that asset on valuation date for the purposes of this Part;

*(g)* expenditure actually incurred which is directly related to the cost of ownership of that asset, which is used wholly and exclusively for business purposes or which constitutes a share listed on a recognised exchange or a participatory interest in a portfolio of a collective investment scheme;

*(h)* in the case of a marketable security or an equity instrument the market value of that marketable security or equity instrument or amount received or accrued from the disposal thereof, as the case may be, that was taken into account in determining the amount of that gain or loss . . .

#### *10.7.2.3 Disposal*

A disposal for CGT purposes refers to events where there is a change in the ownership of an asset.[233] A disposal is defined as any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset.[234] Specifically included in this definition are the following actions: [235]

- the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
- the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;
- the scrapping, loss, or destruction of an asset;
- the vesting of an interest in an asset of a trust in a beneficiary;

[233] See Cassidy "Capital Gains Tax in South Africa – Lessons from Australia" *South African Mercantile Law Journal* (2004) 165.
[234] Par 11(1) of the Eighth Schedule to the Act. See Swart 6–7.
[235] Par 11(1)(a) – (g) of the Eighth Schedule to the Act. See further on disposals Erasmus and Boonzaier *Capital Gains Tax – A Guideline* (2002) 15–22; Davis 10–19; Williams *Capital Gains Tax – A Practitioner's Manual* 175–187; Geach 30–32; Olivier *Meditary Accountancy Research* 42–43.

- the distribution of an asset by a company to a shareholder;
- the granting, renewal, extension or exercise of an option; or
- the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement.

#### *10.7.2.4 Persons Liable to Capital Gains Tax*

Following the South African residence-based taxation, CGT is charged on a disposal by a taxpayer who is resident in South Africa.[236] A disposal by a non-resident only attracts CGT if, firstly, the asset disposed of is immovable property situated in South Africa or the non-resident holds any right in the immovable property situated in South Africa; and, secondly, if the asset disposed of is attributable to a permanent establishment of the non-resident in South Africa.[237]

An interest in immovable property situated in South Africa includes any equity shares held by a non-resident in a company or ownership or the right of ownership of the non-resident in any other entity or a vested interest of the non-resident in any assets of a trust if 80% or more of the market value of those equity shares, ownership or right of ownership or vested right, as the case may be, at the time of the disposal thereof is attributable directly or indirectly to immovable property in South Africa held otherwise than as trading stock.[238] Furthermore, in the case of a company or other entity, the non-resident must hold directly or indirectly at least 20% of the equity share capital of that company or ownership or right to ownership of the other entity.[239]

Immovable property held as trading stock is excluded in determining whether a non-resident holds immovable property or holds an interest in immovable property. When a non-resident holds the interest through a company or other entity, the interest in

[236] Par 2(1)(a) of the Eighth Schedule to the Act.
[237] See par 2(1)(b) of the Eighth Schedule to the Act; Williams *Capital Gains Tax – A Practitioner's Manual* 5.
[238] Par 2(2) of the Eighth Schedule.
[239] Par 2(2)(b) of the Eighth Schedule.

immovable property includes a situation where the non-resident, either alone or together with connected persons, directly or indirectly holds at least 20% of the equity share capital of the company or the ownership or right to ownership of the other entity.[240]

Based on the discussion above, a resident IHC will be liable for capital gains tax in South Africa by virtue of its tax residence. Due to the residence-based tax system, the South African IHC will be subject to CGT on its capital gains realised anywhere in the world. By implication, if the IHC disposes of an interest in another company, such transaction will be subject to CGT and therefore any gain realised therefrom will be taxable unless one of the exceptions applies or the participation exemption applies.[241]

#### *10.7.2.5 Exclusions*

The CGT regime does not apply to certain disposals. These include the disposal of primary residence,[242] personal use assets,[243] retirement benefits,[244] small business assets,[245] interest in equity share capital of a foreign company[246] and disposals by public benefit organisations[247] and by creditor of a debt owed by a connected person.[248] Pertinent to this study is the exclusions relating to disposals by creditor of a debt owed by a connected person and disposal of interest in equity share capital of a foreign company.

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[240] See Divaris and Stein 394–395.
[241] See par 64B of the Eighth Schedule.
[242] Part VII of the Eighth Schedule. The primary residence exclusion applies to the gain or loss determined on the disposal of a primary residence in the calculation of a natural person's aggregate capital gain or loss. The residence should be located in South Africa and only applies to South African residents. However, the resident does not have to own the asset. An interest in the asset suffices. For a detailed discussion of the primary residence exclusion see Silke and Stretch "Capital Gains Tax – Primary Residence Exemption" *Taxgram* Issue No 4 (2001) 4–5; Williams *Capital Gains Tax – A Practitioner's Manual* 308–329.
[243] Par 53 of the Eighth Schedule. Personal assets are assets used mainly for purposes other than the carrying on of a trade. These assets include furniture, clothing, jewellery and a private motor vehicle. See Williams *Capital Gains Tax – A Practitioner's Manual* 330.
[244] See Williams *Capital Gains Tax – A Practitioner's Manual* 331. In terms of Par 54 of the Eighth Schedule, lump sum benefits from pension, provident, retirement and annuity funds are not subject to CGT whether paid by a resident or non-resident.
[245] Par 57 of the Eighth Schedule provides for the exclusion of gains made on the disposal of active business assets by a natural person carrying a small business as defined. The amount disregarded is up to R750 000 of the gain. For a detailed discussion of the exclusion on small business assets see Silke and Stretch "CGT: Disposal of Small Business Assets" *Taxgram* Issue No 8 (2001) 2
[246] Par 64B of the Eighth Schedule.
[247] Par 63A of the Eighth Schedule. See also Williams *Capital Gains Tax – A Practitioner's Manual* 345.
[248] Par 56 of the Eighth Schedule.

Other exclusions would generally not be available to an IHC based on its nature and functions.

*(a) Disposals by creditor of a debt owed by a connected person*

The provision relating to the disregarding of disposals by the creditor of a debt owed by a connected person applies in respect of losses realised in such a disposal. Where a creditor disposes of a claim by a debtor who is a connected person in relation to that creditor, that creditor must disregard the loss determined in consequence of that disposal.[249]

This provision implies that a resident holding company or other connected person of an IHC cannot reduce the amount of taxable gain by discharging the IHC of its indebtedness to the resident company.

However, the loss can be considered to the extent that the claim disposed of represents any of the following: [250]

- a capital gain which is included in the determination of the aggregate capital gain or aggregate capital loss of that debtor;
- an amount which the creditor proves must be or was included in the gross income of any acquirer of that claim;
- an amount that must be or was included in the gross income or income of the debtor or taken into account in the determination of the balance of assessed loss of the debtor; or
- a capital gain which the creditor proves must be or was included in the determination of the aggregate capital gain or aggregate capital loss of any acquirer of the claim.

[249] Williams *Capital Gains Tax – A Practitioner's Manual* 71.
[250] Para 56(2)(a) – (d) of the Eighth Schedule to the Act.

*(b) Disposal of interest in equity share capital of a foreign company*

Par 64B provides that a taxpayer must disregard any capital gain or capital loss determined in respect of the disposal of any interest in the equity share capital of any foreign company if that person[251] immediately before that disposal held at least 20% of the equity share capital in that foreign company. In addition, that person should have held that interest for a period of at least 18 months prior to that disposal, unless that person is a company and that interest was acquired by that company from any other company which forms part of the same group of companies and that company and other company in aggregate held that interest for more than 18 months.[252]

The net capital gain included in the year of assessment applies in respect of any capital gain determined in respect of any disposal of any interest in the equity share capital of any foreign company by a person who is or was disregarded as stated above if:[253]

1. the foreign company prior to that disposal was a CFC in relation to that person or any other company in the same group of companies as that person;
2. the interest in the equity share capital of that foreign company was disposed of to a connected person in relation to that person either before or after that disposal;
3. that person disposed of that equity share capital for no consideration or for consideration which does not reflect an arm's length price, other than a disposal by means of a distribution. Alternatively that person disposed of the equity share capital by means of a distribution;[254] and

[251] Par 64B(2) of the Eighth Schedule to the Act. If the taxpayer in this regard is a company, this requirement relates to that company, together with any other company in the same group of companies as that company.
[252] See Scholtz *CGT, Companies and Their Shareholders* (2005) 22; Williams *Capital Gains Tax – A Practitioner's Manual* 347. In determining the total equity share capital in a foreign company, there shall not be taken into account any share which would have constituted a hybrid equity instrument, but for the three-year period requirement contained in that section and that interest is disposed of to a person who is not a resident. Proviso to para 64B(2) of the Eighth Schedule to the Act.
[253] Par 64B(3) of the Eighth Schedule to the Act.
[254] This provision applies unless the full amount of the distribution would have been subject to STC if the companies did not constitute a group of companies (and benefited from the group dividend exemption contained in s 64B(5)(f)). It would also not apply to the amount that was included in the income of the shareholder of such company or would have been included if it was not a dividend excluded in terms of s 10(1)(*k*)(ii)(*dd*). As a further alternative, that person disposed of any consideration received or accrued from the disposal of that equity share capital in terms of any transaction, operation or scheme of which the

4. that foreign company ceased in terms of any transaction, operation or scheme of which the disposal of the equity share capital forms part, to be a controlled foreign company in relation to that person or other company in the same group of companies as that person.

Where the above provisions do not apply to any distribution the full amount of the distribution would have been subject to STC if the companies did not constitute a group of companies (and benefited from the group dividend exemption contained in section 64B(5)(f)) and the company to which that distribution was made, disposes of any amount of that distribution that company must be treated as having disposed of the interest in the equity share capital of that foreign company by means of a disposal which is or was disregarded.

A taxpayer must disregard any capital gain or capital loss determined in respect of any capital distribution received by or accruing to that person from a foreign company where that person holds at least 20% of the total equity share capital in that company.[255] This provision does not apply in respect of any distribution which forms part of any transaction, operation or scheme in terms of which any capital gain is disregarded while any corresponding expenditure is taken into account by that person or any connected person in relation to that person in determining the liability for tax of that person or connected person, as the case may be, in terms of this Act.

These provisions do not apply in relation to a foreign financial instrument holding company or a non-resident company whose capital gains are taxable due to the holding of an interest in immovable property.[256]

disposal of the equity share capital forms part for no consideration or for consideration which does not reflect an arm's length price or by means of a distribution by a company, unless the full amount of that distribution unless the full amount of the distribution would have been subject to STC if the companies did not constitute a group of companies (and benefited from the group dividend exemption contained in s 64B(5)(f)).

[255] Once again in determining the total equity share capital of a company, any share which would have constituted a hybrid equity instrument but for the three-year period requirement contained in section 8E shall not be taken into account. See further on this aspect Scholtz 38.

[256] Par 64B(2) read with para 2(2) of the Eighth Schedule to the Act and section 41 of the Act.

#### *10.7.2.6 Capital Distributions*

The capital gains tax regime provides for special treatment for company distributions that constitute capital distributions. "Capital distribution" is defined as any distribution or a portion thereof by any company that does not constitute a dividend or that constitutes a dividend but is exempt from STC because it is declared in the course or in anticipation of a liquidation, winding up, deregistration or final termination of the corporate existence of a company.[257] A "distribution" is defined for purposes of these provisions as any transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder, including any issue of shares or debt in that company, or any option thereto, regardless of whether that transfer constitutes a dividend.[258]

Where a company distributes an asset to a shareholder (distribution *in specie*) or a repayment of capital to a shareholder, that company is treated as having disposed of that asset to that shareholder on the date of distribution for an amount received or accrued equal to the market value of that asset on that date.[259] A shareholder who receives a capital distribution of cash or an asset *in specie* after 1 October 2007 treats the amount of that cash or the market value of that asset *in specie* as proceeds.[260]

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[257] Par 74 of the Eighth Schedule to the Act definition of "capital distribution" read with section 64B of the Act. See Mitchell "Capital Distributions" 2007 *Tax Planning* 143.
[258] Par 74 of the Eighth Schedule to the Act definition of "distribution."
[259] Par 75 of the Eighth Schedule to the Act. "Date of distribution" is also defined for purposes of the company distributions provisions to mean "the date of approval of the distribution by the directors or by some other person or body of persons with comparable authority conferred under the memorandum and articles of association of the company making the distribution or under a law, regulation or rule to which that company is subject, except where the distribution is made— (*a*) by a company subject to the condition that it be payable to a shareholder of the company registered in that company's share register on a specified date, in which case it must be that date; (*b*) by a company to a shareholder of that company otherwise than by way of a formal declaration of a dividend, in which case it must be the date on which the shareholder became entitled to that distribution; or (*c*) by the liquidator of a company to a shareholder of that company in the course of the winding up or liquidation of that company, in which case it must be the date on which the shareholder became entitled to that distribution."
[260] Par 76 of the Eighth Schedule to the Act as amended by the Taxation Laws Amendment Bill 13 of 2008. The purpose of the 2008 amendment is to ensure that capital distributions received or accrued on or after 1 October 2007 are treated as proceeds when a part-disposal occurs. Prior to the amendment, no provision was made of the treatment of the distributions made on or after 1 October 2007. Scholtz 38.

Where there is a part disposal of an asset, the base cost of the part disposed of is pro rated to the base cost of the asset in proportion to the total market value of the asset.[261] Similarly, the market value of the part disposed of is pro rated to the market value of the asset in proportion to the total market value of the asset.[262]

These provisions would affect the distributions of an IHC that is effectively managed in South Africa to its shareholders. This applies to resident shareholders and non-resident shareholders in companies with an interest in immovable property located in South Africa. Where the distribution is subject to STC the effect of the incidence of the STC is similar for both residents and non-residents. It is expected that the effect will remain the same once the new dividend tax system is in place, as non-residents will be equally taxable as residents.

As stated in Chapter 7,[263] the Dutch tax system does not make a distinction between capital gains and other income. As a result capital gains are taxed the same as other income. On the other hand, similar to the South African tax system, the Mauritian system does not subject capital gains to tax unless such gains arise from the disposal of land situated in Mauritius.[264]

## 10.8 TAX RULINGS

A detailed advance tax ruling (hereinafter referred to as an "ATR") system was introduced in the South African tax system in 2004[265] and came into effect on 01 October 2006.[266] The ATR system is intended to promote clarity, consistency and certainty in the interpretation and applications of the tax laws, and by so doing, assist taxpayers to

[261] Par 33(1)(a) of the Eighth Schedule to the Act. See Stein "Part Disposals and CGT" 2004 *Tax Planning* 36.
[262] Par 33(1)(b) of the Eighth Schedule to the Act. See Stein *Tax Planning* 36–37; Kolitz "Part Disposals" 2002 *Tax Planning* 42.
[263] See Chapter 7 par 7.3.3.
[264] See Chapter 8 par 8.2.
[265] The advance tax rulings provisions were inserted into the Income Tax Act by s 12(1) of the Revenue Laws Amendment Act 34 of 2004.
[266] The advance tax rulings provisions were put into effect by the President through Proclamation 43 of 2006. See Silke and Stretch "Discussion Paper on Advance Tax Rulings" 2004 (Issue No 3) *Taxgram* 1–3.

comply with the tax laws.[267] The system is not intended to assist tax advisers in devising tax avoidance schemes.[268]

The Act empowers the Commissioner of the South African Revenue Service (hereinafter referred to as "the Commissioner") to issue three forms of binding tax rulings, namely a binding general ruling, a binding private ruling and a binding class ruling. The Commissioner may also issue a private opinion that does not have the binding effect referred to as the non-binding private opinion. In terms of section 76D the Commissioner may make an advance tax ruling on any provision of the Act.[269]

Upon the coming into effect of these provisions, the Commissioner set up a subdivision of the South African Revenue Service (hereinafter referred to as "SARS"), referred to as the Advance Tax Rulings Unit. This unit's sole responsibility is to receive applications for rulings, scrutinise them and issue rulings where the facts warrant a ruling.

### 10.8.1 Binding General Rulings

A binding general ruling is a ruling that is initiated and issued by the Commissioner on topics of general interest.[270] These take the form of practice notes and the interpretation notes that were already being issued by SARS. These rulings are binding on the Commissioner and both the Commissioner and the taxpayers can cite them as precedent in tax proceedings before the Commissioner or the courts.[271] Meyerowitz states that "[t]he Commissioner may withdraw or modify these rulings, but such withdrawal or modification generally cannot take effect prior to the publication of the notice of such action."[272] A change in the law relating to the subject of the ruling immediately affects the validity of the ruling without any action by the Commissioner.

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[267] See s 76C of the Act. See also Meyerowitz, Emslie and Davis "Advance Tax Rulings System" *The Taxpayer* (2006) 192.
[268] PricewaterhouseCoopers *Income Tax Guide* (2006) 288.
[269] See Ware "Advance Tax Rulings" 2005 *Tax Planning* 29.
[270] See s 76P(1).
[271] See s 76H(3). Meyerowitz *Meyerowitz on Income Tax* (2008) par 33.27.
[272] Meyerowitz par 33.27.

These rulings are available for IHCs in the nature of practice and interpretation notes without the IHC disclosing the nature of the transactions it seeks to enter into. It is for the IHC to ensure that the transaction that it enters into fits the details of the ruling.

### 10.8.2 Binding Private Rulings

These rulings are initiated by the taxpayers and are issued by the Commissioner setting out the Commissioner's opinion regarding the interpretation or application of tax provisions in respect of a specific set of facts relating to a proposed transaction.[273] These rulings are binding on the Commissioner in relation to the particular taxpayer and only as far as the specific facts upon which the ruling was granted are concerned. The ruling can be cited by the Commissioner and the taxpayer in any tax proceedings.[274] No other taxpayer can cite the ruling in such taxpayer's tax proceedings nor can the taxpayer to whom the ruling was granted cite the ruling in any other tax proceedings.[275] Silke and Stretch state that "[p]rovided that there is full disclosure of material facts, the ruling will generally be binding on the Commissioner when the assessment is made in connection with that transaction."[276]

The Commissioner may withdraw a binding private ruling prospectively. In addition, section 76N(3) empowers the Commissioner to withdraw or modify a binding private ruling retrospectively if such ruling was made in error and any of the following circumstances apply:

- The applicant has not yet commenced with the proposed transaction;
- There is any person other than the applicant who will suffer significant tax disadvantage if the ruling is not withdrawn or modified and the applicant will suffer comparatively less if the ruling is withdrawn or modified; or

[273] See s 76Q(1).
[274] See Ware *Tax Planning* 30.
[275] See s 76H(4) of the Act. See Ware *Tax Planning* 30.
[276] See Silke and Stretch "Advance Tax Ruling System Implemented" *Taxgram* November/December 2006 (Volume 10) 6. See also Meyerowitz, Emslie and Davis *The Taxpayer* 192.

- The effect of the ruling will materially erode the South African tax base and it is in the public interest to withdraw or modify the ruling retrospectively.[277]

In the operations of the IHC, where necessary, the IHC would apply for binding private rulings where it requires certainty of tax treatment.

#### 10.8.3 Binding Class Rulings

A binding class ruling is a ruling regarding the application or interpretation of the Act to a specific class of persons in respect of specific facts regarding a proposed transaction.[278] The purpose of these rulings is to relieve each participant in a multi-taxpayer transaction of the need to obtain separate binding private tax rulings relating to the same transaction.[279]

This ruling is initiated by a class of persons and issued by the Commissioner and is binding upon the Commissioner in relation to the particular class of taxpayers and only as far as the specific facts upon which the ruling was granted are concerned.[280] The ruling can be cited by the Commissioner and that class of taxpayers in any tax proceedings. No other taxpayer can cite the ruling in such taxpayer's tax proceedings nor can the taxpayer to whom the ruling was granted cite the ruling in any other tax proceedings.[281] The provisions relating to the withdrawal of the binding class rulings is the same as those that apply to binding private rulings.[282]

The IHC would only apply to use this form of rulings where there is a group of taxpayers that are affected by the ruling. The group of taxpayers may include or be limited to companies in the same group of companies with the IHC. Thus they may include the subsidiaries that are taxable in South Africa.

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[277] See also Meyerowitz, Emslie and Davis *The Taxpayer* 192.
[278] See s 76R(1).
[279] See Meyerowitz par 33.27
[280] See s 76J(1).
[281] See s 76H(4). See also Ware *Tax Planning* 30.
[282] See s 76M.

### 10.8.4 Non-Binding Private Opinions

The Commissioner may issue a non-binding private opinion to a person regarding the particular and specific set of facts and circumstances or a particular transaction.[283] As its name suggests, a non-binding private opinion does not have any binding force upon the Commissioner.[284] A non-binding private opinion may not be cited in any proceedings before the Commissioner or the courts other than a proceeding involving the person to whom the non-binding private opinion was issued.[285] Any written statements issued by the Commissioner prior to the coming into effect of the provisions regarding ATRs are deemed to be non-binding private opinions unless the Commissioner prescribed that the statement has a binding effect.[286]

As was seen in Chapter 7,[287] the Dutch system has a fairly extensive tax rulings system. It was also seen in Chapter 8[288] that the Mauritian tax system provides for an advance tax rulings system. However, neither of these systems is as comprehensive as the South African system.

## 10.9 GROUP TAXATION IN SOUTH AFRICA

As mentioned in Chapter 6,[289] South Africa does not presently have a system of group taxation. The tax provisions applicable to company restructuring do however provide some relief to a limited extent akin to group taxation. In addition, the idea of group taxation has been considered before in South Africa. In 1986 the Margo Commission[290] recommended that group taxation should not be introduced in South Africa.

[283] See s 76I(1).
[284] See s 76I(2). See also Ware *Tax Planning* 30.
[285] See s 76I(3).
[286] See s 76I(5).
[287] See Chapter 7 par 7.5.2.
[288] See Chapter 8 par 8.3.2.
[289] See Chapter 4 par 4.6.
[290] Margo Commission *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* 1986.

Subsequently, in 1995 the Katz Commission[291] recommended the adoption of a system of group taxation in the form of fiscal unity. The Katz Commission referred to it as "tax consolidation". Although the recommendations of the Katz Commission have not (yet) been implemented, they are part of authoritative literature that supports the introduction of group taxation for South Africa. This is because it is the latest commission to consider the need for group taxation in South Africa.

### 10.9.1 Margo Commission

In 1986 the Margo Commission considered whether South Africa should adopt a system of group taxation on a consolidated basis. The Commission, by a majority vote, recommended that South Africa should not move towards a group taxation system.[292] A minority of the commissioners, however, were in favour of the introduction of group taxation.[293] The main reasons for not introducing group taxation can be summarised as follows:[294]

1. Group taxation would result in significant loss of revenue that the fiscus could not afford at that time;
2. It undermines the principle of separate identity of companies, and companies would avoid taxes by trading losses;
3. That it would result in prejudice to creditors if profits are transferred from the company and could result in minority shareholders being expelled from the group.

The first objection was linked to the time at which the commission made the recommendations. It does not imply that South African circumstances would not change and eliminate the concern. According to the National Treasury, consolidated government revenue has increased significantly as a percentage of gross domestic production since 2004 as a consequence of strong economic growth and more efficient revenue

[291] Katz Commission *Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* 1995.
[292] Margo Commission Report par 10.107.
[293] Margo Commission Report par 10.108.
[294] Margo Commission Report par 10.105.

collection.[295] The downturn of the world markets experienced since early 2008 could have an impact on the South African economy and consequently tax revenue collections.[296]

The last two reasons do not take into account the fact that a group of companies is in effect largely owned by the same investor. Such companies could operate as various divisions or branches of a company. The Commission acknowledged, but was not persuaded by, the fact that a group of companies could achieve the benefits of group taxation by engaging in various structural steps such as merging group assets into a single holding company.

In summary, the main disadvantages of the absence of a system of group taxation were as follows:[297]

1. It is a disincentive to international investment in South Africa;
2. It is unfair for a group, which is one economic entity, not to be able to set off losses from loss-making divisions;
3. It impairs capital formation; and
4. It provides an impetus towards large divisionalised companies.

### 10.9.2 The Katz Commission Recommendations

The Katz Commission proposed a gradual approach to the introduction of group taxation in the form of tax consolidation beginning with what it termed a "simplified consolidation method". It recommended that "progress towards a full consolidation system, based on the principles of loss offset and adjustments to taxable income which are widely followed internationally, should be deferred until the impact of the shift to

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[295] National Treasury *Budget Review* (2009) 49.
[296] See South Africa's Economy – Tough Times Ahead http://www.economist.com/displayStory.cfm?story_id=13109968 accessed on 02 April 2009.
[297] Margo Commission Report par 10.106.

group taxation on the fiscus can be evaluated and the problems of administration have been identified and addressed."[298]

The Commission proposed a method which aggregates the taxable incomes of group members on a year-by-year basis as opposed to a method which reconciles consolidated taxable income with consolidated accounting income.[299] It is proposed that a group, for purposes of group taxation, would be limited to South African resident companies as defined in section 1.[300]

It is not clear whether by "South African companies" the Commission envisaged tax-resident companies or companies that are merely incorporated in South Africa. It is, however, submitted that companies incorporated in South Africa, but that are not subject to tax in South Africa (by virtue of their place of effective management being located in another jurisdiction), would not form part of the group. Should companies that are not subject to tax in South Africa be included in the group, resident companies could set off the losses of non-resident companies against their South African taxable income without the corresponding inclusion of the income of non-resident companies in the South African tax net.

Logically, a company that is permanently established in South Africa with its effective management outside South Africa should also be included in group taxation as it would be taxable in South Africa. While this position would be similar to the Dutch treatment of permanent establishments, it would also mirror the Luxembourg requirement that the permanent establishment should be subject to taxation comparable to the local corporate income tax.[301] For South African purposes the tax treatment of a permanent establishment

[298] Katz Commission report par 10.6.4. See also Wilcocks and Middelmann "Evaluation of the Need to Introduce a System of Group Taxation in South Africa" http://www.up.ac.za/dspace/handle/2263/5460 accessed on 14 January 2008.
[299] Katz Commission report par 10.5.3.
[300] Katz Commission report par 10.5.7. Close corporations would not be allowed to access this system.
[301] See Art 164bis (1) and (2) of the Luxembourg Law of 4 December 1967 on Income Tax (*loi concernant l'impôt sur le revenue*); Warner *Luxembourg in International Tax Planning* (2004) 105 – 107. Rawal *The Taxation of Permanent Establishments: An International Perspective* (2006) 96.

is equated to the tax treatment of resident companies by the imposition of a higher tax of 33%.

The main features of the simplified consolidation method as proposed by the Katz Commission[302] are the following:

(a) For the purposes of qualifying for group tax relief, a group should comprise a holding company and all its wholly owned subsidiaries. The term "wholly-owned" should be defined to refer to both direct and indirect interests held by the holding company, determined on the equity share capital of the companies concerned, with allowance for equity shares to be held by full time employees, including executive directors, in terms of share incentives schemes, not exceeding 10% of the company's equity share capital.

(b) The consolidated tax liability of a group will be calculated from "sub-returns" required for each member company in which taxable income or assessed loss will be determined on the basis of the current tax regime, save for a limited number of proposed adjustments.

(c) The initial assessed losses of member companies will be ring-fenced, and any loss incurred by a company in the group in a subsequent year of assessment will only be available to be set off against income from another company in a group in the same year of assessment.

Despite the Katz Commission's recommendations, South Africa still does not have a group taxation system. However, there have been calls by some taxpayers for the National Treasury to consider introducing such a system given the benefits that taxpayers would derive from such a system.[303] National Treasury has embarked on a research project to assess the suitability of the tax consolidation in South Africa. However, the introduction of such a system is expected to be considerably delayed as the focus is

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[302] See Katz Commission report par 10.6.2.
[303] See Garven *Budget Prediction* http://www.bowman.co.za/LawArticles/Law-Article.asp?id=2132417248 accessed on 14 January 2008.

currently on other imminent and major changes to the tax laws, including the conversion of the STC to a shareholder tax and a possible rewriting of the Act.[304]

### 10.9.3 Current Law

While the South African tax system currently does not allow taxation of a group of companies as a single unit or entity and the recommendations of the Katz Commission have not yet been implemented, there are tax deferment rules that apply to company groups. Properly construed, one could say that South Africa has a partial and conditional group taxation system since the system applies in particular circumstances.[305] "The aim of the rules in South Africa is to allow the transfer of assets without attracting immediate taxation consequences in respect of transactions between group companies and between founding shareholders and their company."[306] Companies form a group where there is a 70% holding within them. The rules apply in the transactions outlined below within a group.

#### *10.9.3.1 Company Formations*

A company formation transaction is a transaction in terms of which a person disposes of an asset to a resident company for equity shares and after that transaction that person (the acquirer) either holds a qualifying interest or is a natural person who will work on a fulltime basis in the business of that company of rendering any service.[307] Subject to certain conditions where a person disposes of an asset in terms of the company formation transaction, that person is deemed to be one and the same person as the company he or she is disposing the asset to. The effect is that the capital gains tax that would be payable

[304] Discussion with Keith Engel, Chief Director: Tax Policy, South African National Treasury on 02 December 2008.
[305] These are often referred to as special corporate tax rules or roll-over relief.
[306] Huxham and Haupt *Notes on South African Income Tax* (2008) 289.
[307] See s 42(1) of the Act. See also Tickle "Group Rationalisation" 2007 *Tax Planning* 82.

in terms of that disposal is not charged.[308] For these provisions to apply, both parties must jointly make an election to trigger the application.[309]

#### *10.9.3.2 Intra-Group Transactions*

An intra-group transaction is a transaction in terms of which any asset is disposed of by one company to another company which is resident and both companies form part of the same group of companies at the end of the day of that transaction.[310] These provisions are subject to a joint asset-by-asset election by taxpayers.

The following election options are available:

- A capital asset is deemed to have been transferred at the base cost of the asset to the transferor if the transferee acquires it as such;[311]
- Trading stock is deemed to have been transferred at tax value if the transferee acquires it as such;[312]
- An allowance asset is transferred at tax value if the transferee acquires it as such;[313] and
- An allowance in respect of future expenditure on contracts is transferred to the transferee if the contract is disposed of as part of the disposal of a business as a going concern in terms of the intra-group transaction.[314]

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[308] According to Deneys Reitz attorneys, "[w]here the market value of the asset transferred exceeds the case cost the disposal will be deemed to have taken place at base cost on the date of disposal i.e. there will be no deemed capital gain in the hands of the transferor and the transferee will be deemed to have obtained the asset at the base cost and on the date on which it was originally acquired by the transferor. If the asset is disposed to the transferee at a capital loss, the loss must be disregarded but it may be set off against any future gain on the disposal of an asset by the transferor to the transferee provided that the transferor still holds a qualifying interest in the transferee. In such an instance the base cost of the asset to the transferee will be the market value of the asset." See http://www.deneysreitz.co.za/seminars/item/mergers__acquisitions_and_share_buybacks_seminar_capital_gains_tax_consequences_for,111.html accessed on 15 October 2008.
[309] See s 42(1)(c).
[310] See s 45(1)(a).
[311] See s 45(2)(a).
[312] See s 45(2)(b).
[313] See s 45(3)(a).
[314] See s 45(3)(b).

#### *10.9.3.3 Liquidation, Winding-up and Deregistration*

These are transactions in terms of which the corporate existence of a company ceases. Where a liquidating company disposes of a capital asset to its holding company the asset is deemed to have been transferred at its base cost to the transferor.[315]

## 10.10 TRANSFER PRICING PROVISIONS

South African tax law provides for transfer pricing provisions. The current provisions were introduced into the Act with effect from 19 July 1995.[316] Prior to this the Act contained limited transfer pricing provisions in terms of which profits could be adjusted to comply with article 9 of the relevant tax treaty.[317] Generally, article 9 of the South African treaties contains provisions applicable to connected parties.[318] Furthermore, transfer prices could be challenged on the basis of expenditure being grossly excessive in terms of the general deduction formula[319] or in terms of the then general anti-avoidance provision.[320] The current provisions are more comprehensive.

Currently, the transfer pricing provisions are contained in section 31(2). The section provides as follows:

Where any supply of goods or services has been effected—

(*a*) between—

(i) (*aa*) a resident; and

(*bb*) any other person who is not a resident;

(ii) (*aa*) a person who is not a resident; and

[315] See s 47. See also Meyerowitz par 17A.43-17A.50; Silke and Stretch "Liquidation, Winding-up and Deregistration" 2002 (Issue No 10) *Taxgram* 5.
[316] Section 31(1).
[317] S 31 as at 18 July 1995.
[318] Connected parties are referred to in South African tax treaties as "associated enterprises".
[319] See s 11(a) read with s 23(g).
[320] See s 103(1).

(*bb*) a permanent establishment in the Republic of any other person who is not a resident; or

(iii) (*aa*) a person who is a resident; and

(*bb*) a permanent establishment outside the Republic of any other person who is a resident;

(*b*) between those persons who are connected persons in relation to one another; and

(*c*) at a price which is either—

(i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or

(ii) greater than the arm's length price,

the Commissioner may, for the purposes of this Act in relation to either the acquiror or supplier, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.

In adjusting the prices the Commissioner applies the guidelines provided by the Organisation for Economic Co-operation and Development.[321] In applying these guidelines the arm's length price is determined by using the (i) Comparable Uncontrolled Price Method (ii) Resale Price Method (iii) Cost Plus Method (iv) Profit-split Method; and (v) Transactional Net Margin Method.[322]

In addition to adjusting the consideration paid for the goods or services and determining the taxpayer's taxable income based on the adjusted amounts, the additional income or

[321] Some commentators view the application by SARS of the OECD guidelines as somewhat deviating from the correct application in that SARS considers that SARS may select a mid-range price and that SARS recommends the use of more than one method. See Stanley and Potgieter "Transfer Pricing: Comment on Revenue's New Practice Note" October/November 1999 *Executive Business Brief* 21.

[322] See a discussion on arm's length in Chapter 5 in par 5.3.8.1 and in Chapter 6 in par 6.3.1.2.

reduced loss of the taxpayer is deemed to be a dividend for which secondary tax on companies is payable.[323] The advance pricing agreement system is not available in South Africa.[324]

As was seen in Chapter 7,[325] the Dutch tax system provides for transfer pricing provisions that, like the South African provisions, are based on the Organisation for Economic Co-operation and Development transfer pricing guidelines. The Mauritian system, as was seen in Chapter 8,[326] does not contain transfer pricing provisions.

## 10.11 THIN CAPITALISATION PROVISIONS

Thin capitalisation provisions were introduced in 1995 in order to counter thin capitalisation practices which may have adverse tax implications for the South African fiscus upon the relaxation of exchange controls.[327]Section 31(3) of the Act contains the thin capitalisation provisions and provides as follows:

> (3) (*a*) Where any person who is not a resident (hereinafter referred to as the investor) has granted financial assistance…whether directly or indirectly, to—
>
> (i) any connected person in relation to the investor who is a resident; or
>
> (ii) any other person (in whom he has a direct or indirect interest) other than a natural person, which is a resident (hereinafter referred to as the recipient) and, by virtue of such interest, is entitled to participate in not less than 25% of the dividends, profits or capital of the

[323] For a detailed discussion on the application of transfer pricing provisions in South Africa see SARS *Practice Note* No 7 (6 August 1999).
[324] See Olivier and Honiball 501. An advance pricing agreement is an agreement between the tax authorities and the taxpayer as to the acceptable price for goods or services in a connected party transaction.
[325] See Chapter 7 par 7.3.6.
[326] See Chapter 8 par 8.2.3.
[327] See SARS *Practice Note No 2* (14 May 1996) par 1.1.

recipient, or is entitled, directly or indirectly, to exercise not less than 25% of the votes of the recipient,

and the Commissioner is, having regard to the circumstances of the case, of the opinion that the value of the aggregate of all such financial assistance is excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners' capital, other than permanent capital in the form of financial assistance as so contemplated) of such connected person or recipient, any interest, finance charge or other consideration payable for or in relation to or in respect of the financial assistance shall, to the extent to which it relates to the amount which is excessive as contemplated in this paragraph, be disallowed as a deduction for the purposes of this Act.

(*b*) For the purposes of paragraph (*a*), financial assistance granted indirectly shall be deemed to include any financial assistance granted by any third person who is not a connected person in relation to the investor, a connected person contemplated in paragraph (*a*) or the recipient, where such financial assistance has been granted by arrangement, directly or indirectly, with the investor and on the strength of any financial assistance granted, directly or indirectly, by the investor or any connected person in relation to the investor, to such third person.

In determining whether financial assistance is excessive or not in relation to fixed capital the Commissioner applies a ratio in terms of which the financial assistance should not exceed three times the fixed capital of the resident company to which financial assistance is granted.[328] If the financial assistance is excessive the interest thereon is not allowed as a deduction for income tax purposes. Interest charged at excessive rates is also not allowed as a deduction. Where a loan is denominated in rands or a foreign currency a rate

[328] Olivier and Honiball 514.

not exceeding the weighted average of the South African prime interest rate, or the relevant inter-bank rate, respectively, plus 2% will be regarded as acceptable.[329]

The South African debt-to-equity ratio of 3:1 compared to those of its trading partners is not adverse. As is shown in Table 3, it comes third together with a few other countries, after Botswana and Italy. The problem with allowing high levels of gearing is that the tax base of the host country would be compromised by the payment of deductible interest. For purposes of attracting IHCs and ensuring that the financing of IHCs and therefore the underlying investments is not constricted, the Netherlands and Germany offer apposite variations.

[329] See SARS *Practice Note No 2* par 2.2.

**TABLE 3**

| **Countries Globally** | **Debt-to-equity ratio** | **African Countries** | **Debt-to-equity ratio** |
|---|---|---|---|
| Australia | 3:1 | Botswana | 10:1 |
| People's Republic of China | 3:1 | Mauritius | None |
| France | 1.5:1 | Nigeria | None |
| Germany | 1.5:1 | Zimbabwe | 3:1 |
| India | none | | |
| Italy | 4:1 | | |
| Japan | 3:1 | | |
| Netherlands | 3:1 | | |
| Spain | 3:1 | | |
| United Kingdom | none | | |
| United States | 1:5:1 | | |

Source: Ernst & Young (2006) *Worldwide Corporate Tax Guide*

As to back-to-back arrangements,[330] SARS considers that such arrangements constitute "financial assistance granted indirectly". According to SARS an arrangement in terms of which a foreign parent company makes a loan to any person on condition that that person on-lends the funds to a South African subsidiary of that parent company that loan constitutes financial assistance. Accordingly, if the foreign parent company provides a guarantee to any non-resident as security for a loan to the South African subsidiary, the debt will be treated as financial assistance.

[330] A back-to-back arrangement or loan is an arrangement where one party grants a loan to another who on-lends the funds to a third party to the arrangement. Honiball and Olivier 571 describe a back-to-back arrangement as "an arrangement or transaction between at least three entities where the arrangement or transaction between the first and second entities is mirrored or substantially similar to the arrangement or transaction between the second and third entities."

However, financial assistance would not be granted where a foreign parent company provides a guarantee to a South African resident as security for a loan to the South African subsidiary, as the foreign company will not receive any interest and the recipient of the interest will be taxed thereon.[331] In this regard Olivier and Honiball caution that the transfer pricing arm's length rule would require the South African subsidiary to pay a guarantee fee to the foreign parent company which would normally form part of financial assistance granted directly to the South African subsidiary. Olivier and Honiball state that "Exchange Control approval for such fee would be required, and that is not easily obtained".[332]

As was seen in Chapter 7,[333] the Dutch thin capitalisation rules are similar to the South African rules, including the debt-to-equity ratio of 3:1. It was also seen in Chapter 8[334] that Mauritius does not have thin capitalisation provisions at all.

## 10.12 INTERNATIONAL HEADQUARTER COMPANY REGIME

In 2000 the residence-based system of tax was introduced in South Africa.[335] When this system was introduced, concerns raised by the Katz Commission were realised in that headquarter companies would be subject to tax also on income sourced outside South Africa. This is because the South African residence-based tax system is a pure system in terms of which residents are taxable on their worldwide income, subject to certain specific exceptions. Ordinarily, since international headquarter companies are incorporated in South Africa, they would be resident in South Africa. In order to avoid this, the legislature defined and specifically excluded international headquarter companies from the definition of "resident".

An "international headquarter company" was defined[336] as a company:

331 SARS *Practice Note No 2* par 8.
332 Olivier and Honiball 516.
333 See Table 3 above and Chapter 7 par 7.3.7.
334 See Chapter 8 par 8.2.3.
335 See s 2 of the Revenue Laws Amendment Act 59 of 2000.
336 S 1 definition of "international headquarter company" as at 31 May 2004.

(a) the entire equity share capital of which is held by persons who are not residents or trusts;

(b) where any indirect interest of residents or of any trust in such equity share capital does not exceed 5% in aggregate of the total equity share capital of such company; and

(c) where 90% of the value of the assets of such company represents interests in the equity share capital and loan capital of subsidiaries of such company which are not residents and in which such company holds a beneficial interest of at least 50%.

The intended effect of the exclusion from the definition of "resident" was that the CFC provisions and provisions relating to the taxation of foreign dividends would not apply to the international headquarter companies and the income of the subsidiaries would not be imputed to such company. The international headquarter company was also not taxable on the dividends received from its foreign subsidiaries or its foreign-source income. Because secondary tax on companies is imposed on resident companies, the international headquarter company was not subject to secondary tax on companies on the dividends declared.

In terms of this construction, at first glance, the international headquarter company would achieve the exclusion from the tax base in South Africa, and would therefore hypothetically attract foreign investors to South Africa. A major flaw that was overlooked at inception was that as an international headquarter company was not a resident of South Africa, it would not benefit from tax treaty relief as treaties only apply to residents of the contracting state.

This exclusion from the tax treaty benefit meant that the income of the international headquarter company would be taxed in the country of its shareholders either under the CFC legislation of that country or when it declares the dividend. Thus, the international headquarter company was not entitled to tax treaty benefits and this resulted in potential double taxation.

Exchange control provisions also restricted the use of the international headquarter companies. The exchange control provisions limited the outflow of funds. Prior to 2004, the limits were R2 billion for each new and approved African investment and R1 billion for each new and approved investment elsewhere in the world. On application, a further 20% of excess costs of a new investment (as opposed to an improvement on an already existing investment) could be funded by cash holdings if the investment limit had been utilised.[337] The international headquarter company, as an exchange control resident was also subject to local borrowing restrictions, restrictions on interest on foreign loans and restrictions on fees payable to non-resident companies.

Exchange control and the inability of the international headquarter companies to access tax treaty benefits significantly undermined the essence of the international headquarter company. Furthermore, the international headquarter company regime was considered to result in harmful tax competition. This resulted in the special regime for international headquarter companies being repealed with effect from 1 June 2004. The official reasons for the repeal by the legislature of this regime were stated as follows:[338]

> Under the international best practice, the exemption could be viewed as a "Harmful Preferential Tax Regime". The 90% foreign ownership requirement makes the IHC a ring-fenced regime, whereby a country isolates its own economy from tax concessions by providing a special regime solely to foreign controlled taxpayers. International pressure requires that regimes of this kind be eliminated. The regime was also ineffective. Firstly, in terms of Exchange Control Regulations, the South African Reserve bank restricted the currency flow of 90% foreign owned South African subsidiaries. Secondly, as the IHC was a non-resident for tax purposes, it could not qualify for the benefits of certain Double

[337] See Olivier and Honiball *International Tax – A South African Perspective* (2008) 533. See further on this discussion par 10.6.5.
[338] Explanatory Memorandum to the Revenue Laws Amendment Bill of 2003 at 38.

Taxation Agreements entered into by South Africa with other countries. It is, therefore, proposed that the IHC regime should be removed.

Based on the above, it is clear that the intention of the legislature to create a suitable environment for the use of an international headquarter company was disrupted by the actual wording of the Act and the application of the tax treaties. South Africa could not have intended to cede its taxing right and tax base to other countries. The question that arises is: Could the intention of the legislature not have been achieved by a different legislative construction? The answer to this question is in the affirmative. The cause of the demise of the international headquarter exclusion was contained in its construction as a company that was not a resident.

For the purpose of tax treaties, the international headquarter company should not have been excluded from the definition of resident. In this way it would have benefited from the treaty provisions. In order to ensure that the international headquarter company is not subject to STC a specific exemption could have been enacted. This would have accorded with the specific exemption of other entities that are indeed exempt, such as fixed property companies[339] and long-term insurance companies.[340] This would ensure that the international headquarter company was not taxable on the dividends received from its foreign subsidiaries or its foreign-source income and that the CFC provisions do not apply to the company.

The exchange control provisions restricted the currency flow of foreign-owned South African subsidiaries. Prior to 2008 outward investment by South African residents was allowed if the investment was a foreign direct investment. A foreign direct investment was an investment which resulted in the resident having at least 10% of the voting rights in the foreign company and the resident and the foreign company being engaged in the same line of business. Once these requirements were satisfied, the resident had to apply to the South African Reserve Bank (SARB) for approval by convincing the Bank that

[339] See section 64B(5)(b).
[340] See section 64B(5)(g).

there was a quantifiable benefit for South Africa to be derived from the investment. As from 27 October 2009, foreign investment of up to R500 million is allowed without any approval.

The South African exchange control policy in 1997 was strict and emphasised the restriction of the repatriation of funds from South Africa. This policy has since been changed and exchange controls accordingly relaxed. Had the policy been as relaxed at the time of the coming into effect of the CFC legislation, or at the time that is appeared to the South African Revenue Service and the National Treasury that the exchange control provisions interrupt the use of the international headquarter company, it would have been appropriate to amend the exchange control rules in order to remove the restriction of the use of an international headquarter company. Be that as it may, it should be noted that the procedural requirement that the resident should apply to the SARB where the investment exceeds R500 million does not amount to a substantive prohibition.

## 10.13 CONCLUSION

The South African tax system contains features that are conducive to the location of an IHC in South Africa. The main features that make the Netherlands a suitable jurisdiction to host an IHC – the participation exemption and the advance tax rulings system – are also found in the South African tax system. However, the presence of a broad controlled foreign company system as well as exchange control provisions are causes of concern for investors.

With regard to the CFC provisions, the available exclusions offer the IHC some reprieve in relation to the income of foreign operating subsidiaries. As was seen above, and as will be seen in Chapter 11, these controlled foreign company and exchange control provisions are not prohibitive to the operation of the IHC in South Africa.

The STC system is currently undergoing change. This change would offer IHCs certainty of the taxation as it is a move towards the more familiar system of taxation of dividends.

It would also offer the IHCs DTA relief where the IHC pays dividends to its holding company that may not be resident in South Africa.

Where the IHC receives dividends from its foreign operating subsidiaries, the current tax treatment also offers considerable benefits. The main and most noteworthy benefit is the participation exemption. The participation exemption would apply in many cases, as the IHC is expected to have a considerable shareholding in the foreign operating companies. Furthermore, the rebate in respect of foreign taxes on income would reduce the tax burden in South Africa on the IHC's receipt of foreign dividends and other income. The participation exemption in relation to capital gains on the disposal of shares in the subsidiaries would also ease the tax burden where the IHC restructures the group.

Transfer pricing and thin capitalisation provisions are necessary as anti-avoidance provisions to prevent the movement of capital offshore and the consequent erosion of the tax base. An IHC that operates genuinely should not be perturbed by the existence of these provisions. The availability of the advance tax rulings system would ensure that the IHC appreciates the tax implications of the transactions even before it enters into these transactions.

In Chapter 11 the suitability of South Africa to host an IHC will be analysed in more detail. Chapter 11 also includes a discussion of whether there is a need for the tax system to be adjusted and, if so, how the tax system should be adjusted to better accommodate IHCs.

***CHAPTER 11***

# CONCLUSIONS AND RECOMMENDATIONS

## 11.1 INTRODUCTION

In Chapter 2 this thesis identified an IHC and its functions and compared the nature of an IHC and its functions with those of business entities that are similar to the IHC. This was followed by a discussion of the tax and non-tax reasons for forming an IHC as well as the characteristics of the ideal environment in which it operates.

The thesis also discussed the attitude that the countries with regimes that are tailored for IHC operations face from the international community. It was observed that the Organisation for Economic Co-operation and Development encourages its member states and all other countries to create an arduous environment for investors wanting to operate through countries that are engaged in harmful tax competition. This was followed by an outline of the Dutch and the Mauritian tax systems. As was seen in Chapter 5, the Dutch system is generally structured in such a way that it is not adverse to IHC operations, while the Mauritian system is specifically designed to create a tax environment that is favourable to IHC operations.

The thesis also extensively examined the South African income tax system in so far as its provisions affect the operation of an IHC. The key considerations in the South African tax system in relation to IHCs are the provisions relating to controlled foreign companies, the taxation of foreign dividends, foreign tax credits, capital gains tax and thin capitalisation provisions. Exchange control was also discussed due to its impact on the inward and outward flow of funds.

## 11.2 BACKGROUND

Following the discussion in Chapter 10 on the South African tax system, it is clear that the South African tax system is not designed to discourage investors from setting up IHCs in South Africa. Furthermore, substantively it would not discourage or drive away investors who are interested or who already have a presence in South Africa from operating in South Africa, as the case may be. That is a noteworthy development in the South African tax system.

The existence of instruments that could deter investors such as capital gains tax and exchange control is neutralised by the effect of the actual application of those provisions. For example, the exchange control does not prohibit the operation of the IHC but requires the South African Reserve Bank's approval, and in terms of the capital gains tax system the non-resident investors in an IHC are not subject to capital gains tax on their disposal of interests in the IHC. The result is that if the investors consider the actual effect of these instruments on commercial transactions that the IHC is expected to enter into, it would be found that these instruments do not have a substantive negative impact on the IHC operations.

Drawing on the lessons learnt from the Dutch and the Mauritian tax systems, a few aspects relating to the suitability of the South African tax system could arguably be improved on in order to make the system more attractive to IHCs as part of its broader policy to attract foreign direct investment. This is in light of the fact that the South African government has announced its intention to make South Africa particularly attractive as a gateway to investment in South Africa,[1] thus requiring that the tax system should not only be suitable but actually attractive for investment. In order to achieve this goal, and in recognition of the business structural flexibility that investors require in the economies that they conduct business, the South African tax regime needs to be ideal for the acquisition, management, reorganisation and disposals functions of an IHC.

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[1] See Chapter 1 par 1.2.2.

The Katz Commission recommended that the South African tax regime should be developed in such a way that it would encourage the location of international headquarter and holding companies.[2] The relevant tax developments since the Katz Commission's recommendations as well as the proposals made in this chapter will be juxtaposed with the Katz Commission's recommendations to assess whether legislative amendments to date and the recommendations made in this thesis could give effect to the Katz Commission's recommendations.

Pursuant to the Katz Commission's recommendations, an international headquarter regime was introduced in South Africa together with a residence-based system of taxation. The South African international headquarter regime was discussed in Chapter 10. The relevance of the tax on international headquarter companies to the taxation of IHCs, as was stated in Chapter 2, is that the main tax instruments affecting international headquarter companies also apply to IHCs. Of specific relevance are corporate income tax, controlled foreign company legislation, dividends tax, thin capitalisation and exchange control.

Once again drawing on the experiences in the Netherlands and Mauritius, this chapter engages with the key instruments that are considered when a decision to locate an IHC in South Africa is made, namely: (i) headline corporate income tax; (ii) taxation of dividends and the withholding thereof; (iii) controlled foreign company provisions; (iv) participation exemption; (v) thin capitalisation rules; (vi) advance tax rulings system; and (vii) exchange control. Finally, this chapter illustrates that the implementation of the favourable regime for IHCs would comply with the non-discrimination provisions of the South African tax treaties.

[2] See Chapter 1 par 1.2.2.

## 11.3 ASSESSING THE SUITABILITY OF SOUTH AFRICA TO HOST IHCs

### 11.3.1 Corporate Tax Rate

Before an adjustment of the corporate tax rate could be considered as an incentive to encourage the hosting of IHCs, it is important to compare the corporate tax rate of South Africa with tax rates in other countries. If the corporate tax rate of South Africa is lower than the tax rates of its competitors in terms of IHC location, this would be an indication that further lowering the tax rate might not be a necessary or even an appropriate instrument to attract IHCs. It would indicate that an adjustment of some other aspects (not necessarily the corporate income tax and other tax aspects) might be necessary.

It would not be ideal to reduce the corporate tax rate for foreign-owned IHCs alone. A reduction applicable specifically for IHCs would amount to unfair tax competition with other countries and undermine the principle of tax neutrality. If the corporate income tax rate is reduced, such reduction will have to be applicable to all companies. The cost of a general reduction of the corporate tax rate would be tremendous vis-à-vis the benefits that would be derived therefrom. A reduction of 1% from 30% to 29% in 2005 reduced tax revenue by R2 billion.[3]

Currently, the South African corporate tax rate is 28%.[4] Since 1997 when the Katz Commission tabled its recommendations, it has been reduced regularly from the 35% at the time.[5] The average rate for South Africa's main trading partners is 28.25%, with Germany having the lowest rate at 15% and Zambia the highest at 35%.[6]

Given the above, South Africa's corporate tax rate does not disadvantage it as an ideal IHC hosting jurisdiction. Quite interestingly, the rate is lower than the rates of some

[3] See National Treasury *Budget Review* (2005) 83.
[4] Currently, secondary tax on companies has to be taken into account at the level of the company when it declares dividends.
[5] See South African Revenue Service *Guide for Tax Rates, Duties and Levies* (2008) par 1.1 available on http://www.sars.gov.za/home.asp?pid=4589 accessed on 19 February 2009.
[6] See Chapter 10 par 10.4 Table 1.

countries whose infrastructure and therefore key determinants are weaker than that of South Africa. Furthermore, various other factors would counter the further reduction of the headline corporate tax rate. Among them is the fact that there is presently a huge gap between the corporate tax rate and the marginal tax rate of 40% in respect of personal income tax – resulting in the increased pursuit of arbitraging by taxpayers.

Furthermore, should a lower tax rate be provided only for IHCs this would have the impact of most current entrepreneurs restructuring their business designs in order to avail themselves of the lower rate. This could result in the company groups creating further intermediary companies offshore in order for such companies to hold shares in the South African IHC.

### 11.3.2 Taxation of Dividends

The South African system of taxation of dividends is undergoing change. The secondary tax on dividends (hereinafter referred to at the "STC") system is being replaced by a dividend tax system.[7] Under the STC system the company distributing the dividend is subject to tax on the net amount of dividends distributed.[8] One of the reasons for the change was that the international community was not familiar with the STC. Furthermore, under the STC system, there is no treaty relief where the dividend is paid to a non-resident, as STC is seen as a tax on the company declaring the dividend and not the shareholder.

Under the new dividend tax system, the shareholder receiving the dividend would be subject to tax on the amount of dividends received.[9] The rate of the STC tax rate has been

[7] National Treasury *Budget Review* (2007) 67–68; National Treasury *Budget Review* (2008) 61–62. Refer to budget Review for 2008. See also Mitchell *et al* "Secondary Tax on Companies" 2008 *Income Tax Reporter* 48.
[8] On the nature of STC as a tax on the company and not on dividends or the shareholder *see Volkswagen of South Africa (Pty) Ltd v C: SARS* 70 SATC 195; Silke and Stretch "High Court: STC not a Tax on Dividends" 2008 (Issue No 9) *Taxgram* 9–10.
[9] See Silke and Stretch "From STC to a Shareholder Dividends Tax" 2008 (Issue No 4) *Taxgram* 3–4.

reduced from 25% to 12.5% in 1996 and further to 10% in 2007.[10] This 10% is the rate at which the new dividend tax will be levied, at least initially.

In terms of the new dividend tax system, individual and non-resident shareholders are liable to a dividend tax. Resident companies and certain specific entities are exempt. A resident company declaring the dividend has a liability to withhold the tax where the recipient is liable for the tax. Thus, the liability is two-fold. The shareholder has the liability for the dividend tax and the company declaring the dividend has the liability to withhold the tax and pay it over to the South African Revenue Service. Where the shareholder receiving the dividend is a non-resident, the company paying the dividend should withhold the full dividend tax of 10%. The rate of tax liability on the non-resident shareholder could be reduced by provisions of a tax treaty between South Africa and the country of residence of the shareholder to 5%. In the latter case the company paying the dividend should accordingly withhold 5%.

The imposition of a tax on dividends and a withholding tax on dividends is a matter within the jurisdiction of the country of residence of the company declaring the dividend. Some countries, for example Mauritius, do not impose a tax on dividends and therefore the possibility of a dividend withholding tax falls away. A withholding tax on dividends can also be excluded where the tax on dividends is levied only on dividends declared to residents or by tax treaty provisions.

Based on the above, although the change to the shareholder dividend system was not necessarily engendered by the financial centre for Africa strategy, the conversion would enhance South Africa’s competitiveness in respect of attracting holding companies. It is acknowledged that certain countries’ withholding taxes are reduced by treaties to zero. Such a factor is not necessarily bad for South Africa. As Vann states, “[a] small but positive treaty rate in the source country also provides some incentive for reinvestment of

[10] See See South African Revenue Service *Guide for Tax Rates, Duties and Levies* par 1.1; National Treasury Budget Review (2007) 67.

profits (a major source of investment) by foreign investors without unduly distorting the tax position in the residence country of the investor."[11]

Another motivation for retaining a withholding tax on dividends is to reduce or completely prevent the cessation of companies' residence in South Africa and taking up of residence elsewhere, i.e. re-domiciling or exodus of companies. Like exchange control, the tax system can be used to retain the residence of companies in a country by imposing taxes on change of residence. Without a withholding tax on dividends a resident company could distribute a South African subsidiary to a non-resident holding company as a dividend *in specie*, thereby avoiding the capital gains tax consequences that would have arisen if the company was sold or liquidated or simply changed residence. A minimal withholding tax would reduce the rate at which companies cease to be resident, although it could, to a limited extent discourage the establishment of some IHCs.[12]

### 11.3.3 The Participation Exemption

The South African participation exemption applies where the shareholder receiving the dividend holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend.[13] Where the recipient shareholder is a company, the 20% holding could be by such shareholder together with any other company in the same group of companies as that recipient shareholder.[14] The effect of the application of the participation exemption is that foreign dividends received by a resident company are exempt from tax in South Africa.

[11] Vann "International Aspects of Income Tax" in (ed Thuronyi) *Tax Law Design and Drafting* (1998) 772.

[12] Investors would generally prefer to distribute companies that have been in existence for long periods in this way because the growth in the value of the company would attract a high amount of capital gains tax. A new company would better be disposed off while its base cost is higher than the appreciation in value of its assets. South Africa currently has a system in terms of which a company is deemed to have distributed dividends to the extent of profits and reserves available for distribution in that company. However, currently this is not a withholding tax. See s 64C(2)(f).

[13] See S 10(1)(k)(ii)(dd). The holders of equity share capita generally have an unlimited right to participate in the dividends declared by the company and in the capital of the company on liquidation or deregistration. Preference shares on the other hand generally do not qualify as equity share capital because they would typically have fixed dividend and repayment terms. See Olivier at 141.

[14] S 10(1)(k)(ii)(dd).

The effective tax treatment would therefore be that the dividend is only taxed in the country where the subsidiary distributing the dividend is resident if that country imposes a tax on dividends. Generally, if South Africa has a tax treaty with that country, the treaty would reduce or eliminate the tax on those dividends. If there is no treaty, South Africa would grant a foreign tax credit under section 6*quat* for taxes paid in the other state with the result that the tax paid will in effect be limited to the higher of the tax on dividends in that country or the South African marginal individual tax rate of 40%. The limit to the South African marginal tax rate of 40% is because dividends are included in the definition of gross income.[15]

Two provisos ensure that for purposes of the participation exemption, the shareholding is of genuine equity shares. These provisos prevent deductions from being generated by shifting payments offshore, followed by the tax-free return of these funds in the form of exempt foreign dividends. The provisos exclude hybrid equity instruments[16] and any foreign dividend which forms part of any transaction, operation or scheme in terms of which any amount received by or accrued to any person is exempt from tax while any corresponding expenditure (other than expenditure for the delivery of any goods, including electricity) is deductible.[17]

The participation exemption is a widely known concept of taxation. Its application is generally uniform, although the qualifying criteria differ. Therefore, investors are likely to be encouraged by its existence to invest in a country in which the tax system includes the exemption. In addition, the South African participation exemption is not linked to any period of holding. Thus, it is available from the tax year in which the South African shareholder acquires the required amount of shares in the foreign company.

As stated, the exemption is available where the resident holds at least 20% of the total equity share capital and voting rights in the company declaring the dividend. In the analysis of the Dutch participation exemption it was stated that the qualifying

[15] S 1 para (k) of the definition of “gross income”.
[16] See s 10(1)(k)(ii)(dd)(A).
[17] See s 10(1)(k)(ii)(cc).

shareholding in the Netherlands is 5%. It was also indicated that this low qualifying percentage enhances the Netherlands's position as a holding company jurisdiction.[18]

In international company structures where multi-billion investments are involved, a 5% shareholding in a company, though not necessarily a controlling share, can constitute a considerable holding, implying more than a mere uninterested portfolio holding. Furthermore, if it is expected for investments to enhance infrastructure in Africa, such investments should involve huge amounts. As a result, a 5% holding in an African subsidiary could constitute huge amounts of capital. A 20% participation exemption does not particularly advertise South Africa as an ideal jurisdiction for an IHC.

### 11.3.4 Controlled Foreign Company Legislation

The South African controlled foreign company (hereinafter referred to as "the CFC") legislation attributes the income of South African foreign-owned CFCs to the owners of the CFCs in South Africa. Shareholders in the CFC holding less than 10% of the shares in the CFC are not subject to this attribution. These shareholders are subject to a foreign dividend tax on declaration of the dividend of the CFC. Shareholders holding between 10% and 20% can elect that the provisions of the CFC legislation should not apply to them, thereby exempting their proportionate share of the income of the CFC from attribution.[19]

Shareholders holding more than 20% of the shares in a CFC are subject to full attribution. Upon receipt of dividends from the CFC, such dividend will be exempt as it arises out of amounts that have already been taxed in South Africa. The income of the CFC could also be exempt *inter alia* because it arises out of income of a CFC that has a foreign business establishment. In this case the subsequent dividend will still be exempt due to the participation exemption.

[18] See Chapter 7 par 7.3.1.
[19] See s 9D definition of controlled foreign company read with s 9D(2).

Operating subsidiaries of an IHC should always have the foreign business establishment exemption as they are expected to carry on active business activities in the foreign country. If not, the passive income earned by the CFC should be subject to full attribution in South Africa. The aggregate South African tax implications for the income derived from a CFC with the foreign business exemption is that when the IHC declares the dividend to its shareholders, such dividend will be subject to a dividend withholding of 10%. This rate would be generally reduced to 5% where the shareholders of the IHC are resident in countries that have tax treaties with South Africa.

These provisions provide for a dual step of tax relief, i.e. at the level of the CFC and at the level of the IHC. But for the relief the effective South African tax would be 35.2% (28% corporate tax rate plus 72 remaining amount after tax multiplied by 10% STC rate). This treatment is not adverse to the operations of an IHC. However, as will be seen later, it is not the actual substantive tax treatment that makes the CFC regime not desirable, but the mere presence thereof and the uncertainty that it brings.

### 11.3.5 Thin Capitalisation

The funding of the IHC may take the form of a loan or equity. As discussed in Chapter 5,[20] the funding of a South African IHC by non-resident shareholders could be subject to the thin capitalisation rules. If the 3:1 debt-to-equity ratio is not complied with, the excess interest is allowed as a deduction. Furthermore, the excessive and disallowable interest is deemed to be a dividend declared in terms of section 64C(3)(e) of the Act and secondary tax on companies is payable on the excessive and disallowable interest.[21]

It is submitted that, with the new dividend tax, the excessive and disallowable interest is likely to be deemed to be a dividend and subject to tax in the hands of the shareholder. Thus, the company paying the dividend could have a withholding liability in this regard

[20] See par 5.3.8.2.
[21] See s 64C(2)(e) read with s 31(3). See also *South African Revenue Service Practice Note No 2* of 14 May 1996 par 9.

and, upon default, the company paying and the shareholder receiving the interest will be jointly and severally liable for the tax thereon.

With reference to the debt-to-equity ratio, the equity of the company refers to the fixed capital of that company alone, excluding the capital of its underlying investment. The equity of the company takes into account the share capital, share premium, accumulated profits of a capital and revenue nature and the permanent owner's capital (excluding any financial assistance) in circumstances where there is no share capital.[22] Given that thin capitalisation is based on accounting concepts, the computation of fixed capital is unlikely to be changed by the new dividend tax.

In Germany the general debt-to-equity ratio is 1.5:1. However, holding companies whose primary purpose is investing in and financing subsidiaries or companies whose investments in subsidiaries account for at least 75% of the subsidiaries' gross assets qualify for an increased debt-to-equity ratio of 3:1.[23]

In the Netherlands, the debt-to-equity ratio is 3:1. In addition, a company may elect to apply the group ratio. If the company makes this election, the company will look at the commercial consolidated debt-to-ratio of the group (including international members of the group) of which it is a member. If the company's commercial debt-to-equity ratio does not exceed the debt-to-equity ratio of the group, the tax deduction for interest on connected person loans is allowed.

A combination of these two systems could provide a solution where the high gearing of IHCs could be met with harsh tax consequences. Holding companies, whose primary purpose is investing in and financing subsidiaries, could be allowed to make an election in terms of which the company can take into account the commercial consolidated debt-to-ratio of the group of which it is a member. It should be noted, however, that simply

[22] See *South African Revenue Service Practice Note No 2* of 14 May 1996 par 4.3. Fixed capital is reduced by any reserves and increased by any losses resulting from the revaluation of assets.

[23] See *Germany: Thin Capitalization Rules Finalized* (2004) http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12597&SID=470390&TYPE=20 accessed on 27 November 2008; See also Ernst & Young *Worldwide Corporate Tax Guide* (2006) 314.

adopting a hybrid of the German and the Dutch systems could lead to a proliferation of avoidance schemes. Furthermore, the system should be adopted with caution, as it is based on and practiced in countries in which group taxation is operative. The allowable debt-to-equity ratio in this case could be reduced to 2:1 in light of the broader consideration of the group assets.

The distinction between holding companies whose primary purpose is investing in and financing of subsidiaries and other companies or holding companies is based on the unique nature of the functions of the companies. It is not based on the residence or otherwise of the shareholders of the companies. The back-to-back loan treatment still causes concern, as the IHC uses these to fund its subsidiary operations. The IHC generally makes not gain from these loans, as the terms (including interest charged) of both loans are generally identical.

### 11.3.6 Advance Tax Rulings

As was seen in Chapter 10,[24] South Africa introduced an advance tax rulings system in 2004 and implemented it with effect from 2006 to give certainty to the tax treatment of transactions. The Act provides for binding general rulings, binding private rulings and binding class rulings that can be issued by the Commissioner for the South African Revenue Service. In addition, it provides for non-binding private opinions.

As we have seen in relation to the Netherlands, the availability of an advance tax rulings system provides investors with a high degree of certainty regarding proposed transactions. As a result of this certainty investors prefer to conduct business in countries which provide for the advance tax rulings system. The Netherlands provides for a system similar to the system of binding private rulings in South Africa. In addition, the South African advance tax rulings system is broader and provides for general and class rulings as well as non-binding private opinions. The importance of non-binding private opinions is that the person to whom the opinion was issued can use the opinion in order to

[24] See par 10.8.

strengthen his case against the Commissioner where the subject of the opinion is in dispute.

When the Katz Commission assessed the suitability of the South African tax system to host headquarter companies, and at the inception of the financial centre for Africa project by the National Treasury, the advance tax ruling system had not yet been introduced into the South African tax system. As a result South Africa was not assessed on its current capabilities brought about by the advance tax rulings system to host such structuring entities. In its current form, the South African advance tax ruling system is more advanced than that of the Netherlands, as the South African system provides for different forms of rulings with varying levels of binding effect. This aspect does position South Africa as a formidable jurisdiction to host IHCs.

### 11.3.7 Exchange Control

As stated in Chapter 10,[25] the South African exchange control quantitative requirements have undergone evolution, and this has resulted in their being more relaxed in recent years. Prior to 2004, the monetary limits for outbound investment were R2 billion for each new and approved African investment and R1 billion for each new and approved investment elsewhere in the world. On application, a further 20% of excess costs of a new investment (as opposed to an improvement on an already existing investment) could be funded by cash holdings if the investment limit had been utilised.[26]

As further stated in Chapter 10,[27] resident companies are allowed to transfer amounts up to R50 million per year for investment offshore investment from South Africa for each new and approved foreign investment. Approval from the SARB is required if a resident company requires transferring any amount in excess of the R50 million. The approval requirement is not a prohibitive provision. However, although it is merely a procedural

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[25] See par 10.6.5.
[26] See Olivier and Honiball 533.
[27] See par 10.6.5.

requirement, it brings uncertainty to investors and as a result discourages the location of IHCs in South Africa.

The prohibition against the use of loop structures hinders certain South African joint-venture relationships with foreign stakeholders. These joint ventures would allow the IHC to hold shares in a company resident outside the Common Monetary Area (hereinafter referred at “the CMA”) together with other companies. The non-CMA company would then access investments within the CMA. This prohibition does not diminish the benefits of locating an IHC in South Africa enough to cause immediate concern. It would benefit the other African countries in which the non-CMA company is located.

## 11.4 RECOMMENDATIONS

As stated above, currently the South African tax system viewed in its totality is not adverse to the location and functioning of the IHC in South Africa. Furthermore, the exchange control regulations are not prohibitive to the operation of the IHC. However, the mere existence of exchange controls, a controlled foreign company regime, capital gains tax and thin capitalisation rules are a deterrent to investors considering locating their IHC in South Africa. The existence of these provisions inhibits the free flow of funds to and from the IHC.

The delay in obtaining confirmation on whether the tax provisions would adversely affect the transactions of the IHC is a cause for concern for investors. Equally, the uncertainty attached to application of the tax rules and whether the South African Reserve Bank would approve the transactions of the IHC discourages investors from locating the IHC in South Africa.

As a result of the above, it is recommended that certain changes be made to the exchange controls and certain aspect of the tax regime to encourage the location of IHCs in South Africa without compromising the tax base or undermining the role of exchange controls.

It is noted that while the viability of operating an IHC through a permanent establishment is beyond the scope of this thesis, the below recommendations could also apply to a non resident company that conducts IHC activities through a permanent establishment located in South Africa.

### 11.4.1 Exchange Controls Recommendations

Changes to exchange controls do not affect South Africa's status as a country that does not engage in harmful tax practices or otherwise. This is because exchange controls are not a component of tax. Thus an adjustment of the exchange control provisions is immaterial to international attitudes to South Africa's tax practices.

#### *11.4.1.1 Recommendation regarding the Residence of an IHC*

In order to avoid the exchange control hindrance a South African IHC could be treated as a foreign company for exchange control purposes only and not for tax purposes. In order to qualify for this regime, the South African company must be required to be a wholly foreign-owned and at least 80% cent of its assets must consist of shares and/or debt in foreign subsidiaries (i.e. a foreign company in which the South African company directly or indirectly owns 80% or more of the shares). Exchange control treatment as a foreign company will mean that the South African company can freely engage in cross-border activities without any approval required.

#### *11.4.1.2 Recommendation regarding Loop Structures*

Along the same lines, the rules against loop structures should also be reconsidered. These rules have the unintended effect of hindering the ownership of foreign subsidiaries held by domestically controlled South African IHCs. The rules that prevent South African companies from utilising companies resident outside the Common Monetary Area (hereinafter referred to as "the CMA") subsidiaries as a means of accessing CMA subsidiary investments are of particular, but not immediate, concern. The loop structure rules are also hindering certain South African joint-venture relationships with foreign stakeholders.

These rules against loop company structures could be reduced to the extent possible without giving rise to exchange control leakage. Once again, a South African company that is wholly foreign-owned and 80% of whose assets consist of shares or debt in non-resident companies should be deemed as a non-resident in South Africa for exchange control purposes. In line with the South African government's objective of making South Africa a gateway into Africa, this special treatment should be subject to a condition that the non-resident company which invests in the CMA should be resident within Africa.

This prohibition does not restrain the benefits of locating an IHC in South Africa enough to cause immediate concern. It would benefit the other African countries in which the non-CMA company is located. The real effects of this prohibition should be observed once the law has been adjusted so that a change could be made subsequent to a full appreciation of the negative effects of the prohibition.

### 11.4.2 Recommendation on the Special Income Tax Dispensation for IHCs

The South African income tax system contains three sets of rules that could pose a significant barrier to a viable IHC regime: (i) the taxation of cross-border dividends, (ii) the anti-avoidance controlled foreign company rules, and (iii) certain aspects of the thin-capitalisation rules. The recommendation is to eliminate these barriers without the legislative change being viewed as a harmful tax practice as defined by the OECD.

In accordance with this approach, a special tax dispensation should apply to a wholly-owned South African company that owns foreign subsidiary shares and loans that consist of 80% of the company's gross asset total. This 80% foreign asset requirement should not be problematic because ownership of the South African company can be either South African or foreign (and the entity can freely engage in local business activities). If a

South African company satisfies this requirement, the benefits outlined below should apply.

#### *11.4.2.1 Recommendation regarding the Participation Exemption*

Under the current participation exemption, South African companies (among others) are not subject to tax on dividends and capital gains associated with 20% or more owned foreign subsidiaries.[28] However, dividends paid by a South African company derived from these amounts are often subject to secondary tax on companies or will be subject to the new shareholder dividend tax.[29]

It is recommended that dividends from these companies should be exempt on condition that each shareholder of the South African company owns at least 20% of the equity shares of a South African company. This dividend exemption should apply to the extent of the participation exemption profits generated by the IHC. In essence, the South African company IHC should be ignored.

This proposal would mean that foreign owners of an IHC could effectively duplicate participation exemption at the level of the IHC that is a shareholder in the foreign subsidiary. This rule should not be viewed as a harmful tax practice because foreign and domestic shareholders would benefit equally from the exemption.

#### *11.4.2.2 Recommendation regarding CFC Ownership Rules*

Under the CFC rules, a foreign company is subject to CFC rules if South African persons own more than 50% of the foreign company either directly or through a foreign subsidiary.[30] Hence, if a foreign parent company owns a South African company, and the

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[28] S 10(1)(k)(ii)(dd).
[29] See s 64B and s 56(1) of the Revenue Laws Amendment Act 60 of 2008. The Revenue Laws Amendment Act of 2008 introduced ss 64D-64L which contains provisions of the new dividends tax and which will come into effect on a date to be determined by the Minister of Finance by notice in the *Gazette*. This date has not yet been determined.
[30] See s 9D.

South African company owns a foreign subsidiary, the foreign subsidiary is subject to the CFC rules. This CFC determination occurs at the South African company level even though no CFC regime would exist if the foreign parent company held the foreign subsidiary shares directly.

It is recommended that the CFC status of the South African IHC must be determined at the level of the IHC that is a shareholder in the foreign company. Because the shareholder in this case is foreign, the foreign subsidiary would be free from CFC treatment. In this regard the CFC provisions would not apply to the non-resident shareholder. However, they would apply to the resident shareholders and the dividends received by the resident shareholders would be subject to tax. In this regard the income of the subsidiary should be exempted by the foreign business establishment exemption and the dividends will be exempted by the participation exemption.

This look-through should not be problematic from an OECD perspective because it applies both to residents and non-residents. Thus the OECD would not see it as harmful tax competition that applies only to non-residents and therefore intended at unfairly competing with other tax jurisdictions. Furthermore, this look-through approach is akin to a limited version of the United States hybrid entity rules (none of which are viewed as a harmful tax practice). It is also questionable whether South Africa should be forced to apply its CFC rules when the ultimate foreign owner is typically subject to CFC rules in its home country. This recommended relief mechanism essentially prevents South African-owned foreign companies from being subject to CFC rules imposed by more than one country.

#### *11.4.2.3 Recommendation regarding Thin Capitalisation Rules*

IHCs are often intermediaries in back-to-back loan relationships. In these situations, the foreign parent company loans sums to the South African IHC, and the South African IHC on-lends the money to its foreign subsidiaries. The back-to-back loans should generally give rise to matching interest income and deductions but for the potential application of the thin capitalisation rules. The thin capitalisation rules could easily operate to deny the interest deduction for the South African IHC, especially if the back-to-back arrangements are large in relation to the total IHC equity (i.e. leaving the IHC with taxable income even though no net economic profit arises within the company).

While large foreign shareholder loans are problematic as a general rule, the back-to-back nature of the loans for the IHC should be ignored within the thin capitalisation context. The loans could only be ignored for thin capitalisation purposes where the loan and the interest thereon between the non-resident shareholder of the IHC and the IHC and the loan between the IHC and its subsidiary are matched. This practice of not applying the thin capitalisation regime should not be viewed as a harmful tax practice because South Africa is merely waiving anti-avoidance rules that would otherwise apply solely to foreign-owned South African companies.

### 11.4.3 Recommendation on the Introduction of Group Taxation

Group taxation comprises special rules that are applicable to members of a group of companies under which the group is broadly assimilated for tax purposes to a single company. Group taxation systems may broadly be divided into the three main categories (i) the fiscal unity system in terms of which the company group is treated as a single business entity for tax purposes; (ii) group contribution system which involves the contribution by profit-making companies in the group to one or more loss-making companies within the same group; and (iii) the group relief system in which a loss-making company surrenders its current losses to the profitable companies in the group.

The South African tax system does not provide for group taxation in any of the above categories. In 1995 the Katz Commission[31] proposed a gradual approach to the introduction of group taxation in the form of tax consolidation beginning with what it termed a "simplified consolidation method". It recommended that "progress towards a

[31] Katz Commission, *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* 1995.

full consolidation system, based on the principles of loss offset and adjustments to taxable income which are widely followed internationally, should be deferred until the impact of the shift to group taxation on the fiscus can be evaluated and the problems of administration have been identified and addressed."[32]

Despite the Katz Commission recommendations, South Africa still does not have a comprehensive group taxation system. However, there have been calls by some taxpayers for the National Treasury to consider introducing such a system given the benefits that taxpayers would derive from such system. National Treasury has embarked on a research project to assess the suitability of the tax consolidation in South Africa.[33]

A group taxation system would enhance South Africa's suitability as an IHC hosting jurisdiction. The method of introduction proposed by the Katz Commission is cautious and involves fewer risks to the fiscus. However, such introduction should be delayed, as the impact of the tax concessions made in the recent past has not yet been quantified. These concessions include the introduction of the dividend tax system,[34] the incentives for industrial policy projects[35] and venture capital companies[36], and the extension of the depreciation regime.[37] The aggregate cost of these concessions is expected to tremendously reduce revenue collections for a few years and it will take time for the fiscus to adjust to those reduced collections.

## 11.5 ADDRESSING RECOMMENDATIONS OF THE KATZ COMMISSION

As stated in Chapter 1,[38] in 1997 the Katz Commission recommended an adjustment to the tax treatment of holding companies in South Africa. This was based on the fact that

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[32] Katz Commission par 10.6.4.
[33] Discussion with Keith Engel, Chief Director: Tax Policy of the South African National Treasury on 18 June 2009.
[34] See s 64D-64L.The new dividend tax system defers the taxation of dividends to the last point of declaration to the individual or non-resident. Furthermore, companies are allowed to keep and use tax credits for a period of five years. This is costly to the fiscus and such cost has not yet been quantified.
[35] See s 12I.
[36] See s 12J.
[37] See for example s 12DA, 12F, 13*quin*, 13*sex* and 13*sept*.
[38] See par 1.2.2.

such a repositioning would encourage local investors to expand offshore without sending scarce human resources abroad and foreign investors to expand into Africa through South Africa. The Katz Commission identified the aspects mentioned below as the key fiscal attributes of a regime conductive to the formation of international holding companies.[39]

### 11.5.1 A Reasonable Double Tax Agreement Network

As stated in Chapter 10, the South African tax treaty network has increased since 1997. In addition, the South African tax treaties are currently being renegotiated to provide *inter alia* for a reduced withholding tax on dividends paid to non-residents.[40]

### 11.5.2 The Exemption of Offshore Corporate Dividend Income from Local Income Tax

Under current participation exemption, South African companies (among others) are not subject to tax on dividends associated with 20% or more owned foreign subsidiaries.[41] The recommendation on participation exemption proposes that foreign owners of an IHC should be able to duplicate participation exemption at the level of the IHC that is a shareholder in the foreign subsidiary. That means that the dividend that is on-declared by the IHC to the shareholders of the IHC would not be subject to a withholding tax on dividends.

### 11.5.3 The Exemption of Defined Offshore Corporate Income from Local Income Tax

The recommendation on CFC ownership rules seeks to exempt income earned by the IHC from its CFCs from the South African CFC rules.

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[39] Katz Commission *Fifth Interim Report* par 7.1.4.
[40] National Treasury *Media Statement – Revised Taxation of Distributed Profits: Conversion of the Secondary Tax on Companies ("STC") to a Shareholder Dividends Tax 20 February 2008* available on http://www.treasury.gov.za/comm_media/press/2008/2008022001.pdf accessed on 17 June 2009
[41] S 10(1)(k)(ii)(dd).

### 11.5.4 The Absence of Local Corporate Capital Gains Tax

Capital gains tax has been introduced since the Katz Commission's recommendations. However, under current participation exemption, South African companies are not subject to tax on capital gains associated with 20% or more owned foreign subsidiaries.[42] The capital gains tax should not pose a problem considering that the shareholding of the IHC in foreign companies is expected to be substantive, and in most instances 100%.

### 11.5.5 Low or No Local Withholding Tax on Dividends Paid to Shareholders

In terms of the new dividend tax, dividends paid to shareholders of South African resident companies will be subject to tax. Where there is a tax treaty between South Africa and the country of residence of the shareholders, the tax could be reduced to 5%. As indicated as regards withholding tax on dividends,[43] a small tax rate is essential and justified. Besides the above, the duplication of the participation exemption in terms of the recommendation on participation exemption has the effect that the dividend that is on-declared by the IHC to the shareholders of the IHC would not be subject to a withholding tax on dividends.

### 11.5.6 An Efficient Local Tax Rulings System

Subsequent to the Katz Commission recommendations, a comprehensive advance tax ruling system has been introduced.

[42] Par 64B of the Eighth Schedule.
[43] See par 10.4.2.

## 10.6 COMPLIANCE WITH THE NON-DISCRIMINATION CLAUSE IN SOUTH AFRICAN TAX TREATIES

South African tax treaties contain a non-discrimination clause which is based on the OECD Model Tax Treaty provisions. The non-discrimination clause in relation to companies in Article 24(1) provides as follows:

> (1) Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

In relation to the branches or permanent establishments Article 24(3) of the Model Tax Treaty provides as follows:

> (3) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on the enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

IHCs operating in South Africa would be resident in South Africa irrespective of their shareholder's residence. A company operating as an IHC that is not resident in South Africa would not be taxable in South Africa, other than on the income sourced in South

Africa. Due to the nature of the IHC and its functions, it is not expected that it would generate regular income in South Africa.

As stated above, a branch of a non resident company conducting business of an IHC in South Africa would be treated similarly to an IHC in terms of the above recommendations. However, South African sourced income of the branch will be taxed in full as would be the case with South African sourced income of an IHC. This would ensure that the holding company regime in South Africa does not fall foul of the non-discrimination clause of the double tax treaties.

## 11.7 CONCLUSION

The South African tax system in general is not based on attracting foreign direct investment. It does not compromise its base and revenue in order to attract investments. As a result, South Africa is not challenged in terms of engaging in harmful tax practices. This respectable status could be threatened if too much emphasis is placed on relaxing the tax system in order to create a favourable environment for foreign direct investment.

Tax incentives are secondary to more fundamental determinants as a factor in attracting foreign direct investment. Investors adopt a two-stage process when evaluating countries as investment locations, starting with the screening of countries based on their fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where not only tax concessions but also grants and other incentives become important.[44] This process of attraction implies that incentives alone would not position South Africa as a favourable IHC location.

In an attempt to attract foreign direct investment and to position South Africa as a gateway to Africa, macro- and micro-economic developmental interventions should be embarked upon. The key non-tax determinants are at the forefront of the positioning of South Africa as a leading IHC jurisdiction in Africa. This is evidenced by the fact that

[44] See United Nations Conference on Trade and Development 11.

South Africa already attracts a huge number of foreign investors to and through South Africa into the rest of the continent. Alongside the tax recommendations made in this thesis, the enhancement of such key non-tax determinants could considerably improve South Africa's position as an ideal IHC location.

An examination of the South African tax system in so far as its provisions affect the operation of an IHC revealed that the South African tax system is not particularly adverse to the operation of a South African IHC. In particular, the replacement of the secondary tax on companies by a more internationally friendly system of dividend tax and the concomitant relaxation of the exchange control regulations have already enhanced South Africa's position as an IHC holding jurisdiction.

The comparison between South Africa and its trading partners revealed that the South African corporate income tax rate is lower than the average of its trading partners. The loss of revenue and the discrepancy between the personal income tax rate and the corporate income tax rate do not justify the further reduction of the corporate income tax rate. As regards the tax on dividends and the withholding thereof, the South African system imposes one of the lowest rates both for treaty partners and non-treaty partners. A further reduction of this (rate reduced by treaties) would disincentivise the reinvestment of profits by foreign investors.

The system adopted in Mauritius is rejected as it provides an outrageous incentive to attract passive mobile income. This has resulted in Mauritius retaining an entrenched status as a world-class tax haven irrespective of its infrastructure and capabilities to attract investment other than through tax incentives. As a result, tax authorities are constantly working towards curbing tax structures that exploit the use of the Mauritian global business licence holder companies regardless of the treaty relationships they have with Mauritius.

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