

EFFECTIVE MANAGEMENT – THE SOUTH AFRICAN COURTS’ INTERPRE- TATION COMPARED TO OECD PRINCIPLES

Nonkululeko Noxolo Ntombela	Student number 11306000	Email: xoliegh@yahoo.com
Department:	Mercantile Law	
Supervisor:	Adv. Cornelius Louw	

Dissertation submitted in partial fulfilment of the requirements for the degree

LLM (TAX LAW)

in the

FACULTY OF LAW

at the

UNIVERSITY OF PRETORIA

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of LLM (Taxation) at the University of Pretoria. It has not been submitted before for any other degree or examination at any other university.

Nonkululeko Noxolo Ntombela

September 2014

Contents

CHAPTER 1	5
1. INTRODUCTION	5
1.1 BACKGROUND AND A BRIEF HISTORY OF THE BASIS OF TAXATION IN THE REPUBLIC OF SOUTH AFRICA	5
1.2 TAXING PRINCIPLES AND DOUBLE TAXATION (SOURCE V RESIDENCE)	7
1.3 GUIDANCE FROM “CENTRAL MANAGEMENT AND CONTROL”	9
1.4 GUIDANCE FROM “PLACE OF MANAGEMENT”	11
CHAPTER 2	13
2. SARS INTERPRETATION	13
2.1 STATUS OF SARS INTERPRETATION NOTES	13
2.2 INTERPRETATION NOTE 6	14
2.3 THE SARS DISCUSSION PAPER	15
2.4 CRITICISMS OF INTERPRETATION NOTE 6	16
2.5 INTERNATIONAL BENCHMARKING	17
2.6 CRITICISM OF A “BOARD-CENTRIC” APPROACH	18
2.7 THE OECD AND THE COMMENTARY ON ARTICLE 4 OF THE MODEL TAX CONVENTION	18
CHAPTER 3	20
3. THE OECD APPROACH	20
3.1 COMMENTARY ON THE OECD MODEL TAX CONVENTION	20
International standard	20
OECD Commentary on Article 4(3): 2000	20
3.2 COMMENTARY	21
3.3 OBSERVATIONS ON THE COMMENTARY	23
3.4 RESERVATIONS ON THE ARTICLE	24
3.5 IMPACT OF THE COMMUNICATIONS REVOLUTION ON THE APPLICATION OF “PLACE OF EFFECTIVE MANAGEMENT” AS A TIE-BREAKER RULE	25
3.6 SUMMARY OF KEY FACTORS IN DETERMINING PLACE OF EFFECTIVE MANAGEMENT	27
CHAPTER 4	29
4. DISCUSSION OF SOUTH AFRICAN CASE LAW	29
4.1 OCEANIC TRUST CASE	29
4.2 TRADEHOLD LIMITED	32

5. DISCUSSION OF FOREIGN CASE LAW	35
5.1 WOOD V HOLDEN.....	35
5.2 LAERSTATE V APPELLANT	38
5.3 MARK HIGGINS RALLYING.....	40
5.4 COMMISSIONERS FOR HER MAJESTY’S REVENUE AND CUSTOMS V SMALLWOOD AND ANOTHER.....	43
CHAPTER 6	46
6. DISCUSSION OF VARIOUS AUTHORS ON “PLACE OF EFFECTIVE MANAGEMENT”	46
CHAPTER 7	48
7. CONCLUSION.....	48
8. BIBLIOGRAPHY	49

CHAPTER 1

1. INTRODUCTION

1.1 BACKGROUND AND A BRIEF HISTORY OF THE BASIS OF TAXATION IN THE REPUBLIC OF SOUTH AFRICA

In 2010 and in the midst of the tsunami of excitement of the 2010 World Cup, the South African National Treasury proposed a new “Gateway to Africa” initiative.¹ This initiative was intended to make South Africa a more attractive base for investment in other African countries by both domestic and offshore investors.

One of the components of this initiative was the Headquarter Company regime. The proposal was that companies that meet the requirements of a Headquarter Company would enjoy various tax benefits, including relief from South Africa’s controlled foreign company rules² found in section 9D of the Income Tax Act.³

According to the SARS’ Discussion Paper, taxpayers and tax practitioners raised concerns that foreign subsidiaries held by Headquarter Companies may be treated as South African residents under SARS’ approach to determining a company’s place of effective management as outlined in SARS’ Interpretation Note 6.⁴

The place of effective management is one of the two tests used to determine whether or not a company or other person other than a natural person (juristic person) is a South African tax resident. In addition, the place of effective management test is also used as the “tie breaker” in many of the double taxation agreements (“DTAs”) that South Africa has entered into with other countries, particularly those DTAs that are based on the Model Tax Convention on Income and Capital of the Organisation for Economic Co-operation and Development (“OECD”).⁵ This tie-breaker rule applies to determine the tax residency of a juristic person where that

1 Discussion paper on Interpretation Note 6 on place of effective management issued by the South African Revenue Services in September 2011 (hereafter “SARS Discussion Paper”).

2 SARS Discussion Paper.

3 58 of 1962 (“the Act”).

4 SARS Discussion Paper.

5 Olivier and Honiball *International Tax A South African Perspective 2011* (2011) 25.

juristic person could otherwise be considered a tax resident of both Contracting States under their specific domestic legislation.⁶

Going back a few steps, it is trite knowledge that taxation is the means whereby the State collects funds from its taxpayers to pay for its administration and for the various benefits that it provides to its citizens and residents.⁷

South Africa changed from a source-based system, for years of assessment commencing on or after 1 January 2001, to a residence-based system of taxation.⁸ This change essentially means that the world-wide receipts derived by a “resident” as defined in section 1 of the Act are included in the resident’s gross-income.⁹ Residency is therefore one of the most fundamental and most important concepts in the Act.

In general, the goals of the residency test are to ensure certainty and predictability on the one hand and to prevent manipulation on the other.¹⁰ Unfortunately, there is considerable tension between these two goals.

Section 1 of the Act defines a “resident” as meaning 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”.

In order to balance the above competing considerations, South Africa has adopted two tests for determining the tax residency of a juristic person. Under the first test, a juristic person is regarded as a tax resident if it is incorporated, established or formed in South Africa. This is a formal test and is generally straightforward in its application. However, it is also open to manipulation, particularly in the modern

6 *Supra* 25.

7 Haupt *Notes on South African Income Tax* (2012) 1.

8 Revenue Laws Amendment Act 59 of 2000.

9 Stiglingh *et al Silke: South African Income Tax* (2013) (hereafter “Silke”) 53.

10 Van der Merwe “The Phrase ‘place of effective management’ Effectively Explained?” 2006 *SA Merc LJ* 121 124-125 (hereafter “Van der Merwe”).

global environment, and may have “little or no connection to the entity’s actual economic and business links”.¹¹

The second test looks to a juristic person’s “place of effective management”. This test has been recognised as a “less artificial measure” that looks to “substance over form”.¹² “For these reasons, it is generally considered less easy to manipulate, but has presented difficult issues of general interpretation and practical application, both in South Africa and elsewhere”.¹³

As a result of the above definition of a “resident”, a person, other than a natural person, which has its place of effective management in South Africa will be regarded as a “resident” as defined. The effect is tremendous as that person will be subject to tax on its world-wide income,¹⁴ that is, income derived within and outside South Africa.

1.2 TAXING PRINCIPLES AND DOUBLE TAXATION (SOURCE V RESIDENCE)

There are two main principles in terms of which countries seek to tax income, that is, the source principle or residence principle. Income derived by a person may be taxed by a country as a result of a connection between the country and the generation of the income – source jurisdiction. For example, a business is carried on in the country, real property is located in the country, or an employee works in the country. Countries assert source jurisdiction over tax income on the basis that the income is generated from economic activity within the country.

Countries may also tax income (wherever derived) because of the person earning the income is a resident of that country (residence jurisdiction). A country’s justification for residence tax may be seen to rest on the need to finance its public goods and social infrastructure, and the nexus between the consumption of such

11 Van der Merwe 121.

12 Van der Merwe 122.

13 SARS Discussion Paper.

14 Olivier and Honiball *International Tax A South African Perspective 2011* (2011) 25.

public goods and social infrastructure by persons who are residents having an over-all capacity to pay.

Like South Africa, most countries tax income on both the source and residence basis. That is, a resident person is usually taxed on income from both domestic and foreign sources, whilst non-residents are only taxed on domestic sourced income.

Most instances of double taxation will arise as a result of residence-source jurisdictional conflicts. This is where a Contracting State will seek to tax a person because he or she is a resident of that Contracting State and the other Contracting State will seek to tax the same person because the income was sourced from that other Contracting State.

Double taxation can also arise from residence (residence conflicts), where both Contracting States treat a person as a “resident” for tax purposes under their domestic law (with the result that the person is fully liable for tax in both States). Therefore, the main focus of Double Tax Conventions is to avoid such double taxation which, if not addressed, may impede cross-border flows of trade, investment and capital.

The OECD Model Tax Convention deals with residence (residence conflicts) through tie-breaker rules in Article 4 which allocate residence of the “dual resident” person to one of those States, so that that person is treated as a resident solely of that State for the purposes of the Convention. In the case of individuals, the tie-breaker rules look at various indicia of personal attachment to a State with a view to determining to which State “it is felt to be natural that the right to tax devolves”.¹⁵

In the case of companies and other bodies of persons, a tie-breaker rule based on personal attachment is clearly not appropriate. The Commentary also rejects a tie-breaker based on purely formal criteria such as registration. In giving preference to

¹⁵ OECD Commentary on Article 4 of the Model Tax Convention para 10.

the State where the entity is “actually managed”,¹⁶ it would seem that the intention is to select a criterion which reflects where the main management decisions are taken.

Paragraph 3 of Article 4 of the OECD Model Tax Convention provides that a non-individual “shall be deemed to be resident only of the State in which its place of effective management is situated”.

In the absence of any specific definition of “place of effective management”, many commentators have been influenced by concepts used in domestic tax law residence rules, such as “central management and control”¹⁷ and “place of management”,¹⁸ when considering the meaning of the term “place of effective management”.

1.3 GUIDANCE FROM “CENTRAL MANAGEMENT AND CONTROL”

Central Management and Control is one of the residence tests adopted in a number of countries such as Australia, Ireland and United Kingdom for non-individuals. Under Section 6(1) of Australia’s Income Tax Assessment Act 1936, a company is a resident of Australia if

- it is incorporated in Australia; or
- it carries on business in Australia and is centrally managed and controlled in Australia; or
- it carries on business in Australia and its voting power is controlled by shareholders resident in Australia.

Understanding the factors that determine a place of central management and control may provide assistance in determining a place of effective management. In Australia the term “centrally managed and controlled” is not defined in the domestic tax legislation. However, unlike South Africa, there are a number of court cases which provide some guidance on how the place of central management and control is to be determined.

16 Commentary on Article 4 of the Model Tax Convention para 22.

17 Hamilton and Deutsch *Guidebook to Australian Taxation*, looseleaf, para [6.140].

18 Vogel *Double Taxation Conventions* (1997) 262.

According to a number of court decisions, while determining a place of central management and control is a question of fact, it ordinarily coincides with the place where the directors of the company exercise their power and authority (which will generally be where they meet).¹⁹ A leading case which established this principle is the *De Beers*²⁰ case. In *De Beers*, a company registered in South Africa worked diamond mines, had its Head Office and held its general meetings of shareholders all in South Africa. Its directors held meetings both in South Africa and in the United Kingdom, but directors' meetings held in the United Kingdom were found to be those where real control of the company was exercised. Accordingly, the company was found to be resident in the United Kingdom.

In a number of Canadian cases,²¹ the courts, relying on the statement of the Lord Chancellor in the *De Beers* case, have found that the place of central management and control was where the company "really keeps house and does business". Some of the factors taken into account when determining this place included:

- place of incorporation;
- place of residence of shareholders and directors;
- where the business operations take place;
- where financial dealings of the company occurred; and
- where the seal and minute book of the company were kept.

However, this general rule is by no means conclusive. The courts have also taken certain other factors into account when determining the place of central management and control. In an Australian case,²² the taxpayer company was regarded as a resident of the Northern Territory where the actual business operations were located, notwithstanding that the directors' meetings were held in another State. This conclusion was based on the fact that:

19 *Waterloo Pastoral Co Ltd v FCT* (1946) 72 CLR 262; *Capitol Life Insurance Co v R* (1984) CTC 141; and *Gurd's Products Co v R* (1985) CTC 141.

20 *De Beers Consolidated Mines* (1906) AC 455.

21 *Birmount Holdings Ltd v R* (1978) CTC 358; *Tara Exploration & Development Co Ltd v MNR* (1970) CTC 557; and *Capitol Life Insurance Co v R* (1984) CTC 141.

22 *North Australian Pastoral Co Ltd v FCT* (1946) 71 CLR 623.

- the company's whole undertakings, being, incorporation, registered office, public office and full books of account were located in the Northern Territory;
- the directors met in Brisbane, Queensland, as a matter of convenience;
- the manager of the property in the Territory took responsibility for the success or failure of the venture; and
- visits to the property by the directors and consultation with the manager were acknowledged to be of importance when reaching policy decisions.

However, in *Malayan Shipping Co Ltd v FC of T*,²³ the court held that the company was resident of Australia because the managing director exercised complete management and control over the business operations of the company from Australia, notwithstanding that the trading operations were conducted abroad.

In certain exceptional circumstances, the place where the controlling shareholder (such as a parent holding company) makes its decisions may be relevant in determining where the central management and control is located. In *Unit Construction Co Ltd v Bullock (Inspector of Taxes)*,²⁴ three wholly-owned subsidiary companies were incorporated in Kenya. By their articles of association, powers of management were vested in the directors who were located in Kenya and who could not validly hold meetings in the United Kingdom. However, these management powers were not in fact exercised by the local directors who stood aside in all matters of real importance, so that it was the board of directors of the parent company in the United Kingdom that effectively made all the decisions. This resulted in the subsidiaries being held to be United Kingdom residents.

1.4 GUIDANCE FROM “PLACE OF MANAGEMENT”

Place of management is another residence test adopted by a number of treaty countries such as Germany and the Netherlands to determine residence of non-individuals. Switzerland, like South Africa, uses the concept of “place of effective management” in their domestic law.

23 (1946) 71 CLR 156.

24 [1959] 3 All ER 831.

In Swiss practice, a distinction is drawn between the place of effective management and merely administrative management or decision-making by executive bodies (where the decisions of a board of directors are limited to control of the company and to basic decisions). Although there are no court decisions on the meaning of the term “place of effective management”, it would be expected that the same interpretation would apply to the term as that used in Swiss treaties and its domestic law.

It is against this background and scope that I seek to interrogate the term “place of effective management” in the South African context as a result of the enormous consequences it has for international companies. This study explores the approach taken by the South African Revenue Services (“the SARS”) as described by the SARS in Interpretation Note 6. I also explain the approach taken by the OECD, discuss South African and international case law on the subject and lastly discuss the opinions of various authors. I finally make a determination in the concluding chapter as to whether South Africa has taken the correct approach in the interpretation of the term “place of effective management”.

CHAPTER 2

2. SARS INTERPRETATION

The SARS issues various Interpretation Notes to assist taxpayers in the interpretation of the Act.

2.1 STATUS OF SARS INTERPRETATION NOTES

Interpretation Notes issued by SARS do not, as a rule, carry the force of law; they do not form part of substantive law and are not proper administrative guidelines.²⁵ Interpretation Notes merely represent the opinions of head-office personnel at SARS on the meaning of a particular section in the Act, and therefore Interpretation Notes only convey a non-binding opinion. Yet in practice revenue officials tend to follow the guidance as laid down in the Interpretation Notes.²⁶ However, an Interpretation Note can be published as a binding general ruling under section 76 of the Act (this practice amounts to the Commissioner obtaining a quasi-legislative power over his own administration).

To date, no local case law exists to clarify whether an Interpretation Note may form the basis of a claim based on the legitimate expectation doctrine.²⁷ Meyerowitz indicates that despite Interpretation Notes not carrying the force of law, to the extent that the SARS does not adhere to its practice as set out in the Interpretation Note without due warning of a change, taxpayers prejudiced thereby could raise an objection based on the doctrine of legitimate expectation. The decision in *Special Board Decision No. 187 SASBDR 3*, supports Meyerowitz's sentiments.

An Interpretation Note is probably not specific enough to a particular taxpayer to sufficiently create a definite expectation that the SARS will apply the law in a certain way on the particular facts of all taxpayers.

When a South African domestic court has to interpret legislation it has to adhere to section 233 of the South African Constitution.²⁸ Section 233 provides that a judge

25 ITC 1675 (1998), 62 SATC 219.

26 ITC 1675 (1998), 62 SATC 219.

27 Meyerowitz D Meyerowitz on *Income Tax* (2005) 3.4.

28 Section 233 of the Constitution of the Republic of South Africa, 1996.

must give preference to any reasonable interpretation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

2.2 INTERPRETATION NOTE 6

The background to Interpretation Note 6 states that the

“inconsistent use of the concepts ‘managed and controlled’, ‘managed or controlled’ and ‘effectively managed’ was addressed simultaneously and a more uniform approach is now followed in the Act. The reference to ‘managed or controlled’ in Practice Note No 7 dated 6 August 1999, paragraph 1.1.3, is therefore no longer applicable”.²⁹

What is interesting to note is that according to Interpretation Note 6, in order to interpret the meaning of “place of effective management”, one would have to apply the ordinary meaning of the words taking into account international precedent and interpretation.

In terms of Interpretation Note 6, the place of effective management is not the same as shareholder control or control by the board of directors. “Management focuses on the company’s purpose and business and not on the shareholder function.”³⁰ Interpretation Note 6 states that in order to determine the place of effective management

“one should keep in mind that it is possible to distinguish between

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions and make and implement day-to-day/regular/operational management and business activities; and
- the place where the day-to-day business activities are carried out or conducted”.³¹

According to the general approach as stipulated in Interpretation Note 6, the place of effective management is 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 of directors meets*. Management by the directors or senior managers refers to the execution and implementation of policy and strategy decisions made by the board of direc-

29 Interpretation Note 6 para 1.

30 Interpretation Note 6 para 3.1.

31 Interpretation Note 6 para 3.1.

tors. Thus, the place of effective management can also be referred to as the place of implementation of the entity's overall group vision and objectives.

According to the Interpretation Note:

"No definitive rule can be laid down in determining the place of effective management and all the relevant facts and circumstances such as those listed below must be examined on a case-by-case analysis:

- where the centre of top level management is located;
- location of and functions performed at the headquarters;
- where the business operations are actually conducted;
- where controlling shareholders make key management and commercial decisions in relation to the company;
- legal factors such as the place of incorporation, formation or establishment, location of the registered office and public officer;
- where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- the frequency of the meetings of the entity's directors or senior managers and where they take place;
- the experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- the actual activities and physical location of senior employees;
- the scale of onshore as opposed to offshore operations;
- the nature of powers conferred upon representatives of the entity, the manner in which [those] powers are exercised by the representatives and the purpose of conferring the powers to those representatives."

All businesses are different, thus there are no hard and fast rules and the above is certainly not an exhaustive list. If business is conducted from different locations, in order to ascertain the place of effective management one would have to determine the place with the strongest economic nexus. Thus, all cases must be judged on their own facts and circumstances.

2.3 THE SARS DISCUSSION PAPER

As set out above, SARS' approach to the term "place of effective management" is currently explained in Interpretation Note 6 and the general approach taken by Interpretation Note 6 is that a company's place of effective management is "the place where the company is managed on a regular or day-to-day basis by directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets". The focus is thus on the location where policy and strategic decisions are executed and implemented by a

company's senior management, rather than the place where the ultimate authority over the company is exercised by its board of directors or similar body.³²

As noted above, Interpretation Note 6 emphasises that the determination of a company's place of effective management is an intensely factual question. Therefore, SARS' view is that the issue requires a case-by-case analysis of the relevant facts and circumstances.

The purpose of the SARS Discussion Paper was to invite comments from the general public regarding their concerns on the Interpretation Note and possibly to include practical solutions to the issue.³³

2.4 CRITICISMS OF INTERPRETATION NOTE 6

SARS issued a discussion paper in September 2011 inviting comments from taxpayers and tax practitioners regarding their concerns regarding the interpretation of the term "place of effective management" and in particular, Interpretation Note 6. The discussion paper takes note of the fact that the revised Interpretation Note must balance multiple and sometimes competing goals. First, it must help to ensure that the place of effective management provision fulfils its purpose as a substantive test that is not open to "simple, formalistic manipulation".³⁴ Secondly, the revisions should aim to reduce uncertainty wherever possible as Interpretation Note 6 has caused numerous uncertainties.

According to the Discussion Paper, Interpretation Note 6 has been subject to four main areas of criticism:

1. The focus of the general approach on the place where strategic decisions and policies are executed and implemented, rather than the place where those decisions and policies are taken or adopted.

32 SARS Discussion Paper para 5.

33 SARS Discussion Paper para 2.

34 Van der Merwe 124.

The antagonism between the general approach of Interpretation Note 6 and international precedent and guidelines has also led to speculation of whether or not the courts would accept the general approach of Interpretation Note 6 in a treaty context or whether the term might effectively be given different interpretations in treaty and domestic or non-treaty contexts.

2. The inconsistent use of terminology in Interpretation Note 6.

There are numerous inconsistencies in the language used in section 3, which deals with the general approach and section 4 which deals with practical applications. Commentators have also questioned the statutory basis of the use of the “economic nexus” test to determine the place of effective management in situations in which the primary or predominant locus of the “second level” management cannot be identified.

3. The apparent inconsistency between some of the facts and circumstances outlined in the guideline and the general approach.

The two most controversial items in this regard have been:

- “where controlling shareholders make key management and commercial decisions in relation to the company”; and
- “legal factors such as the place of incorporation, formation or establishment, the location of registered office and public officer”.

4. The failure of Interpretation Note 6 to provide specific guidance for cases involving passive or intermediate holding companies.³⁵

2.5 INTERNATIONAL BENCHMARKING

It is trite that the term “place of effective management” does not have universal meaning.

“There are, however, mainly two tests that are applied when determining the location of a company’s place of effective management; the place where the board of directors meets, or the place where the senior management of the company operates. The last mentioned two tests are referred to as the ‘Anglo-American’ and ‘Continental’ tests.”

35 SARS Discussion Paper para 6.

tal' approach respectively, of which South Africa follows the Continental approach."³⁶

2.6 CRITICISM OF A “BOARD-CENTRIC” APPROACH

With the fast moving development in telecommunications technology, the concern has been that the board-centric approach has not been able to keep up to date with our world's fast evolving technology. This has been highlighted by two United Kingdom authorities³⁷ who question whether the use of concepts that were developed way before we had email, telephone and video conferencing facilities are still relevant today.

The gist of this argument is that people do not need to meet in one place in order to communicate and make decisions. With technology such as video-conferencing, Skype, e-mail, cell phones, et cetera. it has become increasingly easy and inexpensive to communicate with people anywhere in the world.

2.7 THE OECD AND THE COMMENTARY ON ARTICLE 4 OF THE MODEL TAX CONVENTION

The OECD has been mindful of the concerns raised by the various commentators. In early 2001 the OECD's Technical Advisory Group (TAG) issued a draft discussion paper, entitled *The impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie Breaker Rule*.³⁸ This OECD Draft Discussion Paper is discussed in greater detail in Chapter 3.

CONCLUSION

It can be gathered from the above that the overall approach taken by Interpretation Note 6 is that the place of effective management is the place where the day-to-day activities of the company or the implementation of business decisions are carried out.

What is fascinating is that the Interpretation Note states that the enquiry is a factual one hence each individual case will be determined according to its particular

³⁶ SARS Discussion Paper para 9.5.

³⁷ Miller and Oates *Principles of International Taxation* (2006) para 4.16.

³⁸ Hereafter “OECD Draft Discussion Paper”.

facts and that we must look at international precedent in our quest to ascertain the place of effective management. I concur with both these approaches.

CHAPTER 3

3. THE OECD APPROACH

“The term ‘international tax’ is a misnomer, as international tax laws do not exist. No tax laws exist which are applicable to all states. The reason for the absence of a global set of international tax laws is obvious: no supranational taxing powers exist (supranational powers do exist to a limited extent in the European Community) and the right to tax forms part of a states sovereign powers.”³⁹

We currently do not have an international taxing body. However, it is predicted that one will be created in the next ten to twenty years by either the United Nations or the OECD.⁴⁰ Whilst South Africa is not a member of the OECD, it does have observer status. This means that South Africa is allowed to sit and participate in OECD meetings but is not permitted to vote. Since most of the DTA that South Africa has entered into are based on the OECD model it is therefore imperative that the interpretation adopted by the OECD is analysed.

3.1 COMMENTARY ON THE OECD MODEL TAX CONVENTION

In a treaty context, it is imperative to establish in which country a person is resident in order to enjoy treaty benefits.

International standard

Despite its widespread use, the term “place of effective management” has never had a universally accepted meaning. Generally, in terms of the OECD commentary on Article 4 of the Model Tax Convention, the place of effective management is the place where “key management and commercial decisions that are necessary for the conduct of the enterprises business are in substance made”.⁴¹

OECD Commentary on Article 4(3): 2000

In paragraph 3(24) of the OECD Commentary, the place of effective management is described as follows:

“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior persons or group of persons (for example a board of direc-

39 Olivier and Honiball *International Tax A South African Perspective 2011* (2011) 1.

40 Shelton *International and Application of Tax Treaties* (2004) 534-539.

41 *CIR v Downing* 37 SATC 249.

tors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given.”⁴²

The 2000 OECD Commentary has been widely criticised for having a “board-centric” approach. Therefore, in the 2008 commentary, the OECD clarification to the term “place of effective management” was amended to include the following wording and deletions:

“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.” [The place of effective management will ordinarily be the place where the most senior persons or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given...]”⁴³

3.2 COMMENTARY

As mentioned above, Article 4 paragraph 3 concerns persons and other bodies of persons, irrespective of whether they are juristic persons. It may be rare in practice for a company to be subject to tax as a resident in more than one State, but is it possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management.

It would not be sufficient to attach importance to a purely formal and legal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company is actually managed.

The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport in Article 8 of the OECD Model Tax Convention. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the “place of management” of the enterprise is situated, while other conventions attach importance to its “place of effective management”, others again to the “fiscal domicile of the operator”.⁴⁴

42 2000 OECD Model Tax Convention on Article 4(3).

43 2008 OECD Model Tax Convention on Article 4(3).

44 OECD Commentary on Article 4(3) para 23. The last sentence was deleted from the definition in the 2008 OECD Model Tax Convention.

As a result of the above considerations, the “place of effective management” has been chosen as the preference criterion for persons other than individuals. The OECD Commentary clearly states that

“the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can only have one place of effective management at any one time”⁴⁵.

The above essentially unpacks the term “place of effective management” into three main elements in its interpretation. Firstly, only major management decisions will be taken into account when ascertaining the place of effective management. Secondly, it is a factual enquiry and will therefore be different from case to case. Consequently, the key managerial and commercial decisions of a small company will be different from those of a large company. Lastly, to be an effective tie-breaker clause, there can only be one place of effective management.

Some countries consider cases of dual residence of persons who are not individuals to be relatively rare and they have opted the stance that those rare cases should be dealt with on a case-by-case basis. In addition, some countries also consider that such a case-by-case approach is the best way to deal with the difficulties of determining the place of effective management of a juristic person that may arise from the use of new and ever-changing communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing paragraph 3 by inserting the following provision:⁴⁶

“3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed by the competent authorities of the Contracting States.”

In applying the above provision, the competent authorities, when determining the residence of a juristic person for purposes of the Convention, would be expected

45 OECD Commentary on Article 4(3) para 24.

46 OECD Commentary on Article 4(3) para 24.1.

to take account of various factors, such as where the meetings of its board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where the accounting records are kept, whether determining that the juristic person is a resident of one of the Contracting States but not of the other for the purposes of the Convention would carry the risk of an improper use of the provisions of the Convention, et cetera.⁴⁷

Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without the indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. Also, since the application of the provision would normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25, the request should be made within three years from the first notification to that person that its taxation is not in accordance with the Convention since it is considered to be a resident of both Contracting States. Since the facts on which the decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.⁴⁸

3.3 OBSERVATIONS ON THE COMMENTARY

As regards paragraph 24 and 24.1, Italy holds the view that the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management of a person other than an individual.⁴⁹ This takes into account that the place of implementation (day-to-day activities) of the substantive and commercial decisions must also be looked at in determining the place of effective management.

47 OECD Commentary on Article 4(3) para 24.1.

48 OECD Commentary on Article 4(3) para 24.1.

49 OECD Commentary on Article 4(3) para 25.

France considers that the definition of the place of effective management in paragraph 24 of the Commentary, according to which “the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made”, will generally correspond to the place where the person or group of persons who exercise the most senior functions (for example a board of directors or management board) makes its decisions. It is the place where the organs of direction, management and control of the entity are, in fact, mainly located.

As regards paragraph 34 of the Commentary, Hungary is of the opinion that in determining the place of effective management, one should not only consider the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made, but should also take into account the place where the chief executive officer and other senior executives usually carry on their activities as well as the place where the senior day-to-day management of the enterprise is usually carried on.

3.4 RESERVATIONS ON THE ARTICLE⁵⁰

Canada has reserved the right to use the place of incorporation or organisation as a test for paragraph 3 with respect to a company that is dual resident and, failing that, to deny dual resident companies treaty benefits.

Japan and Korea have reserved their position on the provisions of Article 4(3) and other articles in the Model Tax Convention that refer directly and indirectly to the place of effective management. Instead of the term “place of effective management”, Japan and Korea have opted to use the term “head or main office” in their DTAs.

France does not agree with the general principle according to which if tax owed by a partnership is determined on the basis of personal characteristics of the partners, these partners are entitled to the benefits of tax conventions entered into by

⁵⁰ OECD Commentary on Article 4(3) paras 27-32.

the States of which they are residents as regards the income that “flows through” that partnership. For this reason, France has reserved the right to amend Article 4(3) in its tax conventions in order to specify that French partnerships must be considered as residents of France in view of their legal and tax characteristics and to indicate in which situations and under which conditions flow-through partnerships located in the other Contracting State or in a third State will be entitled to benefit from the recognition by France of their flow-through nature.

Turkey has reserved the right to use the “registered office” criterion (legal head office) as well as the “place of effective management” criterion for determining the residence of a person, other than an individual, which is a dual resident.

The United States of America has reserved the right to use the place of incorporation test for determining the residence of a company, and, failing that, to deny dual resident companies certain benefits under the DTA.

Germany reserves the right to include a provision under which a partnership that is not a resident of a Contracting State according to the provisions of paragraph 1 is deemed to be a resident of the Contracting State where the place of its effective management is situated and not the place of effective management, but only to the extent that the income derived from the other Contracting State or the capital situated in that other State is liable to tax in the first mentioned State.

3.5 IMPACT OF THE COMMUNICATIONS REVOLUTION ON THE APPLICATION OF “PLACE OF EFFECTIVE MANAGEMENT” AS A TIE-BREAKER RULE

In February 2001 the OECD issued a discussion paper from the Technical and Advisory Group on monitoring the application of existing treaty norms for the taxation of business profits (“OECD Draft Discussion Paper”). The purpose of the Draft Discussion Paper was to identify possible limitations that are likely to be faced in the application of the “place of effective management” tie-breaker rule in the cur-

rent and possible future environment of electronic commerce and technology and to identify possible solutions.⁵¹

In our advancing modern environment, the application of the indicators for determining the place of effective management as laid down by the OECD may not result in a clear determination of which State should be given preference as the State of residence, or may result in an outcome which does not appear to accord with the policy intentions of the residence provision.

Seeing that the test of “place of effective management” is one of substance over form, in theory it should always produce results which reflect the true policy intention of the tie-breaker rule. However, the availability of advanced and evolving communications technology such as videoconferencing or electronic discussion group applications via Internet means that it is no longer necessary for a group of persons to be physically located or meet in one place to hold discussions and make decisions. In a modern environment, application of the traditional approach can produce results which do not reflect the intention of the tie-breaker rule.⁵²

If senior managers adopt conferencing through the Internet, for example, as a key medium for making management and commercial decisions and those managers are located throughout the world, it may be difficult to determine a place of effective management. In such cases, a place of management might be regarded as existing in each jurisdiction where a manager is located at the time of making decisions, but it may be difficult (if not impossible) to point to any particular location as being the place of effective management.

German case law⁵³ suggests that the residence of a company may be determined by the residence of the top manager, in cases where the place of management cannot be determined. Perhaps this approach could be extended to companies managed by a board of directors or senior executives. However,, it is becoming

51 Tax and e-commerce at the OECD “The impact of the communications revolution on the application of the ‘place of effective management’ as a tie-breaker rule”, issued February 2001.

52 OECD Draft Discussion Paper 6.

53 Vogel *Double Taxation Conventions* (1997) 262.

increasingly likely that situations will arise where those people are not all residents of one country.

It may be difficult to determine, for example, a place of effective management when half of the directors reside in country A, while the other half reside in Country B. This example has become more prevalent as more companies list on multiple stock exchanges. It would even be more difficult if these directors did not physically meet but use e-commerce as a means of communicating to each other.

Although the use of technology may increase the number of cases where a place of effective management may exist simultaneously in multiple jurisdictions, this possibility has also been recognised in traditional business operations. Lord Radcliffe stated in *Bullock v The Unit Construction Co Ltd*⁵⁴ that

“individual cases have not always so arranged themselves as to make it possible to identify any one country as the seat of central management and control at all. Though such instances must be rare, the management and control may be divided or even, at any rate in theory, peripatetic”.

3.6 SUMMARY OF KEY FACTORS IN DETERMINING PLACE OF EFFECTIVE MANAGEMENT

A place of effective management will generally be where key management and commercial decisions necessary for the conduct of a business are in substance made and given. This will ordinarily be where the directors meet to make decisions relating to the management of the company, but the determination of a place of effective management is a question of fact and other relevant factors taken into account by the courts have included:⁵⁵

- where the centre of top level management is located;
- where the business operations are actually conducted;
- legal factors such as the place of incorporation, the location of the registered office, public officer, etc.;
- where controlling shareholders make key management and commercial decisions in relation to the company; and
- where the directors reside.

54 38 TC 739.

55 OECD Draft Discussion Paper 7.

It should be noted that while there is guidance from cCentral management and control and the place of management, and that the place of effective management will ordinarily lie with the directors, in certain circumstances these strategic decisions and powers may be exercised by others. For example, the guidance provided in paragraph 24 of the Commentary on Article 4, makes it clear that the relevant considerations is where the high level decision making occurs. If this function is performed by persons other than the Board of Directors, then the relevant consideration is the place where those other people make their decisions.

In the past, in an environment where the most senior manager or managers tended to operate from and meet in a single location such as a head office, determination of the place where key management and commercial decisions were taken, was not too difficult. The place where the top-level management activities occurred would mainly coincide with the place where the company was incorporated and had its registered office, where the business operations were conducted and where the directors or senior managers resided. It was therefore, as the Commentary states “rare in practice for a company, etc. to be subject to tax as a resident in more than one State”.⁵⁶

⁵⁶ Commentary on Article 4 of the Model Tax Convention para 21.

CHAPTER 4

4. DISCUSSION OF SOUTH AFRICAN CASE LAW

This chapter deals with the only two South African cases concerning the place of effective management. The most interesting thing about the two cases is that the SARS Interpretation Note is not mentioned in either of them.

4.1 OCEANIC TRUST CASE⁵⁷

ISSUE

On 29 October 2009, the Oceanic Trust approached the Western Cape High Court seeking a declaratory order in its capacity as the sole trustee of the Specialised Insurance Solutions (Mauritius) Trust (“SISM”) confirming that SISM was (amongst other requests) not a resident as defined in section 1 of the Act.

FACTS

Oceanic Trust is a company incorporated in Mauritius, it was the sole trustee of SISM which was also formed and registered in Mauritius by a Deed of Settlement dated 31 October 2000.

SISM conducted business as a captive reinsurer to mCubed Life Limited (“mCubed Life”) from its inception in 2000 until 2006 when its reinsurance agreement with mCubed Life was terminated. The premiums of the policies of reinsurance by mCubed Life with SISM were transferred to SISM and constituted assets invested by SISM in South Africa and elsewhere in a variety of investments. SISM used the services of an asset manager in South Africa to manage the assets that were invested in South Africa. When a policy came to an end, SISM was obliged in terms of the agreement with mCubed Life, to return the assets to mCubed Life, together with any growth, less the fees to which it was entitled and all expenses incurred by it in terms of the policy.

⁵⁷ *Oceanic Trust Co Ltd NO v The Commissioner for the South African Revenue Services* (case number 22556/09) (hereinafter “*Oceanic Trust*”).

At all times during business operations SISM had prepared its financial accounts and accounted for income tax in Mauritius. For all intents and purposes, SISM was of the opinion that its tax obligations were in Mauritius and not in South Africa.

On 20 July 2009, the SARS issued SISM with an assessment on the basis that SISM was a “resident” of South Africa as it had its place of effective management in South Africa. In response to the assessment, SISM filed a Notice of Objection dated 28 August 2009. SARS had then requested Standard Bank to act as its agent and remitted a portion of the assessment amount from SISM's bank account.⁵⁸

The Oceanic Trust, as the applicant in the matter, requested an urgent application to the High Court and requested the court to determine:

1. that the SISM trust was not a South African resident;
2. that the SISM did not carry on business through a permanent establishment in South Africa; and
3. payment by the SARS of R20 million which was transferred from SISM's Standard Bank account.⁵⁹

SARS' reasons for issuing the assessment are summarised below:

SISM is registered as an offshore trust in Mauritius, and is licensed in Mauritius to conduct business as a provider of long-term insurance. SISM is registered in South Africa as a trust under the South African Trust Property Control Act.⁶⁰ SISM's main activity is to carry out captive re-insurance business.

SISM derived all its business from mCubed Life, a South African entity. In actual fact, SISM was set up in 2000 to conduct business as a captive reinsurer of mCubed Life. According to the information in SARS' possession, the instructions on reinsurance premiums, policies and maturities came from mCubed Life and sometimes from mCubed Holdings Limited.

⁵⁸ *Oceanic Trust* para 9.

⁵⁹ *Oceanic Trust* para 11.

⁶⁰ 57 of 1988.

mCubed Life made decisions in accordance with the re-insurance agreement with SISM on how all the premiums were to be handled by SISM. SISM had appointed corporate money managers (a wholly-owned subsidiary of mCubed Holdings Limited) to be asset managers and South African investment advisors. However, from time to time the corporate money managers received instructions from SISM.

It is imperative to note that all investments of SISM were made in South Africa. SISM generated income from business activities actually conducted in South Africa *albeit* for the period under review.

SISM held its bank account with Standard Bank (a South African bank). The Standard Bank accounts did not show any transfers of money from South Africa to Mauritius and vice versa.

SARS had requested SISM to provide them with minutes of board meetings which had been held in Mauritius to evidence the claim that SISM's business was run in Mauritius by its trustees, Oceanic Trust. However SARS did not receive that information from SISM.

SARS' letter of assessment concluded that SISM was effectively managed in South Africa and not Mauritius where the trustees of Oceanic Trust was situated. Thus, SISM was a resident of South Africa and is therefore liable for taxes under the Act.

Oceanic Trust relied on the English case of *Smallwood*⁶¹ in support of its argument that the SISM trust was not a resident of South Africa as its residence was in Mauritius. The courts stated that "I do not think that on the Smallwood test, the applicant has made out a case for declaratory relief in this court".⁶²

61 *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Amor* 2010 EWCA Civ 778 (hereafter referred to as "*Smallwood*").

62 *Oceanic Trust* para 56.

In issuing the assessment, SARS had relied on the definition of “resident” in section 1 of the Act and the DTA between South Africa and Mauritius which essentially uses the place of effective management as the tie-breaker provision.

CONCLUSION

The court concluded that although the facts were not sufficiently clear to make a decision, the place where key management and commercial decisions that were necessary for the conduct of SISM’s business, was not established to be outside South Africa.

“It would appear to me that at least some key management decisions and at the very least, key commercial decisions necessary for the conduct of SISM’s business were in substance made in South Africa. Therefore, applying the *Smallwood* test, that facts to the extent that they have been established, do not, in my view, establish that the place of effective management of SISM was in Mauritius, and not in South Africa.”⁶³

4.2 TRADEHOLD LIMITED⁶⁴

This case was an appeal from the Tax Court by the Commissioner of the SARS and judgment was delivered Griesel J.

“Tradehold was successful in appealing against an additional assessment raised by the Commissioner based on a taxable capital gain which, according to the Commissioner arose from a deemed disposal by Tradehold of its shares in Tradegro Holdings Limited, in terms of para 12(1) of the Eighth Schedule to the Act.”⁶⁵

Tradehold is an investment holding company incorporated in South Africa. In the particular year of assessment, being 28 February 2003, Tradehold’s only asset was 100% shareholding in Tradegro Holdings, which owned 100% of Tradehold Limited (a company incorporated in Guernsey), which in turn owned 65% of the issued share capital in a UK-based company, Brown & Jackson plc.

On 2 July 2002, Tradehold’s board of directors in Luxembourg resolved that all future board meetings would be held in Luxembourg. Consequently, Tradehold became effectively managed in Luxembourg. However, Tradehold remained a South African resident by virtue of the definition of “resident” at the time in section 2 of

63 *Oceanic Trust* para 58.

64 *Commissioner for the South African Revenue Services v Tradehold Ltd* (case number 132/11) (hereafter referred to as “*Tradehold*”).

65 *Tradehold* para 1.

the Act⁶⁶. The residency of Tradehold changed with effect from 26 February 2003 when the definition of “resident” in the Act changed and therefore Tradehold ceased to be a South African resident.⁶⁷

“Relying on the provisions of paragraph 12 of the Eighth Schedule to the Act, the Commissioner contended that when the respondent relocated its seat of effective management to Luxembourg on 2 July 2002, or when it ceased to be a resident of the Republic on 26 February 2003, it was deemed to have disposed of its only relevant asset, namely its 100 per cent shareholding in Tradegro Holdings, resulting in a capital gain being realized in the 2003 year of assessment of R405,039, 083. This tax is colloquially referred to as an ‘exit tax’.”⁶⁸

Paragraph 12(1) of the Eighth Schedule is a deeming provision. It mentions a person being treated “as disposed of an asset”. Paragraph 12 is triggered when a person ceases to be a resident of South Africa in terms of the Act or is treated as not being a resident under a DTA.

Tradehold contended that if there was a deemed disposal of the investment by Tradehold during the 2003 year of assessment, the capital gain that resulted from that disposal was not taxable in South Africa but it in Luxembourg. The reason was that at the time of the disposal Tradehold was deemed to be a resident of Luxembourg as a result of Article 4(3) of the DTA between South Africa and Luxembourg. Article 4(3) deems the residence of an entity to be where its place of effective management is situated.

Article 13(4) of the same DTA provides as follows “Gains from the alienation of any property other than that referred to in paragraph 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.” In response to the above, the Commissioner contended that Article 13(4) does not refer to alienation of property resulting from a *deemed* disposal of property but a *real* disposal of

66 Prior to the amendment, the term “resident” was defined as follows:

“‘Resident’ means any-

(a) natural person who is...

(b) 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 (but excluding any international headquarter company).”

67 The amendment on 26 February 2003 added the following words to the definition of “resident”: “but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between Governments of the Republic and that other country for the avoidance of double taxation.”

68 *Tradehold* para 4.

property. The Commissioner contended that if Article 13(4) applied to a deemed disposal that would have the effect that there can never be a deemed disposal as contemplated in paragraph 12 in a DTA context, or rather with countries with similar provisions in their DTAs with South Africa.

CONCLUSION

The Court held that the term “alienation” as used in a DTA context must be given a meaning that is congruent with the language of the DTA having regard to its objects and purpose.⁶⁹

“Consequently, Article 13(4) of the DTA applies to capital gains that arise from both actual and deemed alienations or disposals of property. It follows therefore that from 2 July 2002, when Tradehold relocated its seat of effective management to Luxembourg, the provisions of the DTA became applicable and that country had exclusive taxing rights in respect of all of Tradehold’s capital gains.”⁷⁰

⁶⁹ *Tradehold* para 23.

⁷⁰ *Tradehold* para 26.

CHAPTER 5

5. DISCUSSION OF FOREIGN CASE LAW

This chapter deals with four very well-known court decisions from the United Kingdom. The discussion follows the order in which they were heard.

5.1 WOOD V HOLDEN⁷¹

Wood v Holden has a set of very complicated and detailed facts. For the purposes of this study, only the salient and most important facts are discussed.

ISSUE

That Eulalia, a company incorporated in the Netherlands, had its central management and control in London and therefore had to account for capital gains tax in the United Kingdom following the disposal of shares.

FACTS

Wood v Holden is an appeal under section 56A of the Taxes Management Act 1970 from the decision of the special commissioners. The special commissioners had dismissed the appeals of Mr Wood and his wife ("the Woods"), from amended assessments to capital gains tax made by the Inland Revenue on 17 October 2001.

The Woods owned 96% ordinary shares in Ron Wood Greeting Card Ltd ("Greetings"), a trading company operating a chain of birthday card shops. The other 4% was held by a number of employees and a personal acquaintance of Mr Wood.

On 27 March 1995, the Woods engaged Price Waterhouse Corporate Finance ("PwC") to locate a purchaser for Greetings. The Woods thereafter set up a number of Settlements. One of the Settlements was a Discretionary Trust and Barclaytrust was appointed as the trustee of the Discretionary Trust. Barclays Private Trust (BVI) Limited was appointed as the trustee of the other Settlements. Barclaytrust was based in Geneva and a 100% shareholder of Barclays Private Trust

⁷¹ *Wood v Holden* 2006 EWCA Civ 26 (hereafter referred to as "*Wood v Holden*"). The case was decided before the 2008 OECD Commentary.

(BVI) Limited. Thereafter, the trustees of the trusts incorporated Copswood Investments Limited (“CIL”), a company incorporated in the British Virgin Islands.

Ron Wood Greetings Card Holdings Limited (“Holdings”) was formed as an off-the-shelf company in September 1995. Both the Woods held shares in Holdings. In October 1995, the Woods gave a portion of their Holdings shares to CIL and a portion of their Greetings shares were transferred to Holdings.

CIL then purchased a dormant Dutch company, Eulalia Holdings BV (“Eulalia”) and ABN AMRO Trust Company, which was a Dutch resident, was appointed as the sole managing director. CIL’s shares in Holdings were purchased by Eulalia, whereafter Eulalia sold those shares to an independent third party.

Under English law, the residence of a company that is not incorporated in the United Kingdom, is not determined by the law of the country of incorporation but by the central management and control test as was set out by the House of Lords in the *De Beers* case.⁷²

The case of *Calcutta Jute Mills Co Ltd v Nicholson*⁷³ established the principle that the residence of a company is where the directors meet and where they transact their business and exercise the powers conferred upon them.

“The basic principle established in *De Beers* [1906] AC 455 is that a company resides where its real business is carried on ‘and the real business is carried on where the central management and control actually abides,’... The word ‘actually’ is crucial since it was decided in *Unit Construction Co Ltd v Bullock* that ‘it is the actual place of management, not that place in which it ought to be managed, which fixes the residence of a company’.”⁷⁴

The case for the Revenue was that ABN AMRO did not in fact take the decisions as the managing director but did what it was told to do by either Mr Wood or PwC acting on Mr Wood’s instructions.

“Having reached the conclusion that Mr and Mrs Wood had failed to satisfy them that, on the basis of the ‘central management and control’ test, Eulalia was not resident in the United Kingdom, the special commissioners turned to consider the posi-

72 *Wood v Holden* para 15.

73 (1876) 1 TC 83.

74 *Wood v Holden* para 15.

tion under the test of 'effective management' posed by article 4(3) of the double tax convention."⁷⁵

The judge held that in trying to ascertain where the central management of a company that is incorporated outside the United Kingdom "it is essential to recognise the distinction between cases where management and control of the company is exercised through its own constitutional organs (the board of directors or the general meetings) and cases where the functions of those constitutional organs are "usurped" – in the sense that management and control is exercised independently of, or without regard to, those constitutional organs."⁷⁶ The judge also emphasised that it is important to make the distinction between an outsider proposing, advising and influencing the board of directors and an outsider dictating to the board of directors. The directors of Eulalia were not bypassed in the decision-making. They were the ones who executed all the necessary documents in the acquisition and subsequent disposal of the shares.

The judge of appeal made the following findings:

- the judges were correct in concluding that Eulalia was resident in the Netherlands as per that facts that they found;
- there was no evidence showing that PwC dictated any decision to ABN AMRO;
- there was also no reason why ABN AMRO should not accept the terms upon which Holdings shares were offered by CIL; and
- the special commissioners had erred in deciding the ABN AMRO had not made "effective decisions".

Lord Justice Chadwick thus upheld the decision of the judge in holding that Eulalia was resident in the Netherlands. He also added that it was unnecessary to consider whether the position would have been different under the place of effective management test. He added that he did not think the conclusion would have been different under the current circumstances.

⁷⁵ *Wood v Holden* para 21.

⁷⁶ *Wood v Holden* para 27.

5.2 LAERSTATE V APPELLANT⁷⁷

It is very interesting to note that this case was heard (11 August 2009) approximately 15 years after the transactions in question took place. Like *Wood v Holden* above, *Laerstate* is based on a very complex set of facts. Only a summary of the most relevant set of facts are considered in this study.

ISSUE

Determination of the residency of Laerstate between 1992, when it acquired its interest in Lonrho plc and at which time Dieter Bock (“Bock”) was one of its directors, and 1996, when Laerstate disposed of its shares in Lonrho plc to Anglo American, at which time Bock was no longer a director.

FACTS

Laerstate was a company incorporated in the Netherlands and therefore resident there under Netherlands domestic legislation. Its sole director was Eduard Trapman (“Trapman”).

In December 1992 the entire share capital of Laerstate was acquired by Bock, a German national and business associate of Trapman. These shares were acquired as a corporate vehicle through which investment in Lonrho Plc would be acquired and subsequently disposed. Bock and Trapman were both directors of Laerstate.

During the period in question, Laerstate held nine board meetings. All these meetings were held offshore. Trapman attended four of these meetings without Bock. No meetings took place between November 1994 and March 1996. Bock travelled extensively during this period, spending most of his time outside the UK. In 1996 Bock resigned as a director of Laerstate.

Evidence at the hearing

⁷⁷ *Laerstate v The Commissioner for her Majesty’s Revenue and Customs* [2009] UKFIT 209 (TC).

According to Laerstate's constitution, each director of Laerstate could represent and bind Laerstate with third parties;

According to Dutch legislation there is no legal requirement for a formal record to be kept of board of directors' meetings;

Albeit some board meetings did take place, these were only in relation to ministerial duties and not the policies and core strategic decisions of Laerstate;

Although Bock conducted the entire negotiation and financing of the Lonrho shares and subsequent disposal to Anglo American, it was occasionally with the "assistance, co-operation and concurrence of Trapman". Bock was the one who was ultimately responsible for all the strategic decisions; and

Travel records showed that the management activities performed by Bock were taken in the UK.

According to the reasons for the decision, there is no assumption that the central management and control must be found where the directors of the company meet.

"Where a company is managed by its directors in board meetings it will normally be where the board meetings are held. But if management is carried out outside board meetings one needs to ask who was managing the company by making high level decisions and where, even where this is contrary to the company's constitution."⁷⁸

The mere fact that Bock was resident in the UK does not of itself mean that Laerstate is resident in the UK. "The question is whether he was, as he had authority as a director of the Appellant to do, exercising central management and control in the UK."⁷⁹

At paragraph 33, court held that the mere signing of resolutions and documents is not sufficient for actual management of a company. What is required is an effective decision as to whether or not the resolution should be passed and the documents signed or executed and such decisions require some minimum information to be given to the person signing.

⁷⁸ *Laerstate* para 27.

⁷⁹ *Laerstate* para 39.

Period when Bock was a director

Bock's activities as a director of Laerstate in the UK went much further than ministerial matters or matters of good housekeeping. Bock's activities in the UK as a director of Laerstate were concerned with policy, strategic and management matters. Consequently, the court found that during this period, central control and management of Laerstate were exercised in the UK.

Period after 1996, when Bock was not a director

The court found that Trapman did not take the decisions to do any of the transactions, but that the decisions were taken by Bock. Trapman signed the necessary documents for the transactions as dictated by Bock, hence there was no change in the way Laerstate was managed before and after Bock ceased to be a director. Bock was found to have predominately taken strategic decisions in the UK.

CONCLUSION

Laerstate was found to be a resident of the UK.

5.3 MARK HIGGINS RALLYING⁸⁰

ISSUE

Whether or not the Partnership formed by Mr Roy Dixon ("**Dixon**") and Mr Mark Higgins ("**Higgins**") was centrally managed and controlled outside the UK.

FACTS

Higgins and Dixon were both domiciled in the Isle of Man for UK tax purposes. Dixon was born in 1938 and since 1991 had been domiciled in the Isle of Man. Dixon was a qualified solicitor, who practised in the UK before becoming a successful businessman. He thus had vast legal and commercial experience and in dealing with partnerships and companies. Higgins was born in 1971. Dixon and Higgins met in 1990 when Higgins was an insurance clerk. Dixon identified Higgins

⁸⁰ TC 2010/1682.

as a future star in rally driving and become his mentor, providing encouragement, financial sponsorship and introductions in the world of professional rallying.

In October 1991 Dixon and Higgins entered into a partnership agreement. They had planned to combine Dixon's legal, commercial and management experience with Higgins' driving skills. Dixon wanted Higgins to compete in the international rally scene.

When Higgins had to relocate to the UK, Dixon considered the tax affairs of their partnership and thereafter prepared "Aide Memoir to Partnership Tax" to guide them. Dixon knew that the partnership's central management and control had to continue to be on the Isle of Man, or otherwise outside the UK.

Under cross-examination, Dixon "stated that as well as providing guidance on contractual and other legal matters he also exploited his long-standing connections in the rally world to line up contracts, such as the manufacturers' terms contracts with Vauxhall, Volkswagen and Nissan".⁸¹ It is important to note that all major contracts were executed by the partnership outside the UK.

Higgins testified that he occasionally had to fly to the Isle of Man in order to hold partnership meetings, which Dixon had insisted on. He did not understand Dixon's fuss over making important partnership decisions over the phone, especially when the partnership was not making any profits. He, however, complied, as Dixon was the legal expert.

His Majesty's Revenue and Customs submitted that Higgins had come to the UK in order for him to succeed in the international rallying scene. He had the detailed technical knowledge of the sport and Dixon could give his opinion on whether the contractual terms were fair, hence his activities were of a background nature and did not amount to central management and control.

⁸¹ *Mark Higgins Rallying* para 17.

The partnership cited the case of *Padmore v IRC*⁸² where both the High Court and the court of appeal held that the central management and control of CPA was situated abroad, although the day-to-day activities took place in the UK. CPA partnership had two managing directors who were resident in Jersey. General meetings were held four times a year in Jersey or Guernsey where policy matters were discussed and decisions taken. These decisions were subsequently implemented by the two managing directors.

The partnership also quoted HMRC's Manual⁸³ at paragraph 1630, that "[w]hen an overseas partnership of non-residents expands its activities into the UK, at least one of the overseas partners may become resident here but not domiciled. In that situation the partnership is likely to be clearly controlled and managed abroad".

"The court considered the appropriate test for the location of control and management of the business of the partnership is that adopted by the courts in relation to the residence of a company."⁸⁴ It also took note of the views made by the Tribunal in *Laerstate* where it was held at paragraph 27-29 that

"where a temporary departure from the UK would not of itself give rise to a change of residence, the residence of a company will not fluctuate merely by reason of individual acts of management and control taking place in different territories. The whole picture must be considered in each case".

The court found that the place where the contracts were signed – even the most important ones such as the manufacturers agreement – was not in itself the determining fact. It is evidence of where the decisions were being made. It is the location of the decision-making rather than where the contracts were signed that is important.

Mr Higgins continued to rely on Dixon's expert commercial knowledge and would not conclude any important commercial commitment without first referring it to Dixon for a decision.

82 [1987] STC 36 para 44 and [1989] STC 493 para 495.

83 Mark Higgins Rallying agreed that the Manual did not constitute authority, but was of the opinion that it was a good summary of the relevant law

84 *Mark Higgins Rallying* para 51.

CONCLUSION

It was held that the high level decisions of the partnership, taking the entire picture into consideration, were made outside the UK (Isle of Man), as those were determined by the views of Dixon, who was the commercial brains of the partnership. Higgins referred all business matters to Dixon whilst he concentrated on driving rally cars. Thus, the control and management of the Partnership was wholly situated in the Isle of Man and not the UK.

5.4 *COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS V SMALLWOOD AND ANOTHER*⁸⁵

ISSUE

The main issue on appeal was whether the UK/Mauritian DTA applied which would then exempt the capital gain arising from the disposal from UK Tax. The question was whether the residence was a matter to be determined on the day of the disposal or more generally within the year of the disposal.

FACTS

In 1989 Mr and Mrs Smallwood in their capacity as trustees set up Settlement Trust ("the Trust") for the benefit of themselves and their family members. By the year 2000, the trustee of the trust was a corporation resident in Jersey, Lutea Trustees Limited ("Lutea"). The two main assets of the trust were shares in two quoted companies, FirstGroup plc and Billiton plc ("the shares").

The shares had increased in value and Smallwood was advised to dispose of them and diversify the trust's investments. If the shares were sold by Lutea, a chargeable gain would be attributable to Smallwood under UK Legislation. To circumvent this, Smallwood and his advisors (KPMG) set up a scheme called "Round the World" scheme. The scheme meant that Lutea had to resign in favour of trustees who were resident in a jurisdiction that had a favourable double taxation agreement with the UK, in this case Mauritius. The new trustees in Mauritius would then dispose of the shares and resign before the end of the year of assessment in which the disposal took place in favour of UK based trustees.

85 [2010] EWCA Civ 778.

Consequently, Lutea resigned on 19 December 2000 and was replaced by PMIL, a Mauritian resident. The shares were sold in January 2001 and thereafter PMIL resigned as trustees and the Smallwoods became trustees.

The main arguments put forward by Smallwood:

- Smallwood favoured the “snapshot” approach. In order to ascertain a trust’s residence, one must look at the specific time of the disposal. It was undisputed that Lutea was in Mauritius at that specific time;
- there was no evidence to show that Smallwood or KPMG dictated to PMIL what to do. In other words, PMIL’s decision-making was not usurped by Smallwood or KPMG;
- all meetings took place in Mauritius and resolutions were passed in Mauritius, therefore exercising effective management; and
- there was only an expectation on the part of Smallwood and KPMG that the shares would be sold, as PMIL could still have decided not to sell the shares.

The main arguments put forward by HMRC:

- The facts surrounding the appointment of PMIL lead HMRC to believe that the top-level management or the realistic positive management of the trust had remained in the UK. HMRC accepted that the administration moved to Mauritius but the “key” decisions were made in the UK;
- on the date that PMIL had to sell the shares, they had to be reminded of how many shares they were selling;
- the sale of the shares using Mauritius was motivated by UK tax planning reasons; and
- a holistic approach had to be taken to determine the place of effective management rather than the “snapshot” approach.

On appeal, the judge stated: “In relation to settled property the trustees of the settlement shall for the purpose of this Act be treated as being a single and continuing body of persons (distinct from the person who may from time to time be the trustees) and that body shall be treated as being resident and ordinary resident in

the United Kingdom unless the general administration of the trust is ordinarily carried on outside the United Kingdom and the trustees or a majority of them for the time being are not resident or ordinarily resident in the United Kingdom.”⁸⁶

The judge held that the scheme was devised in the UK by the Smallwoods and KPMG and the steps in the scheme were carefully orchestrated from the UK. It was imperative that the trust had to be transferred to Mauritius for a very brief period (disposal of the shares) and then returned to the UK before the expiry of the financial year. The Smallwoods remained in the UK throughout the scheme. “There was a scheme of management of this trust which went above and beyond the day to day management exercised by the trustees for the time being, and the control of it was located in the UK.”⁸⁷

CONCLUSION

The appeal was allowed in favour of HMRC. The place of effective management was found to be in the UK and therefore Smallwood had to account for tax in the UK.

⁸⁶ *Smallwood* para 69.

⁸⁷ *Smallwood* para 70.

CHAPTER 6

6. DISCUSSION OF VARIOUS AUTHORS ON “PLACE OF EFFECTIVE MANAGEMENT”

In describing the meaning of “place of effective management”, Professor Vogel⁸⁸ suggests that it is similar to that of “place of management” used in the German domestic law. According to German case law, a place of management is regarded as the place where the management’s important policies are actually made. Vogel states that “what is decisive is not the place where the management directives take effect, but rather the place where they are given”.⁸⁹ It is the centre of top-level management, i.e., the place at which the person authorised to represent the company carries on his business-managing activities. If a controlling shareholder does in fact manage the control of the company’s business, that shareholder might be regarded as being in charge of the top-level management, and the place where those decisions are made would appear to be the centre of management. However, Vogel indicates that a place from which a business is merely supervised would not qualify as the place of effective management.

Vogel, also states that, under German law, if the place of management cannot be determined by the application of the above criteria, the top manager’s place of residence may determine the residence of the company.

Meyerowitz’s, view is that “the place of effective management is normally the place where the directors meet on the company business, which may differ from the place where a company carries on business or is managed by staff and directors individually and not as a board. Where the company has executive directors, the facts may reveal that the company is effectively managed where such directors, in contrast to the board of directors as a whole, conduct the company business”.⁹⁰

88 Vogel *Double Taxation Conventions* (1997) 262: “The German domestic term ‘place of management’ is very similar to the treaty term ‘place of effective management’, and even more so because the former term is interpreted by the courts to refer to the factual conditions.”

89 *Supra* 262

90 Meyerowitz D Meyerowitz *on Income Tax 1998/1999* (2000) 104

Van der Merwe, argues that “although the phrase ‘effective management’ is not interpreted consistently, the scale tends to favour decision making on the highest level rather than the day-to-day management as the appropriate basis”.⁹¹ Van der Merwe adds that the OECD Model and its Commentary is a good basis for international opinion even for non-member countries as it also contains opinions of non-member countries, international organisations and other interested parties.

It is thus clear that Vogel, Meyerowitz and Van der Merwe share the same view which differs from that of the Interpretation Note. Instead, their views align with those of international parties. They place more emphasis on where the decisions are taken rather than where those decisions are implemented.

Van der Merwe points out that unlike in South Africa, the OECD does not consider “implementation” in the interpretation of effective management.

“Although it is debatable whether the decisions can be effective without implementation, the limiting of the required actions to decision making will make it easier to pinpoint a single place of effective management, which is essential from a treaty perspective.”⁹²

Oguttu is of the view that the concept of “place of effective management” must not be replaced until a more feasible solution is found that provides certainty *albeit* it is subject to manipulation by modern electronic technology.⁹³ Oguttu also states that although the SARS’ interpretation that recognises the day-to-day activities has its limitations it is a much better test than that of the OECD that recognises central control as an indicator of effective management. She recognises the alternative proposal of defining the “place of effective management” by using a hierarchy of tests as more reliable.

91 Van der Merwe 136.

92 *Ibid.*

93 Oguttu “Resolving double taxation: the concept ‘place of effective management’ analysed from a South African perspective” 2008 XLI No 1 *CILSA* 80-104.

CHAPTER 7

7. CONCLUSION

It is clear from the above discussion that South Africa still has a long way to go in trying to solidify a firm view on the term “place of effective management”. It is also clear from our court decisions that little or actually no weight is given to the SARS’ Interpretation Note. One can argue that there was no need to interpret the concept “place of effective management” using the Interpretation Note as both the cases involved countries which has signed a DTA with South Africa.

It is also clear that South Africa is deviating from international tax norms with its interpretation as articulated in the Interpretation Note. The weight of international opinion seems to favour decision-making at a higher level of management rather than the day-to-day operations and implementation as suggested by the Interpretation Note.

In seeking to ascertain the place of effective management of a company guidance can be obtained from phrases such as “central management and control” and “effective management”. However, the place of effective management can include, but is not restricted to, the place where management and administration are performed on a day-to-day basis, unlike the concept “central management and control”, which refers only to the place where the superior policy and strategic decisions are made.

The SARS’ Discussion Paper indicates that South Africa is likely to follow the OECD guidelines in its interpretation. Thus, the logic of the international case law discussed in this paper will also be applicable in a South African context. On this basis, it is therefore safe to conclude that the interpretation adopted by the SARS’ Interpretation Note is incorrect. However, the view adopted by our courts is in line with international precedent.

8. BIBLIOGRAPHY

1. TABLE OF STATUTES

- Articles of the model convention with respect to taxes on income and on capital (OECD), 28 January 2003
- Income Tax Act 58 of 1962 (as amended)
- Interpretation Note: No. 6- 26 March 2002
- OECD Commentary on Article 4 of the Model Tax Convention
- OECD Discussion Draft: Place of effective management concept: Suggestions for changes to the OECD Model Tax Convention, 27 May 2003
- Tax and e-commerce at the OECD “The impact of the communications revolution on the application of the ‘place of effective management’ as a tie-breaker rule”, issued February 2001

2. TABLE OF CASES

- *Birmount Holdings Ltd v R* (1978) CTC 358
- *Calcutta Jute Mills Co Ltd v Nicholson* (1876) 1 TC 83
- *Capitol Life Insurance Co v R* (1984) CTC 141
- *Capitol Life Insurance Co v R* (1984) CTC 141
- *CIR v Downing* 37 SATC 249
- *De Beers Consolidated Mines* (1906) AC 455
- *Gurd’s Products Co v R* (1985) CTC 141
- *ITC 1675* (1998)/ 62 SATC 219
- *Laerstate v The Commissioner for her Majesty’s Revenue and Customs* [2009] UKFIT 209 (TC)
- *Malayan Shipping Co Ltd v FC of T* (1946) 71 CLR 156
- *Mark Higgins Rallying (a firm) v The Commissioner for Her Majesty’s Revenue and Customs* TC 2010/1682.
- *North Australian Pastoral Co Ltd v FCT* (1946) 71 CLR 623
- *Padmore v IRC* [1987] STC 36
- *Smallwood v HMRC* [2008] STC 209
- *Tara Exploration & Development Co Ltd v MNR* (1970) CTC 557
- *The Oceanic Trust Co. Ltd v CIR* Western Cape High Court Case No. 22556/09
- *Unit Construction Co Ltd v Bullock (Inspector of Taxes)* [1959] 3 All ER 831

- *Waterloo Pastoral Co Ltd v FCT* (1946) 72 CLR 262
- *Wood and Another v Holden* (HMIT) 2006 EWCA VIV 36

3. BOOKS

- Hamilton R and Deutsch R *Guidebook to Australian Taxation*, Legal Books, Looseleaf Services (2005)
- Haupt P *Notes on South African Income Tax*. H & H Publications (2012)
- Meyerowitz D *Meyerowitz on Income Tax 1998-1999* Cape Town: Butterworths (2000)
- Meyerowitz D *Meyerowitz on Income Tax* Cape Town: Butterworths (2005)
- Miller A and Oates L *Principles of International Taxation*, Haywards Heath, Tottel Publishing (2006)
- Olivier L and Honiball M *International Tax A South African Perspective 2011*. 5th Edition, Siber Ink, Cape Town (2011)
- Shelton N *Interpretation and Application of Tax Treaties*. Tottel Publishing (2004)
- Stiglingh M, Koekemoer A, Van Schalkwyk L, Wilcocks J and De Swardt R *Silke: South African Income Tax*. South Africa, Lexis Nexis, (2013)
- Vogel K. *Double Taxation Conventions*, 3rd Edition, Kluwer Law International (1997)

4. ARTICLES, JOURNALS AND OTHER REFERENCES

- Oguttu AW “Resolving double taxation: the concept ‘place of effective management’ analysed from a South African perspective” 2008 XLI No 1 *CILSA* 80-104
- Van der Merwe BA “The Phrase ‘place of effective management’ Effectively Explained?” (2006) 18 *SA Merc LJ* 121