University of the Witwatersrand, Johannesburg

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LIMITATIONS OF THE TERM 'PLACE OF EFFECTIVE MANAGEMENT' AND ITS USE AS AN EFFECTIVE TIE-BREAKER TEST WHEN APPLIED IN THE CURRENT SOUTH AFRICAN BUSINESS CONTEXT

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DECLARATION

I declare that his research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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ABSTRACT

According to South African domestic law, the term 'place of effective management' is 'one of the tests used to determine the residency of a person, other than a natural person' (South African Institute of Tax Practitioners, 2010, p.549). The term 'place of effective management' is not defined in the *South African Income Tax Act 58 of 1962* and there is very limited case law in South Africa which deals specifically with the matter. In an attempt to clarify the term, the South African Revenue Service issued *Interpretation Note 6: Resident: Place of effective management (persons other than natural persons)* (2002) where, as noted by Olivier and Honiball (2008, p.82), 'emphasis is placed on where important decisions are implemented and not where such decisions are taken' as the 'place of effective management'. This is contrary to international guidelines, which typically focus on where important decisions are taken (Olivier and Honiball, 2008, p.75).

Key Words:

Board of directors, central management and control, control, day-to-day decisions, *Discussion Paper on Interpretation Note 6*, *Interpretation Note 6*, key decision making, OECD *Model Tax Convention*, place of effective management

Chapter 1. Introduction

1.1 The Underlying Concepts of Corporate Residency in South African Domestic Law

South Africa has operated under a world-wide tax system for years of assessments commencing from 1 January 2001 (Robertson, 2012). The world-wide basis of taxation is based upon the principles of residency. It is therefore crucial that there is certainty as to what the term 'resident' means. Residency will not only dictate taxing rights under domestic law and double tax treaties, it may also grant relief to the taxpayer, an example of this would be reduced withholding tax rates in accordance with double tax treaties.

Internationally, varying tests are applied to determine corporate residency under domestic law, such tests range from place of incorporation, place of registered office, place of residence of the major shareholders, directors or managers to the place of administration. (Rohatgi, 2005, pp.209-219)

In South African law, the residency based principles are exemplified in Section 1 of the South African Income Tax Act 58 of 1962 (hereinafter referred to as 'the Act'), where a resident is defined to mean any:

> (a) …
>
> (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 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 the governments of the Republic and that other country for the avoidance of double taxation.

Any person, other than a natural person, would be considered resident in South Africa if it is incorporated, established or formed in the Republic; or where the 'place of effective management' is determined to be in the Republic. The first test, namely whether a corporate entity is incorporated, established or formed in the Republic, is referred to as the 'place of incorporation' test. The second test, namely whether a corporate entity is deemed to have its 'place of effective management' within the Republic, is referred to as the 'place of effective management' test. The 'place of incorporation' test and the 'place of effective management' test are mutually exclusive and a corporate entity would be regarded as resident of the Republic should it meet either test.

1.1.1 Place of incorporation test

Inspection of the registration documents of a corporate entity, as issued by the Department of Trade and Industry through the Companies and Intellectual Properties Commission, would confirm whether a corporate entity should be regarded as resident in the Republic. All persons, other than natural persons, registered in South Africa with the Companies and Intellectual Properties Commission would be considered resident by meeting the requirements of the 'place of incorporation' test. The question of whether an entity has been incorporated, established or formed in the Republic is a 'technical requirement, one which is verifiable with the Registrar of Companies'. (Oguttu and Van Der Merwe, 2005, p.310)

However as noted by Olivier and Honiball (2008, p.65):

> Although the place of incorporation test provides simplicity and certainty to both government and taxpayers, it may not necessarily reflect economic reality due to the ease of incorporation and lack of formal connecting factors for corporations in most jurisdictions.

In order to address the shortfall noted by Olivier and Honiball, the more subjective 'place of effective management' test was regarded to cover instances where a corporate entity may be registered in one country, but effectively managed in another country.

1.1.2 The 'place of effective management' test

Under South African law, the 'place of effective management' test considers whether the corporate entity is effectively managed in South Africa. This test is cumbersome in its application as it is not defined in the Act. It is also worth noting that the domestic law interpretation and application of the term 'place of effective management' does vary from country to country.

The South African Revenue Service (hereinafter referred to as 'SARS') noted in the *Discussion paper on Interpretation Note 6 place of effective management* (2011) that in South Africa the term 'place of effective management' is used as a tie-breaker to determine residency (SARS, 2011, p.3). As the term 'place of effective management' is not defined in the Act, it has become necessary for SARS to issue further guidance. In an attempt to provide guidance to the taxpayer, SARS issued *Interpretation Note 6: Resident: Place of effective management (persons other than natural persons)*

(2002) (hereinafter referred to as 'Interpretation Note 6'). According to SARS *Interpretation Note 6* (2002), the 'place of effective management' is essentially where the company is managed on a day-to-day basis by both the directors and senior managers of the company, irrespective of where overriding control is exercised, such as where the board meetings are held (Olivier and Honiball, 2008, p.66).

The interpretation by SARS is contrary to the guidance found in the Commentary on Article 4(3) in the Model Tax Convention on Income and on Capital (hereinafter referred to as 'MTC') by the Organisation for Economic and Cooperation Development (hereinafter referred to as 'OECD') (2014, p.90), which states:

> …the "place of effective management" has been adopted as the preference criterion for persons other than individuals. 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.

1.1.3 The 'central management and control' test as interpreted by the United Kingdom

A third test, which is not adopted in South Africa, is the 'central management and control' test. The interpretation by SARS, namely the 'place of effective management' test, is somewhat contrary to the 'central management and control' test which is adopted in countries such as the United Kingdom.

As noted by Cerioni (2012, p.1095), the focus in the United Kingdom is rather on where occasional, top-level, strategic management decisions are taken. Interesting to note, Cerioni further states that as the term 'central management and control' was being developed, much of the offshore operations would have had top level decision power in the United Kingdom.

The 'central management and control' test was first established in the *De Beers* case (1906). In this case 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 the 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. (Olivier and Honiball, 2008, p.74)

The early authorities of the *Calcutta Jute Mills* case (1876) and the *Cesena Sulphur* case (1876) 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 principle established by Lord Loreburn LC in the *De Beers* case (1906, p.458) is that ‘the real business is carried on where the central management and control actually abides’.

1.2 Determining ‘Place of Effective Management’ and Determining Corporate Residency

As mentioned by Olivier and Honiball (2008, p.74):

> In the case of companies and other bodies of persons, the tie-breaker clauses provided for in art 4(2) of both the OECD and UN MTCs stipulate that a corporate will be resident only in the State in which it is effectively managed.

The term ‘place of effective management’ is not defined in the Act and there is very limited case law in South Africa which deals specifically with the matter. Some guidance is provided by the OECD and SARS in various publications.

1.2.1 Methods of determining a corporate entity’s ‘place of effective management’

Various approaches are applied throughout the world to determine the ‘place of effective management’. When considering the interpretation of the term ‘place of effective management’ in other jurisdictions, ‘substantial differences of opinion, in particular between the interpretation given by the continental and non-continental countries’ are evident. (Olivier and Honiball, 2008, p.79)

- Austria suggests that the ‘place of effective management’ is ‘located at the centre of the business direction’. The centre of the business direction is where ’decisions of a general nature that determine the company’s basic policy […] are made’. There does seem to be an emphasis ‘to attach more importance to the company’s day-to-day management’. (Maisto, 2009, p.297)
- Belgium indicates that the ‘place of effective management’ is determined to ‘correspond to the location where the actual key decisions are taken. (Maisto, 2009, p.275)
- France indicates that ‘place where the “*directoire”* (translated as the “management board”)’ meets would be the ‘place of effective management’, as opposed ‘to the “*conseil de surveillance”* (which would represent the administrative board). Finally the French indicate

that the ‘place of effective management’ is where the ‘organs of direction, management and control’ of the company are located, which would ‘suggest something closer to the headquarters of the company’. (Maisto, 2009, p.275)

- Germany suggests that the ‘place of effective management’ should ‘receive an autonomous meaning, not a meaning based on domestic law’, but one which is ‘influenced by domestic law’ (Maisto, 2009, p.275). According to German case law, the place of management is where ‘management’s important policies are actually made [...] it is the centre of top level management’. (OECD, 2001, p.7)
- Hungary’s view of the ‘place of effective management’ seems to be based on ‘where the top-level executives carry on their activities. (Maisto, 2009, p.275)
- Italy takes the standpoint that ‘place of effective management’ is one which ‘takes account of the place where the main substantial activity of the company takes place’. (Maisto, 2009, p.275)
- The Netherlands suggest that the ‘place of effective management’ would be ‘given its domestic law meaning, which is based on facts and circumstances’, which would ordinarily correspond to where the ‘executive board makes decisions’. (Maisto, 2009, p.275)
- Spain proposes that the ‘autonomous meaning’ be applied. In their view ‘place of effective management’ could be located where the ‘management and supervisory body carries on the key management of the country’, or it could be located where the ‘day-to-day management of the company takes place’. (Maisto, 2009, p.275)
- Switzerland, a distinction is made between a corporate entity’s place of effective management and the places of ‘administrative management’ and ‘decision making by executive bodies’. (OECD, 2001, p.7)
- Canada and the United States place no reliance on the ‘place of effective management’ but rather consider the ‘place of incorporation (although more recent treaties increasingly leave the issue to be decided by mutual agreement)’. (Maisto, 2009, p.275)

According to the OECD discussion draft, *The impact of the communications revolution on the application of “place of effective management” as a tie breaker rule* (2001, pp.7-8), the ‘place of effective management’ will be located where ‘key management and commercial decisions necessary for the conduct of a business are in substance made and given’. The OECD continues to state that the ‘place of effective management’:

> …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:
>
> - 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.

The OECD views the above as guidelines to assist the interpretation of the term 'place of effective management'. According to the OECD, the facts must be applied on a case-by-case basis to determine where the 'place of effective management' is located. The OECD still maintain that the 'place of effective management' is the preferred criterion for persons other than individuals. It is also noted by the OECD that an entity may have more than one place of management, but it can only have a single 'place of effective management' at any one time. (OECD, 2014, pp.90-91)

1.2.2 The 'place of effective management' test as a tie-breaker

Article 4(3) of the OECD MTC (2014, p.26), attempts to provide a solution where dual residency issues may arise as a result of the application of Article 4(1) of the OECD MTC (2014, p.26), which refers to the concept of residence adopted in the domestic laws.

Dual residency conflicts for corporate entities would arise where, for example, a corporate entity is incorporated in South Africa but the board members meet on a quarterly basis in the United Kingdom to manage and control the company. Both South Africa and the United Kingdom would in this instance regard the company as resident according to Article 4(1) of the OECD MTC (2014, p.26).

According to Article 4(3) of the OECD MTC (2014, p.26), should a corporate entity be regarded as resident in both Contracting States due to the application of each countries domestic law principles, 'then it shall be deemed to be a resident only of the State in which its place of effective management is situated'.

To complicate matters further, as noted by Olivier and Honiball (2008, p74), the 'place of effective management' test is not applied consistently in tax treaties entered into by South Africa.

1.3 Research Problem

1.3.1 The statement of the research problem

The current tie-breaker test for corporate entities as interpreted by SARS, namely that residence will be determined based on the ‘place of effective management’, is not in line with Commentary provided by the OECD MTC (2014) and the practice adopted by countries such as the United Kingdom. The research question posed is how effective is the term ‘place of effective management’ as interpreted by SARS when used as a tie-breaker test in the current South African business context.

1.3.2 Research sub-questions

The first research sub-question to be addressed is how the OECD MTC (2014) interprets the term ‘place of effective management’.

The second research sub-question is whether the interpretation of the term ‘place of effective management’, as proposed in SARS *Interpretation Note 6* (2002), is consistent with that of the OECD MTC (2014).

The third research sub-question for consideration is how the United Kingdom interprets the term ‘central management and control’.

The fourth research sub-question is whether the term ‘central management and control’ is comparable to the term ‘place of effective management’ and do these two terms seek to address similar corporate residency issues.

The fifth research sub-question is how does the SARS *Interpretation Note 6* (2002) and the recently issued *Discussion paper on Interpretation Note 6 place of effective management* (2011) address the term ‘place of effective management’.

The sixth research sub-question is how effective is the term ‘place of effective management’ as a tie-breaker test when used to resolve conflict where corporate dual residency problems arise.

1.4 Scope and Limitations

This research report will focus on residence principles for persons other than natural persons. This will include an investigation on the terms 'place of effective management', 'place of incorporation' and 'central management and control'. Residency for natural persons, although referred to, will not be covered in detail.

This research report will investigate the Articles and the associated Commentary contained in the OECD MTC (2014), as far as it relates to the 'place of effective management' tie-breaker test. The United Nation Model Tax Conventions will not be discussed.

This research report will primarily focus on the residency principles and the interpretation thereof, adopted by South African and the United Kingdom.

1.5 Research Methodology

In order to undertake the proposed qualitative research, SARS *Interpretation Note 6* (2002) will be analysed, together with the guidance provided by the OECD MTC (2014) and the supporting documentation issued by the OECD on the matter. Court cases will be interpreted and commentary provided to further expand on the underlying principles. Various publications, books, journals, statutes, guidelines, communications and reports will be reviewed and utilised as the basis of this research.

Chapter 2. Corporate Residence as Defined in terms of Article 4(1) OECD Model tax convention on income and on capital

2.1 Resident and Relief Granted

The early OECD conventions 'were applicable to "citizens" of Contracting States' (OECD MTC, 2014, p.47). This has been updated over time to correctly refer to 'residents', irrespective of nationality. The concept of 'corporate residence' plays a key role in the interpretation and application of tax treaties. As stated in Article 1 of the OECD MTC (2014, p.24): 'This Convention shall apply to persons who are residents of one or both of the Contracting States.'

As noted in the OECD MTC (2014, p.85), the concept of 'resident of a Contracting State' has various functions and is of importance in three cases:

> a) in determining a convention's personal scope of application;
>
> b) in solving cases where double taxation arises in consequence of double residence;
>
> c) in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source.

A person would only be eligible to make use of treaty benefits if the definition of 'resident' is met in either or both of the Contracting States. It is therefore fundamental that clear guidance is provided by the OECD on the meaning of the term 'resident' for purposes of interpreting Article 4 of the OECD MTC.

According to Article 4(1) of the OECD MTC (2014, p.26):

> [T]he term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature...This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2.2 Principles of Domiciled

The definition of 'resident' provided in Article 4(1) of the OECD MTC (2014, p.26), refers to the concept of 'resident of a Contracting State'. When interpreting the term, Article 4(1) of the OECD MTC, states that a resident of a Contracting State means 'any person who, under the laws of the

State, is liable to tax therein by reason of his domicile…' The term 'domiciled' should be interpreted in terms of the domestic law, which may indeed differ from country to country (Maisto, 2009, p.275). A different meaning is attached the term 'domicile' in common law jurisdictions than the meaning which is attached to the term in civil law jurisdictions (Olivier and Honiball, 2008, p.85).

The term 'domicile' is normally used in connection with individual taxpayers and is closely related to factual circumstances, whereas when applied in the context of a corporate entity, this term is based on judicial interpretation and may therefore be more extensive. (Maisto, 2009, p.275)

Olivier and Honiball (2008, pp.85-86), stated that under common law domicile can fall under two different categories, being 'domicile by operation of law' and 'domicile by choice'.

Domicile by operation of law can be acquired at birth, where the country of birth would be regarded as the individuals domicile. Domicile by choice refers to the situation where an individual relinquishes the 'links with the domicile of origin and establishes a full, firm and permanent residential relationship with another country'. (Olivier and Honiball, 2008, p.86)

2.3 Principles of Residence

The definition of 'resident' provided in Article 4(1) of the OECD MTC (2014, p.26), refers to the concepts of residence as adopted in the Contracting States' respective domestic laws. This includes the concept of 'residence'.

Article 4(2) of the OECD MTC (2014, p.26) continues further to provide guidance to determine residence for natural persons where an individual is deemed to be resident of both Contracting States. In these instances, residency shall be determined as follows:

> a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
>
> b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
>
> c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
>
> d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

Article 4(2) of the OECD MTC (2014, p.26) does not provide further guidelines to assist in determining residence for corporate entities. The term 'residence' is typically associated with individuals rather than corporate entities. Interestingly, the UK courts held in the *De Beers* case (1906, p.459), that the issue of corporate residency could be approached with a view to liken corporate entities to individuals. Lord Loreburn LC stated the law as follows:

> In applying the conception of residence to a company we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad […] A company resides for purposes of income tax where its real business is carried on.

Although, as noted by Couzin (2002, p137), when commenting on the approach of applying residency principles to corporate entities: 'companies are, of course, more difficult because […] the application to them of the notion of residence is necessarily artificial or metaphorical.'

2.4 Place of Management

Where dual residency issues arise for persons, other than individuals, the corporate entity will then 'be deemed to be a resident only of the State in which its place of effective management is situated.' (OECD MTC, 2014, p.26)

In reading Article 4(3), consideration of Article 4(1) of the same OECD MTC (2014, p.26) must be evoked, namely that domestic law must be consulted to assist in the interpretation of 'place of management'. Differences of interpretation may arise due to contradictory underlying domestic law principles on the term 'place of management'.

Further guidance, by way of the Commentary on Article 4(3), has been provided by the OECD MTC (2014, p.90), stating as follows (emphasis added):

> [T]he "place of effective management" has been adopted as the preference criterion for persons other than individuals. 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 <u>as a whole</u> are in substance made.

The Commentary then goes on to state that 'all relevant facts and circumstances must be examined' to determine the 'place of effective management'. (OECD MTC, 2014, p.85)

The interpretation of 'place of effective management' by the OECD has evolved over a number of years. In the Commentary to the OECD MTC (2000, p.88) the following was noted regarding 'place of effective management' (emphasis added):

> The "place of effective management" is the place where the <u>key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made</u>. The "place of effective management" will ordinarily be the <u>place where the most senior person or group of persons (for example a board of directors) makes its decisions</u>, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given (i.e. the place where the actions to be taken by the entity as a whole are, in fact, determined. All the relevant facts and circumstances must be examined to determine the "place of effective management".

Per the above Commentary issued in 2000 on Article 4(3) of the OECD MTC, it is apparent that there has been a shift in the OECD's approach to corporate residence. The underlying principles have moved from 'where the most senior person or group of persons (for example a board of directors) makes its decisions' (OECD MTC, 2000, p.88) to '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' (OECD MTC, 2014, p.90).

2.5 Criterion of a Similar Nature

Article 4(1) of the OECD MTC (2014, p.26) attempts to provide a comprehensive definition of the word 'resident'. In order to interpret the meaning of 'criterion of a similar nature', we would need to understand the commonalities between the terms 'domicile', 'resident' and 'place of management'. All three terms, as illustrated earlier in the chapter, refer to residence principles.

As stated in the *Kerguelen Sealing & Whaling* case (1939, p.363):

> In some countries residence (or domicile) is made the test of liability for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is 'source of income'; again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. In both systems there is, of course, the assumption that the country adopting the one or the other has effective means to enforce the levy.

It can be concluded that there is a connecting factor between a corporate entity being considered resident and paying tax for the protection offered by the State of residence. This protection, as noted above would relate to the shelter that it provides. In the instance of a corporate entity, this may be an established legal system, foreign trade policies and tax treaties. As stated by Couzin (2002, p.143):

> If every nexus for taxation is a "criterion of a similar nature", i.e. if the requisite similarity is nothing more than the fact that the criterion serves as a basis for taxation, the full expression "liability to tax by reason of domicile, residence, place of management or any criterion of a similar nature" collapses to "liable to tax".

2.6 The *Oceanic Trust* Case

2.6.1 South African case law on the 'place of effective management'

The case provided some insight into the manner in which South African courts would approach the interpretation of the term 'place of effective management'. It must be noted that the courts, in coming to their decision, did not make any reference to the guidance provided by SARS *Interpretation Note 6* (2002).

2.6.2 Background to the case

Oceanic Trust Co. Ltd N.O. (hereinafter referred to as the 'Oceanic Trust') was a Mauritian registered and incorporated company and stood as the sole trustee of the Specialised Insurance Solutions (Mauritius) Trust (hereinafter referred to as the 'SISM Trust').

The SISM Trust was a captive reinsurer for MCubed Life Ltd from 2000 till 2006. In 2006, the reinsurance agreement with MCubed Life Ltd was terminated. Following termination of the agreement, the SISM Trust transferred the reinsurance business to Emerald Insurance Company.

The premiums of the reinsurance agreement would be transferred from MCubed Life Ltd to the SISM Trust and constituted assets invested by SISM in a variety of investments. SISM Trust appointed an asset manager in South Africa to oversee all assets held in country.

When any policy came to an end, the agreement stated that the SISM Trust was obliged to transfer all assets related to the policy to MCubed Life Ltd, together with any growth thereon, less the fees to which it was entitled and all expenses incurred by it in terms of the policy.

During the period of its operations, the SISM Trust prepared financial accounts and submitted income tax returns to the local authorities in Mauritius. The SISM trust never considered that it had any obligation to declare or pay tax in South Africa.

2.6.3 Account of the events that took place

The following events took place prior to the urgent application to the High Court:

1. On 4 March 2008, the SISM Trust received a notice of audit from SARS informing it that SARS intended conducting an audit on the affairs of the trust. Certain information was requested from the SISM Trust.
2. The Oceanic Trust, as the sole trustee of the SISM Trust, responded to SARS and provided certain information as requested. A letter was then issued from SARS to the Oceanic Trust stating that a tax claim would be raised against the SISM Trust and requested reasons why the trust should not be subject to tax in South Africa. The Oceanic Trust, on behalf of the SISM Trust responded with detailed reasoning as to why it should not be taxed.
3. On 20 July 2009, SARS issued an assessment letter to the SISM Trust irrespective of the reasons provided by the Oceanic Trust. In this assessment letter, income tax was raised together with additional tax and interest for the years 2000 – 2007, the total amount raised against the SISM Trust was circa. R1.5 billion. SARS was of the opinion that the SISM Trust was a ‘resident’ in the Republic since its ‘place of effective management’ was in the Republic. SARS also argued that the income which the SISM Trust derived was of South African source which would not have been exempt from tax. The alternative approach for the assessment raised was that the SISM Trust formed a permanent establishment in South Africa.
4. On 28 August 2009, the SISM Trust filed a comprehensive objection against the assessment so raised.
5. Prior to the above objection being filed by the SISM Trust, on 23 July 2009, SARS appointed Standard Bank of South Africa, which were the bankers of the SISM Trust, to act as an agent on behalf of the SISM Trust. In terms of section 99 of the Act, Standard Bank was required to remit the R1.5 billion to SARS. Standard Bank remitted an amount of circa. R20 million to SARS from the SISM Trust’s bank account. This payment was made in 2 separate tranches until a negligible balance remained in the bank account.

6. On 16 September 2009, SARS issued a written notice to the SISM Trust that it would be proceeding with legal action.
7. On 29 October 2009, the Oceanic Trust, acting in capacity as the sole trustee of the SISM Trust, launched an urgent application to the High Court, requesting that the court determine whether:
    a. the SISM Trust is a South African 'resident' as defined in section 1 of the Act;
    b. the SISM Trust has carried on business in South Africa through a permanent establishment as defined in section 1 of the Act; and
    c. SARS is liable to repay the amount of R20m which was removed from the SISM Trust's Standard Bank account.

2.6.4 Statement of facts

In the opinion of the Court, the substantive relief sought in the points above concerned two separate but related issues. This first matter for consideration was whether or not the SISM Trust would be regarded as a 'resident' as defined in section 1 of the Act, or whether it carried on trade in South Africa through a permanent establishment as defined in section 1 of the Act. The second matter concerned the action taken in terms of section 99 of the Act whereby SARS instructed Standard Bank to act as agents and remove funds from the SISM Trust's Standard Bank account.

It was common cause that the High Court had jurisdiction to hear the matter only if the issues to be decided upon were questions of law. The High Court determined that before it could be decided that it had the required jurisdiction to adjudicate on the matter, the facts relied upon by SARS when it had assessed the SIMS Trust would need to be considered.

As discussed above, SARS issued an assessment to the SISM Trust on the basis that it deemed that the SISM Trust fell within the ambit of the definition of a 'resident' in section 1 of the Act. Furthermore, SARS relied upon the definition of 'resident' in Article 4 of the double tax agreement entered into between South Africa and Mauritius. SARS assessed the SISM Trust as being a resident of South Africa and consequently, its worldwide receipts and accruals would be subject to taxation in South Africa. SARS stated in paragraph 20 that the question of where a corporate entity's 'place of effective management' is located is 'one of fact and substance over legal form. It will depend upon a conspectus of all the facts regarding the management and operation of the business.' (*Oceanic Trust*, 2011, para 20)

The facts as set out in the letter of assessment from SARS to the SISM Trust were as follows (*Oceanic Trust*, 2011, para 22):

1. The SISM Trust was registered in Mauritius as an offshore trust. The SISM Trust was licensed in Mauritius to trade as a long-term insurance provider. A Category 1 Global Business Licence was held by the SISM Trust.
2. The SISM Trust was registered as a trust in South Africa.
3. The main activity of the SISM Trust was to carry out captive re-insurance business.
4. The SISM Trust derived all income from MCubed Life Ltd, a company registered and trading in South Africa.
5. In 2000, the SISM Trust entered into a captive reinsurance agreement with MCubed Life Ltd.
6. MCubed Life Ltd made decisions on how premiums were to be handled in accordance with the re-insurance agreement.
7. The SISM Trust had appointed a South African asset manager, Corporate Money Managers (hereinafter referred to as 'CMM'). CMM received regular direct instructions from MCubed Holdings Ltd and its operating division Asset Managing Outsourcing. Both MCubed Life Ltd and CMM were wholly owned subsidiaries of MCubed Holdings Ltd, a company which was listed on the Johannesburg Securities Exchange.
8. All investments of the SISM Trust were made in South Africa.
9. During the period under investigation, all income generated by the SISM Trust was due to business activities conducted in South Africa.
10. The SISM Trust held its bank account with Standard Bank. During the period under review, no money was transferred to Mauritius from South Africa and no money was transferred from Mauritius to South Africa.
11. MCubed Life Ltd was found to have a smaller balance sheet than most of its industry competitors. Many potential policyholders found the MCubed Life Ltd policies attractive, but would not take up the policies as there was a belief that MCubed Life Ltd may not be able to settled potential claims on maturity date. Furthermore, section 34 of the Long Term Insurance Act prohibited MCubed Life Ltd from encumbering any of the assets it held. MCubed Life Ltd became aware that re-insurance companies which conduct business outside of South Africa are not subject to any restriction on encumbrance of assets.
12. MCubed Holding Ltd is a beneficiary of the International Investment Trust which itself is a beneficiary of the SISM Trust.
13. The SISM Trust's initial capital (trust property) amounted to US$1 000.

14. The SISM Trust did not provide SARS with minutes of trustees meetings of SISM Trust in Mauritius or any other documentation to substantiate the claim the SISM Trust was run in Mauritius by its respective sole trustees, the Oceanic Trust.
15. The SISM Trust did not pay taxes in South Africa.

2.6.5 'Place of effective management' per the Smallwood case

The Oceanic Trust, representing the SISM Trust, cited the recent decision in the *Smallwood* case (2010) to support its view that the 'place of effective management' of the SISM Trust was in Mauritius and therefore could not be considered 'resident' in South Africa (*Oceanic Trust*, 2011, para 49).

The salient facts of the *Smallwood* case (2010) are as follows:

1. The *Smallwood* case (2010) concerned the question as to whether a trust would be liable for capital gains tax in the United Kingdom on the sale of shares it was advised to sell. As the sale of the shares would ordinarily attract capital gains tax in the United Kingdom, Mr Smallwood approached his advisor and acted upon advice received.
2. The only trustee, who was a United Kingdom resident, resigned and was replaced by a company based and tax resident in Mauritius. Mauritius does not levy any capital gains tax and it had also entered into an agreement with the United Kingdom under which any chargeable gains on the sale of shares would only be taxable in the State in which the trust was resident.
3. Under instruction from the Mauritian company, the trust was registered as an offshore trust in Mauritius and the shares held by the trust were then sold.
4. Following the sale of the shares, the Mauritian company resigned as the sole trustee and Mr and Mrs Smallwood were then appointed as trustees. The trust was then deregistered as an offshore trust in Mauritius.
5. In the *Smallwood* case (2010) it was held that the 'place of effective management' remained at all times in the United Kingdom. The majority decision, as stated by Lord Justice Hughes, held in paragraphs 51-54 that:

> The taxpayer with whom we are concerned ... are the trustees. Trustees are […] treated as a continuing body: In relation to settled property the trustee 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 ordinarily resident in the United Kingdom unless the general administration of the trusts is ordinarily carried on outside the United Kingdom and the trustees or the majority of them for the time being are not resident or not ordinarily resident in the United Kingdom.
>
> The POEM with which this case is concerned is, as it seems to me, the POEM of the trust, i.e. of the trustees as a continuing body…
>
> ...The steps taken in the scheme were carefully orchestrated throughout from the United Kingdom, both by KPMG and by Quilter. And it was integral to the scheme that the trust should be exported to Mauritius for a brief temporary period only and then be returned, within the fiscal year, to the United Kingdom, which occurred. Mr Smallwood remained throughout in the UK. 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 United Kingdom.

2.6.6 Conclusion reached in Oceanic Trust case

The following key features, relating to the 'place of effective management', were taken into account in reaching a conclusion on the *Smallwood* case (2010) (*Oceanic Trust*, 2011, para 54):

1. The 'place of effective management' is the place where key management and commercial decisions that are necessary for the conduct of the entities business are in substance made;
2. The 'place of effective management' will ordinarily be the place where the most senior group of persons (e.g. a board of directors) makes its decision, where the actions to be taken by the entity as a whole are determined;
3. However, no definite rule can be given and all relevant facts and circumstances must be examined to determine the 'place of effective management' of an entity;
4. There may be more than one place of management, but only one 'place of effective management' at any one time;
5. The decision was based not only on the general test for 'place of effective management' but also on the specific section of the UK legislation which provided that the trustees be treated as a single and continuing body of persons who shall be treated as resident in the UK unless the general administration of the trusts is ordinarily carried on outside the United Kingdom and the trustees or the majority of them for the time being are not resident or not ordinarily resident in the United Kingdom; and
6. The court undertook a painstaking analysis of the facts and the way the scheme was set up and was implemented in order to come to the conclusion on where the 'place of effective management' of the trust in that case was.

In conclusion the courts found that, based on the test set out in the S*mallwood* case (2010), it was not proven that the 'place of effective management' of the SISM Trust was situated outside of South Africa. In paragraph 58 of the *Oceanic Trust* case (2011), it was stated that 'even if the facts are sufficiently clear to make a decision on the place of effective management and commercial decisions that were necessary for the conduct of the SISM's business, were in substance made, has, in my view not been established tp *[sic]* be outside South Africa'.

Chapter 3. The United Kingdom's Interpretation of the Concept of 'Central Management and Control'

To understand the 'place of effective management' test in a treaty context, one has to start with another test, namely the 'central management and control' test (Olivier and Honiball, 2008, p.74).

3.1 The Founding Principles of Corporate Taxation in the United Kingdom

In the United Kingdom, the underlying principles of corporate taxation state that 'a company which is resident in the UK is normally subject to corporation tax on the whole of its chargeable profits on a worldwide basis (subject to relief for double taxation).' (HMRC, 2010g)

The principles followed in the United Kingdom to determine corporate residency are similar to those adopted in South Africa. HMRC (2010a) will regard a corporate entity as resident in the United Kingdom if:

- …it is incorporated in the UK (with certain exceptions); or
- the central management and control of its business is in the [United Kingdom].

The HMRC places the burden of proof on the taxpayer and each corporate entity is required to undertake 'a self-assessment of its residence status' (HMRC, 2010c). According to HMRC (2010g), further investigation by HMRC will only be conducted:

> …in instances where there is reason to believe that the residence of a company will need to be questioned when it is apparent or suspected that:
>
> - its residence status is part of an arrangement to obtain substantial UK tax advantages, which are not countered by the controlled foreign companies legislation, and
> - there is reason to believe that its central management and control is not where it is alleged to be.

The 'central management and control' test is referred to as the common law test as the principles have been founded through case law. In general terms, a company is resident where the 'central management and control' abides.

The significance or otherwise of incorporation was, rather surprisingly perhaps, not settled until the *Egyptian Delta Land* case (1928) where the Lords concluded that the bare fact of incorporation in the United Kingdom did not constitute residence in the United Kingdom. In this case it was concluded that it is in fact 'irrelevant where the central management and control should be exercised under the company's constitution, if it is, in fact, exercised elsewhere, as in the case of foreign subsidiaries who were held to be resident in England since they were wholly controlled by their English holding company. (Collier, 2001, p.58)

3.2 Origins of the 'Central Management and Control' Test

In the latter part of the 19th century, opinions on corporate residency were divided. Among the spectrum of views held by judges and counsel included a simplistic legal view, that a corporate entity would be regarded as resident where it is incorporated. There was also a nascent factual test which sought to discover where the corporate entity itself, apart from the shareholders, could be said to carry on business. Various formulations essentially amalgamating the legal and factual approaches were also in existence. These tests referred to both the practical conduct of the corporate entity's affairs and the provisions of its constitutive documents. (Couzin, 2002, p.31)

The precursor to the *De Beers* case (1906) was a pair of judgements rendered together, the *Calcutta Jute Mills* case (1876) and the *Cesena Sulphur Co* case (1876), in which 'several elements…of considerable importance in the evolution of the case law test for corporate residency' were established (Couzin, 2002, p.35).

3.2.1 The Calcutta Jute Mills case

The background to the *Calcutta Jute Mills* case (1876) was that the company held its board meetings and the annual general meetings in London. All other corporate actions and decisions of a practical nature were concluded in India. The Calcutta Jute Mills Company claimed that it was not resident in the United Kingdom and that its trade was not carried on in the United Kingdom.

During this time, India was under British rule and as such did not charge any significant amounts of tax to British firms operating in India. If Calcutta Jute Mills Company was indeed found to be resident in the United Kingdom for tax purposes, then its Indian income would have been taxable in the United Kingdom, following the residence principles of taxation. (Miller and Oats, 2009, p.63)

The company was an English incorporated company at a time when it would have been exceptional for an English company to have directors and shareholders meetings anywhere but in England. The Judges, while looking at the board of directors and giving much weight to its constitutional role of management in this country, also took into account the fact that annual general meetings were held in the United Kingdom and that the company's place of incorporation was in the United Kingdom. (International Tax Handbook 310)

Calcutta Jute Mills Company had a director in India who ostensibly exercised control in India, but the board of directors held their meetings in London and as stated in the *Calcutta Jute Mills* case (1876, p.83):

> …from that office would issue all the orders to the managing director in Calcutta. No doubt, until he received orders to the contrary, he would have full power and discretion to do what he liked in Calcutta; but at any moment from his Head Office, they might have revoked his authority, or altered the arrangement which he had made connected with the working of the company.

The people in India were mere agents acting solely on behalf of the company to be instructed by the Calcutta Jute Mills Company in the United Kingdom; their acts were the company's acts (International Tax Handbook 310). 'In other words, for all his powers the director was still just a delegate. The decision was that the company was tax resident in the [United Kingdom]. Delegated authority was insufficient to constitute "central management and control"' (Miller and Oats, 2009, p.63).

Following the *Calcutta Jute Mills* case (1876), it was many years before another company residence case came before the Courts and it seems to have been generally accepted that a United Kingdom incorporated company would be deemed resident in the United Kingdom. There was no further litigation dealing with corporate residence until the *De Beers* case (1906) and it is important to remember that De Beers was not a United Kingdom incorporated company. (International Tax Handbook 311)

The judgment in the *Calcutta Jute Mills* case (1876) is the basis on which our later residence ideas rest and on which the case would became the authority on residence. The *De Beers* case (1906) drew heavily on the principles and ideas established in the *Calcutta Jute Mills* case (1876). (International Tax Handbook 314)

3.3 The Evolution of the Term 'Central Management and Control' as Interpreted in the United Kingdom

In the United Kingdom, under case law, the residence of a corporate entity is determined by using the common law rules. In accordance with these rules, a corporate entity will be considered resident where its 'central management and control' abides.

'"Central management and control" refers to the strategic top-level decision making unit in a corporate entity and it follows that typically a corporate entity will be considered resident where the board of directors meet' (Nathan, 2005, p.2). In most cases it would follow that a corporate entity would be regarded as resident in the country where the board of directors meet as this would be evidence of 'central management and control'.

'The location of those meetings may well be an important factor in the determination of the place where the real business is carried on, but there is no rule of law that equates the two' (HMRC, 2010e).

It is not sufficient to solely consider the location of where the board of directors meet. 'The necessity of establishing a common standard for the treatment of different companies meant that the Courts were bound to arrive at a general principle to form an acceptable test of residence' (HMRC, 2010e). As was stated in the *Unit Construction Co Ltd* case (1959, p.738), the rule:

> …might have taken a variety of forms - the country of incorporation, the site of general meetings, the site of meetings of the directors' board were all possible candidates for selection as the criterion. In fact, as we know, the principle was adopted that a company is resident where its central control and management abide…

The word 'actually' per Lord Loreburn LC, as established in the *De Beers* case (1906, p.458), that 'the real business is carried on where the central management and control actually abides', is crucial since it was decided in the *Unit Construction Co Ltd* case (1959, p.729) 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.'

Therefore there is no common standard ascribing residency concluded solely on the basis of where the board of directors meet or ought to meet.

3.3.1 The De Beers case

The principles of the ‘central management and control’ test were first established in the *De Beers* case (1906). In this case a company registered in South Africa worked diamond mines. Its Head Office was situated in South Africa and the general meetings of shareholders were held in South Africa. The Directors held meetings both in South Africa and in the United Kingdom, but the 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 UK resident.

As noted by Couzin (2002, p.46):

> In coming to the conclusion that the taxpayer’s real business was carried on in England and not in South Africa, the following factors were taken into account:
>
> - The company’s head office and general meetings were held in Kimberly;
> - Diamonds were extracted and delivered in South Africa;
> - Some directors lived in South Africa and some meetings took place in South Africa;
> - The majority of directors and other senior officials lived in England;
> - At meetings in England the real control was exercised in London, and these meetings controlled the negotiations of contracts, determined policy, the application of profits and the appointment of directors;
> - All matters requiring a majority vote (including expenses exceeding a specified amount) were controlled in London.

Following on from the *De Beers* case (1906), it can be concluded that the underlying principles of the ‘central management and control’ test are directed at the highest echelons of a corporate entity’s management structure where ultimate control is exercised.

The location of board meetings, although important, is not conclusive. According to the HMRC (2010g):

> [T]he place of directors' meetings is significant only insofar as those meetings constitute the medium through which central management and control is exercised.

Based on the above, ‘central management and control’ does not necessarily follow where the board of directors meet. It may be the case, for example, that ‘central management and control’ is exercised by a single individual acting in the position of a managing director or chairman. The board members may be nothing more than ciphers. In this instance, ‘central management and control’ will be exercised where the managing director or chairman ordinarily makes decisions or effects control over the entity. (HMRC, 2010e)

3.3.2 The Wood case

Further guidance is provided in the *Wood* case (2006) where the matter as to when a corporate entity will be regarded as resident in the United Kingdom when the board of directors takes guidance from persons in the United Kingdom was considered. (Phillips and Fraser, 2006)

The *Wood* case (2006) concerned a tax-planning arrangement in the context of the sale of shares in a family business owned by Mr and Mrs Wood. HMRC challenged the efficacy of the arrangements solely on the basis that one of the companies in the structure was considered tax resident in the United Kingdom. The company in question, which was incorporated in the Netherlands, was a special purpose vehicle named Eulalia Holdings BV, of which the managing director was a Netherlands trust. Its UK tax residency would have rendered ineffective the tax-planning arrangements devised by the Woods' UK-based advisers, Price Waterhouse. Eulalia Holdings BV had only two crucial decisions to take in the context of the structure: the purchase and the sale of a particular shareholding. It was on this share transaction that HMRC sought to tax Eulalia Holdings BV.

The case as presented on behalf of the taxpayer was that Eulalia's affairs were managed in accordance with its constitution - that is, by a sole director in the Netherlands (Eulalia Holdings BV had a sole managing director, instead of a multi-person board). The case presented for HMRC was that the UK-based adviser, Price Waterhouse, exercised such a high degree of influence over the transactions that Eulalia Holdings BV was to carry out, and the Netherlands-based managing director's consideration of the issues was so perfunctory, that central management and control was exercised by the adviser which was based in the United Kingdom and not by the managing director based in the Netherlands.

In the High Court, Justice Park found that the proper conclusion on the primary facts was that Eulalia's affairs were managed constitutionally by the managing director in the Netherlands, and that the company was not UK resident. These findings were approved by the Court of Appeal.

As stated by Nathan (2005, p.4), the following salient points on central management and control can be learned from the *Wood* case (2006):

- The *Wood* case (2006) exemplifies the fact that all situations must be looked at in a realistic manner. It is unrealistic to say that a tax scheme will necessarily affect the determination of corporate residence for all companies participating in the scheme. Additional evidence is required in order to demonstrate that the directors of the companies taking part in the tax scheme have abdicated all control and management over their respective subsidiaries and have allowed the parent or another person to usurp central management and control.

- The important principle that influence does not equate to control was reiterated: the board of directors may act under the influence of another person but that does not necessarily mean that the board of directors has ceased to exercise central management and control.
- It is not necessary to have reams of paper to demonstrate intense activity in a company where the business of the company does not require it. HMRC seemed to suggest that the absence of intense activity by the sole director of the corporate entity meant that the corporate entity could not be resident where the sole director took its decisions.
- That although a subsidiary may be willing to take instruction from its parent company, the subsidiary does not, as a result of such complaisance, cease to be resident in the territory in which its directors meet. What would be required is for the directors of the subsidiary to give up all control and management duties and to allow their role to be usurped by the directors of the parent company.
- If the directors of an overseas company sign documents without due thought, it is difficult to say that the jurisdiction in which those directors meet is the jurisdiction of the residence of the company. However, if such directors do apply their minds and do think about the documents that they are asked to sign and take a decision about whether or not to sign them, the company is resident in the place where the directors take such decisions.

3.3.3 The United Kingdom's current approach to 'central management and control'

The factual basis of the 'central management and control' test greatly restricts the ability of HMRC to provide definitive guidance on residency issues. As highlighted in the *Unit Construction Co Ltd* case (1959, p.729), 'the question where control and management abide must be treated as one of fact or actuality'. This emphasises that the place of 'central management and control' is wholly a question of fact. It follows that factors which together are decisive in one instance may individually carry little weight in another (HMRC, 2010f).

The approach followed by HMRC (2010g), in assessing the relevant facts, is as follows:

> When it has been established where and by whom the company ought to be managed and controlled, the questions to be resolved are matters of fact.
>
> - Do those to whom management is legally entrusted in fact exercise central management and control?
> - If so, where do they carry out this duty?
> - If those entitled to act do not exercise central management and control, where and by whom is it exercised?

It has become clear that the United Kingdom no longer supports the view that the terms 'place of effective management' and 'central management and control' are identical. This is supported by a statement made by HMRC (2010g):

> It is now considered that effective management may, in some cases, be found at a place different from the place of central management and control. This could happen, for example, where a company is run by executives based abroad, but the final directing power rests with non-executive directors who meet in the UK. In such circumstances the company's place of effective management might well be abroad but, depending on the precise powers of the non-executive directors, it might be centrally managed and controlled (and therefore resident) in the UK.

The HMRC now believes that a distinction can be made between the similar terms, 'place of effective management' and 'central management and control'.

The HMRC continues on to state in the *International Tax Handbook* (348) that the 'place of effective management' is generally understood to be the place where the Head Office is located, drawing a distinction between the registered office and the central directing source. The Head Office is considered to be the central directing source where one would expect to find the company directors. The company records would normally be found there together with the senior administrative staff.

Chapter 4. Interpretation Note 6

South Africa transitioned from a source to a residence basis of taxation in 2001. 'The Revenue Laws Amendment Act, 2000 (Act 59 of 2000) introduced a definition of "resident" in section 1 of the Act, which includes the term "place of effective management" as one of the tests to determine the residence of a person other than a natural person' (SARS, 2002, p.1)

No further guidance was provided in the Act as to how the taxpayer should interpret 'place of effective management'. In an attempt to provide further clarity on the term 'place of effective management', SARS issued *Interpretation Note 6* (2002). (Olivier and Honiball, 2008, p.65)

In 2010, the 'Gateway to Africa' initiative was proposed by National Treasury (SARS, 2011, p.2). This initiative formed part of a collection of reforms which sought to 'support South African companies that want to expand into the rest of Africa and offshore'. This objective of National Treasury was to 'boost local tax revenue, dividends, competitiveness and jobs, while supporting economic growth and regional integration across the [African] continent' (National Treasury, Gateway to Africa and other reforms, 2013). One component of the 'Gateway to Africa' initiative was the new headquarter company regime.

4.1 The Interaction Between the Headquarter Regime and 'Place of Effective Management'

The headquarter company regime sought to provide tax benefits to South African resident corporate entities. These benefits included relief from the controlled foreign company rules found in section 9D of the Act. The benefits would be available to corporate entities meeting the requirements for headquarter company status. (SARS, 2011, p.2)

4.1.1 The National Treasury: headquarter company regime

The National Treasury initially proposed that a 'special type of South African corporate holding company' should be formed and registered with the Financial Surveillance Department of the South

African Reserve Bank. This company would then function as the holding company, managing the investments in its African and offshore operations. The following conditions would be imposed on the holding company under the headquarter regime:

1. The holding company must be regarded as a South African tax resident, incorporated and effectively managed and controlled in South Africa.
2. Fund transfers from the parent company to the holding company will be allowed up to R750 million per year.
3. The holding company would be allowed to freely raise and deploy capital offshore, provided these funds are without South African guarantees. Additional domestic capital and guarantees will be allowed on funding genuine foreign direct investment (FDI) in the same manner as the current FDI allowance.
4. The holding company would be allowed to operate as cash management centres for South African multinationals. Cash pooling will be allowed without any restrictions.
5. Local income generated from cash management will be freely transferrable between group companies.
6. The holding company may choose their functional currency and operate a foreign currency account and a rand-denominated account.
7. Only one wholly owned holding company per JSE-listed entity will be allowed. In future, conditions for jointly owned holding company's, multiple holding company's and subsidiaries of non-listed entities may be prescribed.
8. Appropriate governance and transparency arrangements will be required. (National Treasury, 2013, *Gateway to Africa and other reforms*)

4.1.2 Section 9I: Headquarter companies

The conditions to be recognised as a headquarter company have been relaxed somewhat since the introduction of the headquarter company regime as proposed by the National Treasury in 2010. A headquarter company is defined in section 1 of the Act. It states a headquarter company:

> [I]n respect of any year of assessment means a company contemplated in section 9I(1) in respect of which an election has been made in terms of that section;

Section 9I of the Act, on headquarter companies, states in subsection (1) that any company that 'is a resident' and that 'complies with the requirements prescribed by subsection (2)' may elect to be a headquarter company for a year of assessment. In order to meet the definition of resident in South Africa, the headquarter company would need to be effectively managed in South Africa, or incorporated, established or formed in South Africa and not effectively managed in a South African treaty country.

A South African resident company would be able to elect the status of a headquarter company if the following salient requirements are met (section 9I(2) of the Act):

1. For the year of assessment, each shareholder must hold 10% or more of the equity shares and voting rights in the holding company;

2. At the end of each year of assessment, 80% or more of the total assets of the holding company must be attributable to investments in foreign offshore operations. These investments must be in the form of equity; or equity and debt; or intellectual property licensing rights in a foreign offshore company. The holding company must as a minimum hold at least 10% of the equity and voting rights of the foreign offshore company;

3. At least 50% of the holding company's gross income must originate from its foreign offshore investments. This requirement is not applicable if the gross income of the holding company is less than R5 million.

The above requirements would need to be met on an annual basis following which an election would be made by the company to be recognised as a headquarter company as defined.

Concerns have been raised by both taxpayers and practitioners regarding the possible interaction between SARS *Interpretation Note 6* (2002) and the headquarter regime. According to the approach adopted by SARS, 'foreign subsidiaries held by [South African resident] headquarter companies may be treated as South African tax residents' due to the fact that the 'place of effective management' tie-breaker test may be deemed to be located in South Africa.

4.2 Underlying Principles of 'Place of Effective Management' per Interpretation Note 6

The SARS *Interpretation Note 6* (2002, p.2) recognises that the term 'place of effective management' is not defined in the Act. The SARS *Interpretation Note 6* (2002) states that in order for the taxpayer to interpret this term, cognisance must be had of the ordinary meaning of the words, together with international precedent and interpretation of the term.

SARS *Interpretation Note 6* (2002, p.3) makes a clear distinction between the place where:

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

Central management and control carried out by a board of directors is the policy making body within a corporate entity. The executive directors or senior management executing and implementing the policy and strategic decisions, made by the board of directors, is the policy execution body. The place where day-to-day business activities are carried out would form the administrative body of a corporate entity. (Olivier and Honiball, 2008, p.66)

According to SARS *Interpretation Note 6* (2002, p.3), effective management is where the corporate entity is 'managed on a regular or day-to-day basis by the directors or senior managers of the company'. The SARS *Interpretation Note 6* (2002) opines that the policy execution body of a corporate entity forms the 'place of effective management'. The SARS *Interpretation Note 6* (2002) does not recognise the policy making body as a 'place of effective management', stating that no regard should be given to where '…the overriding control is exercised, or where the board of directors meets'.

SARS *Interpretation Note 6* (2002) further clarifies its view, stating that these directors and senior managers are responsible for overseeing the implementation and execution of the company strategies and policies created by the board of directors. These directors and senior managers 'can also be referred to as the place of implementation of the [corporate] entity's overall group vision and objectives'. (SARS, 2002, p.3)

4.3 'Place of Effective Management' in Addressing Current Day Business

As it has already been noted, residency is one of the most fundamental aspects of any residence based tax system. In South African law, the residency based principles as it is applied to corporate entities is exemplified in Section 1 of the Act, where a corporate entity is deemed resident if it was 'incorporated, established or formed in the Republic or which has its place of effective management in the Republic'. The 'place of incorporation' test and the 'place of effective management' test forms the residency tests under South African law. As stated by Van Der Merwe (2006, p.124), the objective of these tests is to balance certainty and predictability against manipulation. As noted by the SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.3), there is 'considerable tension between these two goals'.

It was noted in SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.3) that even though the 'place of incorporation' test is 'formal and generally straightforward in its application […] it is also open to manipulation, particularly in the modern global environment'. Van Der Merwe (2006, p.121) made the comment that the 'place of incorporation' test may have 'little or no connection with the entity's actual economic and business links'. Olivier and Honiball (2008, p.65) commented on the effectiveness of this test, stating 'it may not necessarily reflect the economic reality due to the ease of incorporation and lack of formal connecting factors'.

It is clear that although the 'place of incorporation' test provides a level of certainty to the taxpayer, a corporate entity can easily manipulate this test by registering the entity in a foreign jurisdiction where tax benefits may arise. This test is considered objective in nature as it does not rely on interpretations or opinions, but rather the fact.

The second test, namely the 'place of effective management' test adopts a more subjective approach, one which as noted by Van Der Merwe (2006, p.122) is 'less artificial and where 'substance over form' principles will take precedence. As noted in SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, pp.3-4), the 'place of effective management' test is considered 'less easy to manipulate, but it has presented difficult issues of general interpretation and practical application, both in South Africa and elsewhere'. The *Discussion Paper* continues, commenting that the test is an 'intensely factual question for which no definitive rule or bright line test can be laid down'.

4.4 Criticism Received on Interpretation Note 6

It has been acknowledged by SARS that four main areas of criticism have been received on SARS *Interpretation Note 6* (2002).

4.4.1 The focus of the general approach

The first area of criticism received relates to the emphasis of the general approach as found under section 3.2 of the SARS *Interpretation Note 6* (2002, p.3), where the following is stated (emphasis added):

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

The general approach focuses on the execution and implementation of strategic decisions and policies rather than where the strategic decisions and policies are taken or adopted. SARS has noted that in many cases, an approach focussing 'exclusively, or almost exclusively, on the place where a company's board of directors or similar body meets' would be preferable (SARS, 2002, pp.3-4).

4.4.2 Inconsistent terminology

Criticism has been received on the inconsistent terminology that is used in section 3.2 and section 3.3, which respectively discuss the general approach and the practical application, of SARS *Interpretation Note 6* (2002, pp.3-4).

The general approach in section 3.2 makes reference to the 'place of effective management' located where the 'company is managed on a regular or day-to-day basis'. Whereas the practical application found in section 3.3 looks at the company's 'management functions' as being considered the company's 'place of effective management', further stating that the location of the company's management functions 'might or might not correspond with the place from where the day-to-day business operations/activities are actually conducted from/carried out' (SARS, 2002, pp.3-4).

Concerns of a similar nature have been raised regarding the 'statutory basis for the use of an "economic nexus" test' to determine the 'place of effective management' (SARS, 2002, pp.3-4).

4.4.3 Inconsistent approach

Concerns have also been raised regarding the inconsistent approach found in section 3.4 of the SARS *Interpretation Note 6* (2002, p.4). This section deals with the facts and circumstances, to which SARS has provided further guidance. Two of the items listed have been especially controversial. The first refers to 'where controlling shareholders make key management and commercial decisions'. The second refers to the 'legal factors such as the place of incorporation, formation or establishment, the location of registered office and public officer' (SARS, 2002, pp.3-4).

4.4.4 Lack of guidance for holding companies

The final area of criticism raised is the lack of guidance provided for 'passive or intermediate holding companies'. Concerns have been raised again and it is increasingly relevant due to the new holding company regime.

4.5 Dual Residency: Discussion Paper on Interpretation Note 6

SARS has acknowledged the practical challenges that may arise for taxpayers when determining whether a corporate entity may be regarded as a resident as prescribed in SARS *Interpretation Note 6* (2002). SARS has recognised that 'management structures, reporting lines and responsibilities' may differ from entity to entity 'depending on the [business] requirements'. In order to accommodate the differences noted in management structures, reporting lines and responsibilities, 'absolute guidelines' have been avoided; SARS opted rather to follow a subjective approach, which is by its very nature, would be open to interpretation.

The following guidance has been provided in SARS *Interpretation Note 6* (2002, p.4) to assist the taxpayer in determining a corporate entity's 'place of effective management':

1. If the directors and senior managers execute their day-to-day management functions at a single location, that location will constitute the corporate entity's 'place of effective management'. Please note it is not necessary that this location correspond to the place where day-to-day business operations and activities occur.

2. If the directors and senior managers execute their day-to-day management functions at separate locations the view is held that the 'place of effective management' would best be reflected where the day-to-day operational management and commercial decisions are implemented by the corporate entity. This would be regarded as place where the business operations and activities are actually carried out and conducted. Due to the rapid advances in communication technology (e.g. voice over internet protocol, video conferencing and internet to name a few), directors and senior managers do not necessarily need to be in a single location to successfully execute their management functions.

3. If the nature of the corporate entity is such that the business operations and activities are conducted from various locations, one needs to determine the place with the strongest economic nexus.

The above guidance may provide some clarity to the taxpayer on whether or not a corporate entity would be regarded as a South African resident. Due to the nature of the 'place of effective management' test, prescriptive rules cannot be provided by SARS. The taxpayer would still need to carefully consider all the relevant facts and circumstances in making an assessment. The following facts and circumstances should be considered on a case-by-case basis:

- 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, the 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 the representatives. (SARS, 2002, pp.4-5)

The term ‘effective management’ or ‘effectively managed’ is used by various countries throughout the world, as well as by the OECD in its publications and documentation. However, the term does not have a universal meaning, and the various countries and the members of the OECD have attached different meanings to it.

Chapter 5. 'Central Management and Control' Versus 'Place of Effective Management'

5.1 The United Kingdom's Approach to 'Central Management and Control'

The 'central management and control' test was first established in the landmark *De Beers* case. The *De Beers* case (1906) relied on principles introduced in the *Calcutta Jute Mills* case (1876) and the *Cesena Sulphur* case (1876). In the *De Beers* case (1906, p458), Lord Boreburn LC opinied:

> I regard that as the true rule; and the real business is carried on where the central management and control abides.

5.1.1 Features of the 'central management and control' test as interpreted by the United Kingdom

The HMRC have over the years followed the principles of the *De Beers* case (1906) and in terms of the *International Tax Handbook*, the place of 'central management and control' is determined as the 'central policy core of the whole enterprise', 'directed at the highest level of control of the business of a company' (HMRC, 2010g).

As stated by Couzin (2002, p.43), the words, 'management and control' as used by Lord Loreburn LC when he said 'where central management and control abides', must be located collectively following its unitary nature. The words when interpreted in isolation would give differing results. The word 'management' would be interpreted as the conduct of the senior managers and executives in the day-to-day business of the corporate entity. The word 'control' would be interpreted as the voting rights exercised by shareholders through a general meeting. As noted in *The Gramophone and Typewriter Ltd* case (1908, p.89), it is the directors who manage and control a corporate entity, while it is the shareholders who control the directors.

The 'central management and control' test as stated by HMRC (2010g), focuses on the 'highest level of control of the company', this should not be interpreted as the shareholders of a company as they do not by nature exercise 'management and control' over the company, but it is rather 'control' that it exercised over the company's directors. (HMRC, 2010g)

This was further highlighted in *Waterloo Pastoral Co Ltd* case (1946) that 'central management and control' was found where the most important business decisions were made. In the *Waterloo Pastoral Co Ltd* case (1946) it was concluded that these business decisions were not made in the directors' meetings. It was necessary for the directors to make important business decisions on the spot rather than in the directors' meetings.

5.1.2 The location of management and control exercised by directors

It has been established that the United Kingdom HMRC, interpret the term 'central management and control' as being located where the highest level of management in a corporate entity is being exercised. The highest level of management is not necessarily the board meetings, as stated by Lord Radcliffe in the *Unit Construction* case (1959, p.738), the site of the meetings of the directors' board was not the 'central management and control' test of company residence.

In general, the place of directors' meetings is only significant if those meetings constitute the medium through which the directors exercise management and control over the business operations.

5.1.3 The United Kingdom's view on the 'place of effective management' test

In the Commentary of the 1963 Draft and 1977 OECD MTC, the United Kingdom was recorded as having the view that the place of 'central management and control' equates to the 'place of effective management'. This approach has now been revised with the United Kingdom now stating in HMRC (2010g):

> It is now considered that effective management may, in some cases, be found at a place different from the place of central management and control. This could happen, for example, where a company is run by executives based abroad, but the final directing power rests with non-executive directors who meet in the UK. In such circumstances the company's place of effective management might well be abroad but, depending on the precise powers of the non-executive directors, it might be centrally managed and controlled (and therefore resident) in the UK.

The HMRC (2010b), states that the place of 'effective management will normally be located in the same country as central management and control but may be located at the company's true centre of operations, where central management and control is exercised elsewhere'. A clear distinction is drawn between a company's place of effective management and 'central management and control'. The HMRC acknowledge that it is possible for effective management to be located at the company's true centre of operations and central management and control to be located elsewhere. 'The meaning of "place of effective management" and its distinction, if any, from the place of "central management and control" has yet to be considered by the UK courts'. (HMRC, 2010b)

5.1.4 Dual resident resolution in the United Kingdom

It has been acknowledged by the HMRC (2010d) that situations will often arise where the United Kingdom and the other Contracting State will not use the same criteria to determine whether a corporate entity is resident. For instance the United Kingdom considers both a company incorporated in the United Kingdom and a company centrally managed and controlled in the United Kingdom to be resident in the United Kingdom. In contrast South Africa considers both a company incorporated in South Africa and a company which is effectively managed in South Africa to be considered a South African resident. Without considering the double tax treaty in place between the United Kingdom and South Africa, a company which is incorporated in the United Kingdom and which is effectively managed in South Africa would be considered resident in both States.

Due to the different criteria used from country to country in determining corporate residency, it is not possible to say which factors will be considered by the Competent Authorities when discussing the question of residence. The factors that the HMRC (2010d), will likely consider are as follows:

- The legal connection to each State, namely the place of incorporation or establishment;
- The place of central management and control;
- The place of effective management, where the place of effective management is determined to be different to that where central management and control is exercised;
- Where the company's central business activities are located;
- The economic linkages to each State:
    - o Does the company have a factory, office or shop in the State?
    - o Where are the company's employees based?
    - o Where the company's business is mainly carried on?
    - o Where would the company's customers contact it?
    - o Does any form of double taxation actually arise?
    - o What is administratively the simplest route for the company?

The above factors would be viewed by the UK Competent Authority when deciding their view upon residence. The company would not able to attend or take part in the discussions between the two Competent Authorities but they would be encouraged to make representations regarding the country in which they consider they are resident. (HMRC, 2010d)

According to HMRC (2010d), the UK Competent Authority will then discuss and usually agree an outcome with their counterpart. The agreement will result in one of the following:

- The company is solely resident in the UK;
- The company is solely resident in the other State;
- The company is dual resident in both States, this would arise when:
    - The Competent Authorities could not reach agreement; or
    - Dual residence is the agreed outcome.

5.2 The South African Approach to 'Place of Effective Management'

The SARS *Interpretation Note 6* (2002, p.2) recognises that the term 'place of effective management' is not defined in the Act. The SARS *Interpretation Note 6* (2002) states that in order for the taxpayer to interpret this term, cognisance must be had of the ordinary meaning of the words, together with international precedent and interpretation of the term.

According to SARS *Interpretation Note 6* (2002, p.3), effective management is where the corporate entity is 'managed on a regular or day-to-day basis by the directors or senior managers of the company'.

The SARS *Interpretation Note 6* (2002) does not recognise the policy making body as a 'place of effective management', stating that no regard should be given to where '…the overriding control is exercised, or where the board of directors meets'.

5.2.1 Features of the 'place of effective management' test as interpreted by SARS

According to SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.3) the focus on the 'place of effective management' test is on the 'location where policy and strategic decisions are *executed and implemented*' by the company's directors and senior managers, 'rather than the place where the ultimate authority over the company is exercised by its board of directors or similar body.'

In SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.12) it is acknowledged that the focus of the 'place of effective management' test is on the 'second level of management'. The top level of management would be regarded as the board of directors, those termed the 'policy making body'.

5.2.2 The South African view on 'central management and control' test

SARS has laid criticism against the typical 'board-centric' approach in *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.6), where it states that the 'focus upon decision-making by an entity's board of directors or similar body, has failed to keep pace with changes in telecommunications, international travel and modern business practices.' Two United Kingdom authorities on the matter, Miller and Oates (2006, para 4.16), have noted:

> [W]e might ask whether concepts developed before the age of international telephone and even before the wireless telegraph [...] are still appropriate in today's world [...] The contrast with the current availability of international communications by telephone, e-mail, videophone, video conferencing and the ubiquity of air travel is sharp.

SARS has also noted the comments received from Van Der Merwe (2006, pp.124-125):

> The adequacy of effective management as a tie-breaker rule based upon [the location of superior management decision making] has been questioned. This interpretation of the phrase was coined when companies were generally organised in a hierarchical structure and management could be located at a specific point within a certain period of time. However, modern companies are increasingly run and managed divisionally rather than through the legal entities in which the divisions are formed. This has resulted in an organisational network spread across different countries. Also, due to modern technology, management has become much more mobile and traditional places of effective management may rotate. Technology has furthermore made it possible to manage without the need for a group of persons to be physically located or to meet in one place, for instance at the company's headquarters. Because of these changed management structures and technology, effective management based on where the directors meet becomes a matter of choice and manipulation. Even when based on a wider interpretation of key management and decision making, it is evident that technology makes it difficult to pin effective management down to one constant location, and double or multiple residences or even non-residence may be the result.

It is clear that in SARS's view, the term 'central management and control' as interpreted by the United Kingdom, has not kept abreast of changes in the manner in which corporate entities operate. The board-centric approach is out dated and requires revision.

5.3 Limitations of the 'Place of Effective Management' Test as a Tie-Breaker

5.3.1 Current interpretation fosters uncertainty

The 'place of effective management' test as interpreted by SARS has caused uncertainty for both local and international companies. In SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.11), the areas of uncertainty have been recognised as follows:

1. The current approach adopted by SARS on determining an entity's 'place of effective management' appears to 'conflict with the weight of international authority' as the general approach focuses on where 'strategic decisions are "executed and implemented", rather than where the decision-making, in substance, takes place';
2. The interpretation by SARS appears to 'blur the lines between what have been called the "second" and "third" levels of management'; and
3. There is inconsistency in the approach adopted by SARS, this is demonstrated by the fact that 'certain factors in the "guideline" […] appear to conflict with the general approach'.

As can be seen there is a high degree of uncertainty on how SARS *Interpretation Note 6* should be approached. This uncertainty has been noted by SARS and it is proposed that revisions to SARS *Interpretation Note 6* follow.

Chapter 6. ‘Place of Effective Management’ OECD Model tax convention on income and on capital

6.1 The OECD’s Approach to Determining the ‘Place of Effective Management’

The term ‘place of effective management’ has not been defined in Article 4 of the OECD MTC (2014).

According to the Commentary on Article 4(3) found in paragraph 22 of the OECD MTC (2010, p.191), it would not be sufficient to ‘attach importance to a purely formal criterion like [company] registration. Therefore paragraph 3 attaches importance to the place where the company […] is actually managed.’

The approach followed by the OECD has shifted following the 2008 update to the OECD Commentary. Prior to the 2008 update the emphasis was placed on the company’s board of directors as an indicator for the ‘place of effective management’. In paragraph 24 of the Commentary to the OECD MTC (2000, p.82), it noted that the ‘place of effective management’ is where (emphasis added):

> …<u>key management and commercial decisions</u> that are necessary for the <u>conduct of the enterprise’s business</u> are in substance made. The place of effective management will <u>ordinarily be where the most senior person or group of persons</u> (<u>for example a board of directors</u>) <u>makes its decisions</u>, the place where the actions to be taken by the enterprise as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management.

In the 2008 update the basis for determining a corporate entity’s ’place of effective management’ was deemed to exist where the ‘key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole’. It is likely that this change was as a result of the OECD concluding that ‘it had gone too close to the Commonwealth’s concept of “central management and control” and its reliance on the place where the board meets’ (Maisto, 2009, p.294).

6.1.1 Key factors in determining the ‘place of effective management’

The current approach adopted by the OECD MTC (2014, p.90), is that an entity's 'place of effective management' will be '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 exist where the directors meet to 'make decisions relating to the management of the company'; the determination of 'place of management' is a 'question of fact' (OECD, 2001, p.7).

As noted above the OECD states that the 'place of effective management' will 'ordinarily be where the directors meet to make decisions relating to the management of the company'. There are additional factors that must be considered according to the OECD (2001, pp.7-8) which are: 'where the centre of top management is located'; 'where the business operations are actually conducted'; 'legal factors such as the place of incorporation'; 'where controlling shareholders make key management and commercial decisions'; and 'where the directors reside'.

The OECD guidelines have shifted over the years. Historically the focus placed significant emphasis on the 'top management', the most senior decision making body in an organisation, the board of directors.

The OECD has listed the considerations that would be expected of the competent authorities to take account of in resolving a dispute of dual residency. These considerations can be found in the Commentary under paragraph 24.1 of the OECD MTC (2010, p.192) and are as follows:

- Where the meetings of the board of directors or similar 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 entity is carried on;
- Where the entity's headquarters are located;
- Which country's laws govern the legal status of the entity;
- Where the entity's accounting records are maintained; and
- Whether determining that the entity is resident of one of the Contracting States but not the other for the purpose of the convention would carry the risk of the improper use of the convention.

6.1.2 Proposed changes to the OECD Model Tax Convention and the associated Commentary

In 2001 the Technical and Advisory Group of the OECD released a document entitled *The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie-Breaker Rule*. The purpose of this document was to identify and provide solutions for the possible limitations on the 'place of effective management' test as a tie-breaker given the current and future advancements made in commerce and technology.

This document was then followed, in 2003, by the OECD discussion draft entitled *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Convention*. This document detailed two proposed alternative amendments:

1. The first proposal 'Refinement of the "place of effective management" concept' seeks to refine the currently adopted concept 'place of effective management' by expanding upon the OECD Commentary, specifically that on Article 4(3) of the OECD MTC, by providing guidance on how this concept should be interpreted.
2. The second proposal 'Hierarchy of Tests' offers an alternative version of Article 4(3) of the OECD MTC, together with Commentary thereon, replacing the existing tie-breaker rule for persons other than individuals.

The proposed changes to the 'place of effective management' test put forward the concept that the 'place of effective management' usually corresponds to where the board of directors meet. It was noted in cases where the board of directors merely formalised decisions made by persons in another State that the 'place of effective management' would then be determined to exist in the other State.

The response to the proposed changes was noted by Maisto (2009, p.295):

> When the OECD Member countries subsequently discussed this proposal in light of the public comments received on the discussion draft, it quickly emerged that the reference to the place where the board of directors meets, which had been included in the Commentary in 2000, did not correspond to the view of the majority of the OECD countries but was in fact an interpretation shared by countries that had inherited their concept of corporate residence from the United Kingdom.

The proposed changes in OECD *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Convention* (2003) were abandoned by the OECD.

Maisto (2009, p.297), succinctly worded it when he said that 'after 51 years, the OECD has done a full circle and has returned to something which is not very different from what was originally proposed'. The 'place of effective management' is a question of fact and the process should facilitate the question of dual-residence to be determined by mutual agreement of the competent authorities.

Chapter 7. Conclusions

7.1 Changes to Interpretation Note 6: Proposed by SARS

These above areas of concern have been recognised by SARS and it is proposed in SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.11) that the following approach be adopted:

1. The revisions to SARS *Interpretation Note 6* (2002) need to accommodate the broad variety of factual situations that may arise. It may not be uncommon for a company's board of directors to retain control over major actions while nonetheless giving its senior management the responsibility of the day-to-day running of the business as a whole. Similarly, in many cases, senior management is responsible for the highest level of running the day-to-day business and the actual development and formation of the company's key commercial strategies and policies. The board's role in this instance would be one of ratifying or formally approving those strategies and policies;
2. The senior management body may not be located in one place. Due to the manner in which corporate entities conduct business, given the advances in telecommunications, it is likely that the senior management body may operate from various locations;
3. The place where formal meetings of a board of directors or similar body meets may have little or no connection with where decisions are really made;
4. Passive and intermediate holding companies in turn present issues of their own. This is especially relevant given the introduction of headquarter companies as part the 'Gateway to Africa' initiative; and
5. Any future revisions of SARS *Interpretation Note 6* (2002) cannot eliminate the need for 'all the relevant facts to be examined' in determining a corporate entity's 'place of effective management'; nor can a 'definitive rule' or bright-line test be adopted.

7.2 Principles for Refinement

It is clear that SARS intends to preserve SARS *Interpretation Note 6* (2002). Revisions will be introduced without abandoning the general approach in SARS *Interpretation Note 6* (2002) (SARS, 2011, p.11).

These revisions will look to focus on the areas requiring improvement, following the criticism received on SARS *Interpretation Note 6* (2002). These areas can be summarised as follows:

1. The emphasis of the general approach as found under section 3.2 of the SARS *Interpretation Note 6* (2002, p.3);
2. The inconsistent terminology in section 3.2 and section 3.3, which respectively discuss the general approach and the practical application, of SARS *Interpretation Note 6* (2002, pp.3-4);
3. The inconsistent approach found in section 3.4 of the SARS *Interpretation Note 6* (2002, p.4); and
4. The lack of guidance provided for ‘passive or intermediate holding companies’.

7.2.1 Addressing: Emphasis of the general approach

According to SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.12), the general approach in SARS *Interpretation Note 6* would continue to focus on the ‘second level of management’ in a corporate entity. It would be clarified, that the primary emphasis is upon the highest level of management that ‘call the shots and exercise realistic positive management’. Typically, the function of these senior officers or executives would be as follows:

1. Develop the key operational or commercial strategies and policies;
2. Take decisions on the key operational or commercial actions;
3. Ensure that those strategies and policies are carried out.

The determination of a foreign operating subsidiary’s ‘place of effective management’ would not be influenced by where extraordinary decision making matters are concluded. These extraordinary decisions are those that are commonly reserved for a company’s board of directors. These decisions would generally not be considered the function of the ‘second level of management’. For example, major acquisitions, significant disposals, company mergers or new borrowing facilities would be considered beyond their usual scope and would typically be reserved for the board of directors.

Likewise, the day-to-day operational decision-making by junior and middle management, referred to as the 'third level of management', would also generally fall outside the 'second level of managements' usual scope. This would encompass routine administrative or support functions.

Perhaps, most importantly, in order to more closely align the approach taken in SARS *Interpretation Note 6* with the international norms and to provide further clarity between the so called 'second and third (operational) levels of management', references to the '"implementation" of strategy and policy would be deleted'.

SARS *Interpretation Note 6* would continue to take the approach that 'no definitive rules can be given and that all relevant facts and circumstances must be examined' when determining the 'place of effective management'.

7.2.2 Addressing: Inconsistent terminology

In order to address the criticism raised regarding the use of inconsistent terminology in SARS *Interpretation Note 6*, SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, pp.12-13) proposes that definitions would be provided for the basic terms found in SARS *Interpretation Note 6*. These defined basic terms would then be used throughout SARS *Interpretation Note 6*. The basic terms identified thus far are as follows:

- senior management;
- operational management;
- executive directors;
- non-executive directors;
- head office;
- base of operations; and
- passive holding company.

7.2.3 Addressing: Inconsistent approach

According to SARS *Discussion paper on Interpretation Note 6 place of effective management* (2011, p.13), it is proposed that the following changes be made to the relevant facts and circumstances as found in section 3.4 of SARS *Interpretation Note 6*:

- The deletion of any concepts which would be covered under the 'place of incorporation' test. Specifically any reference to legal factors, such as the place of incorporation, formation or establishment, the location of its registered office and public officer.
- A clarification of the reference to where controlling shareholders make key management and commercial decisions in relation to the company. In particular, the application of this factor would generally be limited to situations in which controlling shareholders in fact "call the shots" and/or the board of directors or similar body is not the true decision-maker. In particular, this factor would be relevant in determining the place of effective management of passive holding companies;
- The following notions would be included as factors to consider when determining a company's' 'place of effective management':
    - The delegation of authority by the board of directors, or a similar body, to another body or committee.
    - Consideration will be had of differing board structures.
    - The identification of various administrative activities and functions that will generally be given little weight when determining the 'place of effective management'.
    - Providing further clarity on the various levels of management identified and refining the distinctions between these levels of management.
    - Provide criteria to assist in determining the base of operations for senior management in situations where senior management travels frequently or operates from multiple locations.

7.2.4 Addressing: Lack of guidance for holding companies

Any revisions should provide sufficient guidance to address the legitimate concerns raised by potential investors in head quarter companies. The revisions should seek to relieve needless anxiety for holding companies with foreign operating subsidiaries which have bona fide foreign operations and local top level managers.

7.3 Changes to Interpretation Note 6: United Kingdom Considerations

As mentioned in Chapter 3, the factual basis of the 'central management and control' test greatly restricts the ability of HMRC to provide definitive guidance on residency issues. This is highlighted in the *Unit Construction Co Ltd* case (1959, p.729), 'the question where control and management abide must be treated as one of fact or actuality'. This emphasises that the place of 'central management and control' is wholly a question of fact. It follows that factors which together are decisive in one instance may individually carry little weight in another (HMRC, 2010f). The approach adopted by the United Kingdom is open to interpretation by the taxpayer and may result in uncertainty. This may increase the burden on both the judicial system, to resolve dual residency conflicts as they arise, and the tax authority, where competent authority may be required to determine residency.

Limitations exist with the term 'central management and control' as currently interpreted in the United Kingdom. These limitations have been noted in Chapters 5 and 6; whether the term 'central management and control' suitably addresses the current and future advances in technology. This is particularly relevant as a single place of management may not be identifiable where board members are located in various States.

7.4 Changes to Interpretation Note 6: OECD Limitations

As discussed in Chapter 1, the interpretation of the term 'place of effective management' as found under Article 4(3) of the OECD MTC (2014, p.26), varies from country to country due to the lack of common international meaning and insufficient guidance provided on how it should be interpreted. This has placed limitations on the 'place of effective management' test as an effective tie-breaker.

As commented by Maisto (2009, p.299), the most practical issue on the current interpretation of the term 'place of effective management', is 'what kind [and level] of management is referred to in that phrase'. There has never been any real agreement between States on this issue (Maisto, 2009, p.298).

7.5 ‘Place of Effective Management’ as a Tie-Breaker

It has been noted that there are clear limitations on the term ‘place of effective management’ as an effective tie-breaker test. These limitations originate on both a local level and at an international level. The ‘place of effective management’ test in its simplest form is to determine taxing rights where issues of dual-residency arise. Due to the limitations noted, the term does not fulfil its purpose and is in need of a review.

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