



University of the Witwatersrand, Johannesburg

WITS Research Report

Place of Effective Management - Who
calls the shots?

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Abstract

Where Contracting States to a Double Taxation Agreement (DTA) refer to their respective domestic law concepts in respect of determining residence for purposes of a DTA, conflicting results may arise which can lead to double taxation and Contracting States being denied treaty relief. The interpretation of the concept of 'Place of Effective Management' as found in the residency tie-breaker clause in Art 4(3) of DTAs (based on the OECD Model Tax Convention on Income and Capital) used to resolve issues of dual-resident companies for purposes of applying the DTA, provides a pertinent example of a need for a common international understanding of treaty terms in order to avoid such potential conflicts.

This paper explores how the term 'Place of Effective Management' should be interpreted in the above context by a South African court of law in order to conform to an internationally accepted meaning of the phrase.

Key words: 'place of effective management', 'resident', 'double taxation agreement', 'CMC', interpretation of statutes, interpretation note 6, OECD, central management and control.

Declaration

I hereby declare this research report to be my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Jaco Mynard Du Toit

31 March 2015

Dedication

This report is dedicated to my wife, Marisca, and my family who have supported me throughout my career. Without their encouragement this report would not have been possible.

With God all things are possible.

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1**List of abbreviations**

The following words, phrases and acronyms shall be construed in accordance with the meaning given hereunder, unless the context clearly dictates otherwise.

Art	article
CMC	Central management and control
Constitution	the Constitution of the Republic of South Africa, 1996
DTA(s)	Double Taxation Agreement(s)
HMRC	Her Majesty's Revenue and Customs (i.e. the UK Revenue Authority)
J(J)	Judge(s)
MTC	Model Tax Convention on Income and Capital
OECD	Organisation for Economic Cooperation and Development
para(s)	paragraph(s)
POEM	place of effective management
SARS	The South African Revenue Service
RSA/SA	Republic of South Africa
s(s)	section(s)
subsec(s)	subsection(s)
UK	United Kingdom
VCLT 1969	Vienna Convention on the Law of Treaties of 23 May 1969, which came into effect on 27 January 1980

In its Discussion Paper on Interpretation Note No. 6 “Place of Effective Management”, the Legal and Policy Division of the South African Revenue Service (‘SARS’) states that¹:

‘South Africa currently has DTAs with 70 other countries. Of those, 55 use place of effective management for the “tie-breaker” rule. Twelve leave disputes to be resolved by the competent authority through the mutual agreement procedure. The DTA with the United States looks to the place of incorporation of a company or other legal person, while the DTA with Iran looks to the location of the registered office of a company or other legal person. The DTA with Canada looks to the place of incorporation of a company....’ (own emphasis)

The term ‘place of effective management’ (‘POEM’) is a familiar concept both in a South African as well as an international context. The concept of POEM is used in South African domestic legislation as one of two tests to determine the tax residency of a company under the Income Tax Act 58 of 1962. Where a company has its POEM in the Republic, it will be deemed to be a resident for South African tax purposes, irrespective of where it is actually incorporated, established or formed and will be taxed accordingly.

In addition, the concept of POEM is also used as a tie-breaker rule in many double taxation agreements (‘DTAs’) concluded by South Africa with other countries, particularly where those DTAs are based on the Model Tax Convention on Income and Capital (‘MTC’) of the Organisation for Economic Cooperation and Development (‘OECD’).² Accordingly, where it has been established under the domestic law of the respective Contracting States (to the DTA) that dual residency of a legal person exists, POEM is utilised as the tie-breaker in order to determine in which Contracting State the legal person (e.g. a company) is resident for purposes of applying the provisions of the DTA.

It is strange then, to find that neither the Income Tax Act 1962, nor the OECD MTC provides a definition of the term ‘place of effective management’, and that uncertainty exists with regards to its interpretation both locally and internationally.

This research paper considers whether a South African court will take cognisance of the international meaning ascribed to POEM when interpreting this concept in local tax legislation as well as for purposes of interpreting a DTA. This question is addressed by virtue of an analysis of both South African and international principles of interpretation. A further analysis of the concept

¹ South African Revenue Service – Legal and Policy: Interpretation and Rulings (September 2011) ‘Discussion Paper on Interpretation Note No. 6 “Place of Effective Management”’, p2.

² Ibid.

of POEM in an international context (with specific regard to the United Kingdom) is performed in order to ascertain whether an internationally accepted meaning or interpretation can be ascribed to this concept – this includes an analysis of international case law dealing with the concept of POEM (or a concept similar thereto). Lastly, current South African guidance on the concept of POEM is analysed in order to glean from it whether a South African interpretation of the concept of POEM has been developed that is supported by South African case law and whether such a meaning is in harmony with the internationally accepted interpretation of POEM. Certain specific scenarios in respect of the practical application of the POEM of a company is also considered.

2.1 The residence basis of taxation in South Africa

Prior to 2001, the South African tax system was a sourced-based system (commonly referred to then as a 'source plus' basis of taxation). It was announced in the Budget Review³ that South Africa would adopt a residence basis of taxation (commonly referred to then as a 'residence minus' basis of taxation) with effect from years of assessment commencing on or after 1 January 2001. In a Briefing Note⁴ released by National Treasury and the South African Revenue Service (hereinafter 'SARS') regarding the residence basis of taxation to be adopted, the most important reasons for the change in the determination of the tax base were cited as follows⁵:

- to place the income tax system on a sounder footing thereby protecting the South African tax base from exploitation;
- to bring the South African tax system more in line with international tax principles;
- the relaxation of exchange control and the greater involvement of South African companies offshore;
- to more effectively cater for the taxation of e-commerce.

The aforementioned changes to the South African tax system apparently stemmed from the findings of the Katz Commission during 1997, where the different basis and principles of taxation were considered.⁶ Although the Katz Commission did not appear at this stage to support a change from the source-based taxation regime to a residence-based regime, the report did indicate that in order to re-integrate our economy into the international circuit, South African tax legislation should utilise concepts and terminology that is internationally recognisable in order to ensure clarity amongst our foreign trading partners.⁷

One such concept introduced and utilised in South African tax legislation is the concept of 'place of effective management' (referred to hereinafter as 'POEM'). The POEM concept is a familiar one in the realm of international tax legislation, especially in the context of Double Taxation

³ The Budget Speech, Trevor Manuel, Minister of Finance, Republic of South Africa (23 February 2000) at p19.

⁴ National Treasury and the South African Revenue Service, 15 September 2000: Briefing Note on the Residence Basis of Taxation.

⁵ Op cit note 2 at p1.

⁶ Katz Commission (7 March 1997) 'Basing the South African Income Tax system on the Source or Residence principle – Options and recommendations', *Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa*.

⁷ Op cit note 4 at para 3.1.5.

Agreements (referred to hereinafter as ‘DTAs’).⁸ In this regard the Katz Commission remarked as follows at paragraph 6.1.2.1 of the report:

‘The current definition of a domestic (read "resident") company is a company incorporated in South Africa, or a company "managed and controlled" in South Africa. The main criticism of this definition is that it has proven subject to relatively simple, formalistic manipulation. This concept is also out of line with the commonly used, and much more substantial, tax treaty expression of "effective management". The Commission recommends that the concept of effective management as referred to in Article 4(3) of the OECD Model Tax Convention be used consistently to designate the tax residence of persons other than natural persons. This may perhaps be best achieved through an appropriate definition in s 1 of the Income Tax Act. Again, the change will have the benefit of employing international and, therefore, commonly understood terminology.’

It appears from the above extract that the Katz Commission viewed the concept of POEM of a company as being different from where a company is ‘managed and controlled’.

In the following paragraphs, the relevance of the concept of POEM is discussed in South African tax legislation.

2.2 POEM in South African tax legislation

After adopting a residence-based taxation system in South Africa, certain key concepts in the Income Tax Act 58 of 1962 were amended in order to cater for and ensure implementation of the new tax regime. Amendments were specifically effected to the definitions of ‘gross income’ as well as ‘resident’ in the Income Tax Act 1962.⁹

The definition of ‘gross income’ in the Income Tax Act 1962¹⁰ currently provides that ‘residents’ are subject to South African income tax on the total amount of income received by or accrued to or in favour of that resident, in cash or otherwise. The Income Tax Act 1962 then continues to define the term ‘resident’ to mean the following in relation to a company¹¹:

‘(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,

⁸ The concept of DTA’s are discussed in more detail below.

⁹ Refer ss 2(c) and 2(h) of the Revenue Laws Amendments Act 59 of 2000.

¹⁰ Section 1 of the Income Tax Act 1962.

¹¹ Ibid.

...

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...' (own emphasis)

Whether a company is incorporated, established or formed in the Republic will depend on the factual circumstances and the relevant provisions of the Companies Act 71 of 2008 will need to be considered.¹² Where a company has its place of effective management in the Republic, it will be deemed to be a resident for South African tax purposes irrespective of where it is actually incorporated, established or formed and will be taxed accordingly. The Income Tax Act 1962 does not provide a definition for the term 'place of effective management', which term is also used elsewhere in the Income Tax Act 1962.¹³

The term POEM is however widely used as a tie-breaker rule in DTAs where it has been established in terms of domestic law of the contracting states that a company is tax resident in both contracting states and will therefore be subject to double taxation. Where such dual residency exist, the DTA usually contains a provision which provides that, in the case of persons other than individuals (e.g. companies), the taxpayer will be resident for purposes of the treaty in the country in which the taxpayer has its place of effective management.¹⁴

It has therefore been argued that although the term POEM, as used in the context of South African domestic legislation and that of the DTA, should prima facie bear the same meaning, the intention and purpose of the legislation in which it appears and the context thereof is not the same and therefore different meanings may be attributed to POEM in these contexts.¹⁵ Gutuza (2012:426) indicates that the above distinction is not supported by the Western Cape High Court in *Oceanic Trust Co Ltd NO v C: SARS* (2012) 74 SATC 1275 ('Oceanic Trust') and that the court did not

¹²A detailed analysis of the company law requirements are not discussed here, but according to s 13 of the Companies Act 71 of 2008, a company can be incorporated by completing and signing a Memorandum of Incorporation and by filing a Notice of Incorporation. Furthermore a foreign company, whose registration has been transferred to the Republic in terms of s 13, will also be considered to be incorporated in the Republic.

¹³ See e.g. s 1 definition of 'country of residence', s 10B, s 11 (gA), s 12R, s 28, s 41, s 44.

¹⁴ Olivier, L & Honiball, M (2011) *International Tax – A South African perspective* 5 ed. (Cape Town: Siber Ink CC) p25.

¹⁵ Gutuza, T 'Has recent United Kingdom case law affected the interplay between "Place of Effective Management" and "Controlled Foreign Companies"?' *South African Mercantile Law Journal* (2012) vol. 24, p. 426.

distinguish between different interpretations of POEM in the above contexts.¹⁶ This case is discussed in more detail below.

The above approach may create an anomaly in the sense that where Company A is incorporated in the USA, but deemed to have its POEM in South Africa, Company A may be considered to be tax resident in both countries under the application of domestic law. When applying the provisions of the DTA concluded between the USA and RSA for purposes of establishing tax residency for treaty purposes, the tie-breaker clause in the DTA may yield a different result in respect of the POEM of Company A in comparison to applying the domestic law concept of POEM.

This begs the question as to the weight and relevance that a South African Court would attribute to the interpretation of the term POEM in the context of DTAs versus the interpretation in a domestic law context and how these principles will be reconciled (where different results arise). This question is discussed below.

2.3 The status of DTAs in South African domestic legislation

2.3.1 The concept of a DTA

A DTA is defined to mean ‘an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation’.¹⁷ In his book, Vogel (1997:21) indicates that DTAs are international agreements, the creation and consequences whereof are determined in accordance to the rules contained in the Vienna Convention on the Law of Treaties of 23 May 1969 which came into effect on 27 January 1980 (hereinafter the ‘VCLT 1969’)¹⁸.

Vogel (1997:20) further indicates that tax treaty rules do not lead to the application of foreign law but rather limit the content and application of domestic tax law in respect of both the contracting states (i.e. both parties to the treaty)¹⁹. Vogel (1997:26 – 27) contends further that tax treaties do not choose between applicable domestic and foreign law, but recognizes that each contracting state will apply its own domestic law, which will in turn be limited by the treaty – as such the treaty establishes ‘boundaries’ on the domestic tax law.²⁰ The result is the limitation of certain

¹⁶ Ibid.

¹⁷ Vienna Convention on the Law of Treaties of 23 May 1969, Art 2, para 1(a). See also Schwarz, J (2002) *Tax Treaties: United Kingdom Law and Practice* (London: Sweet & Maxwell) at 1-02.

¹⁸ Vogel, K (1997) *Double Taxation Conventions* 3 ed. (United Kingdom: Kluwer Law International Ltd).

¹⁹ At para 24 – 26.

²⁰ At para 45a – 45c.

domestic provisions that would otherwise have applied, or obliging one or both of the contracting states to allow for tax credits against domestic tax payable where taxes have been paid in the other state.

In essence then, DTAs are express, binding agreements concluded between States, governed by public international law and are generally interpreted in accordance with the VCLT 1969.²¹ DTAs should, in theory, be able to prevent double taxation where contracting states have overlapping tax claims. It is important to note that DTAs themselves do not create tax claims which would not otherwise have existed under domestic tax law of the contracting states.²² DTAs merely aim to regulate existing tax claims that arise under domestic law. This is usually achieved in one of two ways:

- i. One contracting state waives its tax claim in favour of the other contracting state (the exemption method); or
- ii. One contracting state grants a credit against its local tax for tax paid in the other contracting state (the credit method).²³

2.3.2 DTAs in domestic legislation

According to Olivier & Honiball (2011:303), South African Law includes statute law, common law, international customary law and international law, which in turn are all subject to the Constitution of the Republic of South Africa, 1996 ('the Constitution'). DTAs form part of international law as they represent express agreements concluded between States. As DTAs constitute international agreements, their incorporation into South African legislation must comply with the requirements and formalities set out in s 231 of the Constitution. Section 231(4) provides that 'any international agreement becomes law in the Republic when it is enacted into law by national legislation'.

Accordingly, regard must be had to s 108 of the Income Tax Act 1962 which deals specifically with agreements entered into by the South African government with the government of other countries for, inter alia, the prevention of double taxation (i.e. DTAs). Section 108(2) of the Income Tax Act 1962 refers to s 231 of the Constitution and specifies that DTAs so concluded must be published in the Government Gazette and shall thereafter have the effect as if enacted in

²¹ Op cit note 12 at 302.

²² Danzinger, E (1991) *International Income Tax: The South African Perspective* (Durban: Butterworths) at p329, para 19.1.4.

²³ Op cit note 16 at p27, para 46.

the Income Tax Act 1962 (i.e. it will form part of domestic tax legislation and bear the same force as other sections of the Income Tax Act 1962).

In South Africa, DTAs do not become part of domestic legislation by way of specific adoption (i.e. by way of specific implementing legislation). DTAs are incorporated into domestic law in terms of the Constitution as set out above and rank equal to local legislation. DTAs may therefore also be overridden by local legislation, if specifically provided for.²⁴

2.3.3 Interpretation of DTAs

Tax treaties do not have special or privileged status in South African law.²⁵ Accordingly, where uncertainty arises as a result of interpretation of domestic law and treaty provisions which form part of domestic law, regard must be had to the relevant rules of interpretation as well as the Constitution. It should however be noted that where it is established that a conflict exists between domestic law and an international trade agreement, domestic law will prevail.²⁶

As stated above, DTAs are normally interpreted with regard to the VCLT 1969. Articles 31 – 33 of the VCLT 1969 sets out the rules of interpretation in respect of DTAs. These rules are very general and Vogel (1997:39) is of the view that contracting states should aim for a common interpretation that would be acceptable in both states. The ordinary meaning of concepts forming part of ‘international tax language’²⁷ should be ascertained ‘in light of its object and purpose’²⁸. Vogel (1997:37) further contends that the purpose of the treaty should be evaluated objectively as a whole and that the intention of the parties is only relevant in as far as it has been expressed in the text of the relevant DTA.²⁹

²⁴ Olivier & Honiball (2011) at p304. See also Silke on International Tax, §12.7.2.

²⁵ Olivier & Honiball (2011) at p303.

²⁶ *AM Moola Group Ltd v C:SARS* (2003) 65 SATC 414 at p419. According to Brincker in chapter 12 of Olivier *et al* (2003) *International Tax: A South African Perspective* (Cape Town: Siber Ink CC) at §12.7.6, the judgment in *Moola* ‘departs radically from the accepted international interpretation of DTAs’.

²⁷ This phrase was used by the Australian Court in *Thiel v Federal Commissioner of Taxation* 21 ATR 531, 537 (1990) and seems to indicate that when interpreting a DTA, it is not the normal ordinary or everyday meaning/use of the term that must be ascertained, but that the wording of the DTA must be considered in light of a uniform, international meaning that may have developed or that can be ascribed to a specific term in the DTA.

²⁸ Art 31(1) of the VCLT 1969.

²⁹ At para 68 – 72a.

It has been argued that the VCLT 1969 merely codifies customary international law to a large extent.³⁰ Section 232 of the Constitution provides that ‘customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament’. It stands to argue that the principles of interpretation set out in the VCLT 1969 will have to be considered by South African courts when interpreting DTAs, especially where the meaning of a provision in a DTA is unclear or not defined (e.g. in the case of undefined terms used in the DTA, such as ‘POEM’).³¹

Section 233 of the Constitution provides that ‘when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law’. This approach is supported by case law, such as *South Atlantic Development Corporation Ltd v Buchan* 1971 (1) SA 234 (C) where Diemont J stated the following at p207 of his judgement:

‘Although I am surprised that there is no decision in which a South African Court has expressly asserted that international law forms part of our law, I would be even more surprised if there were a decision asserting the contrary. It appears to have been accepted in both the English and the American Courts that international law forms part of their own law.... And there are also one or two indications in decisions in our Courts that judicial notice will be taken of international law.’

When considering the wording of s 108 of the Income Tax Act 58 of 1962, it is clear that DTAs are entered into primarily for the prevention, mitigation or discontinuance of tax being levied by two States in respect of the same income, profits or gains (i.e. to prevent economic and juridical double taxation). Accordingly, domestic legislation that is inconsistent with the purposes of this legislation, should be subordinated to the provisions of the DTA, else the wording of s 108 of the Income Tax Act 58 of 1962 would be meaningless.³² In this regard, it was held in an Australian court case that DTAs are unique international agreements because they confer rights and obligations not just on the Contracting States to the DTA, but also on the taxpayers of the Contracting States and therefore must override domestic legislation.³³

³⁰ Olivier & Honiball (2011) at p302; Schwarz (2002) at p58, 3-30. See also *Fothergill v Monarch Airlines* 3 WLR 209, 218; [1981] A.C. 251, HL at 224. Refer also *Ben Nevis (holdings) Ltd and another v Revenue and Customs Commissioners* [2013] STC 1579; [2013] EWCA Civ 578 at para 17.

³¹ Olivier & Honiball (2011) at p308 states that although South Africa is not a signatory to the VCLT, South African Courts will still be guided by it in treaty interpretation.

³² Olivier and Honiball (2011) at p306 also cites the Australian case of *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR338 which provides support for the contention that international rules of interpretation must prevail over domestic rules where conflict between the two arises in the case of interpretation of DTA's.

³³ *Lamesa Holdings BV* 1997 35 ATR 239, 97 ATC 4229.

Further support for the above position has been provided by South African courts. In the tax court, albeit under the old constitutional dispensation, in ITC 1544 (54 SATC 456) at p460 it was held that:³⁴

‘The terms of a double tax Convention on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby.’

In *Secretary for Inland Revenue v Downing* 37 SATC 249³⁵ at p255, Corbett, JA held that:

‘The effect of proclamation is that, as long as the convention is in operation, its provisions, so far as they relate to immunity, exemption or relief in respect of income tax in the Republic, have effect as if enacted in Act 58 of 1962.’

More recently in the *Commissioner for South African Revenue Service v Tradehold Ltd* [2012] 3 All SA 15 (SCA) at para 17 – 18, the following was stated in respect of the interpretation of DTAs:

‘Double tax agreements effectively allocate taxing rights between the contracting states where broadly similar taxes are involved in both countries. They achieve the objective of s 108, generally, by stating in which contracting state taxes of a particular kind may be levied or that such taxes shall be taxable only in a particular contracting state or, in some cases, by stating that a particular contracting state may not impose the tax in specified circumstances. A double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict...In interpreting its provisions one must therefore not expect to find an exact correlation between the wording in the DTA and that used in the domestic taxing statute...Inevitably, they use wording of a wide nature, intended to encompass the various taxes generally found in the OECD member countries.’ (own emphasis)

Danzinger (1991:328) makes the comment that DTAs generally contain a clause stating that where a term is not defined in the DTA itself, that term will be interpreted in accordance with the meaning ascribed to it under domestic law, unless the context clearly indicates otherwise.³⁶

³⁴ According to Olivier & Honiball (2011) at p304 – 305, the interpretative relevance of such statements are uncertain as it does not form part of South African common or customary law. The authors also note that tax court judgments do not carry a precedent value in South Africa.

³⁵ Also cited as 1975(4) SA 518(A).

³⁶ Op cit note 20 at para 19.1.3. Also refer ITC 789; 19 SATC 434 (1954) and *Baldwins (South Africa) Ltd v CIR* 1961 3 SA 843 (A).

As domestic rules on interpretation differs from one jurisdiction to the next, the status quo appears to be that various countries have adopted the approach to interpreting DTAs in a manner that is consistent with views supported by other contracting states and will consider foreign case law to the extent that local courts would have taken notice of and considered comparable local case law on a specific subject. Vogel (1997:39 – 41) provides numerous examples of countries such as New Zealand, Australia, USA, Canada, Norway, the UK and Germany where the courts have applied comparative measures in order to interpret the meaning of international agreements.³⁷

It appears then that when interpreting the provisions of a DTA, international precedent dictates that a court should not be bound or constrained by its domestic rules or precedent, but should follow principles that are generally accepted by the international community. Olivier and Honiball (2011:310) refers to the various positions adopted in the UK, Australia and Canada from which it appears that there is a tendency towards following a purposive approach (as opposed to a strict or literal approach) to interpretation of a DTA, that regard must be had to the VCLT and that supplementary means (such as foreign case law) will definitely influence the decisions of local courts. The above also indicates that international guidance, such as the OECD MTC, will be instrumental in formulating a proper interpretation of a DTA that is endorsed by the international community.

2.4 Domestic rules of interpretation of fiscal legislation

Certain general rules of interpretation have been developed in South Africa through a plethora of case law, specifically in respect of the interpretation of domestic law. It stands to argue that, following the discussion above, these domestic rules may be of less relevance when it comes to the interpretation of DTAs. However, as the concept of POEM is not defined in DTAs and because DTAs become part of South African domestic legislation under section 108 of the Income Tax Act 1962, regard must be had to the relevant local principles of interpretation – these are briefly set out below.³⁸

³⁷ At para 74a – 77.

³⁸ In ITC 1544 44 SATC 456 at p460 it was held that ‘the terms of a double tax convention on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby....’

The strict and literal approach

Initially, South African courts followed a strict and literal approach in respect of tax legislation. This was largely as a result of case law, such as the English case of *Cape Brandy Syndicate v IRC* 1921 (1) KB 64, where Rowlatt, J indicated at page 71 that:

‘...in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.’³⁹

However, in *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975 (4) SA 715 (A) at 727F–728A, Botha, JA made the following comment:

‘Indeed I do not think that the rule as stated in the *Cape Brandy Syndicate* case, supra, is any different from that applicable in the interpretation of all legislation. However that may be, it is clear from the remarks of Wessels CJ, in the *Delfos* case (supra) that even in the interpretation of fiscal legislation the true intention of the Legislature is of paramount importance, and, I should say, decisive.’

The ‘Golden rule’ of interpretation

The ‘golden rule’ of interpretation, possibly the most important, was arguably first laid down in South African law in *Venter v R* 1907 TS 910 at 913, where Innes, J stated that the aim of interpretation is:

‘to ascertain the intention which the legislature meant to express from the language which it employed. By far the most important rule to guide courts in arriving at that intention is to take the language of the instrument, or of the relevant portion of the instrument as a whole; and, when the words are clear and unambiguous, to place upon them their grammatical construction and to give them their ordinary effect.’⁴⁰

De Ville (2000:95) goes on to state that the origin of the rule arguably goes back to a dictum found in a judgement by Lord Wensleydale in *Grey and Others v Pearson and Others* [1843-1860] All ER Rep 21 (HL) at 36, where the following is stated:

‘The grammatical and ordinary sense of the words is to be adhered to, unless that would lead to some absurdity, or some repugnance or inconsistency with the rest of the instrument, in

³⁹ See in this regard Goldswain, GK (2008) ‘The purposive approach to the interpretation of fiscal legislation – the winds of change’, *Meditari Accountancy Research*, vol. 16, no. 2, pp108-109.

⁴⁰ De Ville, JR (2000) *Constitutional and Statutory Interpretation* at p51 and p94.

which case the grammatical or ordinary sense of the words may be modified, so as to avoid the absurdity and inconsistency, but no farther.’

In *New Union Goldfields Ltd v Commissioner for Inland Revenue* (1950) 3 All SA 310 (A)⁴¹, van der Heever, JA at p317 – 318 confirmed again the ‘golden rule’:

‘The intention of Parliament must of course be sought primarily in the words it used, and if these are clear and unambiguous, interpretation becomes superfluous. It has often been said that unless one is virtually compelled to do so the words used by Parliament should be read in the light of their ordinary and natural sense; and in a taxing statute there is perhaps less justification than in other measures for departing from that sense.’

After the introduction of the Constitutional dispensation in South Africa, the approach to interpreting legislation also had to undergo a change. This was evident from the judgment of Froneman, J in *Matiso and Others v The Commanding Officer, Port Elizabeth Prison and Others* 1994 (3) BCLR 80 (SE)⁴² at p87:

‘The interpretative notion of ascertaining “the intention of the legislature” does not apply in a system of judicial review based on the supremacy of the Constitution, for the simple reason that the Constitution is sovereign and not the legislature. This means that both the purpose and method of statutory interpretation in our law should be different from what it was before the commencement of the Constitution on 27 April 1994. The purpose now is to test legislation and administrative action against the values and principles imposed by the Constitution. This purpose necessarily has an impact on the manner in which both the Constitution itself and a particular piece of legislation said to be in conflict with it, should be interpreted. The interpretation of the Constitution will be directed at ascertaining the foundational values inherent to the Constitution, whilst the interpretation of the particular legislation will be directed at ascertaining whether that legislation is capable of an interpretation which conforms with the fundamental values or principles of the Constitution. Constitutional interpretation in this sense is thus primarily concerned with the recognition and application of constitutional values and not with a search to find the literal meaning of statutes.’

More recently, in *Ngcobo and Others v Salimba CC; Ngcobo v van Rensburg* 1999 (8) BCLR 855 (SC)⁴³ at p866, para 11, Olivier JA stated that there would have to be ‘compelling reasons why the words used by the legislature should be replaced’, that ‘the words should be given their

⁴¹ Also cited as 1950 (3) SA 392 AD; 17 SATC 1.

⁴² Also cited as 1994 (4) SA 592 (SE) 597.

⁴³ Also cited as 1999 (2) SA 1057 (SCA).

ordinary meaning...unless the context shows or furnishes very strong grounds for presuming that the legislature really intended that the word not used is the correct one' and that 'such grounds will include that if we give...their natural meaning, the interpretation of the section under discussion will be *unreasonable*, *inconsistent* or *unjust*...or that the result will be *absurd*... or, I would add, *unconstitutional* or *contrary to the spirit, purport and objects of the Bill of Rights*'.

Courts will however have to be careful and considerate in the use the Constitution as an overarching measure to interpret all statutes, where such an interpretation is not possible on the wording used by the legislator, as the Constitution itself is a statute.⁴⁴

Therefore, when interpreting the provisions of a statute, the golden rule of interpretation is to ascertain the intention of the legislator. The intention of the legislator is primarily to be sought in the language he chose to use. This is established by having regard to the words used in the statute and giving such words, unless specifically defined, their ordinary grammatical meaning. Thus, where the language is both clear and intended, it must be applied as such. It is only where the literal meaning of the words employed would lead to absurdities or anomalies that such meaning would not be applied and other interpretative tools would be used to determine the intention of the legislator. Guidance to the intention of the legislator would also be considered in terms of the wording employed within the relevant section of the Act, and failing that, in terms of the Act as a whole.

The golden rule therefore requires that, in order to ascertain the intention of the legislature, words in a statute must be given their 'ordinary, literal and grammatical meaning'.⁴⁵ However, in light of the supremacy of the Constitution, the wording of the statute will have to be interpreted to conform to the values and principles of the Constitution.

⁴⁴ Refer to the case of Standard Bank Investment Corporation v The Competition Commission and others [2000] 2 All SA 245 (A) at p253 where a passage by Kentridge, AJ in S v Zuma and others 1995 (2) SA 642 (CC) at 652I–653B is quoted with approval, implying that the Constitution and its underlying values cannot be used by the Court to simply ignore the words actually used by the legislator in the statute.

⁴⁵ Olivier & Honiball (2011) at p96.

The purposive approach

Case law also indicates that statutes have to be interpreted in light of the purpose of the statute.⁴⁶ The purpose assists in ascertaining the intention of the legislature.⁴⁷ It can therefore be argued that the purposive approach is but an extension of the ‘golden rule’ discussed above. This approach is mostly utilised where the meaning of a statute is uncertain, obscure or ambiguous and the courts have been hesitant to utilise this approach in instances where the language used in a statute is apparently clear.⁴⁸

The mischief rule

In order to determine the true intention of the legislature and the purpose of the legislation, the courts sometime make use of the ‘mischief rule’.⁴⁹ This rule was, inter alia, set out in *Hleka v Johannesburg City Council* 1949 2 All SA 71 (A) at p79 by Van den Heever, JA as follows:

‘To arrive at the real meaning we have...to consider, (1) what was the law before the measure was passed; (2) what was the mischief or defect for which the law had not provided; (3) what remedy the Legislator had appointed; and (4) the reason of the remedy.’

Accordingly, the court will prefer to give meaning to a statute that prevents the mischief that the legislator identified and aimed to rectify.

The use of dictionaries

Dictionaries are often used in the interpretation of legislation. South African Courts have indicated that dictionaries are a helpful aid in interpretation and may be a useful point of departure, especially where words in a statute are not defined. Dictionaries can assist in establishing the ordinary meaning of words, but regard must be had to the context in which it appears and in

⁴⁶ Op cit note 33 at p244. See also *Dadoo Ltd and others v Krugersdorp Municipal Council* 1920 AD 530 and the judgment by Innes, CJ at p543 where it was emphasised that the court does have the ability to deviate from a literal interpretation in certain instances when interpreting a statute, but that the court does not have the power to legislate and must therefore respect the wording of the statute. This approach is supported by the judgment of Schreiner, JA in *Jaga v Dönges NO and another* 1950 (4) SA 653 (A) at 664E–H.

⁴⁷ Op cit note 33 at p246.

⁴⁸ See in this regard Goldswain (2008:115) where reference is made to *Public Carriers Association and Others v Toll Road Concessionaries (Pty) Ltd and Others* 1990 (1) SA 925 (A) at p943 where Smallberger, JA expressed the opinion that there was only room for the purposive approach in cases where there is ambiguity.

⁴⁹ Op cit note 33 at p247. Support for the ‘mischief rule’ can also be found in *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975 (4) SA 715 (A) at 727F–728A.

certain instances, the dictionary meaning of a word may add little value in establishing the actual intention of the legislature or the meaning of legislation.⁵⁰

Developments in recent case law

In more recent case law, the South African Supreme Court of Appeal in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 2 All SA 262 (SCA), the Court explained the principles of statutory interpretation at paras 18 – 26 and stated the following in respect of the ‘emerging trend in statutory construction’⁵¹:

‘The present state of the law can be expressed as follows. Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation. In a contractual context it is to make a contract for the parties other than the one they in fact made. The “inevitable point of departure is the language of the provision itself”, read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.’⁵²

2.5 Conclusion

It is clear then that the concept of POEM is an important one, as it is used both in South African domestic tax legislation as well as in DTAs. As the Income Tax Act 1962 does not define the concept of POEM and no definition can be found in the DTAs, guidance would need to be sought

⁵⁰ Op cit note 33 at p100. See also the cases referred there such as *Fundstrust (Pty) Ltd (In Liquidation) v Van Deventer* 1997 (1) SA 710 (A) at 726 – 727.

⁵¹ Refer para 19 of the judgment.

⁵² Refer para 18 of the judgment.

as to the correct interpretation of this concept. There are various sources from which guidance can be obtained, both locally and internationally and South African courts will have regard to all relevant material when interpreting the concept of POEM in a DTA. Accordingly, these sources and their contributions to the meaning of the term 'POEM' are discussed below.

It is important to note that section (b) of the definition of 'resident' is also applicable to other legal entities such as close corporations and trusts. As the internal structure, operation and management of each of these legal entities differ, this may impact on the determination of the POEM of each entity and accordingly the discussion that follows will mainly focus on the interpretation of POEM as it relates to companies.

3 The international interpretation of POEM

3.1 Introduction

There appears to be various meanings attached to the term POEM as used in the DTA context.⁵³ The most common phrases which is equated with POEM can be summarised as follows:

- The place where the board of directors meet;
- The place where senior management operates; or
- The place where 'CMC' is exercised.

However, these phrases all have different meanings and may lead to varying results when applied in practice. The question therefore arises as to which meaning is most widely accepted by the international community and member (as well as non-member) states of the OECD. The value of the OECD MTC and Commentaries are discussed below in order to ascertain whether the meaning and interpretation of POEM can be construed therefrom.

3.2 The OECD Model Tax Convention and Commentary

The commentary to the OECD MTC is not intended to form part of any DTA, but is drafted and agreed to by experts and great weight is attached to the commentary as an interpretative tool in order to ascertain the true meaning and practical application of the provisions of the OECD MTC.⁵⁴ OECD member countries will also sometimes indicate observations to the Commentaries in respect of certain articles of the MTC in order to indicate and clarify how these articles will be interpreted in their respective jurisdictions. In certain instances, the OECD member countries have indicated reservations to the articles of the MTC which is also noted in the Commentaries.⁵⁵ Various changes or additions to the Commentaries have been made since 1977 and these changes would normally apply retrospectively to conventions concluded prior to these changes being adopted, as the general consensus is that these changes to the Commentaries merely reflect the proper interpretation of the member states of existing provisions/articles of the MTC.⁵⁶

⁵³ Olivier & Honiball (2011) at p37.

⁵⁴ The OECD MTC 2014, para 28 – 30.

⁵⁵ The OECD MTC 2014, para 31 – 32.

⁵⁶ The OECD MTC 2014, para 35.

Vogel (1997:43) states that the OECD MTC and Commentary is an important source when it comes to the interpretation of a DTA as it gives courts the ability to find a common international interpretation.

South Africa is not a member state of the OECD, but has observer status. South African tax treaties are however largely based on the OECD Model Tax Convention on Income and Capital (hereinafter the OECD MTC). Accordingly, the OECD MTC should at least have persuasive influence when it comes to the interpretation of DTAs concluded by South Africa.⁵⁷

Olivier (2011:312) is of the view that the OECD MTC Commentary forms part of South African customary international law by virtue of its acceptance in South African case law and its general use in the interpretation of DTAs. There is also support for the contention that the OECD Commentary is a supplementary means of interpretation under art 32 of the VCLT and accordingly South African courts will utilise this to confirm the ordinary meaning of a term, where the meaning of a term is ambiguous, obscure, absurd or unreasonable under the primary rules contained in art 31 of the VCLT.⁵⁸ Oguttu (2008:102) references the case of CIR v Downing (1975) 37 SATC 249 where the court held that South Africa is bound to take cognisance of interpretational guidelines laid down by the OECD in its model commentary in respect of the OECD MTC.⁵⁹

Schwarz (2002:59) is of the view that, with specific reference to the interpretation of DTAs in the UK, the Commentary to the OECD MTC 'has found a favored position as an aid to interpretation by the courts'.⁶⁰ However, he also indicates that the courts have not yet established when the Commentary must be utilised and what its place in the hierarchy of interpretative rules is. As the Commentary is regularly updated, it is also unclear what the position is with respect to DTAs that were concluded prior to the updates to the Commentary.

In the UK, case law has crystalised certain principles in respect of the interpretation of DTAs, which includes, inter alia, that a strict literal approach is not appropriate and that a purposive approach, unrestrained by English domestic law or precedent should rather be adopted, especially where ambiguity may arise; further that the approach should be international and not exclusively English as the DTA is addressed to an international audience; that regard should be had to the

⁵⁷ Olivier et al (2003) at §12.11.2.

⁵⁸ Olivier & Honiball (2011) at p312. The OECD MTC Commentary can therefore arguably not be used as a primary source of interpretation.

⁵⁹ Oguttu, AW (2008) 'Resolving double taxation: the concept "place of effective management" analysed from a South African perspective', *Comparative and International Law Journal of South Africa*, vol. 41, pp. 80-104.

⁶⁰ At para 3-32.

VCLT, especially art 31(1) and that the real intention of the parties must be ascertained from the language used in the DTA; that, in accordance with the principles set out in art 32 of the VCLT, subsequent commentary on a convention as well as the decisions of foreign courts will only have persuasive value and that consideration of international case law is discretionary, not mandatory, and will usually be resorted to only when the other principles leave the meaning of the relevant provision unclear or ambiguous.⁶¹

3.3 OECD Commentary on Article 4 of the OECD Model Tax Convention

Article 4 of the OECD MTC deals with establishing residency of a contracting state for purposes of applying the treaty between the two contracting states. Article 4(1) establishes the definition of ‘resident’ and article 4(3) sets out the tie-breaker test where dual residency exists. These sections read as follow:

‘Article 4 - Resident

1. For the purposes of this Convention, the 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, and also includes that State and any political subdivision or local authority thereof. 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. ...
3. Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.⁶² [*own emphasis added*]

At this stage, it is important to also note the provisions of article 3(2) of the MTC, which reads as follow:

‘Article 3 – General Definitions

1. ...

⁶¹ Refer Schwarz (2002:45-47) as well as the Fothergill case supra, IRC v Commerzbank AG [1990] STC 285 at 297-298 and Memec plc v IRC [1998] STC 754 at 766g. More recently, these principles were again cited with approval in the Ben Nevis supra at para 16.

⁶² The OECD MTC 2014.

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.’⁶³

Article 3 deals with terms that are not defined in the MTC and consequently states that the contracting state can ascertain the meaning with reference to any domestic law (whether tax related or otherwise).⁶⁴

In order to enjoy benefits under a DTA, a contracting state must be a ‘resident’ of such state (for tax purposes) and must in addition be liable (i.e. subject) to tax in such state. The wording of art 4(1) clearly makes reference to the domestic law of the contracting state in order to determine the aforementioned.⁶⁵ It is further clear that art 4(1) does not apply to a person who is liable to tax in a contracting state solely because of the fact that the person derives income from a source within that state.⁶⁶

It is important to note that residency for South African domestic law purposes is an annual event, whereas residency for treaty purposes is determined on a day-to-day basis.⁶⁷ Furthermore, when a taxpayer is deemed to be a resident of another Contracting State for purposes of a DTA, that taxpayer is exclusively regarded as a resident of that other Contracting State and is not regarded as a South African tax resident any longer.⁶⁸

⁶³ The OECD MTC 2014.

⁶⁴ The OECD MTC 2014: Commentary on article 3, para 13.1.

⁶⁵ Silke on International Tax, §17.5.2 discuss certain observations on art 4(1) of the OECD MTC and references an article by Philip Baker where reasons are provided why the term ‘resident’ for treaty purposes is not merely defined to have the same meaning as the domestic law concept of ‘resident’. It is indicated that this would have been the natural result under art 3(2) of the OECD MTC.

⁶⁶ Baker, P (2002) Double Taxation Conventions – A manual on the OECD Model Tax Convention on Income and Capital (London: Sweet & Maxwell Tax Library, Thomson Reuters), para 4B.01. See also Silke on International Tax, §17.5.2 where it is stated that ‘where a person is not subject to as comprehensive a tax liability as is imposed in the state, that person will not be regarded as a ‘resident’ for purposes of the treaty’.

⁶⁷ Olivier & Honiball (2011) at p31. For purposes of the DTA, a taxpayer may therefore be resident for part of the year in different Contracting States.

⁶⁸ Olivier & Honiball (2011) at p33. See also the definition of ‘resident’ in s1 of the Income Tax Act 1962 and the discussion below in respect of the 2008 Updates to the OECD MTC. Baker (2002: 4B.02) states that a company does not automatically cease to be a resident of a Contracting State in terms of its domestic law, merely because the application of the provisions of a DTA has deemed that company to be a resident of the other Contracting State. However, certain countries (e.g. the UK) have provided specifically in their domestic law that, where a company is

Where it is determined under art 4(1) that a person other than an individual (i.e. a company, trust, partnership etc.) is a resident of both contracting states, after applying the domestic law of both contracting states, regard must be had to art 4(3) which contains the so-called tie-breaker test in the case of dual residency. Art 4(3) then proposes the POEM as a tie-break test for determining residency of a Contracting State, for purposes of the DTA. Various problems arise as a result of the POEM test:

- i. First, as there is no definition in the OECD MTC of the term ‘POEM’, uncertainty exist as to the meaning thereof in an international context. However, various sources (such as the Commentary to the OECD MTC) exist that provide guidance in order to establish an internationally accepted meaning of the term POEM. This is discussed in further detail below.
- ii. The POEM test is also used under South African domestic law as one of the criteria to qualify as a ‘tax resident’, but the term POEM is not defined under domestic tax law and the meaning thereof is not clear.⁶⁹ The interpretation of POEM in the South African context is discussed in the following chapters below.
- iii. As referred to above in article 3(2) of the OECD MTC, the term POEM may be defined in the domestic law of both contracting states and ascribed a domestically accepted meaning which does not necessarily accord with the generally recognized international tax principles – this may lead to the tie-breaker clause in art 4(3) being ineffective and not yielding a result, or resulting in double taxation.⁷⁰
- iv. Not all DTAs entered into by South Africa uses the POEM as a tie-breaker clause in the DTA.⁷¹

a resident of another state for the purposes of a DTA, that company will accordingly be treated as non-resident for purposes of domestic law of that state.

⁶⁹ Refer the definition of ‘resident’ in s 1 of the Income Tax Act 1962.

⁷⁰ Olivier (2011:39) states that there is no authority for the popularly supported view that the interpretation in accordance with the domestic law of the ‘State of source’ will override its counterpart definition in the domestic laws of the ‘State of residence’.

⁷¹ Olivier & Honiball (2011) at p37. The RSA/USA DTA utilizes the place of incorporation as a tie-breaker and in terms of the RSA/Canada DTA, the competent authorities will settle the question.

3.3.1 The OECD MTC Commentary of 2014

A new updated version of the OECD MTC Commentary has recently been published and was released on 15 July 2014 ('the 2014 Commentary'). There has been no noteworthy changes when compared to the 2010 Commentary in respect of the interpretation of POEM.

The main Commentary on art 4(3) can be found in paras 21 – 24 of the Commentary. The Commentary states that problems usually arise where the Contracting States attach weight to different factors under domestic law in order to determine residency (e.g. residency or incorporation of the taxpayer versus its place of management). Accordingly, it was decided to utilise the concept of POEM as decisive factor in such cases where a conflict arises under art 4(1), as it would be more difficult to manipulate this concept to obtain artificial residency.

Para 24 of the Commentary currently states that POEM '...is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.' [*own emphasis added*]

Para 24.1 further states that certain countries are of the view that cases of dual residency are rare and should accordingly be dealt with on a case by case basis, rather than formulating a specific rule to try and cater for this situation. Either way, it is acknowledged that the POEM test is still a problematic aspect to deal with in the context of the DTA, especially given the developments in new technology and methods of communication by the management, board of directors and even shareholders of big multinational companies. The Commentary recommends further that in these situations where contracting states want to leave the decision of POEM up to the competent authorities to settle, the contracting states should replace the provisions of their DTA with an enabling provision for determining residency by mutual agreement. It is recommended that these factors should be listed to enhance certainty for the taxpayer as to how these provisions will be applied. The factors that can be taken into account are not limited and can include⁷²:

- place of effective management of the taxpayer;
- the place where the taxpayer is incorporated or otherwise constituted;
- where the meetings of the taxpayer's board of directors or equivalent body are usually held;
- where the chief executive officer and other senior executives usually carry on their activities;

⁷² The OECD MTC 2014: Commentary on article 4, para 24.1.

- where the senior day-to-day management of the taxpayer is carried on;
- where the taxpayer's headquarters are located;
- which country's laws govern the legal status of the taxpayer;
- where the taxpayer's accounting records are kept;
- whether allocating treaty benefits to one of the Contracting States carry the risk of an improper use of the provisions of the Convention (i.e. abuse of the treaty).

According to the Observations on the Commentary on article 4, Italy supports the view that the place where the main and substantial activity of the company is carried on should also be counted as a determining factor.⁷³ France is of the view that the POEM as expressed in para 24 above 'will generally correspond to the place where the person or group of persons who exercises the most senior functions (for example a board of directors or management board) makes its decisions. It is the place where the organs of direction, management and control are, in fact, mainly located.'⁷⁴ According to paras 28 – 31 of the Reservations to the Commentary, Japan and Korea utilises the term 'head or main office' in their DTAs, instead of 'POEM', while Turkey reserves its right to use 'registered head office' and the USA similarly utilises 'place of incorporation' as alternative tests to determine residency. In certain instances, these countries will deny treaty benefits to dual resident countries.

3.3.2 The development of the Commentary to date

Since its introduction in 1977, there has been various changes and updates to the Commentary on POEM, as well as separate OECD publications on this subject that showcases different schools of thought on this subject. However, prior to the year 2000, the Commentary provided very little guidance in respect of the meaning of what constituted effective management.⁷⁵

In order to establish a practical interpretation of POEM, it is necessary to consider the proposed changes, the reasoning behind such changes and the subsequent acceptance or rejection thereof in the final Commentaries. The salient changes and developments of the relevant Commentary is discussed below.

⁷³ The OECD MTC 2014: Observations on the Commentary on article 4, para 25.

⁷⁴ The OECD MTC 2014: Observations on the Commentary on article 4, para 26.3.

⁷⁵ Baker (2002:4B.16).

3.3.2.1 *The OECD MTC Commentary of 2000*

Para 24 of the Commentary was amended in the year 2000 to provide more clarity on the interpretation of POEM and an additional statement was added that ‘The place of effective management will ordinarily take place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where actions to be taken by the enterprise as a whole are determined; however, no definite rule can be given and all relevant facts and circumstances must be examined...’.⁷⁶ [own emphasis added]

It was clear that the focus for determining effective management was at the top level of management of the company. Emphasis was also placed on the operations of the enterprise as a whole, i.e. the whole business would need to be considered, together with its activities, in order to establish the POEM. It appears further from the above that the decisive factor is where such decisions and management directives are given, and not necessarily where the decisions take effect. Vogel (1997:262) states that the place from which the business operations are merely supervised will not suffice and that the place of actual ‘commercial management’ will prove to be decisive.

Furthermore, paras 8.1 to 8.4 was added to the Commentary in order to provide clarification on the meaning of art 4(1) of the OECD MTC.⁷⁷

3.3.2.2 *The OECD TAG Discussion Paper of 2001*

During February 2001, the OECD Technical Advisory Group (‘TAG’) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits released a discussion paper titled ‘The Impact of the Communications Revolution on the application of “Place of Effective Management” as a tie breaker rule’ (‘the OECD TAG Discussion Paper 2001’).⁷⁸

The discussion paper emphasises that determining POEM is a question of fact.⁷⁹ As stated above, there is no definition for POEM anywhere in the DTA, notwithstanding the fact that the concept is used in various articles throughout the DTA and accordingly guidance has been sought from domestic tax law concepts in respect of residency such as ‘CMC’ and ‘place of management’.⁸⁰

⁷⁶ The OECD MTC 2000: Commentary on article 4, para 24.

⁷⁷ Baker (2002:4B.04).

⁷⁸ See also Olivier & Honiball (2011:40) for a discussion of the salient points in respect hereof.

⁷⁹ The OECD TAG Discussion Paper 2001, para 13.

⁸⁰ The OECD TAG Discussion Paper 2001, para 16.

Guidance from CMC

Countries such as the UK, Canada and Australia uses the concept of CMC in their domestic legislation in order to determine residency for non-individuals.

However, CMC is not a defined concept in the domestic law of these jurisdictions and the meaning has historically been explored in case law, which is discussed in further detail in para 4.2 below. Certain factors have however been crystallised that can provide guidance on the concept of POEM:⁸¹

- Determining CMC is a question of fact, but usually coincides with the place where the directors of the company exercise their power and authority (i.e. generally where the directors meet);
- Place of incorporation, registered/public office of the company or place of residence of shareholders (e.g. parent company) and directors (arguably to the extent that they are responsible for managing the business);
- Place where the business operations or financial dealings of the company take place;
- Where the minute books, financial records or books of account of the company are kept;
- Where important policy and strategic business decisions are taken;
- The nature of the business operations and whether it can be managed and controlled from a location different from where the actual activities are conducted; and
- Powers granted in terms of the Memorandum of Incorporation ('MOI') or Articles of Association of the company to its directors in respect of exercising control of the company and whether these powers are in fact exercised by the nominated individuals and the degree of autonomy with which they operate.

Guidance from Place of Management

Countries such as the Switzerland, Netherlands and Germany uses the concept of place of management in their domestic legislation in order to determine residency for non-individuals.⁸²

In Switzerland, effective management is distinguished from mere administrative management functions. In Germany, the views of Vogel (1997:262) is supported by the TAG in that the terms

⁸¹ The OECD TAG Discussion Paper 2001, paras 17 – 24.

⁸² The OECD TAG Discussion Paper 2001, para 25.

‘place of management’ and ‘place of effective management’ would bear similar meanings. German case law suggests that ‘a place of management is regarded as the place where the management’s important policies are actually made’. Weight must be attached to the place where these management directives are given, not where they are implemented or take effect. The focus point is ‘the centre of top level management’ which in turn is defined as ‘the place at which the person authorised to represent the company carries on his business managing activities’.⁸³

In terms of this approach however, the centre of top level management would have to first be identified by the revenue authorities. It appears that where this test is inconclusive, the place of residence of the top manager may be decisive – this default approach however appears to be very formalistic and open to manipulation.

Developments in the modern technological era

The TAG notes that in the past, all of the factors listed above usually coincided in order to indicate a single place where the business was effectively managed from (i.e. top management would reside, meet and conduct their management activities in the place where the company was incorporated). Due to the development of technology, sophisticated communication methods and ease of international travel, management is not necessarily physically located or resident where the company is incorporated.⁸⁴

The above may result in taxpayers being dual resident for tax purposes and POEM as the tie-breaker clause in the DTA being ineffective.

The application of POEM in multi-jurisdictions

Notwithstanding the above developments, the TAG is of the view that since POEM is effectively a ‘substance over form’ test, it should theoretically be able to yield a result in accordance with the ‘true policy intention of the tie-breaker rule’. However, as a result of the use of technology, scenarios may occur where the top-level management responsible for making the management decisions are located in multiple jurisdictions and communicate electronically without the requirement of all being physically present in a single location at any given time, especially in big multi-national companies.⁸⁵ This may result in a scenario where the POEM of a company is

⁸³ The OECD TAG Discussion Paper 2001, paras 26 – 30.

⁸⁴ The OECD TAG Discussion Paper 2001, paras 33 – 34.

⁸⁵ This problem was already identified by Lord Radcliffe in *Bullock (H.M. Inspector of Taxes) v The Unit Construction Company Ltd* (1958 - 59) 38 TC 712 at p739 where it was stated that it would not always be possible to identify only one country as the ‘seat of central management and control’.

situated simultaneously in various jurisdictions and accordingly the use of POEM as a tie-breaker test may be ineffective. The discussion paper therefore proceeds to discuss various options that may pose a viable alternative tie-break solution:⁸⁶

A. *Replace the POEM concept*

Various alternatives to POEM have been proposed for the tie-breaker test such as:

- i. The place of incorporation or, where the taxpayer is an unincorporated association, the place where the corporate law applies to the enterprise:
 - This test will create more certainty as its application is easily understood, it places very little administrative burden on taxpayers and costs in respect of compliance are kept to a minimum;
 - This approach however is open to manipulation and does not answer the question of real effective management and may allow for a discord between the actual POEM and the place of incorporation;
 - The test is not flexible enough to cater for a change in circumstances such as where a company moves its POEM over a period of time;
 - It is fairly easy to incorporate a new company in another jurisdiction and sell an existing business across to the newly incorporated entity, in order to circumvent being a tax resident of a specific Contracting State;
 - In certain jurisdictions, a company can have multiple places of incorporation which will render the tie-breaker ineffective.
- ii. The place where the directors/shareholders reside:
 - By looking solely to the residence of top management of the company in order to establish residency, one may not get a clear or equitable result. As discussed above, due to developments in communication technology and international travel, this may distort the outcome of the tie-breaker test. Similarly, where the shareholders are legal entities, this test may lead to inequitable results.
- iii. The place where the strongest ‘economic nexus’ exist:
 - The view is expressed that a taxpayer’s economic nexus (or connection) to a particular state can be expressed by the ‘factors of production’, i.e. the extent to which the

⁸⁶ The OECD TAG Discussion Paper 2001, paras 47 – 75.

company utilises the resources of the country in which it operates (e.g. land, labour, capital, enterprise and arguably also infrastructure) to generate revenue and profits.

- An argument exists that this nexus can be used as a tie-breaker test in order to establish to which country a company has its closest link/connection. This stems from the view that if a company uses the resources of a state in order to generate revenue, that company should contribute to that state in the form of ‘residence-based taxes’.
- Where a company utilises the resources of multiple states, its closest economic nexus would require a determination (similar to that of individuals) of where the closest connection can be found;
- The counter argument to the above is that this test is indicative of source-based taxation rather than residence-based taxation and would therefore be ill-equipped to act as a tie-break test where residency must be determined. Also the test may require subjective comparison of certain factual circumstances which may be cumbersome in its application and may result in discrimination against large multinational companies operating in smaller states.

B. Refine the POEM test

Two alternatives have been suggested in order to refine the POEM test:

- i. The first suggestion is to make a determination based on certain pre-determined principal factors.
 - The wording used in para 24 of the OECD MTC of 2000 suggest that the principal factors are where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made; where the most senior person or group of persons makes its decisions; and the place where actions to be taken by the enterprise as a whole are determined.
 - The wording used in para 24 further suggests that supplementary factors should also still be considered and accordingly the following have been suggested where the principal factors do not yield a single POEM, e.g. location and function of headquarters; Indication of CMC as stated in the company documents such as MOI or Articles of Association; place of incorporation/registration. (This is not an exhaustive list.)
- ii. The second suggestion is to give a weighting to the factors identified.

C. Establish a hierarchy of tests

Art 4(2) of the OECD MTC sets out a hierarchical approach in respect of individual residency tie-breaker. The suggestion is made that a similar approach be adopted and some refinements made in order to establish the tie-breaker clause for non-individuals.

The first suggestion above under 'B' in respect of the refined POEM test should normally provide a solution in line with the underlying policy considerations. Should this test fail in its application (mostly 'exceptional circumstances'), further tests should be applied in order of preference:

- First, the POEM test;
- Second, Place of Incorporation test;
- Third, the Economic Nexus test; and
- Fourth, by Mutual Agreement between the parties.

D. A combination of alternative tests

It is suggested that where some of the tests set out above may fail to produce a result when applied to the facts in isolation, implementing a combined test may produce a solution, e.g. initially applying the POEM test and imposition of a hierarchy of tests thereafter.

E. Deny treaty relief to Contracting States

Albeit somewhat extreme, the view is heralded that where the true POEM cannot be established from the facts or yields results not in accordance with the spirit of the provision, such dual resident contracting states should merely be denied treaty benefits in order to deter taxpayers from abusing the treaty provisions.

Conclusion

The view is expressed that in most cases the current POEM test will provide the correct answer when applied as a tie-breaker in the DTA, but that it will not work in all cases.

The 'economic nexus' test appears to have had some merit and mention was made that this test should be further explored as an alternative to the POEM tie-breaker test, alternatively more relevant factors should be identified and listed in the commentary and possible weighting should be attached to such factors.

3.3.2.3 *The OECD TAG Discussion Paper of 2003*

During May 2003 and as a follow up to the OECD TAG Discussion Paper 2001, the OECD TAG released a follow-up paper titled ‘Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (27 May 2003) Discussion draft - Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention’ (OECD Publishing) (‘the OECD TAG Discussion Paper 2003’).⁸⁷

Again, two alternative proposals were discussed and is set out in further detail below.

A. *Refinement of existing POEM concept*

The object of this proposal is stated as refining the concept of POEM ‘by expanding the Commentary explanations’ in respect of interpretation. The suggested changes to the commentary were, in brief, as follow⁸⁸:

- An entity can have multiple places of management, but only one place of effective management;
- The POEM test should focus on where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made and where the actions to be taken are determined;
- Where the key/strategic management and commercial decisions are in substance made in one Contracting State, but formalised in another Contracting State, the following principles should be applied:
 - POEM will be in the Contracting State where the board of directors originally made the decisions, not in the Contracting State where the subsequent meetings are held to formalise these decisions;
 - POEM will be in the Contracting State where the controlling interest holder of the company effectively makes the decisions that ‘go beyond decisions related to the normal management and policy formulation of the group’s activities’ – i.e. these decisions must go beyond the normal ‘type of decisions that the parent company of a multinational group would be expected to take as regards the direction, co-ordination and supervision of the activities of each part of the group’;

⁸⁷ See also Olivier & Honiball (2011:40 – 41) for a discussion of the salient points in respect hereof.

⁸⁸ The OECD TAG Discussion Paper 2003, paras 6 – 7.

- POEM will usually be in the Contracting State where the executive officers of the company perform their functions, even where the board of directors, situated in another Contracting State, routinely approves the decisions made by these executive officers. When considering whether the board is merely approving a decision that was in substance made somewhere else, it would be important to consider where advice given in respect of various options were considered and where the process of reaching a conclusion occurred.

B. Hierarchy of tests

It was suggested here that the existing tie-breaker in art 4(3) of the OECD MTC be replaced with a new version that mirrors the current residency test used for individuals in art 4(2). This would imply that four different rules are applied in succession (i.e. should the first rule be unsuccessful in obtaining a result, the second rule will be consulted etc.) – the discussion below is accordingly based on the assumption that the preceding rule in the hierarchy could not successfully be applied in order to resolve the tie-break. The proposed hierarchy is as follow where dual residency results from the application of art 4(1):

- i. **First**, the company shall be deemed to be resident only of the State in which its POEM is situated;
 - The comments set out above under ‘A’ is proposed to be brought into the commentary, all relevant facts and circumstances must still be considered.
- ii. **Second**, the company shall be deemed to be a resident only of the State:
 - with which its economic relations are closer [Option A];
 - This will involve a factual assessment of which Contracting State’s resources are utilised more by the company, as well as use of legal, financial, physical and social infrastructures.
 - Various factors will need to be considered, including location of company headquarters, location of assets and employees, where most of the activities are carried on and revenue is generated, where most of the senior management functions are carried on and from which State’s laws the entity derives its legal status. (This list is not exhaustive.)
 - in which its business activities are primarily carried on [Option B]; **or**
 - A functional analysis will have to be performed in respect of the activities carried on by the company in the Contracting States.

- in which its senior executive decisions are primarily taken [Option C];
 - A determination must be performed as to in which country the majority of the senior executive decisions are taken; the proposed commentary seems to indicate that this will usually be in the state where the company’s headquarters are located and the senior executives should normally also be found there.
- iii. **Third**, the company shall be deemed to be resident of the State in terms of whose laws it derives its legal status from;
 - This will normally be the State in terms of whose laws the company has been established/incorporated, or the State in which a company has been continued (e.g. where the company’s corporate existence has been migrated to a new jurisdiction).
- iv. **Fourth**, the competent authorities of the Contracting States can settle the question by way of mutual agreement.
 - The standard existing procedure as set out in art 25 of the OECD MTC will be followed.

3.3.2.4 *The OECD MTC Commentary of 2008*

In 2008, the reference in the Commentary to the ‘most senior management’ (added in 2000) was removed. The Commentary was also updated to provide for Contracting States to resolve the issue of residency by way of mutual agreement.⁸⁹ The factors as set out above under the OECD MTC 2014 was also introduced into the Commentary as factors to be taken into account when determining POEM and optional wording proposed by the OECD was included in the Commentary in para 24.1 in respect of countries that adopt a case-by-case approach in respect of the determination of POEM in cases of dual residence under the DTA.⁹⁰ Certain changes to the mutual agreement procedure was also introduced.

⁸⁹ Olivier & Honiball (2011) at p39.

⁹⁰ According to comments provided by The Business and Industry Advisory Committee to the OECD (31 May 2008) ‘BIAC Comments on the OECD Public Discussion Draft: Draft Comments on the 2008 Update to the OECD Model Convention’, p4 – the suggested wording introduced by the OECD was not well received by the international business community as a case-by-case approach creates uncertainty amongst the members and since member states always have the opportunity of the mutual agreement procedure in cases of uncertainty or dispute, this wording was considered to be unnecessary.

Furthermore, a change to para 8.2 of the Commentary on Art 4 also excludes from the definition of a resident of a Contracting State, foreign-held companies ‘that are exempted from tax on their foreign income by privileges tailored to attract conduit companies’.⁹¹

The 2008 update further added to the ambit of Art 4(1) in that ‘[I]t also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State’s tax law, are considered to be residents of another State pursuant to a treaty between these two States.’⁹² Professor Kees van Raad is of the view that the effect of this interpretation is that dual resident companies will be denied access to the other DTAs concluded by the ‘losing’ Resident Contracting State in which that company has been classified as non-resident under a DTA.⁹³

3.3.3 Conclusion

It appears that since the publication of the 2003 discussion paper, the OECD has not released any further indication of whether they intend to take any of the above proposals forward or whether a preference has been established in respect of the above options. South Africa has also not commented on what position, if any, it will adopt in respect of the above.⁹⁴

It appears that the OECD acknowledges that the current meaning of POEM and the application of the tie-breaker clause in art 4(3) is not always clear and unambiguous. It is unclear however why the OECD has not implemented the bulk of the suggested changes into the Model Tax Convention or Commentary.

What is further unclear is the fact that the Commentary maintains the position that a company can have more than one place of management, but cannot have more than one place of ‘effective’ management at any one time. This statement appears to stem from the fact that the OECD MTC uses POEM as a tie-breaker, which would not be effective if a company could have more than one POEM at any given time.⁹⁵ This presumption surely depends on the nature of the test applied and the factors considered for determining POEM. Furthermore, with the use and development of new technology, this view of the OECD may require revision.

⁹¹ The OECD MTC 2008: Commentary on Article 4, para 8.2. This will arguably exclude South African Headquarter Companies from the ambit of these provisions.

⁹² Ibid.

⁹³ Van Raad, K (2009) ‘2008 OECD Model: Operation and Effect of Article 4(1) in Dual Residence Issues under the Updated Commentary’, Bulletin for International Taxation (IBFD), May/June 2009, pp. 189.

⁹⁴ Olivier & Honiball (2011) at p41.

⁹⁵ Silke on International Tax, §17.5.4.1.

These 2008 changes in respect of the Commentary to POEM may indicate a change in the OECD's view in respect of which level of management should be considered when determining the POEM of a company (i.e. top-level management which refers to broader strategic type management as opposed to daily operational management).

In addition, the debate on whether the focus should be on where management decisions are taken/made or where these decisions are implemented has not been resolved. It appears that the key factor here is determining which level of management is being considered in determining residency of the company. In this regard, Van der Merwe, BA (2002) 'Residence of a company – the meaning of “effective management”', *South African Mercantile Law Journal*, vol. 14, p 85, states that:

‘This issue relates to the level of management on which it is intended that residence should depend. If the level of management determining the place of effective management is that of superior, policy-type management, then it may be possible to the limit the nature of management to making decisions only. But if management were to refer to hands-on operational management, the implementation of decisions would necessarily form an important part of management, and it would be difficult to consider one without the other.’

The above passage is also quoted with approval in Silke, where the author emphasises that the focus should be on those key management and commercial decisions that are necessary for the conduct of the business – where these decisions are accordingly made by the ‘hands-on operational management of the company’, this will be indicative of the POEM. However, the view is stated that generally these type of decisions will be made at a more superior level of management.⁹⁶

⁹⁶ Silke on International Tax, §17.5.4.1.

4 International case law - Establishing the meaning of POEM

4.1 Introduction

There is not much South African case law on the subject of POEM, but the meaning of POEM appears to have been influenced, to a certain extent, by the meaning of the phrase central management and control ('CMC'), a well-known concept under English law.

As discussed above, CMC usually refers to the 'central policy core of the whole enterprise or 'the highest level of control of the business'. However, the highest level of control is not ascribed to the shareholders but rather to the policy-making decisions of the directors of the company, and while this remains a factual enquiry, the tendency is to equate this concept with the place where the directors of the company exercise their power and authority (i.e. generally where the directors meet).⁹⁷

The question now arises, as put by Van der Merwe (2002:85), if, in the absence of a specific definition of POEM, inference can be drawn from international concepts such as 'CMC' and 'management and control' and the substantial amount of authority that exist in respect thereof, and whether the meaning of these phrases are 'similar enough to allow cross-analysis and guidance'. Van der Merwe (2002:86) further states that these phrases are viewed as close (similar) concepts and that the concept of management and control is not unfamiliar in South African domestic law.⁹⁸ Accordingly, where South African courts have had to interpret these concepts, heavy reliance was placed on English case law.

Van der Merwe (2002:87) indicates that Vogel is of the view that Britain's concept of place of management and control cannot be compared to the treaty concept of POEM because under Britain's law, a company can be managed and controlled in more than one state at any given time, while according to the OECD, a company can only have one POEM at any given time. However, Van der Merwe further indicates that authors such as Edwardes-Ker and Sandler supports the fact that these concepts, even though not identical, are comparable.⁹⁹ Van der Merwe (2002:91) concludes that when interpreting the phrase 'effective management', 'our courts/ like those in Australia and Ireland, relied, and continue to rely, heavily on British case law'.

⁹⁷ Silke on International Tax, §17.5.4.1.

⁹⁸ The now repealed definition of 'domestic company' referred to 'a South African company or a company that is managed and controlled in the Republic'.

⁹⁹ Also see the references quoted there such as Sandler, D (1998) *Tax Treaties and Controlled Foreign Company Legislation*, 2ed and Edwardes-Ker, M (1994) *Tax Treaty Interpretation* §46.02.

Gutuza (2012:430) also indicates that despite there being differences and limitations in using the test for CMC when compared to POEM, the guidance provided by the UK courts in respect of CMC are useful when analysing the factors to be considered for the POEM enquiry. Furthermore, Van der Merwe (2006:135) states that ‘a domestic court asked to examine the meaning of “effective management” in s1 of the Income Tax Act or in a double taxation agreement would need to consider the international interpretation of this phrase’.

In the UK, according to the United Kingdom Revenue Manual: INTM120210 - Company residence: Guidance originally published in the International Tax Handbook (‘UKRM INTM120210’), since 1988, a company is deemed to be a resident of the UK for tax purposes if that company is incorporated in the UK (subject to a few exceptions).¹⁰⁰ Prior to 1988, there has never been a statutory definition of what makes a company ‘resident’ for purposes of tax legislation. It is however a well-established principle that a company is resident where its CMC is to be found.¹⁰¹ Although the incorporation rule now overrides the CMC test, the former has not eliminated the latter and the latter rule is still relevant in the UK when companies that are not incorporated in the UK are involved.

Baker (2002:4B.17) indicates that in the UK, Inland Revenue formerly heralded the view, prior to 1983, that the POEM of a company was the same as the place where the business was managed and controlled. However, in 1983 Inland Revenue issued a Statement of Practice¹⁰² declaring a revised view that ‘effective management may, in some cases, be found at a place different from the place of CMC’. Baker (2002:4B.18) accordingly goes further to argue that the above suggests that UK Inland Revenue considers there to be a distinction between effective management (i.e. the place where actual management of the company is carried out on a day-to-day basis) and CMC (i.e. where the ultimate control of major policy decisions and the final directing power rests).

Even though the prevailing opinion in respect of the above may have changed in so far as that POEM is now considered to be a concept similar (rather than equivalent) to CMC, and given that POEM may very well have a different meaning to ‘place of management and control’, the case law and commentary in respect of ‘management and control’ can still be very helpful in the interpretation of the POEM concept.¹⁰³

In Australia, in terms of para 6(1)(b) of Australia’s Income Tax Assessment Act 1936 (‘ITAA 1936’), a company not incorporated in Australia will be a resident of Australia if, inter alia, it

¹⁰⁰ Van der Merwe (2002:86) and s 66 of The Finance Act 1988 of the United Kingdom.

¹⁰¹ UKRM INTM120210: ITH300.

¹⁰² SP 6/83 on Company Residence – this has subsequently been replaced by SP 1/90.

¹⁰³ Silke on International Tax, §17.5.4.1.

carries on business in Australia and is centrally managed and controlled in Australia.¹⁰⁴ According to Van der Merwe (2002:87), the phrase ‘centrally managed and controlled’ is not defined in Australian domestic tax law, but courts generally follow the interpretation as laid down in the case of *De Beers Consolidated Mines Ltd v Howe* (1906) AC 455 (discussed below).¹⁰⁵

As discussed above, the OECD TAG Discussion Paper 2001 indicates that useful guidance can be obtained from the case law discussed below in respect of the impact of the concept of CMC regarding the interpretation of POEM. Below follows a more detailed discussion of these cases and their interpretative value.

4.2 UK Case Law

4.2.1.1 Cesena Sulphur Company Ltd v Nicholson (1876) 1 TC 88; Calcutta Jute Mills Ltd v Nicholson (1876) 1 TC 83

The above cases were heard together and in the UK and judgment was postponed until both cases had been heard by the court.

In the *Cesena Sulphur Company* case, the company, *Cesena Sulphur Company Ltd* (‘Cesena’), was incorporated under the UK Companies Acts (of 1862 and 1867) as a joint stock company and subsequently registered in Italy, where the main operations were located. Cesena’s registered office was in England where the board of directors managed its UK affairs. Two or three members of the board (including the managing director) resided in Italy where the practical (day-to-day) management was carried on and all profits were earned. The original books of account and money was kept in Italy, with copies of the accounts, as well as dividends required for the English shareholders being sent to England. The shares of Cesena were held by English (one third) and foreign shareholders.

In the *Calcutta Jute Mills* case, the company, *Calcutta Jute Mills Ltd* (‘Calcutta’), was incorporated under the UK Companies Acts (of 1862 and 1867) as a joint stock company and was registered only in the UK, with its operations solely located in India. Calcutta had no office or other place of business in the UK. The board of Calcutta had been given extensive powers, including the ability to appoint directors in Calcutta and delegate powers to these directors in respect of operating the company’s affairs. All books, accounts and documents were kept,

¹⁰⁴ Australian Taxation Office: Taxation Ruling TR 2004/15, ‘Income tax: residence of companies not incorporated in Australia – carrying on business in Australia and central management and control’, para 4.

¹⁰⁵ *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* 64 CLR 15 at 241.

received and dealt with by the Indian management and only the funds necessary for reimbursement of expenses and the UK directors' portion of profits were remitted to the UK to be distributed as dividends to the shareholders.

The question before the court was whether Cesena and Calcutta was liable to pay income tax as UK residents (i.e. on all profits generated by the respective businesses in Italy/India), or only in respect of profits remitted to the UK for distribution amongst the UK shareholders. The Court accordingly considered the question of where the CMC was located in order to determine the residency of these companies for income tax purposes.

Upon consideration of the memorandum/articles of association of both companies, it was clear that ultimate management and control rested with the boards of these companies, the directors whereof mainly resided and held meetings in the UK. The shareholders meetings were also scheduled to be held in the UK. In the Calcutta case, it was pointed out that Calcutta was entirely under the control of its governing body (i.e. the directors in England) who merely appointed agents in India to act on their behalf, that general and special meetings of shareholders were largely held in the UK and the power to transact was exercised at these meetings of the board and shareholders – accordingly Calcutta resided in the UK. In the Cesena case, it was pointed out that the objects of the company as set out in the articles of association can play a defining role in establishing what the business of the company actually is and therefore who manages and controls that business.

In both cases, the court made reference to a resident company enjoying protection under the laws of the state in which such company resides and accordingly that the company must compensate the state via the payment of tax on its profits generated. The court however refrained from expressing a view on whether a company can be resident in more than one country at the same time.

Some interesting points made by Huddleston on p451 – 454 of the judgment can be summarised as follows:

- The word 'residence' usually connotes a natural person and an 'artificial residence must be assigned to this artificial person' (i.e. the company) – formed 'on the analogy of natural persons';
- The actual residence of a company is where the 'real trade and business is carried on', 'the central point of the business', and 'the real and substantial business was carried on';
- The place of registration of a company is merely a factor that will be taken into account in determining the residence of a company.

Certain writers have questioned whether a similar outcome would have been reached in South Africa, based on the current South African law and guidance issued by SARS in Interpretation Note 6 ('IN6')(discussed below).¹⁰⁶ Maroun and Padia (2012:126) indicate that although the place where board meetings take place is a factor to be considered according to Interpretation Note 6, it is likely not a primary indicator of the POEM.

These cases accordingly should be distinguished on the basis of the heavy reliance placed on the roles of the respective boards of directors of the companies, even though actual day-to-day or operational management of the businesses was carried on outside of the UK.

4.2.1.2 De Beers Consolidated Mines Ltd v Howe (1906) AC 455

In the De Beers case, the company, De Beers Consolidated Mines Ltd ('De Beers') was registered in South Africa (at that stage, the Colony of the Cape of Good Hope), with its head-office formally situated in Kimberley, where general meetings of shareholders were held and where the general accounts were also kept. The company had various directors (three permanent and sixteen ordinary) situated both in South Africa as well as London (UK) with whom resided the management and control of the company – the majority of these directors being in London.

De Beers was in the business of mining and selling diamonds. Diamonds were mined in Kimberley, South Africa, where the mining operations were situated. Thereafter diamonds were sold to a London Diamond Syndicate in terms of various contracts negotiated and executed in London. Both the mining as well as the sale of diamonds were crucial aspects of the business.

The question arose whether De Beers was tax resident in the UK as a result of its CMC being located in the UK and therefore being liable to pay income tax in the UK.

On the evidence presented, it appears that most of the major decisions were made in London such as appointment of four committees (Finance, Diamond, Machinery and Dynamite Committees), most financial decisions (specifically those relating to the acquisition of other businesses),

¹⁰⁶ Maroun, W & Padia, N (2012) 'Determining the residency of companies: Difficulties in interpreting the "Place of Effective Management"', *Journal for Economic and Financial Sciences*, vol. 5, no. 1, pp. 125 (Maroun & Padia 2012). Also refer the South African Revenue Service (26 March 2006): Interpretation Note No. 6 'Resident: Place of Effective Management (persons other than natural persons)' (hereinafter 'IN6') and the South African Revenue Service – Legal and Policy Division (September 2011): 'Discussion Paper on Interpretation Note No. 6 "Place of Effective Management"' (hereinafter 'SARS Discussion Paper').

authorisation of acquisitions and disposals of machinery and equipment for use on the mine, negotiation of sale contracts, appointment of a new chairman and various other important commercial decisions. These decisions seem to have been passed unchallenged during the directors' meetings in London and where appropriate, communicated to Kimberley for confirmation – this however appears to have been a mere procedural formality. The day-to-day operational management in respect of mining was situated in Kimberley, while sales were being managed from London. It was also shown that the directors in London exercised a 'controlling influence' over the accounts of De Beers.

It was contended that, as De Beers was neither incorporated in the UK, nor carried on any trade within the UK, De Beers could not be tax resident in the UK. These arguments were rejected by the court, as well as the argument that the company could not 'dwell outside the area of the jurisdiction of the law which created it'.

In delivering its judgement, the Court stated that some 'artificial test' has to be applied when determining the residence of a company and that the procedure adopted should be analogous to that of determining residency of an individual. In this regard, the Lord Chancellor states at p212 – 213 that:

'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.'

The Court cited with approval (at p213) the *Cesena Sulphur Company* and *Calcutta Jute Mills* case and confirmed the principle that:

'...a company resides, for purposes of Income Tax, where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule; and the real business is carried on where the CMC actually abides.'

The Court stated further that the business operations and trading activities of the company must be scrutinised, and in doing so found that:

- the business activities of De Beers constituted one indivisible trade/business carried on in the UK at the London office;

- the ‘head and seat and directing power’ of De Beers were at the London office and that the ‘chief operations’ of the company was actually in substance ‘controlled, managed and directed’ from the UK.

Silke is of the view that this judgement, properly construed, cannot be interpreted to mean that ‘CMC’ refers to the day-to-day running of the business or the voting power of the shareholders. It is further noted that, as the words ‘management’ and ‘control’ and joined by the conjunctive ‘and’, the term ‘management and control’ as expressed in Lord Loreburn’s statement above, denotes one indivisible concept and is located collectively.¹⁰⁷

Maroun and Padia (2012:125) is of the view that although the location of central management can be an indicator to the POEM, the phrase ‘CMC’ as expressed in UK law, appears not to make such a prominent distinction between the different levels of management as in the South African interpretation of POEM – accordingly this may lead to differences in the interpretations of the two concepts.

4.2.1.3 American Thread Company v Joyce (1912) 6 TC 1/163

In the American Thread Co case, the American Thread Company (‘ATC’) carried on its business operations solely in the USA, where it was registered. Its shares was 100% held by the English Sewing Cotton Company (‘ESCC’), a company registered and carrying on business in the UK. In accordance with the by-laws of the ATC, it had 7 directors, 3 of which resident in the USA and there was to be appointed by the board an executive committee in the USA to operate the day-to-day business of the company. Regular board meetings were held in the USA, though extraordinary meetings were held in the UK.

Of importance is that certain essential and exceptional powers (relating directly to the management and control of the ATC) were reserved for the board convening at the extraordinary meetings in the UK and in practice, the important decisions (such as those relating to ordinary dividend declarations, supervisions over accounts, funding arrangements, sale and acquisition of assets, business processes, appointment of directors, significant agreements to be concluded and important policy matters) were made at these meetings.

The Court of Appeal referred with approval to the tests laid down in the cases discussed above and added that establishing CMC is a question of fact that must be determined ‘not according to the construction of this or that regulation or by-law but upon a scrutiny of the course of business and trading’. The Court further stated that the ‘head and brain of the trading adventure’ or ‘the

¹⁰⁷ Silke on International Tax, §14.42.

head and seat and directing power of the affairs' must be decisive. The Court again drew an analogy to the individual test for determining residency and held that this test must also hold true in case of determining residency for companies as residency cannot in a literal or natural sense be applied to a company. Buckley, LJ stated that a corporation, just like an individual, can have more than one place of residence. It was further acknowledged that under different systems of law (or even under the same system of law) there may be different requirements for establishing residency in different scenarios.

The Court found that the real control was not vested in the directors of the company running the actual operations in the USA (i.e. the executive committee only fulfilled the role of managers). CMC was held to be in the UK where the strategic management was situated.

4.2.1.4 Swedish Central Railway Company v Thompson [1925] AC 495; [1924] All ER Rep 710

In this appeal to the House of Lords, the matter to be decided was whether a company, incorporated in the UK, that had subsequently altered its articles and removed all control and management from the UK to the head office in Sweden, where it carried on its actual business operations, could have more than one place of residence for purposes of determining the extent of its liability to tax under UK income tax legislation. The directors appointed a committee to transact mere administrative matters in the UK and no profits were remitted to the UK, aside from dividends declared in Sweden and paid to the UK shareholders.

Viscount Cave, L.C. stated that, in principle, the CMC of a company could be divided and that a company may "keep house and do business" in more than one place; and if so, it may have more than one residence'. The corporation was once again likened to an individual when determining residence.

However, Lord Atkinson, in his dissenting judgment, stated that the above statement contradicts the precedent set by earlier judgments discussed above and that it would appear that 'two systems of CMC of one entire business situated in two distinct and separate places' would not be possible.

4.2.1.5 Egyptian Delta Land and Investment Company Ltd v Todd [1929] AC 1

In a case with similar facts to that of the Swedish Central Railway Company case (discussed above), the House of Lords was again tasked with establishing whether a UK incorporated company that exclusively (but for some minor administrative matters) carried on business in Egypt, could be held to be resident in the UK and accordingly subject to tax within the meaning

of the relevant income tax legislation, purely as a result of its incorporation under the UK Companies Act.

This case was distinguished from the Swedish Central Railway Company case and the guidance laid down in the De Beers case was followed. Incorporation was merely held as a contributing factor to be considered in determining tax residence, and that for income tax purposes the dominant factor would be where the real business of the company was carried on (i.e. where the CMC was situated).

4.2.1.6 Unit Construction Company Ltd v Bullock (H.M. Inspector of Taxes) [1960] AC 351, [1959] 3 All ER 831

In the Unit Construction Company case, the House of Lords found that the place where *de facto* management of the company was located would trump the location of *de jure* management (i.e. where the company articles of association purport the management to be). The court held that, even where the parent company took over control of the management of a subsidiary company with the directors of the subsidiary company standing aside (albeit contrary to the mandated position set out in the company constitution), CMC would be determined as a question of fact.

Maroun and Padia (2012:126) again distinguishes the approach followed by the court from what is a likely South African approach, where focus is placed on the different levels of management. In this instance, the directors of the three African subsidiary companies were involved in and remained in control of the day-to-day operational management of their companies throughout. However, the parent company regularly met in the UK in order to make strategic decisions for the group as a whole and, after the subsidiaries started incurring heavy losses, directly intervened in the management and operations of the subsidiary companies and started making certain key decisions in respect of the subsidiaries. This intention of the shareholder was communicated to the chairman of the board of the subsidiary companies and was accepted as such.

Lord Cohen stated that it was exceptional for a shareholder to usurp the control of its subsidiary company and that under normal circumstances, the shareholder would operate through the board of the subsidiary company.

Of particular interest is Viscount Simonds statement at p5 of the judgment:

“The business is not less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution however imperative. If, indeed, I must disregard the facts as they are, because they are irregular, I find a company without any central management at all. For though I may disregard existing facts,

I cannot invent facts which do not exist...I come, therefore, to the conclusion...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.”

4.2.1.7 Untelrab Ltd v McGregor [1996] STC (SCD) 1

In the Untelrab case, the question that arose before the Special Commissioners was one of the relationship between a UK parent company and its non-resident subsidiaries. In particular, the question arose whether the subsidiary companies’ boards of directors merely ‘rubberstamped’ the decisions taken in the UK or whether the subsidiaries’ directors actually exercised effective management and control of these subsidiary companies in the various jurisdictions.

The facts evidenced that day-to-day management resided in the directors of the subsidiaries. The group operated on a decentralised basis and decision-making was delegated to the group subsidiaries. The group policy in respect of the operation of overseas subsidiaries set out that advice could be obtained from the UK, but that no major decisions were to be taken from the UK. The UK head office was to play a strategic role and monitored tight financial control of the group as a whole. The subsidiary companies’ boards met in Bermuda and Guernsey respectively, transacted the companies’ business there and would have refused any order to carry out proposals or instructions received which were unreasonable or improper.

The Commissioners found that, whilst the subsidiary companies were willing and complacent to do the bidding of their holding company, it still performed its functions as a separate company and was not usurped or ‘displaced’ by the will of its holding company (i.e. the board did not relinquish control of the company to its shareholder). It was further held that it was not unnatural for the board of a wholly-owned subsidiary to promote the interests of the group as a whole and in doing so, to carry out wishes from its parent company in this regard. This alone does not equate to the board divesting itself from ultimate control of the company. As long as genuine decisions were made by the local company boards which do not merely amount to rubber-stamping of the shareholder’s decisions, control would be retained by the board.¹⁰⁸

¹⁰⁸ An important reference was made to the Australian case of *Esquire Nominees (as Trustee of the Manolas Trust) v Federal Commissioner of Taxation* (1971) 129 CLR 177. This case was cited as authority for the view that the board of a subsidiary company will retain central management and control of its operations, provided that it functions as a board in making decisions, exercising its powers and refuse to do anything improper and inadvisable merely because of a recommendation made by its shareholder (or by any third party for that matter). In this case it was held that even where the board of a special purpose trust company (incorporated in Norfolk Island with resident directors) carried out the pre-planned wishes of the Australian settlors, there was an actual exercise of discretion by the board, who

4.2.1.8 **Wood and Another v Holden (Inspector of Taxes) [2006] EWCA Civ 26; [2006] 1 WLR 1393**

The Wood case came to be heard as an appeal by the UK Revenue against the successful objection by the taxpayers (Mr and Mrs Wood) from an earlier decision where an assessment, originally made by HM Inspector of Taxes, was upheld by the special commissioners.¹⁰⁹

In what appears to be a very elaborate and complicated set of factual circumstances, the detail of which is not all relevant for this discussion, the taxpayers embarked on a restructuring of their investments, under the guidance of their tax advisors, in order to circumvent apparent liability for CGT that would arise in respect of the disposal of 96% shares held by the taxpayers in a UK operating company, Greetings Ltd.

As part of the restructure, various family settlements (trusts) were set up by the taxpayers (as settlors) with off-shore trustees (mainly Suisse and BVI), which trusts in turn held the shares in a newly incorporated BVI company, CIL.¹¹⁰ The taxpayers thereafter incorporated a new UK company, Holdings Ltd, of which the taxpayers ‘gifted’ approximately 50% of the shares in Holdings to CIL. Thereafter, the taxpayers ‘gifted’ their 96% shares in Greetings Ltd to Holdings Ltd. CIL thereafter proceeded to acquire 100% shares in a company, Eulalia BV, incorporated in the Netherlands. CIL immediately thereafter disposed of its approximate 50% shares in Holdings Ltd to Eulalia BV in exchange for an interest-free loan account owing from Eulalia BV to CIL. A short while thereafter, Eulalia BV, as well as the other shareholders (Mr and Mrs Wood), disposed of their shares in Holdings Ltd to a 3rd party purchaser.

Barclays Private Trust (BVI) appointed Condor as the sole director of CIL, while ABN AMRO Trust Co (Netherland) was appointed as the managing director and responsible for the day-to-day activities of Eulalia BV. ABN AMRO would ‘act in accordance with the resolutions of the board

would not have acted to carry out a transaction detrimental to the company. It was found that the settlors had no power to control the directors of the company or the company’s business and could merely take steps to remove the company from its position as a trustee. Accordingly, it was held that, even where a board of directors accede and submit to the wishes of its parent company, such board can still retain effective management and control of its company.

¹⁰⁹ Previously cited as *R v Holden* [2004] STC (SCD) 416, as well as *Mr R.J. Wood and Mrs R.J. Wood v Mrs L.M. Holden* (HM Inspector of Taxes) (2005) EWHC 547 (Ch).

¹¹⁰ The case seems to indicate that the shares in CIL were either directly held by one of the trustees, Barclays Private Trust (BVI) or directly by the various trusts/settlements as ‘A’ and ‘B’ shares.

of directors of the company and the policy instructions issued by the shareholders of the company’.

The question that served before the court was whether it could be argued that Eulalia BV was actually a UK resident company by virtue of its CMC abiding in the UK, accordingly subjecting the disposal of Holdings Ltd’s shares by CIL to Eulalia BV, to CGT in the UK (i.e. the disposal would not be between two non-resident companies which are members of a non-resident group of companies and accordingly exempt from CGT in the UK).

The Commissioners found that the boards of the respective companies were not by-passed by their shareholders, nor did the boards stand aside in the operation of the companies. Again, it was confirmed that it would be a far-reaching conclusion to state that, where a subsidiary company acquired property from its parent company in a non-arm’s length transaction without having due regard to and ‘independent consideration’ of the terms of that agreement, CMC had been ceded to the parent company.

However, in this regard it was noted that there was no real consideration or genuine involvement from ABM AMRO in this transaction. The conclusion reached by the Commissioners in para 145 of their judgment, in that the acts of the board of Eulalia (i.e. of ABN AMRO) was not sufficient to constitute acts of management and control, is summarised as follows on p1407:

‘We do not consider that the mere physical acts of signing resolutions of documents suffice for actual management. Nor does the mental process which precedes the physical act. What is needed is an effective decision...and such decisions require some minimum level of information. The decisions must at least to some extent be informed decisions. Merely going through the motions...does not suffice.’

On appeal, however, Chadwick, LJ, rejected the conclusion reached by the Special Commissioners. He found that:

- the business of the subsidiary company should be analysed – *in casu*, Eulalia was incorporated as a ‘Special Purposes Vehicle’ (‘SPV’) that served a specific commercial purpose and there was no active continuing business that required much regular activity or active management from the board, save for certain specific instances;¹¹¹

¹¹¹ It was noted, at para 25, that these SPV’s serve important commercial purposes within a group and act as principals, as opposed to just mere nominees or agents. Management of these companies ‘tend not to involve much positive outward activity’.

- the normal test for CMC is not superseded by a different test if the nature of the business is such that it does not require much active management from the board;¹¹²
- it is crucial to determine whether the management and control of a non-resident subsidiary company is exercised through the subsidiary's own 'constitutional organs' (i.e. the board) or whether these organs have been usurped in that an 'outsider' is not merely 'proposing, advising and influencing' the decisions of these constitutional organs but have taken over control completely with the board effectively being by-passed;¹¹³
- in the context of applying the POEM test for purposes of art 4(3) of the DTA, HMR needed to identify and establish exactly where the effective management of Eulalia was and could not merely allege that it was not in the UK (i.e. a more detailed analysis and more onerous burden of proof rested on the revenue authority);¹¹⁴
- whether or not the board had sufficient information at their disposal in order to make an informed or 'effective decision' as to the affairs of the subsidiary company in compliance with their fiduciary duties, was irrelevant as a management decision does not cease to be such merely because it was 'ill-informed or ill-advised';¹¹⁵

Accordingly, it was held that the board of Eulalia had strong commercial reasons to accept the terms of agreements placed in front of it and there was nothing surprising about the decision taken by the board, and that the decision had in fact been taken and executed by the local board.

4.2.1.9 The Smallwood cases

In an important line of cases (discussed below), the courts examined the difference between the concepts of 'CMC' and 'place of effective management' in the context of a trust. The case was first heard by the Special Commissioners, who decided in favour of the HMRC. Thereafter, the taxpayer successfully appealed to the High Court (Chancery Division). HMRC then appealed to the English and Wales Court of Appeal, where it was ultimately successful (by a majority of two to one).

¹¹² Refer para 35 of the judgment.

¹¹³ Refer para 27 of the judgment. An 'outsider' was defined in this context as a person who is not himself a participant in the formal process (a board meeting or general meeting) through which the relevant constitutional organs fulfills its function.

¹¹⁴ Refer para 29 of the judgment.

¹¹⁵ Refer para 43 of the judgment.

As Trevor Emslie, SC, duly notes in his discussion of these cases in Emslie, T (2011) ‘The Court of Appeal on “Place of Effective Management”’, *The Taxpayer*, vol. 60 at p 42, ‘...this see-sawing in the three tribunals shows that the meaning of the phrase POEM is sometimes far from clear...’.

The facts of the case are briefly set out below, together with a discussion of the principles established by the various judgments handed down.

Key facts of the case

In 1989, Mr Smallwood (the taxpayer and settlor) created a settlement (i.e. a trust) for the benefit of himself and his family members. The taxpayer is and has always been resident in the UK for tax purposes. The assets of the trust predominantly consisted of shares. At April 2000, the trustee was a Jersey company (‘Lutea’). The taxpayer was advised to dispose of the trust’s existing assets and diversify the investments. In terms of UK law, the taxpayer, being a UK resident and the settlor retaining an interest in the trust, would accordingly be subject to CGT in respect of the envisaged disposal of the trust assets, had the current trustee (i.e. Lutea) been a non-resident throughout the year. Accordingly, KPMG Bristol devised a ‘Round the World’ tax scheme to escape liability from CGT, which in essence involved, inter alia, the following:

- In December 2000, Lutea formally retired as trustee of the trust, immediately after which the taxpayer exercised his power of appointment to appoint a new non-resident trustee, being a Mauritian tax resident company known as PMIL;
- The settlement was accordingly registered as an off-shore trust by the Registrar of Offshore Trusts in accordance with relevant Mauritian legislation;
- During January 2001, the shares owned by the trust was sold;
- During March 2001, PMIL resigned as trustee in favour of the taxpayer (being a UK resident);
- PMIL subsequently arranged for the trust to be de-registered as an off-shore trust in Mauritius.

The scheme was in essence designed and centred on the fact that, at the time of disposal of the trust assets, the trust should be tax resident in a jurisdiction that had entered into a favourable DTA with the UK in terms whereof taxing rights in respect of any capital gain arising from the disposal of assets, would reside solely with that other contracting state (i.e. not with the UK). Mauritius was specifically chosen as it does not itself tax capital gains (although taxing rights be awarded solely to it in terms of a DTA). In addition, the trustee of the trust should for some part of the year have been a UK resident. Accordingly, the result of the ‘tax planning exercise’ was that no CGT should arise in respect of the disposal.

The taxpayers thereafter submitted a UK tax return for the trust in their capacity as trustees in respect of the 2000/2001 year of assessment, and claimed double taxation relief under the DTA with Mauritius in respect of the gains realised on disposal of the trust assets.

Trevor Smallwood Trust v Revenue and Customs [2008] UKSPC SPC00669

The Special Commissioners essentially had to decide on two principal issues:

- a) Whether dual residency (i.e. in the UK and Mauritius) in fact existed under the provisions of the DTA at the time of disposal by the trust of the assets, taking into account the provisions of art 4(1) of the DTA where ‘residency’ is defined for purposes of the application of the DTA; and
- b) If found that such dual residency applied at the time of the disposal, where the POEM of the trust was at such time, taking account of the tie-break provisions of art 4(3) of the DTA, and accordingly determine which country had taxing rights to the capital gains.

The Commissioners analysed the OECD MTC and UK case law in respect of the principles of interpretation of DTAs and whether the concept of CMC could be equated to the meaning of POEM.¹¹⁶

The Commissioners followed a simple approach in respect of establishing dual residency in that if a taxpayer is found to be chargeable (i.e. liable) to tax at any time in any given tax year in a contracting state by virtue of the criteria listed in art 4(1), the taxpayer is ‘Treaty Resident’ for the whole of that tax year for purposes of application of the provisions of the DTA.¹¹⁷ This conclusion led to the trust being held to be dual resident (i.e. UK and Mauritius resident) at the time of disposal of the shares, even though in time the trust only became a UK resident after the actual disposal, but in the same year of assessment that the disposal occurred.

The Commissioners then turned to the question of establishing the POEM of the trust at the time of the disposal in terms of the tie-break provisions of art 4(3) of the DTA. In this regard, the Commissioners referred with approval to the well-known passage by Special Commissioner David Shirley in *Wensleydale’s Settlement Trustees v IRC* [1996] STC (SCD) 241, at para 250J, where the following was stated in respect of the ordinary meaning of POEM:

¹¹⁶ Refer supra note 58 and the case law discussed there. Refer also in general the principles discussed above in respect of the international interpretation of POEM.

¹¹⁷ Refer Emslie (2011) at p43: ‘This definition required the person in question to be liable to taxation in the relevant Contracting State by reason of his domicile, residence, place of management or other similar criterion.’

‘I emphasise the adjective “effective”. In my opinion it is not sufficient that some sort of management was carried on...”Effective” implies realistic positive management. The place of effective management is where the shots are called, to adopt a vivid transatlantic colloquialism.’ *[Own emphasis added]*

In respect of whether and to what extent the concept of ‘CMC’ differed from POEM, the Commissioners stated that the two concepts serve entirely different purposes. CMC is a concept that establishes UK residency, is in essence a one-country test, can exist in two or more countries simultaneously and the purpose whereof is not to determine where residency is to be found if not in the UK. POEM is a tie-breaker concept that resolves cases of dual-residency (i.e. multiple-residency) under the domestic law of each state and accordingly ‘must be concerned with what happens in both states’¹¹⁸. Only after establishing dual-residency does the level of management to be considered become relevant for purposes of establishing POEM, and accordingly whether such level is similar to that of the concept of CMC.

The court accordingly approached the issue of POEM as considering where the ‘real top level management (or the realistic, positive management) of the trustee qua trustee is found’.¹¹⁹ It was held that, even though all the administrative matters were duly complied with in Mauritius under Mauritian law, the influence of the UK resident taxpayer (i.e. Mr Smallwood) and the UK tax advisors (i.e. KPMG) was evident throughout in the process of devising, concluding and implementing the tax structure, which was all arranged carefully beforehand and motivated by UK tax planning. Accordingly, the ‘lower level management decisions’ taken by PMIL to sell the shares was disregarded and the ‘real top level management decisions’ was held to be taken throughout by the parties in the UK.¹²⁰

Interestingly, the court did not opine on whether the powers of the trust were usurped by the settlor of the trust, who had the sole power to appoint trustees, or whether the trustees continued to act independently on the advice received, albeit in the best interest of the beneficiaries of the trust.¹²¹

Trevor Smallwood and Others v HMRC [2009] EWHC 777 (Ch)

The High Court, in overturning the decision of the Special Commissioners, found that the definition of ‘resident’ as contemplated in art 4(1) in essence should bear the same meaning as resident or ordinarily resident in terms of UK local legislation (i.e. there was nothing in UK

¹¹⁸ Refer para 111 – 112 of the judgment.

¹¹⁹ Refer para 130 of the judgment.

¹²⁰ Refer para 143 of the judgment.

¹²¹ Refer the evidence given at para 135 of the judgment.

domestic law that allowed the extension of the residence of the UK trustee back to an earlier part of the tax year when the trustee was a Mauritian resident).¹²² Accordingly, tax residence for purposes of the DTA ('Treaty Residence') could not be determined with the benefit of hindsight and should have been considered at the time of disposal, and not with reference to events that occurred subsequent to the disposal of the shares by the trust.

The court also found that 'the statute does not deem contracting states to have been resident in a country in any part of the tax year other than that in which they were actually resident within the meaning of the taxing statute'.¹²³ Accordingly, no issue of dual-residence (concurrent tax residence) arose and regard should not be had to the tie-breaker provisions of art 4(3) of the DTA in instances where only consecutive periods of residence exists during the same tax year, as there is at any given point in time no competition for residence between the contracting states.

More importantly, it was stated that since the POEM of a company or trust is a 'snapshot assessment' and could change at any time during a particular year of assessment in accordance with the wording contained in the provisions of art 13 of the DTA, POEM should be allocated to a specific contracting state at the date of the disposal of an asset for purposes of determining rights to tax capital gains. It was however acknowledged that the snapshot may have to be modified to take account of a longer period of time over which a specific transaction occurred.

Revenue and Customs Commissioners v Smallwood and another (2010) EWCA Civ 778; (2010) WRL (D) 177

Lord Justice Patten confirmed the view of the Special Commissioners in respect of the interpretation of Treaty Residence as discussed above, and states at para 43 that:

'The definition of "resident" in Article 4(1) is expressly subject to Article 4(3) which therefore applies whenever the alienator is liable to taxation in both Contracting States in respect of the gain. Article 4(3)...is focused on the liability for tax regardless of the period of residence under national law which creates that liability. Looked at in this way, it becomes meaningless and impermissible to draw a distinction between consecutive and concurrent periods of "residence". The DTA is concerned only with the possibility of a double tax charge on the same gain and not with the period of residence which gives rise to it.'

and further at para 46:

¹²² Refer Emslie (2011) at p44.

¹²³ Refer para 43 of the judgment.

‘I also prefer the view of the Special Commissioners that “resident of a Contracting State” under Article 4(1) means chargeable to tax in that state on account of residence and that, for this purpose, one has to take into account the tax treatment of the gain under domestic legislation of both Contracting States regardless of the period of residence which gave rise to the liability.’

Patten, LJ accordingly proceeded to analyse the application of the POEM test to the facts. He confirmed that Professor Dr Klaus Vogel supported the interpretation adopted by the Special Commissioners and that this approach had also been adopted in German case law. After consideration of the relevant case law authority (discussed above) and the OECD MTC, Patten, LJ concluded that the test as set out in *Wood v Holden*¹²⁴ must be the correct test and concluded that the POEM of the trust, as a continuing body, was to be found in Mauritius up until the trustees became UK resident after the disposal of the shares. His findings were based on the fact that the functions of the trustees were not usurped, that the trustees retained their rights and duties as trustees and exercised their discretion at the time of disposal of the shares and that the trustees did not agree to merely act on the instructions received from ‘outsiders’.

However, Hughes, LJ and Ward, LJ disagreed with the above finding on the facts in respect of the POEM and decided that the POEM was situated in the UK. Their findings were based on the fact that scheme was devised in and carefully orchestrated throughout from the UK, it was integral to the scheme that the residency of the trust be ‘exported’ for a short period to Mauritius and then returned to the UK within the same fiscal year, the taxpayer remained throughout in the UK and that the scheme of management of the trust went beyond the mere day-to-day management exercised by the trustees.¹²⁵

Conclusion

The above case is peculiar and the circumstances which gave rise to the question of the determination of POEM are unique as a result of the scheme devised. Accordingly, any knowledge that can be gleaned from this judgment must be read in context of the facts, but is still helpful in the guidance provided on when the question of POEM becomes relevant in the interpretation of a DTA and its analysis on the application of the tie-breaker provisions.

¹²⁴ Supra.

¹²⁵ Refer the ‘Comment’ section by Emslie (2011) at p56 of his discussion.

4.2.1.10 **Laerstate BV v Revenue and Customs Commissioners [2009] UKFTT 209 (TC)**

In one of the most recent cases relating to the concepts of ‘CMC’ and ‘POEM’, Judge Dennis Davis points out the significance of this case lies in the fact that ‘the Tribunal developed a substantive test for locating CMC’ and that this ‘is a purposive approach which may commend itself to South African courts’.¹²⁶

Key background facts

Laerstate BV (‘Laerstate’) was incorporated and resident in the Netherlands in 1988 as an investment holding company, having one director, being a Dutch national, Johannes Trapman (‘Trapman’). In December 1992, a German national, Dieter Bock (‘Bock’), acquired the entire shareholding of Laerstate and was also from that date appointed as director with Trapman.

In December 1992, Laerstate acquired a substantial shareholding in Lonrho plc (‘Lonrho’), a mining group listed on the London Stock Exchange. The acquisition of the Lonrho shares was funded by way of a £100m loan. In 1993, Bock was appointed as joint managing director and CEO of Lonrho and was based in the UK as from this date. He remained on the board of Laerstate until August 1996.

Bock resigned as a director of Laerstate in August 1996, shortly prior to the sale by Laerstate of its Lonrho shareholding to Anglo and as from then, Trapman was the sole director of Laerstate. The reason for Bock’s resignation was sighted as a conflict of interest in respect of his directorships of both companies.

The UK Inland Revenue (‘Revenue’) sought to tax the gain on the basis that Laerstate was resident for tax purposes in the UK at the time that the gain arose. Silke¹²⁷ summarises the crux of the matter before court:

‘In order for Laerstate to be subject to tax in the UK, the ‘CMC’ of Laerstate had to be in the UK (i.e. a resident for domestic law purposes), alternatively, to the extent that Laerstate was a ‘resident’ in the UK and in the Netherlands, the ‘place of effective management’ had to be in the UK in terms of the treaty.’

¹²⁶ Davis, D (2010) ‘The Case of Effective Management’, *The Taxpayer*, vol. 59, pp. 3-5 at p5.

¹²⁷ Silke on International Tax, §17.5.4.1.

Key findings – CMC

The court noted that there is no assumption that CMC must be found where the directors meet, especially when the management is carried on out outside board meetings. The court held that this is entirely a factual enquiry that will be considered ‘upon a scrutiny of the course of business and trading’ and noted further ‘this...test...does not confine itself to a consideration of particular actions of the company such as the signing of documents or the making of certain board resolutions outside the UK if, in a given case, a more general overview of the course of business and trading demonstrates that as a matter of fact CMC abides in the UK’. Accordingly, the entire picture had to be considered.¹²⁸

The court further confirmed earlier principles set out in case law such as Unit Construction Company case and Wood v Holden (refer above). The court also confirmed that ‘the mere actions of signing resolutions or documents do not suffice for actual management’.¹²⁹

The court, in what appears to elaborate on the principle discussed in Wood v Holden in relation to ‘effective decisions’ and the minimum amount of information required, described various scenarios in respect whereof the parent company or majority shareholder (an ‘outsider’) influences the management of its subsidiary company to varying degrees, ranging on a scale from:¹³⁰

- i. the extreme case where a director mindlessly signs, upon instruction from the outsider, a document without even reading it or knowing its contents – this does not constitute a decision for purposes of CMC;
- ii. a more moderate case where the director is aware of what he is signing but has not directed his mind to whether this is the best course of action for the company and, objectively, the director did not at least have the ‘absolute minimum amount of information’ available that a person would need to have to enable him to make such a decision – this does not constitute a decision for purposes of CMC;
- iii. leaning toward the other end of the scale, is the director that considers whether or not to follow the instructions/wishes of the outsider and in making that decision, at least has the

¹²⁸ Refer paras 27 – 29 of the judgment.

¹²⁹ Refer para 33 of the judgment.

¹³⁰ Refer paras 34 – 37 of the judgment. Gutuza (2012) at p 432 refers to this as the ‘four-scenario test’ – a test which is based on differing levels of information placed before the board in order to analyse the CMC (and by analogy, POEM) of a company. Gutuza states that the court has clarified that the de facto POEM is of secondary application and only comes into play when the legal POEM has been usurped.

‘absolute minimum amount of information’ available that a person would need to have to enable him to make such a decision but still less information than a reasonable director would require to make a well-informed or sensible decision – this does constitute a decision for purposes of CMC; or

- iv. towards the other extreme, a director who has available all the information by which to make an informed decision – this does constitute a decision for purposes of CMC.

It is submitted that the above analogy can be applied to various practical duties of directors in their management of the subsidiary company and is not just confined to the signing of documents or agreements.¹³¹

In determining where Laerstate’s CMC was located, the court considered the period during and after Mr Bock was a director of Laerstate – in summary:

- Laerstate acquired shares in Lonrho prior to Bock becoming a director. However evidence suggested that the decision to enter the subscription agreement was made by Bock in the UK and merely implemented by Trapman. During the period when Bock was a director, he conducted the business and carried out activities of a strategic and policy nature, mainly from his UK office. Professional advisers looked directly to Bock for instructions and often referred to Bock alone as the client.
- Even following his resignation, there was no change in the management of the company and Bock continued to exercise control in overriding the remaining director’s powers. Although Trapman dealt with the formalities of resolutions and signing the relevant share sale documents, the court found that he was merely carrying out Bock’s instructions, rather than consciously deciding whether to act or not to act. It was further found that Trapman signed the share sale documents without having sufficient knowledge of the transaction (i.e. he did not have the minimum amount of information available to enable him to even make a decision).
- There was evidence that some resolutions were passed and documents executed outside the UK, however, throughout the relevant period, the company’s actual “*course of business and*

¹³¹ However, in applying this test, the principles as set out in earlier case law should not be discarded in that even ill-informed decisions taken by management remain management decisions nonetheless, as well as the principle that management may be told what to do but it would not follow that CMC lay with an outsider as long as the board actually exercised its own discretion when it comes down to making a decision. Refer the discussions in *Wood v Holden* and *Untelrab v McGregor* supra.

trading” and the key decisions in “*policy, strategic and management matters*” were made by Bock in the UK, rather than by Trapman or at board meetings outside the UK.

- It was found that there were long periods during which no board meetings were held at all, and that Bock carried out all significant management activities during such periods, mostly from the UK.
- Furthermore, substantial communications between Bock and Laerstate’s professional advisers were undertaken substantially in the UK. The court found that Trapman was simply an extension of Bock’s will and wishes, and that Trapman had no input in the strategic or top-level management of the company.

On the facts the court concluded that throughout the relevant period Laerstate’s CMC was based in the UK, Laerstate was therefore a UK tax resident and it follows that Laerstate was subject to tax in the UK on the sale of the Lonrho shares.

Key findings – POEM

The principles established in the Smallwood judgements (discussed above) was confirmed in respect of establishing ‘treaty residence’ and the court confirmed that the principles would apply equally to a company.¹³²

The court further stated that it was irrelevant over which period the POEM test was to be applied ‘because it is the nature of POEM, as it is with CMC, that it has to be applied by reference to facts taken over a period’.¹³³ Accordingly, the court confirmed that the POEM test should yield the same result whether it was applied at an exact point in time or over a period of time.

In applying the aforementioned, the court found that the real top-level management (or realistic positive management) of Laerstate, and accordingly the POEM, remained in the UK throughout.

4.3 Conclusion

In summary then, it appears that much guidance can be ascertained in a South African context, with its lack of local guidance and precedent, from consideration of the UK case law, whether it be in relation to CMC or POEM. It appears that these concepts overlap and in many instances share similar features, but although the concepts are similar, they are not the same. The difference is highlighted specifically when it comes to the context in which the two concepts are applied (i.e.

¹³² Refer para 48 of the judgment.

¹³³ Refer para 49 of the judgment.

CMC in UK local legislation to determine UK residency and POEM as a tie-breaker in the international arena of DTAs).

Based on the above, in order to determine the POEM of a person (other than a natural person), one would consider where, based on all the relevant facts and circumstances of the business as a whole, the key management and commercial decisions, necessary for the conduct of the business, are in substance made – this implies a test of where the real, top-level management (or realistic positive management) is located and where the broader strategy or policy type decisions are made.

Where the key management and commercial decisions that are necessary for the conduct of the business are accordingly made by the ‘hands-on operational management of the company’, this will be indicative of the POEM. However, the view is that generally these type of decisions will be made at a more superior level of management.

Similarly, CMC of an entity has been held to abide where the real business is carried on (i.e. where the company keeps house and does business). Both concepts (CMC and POEM) appear to refer to the place where ‘the shots are called’. Accordingly, various factors relevant for determination of CMC can be used to analyse the POEM, e.g. the ‘four-scenario test’ set out in Laerstate may be helpful to determine whether relevant decisions (required for the conduct of the business) have actually, in substance, been made by management in a POEM enquiry.¹³⁴

Gutuza (2012) at p130 states that the factors taken into account in the South African context of POEM are largely consistent with the UK concept of CMC and that, prima facie, these concepts appear comparable. However, the UK case law focus is almost exclusively on strategic decision making in determination of CMC and the UK does not allocate as much weight to the different levels of management (as is the case in South Africa), except when dual-residency is involved (i.e. where the POEM must be determined).

It appears then that the UK weighting and hierarchy of factors have been established through case law over the years, whereas the position in South Africa, in the absence of a plethora of case law and explicit guidance in the Income Tax Act 1962 and SARS Interpretation Notes, must now be considered to establish whether a South African interpretation has been established in respect of POEM and if so, how this meaning compares to the international concept of POEM as utilised in the DTAs.

¹³⁴ Silke on International Tax, §17.5.4.3.

5 **The interpretation of POEM in South African law**

Silke correctly points out that when Contracting States interpret treaty concepts such as POEM, these Contracting States refer back to their domestic law and it is not difficult to imagine that conflicting views and double taxation may arise where a common international understanding of treaty terms, such as POEM, cannot be established (e.g. where the Contracting States involved consider different levels of management when conducting the POEM test).¹³⁵

Silke further confirms that ‘there is no single, internationally mandated meaning’ of the phrase POEM and the Income Tax Act 1962 does not define the concept. The closest and most related concept is deemed to be that of CMC, but because the South African legislature chose to use different terminology, this likely indicates ‘a desire to denote a concept different from’ CMC.¹³⁶

It is therefore important to establish whether a clear meaning can be attributed to the term POEM in terms of South African law.

5.1 **The ordinary meaning of POEM**

Under the domestic rules of interpretation discussed above, South African courts interpreting the meaning of POEM will have to ascertain and attribute, at least in the first instance, the ordinary meaning of the phrase, taking into account the context in which it is utilised.

As an initial step it may be useful to consider the dictionary meaning of the words, although various meanings may be attributed to the words in different contexts and a court will have to utilise the most appropriate definition in the context to give meaning to the phrase.

The Oxford on-line dictionary defines ‘effective’ as follows¹³⁷:

‘Successful in producing a desired or intended result; Existing in fact, though not formally acknowledged as such; Assessed according to actual rather than face value’,

and defines the word ‘management’ to mean the following:

‘The process of dealing with or controlling things or people; The responsibility for and control of a company or organization’.

¹³⁵ Silke on International Tax, §17.5.4.1.

¹³⁶ Silke on International Tax, §14.42. See also Van der Merwe (2002) at p88 where this view is confirmed and the author states that applying the CMC test can result in multiple residences being yielded.

¹³⁷ Available at <http://www.oxforddictionaries.com/definition/english>.

Accordingly, without consideration of the various other sources discussed here in respect of the meaning of POEM, the POEM of a company can be defined as ‘the place where the actual, factual responsibility for and control of a company is situated’.

Bearing the above in mind as a starting point in the South African determination of POEM, the discussion now turns to other sources available in order to give context and meaning to the phrase.

5.2 Guidance from SARS

SARS attempted to provide some certainty to taxpayers in respect of determining the residence of persons (other than natural persons) by application of the POEM test contained in the definition of ‘resident’ in section 1 of the Income Tax Act 1962 and released the Income Tax Interpretation Note No. 6 (‘IN6’)¹³⁸, dated 26 March 2002, detailing some of SARS’ views on how to interpret POEM in this context.

In the subsequent discussion paper by SARS released in September 2011 (‘the SARS Discussion paper’)¹³⁹, wherein SARS tried to address some concerns raised by taxpayers in respect of the guidance set out in IN6. In the Discussion Paper, SARS acknowledged the fact that the POEM test is also used in the context of DTAs as a tie-breaker, a point which was not previously addressed in IN6. SARS further invited comments and stated that the responses to the Discussion Paper would provide a framework for possible revision of IN6.

Furthermore, it is worth noting that interpretation notes issued by SARS are not legally binding on anyone (including SARS) and it does not constitute law in South Africa.¹⁴⁰

5.2.1 Income Tax Interpretation Note 6

Important to note is that IN6 only dealt with the POEM test in relation to determining the residence of a person. The dual purpose of POEM in South African law was not addressed.

SARS supports the view that, in the absence of a definition of the concept, the ordinary meaning must be attributed, taking into account ‘international precedent and interpretation’ of POEM.¹⁴¹ From the outset, the view was adopted that effective management was not the same as shareholder

¹³⁸ Op cit note 104.

¹³⁹ Op cit note 104.

¹⁴⁰ Refer ITC No 1675 (1998), 62 SATC 219.

¹⁴¹ IN6 at p 2.

control or control by the board of directors, but that focus should be placed on the company's business and purpose.¹⁴²

IN6 further noted that in determining POEM, the general approach adopted is 'the place where the company is managed on a regular or day-to-day basis by directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets. The focus is therefore on the location where policy and strategic decisions are executed and implemented by a company's senior management, rather than the place where the ultimate authority over the company is exercised by its board of directors or similar body.'¹⁴³

IN6 attempts to distinguish between 3 levels of management within the company set-up:

- Top-level or central management and control: exercised by the board of directors:
 - o Van der Merwe (2006:126)¹⁴⁴ states this this level of management does not play a role in SARS' interpretation of determining residence.
- Mid or second tier management: Implementation by executive directors and senior management of policy and strategic decisions made by the board, as well as making and implementing of regular day-to-day operational management and business activities:
 - o Van der Merwe (2006:126) is of the view that it is primarily the location of this type of management that will be regarded as the POEM of a company for purposes of determining residence.¹⁴⁵
- Lower level management: carrying out the actual day-to-day business activities:
 - o Van der Merwe (2006:127) indicates that this level may or may not correspond with the place from where the second tier management is exercised and a distinction should be possible.

In respect of practical application, IN6 adopted a three-stage enquiry that briefly operates as follows:¹⁴⁶

¹⁴² Ibid.

¹⁴³ SARS Discussion Paper, p 3, para 5.

¹⁴⁴ Van der Merwe, BA (2006) 'The Phrase "place of effective management" Effectively Explained', *South African Mercantile Law Journal*, vol. 18, pp. 121-137 at p126.

¹⁴⁵ Van der Merwe, BA (2006) identified a problem with the wording used in a grammatical sense in that 'Activities are not commonly 'made' or 'implemented', but 'take place', are 'carried out' or 'conducted'. The verbs 'make' and 'implement' are usually associated with nouns such as 'decision'. 'order', 'policy', 'plan', 'strategy' or 'procedure'.

¹⁴⁶ IN6, p4, para 3.3 and SARS Discussion Paper, p 3 - 4, para 5.

- 1) ‘First, if the relevant management functions are exercised at a single location, that location will be the place of effective management.’
- 2) ‘Second, if those functions are exercised at multiple locations (for example, where those functions are exercised through distance communications such as videoconferencing or the internet), the place of effective management “would best be reflected where the day-to-day operational management and commercial decisions taken by senior managers are actually implemented, in other words, the place where business operations/activities are actually conducted from/carried out”.’¹⁴⁷
- 3) ‘Finally, if those business operations or activities are conducted from various locations, the place of effective management would be “the place with the strongest economic nexus”.’¹⁴⁸

IN6 emphasis that the determination of POEM remains a factual question which must be determined with regard to all relevant facts and circumstances. A non-exhaustive list of factors to be considered in this regard is set out there (and for convenience sake is reproduced below):

No	IN6 Factors:	Comment/Criticism
1	Where the centre of top level management is located.	This is in line with the OECD TAG Discussion Paper 2001, paras 26 – 30 and the guidance taken from ‘place of management’ (inter alia used in Germany).
2	Location of and functions performed at the headquarters.	The term ‘headquarter’ in relation to a company is uncertain.
3	Where the business operations are actually conducted.	It is uncertain as to what is meant by the term ‘business operations’.
4	Where controlling shareholders make key management and commercial decisions in relation to the company.	It is not common practice for shareholders to make these decisions in respect of a company, rather the board or senior management.

¹⁴⁷ Van der Merwe, BA (2006) at p128 refers to this as a ‘deemed place of effective management’.

¹⁴⁸ Van der Merwe, BA (2006) at p128 states that this test does not feature as a separate test under South African law to determine residence and as such has no standing in our law, unless it is used as part of the POEM test in the DTA.

5	Legal factors such as the place of incorporation, formation or establishment, the location of registered office and public officer.	This factor constitutes a completely separate test for residency in South Africa and has been criticised for being open to manipulation.
6	Where the directors or senior managers or designated manager, who are responsible for day-to-day management, reside.	In the modern era of telecommunications, it is comprehensible that management can take place remotely.
7	The frequency of meetings of the entity's directors or senior managers and where they take place.	This factor may only be relevant in as far as these individuals can be said to 'call the shots' and exercise realistic positive management.
8	The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity.	This may be a relevant factor in practice.
9	The actual activities and physical location of senior employees.	This may be a relevant factor in practice, considering that one is looking to senior management for determining POEM.
10	The scale of onshore as opposed to offshore operations.	It is difficult to see how this factor is relevant as large off-shore operations can be effectively managed on-shore and vice versa.
11	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.	It is unclear whether this factor is referring to the principle where management and control is usurped by an outsider, whether or not allowed under the constitution of the company.

Silke states that it is doubtful whether this list is ‘particularly decisive or enlightening’ and that there are a lot of ‘potentially competing factors or criteria’ which has largely been discredited by the High Court in the *Oceanic Trust* case (discussed below).¹⁴⁹

5.2.2 SARS: Discussion Paper on Interpretation Note 6

The Discussion Paper was explicitly only applicable to determining the POEM of companies.¹⁵⁰ The Discussion Paper confirmed the need for a ‘less artificial manner’ to determine POEM and confirmed that this is in essence a ‘substance over form’ enquiry.

A fair amount of criticism was set out in respect of IN6 in its current form, which can broadly be summarised as follows¹⁵¹:

- 1) The focus, as set out in the general approach in IN6, should have been on where strategic decisions and policies were taken or adopted, instead of putting emphasis on execution and implementation thereof;
- 2) The terminology used is inconsistent and there are discrepancies in the language used in the general approach and the practical application. Furthermore, there appears to be no statutory basis for the use of an ‘economic nexus’ to determine POEM¹⁵²;
- 3) There are apparent inconsistencies in applying the general approach suggested and the guidelines proposed to achieve the goal;
- 4) No guidance has been provided in respect of passive or intermediate holding companies.

It is further argued that the ‘board-centric approach’ followed initially championed by the OECD was not effective in a modern technological era where the hierarchical management structures of companies have changed and companies are managed through divisions rather than legally incorporated subsidiaries, effective management based on where directors meet becomes a matter of choice and manipulation.¹⁵³

The Discussion Paper takes cognisance of the developments in the OECD MTC since 2002, the TAG discussion papers released in 2001 and 2003, as well as the principles discussed in UK case

¹⁴⁹ Silke on International Tax, §14.42.

¹⁵⁰ SARS Discussion Paper, p 2, para 2.

¹⁵¹ SARS Discussion Paper, p 5, para 6.

¹⁵² In this regard, however, see the OECD TAG Discussion Paper 2001 and the discussion above under para 3.3.2.2 where the economic nexus is proposed as an alternative test (i.e. a separate rule).

¹⁵³ Van der Merwe, BA (2006) at p124.

law such as the Laerstate, Smallwood and Wensleydale's Settlement Trustees cases. These principles have been discussed at length above and are not repeated here, save to state that the principles set out in the UK judgments appear not to have been comprehensively discussed and accordingly the Discussion Paper appears not to distinguish sufficiently between factors considered relating to the CMC and POEM tests respectively.¹⁵⁴

The Discussion Paper also sets out some goals that a revised test for determining POEM would need to meet¹⁵⁵:

- 1) It must be a substantive test that is not open to simple, formalistic manipulation.
- 2) Uncertainty must be reduced in so far as the level of management that is being considered and if a differing view to international standards is accepted, this should be explained. The guidelines should also be clarified.
- 3) The test must be able to accommodate a broad variety of factual situations. The composition of the board and management must be evaluated on a case by case basis as the structures and allocation of powers may differ within the group. Passive and intermediate holding companies must be catered for specifically.
- 4) Certainty must be provided in respect of headquarter companies with 'foreign operating subsidiaries that has bona fide business operations and on the ground top level managers responsible for the high-level day-to-day running of those operations'.

The Discussion Paper then establishes 4 areas of development that are discussed below:

A. Refinement of the general focus of IN6

It is suggested that the general approach set out in IN6 should not be abandoned, but clarified in that focus will be on second tier management who 'call the shots' and exercise 'realistic positive management' (i.e. the principles established in UK case law of Wensleydale's Settlement Trustees will be adopted).

The second tier management individuals will apparently be the senior officers and executives responsible for:

'(1) actually developing or formulating key operational or commercial strategies and policies for, or taking decisions on key operational or commercial actions by the company (regardless of whether those strategies, policies and decisions are subject to

¹⁵⁴ Refer the discussions above under para 3.3.2.1 – 3.3.2.4.

¹⁵⁵ SARS Discussion Paper, p 11, para 8.

formal approval by a board or similar body) and (2) ensuring that those strategies and policies are carried out. Areas of decision-making involving extraordinary matters (such as major acquisitions, disposals, mergers or new borrowing) that are commonly reserved to a company's board or its shareholders generally would not be considered part of this "second level of management" for a foreign operating subsidiary and therefore generally would not affect the determination of a foreign operating subsidiary's place of effective management. Similarly, day-to-day operational decision-making by junior and middle management would also generally fall outside of the second level of management, as would the performance of routine administrative or support functions.'¹⁵⁶ (own emphasis)

Furthermore, to bring the approach in line with international principles and to establish clear distinctions between the levels of management, the references in IN6 to implementation of strategy and policy will be deleted and the focus will be on where decisions are made.

B. Terminology

Definitions are to be provided for some of the basic terms in order to create certainty for the taxpayers. These terms would include¹⁵⁷:

- Senior management;
- Operational management;
- Executive/inside directors;
- Non-executive/outside directors;
- Head office;
- Base of operations; and
- Passive holding company.

C. Relevant facts and circumstances

Certain updates and changes are proposed to the current guideline as set out in IN6 (refer table above). It is proposed that certain factors be deleted (e.g. factor 5 in the table above) and that other factors be clarified and refined (e.g. factor 4 should be limited in its

¹⁵⁶ SARS Discussion Paper, p 12, para 8.1.

¹⁵⁷ SARS Discussion Paper, p 12 - 13, para 8.2.

application to situations where the shareholders actually usurp the management function and ‘call the shots’).

It is proposed that the following factors be added to the current list¹⁵⁸:

- Delegations of authority by the board of directors or similar body, for example, to an executive committee.
- Consideration of differing board structures, for example, distinctions between commercial and non-commercial or supervisory boards.
- The identification of various factors that will generally be given little weight, for example, the place where administrative activities, such as the opening of a bank account, take place.
- Refinement of the distinctions between various levels of management. (For example, in companies operating on a divisional basis, individual divisions are often run by an executive vice president or operational manager who reports to a higher level of management that is responsible for the company as a whole. In such a situation, the place of effective management would be the place where that top level of management is primarily or predominantly based).
- Criteria for determining the base of operations for senior management in situations where senior management travels frequently or operates from multiple locations (with meetings held, for example, via video conferencing).

D. Mutual agreement procedure

In situations where there is still disagreements between the Contracting States to the DTA after applying the relevant tests, the revised IN will explicitly provide to resolve the dispute through the mutual agreement procedure.

5.3 Specific issues in relation to the interpretation of POEM

5.3.1 The meaning of POEM in domestic law versus the DTA

As discussed above in chapter 3, the concept of POEM is used in South African domestic legislation as one of two tests to determine the tax residency of a company under the Income Tax Act 1962. Where a company has its POEM in the Republic, it will be deemed to be a resident for

¹⁵⁸ SARS Discussion Paper, p 13, para 8.3.

South African tax purposes, irrespective of where it is actually incorporated, established or formed and will be taxed accordingly.

In addition, the concept of POEM is also used as a tie-breaker rule in many DTAs. Accordingly, where it has been established under the domestic law of the respective Contracting States (to the DTA) that dual residency of a legal person exists (referred to above as 'Treaty Residence'), POEM is utilised as the tie-breaker in order to determine in which Contracting State the legal person (e.g. a company) is resident for purposes of applying the provisions of the DTA.

It is further clear from the discussion above under chapter 3 that 'Resident of a Contracting State' bears a specific meaning as set out in art 4(1), read with art 3(2), of the OECD MTC and from the authorities quoted it seems clear that the treaty concept of residency differs from the meaning thereof under domestic law of each Contracting State. It is also clear that residency for South African domestic law purposes is an annual event, whereas residency for treaty purposes is determined on a day-to-day basis. Furthermore, when a taxpayer is deemed to be a resident of another Contracting State for purposes of a DTA, that taxpayer is exclusively regarded as a resident of that other Contracting State and is not regarded as a South African tax resident any longer.¹⁵⁹

Following from the discussion above in chapter 4 and the case law cited there, it appears that POEM, although not defined in the OECD MTC or South African domestic law, should bear a specific meaning in the context of a DTA in light of its function as a tie-breaker clause in order to determine the sole state of Treaty Residence (i.e. 'dual residence is not an option under treaty law, as it is specifically designed to provide clarity in cases of dual attachment').¹⁶⁰ This interpretation is consistent with the OECD commentary on the MTC in that an entity can only have one place of effective management at any given time. Van der Merwe (2002:89) is further of the view that the above is supported by the fact that POEM is in essence a test of 'substance over form' and that in applying the POEM test, one should accordingly always be able to establish a single POEM.

Considering the above, the question that arise then is whether the concept of POEM as used to determine South African tax residency under domestic legislation and as used as a tie-breaker test under the provisions of a DTA, must (or will) bear the same result if applied to a particular set of facts.

¹⁵⁹ Op cit note 64 and 65.

¹⁶⁰ Van der Merwe (2002) at p 89.

The answer then in short appears simple – these concepts cannot bear the same meaning, mainly as a result of the different functions it has under the legislation, but also because it would render the legislation impractical (i.e. where a foreign incorporated company's South African tax residency has been confirmed in terms of that company having its POEM in South Africa, resulting in comprehensive liability to tax and accordingly Tax Residency in terms of any DTA, a different result would not be possible when construing the meaning of POEM, should the provisions of art 4(3) of the DTA be invoked, to solve a conflict under the DTA).¹⁶¹

Accordingly, a different meaning must be attributed to POEM when used in different contexts under the South African domestic legislation in order to meet the purpose for which it was introduced (i.e. a purposive approach should be followed).

5.3.2 The meaning, nature and levels of management considered

When dealing with the management of a company, various parties come into play (e.g. the shareholders, board of directors etc.) which differ from dealing with other entities such as trusts, where the interested parties may include the founder/settlor, beneficiaries and the trustees. These persons could all exercise some sort of influence in respect of the management of the entity.

Van der Merwe (2006:131) states that a company's powers are usually divided amongst its various organs (such as the board, managing director, committees of directors) and regulated by legislation, the articles and memorandum, as well as common law. Powers of management are usually conferred upon the board or managing director. It is further acknowledged that shareholders' powers to intervene in the day-to-day operations of the company are limited to instances where the board cannot or will not act, and then will be regulated via the shareholders meeting. Directors may however delegate their powers, but must retain the ultimate decision-making powers.

Oguttu (2008) also states that with modern technology, especially in the telecommunications environment, management is now more mobile and do not necessarily need to be physically present at the same location in order to make decisions and that these locations may also rotate. This will likely complicate the determination of a single POEM in respect of multinational companies.

Van der Merwe (2002:81) further states that the term 'effective management' can sometimes be misleading and ambiguous as the word 'effective' can describe the nature of management or the

¹⁶¹ Refer Van der Merwe (2002) at p 92 and Oguttu (2008) at p85 – 87 for support.

level of management involved and may be difficult to apply in practice.¹⁶² Van der Merwe (2002:85) further highlights that, especially in the South African context, in order for a decision to be made effectively, there must also be subsequent implementation of that decision, as the general approach highlighted by IN6 may essentially consider the ‘hands-on operational management’ of the company.

5.3.3 More than one POEM

Van der Merwe (2002:89-91) is of the opinion that in adopting the view that POEM must be determined at a place where the day-to-day management occurs (this will usually be where the business operations are actually conducted), only one POEM can arise. However, it is stated that where the majority view is adopted, i.e. that POEM is situated where the superior management meet to make decisions regarding strategy and policy matters of business as a whole, multiple places of POEM can arise and will lead to interpretative problems. Van der Merwe further states that this problem may be exacerbated by the fact that management decisions may include both making and implementing of such decisions and that the location of making and implementing these decisions may differ.¹⁶³

The problem with Van der Merwe’s comments above is that it appears to operate from the assumption that, especially for purposes of determining tax residence, one must adopt an interpretation of POEM that yields only a single residence. This approach is in fact correct when dealing with the international interpretation of POEM as used in the DTA as a tie-breaker concept, but should not find application when dealing with the concept of POEM in determining South African tax residency. This principle has been confirmed in UK case law cited above and quoted by Van der Merwe in his article – there is no problem with the UK test of CMC yielding multiple residences, provided that one of these residences are the UK, and the same principle should be applied in South African law where POEM is used to determine residency.

Where POEM is determined in the context of establishing residency under South African domestic law, this concept should be interpreted to be more closely aligned with and developed by the South African case law (i.e. the concept should be developed in local law, rather than to

¹⁶² See also Gutuza (2012:427) where reference is made to Lynette Olivier *et al* Juta’s Income Tax Review Service 15 (2010), volume 1, where the commentary states that the concept of ‘effective’ indicates that a court may enquire into the substance of the operations of the taxpayer.

¹⁶³ As authority, Van der Merwe cites Davis, D, Olivier, L and Urquhart ‘Commentary on the Income Tax Act’ (1999/2000) at s9 which states that a management decisions taken would not be effective without implementation.

try and align it with the international interpretation of POEM as used in the DTA). It will likely be established that the meaning of POEM in this regard is similar to the UK concept of CMC.

However, where POEM is determined in the context of a DTA, this concept should be interpreted to be more closely aligned with the internationally accepted meaning of the phrase as set out in guidance provided by the OECD and interpretation of foreign case law on this matter and the test should ideally only yield a single jurisdiction.

5.4 South African case law

There is very little South African case law available on the concept of POEM either as used to determine tax residence in local law or as the tie-break concept under the DTA. What follows is a very brief discussion in respect of the more salient points that has emerged from case law in South Africa.

5.4.1 Oceanic Trust Co Ltd NO v C: SARS (2012) 74 SATC 1275

In *Oceanic*, the applicant, being the trustee, was located in Mauritius and sought declaratory relief from the High Court on whether or not the trust, registered in South Africa, was a ‘resident’ as defined in section 1 of the Income Tax Act 1962, by virtue of having its POEM in South Africa. This was done by having regard to the actions of the trustee.

In finding that the trustee had not made out a case for declaratory relief, the court stated that¹⁶⁴:

‘firstly, for this court to declare that the trust was not a resident of the Republic, will require this court to enquire into the facts and to make factual findings, inter alia, on the question where, in South Africa or in Mauritius, *the trust’s* key management and commercial decisions that are necessary for the conduct of *its* business were in substance made during the years in question and all the material facts relating to the management of *the trust* have not been ‘fully found’ and are not ‘sufficiently clear’ in order to simply pose the question whether the facts are such as to bring this case within the definition of ‘resident’ properly construed. Moreover, the question whether *the trust* was a resident of South Africa was not at this stage simply a question of law and this court was not entitled to enquire into and make the required findings of fact as the making of such decisions has been entrusted to the Tax Court. That, secondly, even if the facts were sufficiently clear to make a decision, the place where key management and commercial decisions that were necessary for the conduct of *the trust’s* business, were in substance made, has not been established to be outside South Africa and that at least some key

¹⁶⁴ Refer *Oceanic* supra at para 57 – 58.

management decisions and at the very least commercial decisions necessary for the conduct of *the trust's* business, were in substance made in South Africa.' (amended wording)

The Court adopted the views as expressed in UK case law of Wensleydale Settlement Trustees and Smallwood where it was stated, inter alia, in respect of POEM, that it is where the centre of top-level management is located (i.e. where the key management and commercial decisions are actually made) or where the 'real top level management (or the realistic, positive management) of the trustee qua trustee is found'. The current OECD commentary on art 4(3) of the MTC was also confirmed as support for the interpretation of POEM. The Court summarised the key features from the Smallwood judgment relating to POEM as follows at para 54:

- The POEM is the place where key management and commercial decisions that are necessary for the conduct of the entities business are in substance made;
- The POEM 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;
- However, no definite rule can be given and all relevant facts and circumstances must be examined to determine the POEM of an entity;
- There may be more than one place of management, but only one POEM at any one time;
- The decision was based not only on the general test for POEM 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
- 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 POEM of the trust in that case was.

In the current instance, the application of the facts of the case to the legal principles established was not conducted by the court as it was restrained by the nature of the application and will accordingly not be discussed here, save for the finding referred to above.

Of great significance here is that the Court did not discuss the possibility of different meanings that can be attributed to POEM in its application as a tie-breaker in the DTA as opposed to determining residency in a domestic law context. In this regard, Gutuza (2012:426) notes that

‘although the term is used in both scenarios and should therefore prima facie have the same meaning, it is submitted that its intention or purpose varies in the context of a country using it to determine “residency” and a DTA using it to determine “best residency” from a choice of at least two residencies’, but states that the court in *Oceanic* did not support such a distinction in the different contexts.¹⁶⁵

Gutuza (2012:428) further notes that the Court in *Oceanic* confirmed that the test is one of substance over form and accordingly that the approach will be:

- 1) First, to establish the ‘de facto POEM’ (i.e. a factual enquiry into POEM) by attributing human characteristics to the company in order to establish where the ‘directing mind’ is to be found which effectively manages it – the mind is located in some individual or body of persons that ‘call the shots’;
- 2) Second, to establish the ‘de jure POEM’ (i.e. a legal enquiry into POEM) by scrutinising the company’s founding documents and relevant law to determine which person or body of persons is entitled to effectively manage the company in terms of its constitution.

Support for the above views are found in earlier South African case law decided in respect of ‘residence’ based on the concepts of ‘ordinary residence’ or ‘managed or controlled’.¹⁶⁶

5.5 Conclusion

From the above it is clear that there are a lot of nuance situations that arise in practice and that will create certain difficulties in applying any test of POEM, no matter how sophisticated it may appear. This results from the fact that POEM is utilised as a test for both local tax residency and as a tie-break test in the majority of DTAs concluded by South Africa.

SARS seems to be confident that their proposals as set out on the Discussion Paper will be able to satisfactorily resolve most conflicts by distinguishing between the various levels of

¹⁶⁵ It is however worth noting that the court in the *Smallwood* judgement at para 29 appears to have stated that such a distinction exists in that a DTA’s ‘purpose is to set out rules for resolving issues of double taxation which arise from the tax treatment adopted by each country’s domestic legislation by reference to a series of tests agreed by the Contracting States under the DTA. The criteria adopted in these tests are not necessarily related to the test of liability under the relevant national laws and are certainly not intended to resolve these domestic issues’.

¹⁶⁶ Gutuza (2012:428 – 429) discusses these authorities such as *Estate Kootcher v Commissioner for Inland Revenue* 1941 AD 256; ITC No 1741, 65 SATC 106; ITC No 1054, 1964 26 SATC 260.

management.¹⁶⁷ However, it still seems that not enough focus has been placed on the different contexts in our law where the concept of POEM is applied.

SARS' approach of following a case-by-case determination appears in line with the international standard, but the extensive amount of facts and circumstances that has to be considered will involve some subjective comparisons and creates uncertainty as there is no single technical requirement that can be used as guidance for the taxpayer.

Although the SARS test retains its flexibility to cater for multiple scenarios and situations, the reality is that, through the developments outside of the tax arena (i.e. in the technological space and changes in the management structures of big multinationals) it is becoming more difficult to pinpoint the exact person that 'calls the shots' or that exercises the 'realistic positive management' in a single location.

The Oceanic trust has also largely discredited the guidance issued by SARS and it is accordingly uncertain what weight, if any, a court will attribute to it in future.

¹⁶⁷ SARS Discussion Paper, p 12, footnote 33.

Conclusion

To conclude then, it is clear that POEM features in two different contexts in the realm of South African tax legislation, being in the context of determining tax residency under the Income Tax Act 1962 and as a tie-break clause in various DTAs to which South Africa is a Contracting State. Albeit an important term, no definition of the concept exists in South African legislation.

The rules of interpretation clearly state that the concept of POEM should be interpreted using the ordinary grammatical meaning of the phrase, taking account of its purpose and the context in which the words are used. It has been argued above that POEM is clearly used in two different scenarios in order to achieve a different purpose in each instance and the term must accordingly be interpreted bearing this in mind.

From the extensive sources discussed above, the only plausible conclusion is that POEM must be attributed a different meaning in each context as the phrase serves entirely different purposes in each context used:

- In the context of determining tax residency, the question that must be decided is whether it can be argued that the POEM of a company is in South Africa. It is possible that a company may have more than one POEM, but as long as it can be proven that one of the places of effective management is in South Africa, the company will be tax resident under the Income Tax Act 1962. This concept should arguably be interpreted in a similar manner to the concept of CMC in the UK to determine UK residency of companies not incorporated or formed in the UK and the ample guidance discussed above can be taken into consideration. South Africa will however need to decide what level of management to focus on in establishing POEM in a domestic context and clarity should be provided on the approach adopted; alternatively, a different term should be introduced into the legislation. Clarity should also be provided as to whether this test will be solely focused on a certain level of management, regardless of whether that level of management, in substance and taking into account all factors, exercises the realistic positive management (real top level management) of the company.
- In the context of art 4(3) of the DTA, POEM is used in an international context and a court will necessarily take account of international principles in interpreting the meaning of POEM in this context. Determining POEM in this context should only yield a single result, else the tie-breaker will be rendered ineffective and such an interpretation will be contrary to the intention of the legislature. The guidance provided by the OECD in its Commentary to the MTC should be adhered to. This is in essence a substance over form test and all the facts and circumstances will be examined in order to determine the place where key management and

commercial decisions necessary for the conduct of the entity's business as a whole are in substance made. If South Africa wishes not to follow the international interpretation of POEM, a formal reservation should be made to the application of the OECD's interpretation of this term, else the international meaning ascribed to POEM will override any meaning purportedly attributed to it under domestic legislation.

7 References

7.1 Statutes

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7.7

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