

Factors to be considered when establishing the place of effective management in a digital economy

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Abstract

South Africa applies a residence-based tax system and accordingly a legal person or company is regarded as tax resident in South Africa if it is incorporated, established or formed in South Africa *or* if it has its place of effective management (POEM) in South Africa. Further, the POEM test is also used as the ‘tie-breaker’ rule in double taxation agreements (DTA’s), which are based on the Organisation for Economic Co-operation and Development Model Tax Convention on Income and Capital and the Commentary thereto (OECD, OECD MTC, and OECD Commentary).

The concept ‘POEM’ has never been defined for tax purposes, not in a South African context, neither internationally. Thus, when ascribing a meaning thereto, one is left to consider the South African Revenue Service’s (SARS) interpretation and the OECD’s interpretation thereof.

Currently SARS considers the POEM to be located where policy and strategic decisions are executed and implemented by a company’s senior management. On the other hand, the OECD considers the POEM to be where key management and commercial decisions of an entity’s business as a whole are in substance made (it appears SARS is also leaning towards this interpretation, based on the most recent draft interpretation note released).

The modern multinational environment and digital economy have significantly changed the way businesses are run. With the evolving communications technology, it is no longer necessary for a group of individuals to be physically present in one location to have a meeting, as it can be held through videoconferencing facilities while participants are located across the globe. This makes it extremely challenging to establish a single POEM.

This dissertation analyses the current factors which are being considered when establishing the POEM and will scrutinise current developments and proposed amendments to legislation and interpretation notes. Comment is made regarding whether these factors acknowledge and address the challenges the digital economy presents when establishing the POEM.

A conclusion is reached that the digital economy is being acknowledged and considered when establishing the POEM, however no specific, additional or different factors are prescribed to establish the POEM in the digital economy. It is considered that undue attention should not be attached to the digital economy, in such a way that it ‘confuses’ the meaning and application of the POEM test. We should not be intimidated by the digital economy and

the same “core principles” which have thus far been of importance in a traditional world should equally apply when establishing POEM in a digital economy.

It is recommended that the South African tax authorities finalise Draft Income Tax Interpretation Note N°6 (Draft IN6). Further, it is recommended that the 2003 discussion draft of the OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits be finalised and that the meaning of POEM be refined. Further, it is proposed that the OECD Commentary include practical examples of establishing the POEM in the digital economy. It is also recommended that the OECD define certain words or terms upfront, in order to eliminate confusion as to the meaning thereof, these are: board, directors, head office/headquarter, senior employees, senior managers and top level management, as also proposed in the Draft IN6.

Abbreviations and Glossary

2001 discussion draft, the	The Impact of the Communications Revolution on the Application of ‘Place of Effective Management’
2003 discussion draft, the	Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention
Act, the	Income Tax Act No 58 of 1962, as amended
CM&C	Central Management and Control
De Beers case, the	<i>De Beers Consolidated Mines, Limited v Howe</i> [1906] A.C. 455
Draft IN6	Draft Income Tax Interpretation Note N°6 (Issue 2), issued by SARS on 14 April 2015
DTA	Double Tax Agreement
G20	Group of Twenty
HMRC	Her Majesty’s Revenue and Customs
IBFD	International Bureau of Fiscal Documentation
IN6	Income Tax Interpretation Note N°6, issued by SARS on 26 March 2002
IN6 Discussion Paper	Discussion Paper on Income Tax Interpretation Note N°6, issued by SARS in September 2011
Laerstate case, the	<i>Laerstate BV v. HMRC</i> [2009] UKFTT 209 (TC)
League of Nations	Financial Committee of the League of Nations

Legal person or company	Person other than a natural person
LOB	Limitation of benefits
MAP	Mutual agreement procedure
Oceanic Trust case, the	<i>Oceanic Trust Co Ltd NO v Commissioner for South African Revenue Service</i> [2012] 74 SATC 127
OECD	Organisation for Economic Co-operation and Development
OECD BEPS Action Plan	OECD Base Erosion and Profit Shifting Action Plan
OECD BEPS Project	OECD Base Erosion and Profit Shifting Project
OECD BEPS Report	OECD Base Erosion and Profit Shifting Report
OECD Commentary	Commentary on the OECD MTC 2014
OECD MTC	OECD Model Tax Convention on Income and on Capital 2014
POEM	Place of effective management
PPT	Principle purpose test
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Service
Smallwood case, the	<i>Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor</i> [2010] EWCA Civ 778
SoP1	Statement of Practice 1, issued by HMRC on 9 January 1990

TAG, the	The OECD's Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits
Tradehold case, the	<i>Commissioner for the South African Revenue Service v Tradehold Ltd</i> (132/11) [2012] ZASCA 61
United Construction case, the	<i>Bullock v. Unit Construction Company</i> [1959] 38 TC 712
Wensleydale case, the	<i>Wensleydale's Settlement Trustees v IRC</i> [1996] STC (SCD) 241
Wood case, the	<i>Wood v. Holden</i> [2006] STC 443

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Chapter 1: Introduction and overview

1.1 Background

1.1.1 The origin of the concept ‘Place of Effective Management’

As early as the 1900’s uncertainty surrounding the concept of corporate residence existed.¹ In order to avoid double taxation, which arose as result of the corporate residence uncertainty, individual States entered into bilateral agreements.² In 1921 the Financial Committee of the League of Nations (League of Nations) tasked four public finance experts³ to prepare a report on double taxation queries.⁴ This lead to the drafting of four model treaties from “1926 through 1927, which were revised and adopted in 1928 by the representatives of 28 States at a conference called by the Secretary General of the League of Nations.”⁵ In the years to follow, the League of Nations encouraged and achieved further development and in 1943 the League of Nations Model regarded a company “to be resident in the country in which it was constituted (ie incorporated).⁶ In the London Double Tax Agreement Model of 1956 this was changed to the country where the company’s ‘real centre of management’ was situated”⁷ Thereafter, the Organisation for European Economic Co-operation, and its successor the Organisation for Economic Co-operation and Development (OECD) “picked up where the preparatory research of the League of Nations had left off” and issued four interim reports from 1956 through 1961,⁸ the report issued on 27 May 1957 proposed that the ‘management and control test’ be used as a tie-breaker⁹ and the fourth report dated 5 November 1957 replaced the concept ‘management and control’ with that of ‘place of effective management’.¹⁰ This ultimately lead to the introduction of the tie-breaker rule ‘Place of Effective Management’ (POEM) which is present in today’s Organisation for Economic Co-operation and Development Model Tax Convention on Income and Capital and the Commentary thereto (OECD MTC and OECD Commentary).

¹ Vogel et al., 1997:16-17

² Ibid

³ Bruins (Rotterdam), Einaudi (Turin), Seligman (New York) and Stamp (London)

⁴ Vogel et al., 1997:17

⁵ Ibid

⁶ Olivier & Honiball (2011:38) cite Avery-Jones (2008)

⁷ Ibid

⁸ Vogel et al., 1997:17 and Organisation for Economic and Co-operation Development (OECD), 2014:8

⁹ Olivier & Honiball, 2011:38

¹⁰ Sullivan, 2011:20

1.1.2 South Africa's tax system

Since 1 January 2001, South Africa has been applying a 'residence-based'¹¹ tax system, having changed from a largely 'source-based'¹² tax system.¹³ This implies that a South African resident, as defined, is subject to tax on world-wide receipts or accruals whereas a non-resident will only be subject to tax in South Africa on receipts or accruals derived from a source within, or deemed to be within, South Africa.¹⁴ Accordingly, the definition of 'resident' per the Income Tax Act 58 of 1962, as amended (Act, the) is of fundamental importance when determining a persons' tax liability in South Africa.

1.1.3 Introducing the concept 'Place of Effective Management' to South Africa's tax system

South Africa first made reference to the concept 'POEM' in the Fifth Interim Report of the so-called Katz Commission in 1997, which dealt with the proposal to change South Africa's tax system from a 'source-based' tax system to a 'residence-based' tax system.¹⁵ The report notes *inter alia* the following:

“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 the definition is that it has proven subject to relatively simple, formalistic manipulation. This concept is also out of line with 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 Section 1 of the Income Tax Act. Again, the challenge will have the benefit of employing international and, therefore, commonly understood terminology.”¹⁶

¹¹ Oguttu (2008:80-81) refers to various writers and states that: “In terms of the residence basis of taxation, residents are taxed on their worldwide income. The justification for the residence basis of taxation is that as a resident enjoys the protection of the state, he should contribute towards the cost of the government of the country in which he resides, even if income is earned outside that country. This basis of taxation is also justified by the fact that residents know that they can always return to the country of residence whenever they want and that they will have the protection of their government whenever they are abroad.”

¹² Oguttu (2008:81) refers to various writers and states that: “The justification for the source basis of taxation is that a taxpayer can be expected to share the costs of running the country which makes it possible for the taxpayer to produce income.”

¹³ SARS, 2011:3

¹⁴ Stiglingh et al., 2015:59

¹⁵ Olivier & Honiball, 2011:27

¹⁶ Olivier & Honiball (2011:27) cite the Katz Commission (1997)

It is evident from above, that the Katz Commission intended that the ‘resident’ definition of a person other than a natural person (legal person or company), as stated in section 1 of the Act, should be amended to reflect ‘effective management’, in order to bring it in line with the OECD’s view. Further, it was recommended that the concept ‘effective management’ should be defined in the Act.

Subsequently, the resident definition was amended in the Act to reflect ‘effective management’ as a criteria. However, to date, the Act has omitted to define the concept ‘effective management’.

1.1.4 The resident definition and the relevance of the concept ‘Place of Effective Management’ in South Africa

In terms of paragraph (b) of the resident definition, contained in section 1 of the Act, South Africa has adopted two tests for determining the tax residency of a legal person.¹⁷ Under the first test, a legal person is regarded as a tax resident in South Africa if it is incorporated, established or formed in South Africa. The second test looks to a legal person’s place of effective management (POEM) (which effectively applies the principle of substance over form¹⁸).¹⁹

Relating to the first test, the terms ‘incorporated’, ‘established’ or ‘formed’ are not defined in the Act.²⁰ However, it is accepted that when a legal person is formed and incorporated in South Africa, in terms of section 13 of the Companies Act 71 of 2008, that legal person will be regarded as a South African tax resident due to its formation and incorporation in South Africa.²¹ It is evident that this is a formal factual test and is generally straightforward in its application.²²

However, it is the second test which hosts the anomalies when establishing a legal person’s tax residency status. When applying the second test, it will be noted that the concept ‘POEM’ is not defined in the Act.²³ Thus, when ascribing a meaning to POEM, one is left to

¹⁷ SARS, 2011:3

¹⁸ Van der Merwe, 2006:122

¹⁹ SARS, 2011:3

²⁰ Van der Merwe, 2006:121

²¹ Stiglingh et al., 2015:65

²² SARS, 2011:3

²³ Olivier & Honiball, 2011:25

consider the South African Revenue Service's (SARS) interpretation thereof, the OECD's views and the opinions of international tax writers.²⁴

Further, the POEM test is also used as the 'tie-breaker' rule in many double taxation agreements (DTAs) that South Africa has entered into with other countries, particularly those DTAs which are based on the OECD MTC.²⁵ This 'tie-breaker' rule is used to determine the tax residency of a legal person where that legal person could otherwise be considered a tax resident of both Contracting States under their domestic laws.²⁶ For example, if a company is incorporated in Mauritius, but is effectively managed in South Africa, that company will be a tax resident in both Mauritius and South Africa, and will be liable for tax in both Mauritius and South Africa, under their respective domestic tax legislation. This seems rather unfair. In order to level the playing field, the DTA 'tie-breaker' rule will come into play and will deem the company to be a tax resident of the country it is effectively managed in, being South Africa in our example. Accordingly, the company will be liable for tax in South Africa on its worldwide receipts and accruals, and may qualify for a tax credit should any taxes be levied in Mauritius on source income.

Reiterating the above statement, when establishing a legal person's POEM and in effect its tax residency status, it is essential to consider the interpretation of SARS as set out in Income Tax Interpretation Note 6 (IN6), the Discussion Paper on Income Tax Interpretation Note 6 (IN6 Discussion Paper) and the subsequent draft Income Tax Interpretation Note 6 (Issue 2) (Draft IN6) and the international view per the OECD MTC and OECD Commentary.

1.1.5 The meaning of the concept 'Place of Effective Management'

Contrary to the concept 'place of management' used in Article 4(1) of the OECD MTC, which refers to domestic law, the concept 'POEM' must be interpreted independently.²⁷ Even though the Act and Articles 4(1), 8(1), 13(3) and 22(3) of the OECD MTC refer to the concept 'POEM', it is still to be defined.²⁸ In fact, this concept has never had a universally

²⁴ Haupt, 2015:30

²⁵ SARS, 2011:2

²⁶ Ibid

²⁷ Vogel et al., 1997:262

²⁸ OECD, 2014:29-36 and Vogel et al., 1997:262

accepted meaning.²⁹ In order to ascribe a meaning to POEM one has to start by ascertaining the ordinary, everyday grammatical meaning of the concept by consulting a dictionary.³⁰

The Oxford dictionary³¹ does not define the concept ‘POEM’ nor the concept ‘effective management’. Accordingly, the definition of the words ‘effective’ and ‘management’ will be scrutinised.

The Oxford Dictionary defines the word “**effective**” as “*producing the intended result, impressive, actual, operative ...*”³²

The Oxford Dictionary defines the word “**management**” as “*managing or being managed, administration of business or public undertakings or people engaging in this, especially those controlling a workforce.*”³³

In *Wensleydale’s Settlement Trustees v Inland Revenue Commissioners case*³⁴ (Wensleydale case, the), Commissioner David Shirley commented on the ordinary meaning of POEM and emphasised the adjective ‘effective’:

“In my opinion it is not sufficient that some sort of management was carried on in the Republic of Ireland such as operating a bank account in the name of the trustees. ‘Effective’ implies *realistic, positive management*. The place of effective management is *where the shots are called*, to adopt a vivid transatlantic colloquialism.”³⁵

(a) SARS’ view of the meaning of POEM

In March 2002, SARS published IN6, which sets out its view regarding the determination of the POEM of a company.³⁶ Although not law, IN6 carries certain weight in the determination of a company’s POEM for domestic tax purposes, since it reflects SARS’ view and how SARS will apply the law in respective cases.³⁷

²⁹ SARS, 2011:5

³⁰ Courts often consult dictionaries in order to arrive at the ordinary meaning of the words. See for example *Commissioner for Inland Revenue v Golden Dumps (Pty) Ltd* 55 SATC 198(a), *Estate Dempers v Secretary For Inland Revenue* 39 SATC 95 (1977 (3) SA 410(A)), *Secretary For Inland Revenue v Charkay Properties (Pty) Ltd* 38 SATC 159 (1976 (4) SA 872(A)), only to name a few.

³¹ 1996

³² Thompson, 1996:276

³³ Thompson, 1996:538

³⁴ (1996) STC (SCD) 241

³⁵ SARS, 2015:5 (Emphasis added)

³⁶ SARS, 2002:1

³⁷ *ITC 1675* [2000], 62 SATC 219 at 229A

IN6 has not strictly followed international guidelines on the interpretation of this concept and has placed a great deal of focus on the *place where strategic board decisions are executed and implemented* as indicators of ‘effective management’, as opposed to where such decisions are *made*.³⁸ It distinguishes between the concepts of ‘management and control’ and ‘effective management’. The general approach taken in IN6 is that a company’s POEM is “*the place where the company is managed on a 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 meet.”³⁹

To recapitulate the above, the focus is 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.⁴⁰

In September 2011 SARS issued IN6 Discussion Paper with the intention to invite the public and tax practitioners to voice their concerns regarding the manner in which the POEM is determined in South Africa and to provide a platform for discussion of possible revision of IN6.⁴¹ IN6 Discussion Paper contains four areas of criticism, the main criticism relates to the general approach, which focusses on *the place where strategic decisions and policies are executed and implemented, rather than the place where those decisions and policies are made and adopted*.⁴²

On 14 April 2015 SARS issued Draft IN6 which provides principles and guidelines to be applied when establishing a company’s POEM. These principles and guidelines take into account comments received in response to the invitation extended to the public and tax practitioners through the IN6 Discussion Paper. These principles and guidelines are in line with paragraph 24 of the 2014 OECD Commentary to Article 4(3). Accordingly, it now appears as if SARS and the 2014 OECD MTC are aiming to be in agreement that “a company’s POEM is *the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made*.”⁴³ Draft IN6

³⁸ SARS, 2002:3-4

³⁹ SARS, 2002:3 (Emphasis added)

⁴⁰ Ibid

⁴¹ SARS, 2011:1

⁴² SARS, 2011:5 (Emphasis added)

⁴³ SARS, 2015:13 (Emphasis added)

further states that “the POEM test is one of *substance over form*.⁴⁴ It therefore requires identification of those persons in a company who actually ‘call the shots’ and exercise ‘realistic positive management’.⁴⁵ It is important to note that on the cut-off date⁴⁶ of this dissertation, Draft IN6 has not been finalised and is not yet effective.

(b) The OECD’s view of the meaning of POEM

As stated above, the OECD MTC does not define POEM, however it provides guidance in the OECD Commentary as to the meaning thereof. Paragraph 24 of the Commentary on Article 4(3) to the OECD MTC, recognises the POEM as “*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.*”⁴⁷

The OECD Commentary further notes that “an entity may have more than one place of management, but it can only have *one* POEM at any one time.”⁴⁸ This evidences the importance of establishing and monitoring the POEM of a company on an ongoing basis. The concept ‘POEM’ has been the topic of lengthy international discussions between various OECD member countries for many years.⁴⁹

(c) Tax authors’ views of the meaning of POEM

South African and international tax authors are not able to agree on the meaning of POEM.⁵⁰

Meyerowitz opines that the POEM “is normally the place where, in the case of a company, the directors meet on the business of the company, which may differ from the place where the company carries on business or is managed by staff or directors individually and not as a board. Where the company has executive directors, the facts may reveal that the company is effectively managed where such directors, in contrast to the board of directors as a whole, conduct the company’s affairs.”⁵¹

⁴⁴ SARS, 2015:14

⁴⁵ SARS, 2015:5

⁴⁶ 30 September 2015

⁴⁷ OECD, 2014:90-91 (Emphasis added)

⁴⁸ Ibid

⁴⁹ Olivier & Honiball, 2011:28

⁵⁰ Ibid

⁵¹ Olivier & Honiball (2011:29) cite Meyerowitz (2004)

Olivier & Honiball state that residency “refers to effective management as the place where the ‘most vital’ management actions take place. Therefore it will be the place where decisions are made that ‘carry some weight’ in the ordinary course of business.”⁵²

Vogel et al. are of the view that effective management is top-level management and it is, therefore, necessary to identify the ‘top-level management’ of the company and to examine where they make and implement decisions. The place where the top-level managers (not necessarily directors) have their offices would be important. The top-level management would typically ‘interfere’ with the usual conduct of the business, although not necessarily with the day-to-day affairs.⁵³ Further, top-level management would be constantly informed of the transactions of the business and their decisions would have a decisive influence on how the transactions are arranged.⁵⁴

(d) Contradicting views of the meaning of POEM

It is evident from the above that SARS’s current view per IN6 (which is effective on the cut-off date⁵⁵ of this dissertation) and the OECD’s view are contradicting, and that different factors are being considered when establishing the POEM. As stated above, IN6 is not law and it is trite “that when a domestic court has to interpret any legislation, s 232 of the Constitution of the Republic of South Africa, 1996, requires it to give preference to any reasonable interpretation that is consistent with international law over any alternative interpretation which is inconsistent with international law.”⁵⁶ Van der Merwe notes that the OECD Commentary may aid in the interpretation of DTA’s based on the OECD MTC, as the OECD Member countries would have taken the OECD Commentary into consideration when drafting DTA’s.⁵⁷ Accordingly, even though South Africa is not an OECD Member State, it can be concluded that when establishing the POEM in the context of a DTA, the view adopted by the OECD should prevail, as it is recognised that many of South Africa’s DTA’s are based on the OECD MTC.⁵⁸

⁵² Olivier & Honiball (2011:29) cite Olivier (2003)

⁵³ Vogel et al., 1997:262-263

⁵⁴ Ibid

⁵⁵ 30 September 2015

⁵⁶ Van der Merwe, 2006:135

⁵⁷ Van der Merwe (2006:136) cites Baker (1991)

⁵⁸ Van der Merwe, 2006:136

1.2 Research question

Should additional or different factors be considered when establishing the POEM in a digital economy?

1.3 Scope of this dissertation

This dissertation will focus on the factors that are currently being considered in South Africa when establishing the POEM and will examine the recent developments and proposed amendments to legislation and interpretation notes in South Africa and will comment if these factors acknowledge and address the digital economy. Consideration will also be given to recent South African judgements concerning the POEM and the factors which were of importance in deciding the matter.

“South Africa is a former British Colony and is a member of the Commonwealth and operates under, what is essentially, an English court system.”⁵⁹ Further, our courts routinely look at United Kingdom precedent for guidance.⁶⁰ In a recent South African tax case dealing with the concept of POEM, the *Oceanic Trust Co Ltd NO v Commissioner for South African Revenue Service* [2012] 74 SATC 127 (Oceanic Trust case, the), reliance was placed on an United Kingdom judgement, the matter between *Commissioner for Her Majesty’s Revenue and Customs v Smallwood and Another* [2010] EWCA Civ 778 (Smallwood case, the).

The United Kingdom domestic legislation refers to Central Management and Control (CM&C) as opposed to POEM.

Accordingly, this dissertation will focus on the factors that are currently being considered in the United Kingdom when establishing the POEM and will examine the recent developments and proposed amendments to legislation and interpretation in the United Kingdom and will comment if these factors acknowledge and address the digital economy. Consideration will also be given to recent United Kingdom judgements concerning the POEM and the factors which were of importance in deciding the matter. This dissertation will also highlight the differences and similarities in the concepts ‘CM&C’ and ‘POEM’.

Many of South African DTA’s follow the OECD MTC. As stated above, in an international context courts will look to the OECD Commentary and interpretation of the OECD MTC when establishing the POEM.

⁵⁹ South African Institute of Chartered Accountant (SAICA), 2011:7

⁶⁰ SAICA, 2011:7

Accordingly, this dissertation will focus on the factors that are currently being recommended by the OECD when establishing the POEM in an international context and will examine the recent developments and proposed amendments to Article 4(3) and the accompanying Commentary and comment if these factors acknowledge and address the digital economy.

Further, this dissertation will establish the impact the OECD's Base Erosion and Profit Shifting Project (OECD BEPS Project) will have (if any) on the factors to be considered when establishing the POEM in a digital economy.

1.4 Limitations of this dissertation

This dissertation will focus on the factors considered in South African, the United Kingdom and the OECD MTC as at 30 September 2015, and will not take into account any proposal or draft documents issued, or amendments made thereafter. Further, this dissertation will not include an analysis of the factors considered by other countries who's residency definition also include the concept 'POEM', neither will it consider the factors taken into account by the Model Tax Convention on Income and on Capital of the United Nations.

1.5 Research method

This dissertation will involve a review of South African and United Kingdom legislation, judgements, discussion papers, explanatory memoranda, literature and articles relating to the POEM and the digital economy, as well as the interpretation and discussion of practical implications of establishing the POEM in the digital economy. Further, the study will include a review of Article 4(3) of the OECD MTC and the accompanying Commentary thereto, proposed amendments thereto and recent developments, the OECD Base Erosion and Profit Shifting Action Plan (OECD BEPS Action Plan), the OECD Base Erosion and Profit Shifting Report (OECD BEPS Report) and related discussion drafts.

1.6 Structure

Chapter 2 serves to contextualise the digital economy and define the terms.

Chapter 3 will look at the POEM from a South African perspective, taking into consideration current domestic legislation and interpretation notes and will scrutinise the recent developments and proposed amendments to legislation and interpretation notes and comment if these factors acknowledge and address the digital economy.

Chapter 4 will look at the POEM from a United Kingdom perspective, taking into consideration current domestic legislation and practice statements and will scrutinise the recent developments and proposed amendments to legislation and practice statements and comment if these factors acknowledge and address the digital economy.

Chapter 5 will look at the POEM from the OECD's perspective, taking into consideration the standing Article 4(3) and the accompanying Commentary and will scrutinise the recent developments and proposed amendments to the Article and Commentary and comment if these factors acknowledge and address the digital economy.

Chapter 6 will review the relevant Actions and Reports of the OECD BEPS Project and will ascertain what impact (if any) it will have on the factors to be considered when establishing the POEM in a digital economy.

Chapter 7 will provide conclusions and recommendations.

Chapter 2: Contextualising the digital economy

2.1 Introduction

Telecommunications and technological advancements are fundamentally changing the way people run their business, especially when trade is conducted electronically (e-commerce).⁶¹

“E-commerce is a term used to describe the wide array of commercial activities carried out by electronic means that enable trade outside of the confines of geographical boundaries.”⁶²

“This technology enables the transmission of voice, data, images and video information to take place in cyberspace by using the Internet.”⁶³ Various authors have opined that “the Internet provides an environment in which automated functions can conduct significant business with little or no physical activity and that these functions can be easily and quickly moved from one jurisdiction to another.”⁶⁴

2.2 Defining the digital economy

Mesenbourg identifies three primary components of the digital economy and defines it as follows:

- **E-business infrastructure** is defined as *the share of total economic infrastructure used to support electronic business processes and conduct electronic commerce*. It includes hardware, software, telecommunication networks, support services, and human capital used in electronic business and commerce.
- **E-business** is defined as *any process that a business organisation conducts over computer-mediated networks*. Business organisations include any for-profit or non-profit entity. Examples of major electronic business process categories include online purchasing, selling, production management, logistics, as well as internal communication and support services. Within each major category one can identify more specific processes... Internal processes include: email capabilities, automated employee services, training, information sharing, video conferencing, recruiting, and telecommuting.
- **E-commerce** is defined as *the value of goods and services sold over computer mediated networks.*⁶⁵

⁶¹ Oguttu, 2008:88

⁶² Ibid

⁶³ Ibid

⁶⁴ Ibid

⁶⁵ Mesenbourg, 2001:2-4

2.3 Understanding the digital economy

The digital economy is borderless and it can be said that geographic jurisdictions do not exist.⁶⁶ Cockfield cites the United States Treasury Departments' report, which notes the difficulties associated with taxing economic activities that occur over a global network without any centralised form of control: "From a certain perspective, e-commerce doesn't seem to occur in any physical location but instead takes place in the nebulous world of cyberspace."⁶⁷

2.4 Linking the digital economy to the Place of Effective Management

Modern technology has provided a platform for management to conduct business without them having to physically meet in one place to decide on a matter. Now, important management decisions can conveniently be made *via*, for example, videoconferencing facilities or electronic discussion group applications while key managers are located across the globe.⁶⁸ One would then be faced with the question as to where the company's POEM is located, as the place where the decisions will be made, will be in multiple locations where each party is located. This uncertainty arises as global computer based communications cut across territorial borders and create a new world for human activity, which greatly undermines the feasibility and legitimacy of laws based on geographical boundaries.⁶⁹ It is clear that the term 'place' has limited meaning in the digital world.⁷⁰ The digital economy creates an opportunity to manipulate the POEM principle, as this principle is governed by national sovereignty, which was developed in the days of "brick and mortar" when physical presence in a jurisdiction was necessary to enforce tax laws.⁷¹ Accordingly, residency has now become a matter of deliberate choice in instances where reliance is placed on the location of management functions to determine the company's POEM.⁷²

2.5 Integration of traditional tax rules and e-commerce tax rules

Cockfield is of the opinion that traditional tax laws and policies are used to govern the new ways of doing business over the internet.⁷³ They have partly based this conclusion on the

⁶⁶ Cockfield et al., 2013:27

⁶⁷ Ibid

⁶⁸ Van der Merwe, 2006:124

⁶⁹ Oguttu, 2008:88

⁷⁰ Oguttu, 2008:88-89

⁷¹ Oguttu, 2008:89

⁷² Oguttu (2008:89) cites Kohl-uta (1998)

⁷³ Cockfield et al., 2013:7

fact that “e-commerce rules have increasingly been ‘absorbed’ into the traditional rules. In particular, the line between e-commerce activities and traditional commercial activities is increasingly blurred ... This perspective supports the view that the internet should be seen as part of the continuum of technology change and that traditional legal mechanisms will suffice to confront challenges promoted by cross-border e-commerce.”⁷⁴ It is evident from above that the authors are suggesting that the traditional factors should be considered when establishing the POEM in a digital economy.

⁷⁴ Cockfield et al., 2013:7

Chapter 3: A South African perspective

3.1 Introduction

This chapter will highlight the factors which are currently being considered in South Africa when establishing the POEM of a company.

Consideration will also be given to recent South African judgements concerning the POEM and the factors which were of importance in deciding the matter.

Further, this chapter will examine the recent developments and proposed amendments to the interpretation of POEM from a South African perspective and will comment if these developments and proposed amendments acknowledge the digital economy and if they provide guidance as to which factors should be considered when establishing the POEM in a digital economy, ie should additional or different factors be considered when establishing the POEM in a digital economy?

3.2 Factors currently being considered when establishing the Place of Effective Management

IN6 was issued by SARS on 26 March 2002. IN6 highlights that the “concept of effective management is not the same as shareholder-control or control by the board of directors” and that “management focusses on a company’s purpose and business and not on the shareholder-function.”⁷⁵

An analysis of IN6 follows:

3.2.1 Income Tax Interpretation Note N°6

(a) SARS’ general approach

The general approach per IN6 is that a company’s POEM 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.*”⁷⁶ As reiterated in IN6 Discussion Paper, SARS regards the POEM to be located “*where policy and strategic decisions are executed and implemented...*”⁷⁷ Thus, it can be said that the POEM is *the place where policy and strategic decisions are*

⁷⁵ SARS, 2002:2

⁷⁶ SARS, 2002:3 (Emphasis added)

⁷⁷ SARS, 2011:3 (Emphasis added)

*implemented and not where they are made.*⁷⁸ However, in IN6 it is noted that management structures, reporting lines and responsibilities vary from entity to entity, depending on the requirements of the entity, so no hard and fast rules can be laid down (alternative).⁷⁹

SARS' IN6 "alternative" interpretation, as stated above, is less manipulative than the OECD's interpretation, being where directors meet and decide on matters.⁸⁰ Although IN6 keeps track with business models in the modern multinational environment and digital economy, it does not provide any assistance in pin-pointing the 'implementation act' and the location thereof "if the act consists of several separate actions undertaken in various jurisdictions through virtual or mobile offices."⁸¹ For example, if a decision is taken locally by a company director resident in South Africa to raise finance from a foreign bank. The director makes a phone call while based in South Africa to arrange for the finance, however, the director flies overseas to sign the finance agreement. The question then arises whether the transaction was implemented locally or offshore.⁸²

"Generally, the most obvious way to avert any doubt in this regard would be for all these decisions and actions to be taken and implemented overseas and for all relevant documentation (for example, board resolutions) to reflect this."⁸³

(b) Practical application of the general approach

IN6 adopts a three-stage inquiry as to the practical application of the general approach.

- Firstly, "if these management functions are executed at a single location, that location will be the place of effective management. This location might or might not correspond with the place from where the day-to-day business operations/activities are actually conducted from/carried out."
- Secondly, if these management functions are executed at multiple locations, due to the directors or senior managers managing *via* distance communication (ie telephone, internet, video conferencing, etc) the view is held that the POEM "would best be reflected where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented, in other words, the place where the business operations/activities are actually carried out or conducted."

⁷⁸ Olivier & Honiball, 2011:25

⁷⁹ SARS, 2002:3

⁸⁰ Van der Merwe, 2006:125

⁸¹ Ibid

⁸² Olivier & Honiball, 2011:26-27

⁸³ Ibid

- Thirdly, if the nature of the company necessitates “that the business operations/activities are conducted from various locations, one needs to determine the place with the strongest economic *nexus*.”⁸⁴

IN6 does not elaborate on the meaning of ‘economic *nexus*’ nor does it provide any guidance on the interpretation thereof.⁸⁵ Van der Merwe notes that the term ‘economic *nexus*’ is not a foreign concept to us.⁸⁶ It means the economic link to or relationship with the subject matter.⁸⁷ When establishing the ‘economic *nexus*’ it is necessary to “find the strongest or the closest economic link.”⁸⁸ Establishing this “closest and strongest economic link”, requires the examination and weighing of several factors such as, where the company has most employees and assets, carries on most activities, derives most of its revenue from or where it has its headquarters.⁸⁹ It has been proposed that factors such as “land, other income producing assets, labour and financial capital” should also be considered.⁹⁰ Neither the OECD nor SARS provides any guidance on the examination and weighing of these factors. This makes the ‘economic *nexus*’ test quite difficult to apply.⁹¹

(c) Levels of management

IN6 distinguishes between three levels of management:

- The first level is “the place where central management and control is carried out by a board of directors”;
- The second level is “the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities”; and
- The third level is “the place where the day-to-day business activities are carried out/conducted.”⁹²

⁸⁴ SARS, 2002:4

⁸⁵ Van der Merwe, 2006:129

⁸⁶ Ibid

⁸⁷ Van der Merwe (2006:129) cites Vogel (1988)

⁸⁸ Oguttu, 2008:101

⁸⁹ OECD, 2003:5

⁹⁰ Van der Merwe, 2006:130

⁹¹ Oguttu, 2008:101

⁹² SARS, 2002:3

It is evident from SARS's general approach that the first and third management levels do not play a decisive role in establishing a company's POEM, however, it remains relevant as a circumstantial factor (discussed below).⁹³

(d) Relevant facts and circumstances

In IN6 there is no hard-and-fast rule which can be applied when establishing a company's POEM and all the relevant facts and circumstances, such as those listed below, must be examined on a case-by-case basis.

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

The above list is not intended to be exhaustive or specific, but serves merely as a guideline.”⁹⁴

Van der Merwe criticises the list as it includes factors which seem to be more in line with the Anglo-American version of the POEM test (overriding central control) than the South African interpretation thereof (day-to-day management).⁹⁵ The list is further questioned as

⁹³ Van der Merwe, 2006:126

⁹⁴ SARS, 2002:4-5

⁹⁵ Van der Merwe, 2006:130

to whether the factors should be viewed qualitatively or quantitatively and if they all carry the same weight.⁹⁶ Van der Merwe refers to the principles embedded in the *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A) at 202-3 and notes that “the factors should not be individually decisive and that the answer should be gleaned from the totality of the facts.”⁹⁷

3.3 Recent court cases and findings

The detailed background facts of the cases below have not been summarised in this dissertation and consideration will only be given to the factors which were of importance in deciding the legal entity’s POEM.

3.3.1 The Oceanic Trust case

The Oceanic Trust case was the first case to be heard in South Africa which considered the meaning of POEM. The matter which came before the court was in the context of a trust, however this case is also relevant for a company where it refers to the POEM of a legal entity in general.⁹⁸

The Western Cape High Court delivered the judgement on 13 June 2011. Although the judgement does not conclude on whether the trust had its POEM in South Africa or not as, in the judge’s view, all the material facts relating to the management of the trust were not “fully found” and were not “sufficiently clear”⁹⁹ the case is of importance as it provides valuable insight as to the view likely to be taken by a court when establishing the POEM.

The court referred to the Smallwood case, and listed the relevant key features relating to the POEM of an entity relevant to the Oceanic case as follows:

- “The POEM is the place where *key management and commercial decisions* that are *necessary for the conduct of the entity’s business are in substance made*;
- The POEM will *ordinarily* be the place where the most senior group of persons (ie 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;

⁹⁶ Van der Merwe, 2006:133

⁹⁷ Ibid

⁹⁸ Gutuza, 2012:424

⁹⁹ The Oceanic Trust case, 2011 at para 57

- Although there may be more than one place of management, there may only be one POEM any one time.”¹⁰⁰

From the above it appears that the international view prevailed, the POEM was where the key management and commercial decisions were in substance made¹⁰¹ and was not where those decisions were implemented, as prescribed in IN6.¹⁰²

3.3.2 The Tradehold case

In the *Commissioner for the South African Revenue Service v Tradehold Ltd (132/11) [2012] ZASCA 61* (Tradehold case, the) the board of directors, while steering a board meeting, resolved that all further board meetings would be held in Luxembourg, accordingly the company became effectively managed in Luxembourg.¹⁰³ Even though it was accepted that the company’s POEM moved to Luxembourg and it was not an area to be decided on, this case may have had a different outcome if it came before the courts to consider if the company’s effective management had actually moved to Luxembourg.

From above it appears that the international view once again prevailed and that the POEM was where the key management and commercial decisions were in substance made.

3.4 Recent developments and proposed amendments

In September 2011 SARS issued the IN6 Discussion Paper with the intention to invite the public and tax practitioners to voice their concerns regarding the manner in which the POEM is determined in South Africa and to provide a platform for discussion of possible revision of IN6.¹⁰⁴ Subsequently, SARS attended to the comments received on the IN6 Discussion Paper and on 14 April 2015 issued Draft IN6 which provides updated principles and guidelines to be applied when establishing a company’s POEM.¹⁰⁵ At the cut-of date¹⁰⁶ of this dissertation, SARS has not yet indicated a date the Draft IN6 will become effective.

¹⁰⁰ The Smallwood case, 2010 at para 54 (Emphasis added)

¹⁰¹ OECD, 2014:90-91

¹⁰² SARS, 2002:3-4

¹⁰³ The Tradehold case, 2012 at para 4

¹⁰⁴ SARS, 2011:2

¹⁰⁵ SARS, 2015:3

¹⁰⁶ 30 September 2015

3.4.1 Discussion Paper on Income Tax Interpretation Note 6

(a) A brief overview of the IN6 Discussion Paper

The IN6 Discussion Paper refers to IN6 and sets out SARS current interpretation of the POEM. Further, the IN6 Discussion Paper sets out the criticism of IN6. It contains four areas of criticism, the main criticism relates to the general approach, which focusses on the place where strategic decisions and policies are executed and implemented, rather than the place where those decisions and policies are made and adopted.¹⁰⁷

Further, the IN6 Discussion Paper elaborates on the international benchmarking, the ‘board-centric’ approach, the OECD MTC and Commentary thereto on Article 4, recent developments in the United Kingdom and provides tentative proposals to the revision of IN6, which is discussed below.¹⁰⁸

(b) Revision of IN6

The IN6 Discussion Paper states that the revision of IN6 must “ensure that the POEM test fulfils its purpose as a substantive test that is not open to ‘simple, formalistic manipulation’.”¹⁰⁹ Both international and local authorities have recognised, that a board-centric approach can no longer meet this challenge in today’s world.”¹¹⁰ The board-centric approach is akin to the Anglo-American approach and regards a company’s POEM to be the place where a company’s board of directors meets and makes decisions.¹¹¹ The revision should also eliminate uncertainty created in IN6 and resolve any apparent conflicts and inconsistencies present in the current IN6.¹¹² It is further stated that the revision should account for a wide variety of situations which may arise in our modern multinational environment and digital economy.¹¹³

(c) Proposed amendments to IN6

The IN6 Discussion Paper proposes that the general approach of IN6 be refined and that it should continue to focus on the “second level of management.”¹¹⁴ Further, in order to combat the inconsistent use of terminology, it is proposed that the basic terms used in IN6

¹⁰⁷ SARS, 2011:5

¹⁰⁸ SARS, 2011:5-14

¹⁰⁹ SARS, 2011:11

¹¹⁰ Ibid

¹¹¹ SARS, 2011:5

¹¹² SARS, 2011:11

¹¹³ Ibid

¹¹⁴ SARS, 2011:12

be defined upfront.¹¹⁵ It is agreed that the wide variety of corporate practices, and the intensely factual nature of the POEM enquiry makes it impossible to lay down a definite rule for establishing a company's POEM and that all relevant facts and circumstances must be taken into account.¹¹⁶ However, it is proposed that several amendments be made to the relevant facts and circumstances which should be considered when establishing a company's POEM.¹¹⁷

(d) SAICA's comments regarding the IN6 Discussion Paper

The South African Institute of Chartered Accountants (SAICA) emailed a letter (summarising various chartered accountant tax practitioner members' comments) to SARS on 31 October 2011, in response to their invite to provide comments on the proposed amendments to IN6 as embedded in the IN6 Discussion Paper.¹¹⁸ SAICA "welcomes and endorses the revised approach, which brings the South African interpretation closer to that of the international norm."¹¹⁹ SAICA sets out an example which highlights the probable issues which may arise if the focus is shifted from the place where strategic decisions are executed and implemented to the place where strategic decisions are made, when ascertaining the POEM. Further, SAICA raises several concerns of the meaning and functions of the senior officials and executives.¹²⁰

SAICA expresses its view over the list of "Relevant fact and circumstances"¹²¹ and notes that it should be restructured similar to the format of the 'tie-breaker' test of the OECD MTC.¹²² "There must be a starting point – ie where top level management carry out effective management, if they do not effectively manage where the next level manage etc."¹²³

SAICA concludes by stating that "the revised IN6 should not underestimate or under-emphasise the role of the board of directors in a South African context" and it should be recognised that the POEM may also likely "be where the board meets."¹²⁴

¹¹⁵ SARS, 2011:12

¹¹⁶ Ibid

¹¹⁷ SARS, 2011:13

¹¹⁸ SAICA, 2011:1

¹¹⁹ Ibid

¹²⁰ SAICA, 2011:5

¹²¹ SARS, 2002:4-5

¹²² SAICA, 2011:6

¹²³ Ibid

¹²⁴ SAICA, 2011:7

3.4.2 Draft Income Tax Interpretation Note 6 (Issue 2)

On 14 April 2015 SARS issued Draft IN6 which provides principles and guidelines to be applied when establishing a company's POEM. These principles and guidelines take into account comments received in response to the invitation extended to the public and tax practitioners through the IN6 Discussion Paper. Further, these principles and guidelines are now in line with those of Article 4(3) of the OECD MTC and its accompanying Commentary. Accordingly, SARS and the OECD MTC are now in agreement that "a company's POEM is *the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made.*"¹²⁵ It is important to note that on the cut-off date¹²⁶ of this dissertation, SARS has not yet indicated when the Draft IN6 will become effective.

(a) Preamble

The preamble to Draft IN6 sets the framework for understanding and contextualising the 'workings' of Draft IN6, by defining several words which have caused controversy in the past. Amongst other, the meaning of the following words have been clarified:

- "**Board** means *the board of directors (or similar body, however designed), that has the legal authority to exercise the powers and perform functions of a company, except to the extent that Company Law or the company's memorandum provides otherwise.*
- **Director** means *a member of the board or an alternate director and includes any person occupying the position of director or alternate director, by whatever name designated.*
- **Head office** means *the place where a company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.*
- **Senior management** means *the level of employees of a company who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis. While terminology may vary, these employees may include:*
 - *Managing Director or Chief Executive Officer;*

¹²⁵ SARS, 2015:13 and OECD, 2014:90-91 (Emphasis added)

¹²⁶ 30 September 2015

- *Financial Director or Chief Financial Officer;*
- *Chief Operating Officer; and*
- *The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).”*¹²⁷

(b) SARS’ revised general approach

As stated above, up until recently, SARS’ ‘general approach’ has been that a company’s POEM is *the place where policy and strategic decisions are implemented and not where they are made.*¹²⁸ However, per Draft IN6 SARS’ ‘proposed’ general principle is now that “a company’s place of effective management is the *place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made.*”¹²⁹ It is evident from above that SARS is proposing to move its focus from the place where policy and strategic decisions are *implemented* to where they are *made*.

In Draft IN6, SARS acknowledges the challenge the digital economy presents when establishing a company’s POEM in a modern multinational environment and notes that the same “core principles” should still apply when establishing a company’s POEM in the digital economy.¹³⁰ Thus, it is clear that SARS is not proposing or going to propose that any different or additional factors should be considered when establishing a company’s POEM in a digital economy.

As in IN6, Draft IN6 notes that a company’s key management and commercial decisions affecting its business as a whole can be made at a single location or at multiple locations. If the decisions are made at a single location, that location will be the POEM and if the decisions are made at multiple locations the POEM will be the location where those decisions are “primarily or predominantly made.”¹³¹

Draft IN6 notes that it is impossible to lay down a set of definite rules to determine a company’s POEM and that all relevant facts and circumstances must be evaluated when establishing the POEM.¹³² Further, a list is provided, which is not intended to be exhaustive,

¹²⁷ SARS, 2015:1

¹²⁸ Olivier & Honiball, 2011:25 (Emphasis added)

¹²⁹ SARS, 2015:4 (Emphasis added)

¹³⁰ SARS, 2015:6

¹³¹ SARS, 2015:5

¹³² SARS, 2015:6

of facts and circumstances that may be considered when establishing a company's POEM.¹³³

(c) Non-exhaustive list of key facts and circumstances

Firstly, it is necessary to identify the individual/s who are “calling the shots”, those who make the key management and commercial decisions.¹³⁴ Once the individual/s have been identified it is necessary to ascertain where the individuals were located when the “decisions were in *substance* actually made.”¹³⁵ The factors below, serve as a guideline to assist in determining the individual/s and the location when establishing a company's POEM.

Head office

“Head office” is defined upfront in the preamble to Draft IN6 and the location thereof is generally a major factor when establishing a company's POEM, as it is often the place where senior management make key company decisions.¹³⁶

Draft IN6 provides the following ‘pointers’ regarding the location of a company's head office:

- If a company's senior management and support staff are all based at *one* location and the public acknowledge that location as the principle place of business, that location will be regarded as the company's head office.¹³⁷
- If a company's senior management and support staff are more decentralised, ie from time to time they operate from offices located in various countries, then “the company's head office would be the location where those senior managers are primarily or predominantly based or where they normally return to following travel to other locations or meet when formulating or deciding key strategies and policies for the company as a whole.”¹³⁸
- If senior management operate “from different locations on a more or less permanent basis and they participate in meetings *via* telephone or video conferencing rather than by being physically present at meetings in a principal location”, then the “head office would normally be the location, if any, where the highest level of management (for example,

¹³³ SARS, 2015:6

¹³⁴ SARS, 2015:7

¹³⁵ Ibid

¹³⁶ Ibid

¹³⁷ Ibid

¹³⁸ Ibid

the Managing Director and Financial Director) and their direct support staff are located.”¹³⁹

- If senior management is so decentralised that it is impossible to determine the company’s head office with reasonable certainty, then “the location of the head office would be of less relevance in determining that company’s place of effective management.”¹⁴⁰

Delegation of authority

Draft IN6 states that a company’s board is permitted to delegated some or all of its authority to an executive committee, consisting of key members of senior management. If this is the case the company’s POEM will be the “*location where the members of the executive committee are based* and where that committee develops and formulates the key strategies and policies.”¹⁴¹

Board

“Board” is defined upfront in the preamble to Draft IN6 and means *board of directors*.¹⁴²

Draft IN6 states that if a company’s board often meets and retains and exercises its authority to govern the company and in substance makes the key management and commercial decisions necessary for the conduct of the company’s business as a whole, then the location of the board meetings may be considered to be the company’s POEM.¹⁴³

It is important to note that it cannot simply be assumed that a company’s POEM is where the board meets.¹⁴⁴ Draft IN6 provides an example to illustrate the point: “if a board has *de facto* delegated the authority to make the key management and commercial decisions for the company to the senior managers and does nothing more than routinely ratify decisions that have been made, the company’s POEM will ordinarily be the place where those senior managers make those decisions.”¹⁴⁵

¹³⁹ SARS, 2015:7

¹⁴⁰ Ibid

¹⁴¹ SARS, 2015:7 (Emphasis added)

¹⁴² SARS, 2015:8

¹⁴³ Ibid

¹⁴⁴ Ibid

¹⁴⁵ Ibid

Draft IN6 provides several factors which need to be considered, when ascertaining if the board is in essence making the decisions or if the board “is limited to formally approving or rubber stamping the decisions made by someone else.”¹⁴⁶ These factors include:

- “Whether the directors have sufficient knowledge and information at hand;
- Whether the directors are suitably qualified and experienced generally and in relation to the particular company; and
- Whether the directors had reasonable time to assess the information and make the decision.”¹⁴⁷

It is reiterated that all the relevant facts and circumstances of a particular case have to be taken into consideration when deciding where the company’s POEM is located.¹⁴⁸

Further, Draft IN6 highlights the necessity to establish the different roles of directors and to distinguish between directors who are making the decisions and directors who are merely ratifying the decisions made by other directors or people.¹⁴⁹

Caution should also be applied if companies have ‘pre-meetings’, basically meetings preceding the board meetings, and it should be established “what happens in the pre-meeting, who participates, where the meeting takes place and what, if any, decisions are made since this could impact on the POEM.”¹⁵⁰

Modernisation and global travel

Draft IN6 acknowledges that “changes in telecommunications, information technology, global travel and modern business practises” may impact a company’s POEM.¹⁵¹ These ‘changes’ imply that the board no longer needs to physically meet at one location to decide on matters, it is possible for several directors to be located in various countries and still be able to attend the meeting through telecommunication facilities.¹⁵² It very often happens that the key directors, with the overriding decision making powers, are not present at the physical meeting. Accordingly, what appears to be the POEM, being the location where the board meets, is not where the “key management and commercial decisions are in substance

¹⁴⁶ SARS, 2015:8

¹⁴⁷ Ibid

¹⁴⁸ Ibid

¹⁴⁹ Ibid

¹⁵⁰ SARS, 2015:9

¹⁵¹ Ibid

¹⁵² Ibid

made.”¹⁵³ Further, it is also possible to decide on a matter through ‘round robin voting’, in these instances it is important to consider how often ‘round robin voting’ is used, the type of decisions made and the location of the participating parties.¹⁵⁴

Obvious from above, it is impossible to lay down a hard and fast rule or to prescribe different or additional factors to determine a company’s POEM in a digital economy and it is vital to understand and to take into consideration all the surrounding facts and circumstances of each case.

Shareholders

Typically shareholder decisions would influence the existence of a company itself or the rights of shareholders as shareholders and would not have an impact on the company’s business “from a management or commercial perspective.”¹⁵⁵ Accordingly, shareholder decisions would usually not be considered when ascertaining a company’s POEM.¹⁵⁶

However, Draft IN6 cautions that it should be born in mind that shareholder involvement may very well be that of effective management if the shareholder/s “usurp” the powers of the directors of the company.¹⁵⁷ This may be the case if the shareholders decide on a matter and instruct the board to approve and implement their decision, without affording the board an opportunity to consider the shareholders’ recommendation and to independently decide on the matter.¹⁵⁸ Accordingly, it is important to distinguish between “shareholder guidance and influence and usurpation.”¹⁵⁹

Further, Draft IN6 notes that special consideration should be given to group scenarios, as parent companies often set limitations of authority or guidelines for subsidiary companies.¹⁶⁰ In these situations it is vital to ascertain what the effect of the limitations or guidelines are on the ‘decision makers’, is the shareholder still deciding on the matter with some guidance or input from the parent company or is the parent company actually calling the shots.¹⁶¹

¹⁵³ SARS, 2015:9

¹⁵⁴ Ibid

¹⁵⁵ Ibid

¹⁵⁶ Ibid

¹⁵⁷ SARS, 2015:10

¹⁵⁸ Ibid

¹⁵⁹ Ibid

¹⁶⁰ Ibid

¹⁶¹ Ibid

Operational management versus broader top level management

Draft IN6 stresses the importance to differentiate between operational management and broader top level management and the decisions they make.¹⁶² Operational management generally oversees the day-to-day business operations and activities of a company and their decisions are generally of less importance when establishing a company's POEM.¹⁶³ On the other hand top level management predominantly consists of senior managers who are responsible for key management and commercial decisions.¹⁶⁴ The location where these decisions are made is critical when establishing a company's POEM.¹⁶⁵

Legal factors

Draft IN6 states that the following legal factors are generally irrelevant when establishing a company's POEM:

- the place of incorporation, formation or establishment of the company;
- the location of the company's registered office; and
- the location of the company's public officer.¹⁶⁶

Economic nexus

Draft IN6 states that a company's economic nexus is generally not relevant when establishing a company's POEM, however it may come into play if the other factors are inconclusive.¹⁶⁷ Draft IN6 does not elaborate on the meaning of economic *nexus* nor does it provide any guidance on the interpretation thereof. Please refer to paragraph 3.2.1(b) for a discussion on the meaning of economic *nexus*.

Support functions

In a modern multinational environment it is trite for companies to centralise support services such as "data management, human resource, customer support or accounting" and to set up these 'shared-services-centres' in countries that have "superior infrastructure, lower costs and a highly skilled workforce."¹⁶⁸ These 'shared-services-centres' are generally housed in a

¹⁶² SARS, 2015:11

¹⁶³ Ibid

¹⁶⁴ Ibid

¹⁶⁵ Ibid

¹⁶⁶ Ibid

¹⁶⁷ Ibid

¹⁶⁸ SARS, 2015:13

group of companies of the ultimate holding company or a separate subsidiary is set up to provide support services to the members of the group.¹⁶⁹

In these circumstances it is important to note that the support services are most likely not performed at the company's head office and that the support services are not akin to the direct support provided to top senior management, as described above. The support services provided by these 'shared-services-centres' are generally of little importance when establishing a company's POEM, as the "managers in charge of those services are often not involved, or only secondary involved, in making key management and commercial decisions that affect the company's business as a whole."¹⁷⁰

3.5 Conclusion

IN6, IN6 Discussion Paper and the Draft IN6 acknowledge the digital economy and the challenges it presents, however no rules or guidance is provided as to specific, additional or different factors that should be considered when establishing a company's POEM in a digital economy. SARS is of the opinion that the same "core principles" should apply in a digital economy, as do in the traditional world.¹⁷¹ Accordingly, the research and discussions presented in this chapter have not been able to identify specific, additional or different factors that should be considered when establishing the POEM in a digital economy, as these factors do not 'exist' in a South African context.

The author is in agreement with SARS, that the same "core principles" should apply in a digital economy, as do in the traditional world.

¹⁶⁹ SARS, 2015:13

¹⁷⁰ Ibid

¹⁷¹ SARS, 2015:6

Chapter 4: A United Kingdom perspective

4.1 Introduction

In the United Kingdom two tests are applied when establishing a company's corporate tax residency. A company will be regarded a resident, if it satisfies either of two tests.¹⁷²

The first test, which has always applied under the United Kingdom tax law, is that a company will be regarded as a tax resident if the Central Management and Control (CM&C) of the company is located within the United Kingdom.¹⁷³ This will apply regardless as to where the company is incorporated.¹⁷⁴ This residency test is not included in the statute, but has been derived from case law and the leading cases which contributed thereto are *De Beers Consolidated Mines, Limited v Howe* [1906] A.C. 455 (De Beers case, the), *Bullock v. Unit Construction Company* [1959] 38 TC 712 (United Construction case, the), *Wood v. Holden* [2006] STC 443 (Wood case, the), and *Laerstate BV v. HMRC* [2009] UKFTT 209 (TC) (Laerstate case, the).¹⁷⁵ Although the place of CM&C is a question of fact, numerous court decisions have held that it ordinarily coincides with the place where the company directors exercise their power and authority, which will generally be where they meet.¹⁷⁶

Her Majesty's Revenue and Customs' (HMRC) approach in applying the law of corporate residence is set out in Statement of Practice 1 (SoP1), published on 9 January 1990.¹⁷⁷

The second test of corporate residence was introduced in the United Kingdom on 15 March 1988.¹⁷⁸ Section 14 of the Corporation Tax Act 2009 states that a company incorporated in the United Kingdom is regarded as a resident.¹⁷⁹ It is emphasised that this test applies in addition to the CM&C test.¹⁸⁰ Thus, foreign incorporated companies will continue to be a tax resident in the United Kingdom if their CM&C is located there.¹⁸¹

Further it is important to note that if a United Kingdom resident company is dually resident in another country with which the United Kingdom has a DTA and if the "tie-breaker"

¹⁷² Smith, 2014:103 para 4.7

¹⁷³ Ibid

¹⁷⁴ Ibid

¹⁷⁵ Ibid

¹⁷⁶ OECD, 2001:5

¹⁷⁷ Smith, 2014:104 para 4.7

¹⁷⁸ Ibid

¹⁷⁹ Ibid

¹⁸⁰ Ibid

¹⁸¹ Ibid

provision in the DTA concludes that the company is resident in the other country for purposes of the treaty, it will be treated as non-resident for United Kingdom taxation purposes.¹⁸²

This chapter will examine the origin and meaning of the concept ‘CM&C’.

Further, this chapter will highlight the factors which are currently being considered when establishing the CM&C of a company.

Consideration will also be given to, both older and more recent, United Kingdom judgements concerning residency and the factors which were of importance in deciding the place of CM&C. I will also consider the United Kingdom courts’ interpretation of POEM when applying the ‘tie-breaker’ provision as prescribed by the OECD MTC.

This chapter will also highlight the differences and similarities in factors being considered by the United Kingdom courts when establishing the place of CM&C or the POEM.

Further, the recent developments and proposed amendments to the interpretation of CM&C and POEM from a United Kingdom perspective will be scrutinised and comment will be made on whether these developments and proposed amendments acknowledge the digital economy and if they provide guidance as to which factors should be considered when establishing the CM&C or POEM in a digital economy, ie should additional or different factors be considered when establishing the CM&C or POEM in a digital economy?

4.2 Origin and meaning of the concept ‘Central Management and Control’

In the early 1900’s when the United Kingdom established its tax system, the tax courts developed the CM&C test as the test for establishing a companies’ tax residence in the United Kingdom.¹⁸³ The CM&C test was specifically developed for situations where companies had their place of management in the United Kingdom, but carried out all their business activities in another country.¹⁸⁴ The De Beers case greatly contributed to the development of the CM&C test criteria,¹⁸⁵ the test of company residency is that stated by Lord Loreburn: “... a company resides, for the purpose of income tax, where its real

¹⁸² Smith, 2014:104 para 4.7

¹⁸³ Cerioni, 2012:1095

¹⁸⁴ Ibid

¹⁸⁵ Smith, 2014:103 para 4.7

business is carried on ... I regard that as the true rule; and the real business is carried on where the central management and control actually abides.”¹⁸⁶

Lord Loreburn’s CM&C test has been endorsed by many subsequent decisions and is still referred to in case law today.¹⁸⁷

However, even though the CM&C test has been around since 1906, it is not defined for tax purposes and when ascribing a meaning thereto, one is left to consider the judicial interpretation thereof and HMRC’s interpretation and guidance, as provided in SoP1.

4.3 Factors currently being considered when establishing the place of Central Management and Control

As stated above, the concept ‘CM&C’ is not defined for tax purposes and when ascribing a meaning thereto we need to consider HMRC’s interpretation and guidance, as provided in SoP1.

An analysis of the SoP1 follows and the factors which are of importance when establishing a company’s place of CM&C are highlighted.

4.3.1 Statement of Practice 1 (1990)

(a) Place of CM&C

SoP1 firstly highlights that successive decided cases have emphasised that the place of CM&C control is wholly a question of fact and it cautions that factors which together are decisive in one instance may individually carry little weight in another.¹⁸⁸

This implies that each case has to be evaluated on its own merits taking into account all facts individually and as a whole.

If a company’s residency status is uncertain, the following approach will be adopted by the HMRC:

- “they first try to ascertain whether the directors of the company in fact exercise central management and control;
- if so, they seek to determine where the directors exercise this central management and control (which is not necessarily where they meet);

¹⁸⁶ The De Beers case, 1906:3

¹⁸⁷ HMRC, 1990:3

¹⁸⁸ Ibid

- in cases where the directors apparently do not exercise central management and control the company, HMRC then look to establish where and by whom it is exercised.”¹⁸⁹

SoP1 states that CM&C is located where the “highest level of control of the business of a company” can be found.¹⁹⁰ The highest level of control of a business is akin to its board, accordingly it can be said that CM&C is located at the place where the board meetings are held. However, caution needs to be applied if the location of the board meetings are not in the same country as the main operations of the business.¹⁹¹ If the directors of a company are actively engaged together in the complete running of the business, then that location would be the place of CM&C irrespective of where the formal board meetings are held.¹⁹² Thus, the location of board meetings are important, but not necessarily conclusive.

SoP1 further notes that there may be instances where CM&C is exercised by a single individual. This may occur when the “chairman or managing director exercises powers formally conferred by the company’s articles and the other board members are little more than cyphers.”¹⁹³ If this is the case, CM&C will be located where the controlling individual exercises his powers.¹⁹⁴

Elaborating on the meaning of control, SoP1 states that “the exercise of control does not necessarily demand any minimum standard of active involvement: it may, in appropriate circumstances, be exercised tacitly through passive oversight.”¹⁹⁵

(b) Parent / subsidiary relationship

SoP1 acknowledges the difficulties the CM&C test poses if the subsidiary and parent company operate in different countries.¹⁹⁶ If a parent company influences the actions of the subsidiary in such a manner as akin to the powers exercised by the sole or majority shareholder in board meetings, HMRC regards the CM&C of the subsidiary to be located where the parent company is resident.¹⁹⁷ Further, in cases where the parent company usurps the functions of the subsidiary’s board or where the subsidiary’s board simply rubber stamps

¹⁸⁹ HMRC, 1990:4

¹⁹⁰ HMRC, 1990:3

¹⁹¹ Ibid

¹⁹² Ibid

¹⁹³ Ibid

¹⁹⁴ Ibid

¹⁹⁵ Ibid

¹⁹⁶ HMRC, 1990:4

¹⁹⁷ HMRC, 1990:4

the parent company's decisions, HMRC is of the view that the subsidiary has the same tax residence as its parent company.¹⁹⁸

In cases where a subsidiary company forms part of a group of companies and the ultimate holding company resides in a different jurisdiction, it would need to be determined if the subsidiary company's board exercises CM&C of the subsidiary's business.¹⁹⁹ In the above determination it should be considered if the subsidiary directors act independently and to what extent they have authority to make investment, production and procurement decisions without reference to the parent.²⁰⁰

4.4 Court cases and findings

The detailed background facts of the particular cases have not been summarised in this dissertation and consideration will only be given to the factors which were of importance in deciding the company's place of CM&C or POEM, where applicable in an international context.

4.4.1 The De Beers case

The De Beers case is known as the 'landmark case' and dates back to 1906. It introduced the concept 'CM&C' to the 'tax world'.

In this case the majority of the directors were resident in the United Kingdom while the company was registered and carried on business in South Africa. The House of Lords found the company to be a resident of the United Kingdom on the assumption that the decision making centre was located in the United Kingdom.²⁰¹ Lord Loreburn stated that:

“... a company resides, for the purpose of income tax, where its real business is carried on ... I regard that as the true rule; and the real business is carried on where the central management and control actually abides.”²⁰²

The House of Lords took the following factors into consideration when they concluded that the tax payers' business was carried on in England and not in South Africa:

- “the majority of directors and other senior staff officials lived in England;

¹⁹⁸ Ibid

¹⁹⁹ Ibid

²⁰⁰ Ibid

²⁰¹ Cerioni, 2012:1109

²⁰² The De Beers case, 1906:3

- the real control was exercised at meetings which were held in London, and those meetings controlled the negotiations of contracts, determined policy, the application of profits and the appointment of directors; and
- all matters requiring a majority vote were controlled in London.”²⁰³

To recapitulate the above, it can be said that a company’s CM&C is located where the directors meetings are actually held.²⁰⁴

4.4.2 The United Construction case

The United Construction case decided on the place of CM&C of three subsidiary companies in 1946. In this case, three wholly owned subsidiary companies were incorporated in Kenya. Their articles of association, vested the powers of management in the Kenyan directors who were located in Kenya. However, these management powers were not exercised by the Kenyan directors. All matters of real importance were decided by the board of directors of the parent company in the United Kingdom. This resulted in the subsidiaries being held to be tax residents in the United Kingdom.²⁰⁵

The factors of importance in deciding the matter were as follows:

- The individuals who actually decided on real matters of importance;
- The location of the identified individuals when they made these decisions;
- The fact that the parent company’s actions were irregular and contrary to the constitution of the company, did not override the factual reality of the case and did not influence, “by whom and from where the subsidiaries were managed and controlled.”²⁰⁶

4.4.3 The Wensleydale’s case

The *Wensleydale case* was decided in 1996 and considered the meaning of the concept ‘POEM’, as stated in the 1976 United Kingdom - Ireland DTA.

The Special Commissioner noted that there had been no reported decision on the meaning of POEM and he went on to refer to Professor Vogel’s Commentary on the meaning of POEM

²⁰³ Olivier & Honiball, 2011:38

²⁰⁴ Oguttu, 2008:85

²⁰⁵ OECD, 2001:6

²⁰⁶ SARS, 2015:10

and noted that the professor opined that the ‘place of management’ was very similar to the POEM since the former depended on factual conditions.²⁰⁷

The Special Commissioner also referred to German case law, which established that the place of management was the centre of top level management, which is where the management’s important policies were actually made.²⁰⁸

He further emphasised the adjective ‘effective’ and opined that it was “not sufficient that some sort of management was carried on.”²⁰⁹ He stated that the term ‘effective’ “implied realistic, positive management” and that the POEM “was where the shots were called, to adopt a vivid transatlantic colloquialism.”²¹⁰

Based on the above, the factors which were of importance in deciding the matter were as follows:

- The POEM equates the place of management;
- Who formed part of the centre of top level management;
- The location of the ‘top level management’ when important policies were actually made;
- The extent of management activities carried out and by whom they were carried out; and
- Where the shots were actually called.

4.4.4 The Wood case

The Wood case dates back to 2006 and had to decide if a company, incorporated in the Netherlands, had its place of CM&C in the United Kingdom, and if so where the company’s POEM was located with reference to the United Kingdom – Netherlands DTA of 1980.

The Wood case involved a United Kingdom tax avoidance scheme which utilised a company incorporated in the Netherlands. It was obvious the Dutch directors received significant advice from various professionals located in the United Kingdom and they were presented with documents, which had been prepared by these United Kingdom professionals, which they had to consider and execute. However, at all times, it was only the Dutch directors themselves who could execute these documents, and thereby effect intention.²¹¹

²⁰⁷ The Wensleydale case, 1996:2

²⁰⁸ Ibid

²⁰⁹ Ibid

²¹⁰ Ibid

²¹¹ Hawkes, 2014:3

The following factors were of importance in deciding the place of CM&C:

- Whilst the United Kingdom HMRC sought to argue on the basis of substance over form (effectively, that the directors were mere ciphers simply undertaking the actions they were advised to), the courts reflected that the constitutional reality of the Dutch company had to be considered;
- It was only the directors who met and exercised control, and so the place of their meetings – which all took place in the Netherlands – had to be considered as the POEM;
- Only if someone in the United Kingdom had usurped the functions of the directors and carried out their functions in the United Kingdom, could the company have been considered a tax resident in the United Kingdom; and
- The form and the formalities of the transactions determined residence and not the “real” nature of the transactions, namely a United Kingdom tax scheme driven by United Kingdom tax professionals.²¹²

As it was held that the company’s place of CM&C was in the Netherlands, there was no need for the court to decide where the company’s POEM was located. However, “it was held that the term POEM is similar to CM&C”²¹³ and his Lordship “found it difficult to see how, in the circumstances of the case, the two tests could lead to different answers.”²¹⁴

4.4.5 The Laerstate case

The Laerstate case was decided in 2009 and the court was required firstly, to consider where the company’s place of CM&C was, for United Kingdom tax purposes and secondly, to consider where the POEM was in terms of the United Kingdom – Netherlands DTA of 1980.

Firstly, it was decided that the Dutch incorporated company was actually managed and controlled by its sole shareholder, Mr Bock, a United Kingdom resident, and that the company’s place of CM&C was therefore in the United Kingdom rather than in the Netherlands, where its sole director, Mr Trapman, a Dutch resident, was located.²¹⁵

The following factors were of importance in the decision and indicated that Mr Bock was playing a dominant role in the company’s CM&C:

²¹² Hawkes, 2014:3

²¹³ Olivier & Honiball, 2011:37

²¹⁴ Cleave, 2006:2

²¹⁵ SARS, 2011:10

- **Signing of documents** - Mr Bock signed various documents on behalf of the company both in the United Kingdom and abroad;
- **Professional advisors** – The professional advisors considered Mr Bock to be the key individual whose wishes concerning the company had to be determined and whose instructions had to be followed. This was supported by the fact that there was a significant amount of correspondence between the professional advisors directly with Mr Bock or between themselves concerning the company and Mr Bock;
- **Negotiations** - Mr Bock negotiated important agreements on behalf of the company whilst in the United Kingdom;
- **The director’s role** – The involvement of Mr Trapman, who was the only director at that time, was held to be administrative in nature as there was no evidence to suggest that he was being kept informed by Mr Bock on various important matters.²¹⁶

In addition, the following factors were of importance in establishing that the company’s place of CM&C was in the United Kingdom:

- **The location of directors’ meetings** – The Tribunal stated that “there is no assumption that CM&C must be found where the directors meet. It is entirely a question of fact where it is found. ... Where a company is managed by its directors in board meetings it will normally be where board meetings are held. But if the management is carried out outside board meetings one needs to ask *who* was managing the company by making high level decisions and *where*, even where this is contrary to the company's constitution.”²¹⁷
- **Signing resolutions or documents** – The Tribunal accentuated that “the mere physical acts of signing resolutions or documents do not suffice for actual management.”²¹⁸
- **The majority shareholder’s influence** – The Tribunal noted that “there is nothing to prevent a majority shareholder, whether a parent company or an individual majority shareholder, indicating how the directors of the company should act. If they consider the wishes and act on them, it is still their decision... The borderline is between the directors making the decision or not making any decision at all.”²¹⁹
- **The director’s actions and considerations** – The Tribunal emphasised that directors who mindlessly sign resolutions or who sign them “without considering whether it

²¹⁶ Hughes, 2010:2-3

²¹⁷ SARS (2011:9) cites the Laerstate case (2009) (Emphasis added)

²¹⁸ SARS (2011:10) cites the Laerstate case (2009)

²¹⁹ Ibid

would be better to sign (them) or not” would not be seen as engaged in the requisite level of decision-making, even if it could be shown that they had “the absolute minimum amount of information that a person would need to have in order to make a decision at all on whether to agree to follow the shareholder’s wishes or to decide not to sign . . .”²²⁰

Secondly, the Tribunal considered the question of ‘effective management’. If a company is resident in the United Kingdom under domestic law, and resident in the Netherlands under the Netherlands law (on account of incorporation there), the United Kingdom - Netherlands DTA of 1980 provides that “... it shall be deemed to be a resident of the State in which its place of effective management is situated.”²²¹

It is stated that ‘effective management’ implies management by the board as a whole, accordingly if one board member is dominant and the remainder are merely “passive placemen”, ‘effective management’ vests in the dominant member.²²² Further, it is stated that ‘effective management’ requires the directors to actually apply their minds to the decisions they make.²²³ De Matos Ala opines that “this requires that boards of directors or trustees must be seen to act according to the standards the law expects of persons holding fiduciary office.²²⁴ Thus, they must be mindful of their fiduciary duties and act with due prudence and circumspection when passing resolutions and signing agreements.²²⁵ In particular, directors and trustees must demonstrate their autonomy from outsiders who could be perceived as the true behind-the-scenes managers of the entity.”²²⁶

The following factors were of importance in concluding that the company’s POEM was in the United Kingdom:

- **Top level management participation** – The Tribunal noted that “Mr Bock’s activities were concerned with policy, strategic and management matters and that his activities constituted the real top level management (or realistic positive management).”²²⁷
- **The director’s activities** - The Tribunal found that “Mr Trapman’s activities were limited to signing documents when told to do so and dealing with routine matters such as the accounts.”²²⁸

²²⁰ SARS (2011:10) cites the Laerstate case (2009)

²²¹ Huges (2010:5) cites the Laerstate case (2009)

²²² De Matos Ala, (2015:53) cites the Laerstate case (2009)

²²³ Ibid

²²⁴ De Matos Ala, 2015:53

²²⁵ Ibid

²²⁶ Ibid

²²⁷ Huges (2010:5) cites the Laerstate case (2009)

4.4.6 The Smallwood case

The Smallwood case was decided on appeal in 2010 and the court, amongst other concerns, had to consider where the trusts POEM was, at the time of the sale of the shares, in terms of the United Kingdom – Mauritius DTA of 1981.

“The case dealt with a scheme devised by the settlor and his tax advisors to avoid capital gains tax on the disposal of assets held by a trust. The scheme required the assets to be disposed of during the brief term of office of non-resident trustees followed by their resignation and the appointment of resident trustees. The process of temporarily appointing non-resident and then resident trustees is classified in the case as the ‘exporting’ and ‘importing’ of the trust.”²²⁹

In the case of a trust, the taxpayer is the trustee, who may be one or more individuals or a company or one or more individuals and a company.²³⁰ Thus it is important to ascertain the POEM of the trustee/s.

The following factors were of importance in concluding that the trusts’ POEM was in the United Kingdom:

- The place where key management and commercial decisions were in substance made;
- The place where the most senior group of persons (e.g. a board of directors) made its decisions, where the actions to be taken by the entity as a whole were determined.²³¹

The case further rejected a ‘snapshot’ approach and held that one should take a ‘holistic’ approach to the determination of the trusts’ POEM.²³²

Although this case dealt with the determination of the POEM of a trust, the court’s decision is considered to be useful as the principles and facts that were considered are equally relevant in the context of companies.²³³

²²⁸ Huges (2010:5) cites the Laerstate case (2009)

²²⁹ De Matos Ala, 2015:49-50

²³⁰ Cleave, 2011:9

²³¹ Cleave, 2011:3

²³² SARS (2011:9) cites the Smallwood case (2010)

²³³ SARS, 2015:5

4.5 Differences and similarities in the factors concerning the place of Central Management and Control and the Place of Effective Management

By referring to the United Kingdom cases set out above, the differences and similarities in factors being considered by the United Kingdom courts when establishing the place of CM&C or the POEM will be highlighted below.

4.5.1 The purpose of the Central Management & Control test and the Place of Effective Management test.

It is important to note that the two tests have very different purposes. CM&C is essentially a one-country test with the purpose of determining whether a company is resident in the United Kingdom or not while the POEM is a tie-breaker test with the purpose of resolving cases of dual residence by determining in which of two States it is to be found.²³⁴ If it is established that the company is a resident of the other State, then section 18 of the CTA 2009 states that the company must be regarded as a non-resident for all United Kingdom tax purposes.²³⁵

4.5.2 Similarities in factors being considered

In *The Wood* case it was held that the concept ‘POEM’ is similar to that of ‘CM&C’²³⁶ and that the two tests are in substance the same.²³⁷

Oguttu opines that the concept ‘POEM’ and the concept ‘CM&C’ “are often interpreted as synonymous, as both concepts refer to the place where the main policy and strategic decisions are made by the board of directors.”²³⁸

Although there are internationally conflicting views on whether the concept ‘POEM’, as per the OECD MTC, is the same as the concept ‘CM&C’, it is clear that the POEM test was significantly influenced by the CM&C test, as it was first laid down in the *De Beers* case.²³⁹

²³⁴ Huges (2010:5) cites the *Smallwood* case (2008)

²³⁵ Hawkes, 2014:2

²³⁶ Cleave, 2006:2

²³⁷ Hawkes, 2014:2

²³⁸ Oguttu, 2008:85

²³⁹ Olivier & Honiball, 2011:38

Referring to the analysis of the factors being considered when determining the place of CM&C or the POEM, as set out in the cases above, it is evident that the following factors are the core when establishing both the place of CM&C and the POEM:

- Identifying the individuals who actually decide on real matters of importance and who form part of the centre of top level management, including the consideration of any usurped functions;
- Establishing the location of the identified individuals when they actually decide on real matters of importance.

4.5.3 Differences in factors being considered

Vogel opines that the concept ‘CM&C’ is much wider than that of POEM.²⁴⁰

“Although it is clear from United Kingdom revenue manuals that effective management indicates a form of management lower than CM&C, in practice it will often coincide. In a United Kingdom manual it is stated that the second level of management is the place where you would expect to find the executives and senior staff who actually make the business tick, and the place where one would expect to find the finance director, for example, sales director, and, if there is one, the managing director. As these executives would be on the board of directors, the location of the POEM will only differ from the place where CM&C is exercised, if the term ‘effective management’ refers to where the directors normally reside and not where they may go to specifically for board meetings.”²⁴¹

It is evident from the stated cases and the above, that there are no material differences in the factors which are considered when establishing the place of CM&C and the POEM.

4.6 Recent developments and proposed amendments

At the date of this dissertation, I am not aware of any proposals or amendments to be made to the United Kingdom tax legislation or SoP1, regarding the determination of a company’s CM&C.

4.7 Conclusion

The United Kingdom tax law and SoP1 do not explicitly acknowledge the digital economy or the challenges it presents and no rules or guidance is provided as to specific, additional or

²⁴⁰ Vogel et al. 1997:268

²⁴¹ Olivier & Honiball, 2011:26

different factors which should be considered when establishing a company's place of CM&C in a digital economy. Accordingly, the research and discussions presented in this chapter have not been able to identify specific, additional or different factors that should be considered when establishing the place of CM&C or POEM in a digital economy, as these factors do not 'exist' in an United Kingdom context.

Chapter 5: An international perspective

5.1 Introduction

Before any country can levy a tax on income, a connection or ‘tax *nexus*’ must be established between itself and that income, such as the ‘residence basis of taxation’ or the ‘source basis of taxation’.²⁴² As some countries tax on a ‘residence-basis’ and other tax on a ‘source-basis’, double taxation of the same income may occur, this could either be ‘juridical’²⁴³ or ‘economic’²⁴⁴ double taxation.²⁴⁵ Juridical double taxation may occur because of a coincidence of source and residence bases of taxation imposed on a taxpayer by two different countries or it may be caused by the coincidence of two States’ residence bases of taxation.²⁴⁶ The latter is the focus of this dissertation.

To expand on the above, a company will be considered a dual resident if it is incorporated or formed in one state but has its POEM in another.²⁴⁷ In order to ease the resultant double taxation, this is if the two States have entered into a DTA, the OECD MTC tie-breaker rule provides that the dual resident company will only be considered to be a resident of the state in which its POEM situated.²⁴⁸

This chapter will analyse the interaction between the OECD MTC and domestic law when ascribing a meaning to the concept ‘POEM’.

Further, this chapter will highlight the factors which are currently being considered by the OECD when establishing the POEM of a company.

Consideration will also be given to recent developments and proposed amendments to the interpretation of POEM from an international perspective and will comment if these developments and proposed amendments acknowledge the digital economy and if they provide guidance as to which factors should be considered when establishing the POEM in a digital economy, ie should additional or different factors be considered when establishing the POEM in a digital economy?

²⁴² Oguttu (2008:80) cites Meyerowitz (2002-2003)

²⁴³ Oguttu, 2008:81 states that: “Juridical double taxation occurs when two states impose the same or comparable taxes on the same taxpayer, in respect of the same subject matter and for identical periods.”

²⁴⁴ Oguttu, 2008:81 states that: “Economic double taxation occurs when a double tax is charged by two countries on the same income in the hands of different persons.”

²⁴⁵ Oguttu, 2008:81

²⁴⁶ Ibid

²⁴⁷ Oguttu, 2008:82

²⁴⁸ Ibid

5.2 Interaction between the OECD MTC and domestic law

Article 3(2) of the OECD MTC states that:

“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.”²⁴⁹

The above implies that if a term is not defined in the OECD MTC, then a Contracting state can make use of the meaning of that term as it is understood under its domestic legislation.²⁵⁰

As Article 4(3) of the OECD MTC does not define the concept ‘POEM’, it merely provides guidelines as to the meaning thereof in paragraph 24 of the OECD Commentary on Article 4(3), the Contracting States may resort to using the domestic meaning of the concept.²⁵¹

Drawing from chapter 4, it can be supposed that the United Kingdom’s concept ‘CM&C’ is likened to the concept ‘POEM’ and is to be found where the director meetings are actually held.

As stated in paragraph 3.2.1 above, in a South African context it can be said that the concept ‘POEM’, as per IN6, is akin to the OECD MTC’s concept ‘POEM’ and is to be found where policy and strategic decisions are executed and implemented by a company’s senior management.

However, the purpose of the concepts in a domestic and international framework are very different.²⁵² As stated in paragraph 4.5.1 above, CM&C (and so also POEM in a South African context) is essentially a one-country test with the purpose of determining whether a company is resident in the United Kingdom (or South Africa in a South African context) or not, while the POEM, as per the OECD MTC, is a tie-

²⁴⁹ OECD, 2014:25

²⁵⁰ Oguttu, 2008:84

²⁵¹ Ibid

²⁵² Oguttu, 2008:85

breaker test with the purpose of resolving cases of dual residence by determining in which of two States residency is to be found.

It can thus be said that although Article 3(2) of the OECD MTC permits countries to resort to the domestic meaning of a term that is not defined in the OECD MTC, the article also makes it clear that this has to be done in context of the intention/purpose of the OECD MTC.²⁵³ Article 4(3) of the OECD MTC makes it clear that there can only be one POEM at any one time, thus any domestic definition of the term that does not bring out this result is clearly against the OECD's intentions/purpose.²⁵⁴ Accordingly, it can be said that unilaterally relying on Article 3(2) to equate the term POEM with other domestic terms, without considering the context of Article 4(3), would result in the loss of the uniformity of the long existing OECD MTC and its Commentary.²⁵⁵

Thus, the guidance provided in paragraph 24 of the OECD Commentary on Article 4(3) should prevail when ascribing a meaning to the concept 'POEM' for DTA's which are based on the OECD MTC.

Article 4(3) of the OECD MTC and the relating commentary in paragraph 24 of the OECD Commentary is discussed below.

5.3 Factors currently being considered in an international context

5.3.1 Factors currently being considered by the OECD

Article 4(1) of the OECD MTC states that:

“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.”²⁵⁶

Further, Article 4(3) of the OECD MTC states that:

²⁵³ Oguttu, 2008:87

²⁵⁴ Ibid

²⁵⁵ Ibid

²⁵⁶ OECD, 2014:26

“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.”²⁵⁷

As noted above, the concept ‘POEM’ is not defined by the OECD, however paragraph 24 of the OECD Commentary on Article 4(3) offers some guidance on the meaning of the concept. Paragraph 24 states that:

“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”²⁵⁸

It is disappointing that the above commentary does not clarify which facts and circumstances should be considered ‘relevant’ and, as such, each of the two Contracting States is free to determine which facts and circumstances are decisive.²⁵⁹ The above passage merely implies that the OECD follows a board-centric approach and the POEM will generally be where key management and commercial decisions necessary for the conduct of a business are in substance made and given.²⁶⁰ This will ordinarily be where the directors meet to make decisions relating to the management of the company.²⁶¹ However, the determination of the POEM is a question of fact and all relevant facts and circumstances must be examined.²⁶² Where courts have decided the POEM, the following factors have been regarded as important:

- Where the centre of top level management is located;
- Where the business operations are actually conducted;
- Legal factors such as the place of incorporation, the location of the registered office, public officer, etc;
- Where controlling shareholders make key management and commercial decisions in relation to the company; and
- Where the directors reside.²⁶³

²⁵⁷ OECD, 2014:26 (Emphasis added)

²⁵⁸ OECD, 2014:90-91

²⁵⁹ Pötgens et al., 2014:1-2

²⁶⁰ OECD, 2001:7

²⁶¹ Ibid

²⁶² OECD, 2014:91

²⁶³ OECD, 2001:7-8

It should be noted that the POEM will generally lie with the directors, however in certain circumstances these strategic decisions and powers may be exercised by others.²⁶⁴ For example, paragraph 24 of the OECD Commentary on Article 4, highlights that the relevant consideration is “where the high level decision making occurs.”²⁶⁵ If this function is performed by persons other than the board of directors, then the relevant consideration is the place where those other people make their decisions.²⁶⁶

5.3.2 International writer’s views and comments

Vogel cautions that if a controlling shareholder affects the usual conduct of the business and is constantly informed of the company’s transactions and has a decisive influence on how transactions are dealt with, it can be said that such a shareholder is in charge of top level management.²⁶⁷

Vogel’s view is that “the POEM is the place where the higher level of day-to-day running of the business takes place.”²⁶⁸ It is further noted that the running of a business is not limited to implementation and administration, but that it also entails a range of decision making steps necessary for the functioning of the business, however it does not necessarily include strategic decision making.²⁶⁹ Vogel continues and provides the following illustrative examples:

“Holding company A in country X has many operating subsidiaries in other countries, including Subsidiary B in country Y. The board of directors of company A makes strategic decisions relating to the operating subsidiaries, including their capitalisation, their ability to raise debt and the nature of that debt, the products they are to manufacture or sell, the geographical area in which they can operate, and their target cost structures and profit margins. These subsidiaries’ mandate is to operate within these parameters. Company B takes all operating decisions necessary to conduct the business in the context of its mandate, including hiring and firing workers, sourcing supplies, marketing and advertising, competing with local rivals, dealing with local authorities and so on. In this case, there is little doubt that the day to day business is run in country Y, and the effective management is also located there.”²⁷⁰

Vogel then elaborates on the above example:

²⁶⁴ OECD, 2001:8

²⁶⁵ Ibid

²⁶⁶ Ibid

²⁶⁷ Vogel et al., 1997:263

²⁶⁸ Olivier & Honiball (2011:28) cite Vogel et al. (1997)

²⁶⁹ Olivier & Honiball, 2011:28

²⁷⁰ Ibid

“As in the example above, but Company A requires Company B to consult it on all operating decisions, including hiring and firing workers, sourcing supplies, marketing and advertising, competing with local rivals, dealing with local authorities, and so on. The subsidiary therefore has an extremely narrow mandate – in fact, Company B makes no real operating decisions and there is therefore little doubt that the day-to-day business is run in Country X, and that the effective management is located there.”²⁷¹

It is evident from the above, that all the relevant facts and circumstances must be examined when establish the POEM, as provided for in paragraph 24, and that no hard and fast rule can be laid down to determine the POEM of a company.

Further, various commentators have commented that the traditional board-centric approach, which focusses on the board of directors’ or similar body’s decision making, has failed to keep pace with changes in telecommunications, international travel and modern business practices.²⁷² For example, two United Kingdom authors have noted:

“We might ask whether concepts developed before the age of international telephone and even before the wireless telegraph . . . are still appropriate in today’s world. . . The contrast with the current availability of international communications by telephone, e-mail, videophone, video conferencing and the ubiquity of air travel is sharp.”²⁷³

These issues have also been a matter of concern in South Africa and in IN6 Discussion Paper, academic BA van der Merwe has stated:

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

²⁷¹ Olivier & Honiball, 2011:28

²⁷² SARS, 2011:6

²⁷³ SARS (2011:6) cites Miller & Oates (2006)

management down to one constant location, and double or multiple residences or even non-residence may be the result.”²⁷⁴

As the concept ‘POEM’ is one of substance over form, it should always produce results which reflect the true policy intention of the tie-breaker rule.²⁷⁵ In today’s modern multinational environment together with the digital economy evolution, the OECD’s interpretation of the POEM cannot achieve this, and it is questioned if it can be relied upon as an effective tie-breaker test.²⁷⁶

5.4 Recent developments and proposed amendments

The OECD acknowledges that in a modern multinational environment, the application of the above factors may not result in a clear determination of which state should be given preference as the state of residence, or may result in an outcome which does not appear to accord with the policy intentions of the provision.

Accordingly, in 1999 the OECD’s Committee on Fiscal Affairs set up the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (TAG, the), with the general mandate to “examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules.”²⁷⁷ In February 2001, the TAG issued a draft discussion paper, entitled “The Impact of the Communications Revolution on the Application of ‘Place of Effective Management’ (2001 discussion draft, the) as a Tie-Breaker Rule” and in May 2003, the TAG issued a second draft discussion paper, entitled “Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention” (2003 discussion draft, the).²⁷⁸

I will now proceed and analyse the relevant proposals of the draft discussion papers.

²⁷⁴ SARS, 2011:6

²⁷⁵ OECD, 2001:8

²⁷⁶ Oguttu, 2008:90

²⁷⁷ OECD, 2004:3

²⁷⁸ Ibid

5.4.1 “The Impact of the Communications Revolution on the Application of ‘Place of Effective Management’ as a Tie Breaker Rule”

The purpose of this paper was to identify possible limitations embedded in the application of the POEM tie-breaker test in the digital economy and to identify possible solutions.²⁷⁹

(a) Limitations in a digital economy

The discussion paper emphasises the possibility of a company having its POEM in *multiple-jurisdictions*.²⁸⁰ For example, if senior managers adopt videoconferencing as the key medium for making management and commercial decisions and those managers are located across the globe when making those decisions, it may be difficult to determine a POEM.²⁸¹ In such instances, it may be regarded that a place of management exists in each jurisdiction where a manager is located at the time the decision is made, but it may be difficult (if not impossible) to point to any particular location as being the one POEM.²⁸²

The next concern highlighted in the 2001 discussion draft, is the increased incidents of *mobile* POEM’s. This will occur for instance, where the managing director of a company, who is responsible for the management of that company, is constantly on the move.²⁸³ In some extreme cases, that person may consistently be making decisions while flying over the ocean or while visiting various sites in different jurisdictions where his business is conducted.²⁸⁴ Similarly, where a board of directors may arrange to meet in different places throughout the year, it may be difficult to pin point a single location as the POEM.²⁸⁵

From the above it is evident that “the characteristics of effective management may exist in a number of jurisdictions and it may be said to exist simultaneously in more than one jurisdiction without a specific single jurisdiction being dominant.”²⁸⁶ Thus, to the extent that the POEM test fails to provide a clear allocation of residence to one country, it may be seen to be an ineffective rule.²⁸⁷

²⁷⁹ OECD, 2001:8

²⁸⁰ Ibid

²⁸¹ Ibid

²⁸² OECD, 2001:8-9

²⁸³ OECD, 2001:9

²⁸⁴ Ibid

²⁸⁵ Ibid

²⁸⁶ OECD, 2001:10

²⁸⁷ Ibid

(b) Proposed solutions and considerations

The TAG proposed that the following options should be considered in order to achieve a tie-breaker rule that will identify a single POEM in all cases:

- A. Replace the concept ‘POEM’;
- B. Refine the POEM test;
- C. Establish a hierarchy of tests; or
- D. A combination of refining the POEM test and establishing a hierarchy of tests.²⁸⁸

Options A, C and D (above) do not fall within the ambit of this dissertation as it does not address the factors which are of importance when establishing the POEM in a digital economy, but rather propose alternative residency tests. I will now proceed and evaluate how the POEM test is proposed to be refined.

Refinement of the concept ‘Place of Effective Management’

The TAG suggests that the existing POEM test should be refined by, either making a determination on the basis of predominant factor/s or by assigning a weighting to various factors.²⁸⁹

The construction of paragraph 24 of the 2000²⁹⁰ Commentary presupposes that the determination is on the basis of the following predominant factors:

- Where the key management and commercial decisions are made in substance;
- Where the most senior person or group of persons makes its decisions; and
- Where the actions to be taken by the enterprise as a whole are determined.²⁹¹

In most cases dealing with the company residence tie-breaker, the application of the above three factors should deliver a decision which reflects the underlying policy intent.²⁹² This may be considered the norm.²⁹³

However, there may be instances where the above predominant factors do not produce a single POEM.²⁹⁴ In such cases it may be necessary to consider other additional factors, as is

²⁸⁸ OECD, 2001:10

²⁸⁹ OECD, 2001:12

²⁹⁰ It should be noted that the paragraph 24 of the OECD Commentary has since been updated and the only predominant factor present in paragraph 24 of the 2014 OECD MTC is where the key management and commercial decisions *as a whole* are in substance made.

²⁹¹ OECD, 2001:12

²⁹² Ibid

²⁹³ Ibid

suggested in paragraph 24 of the OECD Commentary where it states that “All relevant facts and circumstances must be examined to determine the place of effective management.”²⁹⁵ The TAG suggests that the following ‘other factors’ could be considered in association with the predominant factors when ascertaining the POEM:

- Location of and functions performed at the headquarters;
- Information on where central management and control of the company is to be located (contained within company formation documents ie articles of association etc);
- Place of incorporation or registration;
- Relative importance of the functions performed within the two States; and
- Where the majority of directors reside.²⁹⁶

The TAG extended an invitation to the public to make comments and to provide insights as to the weighing of the above factors and determining whether there are any other factors which should be taken into account.²⁹⁷

5.4.2 “Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention”

Subsequently the TAG received comments (on the draft discussion paper discussed above at paragraph 5.4.1) and examined those comments and found that they support the alternative options of providing clarification of the POEM concept as a tie-breaker test and developing a hierarchy of different tests.²⁹⁸

In May 2003 the TAG issued the ‘follow up’ discussion draft entitled “Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention”, which included the two alternative proposals, mentioned above.²⁹⁹ The first proposal seeks to refine the ‘POEM’ concept by expanding the OECD “Commentary explanations as to how the concept should be interpreted.”³⁰⁰ The second proposal entails a hierarchy of tests and puts forward an alternative version of Article 4(3) of the OECD MTC, together with commentary thereon.³⁰¹

²⁹⁴ OECD, 2001:12

²⁹⁵ Ibid

²⁹⁶ OECD, 2001:12-13

²⁹⁷ OECD, 2001:15

²⁹⁸ OECD, 2003:1

²⁹⁹ Ibid

³⁰⁰ Ibid

³⁰¹ Ibid

The second proposal does not fall within the ambit of this dissertation as it does not indicate which factors are of importance when establishing the POEM in a digital economy. I will now proceed and analyse how the POEM test is proposed to be refined.

(a) Refinement of the concept ‘Place of Effective Management’

It is suggested that the wording of paragraph 24 of the OECD Commentary should be replaced/expanded in order to provide guidance as to how the concept should be interpreted.³⁰² The suggested wording of the refined concept is as follows:

“As a result of these considerations, the “place of effective management” has been adopted as the preference criteria for persons other than individuals.

An entity may have more than one place of management, but it can have only one place of effective management at any one time.

The place of effective management is the place where the *key* management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made, *i.e.* the place where the actions to be taken by the entity as a whole are, *in fact*, determined. *All the* relevant facts and circumstances must be examined to determine the place of effective management.

The place of effective management *is* ordinarily the place where the most senior person or group of persons (for example a board of directors) make its decisions, *which normally corresponds to where it meets. There are cases however, where the key management and commercial decisions necessary for the conduct of the entity’s business are in substance made in one place by a person or group of persons but are formally finalised somewhere else by it or by another person or group of persons. In such cases, it will be necessary to consider other factors. Depending on the circumstances, these other factors could include:*

- *Where a board of directors formally finalises key management and commercial decisions necessary for the conduct of the entity’s business at meetings held in one State but these decisions are in substance made in another State, the place of effective management will be in the latter State.*
- *If there is a person such as a controlling interest holder (e.g. a parent company or associated enterprise) that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity’s business, the place of effective management will be where that person makes these key decisions. For that to be the case, however, the key decisions made by that person must go beyond decisions related to the normal management and policy formulation of a group’s activities (e.g. the type of decisions that a*

³⁰² Oguttu, 2008:93

parent company of a multinational group would be expected to take as regards the direction, coordination and supervision of the activities of each part of the group).

- *Where a board of directors routinely approves the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the place of effective management of the entity. In distinguishing between a place where a decision is made as opposed to where it is merely approved, one should consider the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed.*”³⁰³

The above evidences that the refinement of the concept centres on the “making” of key management and commercial decisions, which take place “where the actions to be taken by the entity as a whole are, in fact determined.”³⁰⁴ In effect, the 2003 discussion draft reiterates the 2000 OECD interpretation of the term that relies on the location of superior management decision making.³⁰⁵

Van der Merwe opines that the 2003 discussion draft does provide some insight into the OECD’s way of thinking and it confirms that the OECD’s interpretation of the concept, relies on the location of “superior management decision making.”³⁰⁶ The author is in agreement with Van der Merwe, who cautions that the 2003 discussion draft does not provide insight as to the interpretation of the concept in a technology advanced environment and it will be “difficult to pin effective management down to one constant location, and double or multiple or even non-residence may be the result.”³⁰⁷

Oguttu questions the adequacy of effective management as a tie-breaker rule based upon the factors set out in the 2003 discussion draft.³⁰⁸ The author is in agreement with this statement, as these factors can easily be manipulated to achieve the desired POEM.

Since the publication of this report, no further steps have been taken by the OECD in this regard. This may well be an indication that the OECD does not intend to take any of the proposals further.³⁰⁹

³⁰³ OECD, 2003:2 (Proposed additions to the 2000 OECD Commentary appear in italics)

³⁰⁴ Vander Merwe, 2006:123

³⁰⁵ Oguttu (2008:94) cites Van der Merwe (2006)

³⁰⁶ Van der Merwe, 2006:124

³⁰⁷ Van der Merwe (2006:124-125) cites Schäfer & Spengel (2002)

³⁰⁸ Oguttu, 2008:94

³⁰⁹ Olivier and Honiball, 2011:41

5.4.3 2008 Update to the OECD Commentary

Subsequent to the 2003 discussion draft, paragraph 24 of the OECD Commentary to Article 4(3) was amended in 2008. This amendment in essence removed the third sentence, which was introduced to paragraph 24 of the OECD Commentary as part of the 2000 update.

The said change is reflected below:

“As a result of these considerations, the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business *as a whole* are in substance made. ~~The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and a~~All relevant facts and 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.”³¹⁰

Now that the importance attached to the board of directors has been removed, paragraph 24 of the OECD Commentary provides a general statement which seems to be open to support different levels of management.³¹¹

Further, paragraph 24.1 of the OECD Commentary was included to propose an *alternative* provision to the current Article 4(3). Paragraph 24.1 of the OECD Commentary allows States to solve cases of dual residency on a case-by-case basis, if such an “approach is the best way to deal with the difficulties in determining the POEM of a legal person that may arise from the use of new communication technologies.”³¹²

The *alternative* to the current Article 4(3) provides:

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

³¹⁰ Olivier & Honiball, 2011:39; OECD, 2008:77 (Italic words represent added words in 2008 and strikethrough a deletion)

³¹¹ Sullivan, 2011:26

³¹² OECD, 2008:77 (Emphasis added)

provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.”³¹³

The OECD Commentary provides that the competent authorities should consider the following factors when applying the above *alternative* provision:

“Such as where the meetings of its board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person’s headquarters are located, which country’s laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc.”³¹⁴

A number of States have validated and recommended this alternative approach, therefor accepting this alternative article.³¹⁵

However, Le Broe has criticised the 2008 update, he argues that the OECD Commentary now provides ‘other factors’ to be taken into account when applying the alternative to Article 4(3), however no such guidance is provided for the current tie-breaker rules. He argues that the change may jeopardise the legal certainty of taxpayers affected by the tie-breaker. “The current rule is merely given a general principle, which is seen to be unsatisfactory.”³¹⁶

The alternative article provides that the authorities “shall endeavour” to settle by mutual agreement, therefore there is no obligation on the authorities to reach a solution. This is detrimental to the dual resident company, as it cannot claim treaty benefit as a resident of either contracting state until the competent authorities have reached a solution.³¹⁷

Subsequently the OECD MTC and Commentary was updated in 2010 and 2014, however no amendments were made to Article 4(3) and the relating OECD Commentary.

³¹³ OECD, 2008:77

³¹⁴ OECD, 2008:77-78

³¹⁵ Sullivan (2011:27) cites Giner (2009)

³¹⁶ Sullivan (2011:27) cites Le Broe (2008)

³¹⁷ Sullivan (2011:27) cites Russo (2008)

5.5 Conclusion

The TAG prepared two discussion drafts with the purpose of identifying the limitations we are likely to face with the application of the POEM tie-breaker test in the current and future environment of electronic commerce and technology and to propose solutions.³¹⁸

Further, paragraph 24.1 of the OECD Commentary was included in 2008 to propose an alternative provision to the current Article 4(3). Paragraph 24.1 of the OECD Commentary allows States to solve cases of dual residency on a case-by-case basis, if such an “approach is the best way to deal with the *difficulties in determining the POEM of a legal person that may arise from the use of new communication technologies.*”³¹⁹

From above it is evident that the OECD acknowledges the digital economy and the challenges it presents when ascertaining the POEM.

However, the above mentioned discussion drafts are currently no more than proposals.

Therefore, it is concluded that the OECD does not provide any guidance as to specific, different or additional factors that should be considered when establishing the POEM in a digital economy.

³¹⁸ OECD, 2001:3

³¹⁹ OECD, 2008:77 (Emphasis added)

Chapter 6: The OECD BEPS Project

6.1 Introduction

Globalisation, digitalisation, the easy movement of capital and rapidly changing business models have provided a platform for companies to explore gaps in international tax rules in order to minimise tax liabilities.³²⁰

Base erosion occurs when a company attempts to reduce its taxable income and thereby reduce the amount of tax it has to pay, for example when a company has its POEM in a low/no tax jurisdiction.³²¹ The practice of profit shifting is to move profits from one jurisdiction to another, this is advantageous where the taxable profits are moved from a high tax jurisdiction to a low/no tax jurisdiction (because there is a saving due to the difference in tax rates).³²²

Accordingly, the Group of Twenty (**G20**)³²³ has identified the need for a “multilateral solution” and has instructed the OECD to develop recommendations on “how to tackle aggressive and harmful international tax planning.”³²⁴ This is known as the OECD BEPS Project and has two key pillars, which are:

- To align, more strictly, substance and taxing rights; and
- To address double non-taxation.³²⁵

In July 2013 the OECD launched the OECD BEPS Action Plan which identified 15 specific actions to equip governments with the domestic and international instruments to address these challenges.³²⁶ The OECD’s Committee on Fiscal Affairs is attending to the technical work on the OECD BEPS’ Actions.³²⁷

³²⁰ An Roinn Airgeadais Department of Finance, 2014:2

³²¹ Ibid

³²² Ibid

³²³ The G20 Finance Ministers and Central Bank Governors was established in 1999 to bring together industrialised and developing economies to discuss key issues in the global economy. The G20 comprises the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States of America. The remaining seat is held by the European Union, which is represented by the rotating Council presidency and the European Central Bank.

³²⁴ An Roinn Airgeadais Department of Finance, 2014:2

³²⁵ Ibid

³²⁶ Ibid

³²⁷ Ibid

The Actions include³²⁸: Action 1 – Address the tax challenges of the digital economy; Action 2 – Neutralize the effects of hybrid mismatch arrangements; Action 3 – Strengthen Control Foreign Company rules; Action 4 – Limit base erosion *via* interest deductions and other financial payments; Action 5 – Counter harmful tax practices more effectively, taking into account transparency and substance; Action 6 – Prevent treaty abuse; Action 7 – Prevent the artificial avoidance of Permanent Establishment status; Action 8 – Assure that transfer pricing outcomes are in line with value creation: intangibles; Action 9 – Assure that transfer pricing outcomes are in line with value creation: risk and capital; Action 10 – Assure that transfer pricing outcomes are in line with value creation: other high risk transactions; Action 11 – Establish methodologies to collect and analyse data on BEPS and the actions to address it; Action 12 – Require taxpayers to disclose their aggressive tax planning arrangements; Action 13 – Re-examine transfer pricing documentation; Action 14 – Make dispute resolution mechanisms more effective and Action 15 – Develop a multilateral instrument.³²⁹

It is disappointing that none of the above Actions were specifically dedicated to addressing the POEM issues which are being faced.

Subsequently, the OECD released several OECD BEPS Public Discussion Drafts, and on 16 September 2014 the OECD published seven papers, which addressed Actions 1, 2, 5, 6, 8, 13 and 15, as a first tranche of deliverables under the OECD BEPS Project.

Although Actions 2 and Action 6 did not specifically deal with POEM challenges, they do provide recommendations with regard to changes to Article 4(3) of the OECD MTC.³³⁰

I will now proceed and scrutinise the recommendations.

6.2 Action 2 and Action 6 recommendation/s

The OECD BEPS Report³³¹ on Action 6 of September 2014 proposes several changes to the OECD MTC.³³² These changes *inter alia* include amendments to the residence article,

³²⁸ OECD, 2013:1-4

³²⁹ Actions 1, 2, 5, 6, 8, 13 and 15 were included in the 2014 Deliverable and Actions 3, 4, 7, 9, 10, 11, 12 and 14 are due in September/December 2015

³³⁰ Pötgens et al., 2014:2

³³¹ This report includes recommendations of the OECD Public Discussion Draft entitled *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* of 14 March 2014 and the OECD Public Discussion Draft entitled *BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* of 19 March 2014.

³³² Wagenaar, 2015:5

Article 4 of the OECD MTC, and the introduction of a limitation of benefits (LOB) article and a principle purpose test (PPT).³³³

It is recommended that Article 4(3) of the OECD MTC be deleted and it is proposed that the residence of a dual resident company³³⁴ should be determined by mutual agreement³³⁵ in all cases.³³⁶ The newly proposed Article 4(3) of the OECD MTC would read as follows:

“Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.”³³⁷

I reiterate that the above provision implies that in the absence of a mutual agreement, treaty benefits would not be available to either state. This raises concerns as the mutual agreement procedure (MAP) between competent authorities could be a lengthy process and it would be detrimental to the involved companies’ finances.³³⁸ The OECD acknowledged these uncertainties, but notes that:

“...situations of double residence of entities other than individuals are relatively rare... (but)... there had been a number of tax avoidance cases involving dual resident companies.”

The above passage creates the impression that the OECD is not particularly ‘fased’ with the consequences embedded in the MAP, as it opines that dual residency is the exception to the norm and that these agreements would rarely have to be entered into.

It is worth noting that the above newly proposed provision is currently included in the OECD Commentary on Article 4 in paragraph 24(1) as an *alternative* to the tie-breaker rule of Article 4(3) of the OECD MTC, and gives decisive weight exclusively to the POEM.³³⁹ However, if the above Action is approved, adopted and implemented by the various OECD

³³³ Wagenaar, 2015:5

³³⁴ for DTA purposes

³³⁵ Article 25 of the OECD MTC

³³⁶ Pötgens et al., 2014:2

³³⁷ Ibid

³³⁸ Wagenaar, 2015:6

³³⁹ Refer to section 5.5.3 of this dissertation where the 2008 OECD updated introduced the alternative provision

member countries, the use of the MAP as a solution in situations in which companies have dual residence would become compulsory and there would be no choice.³⁴⁰

Although POEM remains one of the criteria that can be taken into account by the competent authorities in concluding a mutual agreement, it is not the exclusive criterion when, in connection with a MAP, the States disagree over the interpretation and application of the POEM.³⁴¹

The primary output of Action 6 is the proposed introduction of an LOB article and a PPT. Wagenaar cautions that DTA benefits will not be available for taxpayers who don't meet the conditions of such articles and that DTA access would be significantly restricted.³⁴²

The LOB article requires that shareholdings, loans and intellectual property are held through the countries where the main business activities or the shareholders are located and the PPT requires that such assets are not held through a structure with the principal purpose to obtain DTA relief, unless the benefit is in accordance with a DTA.³⁴³ Accordingly, some international groups may find it challenging to apply the DTA network of any jurisdiction, especially if both their ownership and their business activities are fragmented.³⁴⁴ "Therefore, it seems to require that legal structures should be aligned with commercial, legal and any other non-tax reasons."³⁴⁵

6.3 Conclusion

The OECD's BEPS Project does not address the factors which are of importance when establishing the POEM in a digital economy. It recommends that the POEM residency test be deleted and that all cases of dual residency should be determined by MAP³⁴⁶. The POEM test will merely remain one of the criteria that can be taken into account by the competent authorities in concluding a mutual agreement, and will no longer be the decisive dual breaker test.³⁴⁷

³⁴⁰ Pötgens et al., 2014:2

³⁴¹ Ibid

³⁴² Wagenaar, 2015:6

³⁴³ Ibid

³⁴⁴ Ibid

³⁴⁵ Ibid

³⁴⁶ of Article 25 of the OECD MTC

³⁴⁷ Pötgens et al., 2014:2

Chapter 7: Conclusions and recommendations

7.1 Conclusions

In Chapter 2 Cockfield et al. opined that the e-commerce rules have been ‘absorbed’ into the traditional rules and that the line between e-commerce activities and traditional commercial activities are blurred. This advocates that traditional legal mechanisms will sufficiently confront challenges promoted by the digital economy.

In Chapter 3 it was concluded that South African tax authorities acknowledge the digital economy and the challenges it presents, however no rules or guidance is provided as to specific, additional or different factors that should be considered when establishing a company’s POEM in a digital economy. SARS is of the opinion that the same “core principles” should apply in a digital economy, as do in the traditional world.

Chapter 4 concluded that the United Kingdom tax authorities do not explicitly acknowledge the digital economy or the challenges it presents and no rules or guidance is provided as to specific, additional or different factors which should be considered when establishing a company’s place of CM&C or POEM in a digital economy.

Chapter 5 concluded that the OECD acknowledges the digital economy and the challenges it presents when ascertaining the POEM. However, the above mentioned discussion drafts are currently no more than proposals and do not specifically address the factors which are of importance when determining the POEM in a digital economy, but rather focus on alternative residency tests.

In chapter 6 it is concluded that the OECD’s BEPS Project does not address the factors which are of importance when establishing the POEM in a digital economy. The OECD opines that cases of dual residency are rare. It is recommended that the POEM residency test be deleted and that all cases of dual residency should be determined by MAP.³⁴⁸ The POEM test will merely remain one of the criteria that can be taken into account by the competent authorities in concluding a mutual agreement, and will no longer be the decisive dual breaker test.³⁴⁹

³⁴⁸ of Article 25 of the OECD MTC

³⁴⁹ Pötgens et al., 2014:2

Accordingly, the research and discussions presented in this dissertation have not been able to identify specific, additional or different factors that should be considered when establishing the POEM in a digital economy, as these factors do not 'exist' in a South African, United Kingdom or international context.

The comprehensive conclusion drawn from above would be that undue attention should not be attached to the digital economy in such a way that it 'confuses' the meaning and application of the POEM test. We should not be intimidated by the digital economy and the same factors which are of importance in a traditional tax world should be of importance when establishing the POEM in the digital economy, however careful consideration should be given when applying these 'traditional' factors in the digital economy.

7.2 Recommendation

It is recommended that the South African tax authorities finalise Draft IN6.

In an international context it is recommended that the 2003 discussion draft of the OECD TAG be finalised and that the meaning of POEM be refined. The refinement should include a comprehensive list of 'other factors' that are of importance and a weighting should be attached to each factor. Further, it is proposed that the OECD Commentary include practical examples of establishing the POEM in the digital economy. It is also recommended that the OECD define the following terms upfront, in order to eliminate confusion as to the meaning thereof, such as: board, directors, head office/headquarter, senior employees, senior managers and top level management, as also proposed in Draft IN6.

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