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Dissertation Title: Residence of a person other than a natural person for tax purposes in South Africa: The meaning of the concept “Place of effective Management”

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Research dissertation/research paper presented for the approval of Senate in fulfilment of part of the requirements for the Postgraduate Diploma in Tax specialising in Tax Law in approved courses and a minor dissertation/research paper. The other part of the requirement for this qualification was the completion of a programme of courses.

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UNIVERSITY OF CAPE TOWN  
Department of Commercial Law

**RESIDENCE OF A PERSON OTHER THAN A NATURAL  
PERSON FOR TAX PURPOSES IN  
SOUTH AFRICA: THE MEANING OF THE CONCEPT  
“PLACE OF EFFECTIVE MANAGEMENT”**

Postgraduate Diploma in  
Tax specialising in Tax Law

By

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Words: 11919

December 2013

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# Chapter 1

## Introduction

### 1.1 Background

In South Africa, both their residents and non-residents operate business or conduct commercial transactions within the domestic jurisdiction of South Africa. As a result it is vital to implement a tax system within South Africa to satisfy the domestic and international fiscal objectives as well as balance these objectives accordingly.<sup>1</sup> The fiscal policy objectives include the promotion of domestic trade, international trade and other domestic and international activities.<sup>2</sup> Two bases of taxation known as the source and residence bases have been established in order to cater for the international tax situations, in order to bring an a person other than a natural person into South Africa's tax jurisdiction.<sup>3</sup>

In 2001, Trevor Manuel the former Minister of Finance announced in his Budget Speech that South Africa's basis of taxation will be changed from a source basis to a residence basis of taxation.<sup>4</sup> The source basis of taxation entailed that the taxpayer's residence did not affect the taxpayer's liability of tax purposes.<sup>5</sup>

For the source basis of taxation the taxpayer will be taxed on activities that generated income which were carried on in the Republic.<sup>6</sup> In contextualizing

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<sup>1</sup> KATZ Commission 'Fifth interim report of the KATZ Commission into Tax Reform' in *Fifth interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, Basing the South African Income Tax System, on the Source or Residence principle: Options and Recommendations* (1997) 1.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> National Treasury 'Budget Speech 2001/2002 by the Minister of Finance, T A Manuel, 21February 2001' 2001 available at <http://www.info.gov.za/speeches/2001/010221345p1002.htm>, accessed on 5 July 2013.

<sup>5</sup> Advanced Tax Practitioners 'Are you a resident in South Africa for Tax purposes' 2007 available at <http://www.tax.co.za/a.php?a=96/ARE%20YOU%20RESIDENT%20IN%20SOUTH%20AFRICA%20FOR%20TAX%20PURPOSES>, accessed on 11 April 2013.

<sup>6</sup> L Olivier & M Honiball *International Tax a South African Perspective* 5ed (2011) 11.

the meaning of source, an important case to use is *CIR v Lever Brothers and Unilever Ltd*<sup>7</sup>.

In the *Lever Brothers Case*, Chief Justice Watermeyer held 'that the source of income is not the quarter from which it comes but rather the originating cause of its receipt'<sup>8</sup> and the location of the originating cause<sup>9</sup>. Furthermore, Chief Justice Watermeyer clarified the meaning of originating cause as 'the work which the taxpayer performs to earn income, the *quid pro quo* given in return for which it is received'<sup>10</sup>. Therefore, the test to determine source is twofold firstly, the determinations of the originating cause and secondly, the location of the cause.<sup>11</sup> It is vital the cause of income is first established and thereafter the location of the cause.<sup>12</sup>

From the above, it appears that the courts have used a common sense approach to determine the sources and thereafter a legal ground is found to determine the location.<sup>13</sup> In *Rhodesia Metals Ltd (In Liquidation) v COT*<sup>14</sup> the Supreme Court of Appeal held that "source means not a legal concept but rather something which a practical man would regard as the real source of income".<sup>15</sup> Thus, it was held that sources are determined through the pragmatic view of common sense rather than through a legal concept.<sup>16</sup>

Even though South Africa changed their basis of taxation from source to residence, non-residents will be taxed on their actual or deemed source of income according to section 9 (a)-(h) of the Income Tax Act 58 of 1962.<sup>17</sup> Therefore, the normal source principles as determined and developed by our courts and legislation will continue to be applicable and can therefore not be ignored.

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<sup>7</sup> *CIR v Lever Brothers and Unilever Ltd* 1946 AD 441(hereinafter referred to as 'Lever Brothers').

<sup>8</sup> *Lever Brothers* supra note 7 at para 450.

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*

<sup>11</sup> L Olivier & M Honiball op cit note 6 at 12.

<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid.*

<sup>14</sup> *Rhodesia Metals Ltd (In Liquidation) v COT* 1938 AD 282.

<sup>15</sup> *Rhodesian Metals Ltd (In Liquidation) v COT* 1940 AD 432 at 436.

<sup>16</sup> L Olivier & M Honiball op cit note 6 at 2.

<sup>17</sup> Income Tax Act 58 of 1962 (hereinafter referred to as 'Income Tax Act'), section 9, (a)-(h).

On the other hand, the residence basis of taxation places greater importance on the taxpayer's place of residence or domicile.<sup>18</sup> This system termed a 'residence system' has been effective from 1 January 2001.<sup>19</sup> The residence system taxes residents on their world-wide income. The residence basis of taxation is justified on the grounds that the resident is protected by the Government that the person or person other than a natural person contributes towards, even if income is earned outside the country.<sup>20</sup>

The reasons for the change from a source base to a residence base of taxation were:

- To improve tax system and protect the South African tax base from exploitation or abuse<sup>21</sup>
- To align the South African tax system with international tax principles<sup>22</sup>
- To relax exchange control for greater involvement of South African companies offshore; and<sup>23</sup>
- To effectively provide for e-commerce taxation<sup>24</sup>

The change from the source basis to the residence basis of taxation ensures that there is a tax system implemented in South Africa that is more internationally aligned. The change affects the definition of a resident in terms of section 1 of the Income Tax Act.<sup>25</sup> The residence system will be applicable to both natural persons and a person other than a natural person. The focus of this research paper will be on persons other than natural persons'.

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<sup>18</sup> KATZ Commission op cit note 1 at 1.

<sup>19</sup> South African Revenue Services 'Briefing note on the Residence basis of Taxation' 2000 available at <http://www.info.gov.za/speeches/2000/000918340p1006.htm>, accessed on 15 April 2013.

<sup>20</sup> L Olivier & M Honiball op cit note 6 at 19.

<sup>21</sup> South African Revenue Services 'Briefing note on the Residence basis of Taxation' 2000 available at <http://www.info.gov.za/speeches/2000/000918340p1006.htm>, accessed on 15 April 2013.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

<sup>25</sup> Income Tax Act 58 of 1962, section 1.

## 1.2 Defining “Residence” for a person other than a natural person in South African Tax

In terms of section 1 paragraph (b) of the Income Tax Act, a ‘resident’ for a person other than a natural person is defined as a:

‘person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic;’

The definition is subject to a proviso that states that it:

‘does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation’.<sup>26</sup>

Therefore, from the above definition, two criteria can be used in order to determine whether a non-individual is a South African resident for tax purposes, namely if a person other than a natural person is:

- Incorporated, established or formed in the Republic or;
- Has its place of effective management in the Republic

If either one of the criteria are met, then the person other than a natural person will meet the definition of a resident given in section 1 (b) of the Income Tax Act and the business will be taxed on their world-wide income. For the purposes of act a person other than a natural person is defined as companies, close corporations and trusts.<sup>27</sup>

A person other than a natural person’s place of effective management is of vital importance in determining its residency. Many countries in the world<sup>28</sup> which follow the Organisation for Economic Co-operation and Development

<sup>26</sup> Income Tax Act 58 of 1962, section 1(b).

<sup>27</sup> Ibid at section 1.

<sup>28</sup> Technical Advisory Group Draft Discussion Paper ‘A discussion paper from the Technical Advisory Group on monitoring the application of exiting treaty norms for the taxation of business profits’ in The impact of the communications revolution on the application of “Place of effective management” as a tie breaker rule (2001) at para 25.

Model Tax Convention<sup>29</sup> for their double taxation agreements use “Place of effective Management’ as a tie-breaker rule in the case of dual residency.

### 1.3 Defining Dual Tax Residence

A dual tax resident is a person other than a natural person that may be classified as a resident in more than one tax jurisdiction.<sup>30</sup> Dual residency arises from ‘residence-residence’ jurisdictional conflicts.<sup>31</sup> For non-individuals the Commentary by the OECD Model Tax Convention ‘rejects the formal criteria of registration’ and looks to where the ‘company has actually been managed’.<sup>32</sup>

Globalization and increasing international activity relating to businesses has increased the incidence of dual residency which could potentially result in a person other than a natural person being taxed in both countries, thus being subject to double taxation.<sup>33</sup> For example, South Africa may consider the company as a resident for tax purposes because it was incorporated in South Africa, while Mauritius will consider the same company as a resident for tax purposes because it has its management office in Port Louis.<sup>34</sup> This indicates that there is diversity in how a tax resident is defined depending on whose perspective you are looking at. Therefore, the company is a dual-resident and according to the OECD Model Tax Convention a dual-resident company will only be considered as a resident where its’ “place of effective management “is situated.”<sup>35</sup>

In order to prevent double taxation, Double Tax agreements or bilateral agreements are established between two countries.<sup>36</sup> The Double Tax

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<sup>29</sup> Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (hereinafter referred to as ‘OECD Model Tax Convention’)

<sup>30</sup> L Olivier & M Honiball op cit note 6 at 32.

<sup>31</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 7.

<sup>32</sup> Ibid at para 10.

<sup>33</sup> A Schäfer & C Spengel ‘ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation’ [Discussion Paper 02-81 for the Centre for European Economic Research] (2002) at para 4.2.1.

<sup>34</sup> K Holmes *International Tax Policy and double tax treaties: An introduction to the principles and application* (2007) 23.

<sup>35</sup> Organisation for Economic Co-operation and Development Model Tax Convention ‘Articles of the Model Convention with respect to taxes on Income and on Capital’ (2003) at Article 4(3).

<sup>36</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 3-8.

agreements set out when each country has a right to tax and establishes the rules and negotiated terms between the two countries.<sup>37</sup> The tax treaty via a bilateral agreement or Double Taxation agreement will determine in which country the person other than a natural person is a resident and taxed accordingly.<sup>38</sup>

Thus, the OECD Model Tax Convention provides a tie-breaker rule that deals with the 'residence-residence' jurisdictional conflicts for both individual and non-individuals.<sup>39</sup> For the purposes of this research paper, focus will be placed on non- individuals.

#### **1.4 Objectives**

There is great debate concerning the exact meaning of 'place of effective management' for a person other than a natural person. This research paper will discuss the interpretation by using South African Revenue Services (SARS) Interpretation Note 6<sup>40</sup>, as well as the Organisation for Economic Co-operation and Development (OECD) interpretations<sup>41</sup>. In considering the interpretation of "Place of effective Management"; Chapter 2 will define "Place of effective Management" using recently established case law which provides guidance and the South African Revenue Services Interpretation Note 6. Thereafter, the effectiveness of the South African Revenue Services Interpretation Note 6 will be discussed.<sup>42</sup> In Chapter 3, the Organisation for Economic Co-operation and Development interpretation will be set out and its effectiveness. In addition, Chapter 4 will consist of an international interpretation of "Place of effective Management" and the conclusions will be discussed in Chapter 5.

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<sup>37</sup> L Olivier & M Honiball op cit note 6 at 32.

<sup>38</sup> Ibid at 33.

<sup>39</sup> OECD Model Tax Convention Article 4(3) op cit note 35.

<sup>40</sup> South African Revenue Services 'Income Tax Interpretation Note.6' (2002) (hereinafter referred to as 'Income Tax Interpretation Note.6').

<sup>41</sup> OECD Model Tax Convention Article 4(3) op cit note 35.

<sup>42</sup> Income Tax Interpretation Note.6 op cit note 40.

## Chapter 2

### 2.1 Definition of “Place of effective Management”

On an international level different tests are applied to determine the residence of a person other than a natural person such as “place of incorporation, where the factual and effective day-to-day management takes place, where shareholder control is situated or where the top level or policymaking body makes its decisions”.<sup>43</sup> In South Africa the broad test is applied to establish the residence of a person other than a natural person namely, if it is incorporated, established or formed in South Africa or if they have their place of effective management in South Africa.<sup>44</sup> The test of Place of effective Management is one of facts and circumstances<sup>45</sup> and is used commonly as a dual-residency tie-breaker rule<sup>46</sup>, but the meaning of the phrase has not been interpreted consistently.

The term ‘Place of effective Management’ is not defined in terms of the Income Tax Act. The South African Revenue Services has issued an interpretation note<sup>47</sup> and the Organisation for Economic Co-operation and Development has issued a Commentary<sup>48</sup>. Both are separate attempts to clarify and interpret the meaning “Place of effective Management”, and will be analysed in detail in this chapter.

The Katz Commission of Inquiry introduced of the term “place of effective management” into the South African domestic legislation in 1997. The report stated that:

“The current definition of a domestic company is a company incorporated in South Africa, or a company ‘managed and controlled’ in South Africa.” The main criticism of this definition is that it has

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<sup>43</sup> R Rohatgi *Basic International Tax* (2002) 73.

<sup>44</sup> L Olivier & M Honiball op cit note 6 at 24.

<sup>45</sup> T Gutuza ‘Has Recent United Kingdom Case Law Affected the Interplay Between ‘Place of Effective Management’ and ‘Controlled Foreign Companies’?’ (2012) 24 *South African Mercantile Law Journal* at 437.

<sup>46</sup> B A Van der Merwe ‘Residence of A Company – the Meaning of ‘Effective Management.’ (2002) 14 *South African Mercantile Law Journal* at 122.

<sup>47</sup> Income Tax Interpretation Note.6 op cit note 40.

<sup>48</sup> OECD Model Tax Convention Article 4(3) op cit note 45.

proven subject to relatively simple, formalistic manipulation. The 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 person other than natural person. This may perhaps be best achieved through an appropriate definition in Section 1 of the [Act]. Again the change will have the benefit of employing international and, therefore, commonly understood terminology.”<sup>49</sup>

The Katz Report attached a meaning of “Place of effective Management” which is different from the term “managed and controlled”.<sup>50</sup> Various South African Tax Commentators gave different meanings to the term “Place of effective Management” which will be considered in the next paragraph.

Meyerowitz considered the “Place of effective Management” to be the place where the board of directors or executive directors meet to make to make important business decisions.<sup>51</sup> Davis et al stated that the meaning refers to the place where the “most vital management actions take place”.<sup>52</sup> Olivier refers to the “Place of effective Management” as the where “policy and strategic decisions are made by the board of directors are implemented and not where they are taken”.<sup>53</sup> In the views of the academic writers, their interpretations reveal that there is no consistent meaning to the term “Place of effective Management” and it would be useful to analyse recent case law established in South Africa that provides guidance.

The South African case law recently established provides guidance on the interpretation of “Place of effective Management”; these cases are not binding and provide no authority on the interpretation. In June 2011, the concept “Place of effective Management had come before the South African Western Cape High Court in the recent judgment of *Oceanic Trust Company*

<sup>49</sup> KATZ Commission op cit note 1 at para 6.1.2.1.

<sup>50</sup> L Olivier & M Honiball op cit note 6 at 27.

<sup>51</sup> D Meyerowitz *Income Tax* (2006-2007) at 5.19.

<sup>52</sup> D Davis, L Olivier & G Urquhart *Juta's Income Tax* (1999) at 1 resident-2A.

<sup>53</sup> L Olivier & M Honiball op cit note 6 at 25.

*Ltd N.O. v The Commissioner of the South African Revenue Services*<sup>54</sup> and in 2012 *Commissioner of the South African Revenue Services v Tradehold Limited*<sup>55</sup> came before the Supreme Court of Appeal. The aforementioned cases will be discussed respectively in detail, and links will be established in the context of providing guidance in interpreting the phrase “Place of effective Management”. The *Oceanic Trust* case and *Tradehold* case, relates to trusts and companies respectively and it should be noted that maybe different rules apply when interpreting “Place of effective Management”.

In the *Oceanic Trust* case, the company acted in their capacity as trustee of the Specialised Insurance Solutions (Mauritius) Trust.<sup>56</sup> The *Oceanic Trust* case is relevant because it was the first case regarding “Place of effective Management” of a legal entity in general.<sup>57</sup>

The trust was registered in South Africa and the Oceanic Trust Company Ltd was incorporated, registered and located in Mauritius.<sup>58</sup> Furthermore, an asset manager in South Africa maintained the entire investment portfolio in South Africa.<sup>59</sup> Therefore, an issue regarding the *Oceanic Trust* case was whether the “Place of effective Management” of the trust was in South Africa or in Mauritius.

The Commissioner of the South African Revenue Services proclaimed that the trust was a resident in South Africa as many decisions ‘appeared to be taken in the Republic but they had not been furnished with minutes or trustees resolutions’<sup>60</sup> which authenticated the trust statements.

On the other hand, Oceanic relied on the recent United Kingdom decision of *Commissioner for Her Majesty’s Revenue and Customs v Smallwood &*

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<sup>54</sup> *The Oceanic Trust Co. Ltd N.O v Commissioner of the South African Revenue Services* (NPD) unreported case no 22556/09 (13 June 2011) (hereinafter referred to as ‘Oceanic Trust’).

<sup>55</sup> *Commissioner of the South African Revenue Services v Tradehold Ltd* 2012 (4) SA 184 (SCA) (hereinafter referred to as ‘Tradehold’).

<sup>56</sup> *Oceanic Trust* supra note 54 at para 3.

<sup>57</sup> T Gutuza op cit note 45 at 424-437.

<sup>58</sup> *Oceanic Trust* supra note 54 at para 4.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid at para 14.

*Anor*<sup>61</sup>. The central issue of the *Smallwood* case was residence of a tax treaty when the shares were disposed of, through a 'Round the World'<sup>62</sup> scheme.<sup>63</sup> Thus the concept of "Place of effective management" is applicable due to the treaty tie-breaker provision in Article 4(3) of the OECD Model Tax Convention.<sup>64</sup> If the trust was found resident in the United Kingdom the trust had to pay capital gains tax on the sale of shares according to the section 77 of the Taxation of Chargeable Gains Act<sup>65, 66</sup>.

On the other hand, Article 13(4) of the United Kingdom-Mauritius Tax Treaty stated that capital gains from the alienation of shares "shall be taxable only in the Contracting State of which the alienator is a resident". In this instance the trustee who was resident in Mauritius was the alienator and had to pay capital gains of nil according to section 77 (1) (b)<sup>67, 68</sup>.

The Special Commissioners held that the "Place of effective Management" of the trust was in the United Kingdom.<sup>69</sup> Even though the court relied on the *Smallwood* case it should be noted that the meaning of "Place of effective Management" was used in two different contexts because of the facts and circumstances in each case.<sup>70</sup> However, in my opinion the phrase "Place of effective Management" does not have a different meaning in different jurisdictions.

Furthermore, *Oceanic* relied on *Smallwood* which laid down the principle that the "Place of effective Management" of a trust is where the top level management is located being Mauritius and not where the day-to-day activities of the trust are managed and located.<sup>71</sup> *Oceanic* also relied on the Commentary of the Organization for Economic Co-operation and

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<sup>61</sup> *Commissioner for Her Majesty's Revenue and Customs v Smallwood & Anor* 2010 EWCA Civ 778 (hereinafter referred to as 'Smallwood').

<sup>62</sup> P Baker 'Smallwood: The High Court Decision' (2009) 8 *GITC Review* 3 at 1.

<sup>63</sup> P Baker op cit note 62 at 4.

<sup>64</sup> OECD Model Tax Convention Article 4(3) op cit note 35.

<sup>65</sup> Taxation of Chargeable Gains Act of 1992, section 77.

<sup>66</sup> P Baker op cit note 62 at 3.

<sup>67</sup> Taxation of Chargeable Gains Act of 1992, section 77(1)(b).

<sup>68</sup> P Baker op cit note 62 at 4.

<sup>69</sup> P Baker op cit note 62 at 5.

<sup>70</sup> T Gutuza op cit note 45 at 426.

<sup>71</sup> *Oceanic Trust* supra note 54 at para 49-53.

Development (OECD) Model Tax Convention on Income and on Capital<sup>72</sup> which also interpreted “Place of effective Management” is where the ‘key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made’.<sup>73</sup>

Unfortunately the judge in the *Oceanic Trust* Case did not conclude the location of the trust’s “Place of effective Management” because the material facts of the case were insufficient.<sup>74</sup> The comments made about “Place of effective Management” in the *Oceanic Trust* case were not binding as the matter will be heard by the Tax Court in October 2013. However, the judgment is relevant as it provides guidance on the Court’s interpretation of “Place of effective Management”.

It is important to point out that facts of the *Oceanic Trust* case were contrary to the SARS Interpretation Note 6<sup>75</sup> as discussed above, as SARS interprets the concept of “Place of effective Management” as where the company is managed on a regular day-to-day basis, by the directors or senior managers of the company.<sup>76</sup> Therefore, it is clear that it is unlikely that a formulaic approach of the interpretation of “Place of effective Management” will be applied in South Africa.

In addition, in 2012 the *CSARS v Tradehold Limited*<sup>77</sup> case was the Supreme Court of Appeals’ first international tax ruling of a company as opposed to a trust. The “Place of effective Management” was not an issue before the court, thus providing no authority. However, it provides guidance.

The respondent Tradehold Limited (Ltd) was a South African incorporated investment holding company. The company was listed on the Johannesburg Stock Exchange Limited (JSE Ltd) and therefore publicly accountable

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<sup>72</sup> OECD Model Taxation Convention on Income and on Capital 2000: Full Version ‘Commentary on Article 4: Concerning the definition of resident’ (2000).

<sup>73</sup> Ibid at para 24.

<sup>74</sup> *Oceanic Trust* supra note 54 at para 93-95.

<sup>75</sup> Income Tax Interpretation Note.6 op cit note 40.

<sup>76</sup> Ibid.

<sup>77</sup> *Tradehold* supra note 55.

according to the JSE requirements and responsibilities.<sup>78</sup> During the tax year under consideration, 28 February 2003 year of assessment Tradehold Limited had a wholly owned (100%) subsidiary in Tradegro Holdings which was the company's only relevant asset.

The facts were that on the 2 July 2002, the board of directors in a meeting in Luxembourg decided that all further board of director meetings of the company would be held in Luxembourg. Due to this decision, it resulted that as from 2 July 2001 Tradehold Limited was 'effectively managed' in Luxembourg.<sup>79</sup> The place of effective management, Luxembourg, is in synch with the interpretation by the OECD Article 4 (3) model that an 'entity place of effective management is where the key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made'.<sup>80</sup>

Even though Tradehold Limited was effectively managed in Luxembourg, the company still remained a South African resident for tax purposes because of the definition of the term "resident" in section 1 of the Income Tax Act 58 of 1962, because Tradehold Limited was incorporated in South Africa.<sup>81</sup>

However, this changed as the "resident" definition was amended with effect from 26 February 2003 resulting in Tradehold Limited ceasing to be a South African tax residence because the company was effectively managed in Luxembourg.<sup>82</sup> This was envisaged by the definition of "resident" in section 1 of the Income Tax Act 58 of 1962 which was held by the Supreme Court of Appeal.

What is interesting to note is that the meaning of "Place of effective Management" applied in this case related to where the board of directors met, which is inconsistent with the SARS's Interpretation Note 6<sup>83</sup> issued in

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<sup>78</sup> Johannesburg Stock Exchange 'How to List' available at <http://www.jse.co.za/How-To-List.aspx>, accessed on 10 June 2013.

<sup>79</sup> *Tradehold* supra note 55 at 8.

<sup>80</sup> OECD 'Commentary on Article 4 : Concerning the definition of resident' op cit note 72 at para 24.

<sup>81</sup> P Dachs 'South Africa: South Africa Supreme Court of Appeal issues first international tax ruling' (2012) 23 *International Tax Review* 5 at 63.

<sup>82</sup> *Tradehold* supra note 55 at para 3.

<sup>83</sup> Income Tax Interpretation Note.6 op cit note 40.

2002 which refers to where the day-to-day activities of a company are conducted. Furthermore, it is interesting that both the taxpayer and the Commissioner accepted Luxembourg as the “Place of effective Management” and allowed Tradehold Limited to cease being a South African tax residence. From the above stated, it is clear that there is uncertainty about the basis of the argument held in *Tradehold*.

The facts of *Tradehold*, although not directly relevant to the interpretation of “Place of effective Management”, indicate the importance of determining ‘residence’ of a company. The appellant, the Commissioner of SARS relied on provisions of paragraph 12 of the Eighth Schedule to the Income Tax Act in an attempt to tax the capital gain of the deemed disposal of its 100% shareholding in Tradegro Holdings worth ‘R 405 039 083’<sup>84</sup> in the 2003 year of assessment.

However, Tradehold Limited appealed to the Supreme Court of Appeal against the additional assessment raised by the Commissioner regarding the capital gain.<sup>85</sup> The Supreme Court of Appeal relied on ‘article 13(4) of the Double taxation agreement entered into by South Africa and Luxembourg’.<sup>86</sup>

The Tax Court held that because no exceptions in article 13 were applicable and that the Commissioner’s argument that the shareholding in Tradegro Holdings was a deemed disposal of property was not accepted as an alienation of property in terms of article 13(4), Tradehold Limited’s appeal was upheld on this basis and as a result successful.

In addition, it was accepted that Tradehold Limited was not a South African resident because its “Place of effective Management” was in Luxembourg which indicates that the test plays vital importance in deciding the residency status of a company. Furthermore, according to the Taxpayer’s Editorial in May 2012 it was stated that, ‘since the definition has been amended it is unlikely that another taxpayer will lose its status as a resident by legislative enactment after it has already migrated its place of effective management

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<sup>84</sup> *Tradehold* supra note 55 at para 8.

<sup>85</sup> *Tradehold* supra note 55 at para 9.

<sup>86</sup> *Tradehold* supra note 55 at para 4-11.

out of South Africa'.<sup>87</sup> Hence, after the *Tradehold* case many are of the opinion that other taxpayers will not have to face the same consequences.

The judgement by the Supreme Court of Appeal on 8 May 2012 encouraged the Minister of Finance Pravin Gordhan to issue a statement on 9 May 2012. Pravin Gordhan stated the following:

“The capital gains tax system has, since its inception in 2001, been based on the principle that South African residents were taxed on all of their assets, irrespective of where these assets were located. Therefore, whilst it would be unfair to tax a resident's capital gains accumulated before the taxpayer became a resident, equally, not taxing capital gains accumulated while a taxpayer was a resident would be unfair.

The Supreme Court of Appeal judgment that a Double Taxation Agreement applied to a deemed disposal and thus did not allow for an exit charge, appears to disturb the balance that has been achieved. The National Treasury is studying the judgment and that, if necessary, it would propose amendments to the tax laws to clarify that a Double Taxation Agreement does not apply to exempt capital gains upon a person ceasing to qualify as a "resident". To maintain stability in the tax system, I propose that any amendment take effect from May 8 2012.”<sup>88</sup>

The above judgment clarifies that South Africa uses a residence basis of taxation and that an exit charge of capital gains tax will be applicable in future for taxation purposes as it would be unfair not to charge the taxpayer on all their capital gains that have accrued to them while being a resident. The new Section 9H of the Income Tax Act brings into effect the exit charge of capital gains tax which was proposed by Pravin Gordhan on 9 May 2012.<sup>89</sup>

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<sup>87</sup> Taxpayer Editorial 'Taxation by Press Release?' (2012) 61 *The Taxpayer* 5 at 81.

<sup>88</sup> National Treasury 'Statement by Minister of Finance Pravin Gordhan on the Supreme Court of Appeal judgement on taxation of capital gains' available at <http://www.info.gov.za/speech/DynamicAction?pageid=461&sid=27211&tid=67143>, accessed on 15 June 2013.

<sup>89</sup> Income Tax Act 58 of 1962, section 9H.

Furthermore, the *Tradehold* and *Oceanic Trust* cases has provided guidance and introduced the idea in the context of South African case law of the meaning of “Place of effective Management”. The judgments of both cases have provided taxpayers insight on how the courts would interpret the phrase and what information would be relevant in determining the location of persons other than natural person’s “Place of effective Management”, even though the cases were not binding. Although there is some guidance given in case law, it is still necessary to analyse the meaning of “Place of Effective Management” in further detail.

## **2.2 Evaluation of SARS Interpretation of “Place of effective Management”**

The South African Revenue Services (SARS) issued the Income Tax Interpretation Note 6 on 26 March 2002.<sup>90</sup> The Interpretation note gives guidance on the meaning of “Place of effective Management” for a person other than natural person.<sup>91</sup>

As previously stated the term “Place of effective Management” is not defined by the Income Tax Act and the ordinary meaning of the words prescribed by The Oxford English Dictionary will be helpful in establishing the meaning of the phrase, because it will aid a taxpayer to fundamentally understand the concept. The term does not have a universal meaning and various countries such like the United Kingdom Courts have interpreted it as ‘where the controlling shareholder is located’<sup>92</sup>, as well as the OECD have assigned different meanings to it.

The SARS interpretation note makes a clear distinction between:

- ‘the place where central management and control is carried out by a board of directors;’<sup>93</sup>
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of

<sup>90</sup> Income Tax Interpretation Note.6 op cit note 40.

<sup>91</sup> Ibid at 1-2.

<sup>92</sup> T Gutuza op cit note 45 at 425.

<sup>93</sup> Income Tax Interpretation Note.6 op cit note 40 at 2-3.

directors and make and implement day- to-day/regular/operational management and business activities; and<sup>94</sup>

- the place where the day-to-day business activities are carried out/conducted<sup>95</sup>

The above should be kept in mind when determining the meaning of “Place of effective Management” as it distinguishes different levels of management.

In terms of SARS *General Approach* the term “Place of effective Management” refers to where the company is managed on a regular day-to-day basis by the directors or senior managers of the company irrespective of where the board of directors meets. Furthermore, it is where the policy and strategic decisions are implemented not where they are taken.<sup>96</sup>

The General Approach is similar to the United Kingdom Revenue Manuals because “effective management” is referred to as form of management lower than central management and control, which are senior staff and executives.<sup>97</sup> It is important to distinguish if the place where central management and control is carried out by the board of directors is the same place where the day-to-day activities are managed, as this be the Place of effective Management according to SARS .It is vital to also consider where the board of directors or trustees convenes their meetings.<sup>98</sup> In addition, by considering what the function of the board of directors and trustees are will raise the question of whether the directors are decision-makers or implementers which is a deciding factor for “Place of effective Management”.<sup>99</sup>

SARS have established guidelines for interpreting the meaning as it would be difficult to define an absolute test due to “management structures, reporting lines and varying of responsibilities”.<sup>100</sup>

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<sup>94</sup> Income Tax Interpretation Note.6 op cit note 40 at 2-3.

<sup>95</sup> Ibid.

<sup>96</sup> Ibid at 3.

<sup>97</sup> L Olivier & M Honiball op cit note 6 at 26.

<sup>98</sup> Ibid.

<sup>99</sup> L Olivier & M Honiball op cit note 6 at 26.

<sup>100</sup> Ibid.

### 2.2.1 Practical Application

For the practical application of the *General Approach* it refines the place of effective management test and also gives alternative measures.<sup>101</sup> The first 'test' states that if the management functions' are at a single location and the place where the day-to-day activities or operations are carried out in the same place, then the single location will be the place of effective management.<sup>102</sup>

On the other hand, if management functions are not executed at a single location due to senior managers managing the company via distance communication such like telephone, internet conferencing etc. this place would be viewed as the place of effective management which is the second 'test'.<sup>103</sup> Therefore, this means that if the first 'test' is not effective in establishing the place of effective management then the second 'test' of place of effective management test shall be used.<sup>104</sup>

The second 'test' only becomes relevant if the 'distant management by means of modern technology raises the possibility of multiple residences'.<sup>105</sup> Furthermore, in establishing the place of effective management the function of the board of directors and trustees should also be considered for multiple residences.<sup>106</sup> By considering if the directors are decision-makers or implementers will affect where the company's place of effective management is.

From the above information it is clear that the application of the SARS Interpretation Note does not result in a single place of residence, because taxpayers' may have numerous places around the world that operational, strategic and commercial decisions are implemented. In this instance if the first test and second test do not result in one Place of effective Management, then the third 'test' will become relevant. The third 'test' states if the business

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<sup>101</sup> B A Van der Merwe op cit note 46 at 127.

<sup>102</sup> Income Tax Interpretation Note.6 op cit note 40 at 4.

<sup>103</sup> Ibid.

<sup>104</sup> B A Van der Merwe op cit note 46 at 128.

<sup>105</sup> Ibid.

<sup>106</sup> L Olivier & M Honiball op cit note 6 at 26.

operations are conducted from various locations then the Place of effective Management would be “the place with the strongest economic nexus”.<sup>107</sup>

### 2.2.2 Facts and Circumstances

SARS provides a non-exhaustive list of relevant facts and circumstances that will be of assistance when determining a person other than a natural person’s place of effective management. Some of the relevant factors are:

- “Where controlling shareholders make key management and commercial decisions in relation to the company;
- *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”*<sup>108</sup>

The above relevant facts and circumstances should be considered to each case individually when applying the guidelines in the SARS Interpretation Notes 6.

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<sup>107</sup> South African Revenue Services Legal and Policy: Interpretation and Rulings ‘Discussion Paper on Interpretation Note 6 Place of effective Management Section 1 of the Income Tax Act, 1962’ (2011) 9 at 5 (hereinafter referred to as SARS Discussion Paper) .

<sup>108</sup> Income Tax Interpretation Note.6 op cit note 40 at 4-5.

### 2.2.3 Effectiveness of the SARS Interpretation note

In general the SARS Interpretation Note 6 has been subject to four main areas of criticism.<sup>109</sup>

Firstly, the General Approach focuses mainly on a place where the strategic decisions are implemented, rather than where the strategic decisions or policies are taken or adopted.<sup>110</sup> Due to this the SARS approach will not always result in a definitive “Place of effective Management”, but could lead to multiple places. As a result of multiple possible “Places’ of effective Management”, it creates room for manipulation by taxpayers.

Furthermore, some countries which are governed by Double Taxation Agreements (DTA’s) and modelled by the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, taxpayers and tax practitioners are in favour of an approach that focuses on the place where the board of directors or similar bodies meets.<sup>111</sup>

Secondly, the inconsistent use of terminology in the General Approach and Practical Application in the SARS Interpretation Note 6 has raised concerns and uncertainty. The main concerns are regarding the use of the “economic nexus” test to determine the Place of effective Management.<sup>112</sup> The Income Tax Act 58 of 1962 defines residence in section 1 as “place of incorporation, establishment or formation in South Africa or the place of effective management”.<sup>113</sup> There is no mention of ‘economic nexus’ and the SARS’ Interpretation note does not explain the meaning of the phrase nor does it provide any guidelines.<sup>114</sup> Hence, it has no standing in our law.<sup>115</sup>

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<sup>109</sup> SARS Discussion Paper op cit note 107 at 5.

<sup>110</sup> Ibid.

<sup>111</sup> Ibid.

<sup>112</sup> Ibid.

<sup>113</sup> Income Tax Act 58 of 1962, section 1 (b).

<sup>114</sup> B A Van der Merwe op cit note 46 at 129.

<sup>115</sup> Ibid.

Furthermore, the third 'test' is not explicitly linked to effective management but would rather be a useful tool in determining residence, which raises uncertainty in its practicality as a 'test'.<sup>116</sup>

Thirdly, SARS has indicated that each case should be based on a facts and circumstances approach.<sup>117</sup> Due to each case being analysed individually this results in subjective comparisons<sup>118</sup> and uncertainty as it will be difficult to establish where the directors actually reside. Therefore, this flexibility provides an incentive to taxpayers to move their "Place of effective Management" to tax havens such as Isle of Man, Monaco and Cayman Islands.<sup>119</sup>

Lastly, the fourth area of criticism concerns the 'failure by Interpretation Note 6 to provide any specific guidance for cases involving passive or intermediate holding companies'.<sup>120</sup> The Tradehold case involves a holding company and the SARS Interpretation Note 6 was not used in the judgment, which clearly reiterates the aforementioned concern. Furthermore, it is also important to note that none of the relevant factors provided in the SARS list when determining a person other than a natural person's "Place of effective Management", referred to trustees. Therefore the Oceanic Case<sup>121</sup> does not fit any of the above criteria which indicate that the SARS Interpretation note is not useful in every situation.

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<sup>116</sup> B A Van der Merwe op cit note 46 at 128.

<sup>117</sup> SARS Discussion Paper op cit note 107 at 5.

<sup>118</sup> B A Van der Merwe op cit note 46 at 134.

<sup>119</sup> Tax Haven Guide 'OECD's official grey list' available at <http://www.taxhavensguide.com/list-of-tax-havens.php>, accessed on 9 July 2013.

<sup>120</sup> SARS Discussion Paper op cit note 107 at 5.

<sup>121</sup> *Oceanic Trust* supra note 54.

## Chapter 3

### 3.1 Evaluation of the Organisation for Economic Co-operation and Development interpretation of the “Place of effective management”

The Organisation for Economic Co-operation and Development is an international organisation that aims to improve the social and economic well-being of people and countries.<sup>122</sup> The OECD Model has 34 member countries across the globe, from ‘North and South America to Europe and the Asia-Pacific region’<sup>123</sup> who work together to build stronger economies. Both the member countries and non-member countries such like South Africa, amongst others, apply the OECD Model to their double taxation treaties.<sup>124</sup> The OECD Model Tax Convention Commentary provides guidance on the term “Place of effective Management” and therefore it would be useful to look at the provisions of the OECD Commentary to get insight into their interpretation.<sup>125</sup>

Before we gain insight into the term “Place of effective Management”, it would be useful to first define a resident under the OECD Model Tax Convention. According to Article 4(1) of the OECD Model Tax Convention a ‘resident of a Contracting state’<sup>126</sup> is defined as:

‘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’<sup>127</sup>

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<sup>122</sup> The Organisation for Economic Co-operation and Development ‘Our Mission’ available at <http://www.oecd.org/about/>, accessed on 10 July 2013.

<sup>123</sup> The Organisation for Economic Co-operation and Development ‘Member and Partners’ available at <http://www.oecd.org/about/membersandpartners/>, accessed on 25 July 2013.

<sup>124</sup> SA Tax Guide ‘Application of the OECD Model Double Tax Treaty to given situations’ available at <http://sataxguide.wordpress.com/application-of-oecd-model-double-tax-treaty-to-given-situations/>, accessed on 25 July 2013.

<sup>125</sup> OECD ‘Commentary on Article 4: Concerning the definition of resident’ op cit note 72.

<sup>126</sup> OECD op cit note 35 at Article 4(1).

<sup>127</sup> Ibid.

The Commentary on article 4, according to paragraphs 3, 4 and 8 clarifies the term ‘liable to tax’ as ‘fully liable to tax according to the domestic laws of the Contracting state laying down the conditions, under which a person or a person other than a natural person is to be treated fiscally a “resident”’.<sup>128</sup> If a person other than a natural person is fully liable to tax under the contracting laws of two contracting states, it will qualify as a dual resident or a tax treaty resident of both contracting states under Article 4(1) of the OECD Model Tax Convention. In the case of dual residency it will be resolved applying the tie-breaker laid down in Article 4(3) of the OECD Model Tax Convention.

### 3.1.1 The OECD Tie-Breaker Rule

The OECD Model Tax Convention provides guidance on ‘residence-residence’ conflicts which are provided in Article 4 of the OECD Model Tax Convention on Income and in Capital.<sup>129</sup> Since, this research paper is only concerned with non-natural persons; an appropriate tie-breaker rule was developed to resolve non-individual ‘residence-residence’ conflicts.

The tie-breaker rules for non-individuals are set out in Article 4(3) of the OECD Model Tax Convention.<sup>130</sup> In the case where the application of Article 4(1) of the OECD Model Tax Convention results is a person other than a natural person being considered a resident of two Contracting states, Article 4(3) of the OECD Model Tax Convention provides the tie-breaker rule.

According to Paragraph 3 of Article 4 of the OECD Model Tax Convention, it states that a person other than an individual:

‘shall be deemed to be a resident only of the State in which its **place of effective management** is situated’.<sup>131</sup> *[Highlight Added]*

The OECD Model Tax Convention does not define the term “Place of effective Management”. However, the Commentary on Article 4 included in OECD Model Tax Convention on Income and on Capital 2000, provides

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<sup>128</sup> OECD ‘Commentary on Article 4: Concerning the definition of resident’ op cit note 72at para 3,4,8.

<sup>129</sup> OECD op cit note 35 at Article 4.

<sup>130</sup> Ibid at Article 4(3).

<sup>131</sup> Ibid.

guidance on the meaning of “Place of effective Management” in paragraph 24. However, paragraph 24 which interprets the meaning of “Place of effective Management’ has changed through the years and therefore a historical analysis of the Commentary on Article 4 will be discussed.

The Commentary on Article 4 in the 2000 version of the OECD Model Tax Convention , which provides the initial guidance on the meaning of the states the following in paragraph 24:

‘The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior 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 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.’<sup>132</sup>

Therefore, the OECD interprets the term “Place of effective Management” as the place where the ‘key management and commercial decisions’ are made by senior persons.<sup>133</sup> This was the initial tie-breaker rule developed for non-individuals which gave guidance in resolving the issue of dual residency. The SARS Interpretation Note 6 differs to the OECD’s interpretation as it refers to where the company is managed on a regular day-to-day basis by the directors or senior managers of the company irrespective of where the board of directors meets.<sup>134</sup> Meyerowitz<sup>135</sup> and Davis et al<sup>136</sup> are in support of the OECD’s interpretation, while Olivier<sup>137</sup> supports the SARS interpretation.

<sup>132</sup> OECD ‘Commentary on Article 4: Concerning the definition of resident’ op cit note 72 at para 24.

<sup>133</sup> Ibid.

<sup>134</sup> Income Tax Interpretation Note.6 op cit note 40 at 3.

<sup>135</sup> D Meyerowitz op cit note 51 at 5.19.

<sup>136</sup> D Davis, L Olivier & G Urquhart op cit at 52 at 1 resident-2A.

<sup>137</sup> L Olivier & M Honiball op cit note 6 at 25.

Furthermore in February 2001, the Technical Advisory Group (TAG) issued a draft discussion paper titled “*The impact of the Communications Revolution on the Application of “Place of effective Management” as a Tie Breaker Rule*”,<sup>138</sup> which helped refine the “Place of effective Management’ test as concerns were raised about the initial tie-breaker rule.

In refining the meaning of “Place of effective Management” the draft discussion paper suggested that the “Place of effective Management” should be based on predominant factor(s) or weighting various factors.<sup>139</sup>

The original paragraph 24 of the OECD Commentary on Article 4(3) sets out the predominant factors which provide guidance in determining one place of effective management.<sup>140</sup> However, if these predominant factors don’t result in a single “Place of effective Management” other factors such as ‘relative importance of the functions performed within the two States, where the majority of directors reside or information where central management and control of the company is to be located within company formation documents, *inter alia*’.<sup>141</sup> This is similar to the SARS Interpretation Note 6 as it provides facts and circumstances when considering each case.<sup>142</sup>

The TAG also invited that public to suggest what weighting should be given to the factors and if any others should be included.<sup>143</sup>

Thereafter, in 2003 the Technical Advisory Group (TAG) issued a discussion paper entitled ‘*Place of effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention (2003)*’.<sup>144</sup> The discussion paper developed the meaning of “Place of effective management “and also provided an alternative version of the tie-breaker rule consisting of a

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<sup>138</sup> Technical Advisory Group Draft Discussion Paper op cit note 28.

<sup>139</sup> Ibid at para 62.

<sup>140</sup> Ibid at para 63.

<sup>141</sup> Ibid at para 64.

<sup>142</sup> Income Tax Interpretation Note.6 op cit note 40 at 4-5.

<sup>143</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 65.

<sup>144</sup> Technical Advisory Group Discussion Paper ‘Place of effective Management Concept: Suggestions for changes to the OECD Model Tax Convention’ (2003).

“Hierarchy of tests”.<sup>145</sup> Subsequently, the changes made to the Commentary on Article 4(3) paragraph 24 will be discussed in detail.

The Technical Advisory Group in the discussion paper suggested that a person other than a natural person has only one place of effective management at one given time.<sup>146</sup> However, if a person other than a natural person commercial decisions are made in one place by key management but are formally finalised in another place by another person or group of persons, other factors should be considered.<sup>147</sup>

The following factors could be considered depending on the situation. Firstly, if the board of directors formally finalises key management decisions in one country but the key management decisions are made in another country, the “Place of effective Management” will be in the latter country.<sup>148</sup>

Secondly, if a controlling interest holder exists and effectively makes the key management, commercial decisions and goes beyond normal management and policy of a group, the “Place of effective Management” will be where the controlling interest holder makes the key decisions.<sup>149</sup>

Thirdly, if the board of directors regularly approve the commercial decisions made by executive officers of the business, the location where the executive officers execute their functions would be vital in determining the “Place of effective Management’ of a person other than a natural person.<sup>150</sup>

The aforementioned factors are different to the draft discussion paper as it provides more detailed factors which will be of more guidance when applying it to real life circumstances.

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<sup>145</sup> Technical Advisory Group Discussion Paper op cit note144 at para 3.

<sup>146</sup> Ibid at para 7 refer to 24.1.

<sup>147</sup> Ibid at para 7 refer to 24.3.

<sup>148</sup> Ibid.

<sup>149</sup> Ibid.

<sup>150</sup> Ibid.

Lastly in the 2008 update to the OECD Model Tax Convention<sup>151</sup>, the OECD made changes to the Commentary on Article 4 on 17 July 2008. This resulted in paragraph 24 being amended to state the following.

In the instance of dual residence, the authorities of both States shall determine by mutual agreement which State such person shall be deemed to be a resident for the Convention, its place of effective management, place of incorporation or other relevant factors.<sup>152</sup> If no agreement exists, such person will not be exempt from tax provided by this Convention, to the extent it may be agreed by the authorities of the Contracting States.<sup>153</sup> In addition, authorities should consider factors such as 'where the meetings of its board of directors or equivalent body are usually held, where the senior day-to-day management of the person is carried on or where its accounting records are kept, *inter alia*.'<sup>154</sup>

Furthermore, the person concerned with the dual taxation should make a request through the mechanism provided in paragraph 1 of Article 25, within three years from the first time that person is notified that its taxation is not in agreement with the OECD Convention, since it is resident of two Contracting States.<sup>155</sup> Therefore, the authorities can justify their decision related to the relevant time period.<sup>156</sup>

The 2008 version of paragraph 24 has been included in all the post 2008 OECD Model Tax Convention's as well as the Commentaries on Article 4. There have been no signs that this paragraph will change again. In addition, the 2008 version of paragraph 24 has been included in some of South Africa's Double Taxation Agreement's post 2008.<sup>157</sup> For example, the Double

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<sup>151</sup> Organisation for Economic Co-operation and Development: Centre for Tax Policy Administration 'The 2008 Update to the OECD Model Tax Convention' (2008) at para 7.

<sup>152</sup> *Ibid* at para 7 refer to 24.3.

<sup>153</sup> *Ibid*.

<sup>154</sup> *Ibid*.

<sup>155</sup> *Ibid*.

<sup>156</sup> *Ibid*.

<sup>157</sup> South Africa n Revenue Services 'International Treaties and Agreements' available at <http://www.sars.gov.za/Legal/International-Treaties-Agreements/Pages/default.aspx>, accessed on 29 August 2013.

Taxation Agreement between South Africa and Japan includes the latest paragraph 24.<sup>158</sup>

### **3.1.2 Effectiveness of the OECD Interpretation of “Place of effective Management”**

It should be noted that after the historical analysis of paragraph 24 in the Commentary on Article 4, the reason for the numerous changes of paragraph 24, was due to problems that were inherent in the guidance given by the OECD. This indicates that the guidance on the interpretation was not effective and as a result changes were made to paragraph 24. Consequently, the effectiveness of the OECD’s interpretation of “Place of effective Management” and the problem areas will be discussed in detail.

Firstly, the TAG’s draft discussion paper<sup>159</sup> raised issues of concern namely, in paragraph 33 and 34.<sup>160</sup> These paragraphs stated the following:

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

34. However, the communications and technological revolution is fundamentally changing the way people run their business. Due to sophisticated telecommunication technology and fast, efficient and relatively cheap transportation, it is no longer necessary for a person or a group of persons to be physically located or meet in any one

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<sup>158</sup> Convention between the Government of the Republic of South Africa and the Government of Japan for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income in GG 18391 of March 1997.

<sup>159</sup> Technical Advisory Group Draft Discussion Paper op cit note 28.

<sup>160</sup> Ibid at para 33-34.

particular place to run a business. This increased mobility and functional decentralisation may have a significant impact on the incidence of dual resident companies, and the application of the place of effective management tie-breaker rules'.<sup>161</sup>

In response to these concerns of the Draft Discussion Paper, it was noted that 'in a modern 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'.<sup>162</sup> It was further noted that 'given that the "place of effective management" is one of substance over form, in theory, it should always produce results which reflect the true policy intention of the tie-breaker rule'.<sup>163</sup>

This clearly indicates that the "Place of effective Management" as a tie-breaker rule is questioned.<sup>164</sup> Due to the increase in companies being managed divisionally, it is possible for companies to expand into different countries and therefore it could result in dual residency.

Secondly, technology has made management more mobile and it is not always necessary for effective management to always meet in the same location.<sup>165</sup> Due to different corporate structures and technology, the location where directors meet can be chosen and therefore manipulated.<sup>166</sup> In addition, a test based on where the directors are senior managers meet is much easier to manipulate than SARS's Interpretation<sup>167</sup>, which is based on where the day-to-day activities<sup>168</sup> are conducted as it would be more difficult to move the day-to-day operations of the business.

Thirdly, even though the 2003 discussion paper provides more guidance on the meaning of the term "Place of effective Management", the OECD

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<sup>161</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 33-34.

<sup>162</sup> Ibid at para 35.

<sup>163</sup> Ibid at para 36.

<sup>164</sup> B A Van der Merwe op cit note 46 at 124.

<sup>165</sup> B A Van der Merwe op cit note 46 at 124.

<sup>166</sup> Ibid.

<sup>167</sup> Income Tax Interpretation Note.6 op cit note 40.

<sup>168</sup> Ibid at 3.

changed its Commentary on “Place of effective Management” in 2008. The reason for the change was because the OECD concluded that the TAG’s interpretation was not ‘in line with the views of the majority of its member countries as to the meaning of the concept of place of effective management’<sup>169</sup>. In addition, many countries was of the belief that the ‘TAG’s proposed interpretation gave undue priority to the place where the board of directors of a company would meet over the place where the senior executives of that company would make key management decisions’.<sup>170</sup>

Fourthly, from a South African perspective when using the OECD Commentary for guidance there is uncertainty as to which version of paragraph 24 should be used. Does the 2000 version of paragraph 24 apply to treaties entered into before 2008? Furthermore, it is interesting to consider which version did the court’s use in the *Oceanic* case. If it is used as persuasive material, it is plausible to state that we could the version of our choice. However, if the OECD Commentary is legally binding which version should we follow? Furthermore, would it make a difference if we used the initial version versus the amended version included in the 2008 Update to the Model Tax Convention? The above concerns questions how effective the OECD Commentary is, when interpreting “Place of effective Management”.

In addition, the OECD Model Tax Convention Commentary provides guidance on the meaning of “Place of effective Management” for tax treaties which results in the best residence being established between two Contracting States because of dual residency.<sup>171</sup> This is different to the SARS interpretation which gives guidance on the meaning of “Place of effective Management” for non-individuals.<sup>172</sup>

In conclusion, the above discussed areas of concern clarifies that the ‘adequacy of the tie-breaker rule’<sup>173</sup> has been questioned. The

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<sup>169</sup> OECD ‘Draft Contents of the 2008 Update to the Model Tax Convention’ op cit note 151 at para 3.

<sup>170</sup> Ibid.

<sup>171</sup> OECD ‘OECD Model Tax Convention on Income and on Capital - an overview of available products’ available at <http://www.oecd.org/tax/treaties/oecdmtcavailableproducts.htm>, accessed on 5 August 2013.

<sup>172</sup> Income Tax Interpretation Note.6 op cit note 40 at 1-2.

<sup>173</sup> B A Van der Merwe op cit note 46 at 124.

aforementioned areas of concern, suggest that the OECD's initial interpretation in 2000 was not effective and therefore the guidance was amended up until 2008, to provide a clearer interpretation by the OECD on the meaning of "Place of effective Management". Furthermore, concerns have been raised as to whether the OECD Commentary is effective in providing guidance because it relates specifically to tax treaties, and there is uncertainty as to which version of the OECD Commentary should be used in South Africa as authority.

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## Chapter 4

### International interpretation of “Place of effective management” and applicable international tax law

Many treaty countries such as Germany and Netherlands<sup>174</sup> and other countries, namely Switzerland<sup>175</sup>, use the test of place of management to determine the residency of non-individuals.

In Switzerland, the place of effective management, decisions made by executive directors and management conducted by administrative staff are differentiated in order to determine residency.<sup>176</sup>

In addition, in Germany, the ‘place of management test’ is similar to that of the “Place of effective Management” test according to Professor Klaus Vogel.<sup>177</sup> German case law specifies that the “Place of effective Management” is where the top management establishes their policies.<sup>178</sup> Professor Vogel states that “what is decisive is not the place where the management directives take effect, but rather the place where they are given”.<sup>179</sup> The “Place of Management” test adopted by Germany is similar in nature with the OECD Model Tax Convention’s interpretation on “Place of effective Management”.<sup>180</sup>

Furthermore, the United Kingdom courts have used the test of ‘central management and control’ in order to determine non-individuals tax residence, which formed the basis of the “Place of effective Management” test. The following cases are going to be analysed *Wood and Another v Holden*<sup>181</sup> and *Laerstate BV v Revenue and Customers Commissioners*<sup>182</sup> which provide

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<sup>174</sup> L Cerioni ‘The “Place of Effective Management” as a Connecting Factor For Companies’ Tax Residence Within the EU vs. the Freedom of Establishment: the Need for a Rethinking?’ (2012) 13 *German Law Journal* 9 at 1095-1096.

<sup>175</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 26.

<sup>176</sup> Ibid.

<sup>177</sup> K Vogel *Double Taxation Conventions* (1997).

<sup>178</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 28.

<sup>179</sup> K Vogel op cit note 177 at 262.

<sup>180</sup> OECD ‘Draft Contents of the 2008 Update to the Model Tax Convention’ op cit note 151.

<sup>181</sup> *Wood and Another v Holden* (HMIT) [2006] EWCA Civ 26.

<sup>182</sup> *Laerstate BV v Her Majesty’s Revenue and Customs Commissioners* [2009] UKFTT 209 (TC).

United Kingdom guidance and authority on the location of the “Place of effective Management” of a company.

The *Wood and another v Holden*<sup>183</sup> is the leading case on company residence in the United Kingdom for charging capital gains. The case indicates that Mr. and Mrs. Woods tried avoiding paying capital gains by selling of their birthday card company called Ron Wood Greeting Cards Holdings Limited (“Holdings”).<sup>184</sup>

The facts of the case reveal that Mr and Mrs Woods’ had a number of trusts that were set up in the British Virgin Islands. The trusts owned all the shares in Copeswood Investments Limited (CIL) which was a British Virgin Islands Company. Thereafter, Mr and Mrs Woods by way of gift gave 49.99% of shares in Ron Wood Greeting Cards Holdings Limited (Holdings) a UK company to CIL.<sup>185</sup>

Copeswood Investments Limited acquired all of the share capital of Eulalia Holdings BV (Eulalia) a Dutch incorporated company, who was resident in the Netherlands.<sup>186</sup> Thereafter, Copeswood Investments Limited sold its shares in Holdings for a substantial consideration to Eulalia.<sup>187</sup> This suggested that Copeswood Investments Limited sold its shares in Holdings to Eulalia Holdings BV, to take advantage of s14(1) provision in the Taxation of Chargeable Gains Act of 1992.<sup>188</sup> Section 14(1) provision could allow a group to be declared ‘non-resident’ if two or more companies within that group were non- resident.<sup>189</sup>

This ultimately boiled down to the appellant having to prove that the “Place of effective Management” of CIL was in Netherlands and thereby proving that CIL is a tax resident of Netherlands. The Double Taxation Agreement stated that if it the company was a Netherlands resident it would be taxed under Dutch domestic law.

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<sup>183</sup> *Wood and Another v Holden* supra note 181.

<sup>184</sup> A Nathan ‘*Company Residence after Wood v Holden*’ (2005) 5 *GITC Review* 1 at 1.

<sup>185</sup> *Ibid.*

<sup>186</sup> *Ibid.*

<sup>187</sup> A Nathan op cit note 184 at 2.

<sup>188</sup> Taxation of Chargeable Gains Act of 1992, section 14(1).

<sup>189</sup> *Ibid.*

This argument also hinged on the fact that:

‘under English law, the residence of a company not incorporated in the United Kingdom was not determined by the law of the country of incorporation but by the central management and control test propounded by the House of Lords in *De Beers*’.<sup>190</sup>

Lord Justice Chadwich held that the location of effective management is where effective management decisions are made and to that extent, all effective decisions made by Mr and Mrs Woods and all and their respective agents were made in the United Kingdom.<sup>191</sup> In conclusion, the appellant (Wood) was held as a resident of the United Kingdom and consequently was held liable for the capital gains.

In addition, the *Laerstate* case provided a broader approach to the interpretation to the ‘central management and control’ test.<sup>192</sup> The issue in the *Laerstate BV v Revenue and Customers Commissioners*<sup>193</sup> was whether the company was resident in the United Kingdom.

The facts of the case state that *Laerstate* (BV) was a Dutch incorporated company who acquired an interest in *Lonrho Plc.* in 1992, which it subsequently sold in 1996. Through the years, Mr. Bock was one of the directors of the company who subsequently resigned. The facts however indicate that Mr. Bock still effectively ‘retained and controlled’<sup>194</sup> the decisions in *Laerstate* even though he resigned and most decisions were made by him in the United Kingdom<sup>195</sup>.

<sup>190</sup> *Wood and Another v Holden* supra note 181 at para15.

<sup>191</sup> *Ibid* at para 21.

<sup>192</sup> T Gutuza op cit note 45 at 431.

<sup>193</sup> *Laerstate BV v Revenue and Customers Commissioners* supra note 182 at para 50.

<sup>194</sup> A Wall ‘*Laerstate: the dangers of the UK corporate residence test*’ 2009 at 2 available at [http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CCsQFjAA&url=http%3A%2F%2Fwww.jonesday.com%2Ffiles%2FPublication%2Faff0ade7-509c-4ff3-9258-06df9155613b%2FPresentation%2FPublicationAttachment%2Fe38a5d3e-7f73-4c1e-a335-08e263e294c4%2FIHLLaerstate.pdf&ei=bB4mUqn4BMSVhQe07YGoCQ&usg=AFQjCNHP8BWfKTKp7pZlUKPreZJabbvGWQ&sig2=nDSKPH7u\\_C3rZmyWtsnt4Q&bvm=bv.51495398,d.d2k](http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CCsQFjAA&url=http%3A%2F%2Fwww.jonesday.com%2Ffiles%2FPublication%2Faff0ade7-509c-4ff3-9258-06df9155613b%2FPresentation%2FPublicationAttachment%2Fe38a5d3e-7f73-4c1e-a335-08e263e294c4%2FIHLLaerstate.pdf&ei=bB4mUqn4BMSVhQe07YGoCQ&usg=AFQjCNHP8BWfKTKp7pZlUKPreZJabbvGWQ&sig2=nDSKPH7u_C3rZmyWtsnt4Q&bvm=bv.51495398,d.d2k), accessed on 29 August 2013.

<sup>195</sup> *Laerstate BV v Revenue and Customers Commissioners* supra note 182 at 50.

The Court stated that in order to determine the residence of the company the 'central management and control' test should be applied, where central management would be the location where high-level and strategic decisions were made.<sup>196</sup> The appellant (Laerstate) argued that the central management and control is where the board of directors signs relevant documents. Since, the majority of Laerstate's documents were signed outside the United Kingdom it was therefore, not a resident.<sup>197</sup>

According to Gutuza the Court used a 'four-scenario test in order to determine the location of the 'central management and control'. 'The court identified four scenarios in which the Board signs certain documents or resolutions:

- The Board signs these documents without considering the implications; its signing is 'mindless'.
- The Board has limited information at the time of the shareholder's instructions; it considers this information in making its decision to sign, and it signs on the basis of this information.
- The Board has the absolute minimum information available; this is less than a reasonable director would require in deciding whether to follow the shareholder's wishes. The ill-informed or ill-advised decision taken by the Board is still a decision by the management of the company.
- The Board has sufficient information to make an informed decision.<sup>198</sup>

The four-scenario test indicates that where the person controlling the decisions is not a part of the board of directors, the 'central management and control' is where the person who controls the decisions is located.<sup>199</sup>

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<sup>196</sup> A Wall 'Laerstate: the dangers of the UK corporate residence test' 2009 at 2 available at [http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CCsQFjAA&url=http%3A%2F%2Fwww.jonesday.com%2Ffiles%2FPublication%2Faff0ade7-509c-4ff3-9258-06df9155613b%2FPresentation%2FPublicationAttachment%2Fe38a5d3e-7f73-4c1e-a335-08e263e294c4%2FIHLLaerstate.pdf&ei=bB4mUqn4BMSVhQe07YGoCQ&usg=AFQjCNHP8BWfKTKp7pzlUKPreZJabbvGWQ&sig2=nDSKPH7u\\_C3rZmyWTSnt4Q&bvm=bv.51495398,d.d2k](http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CCsQFjAA&url=http%3A%2F%2Fwww.jonesday.com%2Ffiles%2FPublication%2Faff0ade7-509c-4ff3-9258-06df9155613b%2FPresentation%2FPublicationAttachment%2Fe38a5d3e-7f73-4c1e-a335-08e263e294c4%2FIHLLaerstate.pdf&ei=bB4mUqn4BMSVhQe07YGoCQ&usg=AFQjCNHP8BWfKTKp7pzlUKPreZJabbvGWQ&sig2=nDSKPH7u_C3rZmyWTSnt4Q&bvm=bv.51495398,d.d2k), accessed on 29 August 2013.

<sup>197</sup> Ibid.

<sup>198</sup> T Gutuza op cit note 45 at 432.

This test broadened the 'central management and control' test and shows that other relevant factors should also be considered. In this instance, since Mr. Bock was the controlling mind and he was located in the United Kingdom it was held that Laerstate was a tax resident in the United Kingdom.

In conclusion, the 'central management and control' test used in the United Kingdom which in substance is the same as the "Place of effective Management" test used in South Africa should be applied to each case on a 'facts and circumstances' <sup>200</sup>approach.

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<sup>199</sup> Ibid.

<sup>200</sup> T Gutuza op cit 45 at 433.

## Chapter 5

### Conclusions

When defining residence for a non-individual in South Africa two criteria can be used, namely it's "Place of effective Management" in the Republic. The "Place of effective Management" test is one of facts and circumstances.<sup>201</sup> Therefore, when applying the test the relevant facts and circumstances of each case must be analysed and ultimately the true intention of the company about where it is effectively managed will be determined.<sup>202</sup>

In practice the true intention of where the company is effectively managed is not always obtained therefore various factors must be considered. Many companies have expanded globally and as a result their company structure has grown. In some instances it has resulted in companies being managed divisionally.<sup>203</sup>

Since management cannot physically meet, they use advanced technology such as video-conferencing, e-mail or group chats via the internet to conduct meetings. Therefore, due to the structure of modern companies and advanced technology it makes it difficult to pin-point one location as a company's "Place of effective Management". Thus, the concept of "Place of effective Management" is of vital importance in determining a person other than a natural person's residency.

Even though the aforementioned real life factors complicate the application of the "Place of effective Management" test, there also has been uncertainty as to how the concept of "Place of effective Management" has been interpreted.

As already pointed out in Chapter 2.2, the South African Revenue Services issued an Interpretation Note 6 which states that a company's "Place of effective Management" should be interpreted as the place where a company is managed daily and where its' policy and strategic decisions are

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<sup>201</sup> Technical Advisory Group Draft Discussion Paper op cit note 28 at para 36.

<sup>202</sup> Ibid.

<sup>203</sup> B A Van der Merwe op cit note 46 at 124.

implemented.<sup>204</sup> On the other hand, international guidance has been considered, namely, the tie-breaker rule which is explained in the OECD Commentary of Article 4(3) (2008).<sup>205</sup> The OECD Commentary provides guidance on the interpretation on the meaning of “Place of effective Management” in paragraph 24, which states that it is the location of where the board of directors conduct their meetings as well as other relevant factors that should be considered.

Furthermore, it is interesting to note that the two recent South African cases which provides guidance on the interpretation of “Place of effective Management”, *Oceanic Trust Company Ltd N.O. v The Commissioner of South African Revenue Services*<sup>206</sup> and *CSARS v Tradehold Limited*<sup>207</sup> held a different meaning of the phrase, which was inconsistent with SARS’s interpretation. Both cases referred to the location where top management was located<sup>208</sup> or where the board of directors meeting was held<sup>209</sup> as the “Place of effective Management”. This suggests that the SARS Interpretation Note 6 is not applied because both cases did not use it to determine its “Place of effective Management”. The SARS Interpretation Note has been subject to four areas of criticism<sup>210</sup> which was discussed above in detail. This indicates that there are some unsatisfactory elements which need further clarification.

In addition, the OECD Commentary also contains certain aspects which are problematic. The OECD has changed the contents within paragraph 24 numerous time in order to refine the guidance. Therefore, it is clear that both the SARS Interpretation Note and the OECD Commentary are not faultless interpretations of the concept of “Place of effective Management” and formulaic approach should not be adapted to the meaning.

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<sup>204</sup> Income Tax Interpretation Note.6 op cit note 40 at 3.

<sup>205</sup> OECD ‘Draft Contents of the 2008 Update to the Model Tax Convention’ op cit note 151 at para 7.

<sup>206</sup> *Oceanic Trust* supra note 54.

<sup>207</sup> *Tradehold* supra note 55.

<sup>208</sup> R C Williams ‘Tax Residence Companies & Trusts-Place of effective Management (The Oceanic Trust Case)’ available at <http://www.thesait.org.za/news/68266/>, accessed on 8 July 2013.

<sup>209</sup> *Tradehold* supra note 55 at para 3.

<sup>210</sup> SARS Discussion Paper op cit note 107 at 5.

The United Kingdom's test of 'central management and control' and the "Place of effective Management" test are considered to be synonymous. Therefore, the noteworthy cases of *Wood and Another v Holden*<sup>211</sup> and *Laerstate BV v Revenue and Customers Commissioners*<sup>212</sup> provide authority in the South African context.

In view of the fact that there isn't a binding court case in the Supreme Court of Appeal, there is still uncertainty regarding the meaning of "Place of effective Management". It suggested that we can either apply SARS's Interpretation or the OECD's Interpretation even though both contain unsatisfactory elements. I am of the opinion that a statutory definition included in section 1 of the Income Tax Act 58 of 1962 would not clarify the meaning of "Place of effective Management". A statutory definition is unlikely to be definitive, as it would still be subject to interpretation because the term "Place of effective Management" is used internationally.

Therefore, in my opinion in order to establish the meaning of "Place of effective Management", we need to wait for a binding court case to come before the Supreme Court of Appeal. Furthermore, an analysis of what facts and circumstances were considered by the Supreme Court of Appeal in determining a person other than a natural person's "Place of effective Management".

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<sup>211</sup> *Wood and Another v Holden* supra note 171.

<sup>212</sup> *Laerstate BV v Revenue and Customers Commissioners* supra note 172.

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