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requirements for the

Degree of

MASTER OF LAWS IN TAXATION

By

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Department of Commercial Law

MASTERS DEGREE IN TAX LAW THESIS

PAPER 1

RESIDENCE OF AN ENTITY FOR TAX PURPOSES – SOUTH
AFRICA: A REVIEW OF THE CONCEPT ‘PLACE OF
EFFECTIVE MANAGEMENT’

DECLARATION

A Research Dissertation presented for the Approval of the Senate in fulfillment of part of the Requirements for the Master of Laws Degree in Taxation in Approved courses and a minor dissertation. The other part of the requirements for this qualification was the completion of a programme of courses. I hereby declare that I have read and understood the Regulations governing the submission of Master of Laws dissertations, including those relating to length and plagiarism, as contained in the Rules of the University of Cape Town, and that this dissertation conforms to those regulations

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To God Be the Glory.

ABSTRACT

The residence article in the OECD Model Tax Convention provides a 'tie-breaker' rule for determining residence where an entity is resident in two different countries in order to avert double taxation. The residence of such a "dual resident" entity is allocated to the country in which its "place of effective management" is situated. One has to determine the location of an entity's PoEM in order to allocate taxing rights to one of the States so as to avert double taxation. According to the OECD, the PoEM is one where the key management and commercial decisions of an entity's business are made. This paper analyses the meaning and effectiveness of the concept 'PoEM' as a tie-breaker rule. It is pointed out that the concept is under serious subversion by means of; inter alia, the exponential growth in e-commerce and the evolution of the communications technology. These developments have seen changes in the way business is run, including the conduct of board meetings. It is further highlighted that the concept suffers a lack of international agreement on its meaning and application. This article thus highlights these problems, and suggests recommendations to bolster the usefulness of the tie-breaker rule from a South African perspective.

DEFINITION OF TERMS

Unless the context dictates otherwise, the following words, phrases and acronyms shall be construed according to the meaning given hereunder:

“Act”	means the Income Tax Act, 1962 (Act 58 of 1962)
“decisions”	whenever used in relation to the OECD refers to ‘key management and commercial decisions made for an entity by its board of directors.
“Note”	in relation to the South African Revenue Service, means the Interpretation Note 6 of 2002
“Republic”	means the Republic of South Africa (RSA)
“tax” & “tax system”	refer to South African taxes, and tax system respectively.
“BoD”	refers to a board of directors
“CMC”	in relation to concepts used in domestic legislation to determine residence of a company, means ‘Central Management and Control’
“DTA”	means Double Taxation Agreement
“HoL”	in relation to courts refers to the House of Lords
“MTC”	in relation to OECD or United Nations, means a Model Tax Convention
“PE”	refers to a Permanent Establishment as defined in Article 5 of the OECD Model Tax Convention
“PoEM”	means ‘place of effective management’
“PoM”	in relation to concepts used in domestic legislation to determine residence of a company, means ‘Place of Management’
“RSA”	refers to the Republic of South Africa
“SPC/V”	refers to a Special Purpose Company (the equivalent of ‘special purpose entity’)

“UK”

refers to the United Kingdom

“US”

refers to the United States of America

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CHAPTER ONE

1.1 Introduction

Before a country can levy a tax on income, a connection or 'tax nexus' must be established between itself and that income.¹ The required connecting factor, which is laid down under the domestic law of the particular country, is that either the person who received the income is connected to the particular country or the activities that produced the income are connected to the country. These connecting factors are respectively referred to as 'residence' and 'source' jurisdictions.² In essence, the residence basis of taxation is based on a sufficient connection between the taxpayer and the country, and on the other hand, the source basis of taxation is based on a sufficient connection between the source of the income and the country.³

A change from a source basis to a residence basis of taxation was adopted in South Africa with effect from years of assessment commencing from 1 January 2001. Under this system, South African residents⁴ are taxed on their worldwide income but certain categories of income and activities undertaken outside South Africa are exempt from South African tax. Such a system

¹ Olivier, Lynette & Honiball Michael, (2005) *International Tax: A South African Perspective* at p.42

² *Ibid*

³ *Ibid*

⁴ See definition of 'resident' in Section 1 of the Income Tax Act.

has been called a residence-minus system of taxation.⁵ Countries, however don't strictly apply either a residence or source basis in a pure form, but usually modify the principles to find some common ground.⁶ When a residence basis of taxation is adopted, an element of the source basis is also adopted, in that non-residents are taxed on income generated within the domestic economy.⁷

A change from a source basis of taxation to a residence basis of taxation in South Africa has been justified on the following lines;⁸

- Shielding the tax base from exploitation;
- Bringing the tax system in line with international tax principles;
- The relaxation of exchange control and the greater involvement of South African companies offshore;
- To effectively cater for the taxation of e-commerce products, services and initiatives,
- The justification for residence based taxation may also rest on the need for South Africa to finance its public goods and social infrastructure, and the nexus between the

⁵ South African Government Information ***Briefing note on residence basis of taxation***
<http://www.info.gov.za/speeches/2000/000918340p1006.htm> [accessed on 31 November 2009]

⁶ *ibid*

⁷ The residence basis of taxation has also been called the 'residence-minus' system of taxation because residents are taxed on their world-wide income, but certain categories of income and activities undertaken outside South Africa will be exempt from South African tax (see ***South African Government Information briefing note, supra.***)

⁸ *ibid*

consumption of such public goods and infrastructure by persons and companies who are residents having an over-all capacity to pay.

As a result of some countries levying tax on a residence basis and others on a source basis is that the same income may be taxable in both countries – double taxation.⁹ Double taxation could either be ‘juridical’¹⁰ or ‘economic’¹¹ in nature. In the case of juridical double taxation, the cause could be the coincidence of source and residence bases of taxation imposed on a taxpayer by two different countries, but it may also be caused by the coincidence of two states’ residence bases of taxation. This scenario exposes an entity to dual tax residence and may result in potential double taxation.

1.2 Dual Tax Residence

When the two states treat the same entity as ‘a resident’ for tax purposes under their domestic laws, that person is said to be ‘dual resident’ and thus fully liable for tax in both states. In order to alleviate the ensuing double taxation, the Organization for Economic Cooperation and Development (“OECD”) has a tiebreaker rule to resolve residence-residence conflicts.¹² This is achieved by allocating the residence of the ‘dual resident’ entity to one of those states so that

⁹ Olivier & Honiball (2005) p.43, 274

¹⁰ Olivier & Honiball (2005:274) defines juridical double taxation as the imposition of comparable taxes by at least 2 tax jurisdictions on the same taxpayer in respect of the same income.

¹¹ Economic double taxation means the inclusion, by more than one state’s tax administration, of the same income in the tax base when the income is in the hands of different taxpayers – see Olivier & Honiball, *supra*

¹² Article 4(3) of the **OECD Model Tax Convention on Income and Capital 2008**

the person is treated as a resident solely of that state for the purposes of the treaty.¹³ Although the OECD suggests tie breaker rules for individuals and non individuals, this article deals only with the tie breaker rules applicable to non-individuals¹⁴. Where each state uses different residence rules, a entity could be considered a dual resident if it is incorporated or formed in one state but has a '*place of effective management*' in another.¹⁵ In order to ensure that only one of the conflicting states has jurisdiction to tax the dual resident company, the OECD Model Tax Convention provides that the dual resident company will only be considered to be a resident of the state in which its '*place of effective management*' is situated.¹⁶

1.3 South African tax residence

The Income Tax Act defines "resident" in relation to an entity 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...***" Clearly the Act employs '*place of effective management*' ("PoEM") as one of the tests to determine the residence of an entity for South African tax liability. As a result of this definition an entity that has a PoEM in South Africa is regarded as a resident in South Africa for tax purposes – such person will be subject to income tax on its worldwide income, that is, income derived within and outside the Republic. It is,

¹³ *Ibid*

¹⁴ For example, companies and trusts

¹⁵ Oguttu A., W. (2008) **Resolving double taxation: the concept "place of effective management" analysed from a South African perspective** Comparative and International Law Journal of Southern Africa, Vol 41, Issue 1 p.82

¹⁶ *Ibid*

however, important to note that an entity is also a resident if it is incorporated, established or formed in the Republic.¹⁷

A company will therefore have its place of residence in South Africa if it meets either one of the following 2 criteria as described in the Act¹⁸:

- (a) If the company or trust is incorporated, established or formed in South Africa; or
- (b) If either of the above have its PoEM in South Africa.

It is submitted that the definition of 'resident' in the case of companies, close corporations and trust is very wide as all the requirements are put in the alternative.¹⁹ Thus a trust established in South Africa will be a resident regardless of where its PoEM is and conversely a trust with a PoEM in South Africa is a resident irrespective of where it is established or formed. It should, however, be borne in mind that the 'place of effective management' test only becomes important if other more formal tests *viz* 'place of incorporation, establishment or formation' are not applicable to a particular entity.

¹⁷ See paragraph (b) to the definition of 'resident' in the Income Tax Act, 58 of 1962

¹⁸ See the definition of "**resident**" in the Income Tax Act, 58 of 1962

¹⁹ *ibid*

Even though the Act does not define the terms ‘incorporated, established²⁰ or formed,’ it is clear that any business entity formed or incorporated in South Africa under the relevant legislation²¹ would reside in South Africa based on this formation or incorporation. It is therefore simple to establish an entity’s place of incorporation or formation since all the documentation²² required for the formation or incorporation of an entity are open to inspection.²³ However, if a company is incorporated outside South Africa, its South African residency can change from time to time depending where the PoEM is located.

One aspect that raises some uncertainty though is the question of what constitutes a place of effective management. This concept has raised many questions in South African income tax, and has created great uncertainty amongst taxpayers. This paper is going to give a discussion on the meaning ascribed to ‘PoEM’ for purposes of South African tax residency

²⁰ Residence status can also be acquired by way of establishment of an entity in South Africa. The term ‘establish’ is not defined in the Act. Some guidance was sought from the OECD Model Tax Convention – however it also does not make its meaning clear although it does mention some examples in Article 5. The Convention includes in the meaning of permanent establishment, a place of management, a branch, office, factory, workshop, as well as a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. The term ‘established’ in the Act is distinguished from incorporation and formation, and refers to factual action, qualifying a person other than a natural person, which is already receiving income but is not yet incorporated or formed.

²¹ See section 32 as read with Section 63 & 64 of the Companies Act, 1973, and Section 2 read with Section 12 of the Close Corporations Act 69 of 1984.

²² According to Section 64 of the 1973 Companies Act, a certificate of incorporation is issued once the articles and memorandum of association has been registered in accordance with the Act.

²³ However, it is not always reliable and pragmatic to locate an entity’s residence basing on these formal determinants since the latter may have no connection with the entity’s actual economic and business links, such as the place of its management or business operations or the locations of its business assets. These formal determinants merely depict a formal connection and may have been chosen randomly by the taxpayer.

CHAPTER TWO

Interpretation of Place of Effective Management in a Domestic context

The Katz Commission of Inquiry recommended the introduction of the term “place of effective management” into the South African domestic legislation.²⁴ 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 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.”

It has been correctly observed that ‘[a] literature survey of earlier efforts by South African tax commentators and the fiscus to interpret the term [‘place of effective management’] produces

²⁴ Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa: (1997) ***Fifth interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa***

<http://www.polity.org.za/polity/govdocs/commissions/katz-5.html> [accessed 20 November 2009]

no consistent result.²⁵ Meyerowitz was of the view²⁶ that the term refers to the place where the board of directors meets to make key decisions, and not where the company business is carried on by its staff (unless board delegates its functions). On the other hand, Davis et al²⁷ noted that effective management takes place where the ‘most vital’ management actions or decisions making an implementation occur. Olivier²⁸ noted that the PoEM is where the day-to-day activities of an entity take place. This need not be the place where an entity’s strategic and policy decisions are made and ultimately controlled. According to the editors of *The Taxpayer*, the PoEM was interpreted as where the day-to-day running of the business takes place, which means that the business is controlled where its board of directors normally meets to transact business operations.²⁹

It is submitted that a true inquiry on the meaning of ‘place of effective management’ in a South African domestic setting has to start by ascertaining the ordinary, everyday grammatical meaning of the phrase. This meaning appears to be the first port of call in interpreting the concept – the so-called golden rule of statutory interpretation. The latter rule requires adherence to the plain words of a statute unless doing so leads to a manifest absurdity or to a result that is contrary to the intention of the legislature.³⁰

²⁵ Oguttu p.96

²⁶ David Meyerowitz on Income Tax (2002 –2003) at par 7.1.

²⁷ Davis D, Olivier L & Urquhart G. (1999/2000) ***Commentary on the Income Tax Act*** ad s35

²⁸ Olivier & Honiball (2005) p.25

²⁹ **(1995) 44 The Taxpayer 68**

³⁰ Du Pleiss Lourens ***Re- Interpretation of Statutes***, 2002, also Venter v R1907 TS 910 at 914 – 915.

2.1 Ordinary Meaning

The phrase PoEM is not defined in South Africa's domestic tax legislation, therefore an initial inquiry has to be made towards establishing its ordinary grammatical meaning. Du Pleiss³¹ notes that:-

“[The ordinary meaning rule of statutory interpretation] assumes that the language of a legislative instrument can be clear and unambiguous and requires that...the language must be given effect without more ado. Clear and unambiguous language is, so it is believed, a “correct” and authentic expression of the intention of the legislature...[t]he ordinary meaning of statutory language is, in other words, glibly identified with what is believed to be the plain or literal or grammatical meaning of language as such.”

The above discussion is clear evidence that dictionaries may be a useful tool in determining the ordinary meaning of words.³² Courts often consult dictionaries in order to arrive at the ordinary meaning of words.³³

³¹ Du Pleiss (2002) p.198-99 at 9.2

³² Du Pleiss (2002) p.200

³³ See for example ***A to Z Bazaars (Pty) Ltd v Minister of Agriculture*** 1975 3 SA 468 (A) (“*deliver*”); ***Secretary for Inland Revenue v Charkay Properties (Pty) Ltd*** 1976 4 SA 872 (A) (“*article*”); ***Roodepoort City Council v Shepherd*** 1981 2 SA 720 (A) (“*staff*”) – the above are examples of cases, only a few of them, where dictionaries were used to determine the ordinary meaning of certain words.

2.1.1 Dictionary meaning of ‘place of effective management’

The word ‘**effective**’ has a subjective content, and its interpretation can differ depending on the particular circumstances of the case.³⁴ The ordinary grammatical meaning of the word can thus be very instructive to unveil its meaning. The Little Oxford Dictionary (1996) defines it as “operative, impressive, actual, producing intended results...” On other hand, the *Concise Oxford Dictionary*³⁵ defines the same word as “*having a definite or desired effect; powerful in effect or impressive or actual, or existing in fact rather than officially or theoretically.*”

The word **management** is defined to mean the “[o]rganisation and coordination of the activities of an enterprise in accordance with certain policies in achievement of clearly defined objectives...”³⁶ The same word also refers to “[d]irectors and managers who have the power and responsibility to make decisions and manage an enterprise. As a discipline management comprises of the interlocking functions of **formulating corporate-policy and organising, planning, controlling, and directing the firm’s resources to achieve the policy’s objectives...**”³⁷ (Emphasis added).

³⁴ See Klaus Vogel (2006) *United States Income Tax Treaties* (March Update) (“Vogel US Treaties”)

³⁵ Concise Oxford Dictionary of English, Eight Edition 1990 at p734

³⁶ Online Business Dictionary: BusinessDictionary.com -

<http://www.businessdictionary.com/definition/management.html> [last visited in April 2009]

³⁷ *Ibid*

It can be deduced from the latter definition that ‘management’ can either be used to refer to person(s) or a process. If used in the former sense, it points to managers; if latter then it refers to the managing activity *viz* organizing, controlling, planning and directing resources to achieve organizational objectives. It is therefore commonsense to attribute the phrase ‘*effective management*’ as not only referring to the management functions but also the people who execute those functions.

The use of an adjective ‘effective’ in the phrase PoEM could imply realistic and positive management.³⁸ It thus connotes something that is real i.e. “actual, existing in fact rather than officially or theoretically”.³⁹ This will merely constitute theoretical management, but not prove actual or official management. Thus in ***Wensleydale’s Settlement Trustees v Inland Revenue Commissioners***⁴⁰ the court pointed out that it is not sufficient that some sort of management was carried on in a specific country such as operating a bank account in the name of the enterprise. The court held that the PoEM would be the location where the shots are called.

It can be seen from the foregoing discussion that ‘PoEM’ may be criticized for being ambiguous because it can either mean the nature or level of management if not management decisions. It has therefore been said that “*effective*” imports a test that is difficult to apply and which

³⁸ Goosen C. (2006) ***International Tax Planning: The concept of Place of Effective Management*** University of Cape Town p.10, Available http://lawspace2.lib.uct.ac.za/dspace/bitstream/2165/281/1/GoosenC_2006.pdf [20/11/09]

³⁹ Concise Oxford Dictionary Eighth Edition p.734

⁴⁰ (1996) Sp C 73

requires an evaluation of the facts and circumstances of each case.⁴¹ This situation is exacerbated by the fact that there are no South African case law precedents to act as authority in deciding where the PoEM of a company is, making it a grey area susceptible to a host of interpretations. Reliance is therefore going to be placed on other sources for guidance. The clearest authority in this regard is the South African Revenue Service (“SARS”) Interpretation Note 6 of 2002.

2.2 SARS interpretation of ‘place of effective management’

Clarity on the domestic meaning of ‘PoEM’ was provided when SARS issued an Interpretation Note⁴² on its determination of a PoEM for persons other than natural persons. SARS advanced their own interpretation by providing a so-called *General Approach*, assisted by an introduction, *Practical Application* and a non exhaustive list of relevant facts and circumstances. The key word here is ‘management’ – phrase ‘*place of effective management*’.

The Interpretation Note puts it clear that one should keep in mind that it is possible to distinguish between the following three important places:

- Where central management and control is carried out by the board of directors;

⁴¹ Van der Merwe, B. A., (2002) *Residence of A Company – the Meaning of ‘Effective Management.’* South African Mercantile Law Journal Vol 14 at p81.

⁴² SARS Interpretation Note No. 6 Dated 26 March 2002

- Where executive directors and senior management execute and implement policy and strategic decisions made by the board of directors, and where they make and implement day to day operational management and business activities, and;
- The place where day-to-day business activities are carried out or conducted.

The place where central management and control is exercised by the board of directors can also be referred to as the '*management of an entity*'⁴³ as opposed to '*management of the business of an entity.*' The SARS Note makes it clear that its 'PoEM' is different from shareholder control or control by the board of directors but rather '*management*' focuses on the company's objectives. This seems to be in line with the United Kingdom Revenue Manuals which says that effective management indicates a form of management lower than central management and control.⁴⁴ It's clear that the place where the board of directors or trustees convenes meetings is only one of the factors that will be considered and would certainly not be a deciding factor. It has been pointed out that where a company wishes to establish the place of board meetings as "effective management", the board members in question should have real authority and proper involvement in and knowledge of the business transactions of the company to be in a position to make the principle decisions of the company.⁴⁵

⁴³ Keith Huxman & Phillip Haunt *Notes on the South African Income Tax* (2005) in par 16.10

⁴⁴ Olivier & Honiball (2005) p55; the authors express the view that in practice the two forms of management will often coincide.

⁴⁵ Olivier & Honiball (2005) p.56

SARS therefore considers the place where the policy and strategy decisions by the board of directors are *implemented* and not where they are *taken* as 'PoEM.'⁴⁶ Thus according to SARS practice, in determining whether an entity is resident in South Africa and therefore liable to pay tax on its worldwide income, the place where implementation of policy and strategy decisions takes place will be decisive. However, the SARS Note does not define the word "implementation", or "implemented" but just gives the 'practical application' of its PoEM concept.

2.2.1 Practical Application

The SARS Interpretation Note tries to achieve a single place of effective management, and consequently a single residence, within a particular tax year through its *Practical application* guidelines.⁴⁷ This is mainly achieved through a mix of options proposed which shall, for convenience, be referred to as 'rules'.

The cardinal rule of the Note appears to be that where the activities relating to execution and implementation of policy and strategy decisions given by the board of directors are executed by

⁴⁶ *Ibid* at 3.2 – it has been pointed out under the SARS Interpretation Note's *General Approach* that the place of effective management is the place where the company is managed on a regular or day to day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets. Apparently SARS interpret 'management' as referring to the execution and implementation of policy and strategy decisions made by the board of directors. It has been also described in the Note as the place of implementation of the entity's overall group vision and objectives.

⁴⁷ Van der Merwe BA (2006) p.127 at 2.3

senior managers at a single location, whether or not they correspond with the place where the daily business operations are conducted or carried out, that location will be the PoEM.⁴⁸

The Note also provides for circumstances where management functions (execution and implementation of policy and strategy decisions by executive managers) are not capable of being exercised at a single location due to the use of distance communication. In this situation, the Note *deems* the PoEM to be where the business operations are actually carried out or conducted.⁴⁹ Deeming the PoEM here means that where the managerial functions in question are not executed at a single location due to management by distance communication like video conferencing, email etc. SARS will come to think or judge that the PoEM will be where day-to-day operational management and commercial decisions taken by the senior managers are actually implemented⁵⁰.

Lastly, SARS provides that where an entity's business operations are conducted or carried out from a host of locations, a place with the strongest economic nexus should be determined.⁵¹ It has been argued⁵² that the 'economic nexus' rule in contradistinction to the preceding rules, has no express linkage to effective management. Van der Merwe⁵³ points out that it gives the impression that it is not offered as a means to locate a PoEM but as an alternative tool to

⁴⁸ *Ibid*

⁴⁹ SARS Interpretation Note para 3.3

⁵⁰ *Ibid*

⁵¹ *Ibid*

⁵² Van der Merwe BA (2006) p.128

⁵³ *Ibid*

determine residence. In essence, the rule appears to have no place in our law unless it can be used as a means to determine a deemed PoEM, or as a tie-breaker test in a tax treaty.⁵⁴ It is questionable whether 'economic nexus' is an appropriate test to confer residence or whether it should only be used as a factor in determining residence (tie-breaker) similar to the individual tie-breaker test of 'centre of vital interests.'⁵⁵

The relevance of the 'economic nexus' concept as a jurisdictional determinant for residence has been queried⁵⁶. Apparently, it's more aligned to the rationale behind the source based jurisdiction. It has, however, been argued that economic nexus as a concept has strong linkage to residence as a jurisdictional determinant: a person is a resident of a country if he/she has close economic and personal ties with a particular country.⁵⁷ Economic connection is characterized to a particular jurisdiction with reference to the extent to which this jurisdiction provides certain facilities and infrastructure used or consumed by an entity in deriving its profits, the entity could be treated and taxed as a resident.⁵⁸ In a paper released by the OECD for public comments, the economic nexus concept has been considered where it is suggested

⁵⁴ Van der Merwe (2006) p.128

⁵⁵ See Organisation for Economic Cooperation & Development (OECD) Model Tax Convention article 4(2)(a)

⁵⁶ Van der Merwe (2006) p.129

⁵⁷ **Kerguelen Sealing & Whaling Co., Ltd v CIR, 1939 AD 487, 10 SATC 363:**The basic rationale of a residence basis of taxation has been said to be that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him..."

⁵⁸ Van der Merwe BA (2006) p.129

that this test determines residence with reference to the country in which an entity is making greater use of economic resources et cetera.⁵⁹

The SARS note, however, tries to cater for potential difficulties which may arise in its proffered interpretation, and to cater for this, it includes a facts and circumstance inquiry to aid the process.

2.2.2 Facts & Circumstances

The application of the above rules in the SARS Note is not meant to be an isolated activity. The Interpretation Note emphasizes that no definitive rule can be laid down in determining the PoEM therefore all the relevant facts and circumstances must be examined on a case-by-case basis. This approach is useful in complementing the SARS general interpretation of 'PoEM.' SARS provides a non-exhaustive list of facts and circumstances that may be relevant in determining the PoEM. Van der Merwe contends that the list includes factors seemingly more connected to the Anglo-American version (overriding central control).⁶⁰ The factors are considered in detail below.

⁵⁹ In February 2001, the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("TAG") publicly released for comments its discussion draft entitled *"The impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule"*; see par 242, option A – 5

⁶⁰ Van der Merwe BA (2006) p.130

- **Location of the centre of top-level management and the entity headquarters.**

It has been pointed out earlier on that SARS interpretation of effective management does not centre on top level management but with day-to-day management.⁶¹ It is submitted that this factor could be just complementary.

- **Where the business operations are conducted.**

Under the SARS *Practical application's* 'rules', a PoEM is considered to be at specific location ('deemed PoEM') where management functions (by executive and senior managers) cannot be executed at a single location because of the use of distance communication. The PoEM in this scenario would be the place where the business operations are actually carried out or conducted. The phrase "**...business operations are conducted...**" could be extended to *mean the place where the said operations are actually carried out or conducted by senior managers.*

- **Where the controlling shareholder(s) make decisions.**

The phrase *key management and commercial decisions'* has origins in the OECD Model Convention.⁶² It connotes those decisions bearing on the position of an entity as a whole. However the OECD Technical Advisory group proposes that these decisions should go above normal management and policy formulation of the activities of a group of companies i.e. it reflects overriding control which is outside the ambit of SARS *General Approach*. It should also

⁶¹However, as these executives (who are responsible for day-to-day management) would be on the board of directors, the location of the place of effective management will only differ from the place where central management and control is exercised, if the term 'effective management' refers to the place where the directors normally reside and not where they may go specifically for board meetings

⁶² See paragraph 24.1 of the OECD Commentary on Article 4.

be noted that overriding control through the making of these decisions is generally a function not attributable to shareholders.⁶³ Controlling shareholders may *de facto* be involved in the management of a company; it has been suggested that this managerial involvement will be on the central control, top management level and not on the day-to-day management relevant to the SARS approach. It is therefore submitted that the inclusion of this factor makes little contribution.

- **The place of incorporation, formation, establishment, and the location of the registered public officer.**

It is reiterated that the existence of these in South Africa negates the need to determine an entity's PoEM. However, it is submitted that such factors would be circumstantial taken into consideration where the entity is not formally or technically connected to South Africa.

⁶³ The division of a company's powers is spelled out in company legislation, the articles, and the common law. The articles of a company usually confer the power to manage a company on the board of directors, and it is accepted that if a power is exclusively conferred upon a specific organ, it should be exercised by that organ alone. The articles should then be interpreted to determine whether the board of directors have the exclusive power to manage in a given instance. It has been argued that where a commonly incorporated provision subjects the managerial powers of the board of directors to the control of the company in general meeting, it does not necessarily result in the shareholders having a final say on the management of an entity since that provision can generally not be interpreted to the effect that members can *exercise* the powers conferred on the directors but *may* regulate whether members can control the directors' exercise of their powers. The Companies Act generally does not give managerial powers to the general meeting but provides it with constitutional powers and controlling in nature. Although the members in general meeting also have certain default powers to intervene and exercise the powers of the board, these are limited to cases where the board cannot or will not exercise its powers or where it exceeds or tend to abuse these powers.

- **The residence of directors and managers responsible for the day-to-day management and the physical location of senior employees.**

The rationale behind these factors could be that the directors/senior managers would need to reside at or near the place where actual day-to-day business activities take place and where the said decisions are implemented. However this may not always be the case since the nature of some companies' business is such that the company as an entity is not required to have a physical presence and allows management to work through the use of technology. The location of the managers and workers' place of residence will be defeated as an indicator of company residence⁶⁴

- **The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity**

BA van der Merwe⁶⁵ contends that the inclusion of this factor is to avert possible manipulation of the facts-and-circumstances test. It is submitted that this factor tallies well with the one relating to the 'nature of powers conferred upon representatives of the entity, the manner in which that powers are exercised by the representatives and the purpose of conferring the powers to the representatives.'

⁶⁴ Van der Merwe, BA (2006) p.133

⁶⁵ Van der Merwe, BA (2006) p.133

- **Other Factors**

(a) Frequency and location of board meetings, the scale of onshore as opposed to offshore operations.

(b) The actual activities and physical location of senior employees

The factors listed above are a means to an end and not an end in itself. They are aimed at providing a connection between a particular entity and a particular country. The factors should therefore not be taken as individually conclusive but the conclusion is a sum total of the facts and circumstances.

As South Africa does not currently have any case law on PoEM, the SARS Note has been commended for giving valuable guidance on SARS practice.⁶⁶ It is, however, important to evaluate the real contribution of the SARS Note to giving a practical meaning to the concept 'place of effective management.'

2.2.3 Effectiveness of the SARS Note

It can be argued that SARS's interpretation may limit the possibility of multiple company residences and the possibility of tax avoidance as the actual implementation of the day-to-day operational management and commercial decisions taken by senior managers is less likely to take place in more than one location.⁶⁷ It has thus been argued that SARS's interpretation keeps

⁶⁶ Oguttu AW p.99

⁶⁷ Van der Merwe BA, (2006) p.125

pace with discernible change in management structures, reporting lines and responsibilities as a result of modern multinational and electronic business environment.⁶⁸

It is submitted that a test of effective management based on the place where directors meet is much easier to manipulate than SARS preferred approach – where high-level management decisions are regularly implemented – depending, obviously with what is meant by implementation. However, the ordinary meaning of ‘*implement*’ is not very helpful in identifying or locating the act of implementing where this ‘act’ consists of several separate actions undertaken in various jurisdictions through virtual or mobile offices.⁶⁹ This may result in a taxpayer having more than one place of effective management in a particular tax year.⁷⁰

The second rule in the Note is very unclear. It provides that where management functions are not exercised in a single location, due to management by distance communication, the PoEM is deemed to be where day-to-day operational and commercial decisions taken by senior managers are actually implemented.⁷¹ In other words it is the place where business operations are actually carried out. No problem arises where the entity in question deals in tangible goods unless business activities, or parts or phases of such activities, are conducted across the globe.

⁶⁸ Van der Merwe, BA (2006) p.125

⁶⁹ Van der Merwe, BA (2006) p.125

⁷⁰ Olivier & Honiball (2005) *supra* provide an example of a grey area: A decision is taken in South Africa by a company director resident locally to raise finance from a foreign bank. A phone call is made by the South African resident director while based locally to arrange for the finance. However, the director flies overseas to sign the finance agreement. A question which arises in these circumstances is whether the transaction was implemented locally or offshore.

⁷¹ SARS Interpretation Note, *supra* par 3.3

However, where intangibles are involved it becomes easy to manipulate PoEM by conducting business operations from various locations.⁷² Van der Merwe⁷³ therefore argues that the rule will not necessarily result in a single place of residence as a taxpayer may have several places across the world where operational and commercial decisions are implemented, and where the business activities, or parts or phases of such business activities, are carried out or conducted.

A related problem in the SARS Note is the 'economic nexus' approach. It says that where business operations or activities are conducted from various locations, one needs to determine the place with the strongest economic nexus.⁷⁴ It has been argued that locating an entity's closest or strongest economic relations require an examination of several factors, for example, where the entity has most employees or assets, carries on most activities, derives most of its revenue, or where it has its headquarters.⁷⁵ This is potentially a difficult exercise since neither the OECD nor SARS's Note provides any guidance on the weight allocations to be given to these factors.⁷⁶

Another problem with the Interpretation Note is the inconsistency inherent in some of its parts. The interaction between SARS's *General Approach*, the introductory distinction between the levels of management and the *Practical approach* is somehow chaotic. To illustrate this point,

⁷² Oguttu A.W, p.100

⁷³ Van der Merwe, BA (2006) p.128

⁷⁴ SARS Interpretation Note at 3.3

⁷⁵ Van der Merwe, BA (2006) p.129

⁷⁶ Oguttu A.W, p.101

the second level of management relates to the implementation by executive directors and senior managers of policy and strategy decisions made by the board of directors. It also involves the making and implementation of regular, day-to-day operational management and business activities. This level of management primarily determines South African entity residence. However, the problem is that the Note's *General approach* does not incorporate all the activities provided in this category. It says that

“[t]he place of effective management...where the company is managed on a regular... basis by the directors or senior managers...” Key words which appear on the Note's second level of management are omitted in the *General approach*, viz, 'make and implement...operational management and business activities'.⁷⁷

It becomes very unclear if these words were correctly and purposefully included in the *Introduction*.⁷⁸

The Note's *Introduction* also refers to second level management as one consisting of 'executive directors or senior management' but the *General approach* omits the word 'executive'. It is trite that executive directors are appointed as employees in some or other executive or managerial position, whereas an ordinary director is usually not expected to do more than attending a reasonable number of board and committee meetings⁷⁹; put differently, the former does day-to-day, hands-on management but the latter would generally be involved in the central

⁷⁷ SARS Interpretation Note at 3.2

⁷⁸ Van der Merwe, BA (2006) p.126

⁷⁹ See *Howard v Heringel* NO 1991 (2) SA 660 at 678

management and control exercised by the board of directors.⁸⁰ Notwithstanding, this omission should not be viewed as an intentional widening of the management scope relevant for determining residence.

It is submitted that the Note's description of the second level management (executive and senior managers) is confusing and ambiguous.⁸¹ It has been pointed out that,⁸²

“[a]ctivities are not commonly ‘made’ or ‘implemented’, but ‘take place’, are ‘carried out or ‘conducted’. These verbs ‘make’ and ‘implement’ are usually associated with nouns such as ‘decision’, ‘order’, ‘policy’...Furthermore, the use of the word ‘activities’ in this context obfuscates a distinction between the second and third level, which is based on ‘where day-to-day business *activities* are carried out or conducted. If [SARS’s] intention was to convey that effective management...is not limited to the acts of executing and implementing strategic board decisions, but includes the implementation of all the regular operational management decisions necessary the effective functioning of the business,⁸³ it would perhaps have been better served by replacing the word ‘activities’ by ‘decisions’. The second level of management will then refer to the execution and implementation of the board’s policy decisions and to the making and implementation of regular, daily operational management and business decisions.”

⁸⁰ Van der Merwe, BA (2006) p.127

⁸¹ SARS Note *supra* at 3.1

⁸² Van der Merwe (2006) p.126

⁸³ Such as the hiring and firing of workers, sourcing supplies, marketing and advertising, competing with local rivals, dealing with local authorities

Another area of uncertainty is SARS's professed intention to deal with issues on a case-by-case basis through employing a facts-and-circumstances approach. Whilst admitted that the facts-and-circumstances approach is more flexible and otherwise preferred, it will somehow bring in subjective comparisons and result in uncertainty since it is hard to establish than a technical requirement such as where the directors reside. It has been argued that its flexibility can be a potential vice; it may provide an incentive to move residence by moving effective management to a tax haven.⁸⁴

Having analyzed the effectiveness of the SARS interpretation of PoEM, it becomes critical to evaluate its standing in South Africa.

2.2.4 How Conclusive is SARS Interpretation Note?

The Note makes it clear that its interpretation is SARS's preferred approach which is obviously different from the UK approach which is based on where overriding central control is exercised.⁸⁵ It is thus critical to examine the interpretation proffered by the SARS Note in light of national and international benchmarks.

SARS has explained the purpose of its Interpretation Notes as follows:⁸⁶

⁸⁴ Van der Merwe B.A. (2006) p.134

⁸⁵ Van der Merwe BA, (2006) p.135

⁸⁶ SARS Practice Notes *Introduction* on <http://www.sars.gov.za>
[accessed on the 6th November 2009]

- To provide guidelines to SARS employees and taxpayers regarding the interpretation and application of the provisions of the various laws administered by SARS.
- These Notes will ultimately replace all the existing Practice Notes and internal circular minutes, to the extent that they relate to the interpretation of the various laws.
- The Notes will be amended in line with policy developments and changes in the legislation

Despite the valuable guidance that the Note gives, it is unfortunate that it's not law and in a number of cases, it has been argued that SARS is not bound by the Notes.⁸⁷ This implies that South African courts are not bound to follow the Notes. Only a High Court decision could confirm and settle SARS's interpretation in a domestic context.⁸⁸

It is doubtful whether courts in South Africa will recognize SARS interpretation of "place of effective management". Section 233 of the Constitution of South Africa⁸⁹ enjoins any domestic court interpreting legislation to give preference to any reasonable interpretation that is consistent with international law. It has been argued that this reference to 'any legislation' would probably not be applicable to legislation that exclusively deal with domestic matters i.e.

⁸⁷ See ITC 1675, 16 SATC 219, 2000 (6) JTLR 219

⁸⁸ Van der Merwe BA, (2006) p.135

⁸⁹ 1996, Act 108 of 1996

Section 233 could be interpreted as requiring consideration of international law only when particular legislation contains some international element.⁹⁰ Van der Merwe (2006: 135) argues that ‘any legislation’ would include the Income Tax Act and treaties concluded by South with other countries, approved by Parliament and published⁹¹ as they either contain international elements or are international in nature. Thus in a treaty context, courts are likely to take cognizance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts utilized in the OECD Model Tax Convention⁹²

The SARS Note clearly is not law in South Africa and thus useful only for domestic interpretation of ‘place of effective management’. Generally such interpretation may not always coincide with

⁹⁰ See Neville Botha *Treaty Making in South Africa: A Reassessment* (2000) 25 South African Yearbook of International Law 69 at 94

⁹¹ In terms of s 108(2) of the Income Tax Act, if the National Executive of South Africa enters into an agreement with the government of any other country to regulate the taxation of income, profits, gains and donations which may be taxable in both countries, as soon as the DTA is ratified and has been published in the Government Gazette, its provisions are effective as if they had been incorporated into the Income Tax Act.

⁹² Tax treaties are international agreements under public international law and thus subject to interpretation according to international law principles. Rules for the interpretation of international agreements are laid down in the Vienna Convention on the Law of Treaties. Articles 31-33 VCLT, dealing with the “interpretation of treaties”, thus provide the framework for assessing the role of the OECD Model Convention and the OECD Commentary in the interpretation process. It is generally recognized that the rules on interpretation contained in the Vienna Convention codify existing international customary law. They thus apply to all international treaties. Along those lines, the High Court of Australia argued in *Thiel v. Federal Commissioner of Taxation* (1990) 171 CLR 338 that the double taxation convention between Australia and Switzerland “is to be interpreted in accordance with the rules of interpretation recognized by international lawyers...” See, also Michael Lang and Florian Brugger *The Role of the OECD Commentary in Tax Treaty Interpretation* available - http://www2.wu-wien.ac.at/taxlaw/publikationen/LangBrugger_australianforum_95ff.pdf [accessed 30.01.2010]

the interpretation used in a treaty context. A comparison between the Note's interpretation and OECD guidelines indicates that the former follows a non-European approach: emphasis is placed on where important decisions are implemented, and not where such decisions are taken. Furthermore, SARS interpretation places more emphasis on day-to-day management whereas the OECD guidelines emphasize occasional, top-level, strategic management.⁹³

It is clear from the foregoing that even where South African courts would be willing to accept the meaning of 'place of effective management' as set out by SARS Note, they may be constrained to extend the same interpretation in a treaty context.⁹⁴ SARS interpretation of 'place of effective management' may not be useful in a treaty context unless it is legislated.⁹⁵ It then becomes imperative to discuss the concept "place of effective management" in a treaty context. It is trite that most of South Africa's treaties are modeled after the OECD Model Tax Convention. An examination of the use and interpretation of the concept by OECD will be very useful in shedding light on the likely interpretation of PoEM in a treaty context, and, *a fortiori*, it being common cause that a tax treaty is effective as if it has been incorporated into the Income

⁹³ Olivier & Honiball (2005) p.68

⁹⁴ Olivier & Honoball (2005) p.69

⁹⁵ Art 3(2) of the OECD Model Tax Convention provides that any term not defined in the Model Tax Treaty shall, unless the context otherwise requires, have the meaning that it has at the 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.

Tax Act once it is ratified and published in the Government Gazette.⁹⁶ The following section discusses and evaluates OECD guidelines and interpretation of the concept of PoEM.

⁹⁶ Section 108(2) of the Income Tax Act

CHAPTER 3

International Interpretation of 'Place of Effective Management'

3.1 Introduction

South Africa has entered into a wide network of tax treaties with both African and non-African countries, and most of these tax treaties are more or less modeled after the OECD Model Tax Convention.⁹⁷ It is trite that the OECD Model Convention has generally received international recognition as a useful tool in the negotiation and interpretation of tax treaties across the globe.⁹⁸ This section is going to give a discussion on international interpretation of the concept 'place of effective management'. The latter interpretation revolves around the OECD Model Tax treaty and its commentary. The meaning and interpretation of the concept 'place of effective management' also becomes clearer, hopefully, by examining the interpretation given to the term by certain selected countries in the world, and other concepts used in domestic legislation.

⁹⁷ Steven Jones *Understanding the principles of double taxation relief (Part 2) Available: - <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page271?oid=37525&sn=Detail> [accessed 30.01.10]*

⁹⁸ Michael Lang and Florian Brugger *The Role of the OECD Commentary in Tax Treaty Interpretation*, *supra*, observed that the OECD Model Convention and the OECD Commentary carry significant weight in the interpretation process if the contracting states chose to follow the wording of the OECD Model in drafting a certain provision. It is then only reasonable to assume that they intended such a provision to have the meaning it has in the OECD Model.

3.2 Dual resident Entity and treaty residence

Article 4(1) of the OECD model tax treaty defines the term ‘resident’ of a contracting state as follows:

“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.”

According to paragraphs 3, 4, and 8 of the commentary to article 4 of the OECD Model Convention, the wording “liable to tax” means a full liability to tax according to the domestic taxation laws of the contracting state in which residency is claimed. An entity will typically be referred to as a dual resident for purposes of a tax treaty if it is, leaving aside application of that treaty, fully liable to tax under the domestic taxation laws of both contracting states and consequently qualifies as a tax treaty resident of both contracting states under article 4(1) of the OECD model convention. In that case the dual residency will normally be undone by applying the tie-breaker rule laid down in article 4(3) of the OECD model convention.

3.3 OECD Tie-Breaker Rule - ‘place of effective management’

Most of South Africa’s tax treaties are based on the Organization for Economic Cooperation and Development Model Tax Convention (hereinafter, “the OECD Model Tax Treaty”). The OECD model treaty is extensively used as a base for the drawing up of many double taxation agreements, including those entered into by South Africa. It is therefore useful to look at the provisions of the OECD Model Tax Treaty to get an insight into their interpretation of ‘place of effective management.’⁹⁹

The Commentary to article 4(3) of the OECD Model Tax Convention reiterates the preference for the place of effective management tie-breaker rule.¹⁰⁰ The latter has been introduced to serve the purpose of resolving the question of which Contracting State must be allocated the residence for a tax treaty purposes. In this case, where the application of article 4(1) of the OECD Model Tax Convention results in an entity being considered a resident of both contracting States, article 4(3) of the OECD Model Tax Convention determines treaty residence by providing 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’.

⁹⁹ Article 4(1) of the OECD Model Tax Convention

¹⁰⁰ Article 4(3) of the OECD Model Convention and paragraphs 22-24 of the Commentary -it should also be noted that in paragraph 24.1 of the commentary, however, it is recognized that, as a result of the different interpretations of the place of effective management, some countries consider it appropriate to deal with dual residents in a different manner. To meet these countries’ concerns, the commentary contains an alternative provision for article 4(3) of the OECD model. This alternative provision refers to the mutual agreement procedure in the case of a dual resident entity and provides that the residency should be decided on by mutual agreement.

It follows from the application of article 4(3) that an entity is deemed to be a resident only of the State in which its place of effective management is situated. The connecting factor of 'place of effective management' chosen for tax treaty purposes has, however, not been comprehensively defined in the OECD Model Convention or in the Commentary. The term refers to 'a facts and circumstances test' consistent with the criterion used for the taxation of income from shipping et cetera¹⁰¹.

The current text of the OECD Model Tax Convention does not define the term 'place of effective management'. Thus article 3(2) of the OECD Model Tax Convention allows the taxing authorities to interpret the term in accordance with their domestic law, whilst taking into account the OECD Model Tax Commentary. The latter defines the term 'place of effective management' 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. All relevant facts and circumstances must be examined to determine the place of effective management...”

Apart from paragraph 24 of the OECD Commentary, there is no further elucidation of the concept. It is implicit from the latter that the determination of the place of effective management is based on certain factors,¹⁰² viz, where the key management and commercial decisions are made in substance, the relevant facts and circumstances, the place where the

¹⁰¹ See paragraph 24 of the OECD Commentary on article 4(3)

¹⁰² Oguttu, AW p.83

actions to be taken by the entity as a whole are determined, and the fact that an entity can only have one place of effective management at a time.

These factors show us that the determination of a PoEM is a question of fact since the factors are based on identifying the place where the underlying policy decisions of an entity are made.¹⁰³ It is important to evaluate the purport of the language used in paragraph 24 of the commentary. It refers to the place where “key...decisions...necessary for the...entity’s business as a whole are in substance made.” It is submitted that this place would in ordinary circumstances be where the directors meet; it could also be the place where the overall top officer who is overall in charge of the whole business of the company customarily makes decisions relating to the management of the company.¹⁰⁴ It is argued that this is generally the purport and spirit of paragraph 24 of the Commentary to article 4 of the OECD Model Tax Convention. This position is in line with France’s observation on the Commentary – it considers that the definition of the place of effective management in paragraph 24 will, in its view, correspond to the place where the person(s) who exercises the most senior functions makes its

¹⁰³ Oguttu, AW p.83

¹⁰⁴ This position seems to be in line with the current thought at the OECD as espoused in the 2008 Update to the OECD Commentary. The latter points out that the proposals put forward in 2003 by the OECD Technical Advisory Group to refine PoEM (through expansion of the Commentary and the use of a hierarchy of tests as an alternative version of paragraph 3 of article 4) were refused by the majority members of OECD as they felt 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. See also Jean-Paul van der Berg & Bart van der Gulik: **The Mutual Agreement Tie-Breaker – the OECD and Dutch Perspectives** (Tax Notes International 2009 pg 417) who point out that two main interpretations seem to exist on ‘place of effective management’ – where the board of directors meet and where senior management operates.

decisions. It considers this place to be ***‘where the organs of direction, management and control of the entity are, in fact, mainly located.’***¹⁰⁵ (Own emphasis)

The OECD Commentary points out that all the facts and circumstances must be taken into account.¹⁰⁶ Thus, where decisions are taken by persons other than the board of directors, the place where those persons meet would be the PoEM. It may so happen that a particular entity has a controlling shareholder who interferes with the usual conduct of the business of the company; if that person is constantly informed of the various transactions of the company and his decisions have a decisive influence on how current entity transactions are dealt with, such a shareholder can be taken into consideration in determining the PoEM of the company.

For the tie-breaker provision in article 4(3) of the OECD Model Tax Convention to work properly, however, there needs to be a common understanding between two contracting states on the meaning of the term ‘place of effective management’. Although paragraph 24 of the OECD Commentary provides a general definition as a guideline, various interpretations still seem almost inevitable.¹⁰⁷

¹⁰⁵ Paragraph 26.3 OECD Commentary to Article 4(3) of the Model Tax Convention (2008)

¹⁰⁶ Paragraph 24 of the OECD Commentary on article 4(3) of the Model Tax Convention

¹⁰⁷ Van der Berg, J.,P., Van der Gulik, B. (2009) ***The Mutual Agreement tie-breaker- OECD and Dutch Perspectives***

Tax Notes International Volume 54 No. 5 at pg 417 Available -

<http://stibbeus.com/upload/1b0d11901210bf315cb01d9a.pdf>

In paragraph 24.1 of the commentary, therefore, it is recognized that, as a result of the different interpretations of the place of effective management, some countries consider it appropriate to deal with dual residents in a different manner.¹⁰⁸ To meet these countries' concerns, the OECD Commentary contains an alternative provision for article 4(3) of the OECD model. This alternative provision refers to the mutual agreement procedure in the case of a dual resident entity and provides that the residency should be decided on by mutual agreement.

3.3.1 The Mutual Agreement Tie-breaker

In rejecting the 2003 draft recommendations proposed by the OECD TAG¹⁰⁹, a significant number of countries indicated that, increasingly, they adopt bilaterally a different approach, based on the facts and circumstance of each case, to solve cases of dual residence of legal persons.¹¹⁰ Under that approach, such cases are to be solved by the competent authorities. After further discussion by the OECD, it was agreed that given the number of countries that are prepared to agree bilaterally to that approach, it should be added to the Commentary on

¹⁰⁸ *Ibid*

¹⁰⁹ See the OECD Discussion Draft: **"Place of effective management concept: Suggestions for changes to the OECD Model Tax Convention"**, (2003) The TAG had proposed to clarify 'place of effective management through an expansion of the Commentary and the use of a hierarchy of tests as an alternative version of paragraph 3 of article 4; these proposed changes were eventually not adopted as the majority members of the OECD favoured an alternative tie-breaker test to the place of effective management concept since a significant number of countries adopt bilaterally a case-by-case approach to solve cases of dual residence of legal persons.

¹¹⁰ See the 2008 Update to the OECD Model Tax Convention p.8, paragraph 4

Article 4 as a possible alternative to the place of effective management concept.¹¹¹ The relevant part of the Commentary reads thus:¹¹²

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

Unlike the mutual agreement procedure in the case of dual resident individuals, there is no obligation on the contracting states (“parties”) to reach an actual agreement on the residency of a dual resident entity. Under this procedure the parties would need to determine the residency of a specific entity for purposes of a tax treaty based on certain factors. However, where no agreement is reached, the dual resident is denied benefits under the tax treaty. The easiest way round the problem seems to be in the taxpayer ceasing to be a dual resident. Where an agreement, is however, not reached the dual resident entity remains a resident of both contracting states for treaty purposes.

¹¹¹ 2008 Update, *supra* p.8

¹¹² See paragraph 24.1 of the OECD Commentary on article 4(3) of the Model Tax Convention

One would imagine the likely consequences of the use of the OECD mutual agreement tie-breaker. Theoretically, unresolved dual residency under the mutual tie-breaker might lead to situations of double taxation.¹¹³ It is however understood that in reality, potential double taxation in some situations might not occur as a result of the domestic tax relief rules of countries involved.¹¹⁴

In spite of the problems of interpretation associated with ‘place of effective management’ and the fact that the OECD interpretation of the term does not always produce an unambiguous result, it is submitted that ‘place of effective management’ remains a more useful concept than the mutual tie-breaker procedure for the determination of tax treaty residence of an entity. It should however, be noted that in interpreting ‘place of effective management, the OECD Model accommodates other domestic concepts in interpreting PoEM.¹¹⁵ However, one thing must be borne in mind, that there are no definitive guidelines and ‘place of effective management’ remains largely a question of fact. To get a clearer guidance of the purpose and scope of the OECD concept ‘place of effective management’, it is critical to evaluate the meaning and application of other domestic concepts used to serve the tie-breaker purpose in certain jurisdictions.

¹¹³ For example, double levy of corporate income tax

¹¹⁴ See for example, s 6quat of the South African Income Tax Act –the rebates granted for foreign taxes paid. It also encapsulates the deduction system. The affected taxpayer might be entitled to an arrangement to avoid the ensuing (economic) double taxation e.g. through the implementation of a participation exemptions. Juridical double taxation could also be avoided through a similar approach.

¹¹⁵ This is provided for in terms of the OECD Model Tax Convention – article 3(2)

3.4 Guidance on the meaning of ‘place of effective management’ from other concepts used in domestic legislation

A lack of a universal meaning of PoEM has seen some countries interpreting the term by using concepts that are used in their domestic tax law residence rules.¹¹⁶ It is thus submitted that concepts like Central Management and Control (“CM &C”), and Place of Management (“PoM”) as applied in jurisdictions like UK and Germany domestic legislation respectively, may act as useful guiding tools in searching for the meaning of ‘place of effective management’ as applied by the OECD mainly because how generally the term is interpreted gives a clue as to its general meaning in practice.

3.4.1 Place of Management

This concept is used in Germany.¹¹⁷ Vogel¹¹⁸ describes the term ‘PoEM’ as similar to PoM as both concepts refer to factual conditions. The latter is regarded in German law as the place where management’s important decisions are actually made, or the centre of gravity of superior management. Vogel¹¹⁹ states that what is decisive is *not* the place where the management’s important directives take place, but rather the place *where they are given*.

¹¹⁶ This practice is apparently supported in *Article 3(2)* of the OECD Model Tax Convention which provides that any term not defined in the Convention, unless the context otherwise requires, a Contracting state can make use of the meaning of the term under the law of that state for the purposes of the taxes to which the convention applies.

¹¹⁷ International Bureau of Fiscal Documentation *The taxation of companies in Europe* (Germany) (Supplementary Service) par 1.2.1

¹¹⁸ Vogel K. (1991) *Double Taxations Agreements* at pg. 183

¹¹⁹ Ibid

Oguttu¹²⁰ argues that if a controlling interest holder is authorized to represent the company and carries out the company's management activities, then that interest holder may be regarded as being in charge of the top-level management, and the place where those decisions are made would therefore appear to be the centre of management. However it has been pointed out that a place from which a business is merely supervised would not qualify as a PoM.¹²¹

3.4.2 Central Management & Control

It has been said that to understand the meaning of 'PoEM' in a treaty context, one has to start with the CM &C test.¹²² This concept is used to determine company residence in Canada, Australia and the UK among other countries. The United Kingdom will be used as a point of illustration in the application of the concept.

The basic rule of UK law of entity residence is that an entity is resident in the UK if either it is incorporated in the UK or the 'central management and control' of the business of the company is carried on in the UK. Where a non-UK resident entity is required in a financing transaction, the latter should not be incorporated in the UK because of the provision that any company

¹²⁰ Oguttu, AW p.84

¹²¹ Vogel K. (1991) ***Double Taxations Agreements*** p.183

¹²² Olivier & Honiball (2005: 65) point out that the concept 'place of effective management' has been substantially influenced by the 'central management and control concept' under the UK tax residence laws.

incorporated in the UK is deemed automatically to be resident in the UK under the common law test¹²³ (subject to very limited exceptions).

The CM &C concept originates in cases dating from the late 19th century, especially the decision of the House of Lords in *De Beers v Howe*². In this decision, Lord Loreburn said that the test ought to approximate as nearly as possible to the test used for determining the residence of an individual. He said that:

"[a] company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a Company... ***a company resides, for purposes of income tax, where its real business is carried on ... and the real business is carried on where the central management and control actually abides.***" (Emphasis added)

Each case turns on its facts. In the above case, the central management and control of the business was in London, where the main board of the company met on a consistent basis, despite the fact that the business of the company was carried out where its mines were located, in South Africa. The court in *De Beers* concluded that the central management and control of a company, in normal circumstances, is equivalent to the decisions made by the

¹²³ see Section 66 of the UK Finance Act 1988

company at board level; in other words, the location where the final decisions that bind the company are considered and made.

One case where the court reached a different view was *Unit Construction Co Ltd v Bullock*.¹²⁴

The court pointed out that where the functions of the board of a subsidiary (Unit Construction which was registered in Kenya) had effectively been usurped by the board of directors of its parent company (which met in London), London was the place of central management and control. No decisions were actually being taken in Kenya at all. All decisions of the company were taken in London by the board of directors of the parent company. Notwithstanding that this may have been outside the constitution of Unit Construction, the House of Lords found that this was where the central management and control was being exercised.

The courts have also held that, even though the board of a company in fact follows instructions given to it, it does not necessarily follow that the control and management lies with the person giving the instructions, so long as the board does exercise its discretion and would refuse to carry out an improper or unwise transaction.¹²⁵

¹²⁴ (1960) AC 351

¹²⁵ Matthew Hodkin & Rose Norton ***The Tax Residence of Special Purpose Companies*** - <http://www.qtnews.com/article/6360.cfm> [accessed on 20.09.09]

It is submitted that the court in De Beers case found central management and control to be in the UK because the strategic decision making was carried out in London. However, following the case of *Wood v Holden* [2006] EWCA Civ 26, [2006] STC 443¹²⁶, one could conceive of De Beer's CM &C being situated in London and its effective management in South Africa. If there were a DTA in place the outcome would have been reversed! It is also apparent that De Beers may have had a permanent establishment in the South Africa, the profits of which would have been taxable there.

Though the CM &C and the PoM tests indicate that the place of effective management will usually be where the directors are situated, these powers may in certain circumstances, be exercised by others. The relevant consideration is thus where high level decisions are made. If parties other than the Board of Directors make these decisions, the place where such decisions are made would have to be borne in mind. This broadness of inquiry flows from the very illusive nature of the PoEM concept, and it may thus be also crucial to have a glimpse at how other selected countries interpret the term in their domestic legislation.

¹²⁶ See discussion below on the *Wood v Holden* case below

3.5 Other Countries' Interpretation

3.5.1 The Netherlands

The main criterion for residence derived from Dutch law is 'place of effective management'.¹²⁷ The Dutch Courts found it to be the place where the management of a company concerned takes the decisions and prepares implements and coordinates these decisions.¹²⁸ According to findings by Dutch courts, control at the highest level is more appropriate than the day-to-day management of a company.¹²⁹ The 'PoEM' will not necessarily be the location of the parent company in a case where it has a strong influence on the decisions of the management of its subsidiary. Only in the case of puppet-on-string management do the courts conclude that the 'place' is location of the parent company.¹³⁰

3.5.2 Italy

Italy's interpretation of 'effective management' takes into account the place where the main and substantial activity of the entity is carried on.¹³¹ The place of effective management is often considered the place of management identified on the basis of real facts and circumstances that have to be considered on a case by case basis.¹³² For instance the Supreme Court of Italy

¹²⁷ Langereis C.H.J *Tax Law* in **Introduction to Dutch Law (2006)** p.460

¹²⁸ *ibid*

¹²⁹ *ibid*

¹³⁰ *ibid*

¹³¹ Dr. Tamburini M **Italian Court Rules on Conduit Companies (the "Luxottica" case)** (Draft) Available:-
http://web.mac.com/marcogreggi/Seminars/conduit_files/conduit_beta.pdf, see, also Oguttu A.W (2008) p.91

¹³² *ibid*

many times ruled that this place is where the directors manage the company or the CEO has his office, that is, the place where the main decisions are taken.¹³³ Italy generally gives more importance, in order to determine the meaning of “place of effective management” and to identify the state of residence of the company, to the place where the main and substantial activity of the entity is carried on.¹³⁴ It is thus submitted that the place where “the main and substantial activity of the entity” is carried on is the place of residence of the people with a fundamental role in the business, like, for instance, those who signs the contracts on behalf of the entity et cetera.

3.5.3 The United Kingdom

The UK tie-breaker test (place of effective management) is set out in s 249 of the Finance Act 1994. It is relevant where a company is resident in the UK under the central management and control test, but is regarded also as being resident in another jurisdiction under the domestic laws of that state and there is a double taxation treaty between UK and that state which contains a tie-breaker clause. If the test applies, the company is to be regarded as resident of the state in which its place of effective management is situated.¹³⁵ There is little UK case law on

¹³³ *Ibid*

¹³⁴ See Article 73 of the Italian Corporate Income Tax – a company is deemed to be a resident in Italy when at least of the following is met for most of any fiscal year in Italy: (1) the legal seat – the seat established in the deed of incorporation; (2) the place of effective management; (3) the place where the enterprise carries on its core business.

¹³⁵ Hodkin & Norton, *supra*

the concept; however, some illumination on its application may be gleaned from the case of *Wood v Holden*.¹³⁶

3.5.3.1 Wood v Holden case

This case basically involved a disposal of shares by an offshore company (generally referred to as CIL), which was registered in the British Virgin Islands to another overseas company, Eulalia ("E BV"), incorporated in the Netherlands. What is crucial to remember, however, was that Eulalia was a wholly owned subsidiary of CIL and that all the transactions were part of an avoidance scheme orchestrated by the taxpayers' Manchester-based accountants. On ordinary principles, the disposal by CIL gave rise to a taxable gain. Since it was a non-resident company, the UK *Taxation of Capital Gains Act* 1992, s. 13 would attribute such a gain on any UK-resident shareholders, and HMRC were arguing that this was indeed the case. However, s. 13 does not apply, when the disposal is between two non-resident companies, because s. 14 extends the provisions of s. 171 (nil gain and nil loss on intra-group transfers) to non-resident groups.

As it was agreed that CIL was not resident in the UK, Mr. and Mrs. Wood were arguing that E BV was also non-resident (so that s. 14 could then apply). HMRC, on the other hand, were suggesting that E BV was in fact resident in the UK, by virtue of the fact that the acts of the board merely put into practice the tax avoidance scheme the UK-based accountants had devised. This would have meant that s. 14 did not apply. The Special Commissioners decided

¹³⁶ [2006] EWCA Civ 26, [2006] STC 443,

that HMRC's assessments on Mr. and Mrs. Wood should be upheld. In the High Court, Park J disagreed. On appeal, the court, *inter alia* pointed out that the provision of tax advice in Manchester was distinct from the client's decision to follow the advice, and thus the mere fact that the board simply followed the advice of PricewaterhouseCoopers (PwC) was not relevant, on the basis that this was advice (and was expressed as such). There was nothing which forced the board to follow the advice.¹³⁷ The Appeal court upheld the High Court's decision and held that E BV central management and control was located in the Netherlands and, therefore, the company was not resident in the UK.¹³⁸

The court in **Wood v Holden** however, did not feel the need to deal explicitly with the question of whether the place of effective management of E BV was in the Netherlands.¹³⁹ However, the

¹³⁷ Hodkin & Norton, *supra*

¹³⁸ Gordon Keith M. **Resident either here or there** Tax Advisor July 2006 at pg 17 also available-
http://www.tax.org.uk/attach.pl/4544/4746/016-017_TA_0706.pdf

¹³⁹ The end of the judgment on appeal in **Wood v Holdern** contained a short reference to another argument advanced on behalf of Mr. and Mrs. Wood. It was referred to only briefly because the conclusion on the central management and control test meant that the second argument (relating to the place of effective management of the entity in question) was unnecessary. Nevertheless, despite the brevity of the judicial comments, an important point is made. The UK Finance Act 1994, s. 249 allows double taxation agreements to be referred to when (as in this case) a company's residence is in issue. It operates if the company would, but for the double taxation agreement, be treated as UK resident. Therefore, for the Court to consider s. 249 it first had to assume, notwithstanding its findings on the issue, that Eulalia was in fact a UK resident company. As Eulalia was also treated as resident in the Netherlands (under Dutch law), it fell to the tie-breaker provisions in the UK-Netherlands Double Taxation Agreement to determine whether it should be treated as resident in the UK or in the Netherlands. This tie-breaker test focused on 'the State in which its place of effective management is situated'.

court observed that, the 'place of effective management' of a company had to be a specific place and not just within a country, and since the HMRC had failed to prove that location in the UK, it lost the case.¹⁴⁰ In the Court of Appeal, Chadwick LJ expressed the sentiment that the tie-breaker provision effectively encapsulates the common law test confirmed in *De Beers*.¹⁴¹ However, for the sake of form, Park J treated the two tests as distinct. It is argued, from the court's attitude on the distinction between the two concepts, that a very thin line separates their application in practice.¹⁴² It is therefore submitted that central management and control test and 'place of effective management' in substance entail the same approach, viz, who makes important decisions for the entity's business and where are they made.

3.5.3.2 UK Inland Revenue Practice

There is little UK case law on the meaning of 'place of effective management', although the Court of Appeal in *Wood v Holden* were very clear that the wording meant that it was necessary to show an actual physical place in the UK where the effective management was carried out in order to satisfy the test - it was not sufficient to show that the management was being carried out somewhere within the UK.

¹⁴⁰ Gordon Keith, *supra*

¹⁴¹ *Ibid*

¹⁴² *Ibid*

The main source of information on how the PoEM' test is treated by the UK authorities is the guidance published by HMRC stating its view of the test.¹⁴³ HMRC states that, in its view, the 'place of effective management' of a company is a different test from its central management and control. The example given by HMRC is of a company which is run by executives based overseas, but with a final directing power which is exercised by non-executive directors who meet in the UK. In such circumstances, HMRC's view is that the CMC of the company will be in the UK but that the PoEM of the company is overseas. Therefore, if the PoEM is in a jurisdiction with a double tax treaty with the UK containing a tiebreak clause, section 249 Finance Act 1994 would mean that the company was resident for all UK tax purposes in the other jurisdiction. In the case of a Special Purpose Company, where the only decisions relating to the activity of the company are taken by the board, it is unlikely that there would be a difference between the results given by the common law test and the tiebreaker test.¹⁴⁴

The foregoing discussion was an attempt to seek a clearer definition of the term PoEM. Concepts like PoM and CM & C have been said to have influenced the concept of PoEM. An inquiry into other countries' interpretation also gives an insight into meaning given to term in certain jurisdictions. It is now necessary to evaluate the overall effectiveness of the OECD interpretation of PoEM.

¹⁴³ UK Inland Revenue Statement of Practice 6/83, also Olivier & Honiball (2005) at pg 67

¹⁴⁴ Hodkin & Norton *supra*

3.6 Evaluation of OECD Interpretation of ‘Place of Effective Management’

OECD’s interpretation of PoEM potentially results in multiplicity of company residence. Although it is stated in article 4(3) of the OECD MTC that there can only be one PoEM, there could be more than one place of management in that the OECD concept emphasizes the place where key management and commercial decisions are made. The advent of the telecommunications and technology revolution changed the way people run their businesses. Businesses are no longer operated from a single location, such as a head office of an enterprise. In the past the place where top level management activities occurred would normally coincide with the place where the company was incorporated and had its registered office or where its business activities were conducted and where the directors or senior managers resided.¹⁴⁵

E-commerce enables the transmission of information in the cyberspace using the internet. It provides an environment in which automated functions can conduct huge business activity with little or no physical operations. These functions can be easily and quickly moved from jurisdiction to jurisdiction. It has been observed, quite correctly, that internet provides the information and opportunities necessary to make residence a matter of deliberate choice rather than fate¹⁴⁶

¹⁴⁵ Van der Merwe (2002) *Residence of a company – meaning of ‘effective management’* South African Mercantile Law Journal Volume 14 at 81-82

¹⁴⁶ Ibid

Oguttu¹⁴⁷ argues that with this increased mobility of resources, functions performed can easily be decentralized and this can have a significant impact of the taxation of dual resident companies, and the concomitant application of the 'PoEM. Thus e-commerce makes it very easy to manipulate the principle of 'PoEM' as it is governed by national sovereignty, having been developed in the days of 'brick and mortar' when physical presence in a jurisdiction was necessary to enforce tax laws.¹⁴⁸ Rapid telecommunications revolution may also result in mobile places of effective management.¹⁴⁹ This situation could occur where the senior person of an entity is constantly on the move. Similarly a board of directors may arrange to meet in different places throughout the year, for example, a board of directors of a multinational company may arrange to meet at the offices of the enterprise around the globe rotationally.

Paragraph 24.1 of the OECD Commentary lists a number of factors that the competent authorities would take into account when applying the approach, such as the place where the meetings of the BoD or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, etc. Countries not applying this approach determine the residence of a legal person on the basis of its PoEM as is provided by Article 4 (3) of the MTC. The old text of paragraph 24 of the 2005 Commentary offered

¹⁴⁷ Oguttu, AW p. 88

¹⁴⁸ Oguttu AW p. 89

¹⁴⁹ Oguttu AW p. 90

guidance to tax authorities and taxpayers to construe the term “place of effective management”.¹⁵⁰ It reads,

“The [PoEM] will ordinarily be the place where the most senior person or group of persons... 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”.

As already indicated, this entire sentence has been deleted from the Commentary. It is thus submitted that the Commentary does not provide for a testable criterion. However, it further states that all relevant facts and circumstances must be examined to determine the PoEM without enumerating possible facts and circumstances to take into account, as opposed to the case-by-case approach. In other words the new Commentary does not offer any guidance to tax authorities and taxpayers. By deleting the sentence mentioned above, the OECD Commentary makes a distinction between two systems. It provides relevant factors to be taken into account when a State applies the case-by-case approach, but only gives a general principle in the case of a State applying the concept of the place of effective management as a tie-breaker rule. By doing this, the legal certainty of a taxpayer resident in a State applying the ‘place of effective management’ as a tie-breaker rule is severely curtailed.¹⁵¹

¹⁵⁰ De Broe, L (2008) *Comments on the 2008 Update to the Model Tax Convention – Place of Effective Management* pg. 1 Available www.oecd.org/dataoecd/24/59/40760215.pdf

¹⁵¹ Ibid at pg 2

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

As the 'place of effective management' is determined by taking a 'substance over form' approach, the result it produces should in theory always reflect the true policy intention of the company.¹⁵² Unfortunately in practice this cannot be the case because of the phenomena of evolving communications technology mentioned in the preceding section. This makes it troublesome to determine the actual 'place of effective management' as it could be 'in more than one place'. Though the number of situations where PoEM simultaneously exists has increased with the use of technology, this scenario had already been recognized in traditional business operations.¹⁵³

As already pointed out above, the emergency of transnational businesses, together with the rapid improvement of global transport systems, also has an effect on the 'place of effective management'. This phenomenon has, among other things, seen the development of 'mobile' places of effective management'.¹⁵⁴ The OECD Model Convention deals with these cases in

¹⁵² Discussion Paper by OECD: "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule" [10 Sept 2009] at 8 – <http://www.oecd.org/pdf/M000015526.pdf>.

¹⁵³ In *Bullock (Inspector of Taxes) v Unit Construction Company, Ltd* [1959] 1 ALL ER 739 the court pointed out that '...individual cases have not always so arranged themselves as to make it possible to identify any one country as the seat of [CM &C] at all. Though such instances must be rare, the management and control may be divided or even, at any rate in theory, peripatetic.'

¹⁵⁴ Discussion Paper by OECD at p.9

article 8. This is an express recognition that 'PoEM' can be located in a ship and will thus be mobile. In order to provide for this 'abnormal' situation, the PoEM is deemed to be in the jurisdiction with which the shipping company has its closest links.

Although the POEM can be manipulated by e-commerce, it is suggested that the concept should not be replaced until a more pragmatic solution is found. It has also been suggested that the POEM concept should not be replaced until a more feasible solution is found that provides legal certainty, accords with the actual economic activities of the company and is administratively practical.¹⁵⁵ Although SARS's preferred approach that recognizes day-to-day management has some unsatisfactory aspects needing clarification, it offers a better tie-breaker test than the OECD interpretation that put emphasis on the place where key management and commercial *decisions are made* as an indicator of effective management. Whilst the OECD puts emphasis on making of decisions, SARS focuses on the place of *implementation* of decisions. It is not clear to what extent would these two functions overlap in practice.

The optional wording proposed in paragraph 24.1,¹⁵⁶ raises, on the one hand, the fundamental question of how far the OECD should go in proposing options to the agreed wording of an article. On the other hand, a case-by-case approach is certainly not a good choice from the perspective of the international business community. Contrary to what is said in the

¹⁵⁵ Oguttu, AW p.103

¹⁵⁶ Paragraph 24.1 deals with countries following a case-by-case approach under the mutual tie-breaker provision.

Commentary,¹⁵⁷ dual residence of enterprises is an issue that could become even more pronounced in the future, due to new forms of doing business and new communication techniques. Since the competent authorities always have the possibility to go for a mutual agreement procedure in cases where they have doubts or do not agree with the decision made by the other authority, the proposed option may be unnecessary.¹⁵⁸

Further to the above, in situations where the two states follow different approaches, the option does not help. It can, on the contrary, have far reaching negative consequences for the business entities in case no agreement can be found, for example, because there is a lack of criteria accepted by both states. No entitlement to treaty benefits or relief will be the consequence for the taxpayer.

It is submitted that the comments made in the last paragraph of paragraph 24.1 are very important in case two states choose the proposed new option. The criteria to be used in dual residence cases should in such situations always be discussed and agreed upon in the course of the bilateral negotiations. Put differently, states entering into bilateral tax treaties should attempt to give a guide on the factors to be used in applying the mutual agreement tie-breaker provision. This provides the much needed certainty to taxpayers and the relevant authorities.

¹⁵⁷ See paragraph 24.1 of the OECD Commentary

¹⁵⁸ BIAC (2008) ***BIAC Comments on the OECD Public Discussion draft: Draft Comments of the 2008 Update to the OECD Model Convention*** p. 4 See <http://www.oecd.org/dataoecd/24/60/40760171.pdf> [accessed on 20.09.09]

These criteria could be highlighted in the Explanatory Memorandum accompanying the draft legislation.

Paragraph 24.1 provides that where the contracting states do not reach a mutual agreement, the dual resident entity should be denied benefits under the treaty. It is considered that the purpose of this provision is to discourage use of dual resident entities.¹⁵⁹ Be that as it may, the contracting states should not blindly deny a dual resident the benefits under a treaty merely because its, *prima facie*, a dual resident. The latter should only forfeit benefits under a treaty after the contracting states have satisfied themselves that the dual residency resulted from an improper tax avoidance motive. In any event, however, contracting states should avoid as much as possible depriving the dual resident certain basic treaty like those under articles 24 (non-discrimination), and 25 (mutual agreement procedure) of the OECD Model Tax Convention.

It is submitted that subjecting dual resident entities to a mutual agreement procedure to decide where the company is resident creates more uncertainty and is time consuming. If the mutual agreement procedure doesn't reach a solution, taxpayers cannot rely on the treaty. This leaves the dual resident entity in limbo as tax authorities cannot come up with a decision as to where the entity is resident.¹⁶⁰ To mitigate this dilemma, it is suggested that the contracting states under a mutual agreement tie-breaker could insert an appropriate provision in the tax treaty

¹⁵⁹ Van der Berg, JP., Van der Gulik, B. (2009) *supra* p.422

¹⁶⁰ International Tax Review (2008) Weekly News [accessed 29-11-09] Available <http://www.internationaltaxreview.com/?Page=9&PUBID=210&ISS=25038&SID=712118>

detailing the time frames to be taken by the contracting states in resolving problems of dual residency.¹⁶¹ Once the time frames elapses, it could mean that taxpayer would automatically be denied benefits under the treaty.¹⁶²

It is commendable that the OECD recognized the susceptibility of its ‘place of place effective management’ to manipulation. Before the 2008 changes to the OECD Commentary on the interpretation of article 4(3), the term was defined inter alia as referring to the place where key management and commercial decisions which take place ‘where the actions to be taken by the entity as a whole are determined’.¹⁶³ The OECD realized that the concept as defined did not provide a suitable tie-breaker test in the face of the communications revolution. Thus the OECD ushered an alternative tie-breaker provision¹⁶⁴ in paragraph 24 of the OECD Commentary to article 4. This appears to be a major stride on OECD’s part considering the concerns which have been raised about the loopholes in the application of the ‘place of effective management’ tie-breaker test.¹⁶⁵ It is quite clear from paragraph 24.1 that it was partly intended to address the

¹⁶¹ *Ibid*

¹⁶² *Ibid*

¹⁶³ See paragraph 24 of the 2005 OECD Commentary to article 4

¹⁶⁴ This tie-breaker test is commonly known as the mutual agreement tie-breaker.

¹⁶⁵ Tax and e-Commerce @ OECD, (2001) **The Impact of the Communications revolution on the application of “place of effective management” as a tie-breaker rule.** A discussion Paper from the (OECD) Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the taxation of business profits, Available www.oecd.org/dataoecd/46/27/1923328.pdf

shortcomings of the 'place of effective management'. The relevant part of paragraph 24.1 reads:

“...some countries also consider that...a case by case approach is the best way to deal with difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of residence of those persons to be settled by the competent authorities.”

SARS interpretation of the term 'place of effective management' seems to be not far from the current OECD interpretation. Like SARS's view, the OECD objected to an interpretation which gives 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. Accordingly, according to OECD, the place of effective management is not necessarily the place where the most senior person (e.g. board of directors) makes decisions.¹⁶⁶ The explicit exemplification of the place where the board of directors meet as 'place of effective management' was thus struck out of the OECD Commentary.¹⁶⁷ It is however understood, that the place where the board of directors meet would be taken as one of the factors in

¹⁶⁶ See Ostwal, P., T. (2008) **OECD Model Tax Convention – 2008 Update and India's position** Available http://www.assochem.org/events/recent/event.../SessionII_TP_Ostwal.pdf

¹⁶⁷ See the **2008 Update to the Model Tax Convention**, note 108 op cit pg. 8

determining the place of effective management. SARS appears to be using a similar approach under the facts and circumstances approach.¹⁶⁸

It is recommended that SARS' interpretation should be refined and be incorporated into section 1 of the Income Tax Act – a definition should be given of the meaning of 'place of effective management.

It has also been suggested, quite correctly, that once South Africa has incorporated SARS's interpretation of 'place of effective management', it could indicate a reservation to the application of the OECD interpretation.¹⁶⁹ This is particularly important since South Africa does not currently have a statutory definition of 'place of effective management' and yet domestic courts are constitutionally bound to follow an interpretation consistent with international law.¹⁷⁰ It has thus been suggested that South Africa could indicate a reservation in terms of which it follows its interpretation of the term 'place of effective management'. This would be possible once the recommendation to insert a definition of the term in the Income Tax Act is implemented, then South Africa can reserve the right to use its interpretation of the term in its double taxation treaty network.¹⁷¹

¹⁶⁸ SARS Interpretation Note, n 32 op cit

¹⁶⁹ Oguttu, AW p.104

¹⁷⁰ See Olivier, L., Honiball M. (2005) pg 33, also Section 233 of the *Constitution of South Africa* Act 108 of 1996.

¹⁷¹ Oguttu, *supra*

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Department of Commercial Law

MASTERS DEGREE IN TAX LAW THESIS

PAPER 2

TAXABILITY OF RECOUPMENTS UNDER THE SOUTH AFRICAN TAX SYSTEM: WHETHER AN AMOUNT STILL OWED TO A CREDITOR CAN BE RECOUPED FOR TAX PURPOSES – A REVIEW OF OMNIA FERTILIZER (PTY) LTD vs. SOUTH AFRICAN REVENUE SERVICES

DECLARATION

A Research Dissertation presented for the Approval of the Senate in fulfillment of part of the Requirements for the Master of Laws Degree in Taxation in approved courses and a minor dissertation. The other part of the requirements for this qualification was the completion of a programme of courses. I hereby declare that I have read and understood the Regulations governing the submission of Master of Laws dissertations, including those relating to length and plagiarism, as contained in the Rules of the University of Cape Town, and that this dissertation conforms to those regulations.

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To **God** Be the Glory for making my studies a success at the University of Cape Town. I love you Lord!

ABSTRACT

The Income Tax Act generally recognizes an unconditional right or entitlement and an unconditional obligation measurable in money as an accrual and an expense respectively. The general deduction formula treats an unconditional liability quantified as at the date of its incurral, as a realized expense or loss prior to its actual discharge. This paper investigates the question whether section 8(4) (a) of the Act is premised upon the principle that an expense or loss only qualifies as a deduction to the extent to which the taxpayer has actually borne it; whether an unconditional obligation (recognized as an expense and deductible under the provisions of the Act) will be recouped only if the obligation in question has otherwise been discharged than for full value. It could be argued that an event occurring before the obligation in question has been discharged can be a recoupment provided it results in an actual saving or benefit for the taxpayer. This paper revolves around a recent court decision bearing on the above stated principles: *Omnia Fertilizer Ltd v Commissioner South African Revenue Service*. It investigates, *inter alia*, the question whether a mere likelihood of a benefit or saving accruing to a taxpayer should be characterized as a recoupment. The paper also discusses the practical problems associated with court's approach in *Omnia Fertilizer case*, and the tax planning points.

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1 INTRODUCTION

Section 8(4) (a) of the Income Tax Act (hereinafter referred to as “the Act”) contains the general recoupment provision. The section provides for an amount to be included in the taxpayer’s income in respect of amounts previously allowed as deductions which have been recovered or recouped during a particular year of assessment. In terms of paragraph (n) of the definition of “gross income” in section 1 of the Act, such recoupments must be included in the taxpayer’s gross income.

In *ITC 1435*¹ it was held that with regard to an asset in respect of which a wear and tear allowance has been allowed, a recoupment can only arise if the asset is sold, destroyed or otherwise disposed of and as a result thereof the taxpayer receives payment in excess of the tax value of the asset. The tax value of an asset in this case is the purchase price less any wear and tear or depreciation allowances allowed in respect of that asset. The provisions of section 8(4)(a) must be applied by taking into account the provisions contained in Sections 8(4)(b) to 8(4)(j).

Section 8(4)(a) currently read as follows (omitting the irrelevant parts):

“[t]here shall be included in the taxpayer’s income all amounts allowed to be deducted...under the provisions of section 11 to 20 inclusive...whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment.”

The use of the words “recovered” and “recouped” in Section 8(4)(a) of the Act differs from the terminology used in the rest of the Act. Taxability usually depends on the question whether an amount was accrued or received. The reference in section 8(4)(a) to a “recovery or recoupment” raises the issue of whether the section can be applicable in the absence of an accrual or receipt. It is therefore important, as a starting point to consider the meaning, and interpretation of the provisions of the relevant section – s 8(4) (a) of the Act.

¹ 50 SATC 117

This paper gives a discussion on Section 8(4)(a) in the context of *Omnia Fertilizer Ltd v C:SARS*². This paper is going to discuss, inter alia, the scope, purport and application of the general recoupment provision as espoused in the decisions of the courts.

² (2003) 65 SATC 159

2 INTERPRETATION – THE GENERAL RECOUPMENT PROVISION

A general recoupment provision was introduced for the first time as Section 11(4)(a) of the Act of 1941.³ As noted by the court in *Mooreesburg Produce Company Ltd vs. CIR*,⁴ the words “recover” or “recoup” carry a very wide meaning. The ordinary meaning of the word “recoup” attest to the fact that it is of very wide import. The word may mean “to receive an equivalent for”, to ‘make up for’.⁵ The same word is also interpreted to mean “to return as an equivalent for; reimburse”.⁶ Put simply, “recoup” has been taken as meaning “to regain a former favourable position.”⁷

The above notwithstanding, it is also critical to ascertain the meaning of the words/phrase within the context of the Act.⁸ It is trite that Section 8(4) (a) requires the inclusion, in a taxpayer’s income, of amounts allowed as a deduction or allowance that is later recovered or recouped. By this requirement, the general recoupment provision effectively neutralizes that deduction,⁹ and so denies a taxpayer the benefit of the deduction or allowance.

The application of the provisions of s 8(4)(a) must be clearly understood, and one has to apply his mind to the scheme and the language of the Act so as to comprehend the intention of the legislature.

2.1 Application of the Provisions

It should also be noted that Section 23(c) of the Act also works to deny a taxpayer a deduction of an expense or loss recoverable under any contract of insurance, guarantee etc. It mirrors the tax treatment of a taxpayer who has an unconditional contractual right as at the date of an expense or

³ Act No. 31 of 1941

⁴ (1946) 13 SATC 245 at 252

⁵ Free Online Dictionary - <http://www.thefreedictionary.com/recoup> [22.12.09]

⁶ Ibid

⁷ Ibid

⁸ Gerrie Swart *Recoupments, Accounting Practice and Income Tax Principles* (2003) Merc LJ at 464

⁹ Ibid

loss to recover it from somewhere.¹⁰ To determine whether any deduction is allowable in respect of such expense the taxpayer is required to bring into account the said benefit.¹¹ Accordingly no recoupment or recovery arises upon the recovery of such expense or loss.

It is submitted that the provisions applies where a taxpayer becomes entitled, after the incurral of an expense or loss, to recover or recoup it, whether such entitlement arises during the incurral year or later.¹² It has thus been noted that the scope and purpose of section 8(4) (a) is clear if it is juxtaposed with Section 23(c)¹³ – denying a deduction in respect of an expense and neutralizing a deduction in respect of an expense that is later recouped or recovered have one aspect in common, *viz*, they allow the deduction of an expense or loss, for tax purposes, only if the taxpayer incurring the expense or loss ultimately bears it.¹⁴ This point was echoed in *ITC 699*¹⁵ where a taxpayer who had sold its business argued that the sale of its business was a capital transaction that could not therefore be subject to the provisions of the then section 11(4) of Act 31 of 1941 which constituted the recoupment provision. The court held, *inter alia*, that it was immaterial that the recoupment arose out of capital transaction and that the recoupment provision was intended as ‘a method of adjusting over allowances.’¹⁶ This principle mirrors the proposition that an amount is recognized as an accrual if it is an accrual for that person’s benefit.¹⁷ (Emphasis is mine)

However, in *ITC 559*¹⁸, the court made a very important point about the operation of the general recoupment provision. The taxpayer in that case had sold a Studebaker car which had been used in connection with his business, and in respect of which the Commissioner, in determining his taxable income for the previous year of assessment, had allowed 74 pounds as an allowance for

¹⁰ s 23(c) of the Act.

¹¹ Swart G, *supra*

¹² Section 8(4)(a) of the Act

¹³ Swart, *supra* at 465

¹⁴ *Ibid*

¹⁵ 17 SATC 98

¹⁶ 17 SATC 98 at 104

¹⁷ Emslie et al (2001) *Income Tax Cases and Materials* at p 30 also *Geldenhuis v CIR* 1947 (3) SA 256 (C), at 266

¹⁸ 13 SATC 306

depreciation. The taxpayer on the sale of the car realized a profit of 104 pounds and the Commissioner treated the amount as representing part of the amounts allowed to be deducted in a previous year of assessment recouped or recovered by the taxpayer in terms of the then recoupment provision of the Income Tax Act, 1941. The taxpayer's argument in the court was that the profit made was a capital sum and that the profit he had made was due to extraneous circumstances, viz, market exigencies. The court clearly pointed out that '[t]he Act simply provides that if appellant *is recouped in amounts which have been previously deducted, it does not say how they are recouped*¹⁹, then the amounts which have been allowed shall be included in the taxpayer's income'.²⁰ As for the argument that the profit was a capital accretion, C.J. Ingram, K.C., just noted that the Act makes no provision for extraneous circumstances, "*[i]t simply says that if in these circumstances a profit is made, the Commissioner shall apply this system.*"²¹ (Emphasis added)

The court's comments in *ITC 559* about the Act's treatment of extraneous circumstances in determining a recoupment are very critical for tax planners. In essence these findings by the court rang the warning bell to tax payers to put their agreements correctly so as not to fall foul of the recoupment's provisions. In the above case, the taxpayer argued that the Commissioner, in looking at the taxpayer's profit made on the sale of an asset in respect of which a deduction had been previously granted, should take into account the effect of elements like the nature and condition of asset (presumably the reasoning that some assets tend to command a better price than others) as well as other factors like the prevailing market conditions in determining the overall price fetched on the market. According to the court, these extraneous factors are irrelevant for the purpose of the recoupment provision – the taxpayer's argument was inclined

¹⁹ The remarks of the court in *ITC 559* are very interesting especially in light of the interpretation adopted by the Supreme Court of Appeal in *Omnia Fertilizer's* case. The court in *ITC 559* pointed out that Act simply provides that if appellant *is recouped in amounts which have been previously deducted, it does not say 'how they are recouped, then the amounts which have been allowed shall be included in the taxpayer's income.*' It is clear that the court pressed on the bare literal interpretation of the words "recoup". It thus becomes easy to understand that the South African courts have inclined towards a literal interpretation of the provisions. If one looks at *ITC 559* closely, the attitude of the courts in construing the provisions of Section 8(4)(a) becomes more than clear.

²⁰ 13 SATC 306 at 307

²¹ 13 SATC 306 at 308

towards apportionment of the profit between the so-called market exigencies and the deduction previously allowed. The court then made it overwhelmingly clear that the Act simply concerns itself with “recoupment” of amounts previously deducted, and that it makes no provision for extraneous circumstances. It was clear in this case that courts²² may be bending towards applying the literal meaning of the provisions – leaving the taxpayer with the task of arranging its affairs prudently to avoid tax inefficient arrangements.

It is clear from the foregoing that taxpayers must engineer their agreements in a tax efficient manner to minimize tax payable under the recoupment provisions. It should always be borne in mind, as pointed out in *Moorresburg Produce Company Ltd v CIR*²³, that the words “recouped or recovered” are interpreted widely. It became abundantly clear that courts generally interpret the provisions literally and broadly in ITC 565.²⁴ In that case the taxpayer attempted to influence the court to take into consideration, in including the profit he made in selling a hotel as a recovery or recoupment, the value of goodwill. The taxpayer was of the view that the profit realized on the sale of the hotels represented the value of goodwill and that no profit had been realized on the assets other than fixed property i.e. that all of his profits was monopolised by the value of the goodwill. In rejecting this argument, the court pointed out that it had to *‘look to the contract itself...and go by the contract of sale.’*²⁵ (Emphasis mine)

The above discussion is clear testimony that taxpayers must stand astute in drafting their contracts or handling commercial affairs. Be that as it may, one should always bear in mind that the question whether or not there had been a recoupment, and if so, in what amount, is of course

²² This finding is anchored very well in the Supreme Court of Appeal’s finding in *Omnia Fertilizer’s* case. In the latter case, the Supreme Court of Appeal Finding the amounts to have been recouped within the meaning of s 8(4)(a), in a unanimous decision the Supreme Court of Appeal concluded that the amounts in question had for all practical purposes reverted to the taxpayer’s ‘pocket’, noting that the provision had to do with the recoupment of amounts, not the extinction of liabilities. The legislature, the court noted, wished to ensure that if the deduction of expenditure was once allowed, a taxpayer should not escape taxation if alleged expenditure was not to be expenditure after all, whether or not liability was legally terminated.

²³ 13 SATC 245

²⁴ 13 SATC 330

²⁵ 13 SATC 330 at 331

a question of fact. It was pointed out by Galgut J in *ITC 1678* (confirmed with approval in *Pinestone Properties CC v C: SARS*) that it is doubtless fair to say that a recoupment can only be said to have occurred if there is sufficient close connection between the repairs on the one hand, and on the other, the proceeds of the event giving rise to the alleged recoupment, for instance, a sale.²⁶ As the tax consequences of a sale agreement will depend on the way the agreement is structured, it of utmost importance that potential buyers and sellers of a business and fixed property to which deductions have been allowed, familiarize themselves with the ensuing tax implications.²⁷ It has been cautioned that it is critical in any sale transaction that the purchase price should be rather allocated or apportioned between the different items of the business sold.²⁸ This point is particularly echoed in *ITC 565*²⁹ where the court pointed out that:-

“There is not a word in this contract about any portion of the price being attributable to any goodwill, and even if it is considered possible to attribute any value to the goodwill, it seems to us, on the figures put before us, to work out to no figure at all. As I have said, we must look at and go by the contract of sale. That contract is silent as to goodwill; therefore, we must look to the consideration what it was paid for, and to the conditions of sale. Our conclusion is reading the conditions of sale, which are not to be varied by any evidence that the purchaser has paid for what is stated in the contract to be paid. We are, therefore, of the opinion that the Commissioner was perfectly correct when he regarded the said amounts of £958 and £397 as being depreciation recouped on the sale of the assets, namely, depreciation previously made for wear and tear, and subsequently recouped on realisation, and adding back these amounts in terms of sec 11(4) of the Act.” (Emphasis mine)

The above decisions notwithstanding, it had remained largely unclear in South Africa how the courts would treat, for purposes of section 8(4)(a), amounts that are written back to a business' income (for accounting purpose only) even though they are still owed to creditors. It has thus

²⁶ 62 SATC 288 at 292

²⁷ Lynette Olivier (2007) *Tax Implications of the Sale of a Business* South African Law Journal Volume 123 Issue 3 at 600

²⁸ Ibid

²⁹ *ITC 565* (13 SATC 330) at 331

been quite clear for most tax planners how the general recoupment provision operated in cases where, for instance, a business/business asset has been sold in respect of which allowances had been previously granted by the Inland Revenue – it would be clear that a recoupment would arise. However, the application of Section 8(4)(a) to amounts still owed to a creditor written back to income in the business' books has been a contentious issue until the Supreme Court of Appeal had occasion to deal with it in *Omnia Fertilizer (Pty) Limited v Commissioner for South African Revenue Service*.³⁰

³⁰ 65 SATC 159

3 OMNIA FERTILIZER (PTY) LTD V COMMISSIONER SOUTH AFRICAN REVENUE SERVICE

3.1 The Facts of the Case

In the tax years preceding 1991 the taxpayer had purchased raw materials` and raised the costs as expenditure incurred in the production of income even where creditors had not issued invoices. In each case, the appropriate expenditure account would be debited and a holding account called “received but not invoiced” would be credited. When an invoice arrived, the amount would be transferred from the holding account to that of the creditor. When certain of the creditors for these purchases failed to submit invoices, the taxpayer would reverse the debits from the holding account to the income account over two years. During the years 1991 to 1994 the taxpayer annually wrote back to income amounts of between R1 million and R 2.2 million. When the Commissioner for the South African Revenue Service included these amounts in the taxpayer’s gross income, the taxpayer objected on the grounds that its mere accounting treatment of them did not render them receipts, accruals, recoveries or recoupments within the meaning of the Act.

3.2 The Issues relating to Section 8(4)(a)

The taxpayer contended that so long as the indebtedness still existed in law, there could be no recoupment. The debts in question had not yet prescribed – it pointed out that a recoupment cannot depend solely on the actions or the subjective decisions of the taxpayer; that the principle is similar to that applicable to accruals – what is required for the recoupment of an expense is proof that a taxpayer will never actually have to pay it. It was further argued on the taxpayer’s behalf that there cannot be a recoupment or recovery of an expense previously deducted merely by reason of the taxpayer’s expectation that it will probably never be called upon to pay a debt where the legal liability giving rise to an allowable deduction still exists.

Apart from the above arguments, the taxpayer also raised a controversial point. It pointed out that the insertion in the Act in 1997 of section 8(4)(m) of the Act³¹ by the legislature had always intended a recoupment as necessarily involving the extinction of a liability. The taxpayer was therefore of the view that its mere accounting treatment of amounts still owed by it at the end of the tax years in question could not turn the amounts involved into ‘recoveries’ or ‘recoupments’ in terms of section 8(4) (a) of the Act.

As a starting point, the court expressed the view that the words “recoup or recover” carry a very wide meaning, and that nothing in the relevant section or its context compels a court to give it a restricted interpretation.³² It was also the court’s sustained view that the Act simply links taxability to the recovery or recoupment of an amount previously allowed as a deduction.

The court, not surprisingly, did not view the introduction of section 8(4) (m) as indicative of the legislature’s intention that a recoupment presupposes the extinction of legal liability. It pointed out that the insertion of the section in the Act in 1997 also signifies that the termination of legal liability is not a requirement for a recoupment to occur. According to the court, the critical question is not whether a debt has for some reason ceased to exist; a debt also ceases to exist on payment, and not only on prescription. It pointed that if a debt ceases to exist before payment occurs; even then there may not be a recoupment until the taxpayer takes some or other step to recoup. This observation by the court is considered to be of utmost importance to financial planning. The court clearly articulated that what is to be considered as a recoupment for the purposes of section 8(4) (a) is not necessarily the extinction of a liability but it is what a taxpayer may do by an overt act. In the instant case, the taxpayer had written back the amounts still owed to a creditor as income. Such action – and nothing more, is taken by the courts as an express signification by the taxpayer that it had ‘recouped’ an amount previously allowed by SARS as a deduction.

³¹ In terms of which a taxpayer who is relieved from the obligation to pay an expense in respect of which a deduction has been allowed, is deemed to have recouped or recovered the amount of it.

³² At 162 ff

In delivering the judgment of the court Howie P stated that section 8(4) (a) of the Act had to do with recoupments of amounts, not the extinction of liabilities. He also made an important observation that:-

“Where unpaid expenditure has been allowed as a deduction from taxable income there is not just an expenditure entry in the taxpayer’s books of account reflecting the relevant debt. There is, in addition, an assertion by the taxpayer, accepted and acted upon by the Commissioner, recognizing the likelihood, if not the inevitability that the debt will not be paid... *If the taxpayer in effect erases the debt from its books and treats the amount concerned as available for another purpose, the questions which arise are: Whether the debt has for some reason ceased to exist and, if not, whether the amount unpaid, but expended in the eyes of tax law, has nevertheless, for all practical purposes, reverted back to the taxpayer’ pockets.*” (Emphasis is mine)

The taxpayer was of the view that (a) was the essential question, whereas the court found (b) to be the crucial inquiry, and that the decision in *ITC 1634*³³ had been correct. The court found that even assuming that the relevant entries *per se* did not effect recoupments of expenditure; the facts compelled the conclusion that the taxpayer, in writing back the debts, had admitted that they had in effect been recouped.

It appeared from the Howie P’s judgment, that he was to some extent influenced some decisions of by similar decisions given by the Special Income Tax Court in *ITC 1634*³⁴ and *1704*³⁵.

3.4 Related Cases

3.4.1 Income Tax Case 1634:

The taxpayer, a shipping and forwarding, and clearing agent, was held to be taxable on amounts owing for services rendered to it, but which had never been invoiced by the creditor. *Wunsh J* in

³³ (1997) 60 SATC 235

³⁴ (1997) 60 SATC 235

³⁵ (2001) 63 SATC 258

the Transvaal Special Court found that there had been a recoupment of expenditure incurred, despite the fact that the creditor had not even raised invoices. The court found that section 8(4) (a) of the Act applied to the amounts not invoiced. In doing so, the special court rejected the contention of the taxpayer that no amounts had accrued as required by the income tax definition of gross income and that the credits were merely accounting entries.

It is quiet curious to note that the judgment by Howie P in the Supreme Court of Appeal (Omnia Fertilizer case, *supra*) was based on more or less similar reasoning as adopted by the Transvaal Special Court on almost similar facts.

3.4.2 Income Tax Case 1704

In this case, the taxpayer was a transport broker concluding contracts for the carriage of goods with customers and then subcontracted the work. The taxpayer invoiced the customer who paid for the carriage and in turn paid the carrier. Its practice was to pay carriers only on receipt of an invoice. The carrier sometimes, through some administrative error, neglected to send an invoice to the taxpayer. However, these debts became due as services had been rendered by the carrier but three years later the prescriptive period ran out. In the year of assessment ended 29 February 1992 contractors let claims worth R55 735 prescribe and in the year of assessment ended 28 February 1993 they lost in this way R166 975. The Commissioner contended that the benefit which appellant enjoyed by treating the debts as extinguished was taxable because it was a recoupment as envisaged by section 8(4) (a) of the Act. Conradie J also assumed that the treatment of the prescribed debts in the taxpayer's books of account had the effect of extinguishing them. It was however, not immediately clear from the judgment of Conradie J to what extent it was based on the findings in *ITC 1634*. *ITC 1704* is, however, distinguishable from *ITC 1634* on the facts – the debts in *ITC 1704* had prescribed, and also that in the latter case, the court accepted the principle that a taxpayer cannot change its fiscal liability merely by the manner in which he keeps his internal accounts.³⁶

³⁶ *ITC 1704* at 263G-H

The above statement by Conradi J that one cannot alter tax liability by the manner internal accounts are kept needs some qualification in light of *Omnia Fertilizer* where the court observed that even assuming that accounting entries *per se* do not effect recoupment of expenditure, the facts compelled the conclusion that the taxpayer, in writing back the debts, had admitted that they had in effect been recouped.

The foregoing is a clear testimony that the “fiscal liability and accounting entries” debate has been dragging on for quite a long time, and the question whether an amount still owed to a creditor can be ‘recouped or recovered’ for tax purposes’ has brought serious confusion among taxpayers who, perhaps, thought that the Act does not give recognition to unrealized profits and losses as well as conditional rights and obligations.³⁷

³⁷ See discussion below at 4

4 TAX TREATMENT OF PROFITS AND LOSSES, UNCONDITIONAL RIGHTS/OBLIGATIONS – INCOME TAX ACT

It appears that the taxpayer's argument in *Omnia Fertilizer*³⁸ that a court can only concern itself with deductions permissible in terms of the Act and not those made in the taxpayer's books of account was influenced by the notion that the Act only recognises unconditional rights and obligations, and does not, inter alia recognise unrealised profits and losses. It is submitted that this reasoning by the taxpayer might have been influenced by the decision in *Commissioner South African Revenue Service v Pinestone Properties*.³⁹ The judgment in the above court is implicit authority for the view that a recoupment presupposes an accrual or a receipt.⁴⁰

In that case, the taxpayer purchased a commercial property for the purpose of letting it and earning rental income. After a fire, it identified certain additional non-fire related repairs that needed to be undertaken. The taxpayer completed the repairs at a cost of R626 519 and looked for tenants for the property, but was not able to let the property. It subsequently sold the property at a capital profit a few months after the repairs had been effected. The Commissioner assessed the taxpayer, including in its taxable income a recoupment of the repairs of R626 519 previously claimed as a deduction, on the basis that section 8(4)(a) recoupment provision refers to a recoupment of all amounts previously deducted under section 11 to 20 of the Act. The Commissioner was of the view that part of the purchase price represented a recoupment of the expenditure incurred on repairs previously claimed.⁴¹ This argument by the Commissioner was undoubtedly premised on previous court decisions holding that the mere disposal of an asset for more than the sum of the original purchase price and the cost of the repair represented a recoupment.⁴²

³⁸ *supra*

³⁹ 63 SATC 421

⁴⁰ Olivier L, *Recoupments: The Facts are Decisive, not the Law* Stellenbosch Law Review (2004) Vol.1 p.160 at 2.2

⁴¹ *Ibid*

⁴² See ITC 1467 52 SATC 28 at 31

The court in *Pinestone Properties* expressed the view that it did not necessarily follow that whenever an asset was sold for more than its historic cost, a recoupment arises. It pointed out that where a non-cash allowance is granted in respect of an asset, it is reasonable to treat the allowance as being recouped when the asset is sold for more than the written down value, but the situation would be completely different when the deduction involved is actual cash expenditure. Applying the ordinary meaning of the words “recovered or recouped” the court held that a recoupment did not take place on the facts as the price at which the property was sold did not amount to the taxpayer “getting back” expenditure previously incurred and deducted for tax purposes.⁴³ Had cash been expended on the repairs a recoupment would only arise where the Commissioner, apart from the fact that the asset had been sold for a price in excess of its historic value, can prove that an amount previously deducted for income tax purposes had been recovered or recouped.⁴⁴

The court held that the Commissioner had the onus to prove a recovery or a recoupment.⁴⁵ The court *a quo* took this to mean that the Commissioner must prove that a greater price had been realized for the property than would have been the case had the repairs not been effected.⁴⁶ The Commissioner could not discharge the burden of proof, so the case turned to the taxpayer’s favour. The court, however stressed the point that its decision did not mean that the cost of repairs can never be recouped – a recoupment will ordinarily arise, for example, where a taxpayer recovers damages for defective or negligent workmanship from a builder or where an insurance company pays the cost of the repairs.⁴⁷

Despite the implicit authority in *Pinestone Properties* case that a recoupment presupposes an accrual or a receipt⁴⁸, it is submitted that the decision in *Omnia Fertilizer* case, *supra* lays to rest

⁴³ At 427B-F

⁴⁴ At 427H

⁴⁵ At 426E-427A

⁴⁶ See ITC 1678 62 SATC 288 at 293 D-E

⁴⁷ At 427H-J. It is however questionable whether the expenditure incurred would have been deductible as Section 23(c) of the Act prohibits the deduction of expenditure which is recoverable under a contract of insurance.

⁴⁸ Olivier L (2004) p.160

the principles to be applied in determining whether or not a recoupment has arisen. It should however, be pointed out that Pinestone Properties case gives a valuable contribution to the issue of who bears the onus to prove the existence of a recoupment.

The question of who bears the onus to prove a point in any proceedings is very pivotal to the success of any legal question before the courts, and this aspect is considered below.

5 THE BURDEN OF PROOF IN SHOWING EXISTENCE OF RECOUPMENT

The court in *Omnia Fertilizer* appears to have confused the application of the question of onus. Without even giving a comment on the findings in *Pinestone Properties CC* in which it was clearly stated that the onus was on the Commissioner to prove a recoupment, the court just said that a taxpayer was required to prove that the Commissioner was wrong in including an amount as a recoupment in gross income.⁴⁹ This approach is confusing in view of the court's findings in *CIR vs. Butcher Brothers*⁵⁰ that the Commissioner had the onus to prove the existence of an 'amount'. In view of this position, the more acceptable interpretation is that the remarks made by the court related to the onus to rebut the evidence placed before the court by the Commissioner. This interpretation is in accordance with the acceptable view that the primary onus to prove the existence of a recoupment is on the Commissioner.⁵¹

It is submitted that the findings of the Natal High Court in *Commissioner South African Revenue Service v Pinestone Properties CC* are not very helpful in determining the question whether an amount still owed to a creditor can be 'recovered or recouped' for tax purposes in circumstances where the taxpayer writes it back to income for accounting purposes. It is however underpinned that the *Pinestone Properties CC* decision is very instrumental in restating the issue of who shoulders the burden of proof in these circumstances – the Commissioner shoulders the burden of proof in accordance with the principles enunciated in *CIR v Butcher Brothers*⁵² case.

What remains to be reviewed is the issue raised in *Omnia Fertilizer* about the effect of section 8(4) (a) on the variation/termination of a contractual obligation or legal liability.

⁴⁹ Olivier, supra at pg 162 para 2.3

⁵⁰ (1945) AD 301

⁵¹ Olivier at pg 164 para 3

⁵² (1945) AD 301

6 VARIATION OF AN OBLIGATION – EFFECT OF SECTION 8(4)(a)

A variation (or waiver, release) of an obligation affects the extent to which an obligation initially recognised as a deduction will be borne by the taxpayer. It is trite that such a situation results in a realised gain or entitlement equal to the amount by which the previously recognised legal obligation has been reduced. The amount of that legally recognised reduction clearly qualifies as a recoupment. The same principles must be found to apply in cases of a debt prescribed.

In *ITC 1704*, *supra*, Conradie J assumed that the treatment of prescribed debts in the taxpayer's books of account had the effect of extinguishing them.⁵³ With all respect for the learned judge, this was unjustified approach to prescribed debts and the concomitant recoupment. It is, however, important to note that the court in this case, unlike *ITC 1634* and *Omnia Fertilizer* cases, accepted the principle that a taxpayer cannot change his fiscal liability merely by the manner in which he keeps his internal accounts.⁵⁴ Conradie J referred to the fact that the debtor (taxpayer) involved may still successfully have to invoke the defence of prescription in order to extinguish the obligation. It is submitted that this approach is untenable since debts do not prescribe by the invocation of this defence by a debtor but by operation of law. A debtor in respect of whom a liability has prescribed cannot be treated differently from a holder of an unconditional right.

The taxpayer in *Omnia Fertilizer* argued that the introduction of section 8(4) (m)⁵⁵ indicated that the legislature had always intended the extinction of a legal obligation recognised as an expense

⁵³ At 261C- D

⁵⁴ At 263G-H

⁵⁵ Section 8(4)(m) provides that where a debtor is released from the obligation to pay a debt that has been previously deducted for income tax purposes, a recoupment will arise. It is submitted that s 8(4)(m) deals with the interrelationship between sections 8(4)(a) and section 20. Put simply, where a company has an assessed loss at the end of its tax year, the provisions of section 20(1)(a)(ii) must be considered. In this regard, when there is a compromise or concession with creditors as a result of which the taxpayer receives a benefit, the balance of the assessed loss is to be reduced by the amount of the benefit, and where the amount of the compromise has been applied to reducing the balance of assessed loss, the remaining balance, if any, would be subject to the provisions of section 8(4)(m). The section will apply as there has been a waiver from an obligation to make payment of

before a recoupment arises. The court was at pains to accept this point. Instead, it pointed out that release from a debt is not entailed in the ordinary meanings of “recovered or recouped”. Howie P had this to say:

“Termination of liability is not itself a recoupment. It merely enables a recoupment. If anything the new paragraph detracts from the [taxpayer’s] argument because it signifies that ordinarily the termination of legal liability is not a requirement for recoupment. There was therefore a need for the inserted paragraph to introduce the deemed meaning.”

What is implicit in the above statement is that the termination of liability ‘is not itself a recoupment [but merely] enables recoupment’ is that a taxpayer must *take some other step* to recoup the amount of the liability that has fallen away.⁵⁶ The court apparently justified the view on its earlier findings that an unpaid debt is recognised as an expense on the basis of an assertion by the taxpayer, accepted and acted upon by the Commissioner recognising the likelihood that the debt will be paid, and that such expense is recouped if the taxpayer ‘in effect erases the debt from its books and treats the amounts concerned as available for another purpose’.⁵⁷ By saying this the court suggested that the resultant saving will only be taken as a recoupment once the taxpayer has recognised it as such in its books of account. Thus the conventional approach that a recoupment should arise only if a legally enforceable benefit accrues to the taxpayer as a result of a change in the legal relationship between the taxpayer and its creditors has to be revisited in view of the court’s recent findings in *Omnia Fertilizer* case.

expenditure actually incurred and such expenditure was previously allowed as a deduction in the current or previous year of assessment. In terms of section 8(4)(m), such person is deemed to have recovered or recouped an amount equal to the amount of the obligation from which the person was so relieved or partially relieved during the year of assessment in which the person was so relieved or partially relieved. Put differently, the amount of a compromise benefit that has been taken into account in reducing the taxpayer’s balance of assessed loss will not also be included as a taxable recovery or recoupment. However, where the value of the benefit, as explained above, exceeds the assessed loss, then only can the excess be taxable as a recovery or a recoupment.

The the insertion of section 8(4)(m) puts its it beyond debate that where a debtor is fully or partially released from the obligation to pay a debt which had previously been deducted for income tax purposes, a recoupment arises.

⁵⁶ Swart, G (2003) at 3.2.5

⁵⁷ *Omnia Fertilizer (Pty) Ltd v Commissioner, South African Revenue Service* at 163G-H)

7 CONCLUSION

In *Omnia Fertilizer*, not only did treatment of the amounts for accounting purposes indicate a recoupment, but a witness also testified that the taxpayer would in all likelihood never be called upon to pay the debts. As a result, from a factual point of view, the amount was recouped, although not from a legal point of view – the court in this regard pointed out that even assuming that the relevant entries *per se* did not effect recoupments of expenditure; the facts compelled the conclusion that the taxpayer, in writing back the debts, had admitted that they had in effect been recouped.⁵⁸ It is, however, submitted that what influenced the court the more in holding that the amounts had been recouped was the accounting treatment of the amounts i.e. treatment of the amounts as income. Taxpayers should be astute in the way they manage their accountys and should avoid willy-nilly writing back of amounts still owed to inept creditors until the prescriptive period runs out.⁵⁹

A question that arises in respect of the *Omnia Fertilizer* case is whether, if the creditors later invoiced the taxpayer in a year subsequent to which the recoupment took place, the taxpayer would be entitled to claim a deduction in that year. It is submitted that the question has to be answered in the negative. Expenditure can be deducted only in the year in which it is actually incurred and not in the year in which it is actually paid. It is not clear from the reported judgment whether this point was ever canvassed before the court. It is submitted that the legislature could consider reviewing this aspect in light of the decision of the court in *Omnia fertilizer*.

Olivier⁶⁰ argues that the decision in *Omnia Fertilizer* may also in future present a challenge with regard to the court's view that legal principles should be ignored completely in judging whether a recoupment has arisen. In doing so, the courts left the doors wide open for amounts to be recouped although legally a taxpayer may still be called upon to pay them.

⁵⁸ Olivier L, (2004) p.165

⁵⁹ *Ibid*

⁶⁰ *Ibid*

It is clear from the foregoing that taxpayers must stand astute in drafting their contracts or handling commercial affairs –always bearing in mind that the question whether or not there had been a recoupment, and if so, in what amount, is of course a question of fact. In this regard the accounting treatment of an amount is of the utmost importance, if not decisive. It is has been put beyond debate in *Omnia Fertilizer* that unless evidence to the contrary exists, once, from an accounting eye, the amounts have been recouped, the courts will hold a similar view, irrespective of whether these amounts are still legally outstanding.⁶¹

⁶¹ *Ibid*

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