

**Startups in South Africa, Barriers to Growth and Opportunity
through Unconventional International Structures**

by

TIMOTHY PETER KELLY

KLLTIM004



Minor dissertation submitted in accordance with

the requirements for the degree of

MASTER OF LAWS (LLM)

at the

University of Cape Town

June 2022

Word count: words 27 460

Supervisor: Professor Jacqueline Yeats

Minor dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Master of Laws (LLM) in approved courses and a minor dissertation. The other part of the requirement 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 dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Timothy Peter Kelly

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source.

The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

Contents

Chapter 1: Introduction.....	5
1.1 Introduction	5
Chapter 2: Understanding what a technology startup is and why they would consider financially immigrating from South Africa	8
2.1 South African technology startups and their challenges	8
2.2 South African startups in comparison to startups elsewhere in Africa and the world 11	
2.3 The reasons why early-stage companies may consider basing their companies offshore.....	12
2.4 An early-stage company’s journey in South Africa	13
2.5 What is an international structure and how to create one?	13
Chapter 3: Restrictions and Relaxations on the Loop Structure	15
3.1 Historical view of the loop structure	15
3.2 Relaxation of the Loop Structure Restriction:	21
3.3 Revised legal framework around the loop structure in practice and market opinion on the relaxed regulations:	27
Chapter 4: Navigating the interplay between transfer pricing, tax residency and intellectual property in the context of setting up a mirror structure.....	31
Chapter 5: Tax Residency: Controlled foreign companies and foreign business establishment	36
5.1 Tax considerations in the context of international structuring	36
5.2 Place of effective management	37
5.3 The OECD	39
5.4 Interpretation of POEM:.....	39
5.5 Consideration of the factors which determine the POEM	43
5.7.1 Head Office.....	43
5.7.2 Delegation of authority:	44
5.7.3 Board	45
5.7.4 Modernisation and global travel	46
5.7.5 Shareholders	47
5.7.6 Limitation of authority:	49
5.7.7 Operational management versus broader top-level management	50
5.7.8 Legal factors	50
5.7.9 Economic nexus.....	51
5.7.10 Support functions	51
5.6 POEM conclusion.....	51

5.7	Controlled foreign companies	52
5.8	Exceptions to the CFC rules	53
Chapter 6: Intellectual Property and anchoring it to an offshore entity		56
6.1	Intellectual Property Strategy and the barriers to moving Intellectual Property offshore.....	57
6.2	The evolving nature of IP.....	59
6.2.3	Economically significant functions.....	60
6.2.4	Use of assets.....	61
6.2.5	Bearing the commercial risk	62
6.3	Arms-length arrangements between Connected Parties	64
6.4	Contractual Framework.....	65
6.5	Introduction to Transfer Pricing	66
Chapter 7 – Transfer Pricing Considerations		68
7.1	Arm’s length principle	70
7.2	Principles of Comparability.....	72
8.2.1	the characteristics of the goods and services	73
8.2.2	the relative importance of functions performed	73
8.2.3	economic and market conditions	74
8.2.4	business strategies	75
8.3	Acceptable methods for determining an Arm’s Length Price	76
8.4	Recap and application to early-stage technology companies.....	77
Chapter 8 – Looking forward: Legislative reform and the mirror structure		79
8.1	South African Venture Capital Association and their recommendations	79
8.2	The mirror structure	81

Chapter 1: Introduction

1.1 Introduction

Based on the hypothesis that conventional loop structures are not entirely accessible to early-stage South African companies due to the tax consequence which is triggered when setting these structures up, this paper will explore, as an alternative to the loop structure – the mirror structure, and how the same ultimate objectives can be achieved by focusing on the relevant rules which govern tax residency, creation of intellectual property and commercial transactions between related entities.

This paper will consider from an early-stage company perspective, considerations which are relevant when deciding whether to domicile in South Africa, or abroad, as well as the considerations relevant to moving from South Africa to an offshore jurisdiction. This paper will further discuss the economic barriers which exist in the world of an early-stage company based in South Africa, and how these barriers affect the likelihood of success of an early-stage company, including the challenge of access to investment, access to market, as well as the social, economic and political risks which exists in South Africa.

The abovementioned factors which will be discussed in more detail, have resulted in South African companies considering different ways of moving their headquarters to an offshore jurisdiction. The objective in doing so is multifaceted and will be unpacked through-out this paper, however in simple terms the goal is to enable the company to operate from a foreign jurisdiction of ones choosing, retain hard currency and claim ownership of intellectual property created by the foreign entity in the offshore jurisdictions.

Most of the assets of an early-stage technology company are typically intellectual property, which can be accessed anywhere in the world. However, if a South African entity intends to transfer ownership to an offshore entity, the intellectual property must however be transferred on an arm's length basis at a market related price to the new offshore entity. For an early-stage company, paying this amount to fund the exportation of intellectual property is often an insurmountable hurdle, and raising investment only to use it to pay the South African entity is likely to be unpalatable to a potential investor.

This paper will consider the loop structure and the various legislative developments around its implementation from a South African perspective, and why setting up the loop structure is not entirely accessible to early-stage South African companies. Previously, the conventional loop structure was restricted by Regulation 10(1)(c) of the Exchange Control Regulations, 1961. Regulation 10(1)(c) states that: *‘no one may enter any transaction whereby capital or any right to capital is directly or indirectly exported from South Africa, except with permission from Treasury and in accordance with any conditions Treasury may impose.’*¹ In a loop structure, the foreign entity would reinvest the authorised funds back into South Africa, either directly or indirectly (via another offshore entity), thereby creating the loop. The reinvestment could be in the form of acquiring South African shares, assets or loan accounts. In some instances, South African resident would export returns on the investment by way of, for example, the payment of dividends, profits, interest and/or loans to the foreign structure. The result of the loop structure is that the investment from the offshore structure into South Africa and the payment of dividends, profits or interest offshore results in the accumulation of value in the foreign jurisdiction over and above the value of the initial investment made in the foreign entity.

Loop structures have, up until recently, only been allowed to the extent that South African individuals are permitted to own a 40% interest in an offshore entity. As a result, these structures were permitted only in very limited circumstances, in addition, South African resident individuals were prohibited from establishing offshore trusts with South African resident discretionary beneficiaries or other offshore structures to acquire the 40% ownership in the offshore entity.

In January of 2021, the South African Reserve Bank (“SARB”) issued the Exchange Control Circular No.1/2021, which effectively lifted the restrictions on loop structures pertaining to individuals, companies and private equity funds that are tax resident in South Africa. The purpose of this is to support South Africa’s growth as an investment and financial hub for Africa and to encourage inward investments into South Africa.

An alternative international group structure to the loop structure, is the mirror structure, which relies on a synthetic bonding of shares between two separate

¹ Currency and Exchanges Manual for Authorised Dealers - <https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/general-public/Currency%20and%20Exchanges%20Manual%20for%20Authorised%20Dealers.pdf>

companies based in different jurisdictions and in its simplest form will have identical shareholding in South African and the foreign entity. Each shareholder would then only be entitled to transact with their shares if they conclude identical transactions in respect of both the South African entity and the offshore entity. This ultimately results in two separate but related entities existing in South Africa and in the foreign jurisdiction, and thus an international group.

This paper will consider the current legislative framework relevant to the commercial arrangements between connected parties based in different jurisdictions, which includes considerations around intellectual property, exchange control and transfer pricing – and how, through proper navigation of the legislative framework, it is possible to legitimately achieve the same result as a loop structure would by using a mirror structure. This can be done by satisfying the prescribed requirements to achieving a foreign tax residence, foreign business establishment and creating intellectual property independently of the South African.

In the following chapters this paper will consider the functions and rules which regulate how a company's place of effective management is determined and established in a foreign jurisdiction. It considers how intellectual property is treated by SARS in the context of moving assets offshore – which is effectively the process of accounting for the exchange in value which is transferred when a company moves out of the South African tax base. This exchange tax is based on the principle that value which is created within South Africa's jurisdiction should be accounted for to the South African Revenue Service. Therefore, when moving an asset (i.e.. *Intellectual Property*) to an offshore jurisdiction, SARS will expect to be remunerated for the value which was contributed by individuals based in South Africa.

Finally, this paper will conclude with a chapter around the current legislative landscape in South Africa and ongoing efforts toward creating a healthier Startup ecosystem.

Chapter 2: Understanding what a technology startup is and why they would consider financially immigrating from South Africa

2.1 South African technology startups and their challenges

There are an estimated 2.4 to 3.4 million formal and informal small, medium and micro enterprises (“SMMEs”) in South Africa², representing 98% of all registered businesses³. The Small Enterprise Development Agency (Seda) reports⁴ that formal and informal SMMEs employed a large number of South Africa’s workforce in 2018: 6.4 million jobs were held in these enterprises⁵. At the time the labor force was made up of a population 16.5 million⁶, and SMMEs employed almost 39% of workers.

Within this large group is a subset called high-growth SMMEs. These are unique businesses that are expected to reach scale in a relatively short period and often create valuable IP. High-growth SMMEs are commonly supported by VC investors.⁷

High-growth SMMEs are central to government’s ambition to position SA as a leader in this new era. They operate at the cutting edge of inventing new technologies and commercialising innovations and are fundamental to ensuring the country remains globally competitive.⁸

Data from Seda⁹ shows that as a group, SMMEs employ almost as many people as large firms, and are more likely to create new jobs compared to large or listed firms. Two independent studies by Intellidex¹⁰ on these companies support the notion that

²FinFind Inaugural South African SMME Access to Finance Report 2018/2019-
<https://www.accesstofinancereport.co.za/pdf/SA-SMME-Access-to-Finance-Report-2017-FINAL-VERSION-FOR-RELEASE-on-10-July-2018.pdf>

³ Ansara, D. & Dimant, T., 2019. Macro Review: *Open for business: A review of the SMME landscape in South Africa*. Centre for Risk Analysis and FinFind’s Inaugural South African SMME Access to Finance Report from 2019.

⁴ Small Enterprise Development Agency (SEDA), Annual Report 2018/2019.

⁵ SMME Employment figures: Small Enterprise Development Agency (SEDA), Annual Report 2018/2019.

⁶ *Amending exchange controls for high-growth SMMEs to support SA’s growth ambitions*, circulated by the South Africa Venture Capital Association (“SAVCA”)

⁷ Ibid.

⁸ Ibid.

⁹ Small Enterprise Development Agency (SEDA), Annual Report 2018/2019, available at URL:

<http://www.seda.org.za/Publications/Publications/SEDA%20Annual%20Report%202019%20Final%20Document%20Sent%20to%20parliament.pdf>

¹⁰ <https://www.intellidex.co.za/>

SMMEs make important contributions to job creation. The South African Venture Capital Association (“SAVCA”) Impact Study 2020¹¹ reported that firms supported by private investments grew their employee base by 22%, compared to 3% by JSE-listed firms. The study also showed that these companies improved innovation, with 64% of portfolio companies reporting that the speed of innovation improved as a result of the investment. Another report on entrepreneurship examined 25 high-growth firms that had created more than 360,000 jobs since their launch. High-growth SMMEs are therefore significant job creators and innovators and key focus areas to improving both employment and productivity in the economy. They cannot attain these significant outcomes without the support of VC investors.¹²

A startup, which forms part of the SMME cohort of businesses, is known as a business in the form of a company, a partnership or temporary organization designed to search for a repeatable and scalable business model. These companies, generally newly created, are in a phase of development and research intended for high growth markets. The term “startup” became popular internationally during the dot-com bubble when a great number of dot-com companies were founded. Due to this background, many consider startups to be only technology companies, but as technology is becoming a normalised business factor, the essence of startups has more to do with innovativeness, scalability and growth.

According to Investopedia which provides a comparably general definition, a startup is a company in the first stages of operations. Startups are founded by one or more entrepreneurs who want to develop a product or service for which they believe there is demand. These companies generally start with high costs and limited revenue, which is why they look for capital from a variety of sources such as venture capitalists.¹³

For purposes of this paper, the focus will be on early-stage technology companies, which will broadly be referred to as “startups” or “early-stage” technology companies, and which are assumed to have the bulk of their value existing in the form of intellectual property which can be accessed and operated globally. This paper will

¹¹ <https://savca.co.za/wp-content/uploads/2020/03/SAVCA-2020-Private-Equity-and-Venture-Capital-Impact-Survey.pdf>

¹² Supra note 7.

¹³ <https://www.investopedia.com/terms/s/startup.asp>

further discuss notion of ownership of intellectual property and how to achieve this in a legitimate and demonstrable fashion.

Startups generally face similar challenges navigating the growth curve, which are only exacerbated by the environmental barriers which exist in South Africa. Before a Startup can become revenue positive it needs to develop a product or service, engage in marketing and sales, legally formalize the business and scale. To achieve this at a level of magnitude (which is often the goal of most early-stage technology companies), the company will need access to an international market and capital investment. Both aforementioned opportunities (access to market and capital at scale) are generally situated offshore, and international investors are generally unwilling to invest their foreign currency into South African startups. As a result, early-stage companies are being forced to move their companies offshore to a jurisdiction which is supportive of their growth and where it can access investment.

To achieve the desired scale and pace of growth, high-growth businesses require a set of features in their environment: access to markets, access to business development support, and access to finance. Their needs change at different stages of their life cycle but all three features are provided in some measure by investors who very often play an active role in the business and get involved in directly supporting founders in growing companies to achieve these needs.¹⁴

High-growth SMMEs have enjoyed their highest levels of investment from South African VC investors, and the increased levels of investment can be attributed to initiatives and government policies such as Section 12J, amended in 2015, however, not all the Section 12J capital raised was invested into VC, but it did result in increased investment in the asset class. Venture capital refers to financing from investors for businesses in the startup and early growth phases. Investors determine that these businesses have long-term, high-growth potential, and tend to make investments in the form of equity and the risk is typically high for investors.

¹⁴ Supra note 7.

2.2 South African startups in comparison to startups elsewhere in Africa and the world

Llew Claasen¹⁵ stated in a recent article on Finance24, that South Africa has the most developed startup ecosystem in Africa – he mentioned that the region also produces more new startups every year than its African peers. However, and regrettably, over the course of the last decade, South Africa has increasingly attracted proportionately less funding for its startups than its peers Kenya and Nigeria.¹⁶

In 2020, Kenyan startups raised \$191 million in funding, Nigerian startups raised \$150 million in funding and South African startups raised \$142 million (approximately R2 billion). When Nigeria first attracted more startup funding than South Africa a few years ago, Llew argues that South Africans could blame it on the ascendancy of the Nigerian economy, whose intention is to become the largest in Africa and its larger population, however shortly afterwards, Kenya attracted more startup funding than South Africa and at the time of publishing that article, Egypt was also on the verge of doing so (2021).¹⁷

Out of that group of African peers, South Africa is the only country to have not yet produced a “unicorn” - a fast growing, young technology business with a valuation of more than \$1 billion.¹⁸

As an investor in African startups himself, Llew admits that his investments depict the same trend – which indicate that investment in South Africa is lagging behind. In the last two years his fund, Newtown Partners, has invested in two Nigerian startups, one Kenyan startup, one Ghanaian startup, one Tunisian startup, one Egyptian startup and no South African startups.

Unsurprisingly then, South African startups are starting to base themselves in a different jurisdiction, where venture capital funding is more accessible and in abundance and the opportunity for growth is good. Common factors which exist in

¹⁵ Llew Claasen is the managing partner of Newtown Partners, a venture capital firm founded by him and Vinny Lingham. The firm invests globally in early-stage, emerging technology and disruptive business model startups. Views expressed are his own.

¹⁶ Claasen, L (2021) “Why exchange controls are still strangling South Africa’s startup ecosystem, News24, 17 September 2021. Available at <https://www.news24.com/fin24/opinion/opinion-why-exchange-controls-are-still-strangling-sas-startup-ecosystem-20210917>

¹⁷ Ibid.

¹⁸ Ibid.

these foreign jurisdictions include stable economies, tax incentives and subsidies, all of which are geared toward creating a thriving eco-system for early-stage companies.

2.3 The reasons why early-stage companies may consider basing their companies offshore

In most cases, startup founders will look to build their business in a jurisdiction which improves their future prospects of attracting investment or a potential acquirer of the business.¹⁹

In addition to the above, early-stage companies in South Africa have a number of barriers to contend with, which include (but are not limited to) *political instability, weak currency and currency fluctuation, emerging market risks, legislative instability, and lack of access to an international market*. Another core deterrent includes the complexity around bringing foreign investment into the country and obtaining acceptance by the South African Reserve Bank – which can be an expensive and complicated process.

An additional reason for a startup to offshore their business might be that a potential investor requires it. In this common scenario, the investor who has the funds, as well as access to networks, connections and active guidance, may be based in Silicon Valley, London or somewhere similar and require as part of the investment, that the startup be incorporated and effectively managed in that offshore jurisdiction, along with any valuable intellectual property.

Similarly, a potential acquirer of the company may require the startup to offshore its business. In this scenario, the assumption is that the company's future buyer is going to require as a condition to their investment that the essential value of the company be based offshore. In the case of a high growth early-stage technology company, the essential value is likely to be intellectual property which is developed in the form of software and code. This is easily accessible in foreign jurisdictions but remains legally owned and therefore located in South Africa.

Having regard to an early-stage company's growth strategy, often the market is based offshore or internationally. As a South African resident, the founders and the company

¹⁹ Dommissie, A, 2018, "The ins and outs of taking your startup offshore", Ventureburn 27 November 2018, available at URL: <https://ventureburn.com/2018/11/taking-business-offshore/>

will need to repatriate all foreign currency earned from offshore clients within a certain period if the company remains a South African tax resident.²⁰

Venture Capitalists can be further broken down into domestic and foreign venture capital investors. For businesses to expand globally, they need investors with a lot of capital, access to bigger markets and who can enable high-growth SMMEs to expand through their networks and expertise. South African investment alone is generally unable to support high-growth SMMEs to achieve scale. This is where international venture capital investors play a fundamental role in supporting high-growth South African SMMEs.²¹

2.4 An early-stage company's journey in South Africa

Adrian Dommissie²², who is the founding partner of Dommissie Attorneys, a boutique law firm which specialises in the venture capital and private equity industry mostly assisting high growth technology based companies, said in an article in response to the challenges faced by early-stage South African technology companies, that “the only real solution available to a small, high growth technology company becomes depressingly clear: The simplest, lowest cost and most effective course of action is to set up a new, offshore business, then to divert their business growth initiatives into the offshore business (which raises future funding) and then stagnate the growth of the South African business over time”.

In this paper consideration is given to the fundamentals associated with setting up a new offshore business which can utilise the existing value created by the South African Company and continue to build on that value by creating intellectual property which is independent from the South African company and the South African tax base.

2.5 What is an international structure and how to create one?

²⁰ Dommissie, A, 2018, “The ins and outs of taking your startup offshore”, Ventureburn, 27 November 2018, available at URL: <https://ventureburn.com/2018/11/taking-business-offshore/>

²¹ *Amending exchange controls for high-growth SMMEs to support SA's growth ambitions*, circulated and spearheaded by the South Africa Venture Capital Association (“SAVCA”)

²² <https://dommissieattorneys.co.za/>

An international structure comprises a group of companies which are spread across multiple locations and ensures the attention of the top management towards developing a holistic and unified approach to international operations. Such a structure facilitates cross-product and cross-geographic co-ordination and reduces resource duplication.

International structuring is illustrative of the goal to set up an international group of companies, ideally with the holding company based in a jurisdiction with political and legal certainty, as well as network and market opportunities for growing the company. Where the founders of a startup are based in South Africa, conventionally this structure would be established by the founders incorporating a company in the offshore jurisdiction, with the offshore company purchasing the shares in the South African company from the founders – thus creating a conventional loop structure. This results in a structure where the founders own a foreign company which owns the South African company (and potentially other subsidiaries around the world).

In the next chapter, this paper will discuss the development of the legislation which governs loop structures, demonstrating the legal uncertainty which has become inherent to South Africa, and unfortunately also permeated the international perception of inward South African investment. This negative perception has forced early-stage companies to reconsider their options around where to base themselves. In the following chapters this paper will dismantle the elements which contribute to the concept of an international group structure, and explores how startups can legitimately achieve an alternative structure which achieves the same purposes by adhering to international standards which govern the creation of intellectual property and the principles which dictate (through the need to participate) international exchange control and transfer pricing.

Chapter 3: Restrictions and Relaxations on the Loop Structure

3.1 Historical view of the loop structure

From a South African perspective, a loop structure is formed when an exchange control resident, being a natural or juristic person based in the common monetary area (the “**CMA**”) holds an investment in a foreign vehicle (i.e. a non-resident entity), which then holds an investment in and/or makes loans to an entity within the CMA. The CMA consists of South Africa, Lesotho, Eswatini, and Namibia (the “**loop structure**”).²³ The loop structure is a popular corporate structure as it is well understood by both founders and investors globally. The loop structure is favoured because of the holding company and subsidiary relationship which is created – this is the conventional ownership structure, with only one entry point and it therefore creates immediate common ground within the venture capital and private equity space between investors and investee, an already higher risk market, as it reduces the perceived risk for the investor and therefore facilitates a more efficient, less complicated investment process.

The South African Reserve Bank’s Financial Surveillance Department (“**FinSurv**”) describes the loop structure in a policy document that was released on 17 November 2016 titled “Exchange Control Special Voluntary Disclosure Programme policy dealing with ‘loop structures’ (including 74/26 structures)” (the “**Policy Document**”)²⁴. This document sets out FinSurv’s policy regarding the regularisation of loop structures in terms of the exchange control special voluntary disclosure programme that was in place between 1 October 2016 and 31 August 2017.²⁵

According to the Policy Document, “Loop Structures entail the formation by a South African resident of an offshore structure which, by reinvestment into the Republic,

²³ Macdonald-Spence, N, 2020, “Loop Structures – what are they and why do they matter”, Spence Law, 20 October, available at URL: <https://www.spencelaw.co.za/post/loop-structures-what-are-they-and-why-do-they-matter#:~:text=WHAT%20IS%20A%20LOOP%20STRUCTURE,an%20entity%20within%20the%20CMA.>

²⁴ Integritax, 2016, Special Voluntary Disclosure Programme: Tax and Exchange Control Relief, November 2016, Issue 206, available at URL: https://www.saica.co.za/integritax/Archive/Integritax_Nov_2016_Issue_206.pdf

²⁵ Botha, L, 2018, “Crossing Borders: The not-so-golden loop structure”, Cliffe Dekker Hofmeyr, 17 August, available at URL: <https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-17-august-crossing-borders-the-not-so-golden-loop-structure.html>

acquires shares, loan accounts or some other interest in a South African resident company or a South African asset²⁶. The Policy Document adds that transactions creating loop structures contravene, the Regulations²⁷, specifically citing Regulation 10(1)(c) of the Exchange Control Regulations, 1961²⁸ (the “**Regulations**”). Regulation 10(1)(c) states that no person shall, except with permission granted by the National Treasury (the “**Treasury**”) and in accordance with such conditions as the Treasury may impose, enter any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic.²⁹ These restrictions are further extended to apply to any intellectual property being transferred by South Africans by way of sale, assignment or cession and/or the waiver of rights in favour of non-residents in whatever form, directly or indirectly – this is not permitted without the prior written approval of the South African Revenue Bank, except where it has been specifically exempt in the AD Manual.

It follows then, that South African residents cannot utilize funds or any other authorized foreign assets to enter into a transaction or a series of transactions, where the purpose and/or effect is to export capital directly or indirectly from South Africa.³⁰

The Treasury’s goal is to promote economic development, good governance, social progress and rising living standards through accountable, economic, efficient, equitable and sustainable management of South Africa's public finances. From a shallow analysis, there may be rationale for restricting the free movement of private capital out of the South African tax base, however having regard to the current global commercial atmosphere, these provisions may be an unsustainable attempt at addressing the goal.

²⁶ Supra note 25.

²⁷ Exchange Control Regulations, 1961 as promulgated by Government Notice R.1111 of 1961-12-01, as amended from time to time.

²⁸ Ibid.

²⁹ Botha, L, 2018, “Crossing Borders: The not-so-golden loop structure”, Cliffe Dekker Hofmeyr, 17 August, available at URL:

<https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-17-august-crossing-borders-the-not-so-golden-loop-structure.html>

³⁰ Subban, V and Da Silva, D, 2021, “South Africa: Removal of prohibition of “loop structures” – don’t forget to check the tax consequences”, Baker McKenzie – Export Control, 5 February, available at URL: <https://www.globalcompliancenes.com/2021/02/05/south-africa-removal-of-prohibition-of-loop-structures-dont-forget-to-check-the-tax-consequences-15012021/#:~:text=As%20noted%20above%2C%20the%20removal,the%20South%20African%20tax%20base.>

The Policy Document describes how a loop structure could be created and its potential consequences (as well as the obvious drivers for its restriction), and provides an example (repeating to some extent the description provided above), which states that if a South African resident individual, trust or corporate entity transfers authorised or unauthorised funds (which could also be existing offshore funds or a combination thereof) from the Republic to set up, a foreign trust or foreign entity (authorised funds are those foreign funds held in a manner that does not contravene the Regulations), then, the foreign trust or entity involved would directly or indirectly (via another offshore entity) reinvest its authorised or unauthorised funds in the Republic, thereby creating a loop structure. The reinvestment could be in the form of South African shares, assets or loan accounts being acquired or created. The South African resident could in some instances thereafter export returns made on the South African investment by way of, amongst other things, the payment of dividends, profits, interest and/or loans to the foreign structure. The result of the loop structure is that the investment of funds from the offshore structure into the Republic and the payment of dividends, profits or interest offshore results in the accumulation of value over and above the nominal foreign investment that was initially made.³¹

This illustrates how Loop Structures can have the effect of reducing South Africa's tax base and could reduce any taxes that the offshore company would have to pay in South Africa. To protect against this, it was legislated that the Treasury's permission is required, along with any conditions which the Treasury may impose, in order to enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic (i.e. loop structures). The Regulations and the Policy Document only refer to the "Republic", however the prohibition against creating loop structures applies to the reinvestment into all countries forming part of the CMA³².

As mentioned above, Regulation 10(1)(c) states that transactions which result in the export of capital from the Republic may only be entered into with the permission of the Treasury and on such conditions as the Treasury may impose. In terms of the AD

³¹ Integritax, 2016, Special Voluntary Disclosure Programme: Tax and Exchange Control Relief, November 2016, Issue 206, available at URL:

https://www.saica.co.za/integritax/Archive/Integritax_Nov_2016_Issue_206.pdf

³² Currency and Exchanges Manual for Authorised Dealers -

<https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/general-public/Currency%20and%20Exchanges%20Manual%20for%20Authorised%20Dealers.pdf>

Manual, Treasury means, in relation to any matter contemplated in the Regulations, the Minister of Finance or an officer in National Treasury who, by virtue of the division of work in National Treasury, deals with the matter on the authority of the Minister of Finance. Loop structures may therefore only be created where certain circumstances exist under and where the Treasury has given its permission for the certain transaction to take place.³³

The AD Manual contains the permissions and conditions that apply to transactions in foreign exchange that may be undertaken by Authorised Dealers and/or on behalf of their clients in terms of Exchange Control Regulation 2(2), which details the related administrative responsibilities as well as the Financial Surveillance Department's reporting requirements – the AD Manual must be read in conjunction with the Regulations. Authorised Dealers are therefore given the authority to permit certain transactions without referring to the Treasury, provided such transactions are “pre-approved” under the AD Manual.³⁴

These exceptions include, firstly, under section B.2(B) of the AD Manual, that a loop structure is permitted where a South African resident has created an unintentional loop structure, by investing with non-resident asset or fund managers who invest in foreign companies that have CMA assets, or in offshore global investment funds that hold CMA investments (directly or indirectly) over which the South African investor has no control. It is important to keep in mind that the South African investor must have made the investment after taking the invested funds abroad legally.³⁵ This would not apply to startups who might want to create a loop structure.

Secondly, in terms of sB.2(F) of the AD Manual, South African technology, media, telecommunications, exploration, and other research and development companies may establish an offshore company to raise foreign funding for their operations, subject to certain conditions. These conditions include registering with FinSurv and ensuring that the established offshore company is a tax resident in South Africa. Such companies may hold investments and/or make loans into South Africa, even though the

³³ Botha, L, 2018, “Crossing Borders: The not-so-golden loop structure”, Cliffe Dekker Hofmeyr, 17 August, available at URL:

<https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-17-august-crossing-borders-the-not-so-golden-loop-structure.html>

³⁴ South African Reserve Bank, “Authorised Dealers”, available at URL:

<https://www.resbank.co.za/en/home/what-we-do/financial-surveillance/authorised-dealers>

³⁵ Supra note 33.

investment or loan would create a loop structure³⁶. However, that company must also operate as a South African tax resident, be incorporated and effectively managed and controlled in South Africa. In addition, the intellectual property of the company must remain registered in South Africa - but may be assigned offshore (subject to the appropriate tax treatment).³⁷ This doesn't solve the issue for early-stage technology companies whose aim it is to retain international revenue which is earned from an international market in the offshore company. This exemption allows for foreign funds to be raised in a foreign company, however the foreign company is deemed to remain a South African tax resident (which investors are unlikely to accept), and the South African startup (which would become a subsidiary of the foreign company) still remains a South African Tax resident and cannot move the intellectual property overseas. Practically, this would likely trigger a red flag to an investor as the foreign company which they are investing in cannot directly hold the value inherent in the company – being the intellectual property.

Third, in terms of sB.2(A) of the AD Manual, a South African company was (being the position prior to the most recent circular which is discussed in the following chapters) permitted to acquire up to 40% equity and/or voting rights, whichever is the higher, in a foreign market entity, which may in turn hold investments and/or make loans into any CMA country. This dispensation does not apply to foreign direct investments where the South African company on its own or where several South African companies collectively hold an equity interest and/or voting rights in the foreign target entity that exceed 40% in total. Loop structures that exceeded the 40% threshold required FinSurv approval with due consideration to transparency, tax, equivalent audit standards and governance. Previously the position under the exchange control regulations was that a South African company could not hold an interest in the foreign entity exceeding 20%. Then the increase to a maximum of 40% interest that may be held was announced in the 2018 Budget and was set out in Exchange Control Circular No. 5/2018, was released on 21 February 2018.³⁸ This exception was also not particularly helpful to startups because they would likely have triggered the threshold

³⁶ Ibid.

³⁷ Exchange Control Regulations, 1961 as promulgated by Government Notice R.1111 of 1961-12-01, as amended from time to time.

³⁸ Botha, L, 2018, "Crossing Borders: The not-so-golden loop structure", Cliffe Dekker Hofmeyr, 17 August, available at URL:

of 40% immediately due to their ownership stake exceeding 40%, and therefore would become reliant on FinSurv approving the Loop Structure in any case. Dependency on regulatory compliance is generally considered a deterrent for startups as continuous engagement requires time and money to fund professionals who are required to assist – time and money are two resources which startups do not have a lot of.

Ancillary to the above, is the consideration of the sale or transfer of intellectual property – the AD Manual further provides under Regulation B.2(A)(iii) that Authorised Dealers may approve the outright sale, transfer and assignment of intellectual property by South African residents, excluding mandated state owned companies as defined in Schedule 2 of the Public Finance Management Act, 1999 (Act No. 1 of 1999), to unrelated non-resident parties at an arm's length and a fair and market related price, provided Authorised Dealers view the sale, transfer or assignment agreement and an auditor's letter or intellectual property valuation certificate confirming the basis for calculating the sale price.

This is not applicable to the startup scenario because, by establishing a loop structure, the offshore company and the startup would be considered connected parties and therefore could not transfer the intellectual property to the offshore company without special permission. If by good fortune a startup were able to obtain permission for an excess shareholding over the 40% threshold, it must still overcome the hurdle of compliance with the requirement of “an arms-length and fair and market related price” which would be payable as consideration for the transfer of intellectual property between the entities (notwithstanding the fact that they are connected).

On a practical level, this effectively means that founders of the company would need to navigate either of the following two routes for transferring the intellectual property to the offshore company:

- without investment the founders would need to fund the offshore company to make the purchase on an arms-length basis at a fair and market-related price, however this is unlikely as founders of an early stage company are unlikely to have that amount of capital readily available, or
- if they were able to obtain investment into the offshore company, they would need to transfer a portion equal to the fair market value of the investment (as the investment would be based on the value of the intellectual property) – this

could be a stumbling block with an investor, as those funds are likely earmarked to fund new market opportunities available to offshore company, and not for the Startup based in South Africa.

There is an alternative to the above, which deals with the evolution of intellectual property, thereby avoiding the legislative framework which regulates the transfer of intellectual property, as there is no transfer of intellectual property – this is considered in more detail in the following chapters.

If the startup is unable to get special permission, or cannot fund the transfer of the intellectual property, the third option to still function as an international group would be to licence the intellectual property to an offshore company in order to allow the offshore company to commercialise it - this requires compliance with Regulation B.2(A)(iv) of the AD Manual.

Under Regulation B.2(A)(iv) of the AD Manual Authorised Dealers are authorised to approve the licensing of intellectual property by South African residents to non-resident parties at an arm's length and a fair and market related price for the term of the agreement, provided Authorised Dealers view the licence agreement and an auditor's letter confirming the basis for calculating the royalty or licence fee. Pursuant to any transaction under B.2(A)(iv) of the AD Manual, all royalties and/or fees emanating from such transactions must also be repatriated to South Africa within a period of 30 days from the date of becoming entitled thereto and reported under category 201 on the FinSurv Reporting System³⁹. Further, the sale, transfer, assignment and/or licensing of intellectual property is subject to appropriate tax treatment. This would not be a good long-term solution for the startup as any foreign entities created would be wholly reliant on the South African entity licencing the intellectual property to the offshore company in order to properly function. If the licencing of intellectual property is pursuant to the exploration of new markets for growth, there could be a significant portion of revenue generated internationally, which in terms of Regulation B.2(A)(iv) of the AD Manual is required to flow back to South Africa for purposes of compliance with the rules around repatriation of funds.

3.2 Relaxation of the Loop Structure Restriction:

³⁹ Regulation B.2(iv)(a) of the Currency and Exchanges Manual for Authorised Dealers

To re-cap, a loop structure entails the formation by a South African resident of an offshore structure which, by reinvestment into the Republic, acquires shares, loan accounts or some other interest in a South African resident company or a South African asset.

As recently as January 2021 it became official that the loop structure prohibition is no more, after the release of Exchange Control Circular 1/2021⁴⁰ (“**Circular**”) by the South African Reserve Bank (SARB) on 4 January 2021.

In terms of the Circular, “in order to support South Africa’s growth as an investment and financial hub for Africa, it is advised that the full ‘loop structure’ restriction be lifted to encourage inward investments into South Africa”. The loop structure restrictions have accordingly been changed to remove the requirement of South African tax residency of the offshore holding company, and foreign holding companies can now loan and fund their South African subsidiaries.⁴¹

The Circular, amongst other things, amends sections B.2(B)(i), B.2(C)(i)(f), B.2(C)(ii)(e) and B.2(G) of the AD Manual. These sections deal with the loop structure prohibition applicable to South African individuals, companies and private equity funds. Where these persons were previously only allowed to hold up to a 40% interest, collectively with other South African residents, in an offshore entity, this limitation will no longer apply.⁴²

With particular relevant to this paper, section B.2(B)(i) is copied and discussed below:

“Resident individuals, companies and private equity funds with authorised foreign assets may invest in South Africa, provided that where South African assets are acquired through an offshore structure (a loop structure), the investment is reported to an Authorised Dealer as and when the transaction(s) is finalised. The aforementioned party also has to view an independent

⁴⁰ Exchange Control Circular 1/2021, available at URL: <https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/financial-surveillance-documents/2021/1-2021.pdf>

⁴¹ Domisse, Adrian, 2021, “Exchange Control Loop Restrictions Lifted”, LinkedIn, 9 January, available at URL: <https://www.linkedin.com/pulse/exchange-control-loop-restrictions-lifted-adrian-domisse/?trackingId=HLKUEb3WV5J9jsosTbuEpQ%3D%3D>

⁴² Botha, Louis, 2021, “Prohibition no more: Loop structure rules amended and related considerations”, Cliffe Dekke Hofmeyr, Tax and Exchange Control Alert, 22 January, available at URL: <https://www.cliffedekkerhofmeyr.com/en/news/publications/2021/Tax/tax-and-exchange-control-alert-22-january-prohibition-no-more-loop-structure-rules-amended-and-related-considerations-.html#:~:text=A%20loop%20structure%20entails%20the,or%20a%20South%20African%20asset.>

auditor’s written confirmation or suitable documentary evidence verifying that such transaction(s) is concluded on an arm’s length basis, for a fair and market-related price.”⁴³

Previously the loop structure was only permitted to the extent that the South African shareholders could hold up to 40% of the shares in the foreign entity, whereas in terms of the most recent Circular, a 100% ownership by South Africans is permitted provided that the company reports the investment to an Authorised Dealer and pays a fair and market related price.

This means (at a minimum and similarly to the original position) that the offshore company must purchase the shares in the startup and must pay the fair market price for the shares, which could be expensive. For example, if a startup has previously raised funds from investors at a valuation of R10million, then this will be the valuation at which Startup’s shares would logically need to be sold to the new offshore company in order to establish the target structure. In this case however, those funds would be paid to the shareholders directly as they are the holders of the shares, and South African shareholders would then be required to pay capital gains tax on their gain – which is not the intended outcome by any means as the investor would want those funds in the holding company. This poses another potential stumbling block for investors, because it means that a significant portion of funds raised by the offshore company will go straight to existing shareholders, and those shareholders will effectively be partially exiting.⁴⁴ This clearly isn’t the intention and isn’t a viable option, unless the investor is comfortable to allow the founders to walk away with that capital amount.

The annual progress report which must be submitted to FinSurv via an Authorised Dealer could also pose a potential risk to negotiations, as offshore investors would

⁴³ Botha, Louis, 2021, “Prohibition no more: Loop structure rules amended and related considerations”, Cliffe Dekke Hofmeyr, Tax and Exchange Control Alert, 22 January, available at URL: <https://www.cliffedekkerhofmeyr.com/en/news/publications/2021/Tax/tax-and-exchange-control-alert-22-january-prohibition-no-more-loop-structure-rules-amended-and-related-considerations-.html#:~:text=A%20loop%20structure%20entails%20the,or%20a%20South%20African%20asset> and Exchange Control Circular 1/2021, available at URL: <https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/financial-surveillance-documents/2021/1-2021.pdf>

⁴⁴ Domnisse, Adrian, 2021, “Exchange Control Loop Restrictions Lifted”, LinkedIn, 9 January, available at URL: <https://www.linkedin.com/pulse/exchange-control-loop-restrictions-lifted-adrian-domnisse/?trackingId=HLKUEb3WV5J9jsosTbuEpQ%3D%3D>

likely be perplexed as to why SARB should be entitled to transparent reporting into operations, shareholding, or funding, of the offshore company.⁴⁵

The details of what information should be included in the annual progress report has not been finally confirmed by SARB, however industry knowledge and bank opinion suggests that the annual progress report should include the following (open list):

- the name(s) of the South African affiliated foreign investor(s);
- a description of the assets to be acquired (including inward foreign loans, the acquisition of shares and the acquisition of property);
- the name of the South African target investment company, if applicable;
- the date of the acquisition as well as the actual foreign currency amount introduced including a transaction reference number.⁴⁶

In addition to the above, all pre-existing unauthorised loop structures (i.e. created prior to 1 January 2021) and/or unauthorised loop structures where the 40% shareholding threshold has been exceeded (created prior to 1 January 2021), must still be regularised with FinSurv.

One of the major industry concerns in this regard is that South African's go about setting up an offshore company only to find that it falls under new and different SARB regulations down the line - putting off investors and potential acquirers.

Another concern expressed by Adrian Dommissie in his article titled "*Exchange Control Loop Restrictions Lifted*"⁴⁷ is that startups react to the good news by setting up a loop structure or amending their current structure, only to be told down the line that the relaxation of the loop restriction has been retracted. The whole idea behind international structures is to build very profitable businesses offshore, mitigating the political, social, legal and economic risks existing in South Africa. If South African startups succeed in doing that, there may be a risk that SARB could introduce regulations that require some of that profit to be taxed in South Africa? There is

⁴⁵ Dommissie, Adrian, 2021, "Exchange Control Loop Restrictions Lifted", LinkedIn, 9 January, available at URL: <https://www.linkedin.com/pulse/exchange-control-loop-restrictions-lifted-adrian-dommissie/?trackingId=HLKUEb3WV5J9jsosTbuEpQ%3D%3D>

⁴⁶ Maitland Fund Services, 2021, "South African Exchange Control – relaxation of loop structures <https://www.maitlandgroup.com/intouch/march-2021/private-clients/south-african-exchange-control-relaxation-of-loop-structures/>

⁴⁷ Ibid.

precedent, as SARB already requires “excess profits” held in offshore subsidiaries to be paid out as dividends, in certain circumstances.⁴⁸

If the holding company is properly set up and acquires all the shares in the South African company, it is still a requirement that the holding company must be effectively managed in the offshore jurisdiction to be a tax resident there. Which in summary means that all corporate decisions need to be taken and demonstrated to have been taken offshore. Otherwise, the holding company could be regarded as a South African tax resident.⁴⁹

In addition, even though the holding company may achieve foreign tax residency, if it is majority owned by South African residents, it will be considered a controlled foreign company (“CFC”). This means the South African shareholders could pay tax in South African on their portion of the offshore company’s profit by falling foul of the exemption under Section 10(B)2. Section 10(B)2 provides that a shareholder of a CFC which has its foreign business establishment in the foreign jurisdiction need not pay dividends tax on income declared in the foreign entity.⁵⁰ This principle is discussed in more detail in the following chapters but in summary means that it has to have sufficient offices, equipment and personnel that can legitimately run that business in the foreign jurisdiction.

Another issue to consider after the new holding company is established, is that if the holding company has a foreign business establishment, and if it earns revenue from “tainted IP” (i.e. IP developed by related parties in South Africa), then the profit related to the tainted IP may still be taxed in South Africa, in the hands of South African shareholders.⁵¹

It is for this reason that the continued development and innovation of relevant IP must take place when introducing an international structure so that the new IP based offshore can be separate and therefore avoid South African taxation broadly on the profits of the company, and only remain accountable for the tax attributable to income resulting from the IP which still remains in South Africa (ie. legacy IP).

⁴⁸ Domnisse, Adrian, 2021, “Exchange Control Loop Restrictions Lifted”, LinkedIn, 9 January, available at URL: <https://www.linkedin.com/pulse/exchange-control-loop-restrictions-lifted-adrian-domnisse/?trackingId=HLKUEb3WV5J9jsosTbuEpQ%3D%3D>

⁴⁹ Ibid.

⁵⁰ Section 10(B)2 of the Income Tax Act 58 of 1962.

⁵¹ Ibid.

Despite the above, there are also some exchange control rules that still remain in place and that need to be complied with where an investment is made into an offshore structure. As applicable to individuals, the remaining rules regarding the foreign investment allowance, is limited to R10 million per year still apply. This dispensation may be used for any legitimate purpose (including for investment purposes abroad as well as the sending of gift parcels in lieu of cash excluding gold and jewellery) at the discretion of the individual without any documentary evidence having to be produced to the Authorised Dealer.⁵²

In the case of South African companies, the remaining rules regarding the foreign investment allowance for investments below and above R1 billion per year, as contained in section B.2(C) of the AD Manual still apply.

This means that in practical terms, where a company wishes to make use of this allowance to invest offshore, it will still require prior approval from an authorised dealer or FinSurv, depending on the nature and terms of the investment.⁵³ Furthermore, the investment into an offshore structure that invests into South Africa will now potentially create an additional reporting requirement. This is because under the Circular any approved investment made under the foreign investment allowance is subject to a requirement that an annual report must be submitted. It is not yet clear whether the annual reporting requirement applicable to the loop structure (as set out in sections B.2(C)(i)(f) and B.2(C)(ii)(e) of the AD Manual) can be combined with the existing annual reporting requirement applicable to offshore investments.⁵⁴

In the case of private equity funds, the remaining rules regarding investing offshore will still apply, including the requirement that private equity funds that are members of the South African Venture Capital Association, mandated to invest outside the CMA, may only do so with FinSurv's prior approval.

⁵² South African Institute of Professional Accountants, 2019, "Part 1 – Taking money out of RSA – Reserve Bank Processes", Bringing Accounting to life, available at URL: https://www.saipa.co.za/wp-content/uploads/2019/10/SAIPA_Taking_money_out_of_the_country.pdf

⁵³ Brincker, Emil, *et al*, 2021, "Tax & Exchange Control Alert", Cliffe Dekker Hofmeyr publication, available at URL: <https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2021/Tax/Downloads/Tax-Exchange-Control-Alert-22-January-2021.pdf>

⁵⁴ *Ibid*.

3.3 Revised legal framework around the loop structure in practice and market opinion on the relaxed regulations:

As of January 2021, SARB announced a lifting of the loop restrictions, which had up until that point prevented South Africans from setting up an offshore holding company for their South African businesses.

Llew Classen explained in an article written for Finance24⁵⁵ that the loop structure is particularly important in the context of startup investing because international startup investors often prefer to contract under legal regimes that they're familiar with and where their investor protections are known.⁵⁶

The major barrier which is particularly prevalent in the world of a startup founder is that it is anticipated that under the exchange control rules, sufficient capital must be available in the foreign structure to allow it to pay the requisite sum of money for the South African shares (which in most cases have already established significant value), where those shares are sold by exchange control resident parties. On this basis, it is only possible to create a loop structure using funds that are legitimately outside of the country (i.e. through legal channels). Individual investors are still subject to the annual permissible allowances which were discussed above, which means that even if the founders had sufficient capital available to fund the transfer of intellectual property and shares to the holding company (unlikely), accessing the funds to facilitate the move may prove difficult and applications to the SARB for specific arrangements may be necessary.⁵⁷

So, although the loop structure is permitted, in practice the offshore company is actually required to buy out the local shareholders at a market related value, thus creating a tax event for existing shareholders that is not linked to a true exit and a capital requirement from new investors that creates no value.⁵⁸

⁵⁵ Claasen, L (2021) "Why exchange controls are still strangling South Africa's startup ecosystem, News24, 17 September 2021. Available at <https://www.news24.com/fin24/opinion/opinion-why-exchange-controls-are-still-strangling-sas-startup-ecosystem-20210917>

⁵⁶ Ibid.

⁵⁷ Bowman Gilfillian, 2021, "South Africa: *Loop structures – opening possibilities in private equity*", IFLR1000, 19 March, available at URL: <https://www.iflr1000.com/NewsAndAnalysis/South-Africa-Loop-structures-opening-possibilities-in-private-equity/Index/12144>

⁵⁸ Claasen, L (2021) "Why exchange controls are still strangling South Africa's startup ecosystem, News24, 17 September 2021. Available at <https://www.news24.com/fin24/opinion/opinion-why-exchange-controls-are-still-strangling-sas-startup-ecosystem-20210917>

Llew additionally mentions in his article that there is a lingering risk, for which precedent exists, that if the startup is successful in setting up the loop structure, SARB may in the future tax profits in the offshore structure.⁵⁹ This is a particularly concerning point, as it is evidence from an investor point of view, that there is a real lack of trust in SARB.

Llew further discussed the fact that the IP transfer exchange control issues centre on the need for the startup's intellectual property to be held in the offshore entity to ensure that international startup investors can contract in familiar jurisdictions with strong investor protections. This is driven by an experienced forecast that when the time comes for the investors to sell the startup (or "exit"), then housing the IP in the offshore entity ensures that there is no risk that the IP cannot be transferred to the buyer. If the intellectual property remains with the South African startup, this risk will always permeate investor and buyer consideration.

In South Africa, although the regulations allow you to petition SARB to transfer intellectual property internationally, it takes a long time for them to consider your request and in many cases, experience has indicated that SARB will not grant startups permission. IP created by a startup in South Africa can almost never be transferred to an offshore entity unless it is through an arms-length transaction at fair market value with an unrelated party. Transferring this IP without SARB approval will put a startup in contravention of exchange control regulations, exposing the company to fines and criminal sanctions and the risk that SARS will reallocate profit from the offshore structure back to South Africa, and create a new tax bill plus penalties and interest.⁶⁰

Finally, a key consideration is that the SARB was only willing to relax the loop rule on the basis that the tax laws were adjusted to address any perceived leakage that may follow. So, one would have expected that tax laws would be introduced that ensured that where South Africans enter into loop structures, the tax treatment of the South African assets held through the loop structure would match the treatment that would have applied, had the South Africans owned those assets directly.⁶¹ The proposed changes to facilitate the relaxation of exchange control require refinement, which is

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Bowman Gilfillian, 2021, "South Africa: Loop structures – opening possibilities in private equity", IFLR1000, 19 March, available at URL: <https://www.iflr1000.com/NewsAndAnalysis/South-Africa-Loop-structures-opening-possibilities-in-private-equity/Index/12144>

what an article released by Werksmans Attorneys addressed, wherein it was stated in that the relaxation of exchange control rules in respect of loop structures will be implemented after the tax amendments are implemented to address the effect of reducing South Africa's tax base by an offshore company in a loop structure.⁶²

Within this context the restriction on "loop" structures will be relaxed on the premise that the proposed amendments to the taxation of dividends received by a CFC as well as capital gains from the sale of shares in a CFC will address the apparent mischief. A CFC is an offshore company in which South African residents, either alone or collectively, hold more than 50% of the participation rights, and the CFC rules provide for the taxable income of the CFC to be calculated as if the CFC was a South African taxpayer and to be attributed to and taxed in the hands of the resident shareholders. In view of the fact that domestic dividends are included in gross income under paragraph (k) of the definition of "gross income" in the Income Tax Act 58 of 1962⁶³ (the "Income Tax Act") but may qualify for exemption under section 10(1)(k)(i), such dividends would typically not be included in the net income of the CFC.⁶⁴

In terms of the proposed draft changes to the Act contained in the Draft Taxation Laws Amendment Bill, 2020 it is proposed that the Act will be amended to tax South African resident shareholders of CFCs, under the CFC rules, on domestic dividends paid to a CFC in a loop structure. The tax on the dividends will be based on a 20/28 ratio, so that 20/28 of the dividend will be included in the taxable income of the CFC, and this is intended to tax the dividend at an effective rate of 20% (i.e. $20/28 * 28\% = 20\%$). This ratio achieves this objective where the shareholder of the CFC is a company, however, where the shareholder is a natural person or a trust the dividend could be subject to an effective tax rate of 32.14% (i.e. $20/28 * 45\% = 32.14\%$).⁶⁵

In addition to the proposed amendments on the taxation of dividends received by a CFC, it is also proposed that the capital gains tax participation exemption should not apply to the disposal of shares in a CFC to the extent the value of the assets of the CFC are derived from South African assets. It would be for the taxpayer to determine what

⁶² Killoran, Ryan, 2020, "Legal Brief October 2020 - Proposed tax changes to facilitate the relaxation of exchange control require refinement", available at URL: <https://www.werksmans.com/wp-content/uploads/2020/10/Proposed-tax-changes.pdf>;

⁶³ Income Tax Act 58 of 1962

⁶⁴ Supra note 63.

⁶⁵ Supra note 62.

portion of the gain is derived from the South African assets and which portion is exempt, which will add complexity to taxpayers' compliance.⁶⁶

A number of submissions have been made to National Treasury to rectify the multiple levels of taxation. In particular, that a credit be granted to the CFC for dividends tax withheld and that CFC inclusion only applies to CFC's which are held by non-corporate shareholders.⁶⁷

Although implementing the conventional loop structure is beneficial for the startups, the uncertainty and potential risk, as well as the disconnect in the tax treatment and allowable structure which now exists has caused players in the startup world to explore an alternative structure.

In the following chapters this paper explores what are commonly understood as mirror structures – this is where duplicate offshore structures are established (“**mirror structures**”). While the mirror structures are fairly well understood (but not considered conventional) and are water-tight in law if properly structured, they introduce some complexity which needs to be explained to existing shareholders, investors and potential acquirers.

Mirror structures have existed for a number of years already due to the previous restrictions on loop structures which were in place and it is only due to the recent relaxation of the loop structure restrictions that the question of whether mirror structures are still necessary has become relevant. Based on the barriers to entry for the conventional loop structure which this paper has dealt with in the previous chapters, it is contended that the mirror structures are still relevant and fit for purpose for startups.

⁶⁶ Ibid.

⁶⁷ Ibid.

Chapter 4: Navigating the interplay between transfer pricing, tax residency and intellectual property in the context of setting up a mirror structure

This chapter outlines the interplay between transfer pricing, tax residency and intellectual property as they apply in the world of a technology startup based in South Africa with the intention of setting up a valuable offshore entity. As discussed in the first chapter, this question is highly relevant at the moment as South Africa, with Cape Town specifically producing, as at the end of 2020, 550 technology startups with over 40,000 people employed in the technology sector.⁶⁸ A large proportion of these companies are positioning themselves to take investment as they grow and aim to compete on a global platform, however their growth can be stunted by a lack of market size, or the inability to get funding due to being based in South Africa.

Llew Claasen wrote in an article that *“the worst thing that can happen to a startup is for it to run out of cash. While you still have cash, you have time, strategic options, and negotiation leverage. Once you've run out of cash, you have none of those”*.⁶⁹

He described that when a company runs out of money, a vicious cycle develops whereby you have no time to come up with new strategic options, no time to pivot or prove new hypotheses, and no leverage to negotiate favourable financing terms. This quickly spirals, results in a loss of investor confidence and founder demotivation, dramatically reducing the likelihood of raising new capital, and increasing the likelihood of failure. In order to succeed, Startups are required to raise capital well in advance of the need and assume that every fundraising will take at least six months to complete. Llew describes fundraising for a startup as a journey, not a destination. If the startup is not constantly raising money as a startup entrepreneur, then they are not working hard enough.⁷⁰

⁶⁸ Staff Writer, 2021, “South Africa’s ‘silicon valley’ has over 450 tech firms and employs more than 40,000 people”, *BusinessTech*, 10 May, available at URL: <https://businesstech.co.za/news/technology/489253/south-africas-silicon-valley-has-over-450-tech-firms-and-employs-more-than-40000-people/>

⁶⁹ Claasens, L, 2021, “The 3 Most Important reasons why startups fail and what can be done about it” *Finance24*, 20 Nov, available at URL: <https://www.news24.com/fin24/opinion/llew-claasen-the-3-most-important-reasons-why-startups-fail-and-what-can-be-done-about-it-20211120>

⁷⁰ *Ibid.*

As previously mentioned, one of the major conditions for foreign investment relates to intellectual property, and centers on the investor's need for the startup's intellectual property to be located in the foreign holding company – this is important to enable international startup investors to contract in familiar jurisdictions with strong investor protections. When the time comes for the investors to sell the startup (or "exit"), then housing the intellectual property in the offshore company ensures that there is no risk that the IP cannot be transferred to the buyer.⁷¹ So, when early-stage South African companies find themselves in a position where their growth is being stunted due to factors which directly relate to the South African venture capital landscape (such as lack of funding from South African investors or a lack of market), they will need to find ways to satisfy the investor's request to locate the intellectual property offshore.

Although the regulations allow a startup to petition SARB to transfer IP internationally, it takes a long time for them to consider the request and in most cases, SARB will not grant permission. IP created by a startup in South Africa can almost never be transferred to an offshore entity unless it's in an arms-length transaction with an unrelated party⁷². Transferring this IP anyway without SARB approval will put you in contravention of exchange control regulations, exposing you to fines and criminal sanctions and the risk that SARS will reallocate profit from the offshore structure back to South Africa and create a new tax bill plus penalties and interest.

Until the Circular was released on 4 January this year, it was largely prohibited for South Africans to invest in offshore structures which owned South African assets or lent money to South Africans. South Africans wanting to retain a majority stake in their businesses while raising cash from foreign investors were effectively penalised – South African technology startups fall squarely within this category.

Further to the above, any income derived from intellectual property which is supplied by the South African entity and therefore ultimately based in South Africa will need to be repatriated to South Africa. Therefore, motivated South African startups are taking steps to understand how they can create a legitimate foreign business establishment in a place of their choosing – this question in essence relies on how IP

⁷¹ Ibid.

⁷² Currency and Exchanges Manual for Authorised Dealers - <https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/general-public/Currency%20and%20Exchanges%20Manual%20for%20Authorised%20Dealers.pdf>

is developed, where the company's place of effective management is determined to and whether the foreign entity is considered to be a foreign business establishment.

As an alternative to transferring the IP across to an offshore holding company on arms-length terms and fair market related prices, the industry has adopted an approach which rather develops, enhances, maintains and commercialises new IP offshore in an offshore company with the same shareholders as the South African company. By doing this, the offshore company will own the newly developed IP and importantly this will be entirely independent of SARS regulations around loop structures. This solution is legal and commercially possible.⁷³

In the following chapters, this paper will discuss the different considerations which are relevant in the context of setting up a 'mirror structure' – these include the concept of *place of effective management*, *foreign business establishment*, *creation of intellectual property and substance* and finally *transfer pricing* - which regulates the exchange of value between the mirrored entities.

In the following chapters this paper will consider:

Why a company would be deemed a tax resident of a certain jurisdiction and how this is determined (by analyzing the rules around the application of *place of effective management*);

Why the concept of a controlled foreign company and a foreign business establishment is relevant to startups;

What intellectual property is and how it can be evolved in a foreign jurisdiction; and

How transfer pricing regulations regulate the exchange of value amongst related parties.

South Africa's transfer pricing rules are contained in Section 31 of the Income Tax Act of 58 of 1962⁷⁴ ("Income Tax Act") and are supported by Practice Note 7⁷⁵, which provides additional guidance to taxpayers on determining an arm's length

⁷³ Domnisse, Adrian, 2019, "A fail-safe way to moving IP offshore: Part 1 [opinion]", Ventureburn, 18 July, available at URL: <https://ventureburn.com/2019/07/a-fail-safe-way-to-moving-ip-offshore-part-1-opinion/>

⁷⁴ Income Tax Act of 58 of 1962, Section 31

⁷⁵ Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>

consideration in relation to cross border related party transactions. The Transfer Pricing rules follow the OECD Guidelines.⁷⁶

South African Transfer Pricing rules apply to South African taxpayers, including South African branches of overseas companies, that have cross-border related party transactions. South Africa implements a self-assessment regime, i.e., the onus is on the taxpayer to provide the evidence that it meets its transfer pricing obligations or to adjust its tax return accordingly.

Transfer Pricing rules are applicable to 'connected persons' as contained in Section 1 of the Income Tax Act. Generally, companies that form part of the same group of companies would be considered connected persons for the purposes of Transfer Pricing, however, the definition is complex and can be widely interpreted. A proposed amendment to Section 31 may see the 'connected persons' definition replaced with the 'associated enterprise' definition for purposes of applying Transfer Pricing rules, however, this amendment is yet to be promulgated.⁷⁷ Whether a conventional loop structure is implemented, or the mirror structure, both the South African entity and the foreign entity will be regarded as Connected Persons, and therefore subject to these rules.

The mirror structure entails the same shareholders (South Africans and foreigners) owning shares in the South African assets and separately they would also own the foreign assets developed by the company over time. Therefore, there is no single group of companies created and no ultimate consolidated financial position. Rather there is a South African asset ownership arrangement and a foreign asset ownership arrangement, which in practice causes some difficulty and also proves difficult to explain to investors and garner trust, as the investment structure is abnormal to the standard in the private equity/venture capital space.⁷⁸ This typically adds some complexity to the deal which results in a longer pre-investment period and a higher cost.

⁷⁶ Grant Thornton, 2020, "Transfer Pricing – South Africa", 1 July, available [Grant Thornton, 2020, "Transfer Pricing – South Africa" https://www.grantthornton.global/en/insights/articles/transfer-pricing-guide/transfer-pricing---South-Africa/](https://www.grantthornton.global/en/insights/articles/transfer-pricing-guide/transfer-pricing---South-Africa/)

⁷⁷ Ibid.

⁷⁸ Bowman Gilfillian, 2021, "South Africa: Loop structures – opening possibilities in private equity", IFLR1000, 19 March, available at URL: <https://www.iflr1000.com/NewsAndAnalysis/South-Africa-Loop-structures-opening-possibilities-in-private-equity/Index/12144>

If the startup is able to get over the explanation hurdle, by implementing a mirror structure, the parties are able to regulate the arrangement through the shareholder agreements to achieve parity in the same way that they would automatically achieve this dynamic through a conventional loop structure, when using the preferred structure of co-investing side by side with the founders through a simple single foreign investment vehicle.

It is therefore important when implementing a mirror structure, that the elements which contribute to creating the place of effective management, foreign business establishment, the evolution of intellectual property, as well as transfer pricing regulations are properly understood and implemented.

Chapter 5: Tax Residency: Controlled foreign companies and foreign business establishment

5.1 Tax considerations in the context of international structuring

*When dealing with tax it simply means that if genuine value is created in Country A, you need to account to Country A's tax authority for that value and pay tax in Country A.*⁷⁹

South Africa has a residence-based tax system, which means residents are, subject to certain exclusions, taxed on their worldwide income, irrespective of where their income was earned. By contrast, non-residents are taxed on their income from a South African source. Since tax systems differ from country to country, there is a chance that a particular amount could be taxed twice. This possibility of double taxation is, however, often alleviated by tax relief contained in various Double Taxation Agreements.⁸⁰

When considering the taxation of South African shareholders, in the context of startup founders having shares in a globally operating group, understanding the concept of tax residency in respect of the company is important. This refers to where a company is deemed to be a resident for tax purposes. Based on where the people who conduct the inner works of an operational company are located when they perform the operational tasks of the business, and depending how substantial those tasks are, will determine whether that company is a controlled foreign company, whether it has foreign business establishment and where newly developed intellectual property is located.

This is more complicated in practice, as it is possible to become a foreign tax residence by satisfying the requirements associated with place of effective management, however remaining a controlled foreign company without a foreign business establishment could have costly tax consequences for South African shareholders.

A company is “resident” in South Africa for tax purposes where it is incorporated in South Africa, or if it is incorporated offshore but its place of effective management is

⁷⁹ Domnisse, Adrian, 2019, “What Startups should know about tax, when setting up an overseas company”, Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

⁸⁰ South African Revenue Service, “Tax and Non-Residents”, available at URL: <https://www.sars.gov.za/individuals/tax-during-all-life-stages-and-events/tax-and-non-residents/>

in South Africa, as described in terms of paragraph (b.) of the definition of “resident” the Income Tax Act⁸¹.

It is therefore necessary to understand what it means for an offshore company to be “effectively managed” in the country in which it is incorporated – and then ensure that those requirements are met. The Income Tax Act does not define this term, but there is both an international approach to this, and guidance provided by the SARB.

International practice in this regard is relevant to explain the global approach to this issue. The Organization for Economic Co-operation and Development (the “OECD”) Model Tax Code of 2017 – Article 4, paragraph 3 – sets out scenarios for when a company can claim to be effectively managed in an offshore jurisdiction. Relevant factors to be taken into account include: where the meetings of the company’s board of directors are usually held; where the chief executive officer and other senior executives usually carry on their activities; where the senior day-to-day management is carried on; where the headquarters are located; which country’s laws govern the legal status of the person; where its accounting records are kept - these factors are discussed in more detail in the following section.

Based on these requirements, a startup should expect to establish, at a minimum, structures in the offshore jurisdiction to show that a genuine board meets, and senior management are located in the same place as the foreign entity, who will take the real decisions necessary to conduct the business. This approach was confirmed by South African courts in *The Oceanic Trust Co Ltd MO v Commissioner, South African Revenue Services* 74 SATC 127.⁸²

5.2 Place of effective management

Interpretation Note 6 (“**IN 6**”) issued by SARS during 2002⁸³, outlines and provides guidance to taxpayers on SARS' view on the meaning of effective management and conducts a "three-stage inquiry" in practically determining this.

⁸¹ Income Tax Act 58 of 1962

⁸² *Oceanic Trust Co Ltd NO v C: SARS4*

⁸³ Interpretation Note No. 6 (issue 2), 2015, “Resident – Place of effective management (companies)”, South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

The first consideration under IN 6 provides that where the management functions of a company are carried out at a single location, that location will be the place where the company is effectively managed.

Second, where the management functions are carried out at multiple locations for instance the use of videoconferencing or email, then the place of effective management is where the regular or day-to-day business operations and activities are run and where operational and commercial decisions are implemented.

And third, where management functions and operations are carried out from various locations and in this instance the place of effective management is the place with the "strongest economic nexus".

IN 6 serves as a guideline, and elaborate comment has been provided on IN 6 in a discussion paper prepared by SARS, titled *Discussion Paper on Interpretation Note 6 place Of Effective Management*⁸⁴.

In this next section of this chapter, there is a focus on the determination of the *place of effective management*, which as noted above, feeds into where the offshore company will be a tax resident.

Paragraph (b) of the definition of “resident” in section 1 of the Income Tax Act⁸⁵, provides that a company will be a tax resident of South Africa in one of the two scenarios:

- a. the company is incorporated, established or formed in the Republic; or
- b. which has *its place of effective management* in the Republic,

The corporate mind is the conceptual mind of the business which takes crucial decisions relating to opportunities, balances the risks involved in those opportunities and deploys capital to exploit those opportunities.⁸⁶ This is understood with reference to the place of effective management of the business (“**POEM**”). In terms of IN 6, when determining a company’s POEM, “a company’s place of effective management

⁸⁴ Legal and Policy: Interpretations and Rulings, 2011, “Discussion Paper on Interpretation Note 6, Place of Effective Management”, South African Revenue Service, [available at URL: https://www.sars.gov.za/wp-content/uploads/Legal/DiscPapers/LAPD-LPrep-DP-2011-02-Discussion-Paper-POEM-on-IN6.pdf](https://www.sars.gov.za/wp-content/uploads/Legal/DiscPapers/LAPD-LPrep-DP-2011-02-Discussion-Paper-POEM-on-IN6.pdf)

⁸⁵ Section 1 of the Income Tax Act 58 of 1962

⁸⁶ Domnisse, Adrian, 2019, “What startups should know about tax, when setting up an overseas company”, Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made”. IN 6 was drafted in order to provide much needed further guidance on the interpretation and application of the term “place of effective management” in determining the tax residence of a company. The approach set out in IN 6 is consistent with the OECD.⁸⁷

5.3 The OECD

The Organisation for Economic Co-operation and Development (“**OECD**”) is an intergovernmental economic organisation with 38 member countries, founded in 1961 to stimulate economic progress and world trade. The OECD’s goal is to shape policies that foster prosperity, equality, opportunity and well-being for everyone. The process of joining the OECD is long and complicated - a nation must be reviewed by different member committees to ensure it conforms with OECD instruments, standards, and benchmarks. The country in question must be willing to reform its economy to meet standards in different areas, like corporate governance, anti-corruption, and environmental protection. The countries designated as key partners, but not members, are Brazil, China, India, Indonesia, and South Africa. Key partners contribute to the OECD's work in a sustained and comprehensive manner. A central element of the collaboration is the promotion of direct and active participation of these countries in the work of substantive bodies of the OECD. South Africa's participation spans a wide array of policy issues, including macroeconomic policy and structural reform, debt management, fiscal policy, domestic resource mobilisation, competition policy, agricultural policy, public governance, rural and urban development, the fight against bribery, development, science, technology and innovation, chemicals testing and tourism.⁸⁸

5.4 Interpretation of POEM:

The term “place of effective management” is not defined in the Act and must be ascribed its ordinary meaning, taking into account international precedent and

⁸⁷ *Commentaries on the Articles of the Model Tax Convention on Income and on Capital*, Condensed Version, dated 15 July 2014 at Paragraph 24, subparagraph 90.

⁸⁸ OECD, “South Africa and the OECD”, Global Relations, available at URL: <https://www.oecd.org/global-relations/keypartners/south-africa-and-oecd.htm#:~:text=Key%20partners%20contribute%20to%20the,substantive%20bodies%20of%20the%20Organisation.>

interpretation. It does not, however, have a universally accepted meaning and various countries, including members of the OECD, continue to attach different meanings to it.⁸⁹

The principles and guidelines applied in IN 6 are consistent with the determination of the POEM when that term is used as a tie-breaker rule in a tax treaty that adheres to paragraph 3⁹⁰ of Article 4 of the condensed version of the OECD Model Tax Convention as at 15 July 2014.⁹¹ This effectively provides that when there is a stalemate between two jurisdictions which apply different interpretations to where POEM is located, that the OECD's guidance will be the default model used in South Africa to interpretate where the place of effective management is located.

The POEM must be supported by the facts. Under section 102 of the Tax Administration Act No. 28 of 2011 a company bears the onus of proving its place of effective management and must, under section 29 of that Act, retain the necessary evidence to support the view taken.⁹²

In terms of the IN 6, a company's POEM is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made. This approach is consistent with the OECD's commentary on the term "place of effective management".⁹³ The POEM is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance and all relevant facts and circumstances must be examined to determine the POEM.⁹⁴

In *Oceanic Trust Co Ltd NO v C: SARS*⁹⁵, Louw J held that the taxpayer had not made out a case for declaratory relief declaring that it was not a resident of South

⁸⁹ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

⁹⁰ The place of effective management is the only criterion considered in paragraph 3. The alternative mutual agreement tie-breaker mentioned in paragraph 24.1 of the Commentary is applied in a number of tax treaties. It takes a number of criteria into account of which the place of effective management is one. The criteria considered in the alternative tie-breaker are not discussed in this Note or this paper.

⁹¹ Supra note 89.

⁹² Ibid.

⁹³ Paragraph 24 of the Commentaries on the Articles of the Model Tax Convention on Income and on Capital, Condensed version, dated 15 July 2014 at 90.

⁹⁴ Supra note 89.

⁹⁵ *Oceanic Trust Co Ltd NO v C: SARS*

Africa because the facts were not “fully found”.⁹⁶ However, applying the approach adopted in *Smallwood*⁹⁷ (which is consistent with that set out in the preceding paragraph), Louw J noted that to the extent the facts were established, they did not establish that the place of effective management was in Mauritius and not South Africa. In other words, the infrastructure and personnel required for the business to operate were not based in or located in OffShoreCo.’s jurisdiction.⁹⁸

International courts in the context of tax treaty interpretation have also provided useful interpretations on the meaning of the place of effective management. For example, in *Wensleydale’s Settlement Trustees v Inland Revenue Commissioners*⁹⁹, Special Commissioner David Shirley made the following comment on the ordinary meaning of place of effective management:

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

(Emphasis added.)¹⁰⁰

In *Smallwood’s* case¹⁰¹ the court held that determining the place of effective management required the court to determine where, based on the facts presented, the real top level of management or *realistic, positive management of the taxpayer*, a trust, was exercised. Although this case dealt with the determination of the place of effective management in the context of a trust, the court’s decision is considered useful because the principles and the type of facts that were considered are equally relevant in the context of companies. The court found that there was a distinction between the *scheme of management (which constituted the key management and commercial decisions)*

⁹⁶ The High Court was not entitled to enquire into and make the required findings of fact.

⁹⁷ *Her Majesty’s Revenue & Customs v Smallwood & another* [2010] EWCA Civ 778.

⁹⁸ Interpretation Note No. 6 (issue 2), 2015, “Resident – Place of effective management (companies)”, South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

⁹⁹ [1996] STC (SCD) 241 at 252

¹⁰⁰ *Supra* note 89.

¹⁰¹ *Trevor Smallwood Trust v Revenue and Customs* [2008] UKSPC SPC00669 in 112 & 114 at 30 and in 130 at 35 and the subsequent appeal in the Court of Appeal, *Her Majesty’s Revenue & Customs v Smallwood & another* [2010] EWCA Civ 778 in 48.

and day-to-day management exercised by the trustees from time to time with the former determining the place of effective management.

A company may have more than one place of management, but it can only have one place of effective management at any one time.¹⁰² If a company's key management and commercial decisions affecting its business as a whole are made at a single location, that location will be its place of effective management. However, if those decisions are made at more than one location, the company's place of effective management will be the location where those decisions are primarily or predominantly made.¹⁰³

Experience has shown that the application of these principles does not present serious problems in the majority of cases. For example, it is relatively easy to determine a company's place of effective management if that company operates in several countries through branches with local managers, but has its head office in South Africa where most of its senior management are located and where most, if not all, of its board meetings take place.

In contrast, the determination in the case of a company that is part of a global group is much more difficult and there are normally multiple facts that need to be taken into account, often involving multiple locations, and from those facts and locations it is necessary to determine a single dominant place where effective management is located by looking at the key management and commercial decisions that are regularly and predominantly made.¹⁰⁴

It's difficult to lay down definitive rules which are used in determining the place of effective management, and all relevant facts and circumstances must be examined on a case-by-case basis. Some of the key facts and circumstances that must be examined in determining a company's place of effective management are discussed below, which are not intended to be exhaustive but rather serve as a guideline.¹⁰⁵

¹⁰² This is consistent with paragraph 24 of the Commentaries on the Articles of the Model Tax Convention on Income and on Capital, Condensed version, dated 15 July 2014 at 91.

¹⁰³ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

¹⁰⁴ Ibid.

¹⁰⁵ Ibid.

As an overview, the place of effective management test is one of *substance over form*. It therefore requires the identification of those persons in a company who actually “call the shots” and exercise “realistic positive management”. Otherwise stated, a company’s place of effective management must be determined by ascertaining what are and who makes the key management and commercial decisions for the conduct of the company’s business as a whole. Once this determination has been made, it is necessary to determine where those decisions are in substance actually made.

5.5 Consideration of the factors which determine the POEM

In the following subcategories, this paper will discuss the elements which are taken into consideration when determining where a company’s POEM is located.

5.7.1 Head Office

The location of a company’s head office, *being the place where a company’s senior management and their support staff are predominantly located*, is generally a major factor in the determination of a company’s place of effective management because it often represents the place where key company decisions are made.

By way of an example, a company whose key management and commercial decisions are made by the board of the company which only meets once a year in the offshore jurisdiction, will be considered in the context of a strong likelihood that key commercial and management decisions were made through-out the year, and therefore the place of effective management may not be where the board meeting is held (offshore jurisdiction), but rather where the more frequent operational decisions are made.¹⁰⁶ Accordingly, the actual location will be a heavily weighted factor which is considered in the context of the other factors, but it is not determinative on its own.

Where a company is established in the conventional manner, with a head office being located in a certain place and all senior management and support staff also being located in that place – and that location also being held out to the public as the company’s principal place of business or headquarters, then it is easy to determine the POEM. However, where a company is decentralised it can be more complex. For example, various members of senior management may operate, from time to time, at

¹⁰⁶ Ibid.

offices located in the various countries where the company operates. In these situations, the company's head office would be the location where those senior managers are primarily or predominantly based or where they normally return to, following travel to other locations or meet when formulating or deciding key strategies and policies for the company as a whole.

It may be the case that senior management is decentralised and therefore impossible to determine where the head office is with any degree of certainty. In these cases, the question of head office would become less relevant and more emphasis would be placed on other considerations.¹⁰⁷

5.7.2 Delegation of authority:

A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members of senior management. In these situations, the location where the members of the executive committee are based and where that committee develops and formulates the *key strategies and policies* for mere formal approval by the full board will often be considered the company's place of effective management. The delegation of authority may be by way of a formal resolution or Shareholder Agreement or based upon the actual conduct of the board and the executive committee. Again, the goal is to determine where the key management and commercial decisions for the company as a whole are in substance made and not where those decisions simply obtain formal approval. This determination applies irrespective of whether the delegation is formal or informal, enforceable or not enforceable. It is critically important to consider what the executive committee does in assessing whether its functions amount to making key management and commercial decisions.¹⁰⁸ This approach further highlights the substance over form model of assessment, and why it is important that companies which aim to establish their place of effective management offshore do not do it with a paper foundation.

¹⁰⁷ Ibid.

¹⁰⁸ Ibid.

5.7.3 Board

The location where a company's board regularly meets and makes decisions may often be the company's place of effective management provided the board retains and exercises its authority to govern the company and does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole. This situation often prevails when the board meetings are held in the same country as the country where the company's head office is located and all the directors participating in the board meetings are physically present at the meetings. The impact on the place of effective management arising from the holding of board meetings in different locations is another aspect that requires consideration. The location of the board meetings, assuming for the moment it is the place where the key management and commercial decisions are made, may or may not be the same as the place where the relevant directors are tax resident.¹⁰⁹

In terms of the IN 6, there is no assumption that a company's place of effective management must be where its board meets. For example, if a board has *de facto* delegated the authority to make the key management and commercial decisions for the company to the senior managers and does nothing more than routinely ratify decisions that have been made, the company's place of effective management will ordinarily be the place where those senior managers make those decisions. This situation would potentially apply, for example, when the formal board meetings are held in a location that bears no relationship to the company's activities or the primary location from where the senior managers perform their duties. Management structures, reporting lines and responsibilities vary from company to company and no hard and fast rules exist and application is on a case by case basis.¹¹⁰

There are a variety of decisions to consider when determining whether a board is making the decisions or, is simply limited to formally approving or rubber-stamping the decisions made by someone else. Considerations of whether the directors had sufficient knowledge and information at hand, whether the directors are suitably qualified and experienced generally and in relation to the particular company, and

¹⁰⁹ Ibid.

¹¹⁰ Ibid.

whether the directors had reasonable time to assess the information and make the decision.¹¹¹

Consideration around board decisions can dig deeper than location and capacities and also delve into the roles of different directors. IN 6 provides that it must be established whether the particular director is involved in the decision-making or is perhaps merely ratifying a decision made by other directors or people. For example, it is possible for a director to be appointed with a governance-focussed role or as a shareholder representative and custodian as opposed to being actively involved in making decisions on behalf of the company. In some companies, executive directors have traditionally been involved in decision-making while non-executive directors have not had a decision-making role and merely provide an oversight role for their appointing shareholders.¹¹²

It can therefore be deduced that a title may give an indication of a particular director's involvement in decision-making, although this is not always the case – and while a title may be useful in identifying the role a particular director performs, it is the actual function a particular director performs and whether it involves participating in key management and commercial decisions that is determinative, not the director's title.¹¹³

In *Laerstate v The Commissioner for Her Majesty's Revenue & Customs*¹¹⁴ the court was in the first instance required to consider where the company was managed and controlled for United Kingdom tax purposes and secondly, it had to consider where the company's place of effective management was for tax treaty purposes. In so doing, the court was required to consider whether a director acted on another person's wishes or instructions without truly considering the merit of those wishes or instructions or whether the director considered the wishes or instructions but still made the decision while in possession of the minimum information required to make a decision. This illustrates the detail that is required when determining based on the substantive approach taken when considering the place of effective management.

5.7.4 Modernisation and global travel

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Ibid.

¹¹⁴ 1 [2009] UKFTT 209 (TC).

Changes in the advances in telecommunications, information technology, global travel and modern business practices can, and have impacted on the determination of the place of effective management. These factors have meant that physical meetings of the board are often no longer required or implemented or, alternatively, that even when physical board meetings are held in a particular location some, possibly a majority, of the directors or the key directors with overriding decision-making powers, are not in the same location as the physical meeting. Consequently, what initially appears to be the location where the decisions are made, that is, the physical location of the board meeting, may not be where the key management and commercial decisions are in substance being made.

The use of round robin voting¹¹⁵ is also something that must be considered from the perspective of the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located. Round robin voting has become a common form of holding meetings especially in the era of COVID-19 where it might have been impossible for certain persons to be physically together in a meeting. Accordingly, it is important not to place an undue focus on the location of where board meetings take place without considering the surrounding facts and circumstances of a particular case.¹¹⁶

5.7.5 Shareholders

Company law or a company's rules or by-laws often reserve the making of certain fundamental decisions for the shareholders of the company – this is a form of shareholder protection which prevents the board from taking certain decisions without the shareholder's approval. For example, such decisions may include the sale of all or substantially all of the company's assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares. Fundamental decisions such as these typically affect the existence of the company itself or the rights of the shareholders as shareholders, rather than the conduct of the company's general business from a management or

¹¹⁵ A resolution passed around for signature without the signatories gathering together in a meeting.

¹¹⁶ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

commercial perspective. Accordingly, such decisions are generally not relevant to the determination of a company's place of effective management.¹¹⁷

There are however some instances where shareholder involvement can cross the line into that of effective management. For example, where a shareholder or group of shareholders effectively usurp the powers of the directors of the company. This situation could arise when the company is wholly owned by a single person (whether a company, other juristic person or individual) or when there are multiple shareholders and those shareholders are either connected persons in relation to each other or are acting in concert. This is a common occurrence in for startups where the founders are also the shareholders. This issue is of particular concern to tax authorities in connection with passive holding companies located in low-tax jurisdictions.¹¹⁸

As mentioned above, there is a distinction between shareholder guidance or influence and usurpation. Influence does not constitute effective management, but undue influence may do so. Notably, shareholders will always look to have an element of influence within the board and in respect of certain decisions which are made, as the board has effectively been assembled by and for the shareholders (which often include specific appointment rights for certain majority or founder shareholders), however the operational control and effective management of the company should always sit with the board – which is the centre of consideration for determination of place of effective management.

IN 6 provides an example, which poses, that if the board considers what the shareholders have recommended and still make the decision independently, then this would not constitute usurpation even if the decision made by the board is in line with the shareholder's recommendation. It is important to establish whether the board independently made its own decisions or is merely implementing what the shareholders have already decided for the company and in that way does not actually make decisions.¹¹⁹

¹¹⁷ Ibid.

¹¹⁸ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

¹¹⁹ Ibid.

In *Unit Construction v Bullock*¹²⁰, the subsidiary companies' constitutions required that they be *managed by their own boards*. The court, however, found that in all matters of real importance affecting central management and control, the real management and control was exercised by the board of the parent company. The House of Lords agreed that although the parent company's actions were arguably unlawful, it did not override the factual reality of by whom and from where the subsidiary companies were managed and controlled.¹²¹

5.7.6 Limitation of authority:

By using an example to illustrate the consideration of limitation of authority— where a Company concludes long-term contracts with clients which extend over a number of years (with a single contract potentially having a significant effect on the financial viability of the Company), and as a result the Company's senior management team are required to sign off on all the contracts. In such a case, the conclusion of sales contracts would represent a predominant key commercial decision for the Company. This could be further complicated by an designed limitation of authority, whereby the company's senior management team is restricted to concluding contracts not exceeding a contract value of R10 million - and for anything over R10 million, the company must submit its recommendation to the parent company who will take the decision.

In this scenario, hypothetically 90% of the contracts which come to the company have a value which exceeds R10 million), and although more detail would be required and all the facts affecting all the key management and commercial decisions of the company as a whole would have to be taken into account, the facts suggest that the effective management of the company may have been usurped by the parent company – as it takes 90% of the material revenue driving decisions in the company. The limitation of authority in this case has effectively removed the company's real

¹²⁰ [1960] AC 351, [1959] 3 All ER 831, [1959] 3 WLR 1022, 38 TC 712, 38 ATC 351, [1959] TR 345, 52 R&IT 828. See also *Laerstate v The Commissioner For Her Majesty's Revenue & Customs [Corporation Tax]* [2009] UKFTT 209 (TC), *Wood & another v Holden (HMIT)* [2006] EWCA Civ 26 and *Commissioner for Her Majesty's Revenue and Customs v Smallwood & Another* [2010] EWCA Civ 778.

¹²¹ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

authority to make decisions and has gone beyond a mere monitoring mechanism or information-reporting requirement.¹²²

5.7.7 Operational management versus broader top-level management

Operational management decisions are generally of limited relevance in determining a company's place of effective management and must be distinguished from the key management and commercial decisions. Operational management generally concerns the oversight of the day-to-day business operations and activities of a company. Whereas key management and commercial decisions are concerned with broader strategic and policy decisions and tend to be made by members of the senior management team.¹²³

What constitutes a key management or commercial decision as opposed to an operational management decision is critical since it is the former that is relevant in the context of establishing the place of effective management. Again, determining what constitutes a key management or commercial decision is an aspect that can be determined only on a case-by-case basis with the location of this decision-making being of critical importance.¹²⁴

5.7.8 Legal factors

Legal factors such as a company's place of incorporation, formation or establishment, the location of its registered office and the location of its public officer are generally not relevant in the determination of a company's place of effective management.¹²⁵ This would be to focus on the form rather than substance. In most cases the inquisition

¹²² Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

¹²³ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

¹²⁴ Interpretation Note No. 6 (issue 2), 2015, "Resident – Place of effective management (companies)", South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

¹²⁵ Ibid.

is purely based on the substance of how the companies key decisions are made in relation to broader strategy.

5.7.9 Economic nexus

The extent of a company's economic nexus with a country is generally irrelevant in the determination of its place of effective management. However, this factor may be considered circumstantial and given some weight in cases where other factors are inconclusive¹²⁶.

5.7.10 Support functions

It is not uncommon for a multinational company to centralise certain support functions (which could include data management, human resources, customer support or accounting), and to locate those services in countries that offer advantages such as superior infrastructure, lower costs or a highly skilled workforce. A group of companies may house these services in the group's ultimate holding company or in a separate subsidiary which provides the services to all the members of the group.

In these situations, the locations where those services are primarily performed and where the senior managers responsible for them are based may be different to the location of the company's head office where the top senior management and the senior management's direct support staff are located.¹²⁷

In these situations the location where such support services may be located is generally of limited relevance to the determination of a company's place of effective management as the service provides are ultimately not involved in decision making activity, but rather acting within the bounds of a contractual mandate.¹²⁸

5.6 POEM conclusion

A company's place of effective management is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made. This approach is consistent with the OECD's commentary on the

¹²⁶ Ibid.

¹²⁷ Ibid.

¹²⁸ Ibid.

term “place of effective management”. A company may have more than one place of management but it can only have one place of effective management at any one time.

There are normally multiple facts that need to be taken into account, often involving multiple locations, and from those facts and locations it is therefore necessary to determine a single dominant place where effective management is located. Definitive rules cannot be laid down in determining the place of effective management and all relevant facts and circumstances must be examined on a case-by-case basis.¹²⁹

In the following chapter this paper will consider controlled foreign companies and foreign business establishment, and the potential tax consequence on a founder whose offshore company is not classified as foreign business establishment.

5.7 Controlled foreign companies

It is not enough to incorporate a company in a foreign jurisdiction with the intention of operating that company as an extension of the South African company which is ultimately controlled by the South African entity - this would give rise to the principle *controlled foreign company* (“CFC”). A CFC is defined in the Income Tax Act simplistically, as a foreign company where South African residents hold more than 50% of its shares. The CFC provisions seek to reduce the opportunity for income to be diverted and taxed offshore in the hands of foreign companies where:

South African tax residents may exercise, directly or indirectly, a majority of the voting rights in the foreign companies or where South African tax residents may participate, directly or indirectly, in the majority of the benefits attached to shares of the foreign companies.¹³⁰

In terms of Section 9D of the Income Tax Act a hypothetical taxable income, “net income”, is calculated as if the CFC is a South African tax resident. In the event of the CFC rules finding application, a notional “net income” calculation must be performed for such company at the end of its “foreign tax year” in accordance with the provisions

¹²⁹ Interpretation Note No. 6 (issue 2), 2015, “Resident – Place of effective management (companies)”, South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

¹³⁰ South African Institute of Chartered Accountancy, 2015, “International Tax, 2546. Foreign business establishments, March 2015 – issue 186”, March, available at URL: https://www.saica.co.za/integritax/2015/2394.Section_9D_rules.htm.

of section 9D of the Act and the proportional amount of such “net income” must be included in the income of the South African residents in proportion to the participation rights held.¹³¹

This rule is based on the principle that it would not be fair for South African shareholders to avoid South African tax by routing their revenue through another country and retaining it there, and the South African Revenue Service’ (“SARS”) rationale for this is that if the offshore company is “passive” and earns “mobile” revenue (i.e. has no substance in the offshore jurisdiction), then this rule will apply to South African shareholders.¹³²

CFCs are subject to section 9D of the Income Tax Act¹³³, and section 9D provides that the net income of the CFC be included in the taxable income of the South African resident in proportion to the resident's rights in that company. This is consistent with the basis that South African residents are taxed on their worldwide income and is therefore aimed at taxing residents who invest their income-earning assets in foreign companies and earn passive or "diversionary" income as a result.

5.8 Exceptions to the CFC rules

There are three exceptions which apply to Section 9D of the Income Tax Act, which allow for the net income of a CFC to be excluded from the taxable income of the South African resident as provided for in the following three instances:

1. If the net income of the CFC is attributable to a "foreign business establishment";
2. Where the de minimus exemption applies; and
3. Where the income of the CFC is taxed at a specific rate in a foreign jurisdiction.

Of relevance to this paper, point 1 effectively provides that if the offshore company establishes a genuine “foreign business establishment”, the rule provided by section

¹³¹Gers, Carmen, 2020, “Loop Structures and the controlled foreign company rules”, ENSight, 18 August, available at: https://www.ensafrica.com/news/detail/3222/loop-structures-and-the-controlled-foreign-co?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration

¹³² Section 9D of the Income Tax Act 58 of 1962 and Dommissie, Adrian, 2019, “What Startups should know about tax, when setting up an overseas company”, Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

¹³³ Section 9D of the Income Tax Act 58 of 1962

9D of the Income Tax Act that the net income of the CFC be included in the taxable income of the South African resident in proportion to the resident's rights in that company will not apply. The logic here is that if one can show that the offshore company is not a passive “shell company” and does not earn revenue passively, but has actual substance in the Offshore jurisdiction, then the revenue and profits can be retained there. To prove that this is the case, and that the offshore company does have real substance, it is necessary to show that all the infrastructure and personnel required to run the business offshore exists.

An foreign business establishment is defined in section 9D(1) of the Act¹³⁴, inter alia, as:

“a fixed place of business located in a country other than the Republic [of South Africa] that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where-

- that business is conducted through one or more offices, shops, factories, warehouses or other structures;
- that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;
- that fixed place of business is suitably equipped for conducting the primary operations of that business;
- that fixed place of business has suitable facilities for conducting the primary operations of that business; and
- that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic...”¹³⁵

It is relevant to note that the presence of a foreign business establishment (“**FBE**”) is only the first requirement in a two-step test, which must be met in order for a CFC to

¹³⁴ Section 9D of the Income Tax Act 58 of 1962

¹³⁵ South African Institute of Chartered Accountancy, 2016, “International Tax, 2546. Foreign business establishments, September 2016 – issue 204”, September, available at URL: https://www.saica.co.za/integritax/2016/2546.Foreign_business_establishments.htm.

rely on the FBE exemption. Secondly, it must be determined whether the specific amount is attributable to the FBE of that CFC.¹³⁶

In the modern globalised economy, many multi-national enterprises conduct more than one business from a single fixed place of business, or conduct various businesses from different locations, but these businesses are housed in one legal entity. The question that arises is: Can a CFC have more than one FBE, or can this exemption only be relied upon for one of the businesses that is conducted through the legal entity which constitutes a CFC?

In an article published by the South African Institute of Chartered Accountancy it stated that it is possible for one of the CFC's businesses to not meet the requirements for an FBE without "tainting" the other businesses of that CFC, which may still meet all the requirements of a FBE. Similarly, it may be possible for certain amounts received by a CFC to be attributable to its FBE and therefore qualify for the FBE exemption, while other amounts that are not attributable to the FBE do not qualify for the exemption and must thus be included in the "net income" of the CFC.¹³⁷

¹³⁶ South African Institute of Chartered Accountancy, 2016, "International Tax, 2546. Foreign business establishments, September 2016 – issue 204", September, available at URL: https://www.saica.co.za/integritax/2016/2546.Foreign_business_establishments.htm.

¹³⁷ Ibid.

Chapter 6: Intellectual Property and anchoring it to an offshore entity

Intellectual Property (“IP”) is a term that describes the application of the mind to develop something new or original, and can exist in various forms, including inventions, brands, design, art, source code and software. IP is an important asset in today's knowledge economy and must be strategically managed by companies.¹³⁸

At a high level, IP is protected in law by patents, copyright and trademarks, which enable people to earn recognition or financial benefit from what they invent or create. By striking the right balance between the interests of innovators and the wider public interest, the IP system aims to foster an environment in which creativity and innovation can flourish through motivated creativity and protected benefit.¹³⁹ However, IP rights exist in many forms and in some cases, they don't need to be registered in order to be of value (literary works, music, know-how, trade-secrets). Each type of IP provides different competitive advantages for its owners and new commercialisation opportunities for organisations.¹⁴⁰ In the case of early stage companies and depending on the nature of the IP, it can often neither be registered, patented or protected by formal copyright, but is rather considered a trade secret or know-how and is stored in a protected manner and protected through contractual stipulations when engaging in business where clients have a limited right to use the IP.

Trade secrets and know-how generally evolve over time as the company develops new process, procedures and products – it follows then, that wherever the “evolved” IP is based would be the revenue driver of the group, as a company would not be creating new IP only to continue using the outdated or redundant IP. This would be similar to developing the technology for the new iPhone with the new feature being the camera and music capabilities, but continuing to use the previous version in the market which does not have any of the new features.

Unsurprisingly, the South Africa government recognises the value in IP and imposes certain taxations on commercial gain driven by the existence of IP which was created

¹³⁸ World Intellectual Property Organisation, “IP and Economics”, available at URL: https://www.wipo.int/econ_stat/en/economics/

¹³⁹ Ibid.

¹⁴⁰ Companies and Intellectual Property Commission, “What is IP”, available at URL: <http://www.cipc.co.za/index.php/trade-marks-patents-designs-copyright/what-ip/>

in the South African jurisdiction. Based on this logic, if founders of a South African startup have initially built their business and all related IP in South Africa and wish to rather anchor the new IP in a foreign jurisdiction in a mirrored entity which they own in equal proportions to the South African entity, then they would need to comply with the relevant legislation in order to establish such new IP independent of the South African tax base, which we discuss below.

In the following sections of this chapter, this paper will discuss what a company needs to implement and action in order to develop new IP which is anchored in the offshore entities jurisdiction. In the context of raising funds or preparing for an eventual offshore exit, this proves valuable as the investor will be able to invest directly into the offshore entity which is both based in the jurisdiction where they are comfortable and the target entity will be the rightful owner of the new and relevant IP.

6.1 Intellectual Property Strategy and the barriers to moving Intellectual Property offshore

As discussed in Chapter 2 there are a number of barriers to investment and access to the global market generally when a company's tax residency and business is established in South Africa. Early-stage technology companies therefore look to move offshore in order to attract offshore investment and have access to a bigger international market. This is only a real consideration for companies that intend to legitimately establish their business offshore. For those companies that wish to merely incorporate and operate controlled foreign company will ultimately be taxed in South Africa and the income earned in by the offshore entity may included in the comes of the South African tax resident shareholders, as per section 9D of the Income Tax Act.¹⁴¹

It is also possible to simply assign the IP from the local entity to the foreign entity, however the exchange control regulations require that SARBs permission must be obtained prior to the transfer, and that the terms of the assignment are to take place at arms-length and for fair market value. This is undesirable and often not possible for early-stage companies, as they will not have the capital to fund the offshore entity to pay fair market value for the IP. In the context of a potential investment being subject

¹⁴¹ South African Reserve Bank, Frequently asked questions, available at URL: <https://www.resbank.co.za/en/home/what-we-do/financial-surveillance/FinSurvFAQ>

to the movement of this IP, the investor would likely be uncomfortable with an arrangement which ultimately allocates a material portion of their investment to the South African company in order to fund the transfer of IP within the group of companies. At an early stage of growth and investment for a startup, the intention is generally to grow offshore and fund that growth through the entity based in the foreign market, and not to direct money back to South Africa.

Naturally, an important consideration is the residence of the intellectual property which drives the revenue of the company. If this is ultimately based in South Africa, then any income derived from that IP will be considered income earned offshore and will therefore need to be shared with the SA company – through license fees and transfer pricing. Therefore, early-stage South African technology companies might look to understand how to locate their intellectual property in the foreign jurisdiction, with a focus on the aspects which genuinely qualify the existence of intellectual property in the offshore location.

Considering this against the backdrop of the South Africa's exchange controls, which are primarily intended to prevent valuable assets from leaving the country – IP falls into the *valuable assets* bucket and is therefore regulated. Accordingly, if the IP represents value of any sort (or could potentially earn taxable revenue), then SARB considers it to be within its scope of enquiry. Therefore, if an entity intends to move IP out of South Africa, then they would need permission from SARB.¹⁴²

If the South African IP were being transferred to an unrelated third party at arm's length and for fair value, then one would simply need to prove to SARB that the South African IP is being sold for a purchase price that is at fair value and on terms which are arms-length. However, where the transfer of IP is a matter of moving IP between two related parties, the notion of paying tax as a result of that transfer is unpalatable, and industry experience has shown that SARB will not readily agree to the request because of its mandate to protect and retain valuable assets in South Africa.

An alternative avenue to “moving IP” which does not require SARB's permission and does not require that the company formally assign its IP to the foreign entity (provided it is dealing with IP of an appropriate nature that can be innovated and developed), is

¹⁴² Dommissie, Adrian, 2019, “A fail-safe way to moving IP offshore, Part 1 [opinion]”, Ventureburn, 18 July, available at URL: <https://ventureburn.com/2019/07/a-fail-safe-way-to-moving-ip-offshore-part-1-opinion/>

the development of new IP in the foreign jurisdiction. This way, the foreign company is able to commercialise the evolved IP offshore by relying on access to the existing IP by way of a contractual arrangement which is compliant with transfer pricing rules.

6.2 The evolving nature of IP

The abovementioned approach results in ownership over the evolved IP in the offshore company which is independent of the South African entity. The approach described below is determined with reference to Section 17 of Practice Note 7 which states that Chapter VI of the OECD Guidelines deal specifically with intangible property, and that the Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with connected persons involving intangible property. The approach described below is outlined in Chapter VI of the OECD Guidelines and deals in detail with intangibles and ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles¹⁴³. In this regard, the company will need to identify and establish the ownership elements relating to the evolving IP, in its chosen country of residence.

In practice, this requires:

Firstly, the offshore company must deliver the economically significant functions relating to development, enhancement, maintenance and commercialisation of the IP.¹⁴⁴

Secondly, the offshore company must supply the assets, resources and funds required for the development of the evolving IP.¹⁴⁵

Thirdly, the offshore company must truly bear the commercial risk of success or failure of the new IP.¹⁴⁶

¹⁴³ OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁴⁴ Page 257, Section 6.32, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁴⁵ Page 248, Section 6.3, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁴⁶ Page 270, Section 6.64, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

In essence, the offshore company must show that it is a genuine business centred around the newly evolved IP. It must show that it performed certain functions, funded the implementation of those functions and built a genuine business that could succeed or fail depending on the IP's success or failure, and the result is that the relevant entity who is responsible for performing these functions and assuming these risks becomes entitled to the compensation due for the intangible asset which has been created.¹⁴⁷

6.2.3 Economically significant functions

The first element, that offshore company deliver the *economically significant functions* relating to *development, enhancement, maintenance and commercialisation* of the IP, is achieved through real governance functions.¹⁴⁸ These are important functions which create the new IP's value and are the principles identified by the OECD which is discussed in relation to the establishment of company's place of effective management.

To show that offshore company performed these functions, one would need to demonstrate that the company has a real governance function that controls all the important functions. In this context, one would expect to see the following:

Firstly, a process which identifies a market opportunity, and a product which solves that opportunity; second, a process that created the product ("giving life" to the solution identified above); third, building the strategy for developing and commercialising the product – and also, budgeting and funding that strategy; fourth, creating a marketing programme with focused outcomes; fifth, enforcing or protecting legal rights over any IP – registrations or contractual protections; and lastly, managing and carefully controlling the quality control of services performed by outsourced entities, especially with related parties (i.e.. the South African business which held the existing IP).¹⁴⁹

So, in practice, one would expect to see that a person located in offshore company's jurisdiction devised the IP in response to a market opportunity and proposed a plan

¹⁴⁷ Page 258, Section 6.32, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁴⁸ Page 258, Section 6.32, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁴⁹ Dommissie, Adrian, 2019, "A fail-safe way to moving IP offshore, Part 1 [opinion]", Ventureburn, 18 July, available at URL: <https://ventureburn.com/2019/07/a-fail-safe-way-to-moving-ip-offshore-part-2-opinion/>

which was adopted at board level to develop, fund and commercialise that IP, and further went through a practical (verifiable) process of creating the real-life product or IP which could then be commercialised. By establishing the above, the enhancement, maintenance and commercialisation functions would follow naturally.¹⁵⁰

The material allocation of revenue and profit to the offshore company will depend on the extent to which the offshore company sets up and manages the essential commercial functions. This is regarded as the most important element of the transfer pricing “strategy” for two reasons:

First, the amount paid by the offshore company to the South African company in terms of the operational agreements needs to be considered. For example, the license agreement fee will depend on how much value the offshore company creates in generating offshore income (e.g. business development activities). As a rule, the more offshore company can claim to generate offshore income through its offshore commercial functions, the lower the license fee paid to the South Africa company could be. This would be more nuanced for the services: the creative and controlling functions should be located in the offshore company, so that the South African company can function as a conventional outsourced service provider.¹⁵¹

6.2.4 Use of assets

The second reason relates to the IP Strategy, which is the function of creating the strategy in which the offshore company builds its own IP and earns revenue from that IP. In order to show that the offshore company earns revenue that is not attributable to the South African companies revenue (and that revenue does not have to be shared as license fees or service fees), the offshore company must actually conduct the functions, assume the risks and contribute the assets necessary to develop and own the IP.¹⁵²

¹⁵⁰ Page 258, Section 6.32, OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

¹⁵¹ Dommissie, Adrian, 2019, “A fail-safe way to moving IP offshore, Part 2 [opinion]”, Ventureburn, 18 July, available at URL: <https://ventureburn.com/2019/07/a-fail-safe-way-to-moving-ip-offshore-part-2-opinion/>

¹⁵² Page 248, Section 6.3, OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

The requirement that the offshore company must supply the assets, resources and funds required for the development of the evolving IP is a clear statement that the business growth which the offshore company aims to achieve should be independently achieved through the offshore company's own means, without receiving any special treatment from the South African company. This principal feeds into the risks which are assumed by the offshore company, as well as the fact that any IP which is developed in the course of building the offshore company, cannot be attributable to the South African company.

6.2.5 Bearing the commercial risk

Third is the requirement that offshore company must truly bear the commercial risk of success or failure of the new IP.¹⁵³ This contemplates strategic and market risks, infrastructure and operational risks, financial risks and transactional risks.¹⁵⁴

With regard to strategic and market risks, this addresses the risk of economic environment, political/regulatory events, competition and technological advancements, social and environmental change. Offshore company in this process is expected to be more exposed to risks in relation to reliance on revenue from clients in the foreign jurisdiction and therefore a reduction in that revenue would be a greater risk to offshore company. Further, the offshore company should bear the sole risk with respect to whether it will recoup any fees paid to the South African company with respect to Services and the cost of development of the product/service. The economic outcome of this risk would be felt exclusively by the offshore company (being self-funded, and exclusively exposed to the success or failure of the platform).¹⁵⁵

Regarding infrastructure and operational risks, this relates to uncertainties associated with the South African company's IP with respect to business execution. This may also include the effectiveness of processes and operations – for example, the fact of whether the South African company performs efficiently, accurately and reliably. Further, Offshore company should be exposed to significant reputational, operational and financial risk with respect to a process failure of the IP supplied by the South

¹⁵³ Supra note 153.

¹⁵⁴ Page 248, Section 6.4, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁵⁵ Page 263, Section 6.45, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

African entity. Although the outcome of these risks would be that revenue for both the South African Company and the offshore company would be impacted – the impact would be far greater for the offshore company’s reputation and its ability to increase its market share in the offshore market.¹⁵⁶

Regarding financial risks, in terms of liquidity, cash flow and financial capacity, the offshore company would need to be entirely independent from the South African company and should be separately funded. The creditworthiness of clients is a risk that impacts on both companies, but the severity of this impact will be greater for the offshore company who relies entirely on offshore clients for its revenue, whereas the South African company would likely already have an established client base in South Africa.¹⁵⁷

Lastly, with regard to transactional risks, this addresses the risk of pricing of the product and services, and payment terms in commercializing the product. This would need to be appropriate for the international market.¹⁵⁸

In summary, the assumption of risks refers to the outcome of the determination of which associated enterprise assumes a specific risk under the guidance provided in Section D.1.2.1 of Chapter I of the OECD Guidelines, taking into account control over risk and financial capacity to assume the risk. Contractual assumption of risk refers to the allocation of risk in contracts between the parties¹⁵⁹. The offshore company should be independently resourced with leadership and staff who have the capability, entitlement and authority to make the decisions in relation to the specific risk arising from the transactions. By ensuring that this structure is in place, the risks relating to offshore commercial activity would accordingly be managed by the offshore company who has the capability for that function. Generally, these risks will be assumed (absolutely, or to a far greater extent) by the offshore company, which has independently invested in acquiring the resources required to discharge the functions required to assume, manage, mitigate and control the risks. On this basis, the offshore

¹⁵⁶ Page 263, Section 6.47, OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

¹⁵⁷ Page 263, Section 6.45, OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

¹⁵⁸ Page 264, Section 6.48, OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

¹⁵⁹ Page 248, Section 6.4, OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

company would expect to benefit from a return on its investment and its decisions to assume the risks. Furthermore, the independent funding of the offshore company renders it with the financial capacity to assume the risk.

6.3 Arms-length arrangements between Connected Parties

A determination that a particular group member is the legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the business after compensating other members of the international group for their contributions in the form of functions performed, assets used, and risks assumed.¹⁶⁰

In identifying arm's length prices for transactions among connected parties, the contributions of members of the group related to the creation of intangible value should be considered and appropriately rewarded.¹⁶¹ The arm's length principle requires that all members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles. It is therefore necessary to determine, by means of a functional analysis, which members perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which members provide funding and other assets, and which member assume the various risks associated with the intangible.¹⁶²

The relative importance of contributions to the creation of intangible value by members of the group in the form of functions performed, assets used and risks assumed will vary depending on the circumstances.¹⁶³

It is not essential that the legal owner physically performs all of the functions related to the development, enhancement, maintenance, protection and exploitation of an intangible through its own personnel in order to be entitled ultimately to retain or be attributed a portion of the return derived by the international group from exploitation

¹⁶⁰ Page 263, Section 6.47, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁶¹ Page 263, Section 6.47, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁶² Page 264, Section 6.48, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁶³ Page 264, Section 6.49, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

of the intangibles. In transactions between independent parties, certain functions are sometimes outsourced to other entities. A member of the group that is the legal owner of intangibles could similarly outsource functions related to the development, enhancement, maintenance, protection or exploitation of intangibles to either independent enterprises or associated enterprises.¹⁶⁴

However, having regard to the above, if the legal owner neither controls nor performs the functions related to the development, enhancement, maintenance, protection or exploitation of the intangible, the legal owner would not be entitled to any ongoing benefit attributable to the outsourced functions.¹⁶⁵

For any outsourcing which does take place, it is a requirement for the legitimacy of the arrangement, that the function performing entity be entitled to an arm's length compensation for any functions it actually performs, any assets it actually uses and risks it actually assumes.¹⁶⁶ This is dealt with through appropriate transfer pricing and facilitated through the contractual framework.

6.4 Contractual Framework

In order to legitimise the process of evolution of new IP in an offshore jurisdiction in a separate company, the parties involved will need to develop a strategy for allocating business value across the international group (as discussed above) – specifically, so that value (and IP in particular) is created and developed by the offshore company in its target jurisdiction. The ultimate goal in this process is to achieve a situation where the offshore company possesses discrete resources, creates its own products, independently commercializes those products and assumes the risks of the business – culminating in the establishment of an offshore company which accrues and develops its own commercial value.

If a certain function cannot be performed by the foreign company, or certain assets of the South African company are still relied on, then the South African company has to be compensated with an appropriate share of the returns earned on the IP in question.¹⁶⁷

¹⁶⁴ Page 265, Section 6.51, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁶⁵ Page 266, Section 6.54, OECD, 2017, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", July 2017.

¹⁶⁶ Ibid.

¹⁶⁷ Supra note 153.

Similarly, where the South African company does provide any services to assist with functions which offshore company cannot perform, then the compensation earned pursuant to the provision of such services should flow to the South African entity and be taxed in South Africa. This means that a material amount of the profit must come back to South Africa (converted into rands) and be taxed here. This is underpinned by the notion that any IP which exists and was created by the South African company (and not by offshore company), would fall under the regulation of SARB's exchange controls.¹⁶⁸

To record the arrangements described above for strategy and transfer pricing purposes, the South African company and the offshore company will need to conclude agreements in terms of which the South African entity licences its software and know how to the offshore company, for the offshore company to commercialize outside of South Africa. And secondly, the South African entity must license an element of the software and know-how to the offshore company, with the intention that the offshore company will integrate that IP into its own products and services.

The South African company will further (at least in the early-stages) provides certain services to the offshore company which will need to be captured in an appropriate services agreement.

These arrangements will record and give effect to the exchange of value for transfer pricing purposes and to facilitate the legitimate evolution of new IP in the offshore company, by the offshore company.

6.5 Introduction to Transfer Pricing

The Transfer Pricing process is how the South African company proves that it is being paid fairly for the South African IP being licensed, and services being provided to the offshore company.

Given that the offshore company is also in its startup phase, founders will have an important opportunity to create and manage each company's roles and functions so that the companies in the group are symbiotic. If this is done strategically, and if that strategy is actually implemented in reality through demonstrable means, then the founders could create a framework for the allocation of both revenue and profit

¹⁶⁸ Ibid.

between the South African Company and the offshore company – by deciding where the value in the “group” is created.

This process is important because Section 31 of the Income Tax Act¹⁶⁹ creates the principle that where a South African company contracts with an Offshore company which is related to the South African company – the terms of that contract must be compared to the terms expected between third parties on an arms-length basis. So, the license transaction and the services transaction will be measured and compared by terms expected to exist between unconnected third parties. To the extent that these terms do not compare, then Section 31 allows SARS to adjust the tax payable by the South African company based on revenue which should have been received by the South African company, had the agreed terms of the transactions actually been on an arm’s length basis.

¹⁶⁹ Income Tax Act 58 of 1962

Chapter 7 – Transfer Pricing Considerations

The term ‘Transfer Pricing’ refers to the process by which related entities set the prices at which they transfer goods and services between each other.¹⁷⁰ This is applicable within businesses and between subsidiaries that operate under common control or ownership, and it extends to cross-border transactions as well as domestic ones.¹⁷¹

Transfer pricing between related parties in different tax jurisdictions is difficult when dealing with intangible property, due to the difficulty and disagreement in attributing exact values and royalty rates to intangible property and the ease at which such values can be manipulated. Transfer pricing control therefore refers to the mechanisms employed by revenue collectors to curb pricing manipulation.¹⁷²

In South Africa, these types of transfer pricing issues are dealt with by SARS in accordance with section 31 of the Income Tax Act, which is based on the transfer pricing provisions provided under Chapter II of the OECD Guideline.¹⁷³ Section 31 was introduced to counter transfer pricing practices which may have adverse tax implications for the South African fiscus. This section consists of a combination of transfer pricing and thin capitalisation provisions and the measures employed to combat transfer pricing schemes are in essence contained in section 31(1) and (2) of the Income Tax Act. The provisions of section 31(3) are more specifically aimed at countering thin capitalisation schemes.

According to the OECD guidelines on transfer pricing the main requirement is to ensure that a transaction is concluded at arm’s length. The OECD guidelines prescribe methodologies for determining arm’s length pricing which have been adopted by a number of countries for their local transfer pricing regulation.¹⁷⁴

SARS controls transfer pricing through section 31 of Income Tax Act which empowers

¹⁷⁰ Marais, Jack and Perumall, Ashlin, 2016, “Transfer Pricing”, Adams brochure, available at URL: https://www.adams.africa/wp-content/uploads/2016/04/ADAMS_Transfer-Pricing_Brochure-2016.pdf

¹⁷¹ Shobit, Seth, 2022, “Transfer Pricing”, Investopedia, updated 17 March 2022, available at URL: <https://www.investopedia.com/terms/t/transfer-pricing.asp>

¹⁷² Supra note 172.

¹⁷³ OECD, Chapter II, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

¹⁷⁴ Marais, Jack and Perumall, Ashlin, 2016, “Transfer Pricing”, Adams brochure, available at URL: https://www.adams.africa/wp-content/uploads/2016/04/ADAMS_Transfer-Pricing_Brochure-2016.pdf

the Commissioner of SARS to adjust the price charged between multinational entities (where one of those entities is a South African tax resident) in situations where the terms on which the related entities are transacting are different to what would reasonably or justifiably have been agreed between two unrelated parties on an arms length basis.¹⁷⁵

This principal of Section 31 of the Income Tax Act is captured below:

“Where any transaction, operation, scheme, agreement or understanding constitutes an affected transaction and any term or condition thereof results or will result in a tax benefit for a party to that transaction, the taxable income of that person must be calculated as if that transaction had been entered into in arm’s length dealing.”¹⁷⁶

To facilitate this calculation, an international model of the arm’s length principle, as set out in the OECD guidelines, has been adopted. SARS promotes the use of the OECD guidelines for such a purpose and prescribes that these guidelines are to be used in interpreting what an arm’s length transfer price is in South Africa.

An *Affected Transaction* to which the transfer pricing provisions are applicable, is any transaction, operation, scheme, agreement or understanding that is entered into directly or indirectly for the benefit of either or both:

- a resident and a non-resident;
- a non-resident and another non-resident that has a permanent establishment in South Africa to which the transaction, operation, scheme, agreement or understanding relates;
- a resident and another resident that has a permanent establishment outside of South Africa to which the transaction, operation, scheme, agreement or understanding relates; or
- a non-resident and a controlled foreign company in relation to any resident and

the persons are connected persons.¹⁷⁷

¹⁷⁵ Ibid.

¹⁷⁶ Ibid.

¹⁷⁷ Practice Note No. 7, 1999 “Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing”, South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>

7.1 Arm's length principle

The first and overriding principle is that transactions between connected persons¹⁷⁸ are to be conducted at arm's length. This simply means that the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.¹⁷⁹ This is a simple, yet fundamental principle which ultimately requires connected persons to contract and negotiate the terms of a transaction *as if* they were not connected persons.

Paragraph 1 of Article 9 of the OECD Model Tax Convention deals with the arm's length principle as follows:

*"[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*¹⁸⁰

The objective is to determine, in the case of a multinational¹⁸¹, what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction¹⁸²) should be used as a benchmark

¹⁷⁸ Supra note 179 – "The meaning of a Connected Person is distinguished into four different types of persons, being a natural person, a trust, a company and a close corporation. In relation to a Company, this includes any other company that is part of the same group of companies, and any person other than a company who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20% of the equity shares of voting rights in the company, and any other company if such company is managed or controlled by any person that is a connected person in relation to such company or any person that is a connected person in relation to the first mentioned person".

¹⁷⁹ Section 7 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁸⁰ Ibid.

¹⁸¹ Supra note 179 – a *multinational* is used to refer to any group of connected persons with members or business activities in more than one country. The term "members" refers to constituent parts (including natural persons) of that multinational, each having a separate legal existence

¹⁸² Supra note 179 - an *Uncontrolled transaction* is a transaction which is concluded at arm's length between enterprises that are not connected persons in relation to each other, which could include transactions at arm's length between a member of a multinational and an unconnected person.

against which to appraise the multinational's prices (the controlled transaction¹⁸³). Any difference between the two transactions can then be identified and adjusted. An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.¹⁸⁴

The arm's length principle is considered the international norm, and the commissioner of SARS is of the opinion that application of this internationally accepted principle will minimise the potential for double taxation. Double taxation occurs on an international level, when two separate jurisdictions impose a comparable income tax with respect to the same item of income on the same taxable person.

The determination of an arm's length consideration is not an exact science but requires judgment on the part of both the taxpayer and the Commissioner. Accordingly, taxpayers and the Commissioner need to approach each case, having due regard for the unique business and market realities applicable to each individual case.¹⁸⁵

An arm's length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where, within that range, a specific arm's length price will lie. In determining an arm's length range the application of the most appropriate method or methods will often result in a range of justifiable transfer prices because this range is arrived at by applying a transfer pricing method to multiple comparable data, or from applying different transfer pricing methods. Deciding on the price within a range would thus involve a degree of judgment.¹⁸⁶

Uncontrolled transactions form the benchmark against which a multinational's transfer pricing is appraised in determining whether its prices are arm's length – in other words, the parties to an Uncontrolled Transaction have no incentive to conclude transactions on terms any less favourable than the best which they're able to achieve and these transactions form the basis on which "arm's length" is measured against.

¹⁸³ Supra note 179 – a *Controlled transaction* is a transaction in terms of which the ownership or control relationship is able to influence the transfer price set. In relation to section 31 of the Income Tax Act, a controlled transaction will be any transaction between connected persons, as defined in section 1 of the Income Tax Act

¹⁸⁴ Section 7 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁸⁵ Ibid.

¹⁸⁶ Section 11.4 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

Where there is substantial divergence between the data in the range, then the material differences in comparability as well as the pricing method would need to be reviewed. Where the transaction falls outside of the arm's length range, it is a matter of judgement as to where in the range the adjustment should be affected. The Commissioner concurs with the view of the OECD that the adjustment should reflect the point in the range that best accounts for the facts and circumstances of the controlled transaction. However, in the absence of persuasive evidence for the selection of a particular point in the range, the Commissioner may select the mid-point in the range.¹⁸⁷

7.2 Principles of Comparability

Comparability is fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. For such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable.¹⁸⁸

According to Practice Note 7, to be *comparable*, means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable.

The assessment of comparability can be affected, *inter alia*, by assessing the characteristics of the goods and services, the relative importance of functions performed, the economic and market conditions, and business strategies – these being discussed in further detail below. Note how the factors relevant to transfer pricing are aligned with the creation of value and evolution of intellectual property discussed in the previous chapter – therefore the greater the responsibility and risk undertaken by the offshore entity, the more value is attributable to the offshore entity and the lower

¹⁸⁷ Ibid.

¹⁸⁸ Section 8 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

the consideration payable between the offshore entity and South African entity for services and licence fees will be.

8.2.1 the characteristics of the goods and services

The characteristics of intangible property is worthwhile considering in determining the value in the open market. For intangible property, these include the form of the transaction, the type of property, the duration of protection, the degree of protection and the anticipated benefits from use of the property, as well as the nature and extent of the services given effect to by the property. The significance of the abovementioned aspects vary depending on the pricing method used. For example, when applying the Comparable Uncontrolled Price (CUP) method, the actual characteristics of the goods and services are critical, whereas when using the Transactional Net Margin method, the characteristics of the goods or services transferred are not nearly as important as the functions and risks undertaken by the relevant entities.¹⁸⁹

8.2.2 the relative importance of functions performed

The compensation for the transfer of property or services between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account the risks assumed and the assets used. In determining whether two transactions are comparable, the functions and risks undertaken by the independent parties should be compared to those undertaken by the connected persons.¹⁹⁰ Most of the recommended transfer pricing methods (Cost Plus, Resale Price, Transactional Net Margin and Profit Split methods) focus on functions performed, risks assumed and assets utilised rather than only on the goods or services being transferred. When applying one of these methods in a transfer pricing analysis, the comparability of functions performed by the member of the multinational and the independent entity or entities to which it is compared is very important. In contrast, the CUP method is based

¹⁸⁹ Section 8.2 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁹⁰ Section 8.3.1 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

on a direct comparison of the price charged for goods or services and the characteristics of the goods or services are therefore significant.¹⁹¹

A practical way of evaluating functional comparability is to prepare a functional analysis. A functional analysis is a method of finding and organising facts about a business' functions, assets (including intangible property) and risks. It aims to determine how these are divided between the parties involved in the transaction under review, and serves therefore, to identify the *economically significant activities* (functions performed, assets employed and risks assumed) that are undertaken by the member of a multinational, and for which it should expect to be rewarded. This identifies the nature and characteristics of the connected party dealings that have to be priced.¹⁹²

In the context of early-stage companies, whose aim is to legitimately move their tax residency and place of effective management to an offshore jurisdiction with a legitimate foreign business establishment status, it is important that the economically significant functions within the group are undertaken by the offshore entity. A functional analysis of each company in the group will help to highlight where such significant functional differences may exist. Importantly, functional analysis is not a pricing method in its own right, rather, it is a tool assisting in the selection of a transfer pricing method and the proper determination of an arm's length price.

8.2.3 economic and market conditions

Due to the varied nature of what would be considered an "arm's length price" across similar products or services in different markets, it's important that relevant and comparable markets are identified for this purpose, or where this isn't possible, that appropriate adjustments are made.

The OECD Guidelines identify a number of factors (open list) used for comparing markets, which include consideration of the geographic location of the markets, the size of the market, the extent of competition in the markets, the availability of

¹⁹¹ Section 8.3.1 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁹² Ibid.

substitute goods and services, the transport costs (if any), and the level of market (retail or wholesale) which the entities are participating.

These factors may have particular relevance for an early-stage South African company engaging with a connected party based offshore depending on the service/product offering, and because South Africa is a smaller market, it can be difficult to obtain comparable companies from the South African market.

8.2.4 business strategies

Business strategies are a legitimate aspect of the arm's length principle, and in this context consideration is given to the business strategies concerning a company's enterprise, including (*open list*) innovation, new product development, degree of diversification, risk aversion and other factors which have a bearing on the daily conduct of business.

Practice Note 7 acknowledges that market penetration schemes are actively utilised and therefore recognises decisions taken to, for example, charge a lower price for a product or service compared to the market, or decrease their tax liability as a result of incurring high start up costs to competitors already established in the market. This is seen as a valid justification if the intention is to decrease profits temporarily in return for higher long term profits – the relevant question is whether a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

The Commissioner may take into consideration the following factors when determining the legitimacy of a strategy which may decrease profits temporarily in return for higher long term profits:

Firstly, whether the conduct of the parties is consistent with the professed business strategy. Secondly, whether the nature of the relationship between the parties to the controlled transaction justifies that the taxpayer bears the costs of the business strategy; and third, whether there is a plausible expectation that the business strategy will produce a return sufficient to justify its costs, within a period of time that would be acceptable in an arm's length arrangement.¹⁹³

¹⁹³ Section 8.5.4 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions :

8.3 Acceptable methods for determining an Arm's Length Price

Neither Section 31 nor the tax treaties entered into by South Africa prescribe any particular methodology for the purpose of ascertaining an arm's length consideration. Given that there is no prescribed legislative preference, the Commissioner would generally seek to use the methods that have been set out below.¹⁹⁴

The most appropriate method in a given case will depend on the facts and circumstances of the case and the extent and reliability of data on which to base a comparability analysis. It should always be the intention to select the method that produces the highest degree of comparability.¹⁹⁵

The choice of the most appropriate method should therefore be based on a practical weighting of the evidence, having regard to the nature of the activities being examined, the availability, quality and reliability of the data, the nature and extent of any assumptions, and the degree of comparability that exists between the controlled and uncontrolled transactions where they are different.¹⁹⁶

As a rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Taxpayers will not be required to undertake an intricate analysis of all the methodologies but should have a sound basis for using the selected methodology. This could entail providing reasons why secondary methods are not appropriate.

The standard transfer pricing methods recognised by the OECD Guidelines, are:

- the comparable uncontrolled price method (CUP method);
- the resale price method (RP method);
- the cost plus method (CP method);
- the transactional net margin method (TNMM); and
- the profit split method.

Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁹⁴ Section 9 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁹⁵ Ibid.

¹⁹⁶ Ibid.

The Commissioner endorses the abovementioned methods as acceptable transfer pricing methods, with the most appropriate of these depending on the particular situation and the extent of reliable data to enable its proper application – it's important to have an understanding of the commercial and economic reality underlying any particular situation when making a determination on which is the most appropriate pricing method.¹⁹⁷

8.4 Recap and application to early-stage technology companies

To recap, transfer pricing is the system used by tax authorities globally to ensure that the profits associated with the creation and transfer of value is appropriately allocated to (and taxed in) the country in which that value was created. In effect then, the tax authorities look to align profits of a Company with the value-creating functions (and the control of commercial risks) across a multinational group.¹⁹⁸

The OECD has developed guidelines which aim to identify the value contributed by each company in a multinational structure, and then to establish the appropriate arm's length price which should be charged by each of those companies. The goal is to allocate revenue (and therefore, profit) fairly across a multinational group, so that each tax authority receives its due share from the value being created by the appropriate allocated functions.¹⁹⁹

This is relevant where a South African company might perform services (i.e. software development) for a connected person who is based in an offshore jurisdiction. The offshore holding company will be required pay an arm's length price for those services, even though the entities are part of the same group.

Accordingly, the structuring challenge presented to these early-stage companies is to identify the process by which the value in a group is created, and to identify where that value is created. Once that is done, each group company's contribution is then "priced" using one or more transfer pricing methods prescribed by the OECD. That then lays

¹⁹⁷ Section 9 of Practice Note No. 7, 1999 "Section 31 Of The Income Tax Act 58 of 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing", South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>,

¹⁹⁸ Dommissie, Adrian, 2019, "What startups should know about tax, when setting up an overseas company", Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

¹⁹⁹ Ibid.

the foundation of the allocation of profit across the group.²⁰⁰

In the context of this paper, it is common for the functions within a group (i.e. South African company and offshore company) to migrate (typically, from South Africa to a target offshore jurisdiction) – and as that happens, the "value creation" will move which has the consequence of re-locating the business relevant IP and reducing the profit that requires to be allocated to the South African company, because the South African company is performing functions which are becoming less relevant and ultimately redundant over time, and the offshore entity is assuming those functions and the creation of new IP.

²⁰⁰ Dommissie, Adrian, 2019, "What startups should know about tax, when setting up an overseas company", Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

Chapter 8 – Looking forward: Legislative reform and the mirror structure

8.1 South African Venture Capital Association and their recommendations

In a policy discussion document titled Amending exchange controls for high-growth SMMEs to support SA's growth ambitions which was circulated and spearheaded by the South Africa Venture Capital Association ("SAVCA")²⁰¹, the backdrop provided for the discussion was layered against the South African governments development objectives, which included the fourth industrial revolution (4IR), ensuring competitiveness and the job creation challenge, which is now even more acute as a result of the Covid-19 pandemic.²⁰²

It was noted that small, medium and micro enterprises ("SMMEs") can make important contributions to these objectives while also contributing to the national fiscus through taxes, with data showing that SMMEs employ nearly half the South African workforce.²⁰³

High-growth SMMEs, which includes startups, are a unique sub-set within the economy in that they often create new intellectual property and are expected to reach scale in a relatively short time. To achieve the scale and pace of growth which they aspire to, they require unique support and financing at different stages, including seed and growth capital.

South African venture capital (VC) investors have increased investment in local startups, reaching almost R1.23bn in 2019. However, even at this level of investment, it is not enough to propel high-growth SMMEs to reach their full potential on a global scale. For these startups to reach their full potential, they often require international capital, partnerships and access to networks to support their growth and international competitiveness.

The challenges around capital-raising and the ability to monetise their intellectual property, are primarily as a result of two barriers. Firstly, the current format of the

²⁰¹ Amending exchange controls for high-growth SMMEs to support SA's growth ambitions, circulated and spearheaded by the South Africa Venture Capital Association ("**SAVCA**")

²⁰² Ibid.

²⁰³ Ibid.

exchange control rules. Where previously the loop structure was restricted to 40% South African ownership, it is now permitted, subject to certain requirements. Unfortunately the relaxations did not go far enough to support startups whose aim it is to raise international capital, as they are typically unable to meet the requirements of the relaxations (specifically the requirement that the loop should be cash-settled using investor funds that are already offshore or via the investor's foreign allowance). Practically, where a startup is undergoing an international capital raise, the South African-based existing shareholders should be entitled to exchange their existing shares in the South African entity for shares in the international entity – this is necessary as the reality is that shareholders of a startup will not have the cash to be able to cash-settle the transactions). On the current regulations, startups will therefore still require prior approval from SARB to raise capital offshore. This creates complexity, causing delays or even worse, potential investors will walk away to other, simpler transactions on offer. This factor adds significant expense that these companies in an early stage of maturity cannot afford.²⁰⁴

Secondly, the restrictions on transferring intellectual property are unduly onerous, adding delays and costs, which SAVCA notes may altogether put off investors and commercial and technology partnership opportunities.

SAVCA proposes as a solution, to implement further relaxations to the exchange control regulations which are specifically applicable to startups. These could allow these companies to begin raising international capital and reporting transactions rather than first having to obtain permissions from SARB. This would have the consequence of allowing South African high-growth SMMEs to own unlimited shares in foreign holding companies that in turn own shares in South African firms, and thus improve their chances of raising international capital. This would maximise the gains to South African investors on an eventual disposal, with returns to the South African fiscus.²⁰⁵

The second solution SAVCA proposes is a reform of the intellectual property exchange controls so that high-growth SMMEs are required to report transactions rather than obtain permissions from SARB beforehand.²⁰⁶

²⁰⁴ Amending exchange controls for high-growth SMMEs to support SA's growth ambitions, circulated and spearheaded by the South Africa Venture Capital Association ("SAVCA").

²⁰⁵ Ibid.

²⁰⁶ Ibid.

8.2 The mirror structure

It is in the context of the restrictive nature of the exchange controls insofar as they apply to startups in South Africa, as well as the inconsistency demonstrated by the legislature in their regulation of this area of law, that the industry practice has adapted to formulate a legally compliant legal structure – known as the mirror structure.

The mirror structure relies on a synthetic bonding of shares between two separate companies based in different jurisdictions and in its simplest form will have identical shareholding in South African and the foreign entity. The mirror structure is able to achieve the same ultimate objectives as the conventional loop structure by focusing the concept of *place of effective management* and how these elements working together provide a solution which does not rely on South Africa's exchange control policy, by dealing with intellectual property through intentional yet organic evolution, and finally transfer pricing - which regulates the exchange of value between the mirrored entities.

It is submitted that currently the mirror structure, although a technically more complex structure compared to the loop structure, is a more accessible and safer form of international structure to rely on by startups as it exists independently and does not rely on a specific formulation of legislation which is subject to change. The reason startups need to have access to an alternative is because the current legislative framework which regulates the relevant areas of law insofar as applicable to startups is effectively inaccessible from a financial point of view, not very user-friendly and even if it were to be amended as per SAVCA's recommendations mentioned above, it may not apply consistently going forward, or worse, may be updated or changed unfavourably at any time – as demonstrated in the past.

Bibliography

Primary Sources:

Legislation, regulations, practice notes and interpretation notes

Currency and Exchanges Manual for Authorised Dealers

Circulars of the Currency and Exchanges Manual for Authorised Dealers - 1/2021

Income Tax Act, 58 of 1962

OECD, 2017, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2017.

Interpretation Note No. 6 (issue 2), 2015, “Resident – Place of effective management (companies)”, South African Revenue Service with reference to the Income Tax Act No. 58 of 1962, 3 November, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf>

Practice Note No. 7, 1999 “Section 31 Of The Income Tax Act, 1962 (The Act) : Determination Of The Taxable Income Of Certain Persons From International Transactions : Transfer Pricing”, South African Tax Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>

World Intellectual Property Organisation, “What is Intellectual Property”, available at URL: https://www.wipo.int/econ_stat/en/economics/

World Intellectual Property Organisation, “IP and Economics”, available at URL: https://www.wipo.int/econ_stat/en/economics/

South African Reserve Bank, Frequently asked questions, available at URL: <https://www.resbank.co.za/en/home/what-we-do/financial-surveillance/FinSurvFAQ>

South African Institute of Chartered Accountancy, 2015, “International Tax, 2546. Foreign business establishments, March 2015 – issue 186”, March, available at URL: https://www.saica.co.za/integritax/2015/2394._Section_9D_rules.htm.

Case law

Oceanic Trust Co Ltd NO v C: SARS4

Her Majesty’s Revenue & Customs v Smallwood & another [2010] EWCA Civ 778.

Wensleydale’s Settlement Trustees v Inland Revenue Commissioners [1996] STC (SCD) 241 at 252

Trevor Smallwood Trust v Revenue and Customs [2008] UKSPC SPC00669 in 112 & 114 at 30 and in 130 at 35 and the subsequent appeal in the Court of Appeal, Her Majesty’s Revenue & Customs v Smallwood & another [2010] EWCA Civ 778 in 48.

Laerstate v The Commissioner for Her Majesty's Revenue & Customs 1 [2009] UKFTT 209 (TC).

Unit Construction v Bullock [1960] AC 351

Secondary Sources:

Articles and websites

Amending exchange controls for high-growth SMMEs to support SA's growth ambitions, circulated by the South Africa Venture Capital Association

Ansara, D. & Dimant, T., 2019. Macro Review: *Open for business: A review of the SMME landscape in South Africa*. Centre for Risk Analysis and FinFind's Inaugural South African SMME Access to Finance Report from 2019.

Botha, Louis, 2021, "Prohibition no more: Loop structure rules amended and related considerations", Cliffe Dekke Hofmeyr, Tax and Exchange Control Alert, 22 January, available at URL:

<https://www.cliffedekkerhofmeyr.com/en/news/publications/2021/Tax/tax-and-exchange-control-alert-22-january-prohibition-no-more-loop-structure-rules-amended-and-related-considerations-.html#:~:text=A%20loop%20structure%20entails%20the,or%20a%20South%20African%20asset.>

Botha, L, 2018, "Crossing Borders: The not-so-golden loop structure", Cliffe Dekker Hofmeyr, 17 August, available at URL:

<https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-17-august-crossing-borders-the-not-so-golden-loop-structure.html>

Brincker, Emil, *et al*, 2021, "Tax & Exchange Control Alert", Cliffe Dekker Hofmeyr publication, available at URL:

<https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2021/Tax/Downloads/Tax-Exchange-Control-Alert-22-January-2021.pdf>

Bowman Gilfillian, 2021, "South Africa: *Loop structures – opening possibilities in private equity*", IFLR1000, 19 March, available at URL:

<https://www.iflr1000.com/NewsAndAnalysis/South-Africa-Loop-structures-opening-possibilities-in-private-equity/Index/12144>

Claasen, L (2021) "Why exchange controls are still strangling South Africa's startup ecosystem, News24, 17 September 2021. Available at

<https://www.news24.com/fin24/opinion/opinion-why-exchange-controls-are-still-strangling-sas-startup-ecosystem-20210917>

Claasens, L, 2021, "The 3 Most Important reasons why startups fail and what can be done about it" Finance24, 20 Nov, available at URL:

<https://www.news24.com/fin24/opinion/llew-claasens-the-3-most-important-reasons-why-startups-fail-and-what-can-be-done-about-it-20211120>

Commentaries on the Articles of the Model Tax Convention on Income and on Capital, Condensed Version, dated 15 July 2014 at Paragraph 24, subparagraph 90.

Currency and Exchanges Manual for Authorised Dealers -
<https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/general-public/Currency%20and%20Exchanges%20Manual%20for%20Authorised%20Dealers.pdf>

Domnisse, A, 2018, “The ins and outs of taking your startup offshore”, Ventureburn 27 November 2018, available at URL: <https://ventureburn.com/2018/11/taking-business-offshore/>

Domnisse, Adrian, 2021, “Exchange Control Loop Restrictions Lifted”, LinkedIn, 9 January, available at URL: <https://www.linkedin.com/pulse/exchange-control-loop-restrictions-lifted-adrian-domnisse/?trackingId=HLKUEb3WV5J9jsosTbuEpQ%3D%3D>

Domnisse, Adrian, 2019, “What Startups should know about tax, when setting up an overseas company”, Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

Domnisse, Adrian, 2019, “What startups should know about tax, when setting up an overseas company”, Ventureburn, 18 January, available at URL: <https://ventureburn.com/2019/01/startups-tax-overseas-company/>

Domnisse, Adrian, 2019, “A fail-safe way to moving IP offshore, Part 1 [opinion]”, Ventureburn, 18 July, available at URL: <https://ventureburn.com/2019/07/a-fail-safe-way-to-moving-ip-offshore-part-1-opinion/>

Domnisse, Adrian, 2019, “A fail-safe way to moving IP offshore, Part 2 [opinion]”, Ventureburn, 18 July, available at URL: <https://ventureburn.com/2019/07/a-fail-safe-way-to-moving-ip-offshore-part-2-opinion/>

Exchange Control Regulations, 1961 as promulgated by Government Notice R.1111 of 1961-12-01, as amended from time to time.

FinFind Inaugural South African SMME Access to Finance Report 2018/2019 -
<https://www.accesstofinancereport.co.za/pdf/SA-SMME-Access-to-Finance-Report-2017-FINAL-VERSION-FOR-RELEASE-on-10-July-2018.pdf>

Gers, Carmen, 2020, “Loop Structures and the controlled foreign company rules”, ENSight, 18 August, available at: https://www.ensafrica.com/news/detail/3222/loop-structures-and-the-controlled-foreign-co?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration

Grant Thornton, 2020, “Transfer Pricing – South Africa”, 1 July, available [Grant Thornton, 2020, “Transfer Pricing – South Africa”
<https://www.grantthornton.global/en/insights/articles/transfer-pricing-guide/transfer-pricing---South-Africa/>](https://www.grantthornton.global/en/insights/articles/transfer-pricing-guide/transfer-pricing---South-Africa/)

Integritax, 2016, Special Voluntary Disclosure Programme: Tax and Exchange Control Relief, November 2016, Issue 206, available at URL: https://www.saica.co.za/integritax/Archive/Integritax_Nov_2016_Issue_206.pdf

Investopedia - <https://www.investopedia.com/terms/s/startup.asp>

Killoran, Ryan, 2020, “Legal Brief October 2020 - Proposed tax changes to facilitate the relaxation of exchange control require refinement”, available at URL: <https://www.werksmans.com/wp-content/uploads/2020/10/Proposed-tax-changes.pdf>

Legal and Policy: Interpretations and Rulings, 2011, “Discussion Paper on Interpretation Note 6, Place of Effective Management”, South African Revenue Service, available at URL: <https://www.sars.gov.za/wp-content/uploads/Legal/DiscPapers/LAPD-LPrep-DP-2011-02-Discussion-Paper-POEM-on-IN6.pdf>

Macdonald-Spence, N, 2020, “Loop Structures – what are they and why do they matter”, Spence Law, 20 October, available at URL: <https://www.spencelaw.co.za/post/loop-structures-what-are-they-and-why-do-they-matter#:~:text=WHAT%20IS%20A%20LOOP%20STRUCTURE,an%20entity%20within%20the%20CMA.>

Maitland Fund Services, 2021, “South African Exchange Control – relaxation of loop structures, available at URL: <https://www.maitlandgroup.com/intouch/march-2021/private-clients/south-african-exchange-control-relaxation-of-loop-structures/>

Marais, Jack and Perumall, Ashlin, 2016, “Transfer Pricing”, Adams brochure, available at URL: https://www.adams.africa/wp-content/uploads/2016/04/ADAMS_Transfer-Pricing_Brochure-2016.pdf

Subban, V and Da Silva, D, 2021, “South Africa: Removal of prohibition of “loop structures” – don’t forget to check the tax consequences”, Baker McKenzie – Export Control, 5 February, available at URL: <https://www.globalcompliancenews.com/2021/02/05/south-africa-removal-of-prohibition-of-loop-structures-dont-forget-to-check-the-tax-consequences-15012021/#:~:text=As%20noted%20above%2C%20the%20removal,the%20South%20African%20tax%20base.>

SMME Employment figures: Small Enterprise Development Agency (*SEDA*), Annual Report 2018/2019.

Small Enterprise Development Agency - <http://www.seda.org.za/Publications/Publications/SEDA%20Annual%20Report%202019%20Final%20Document%20Sent%20to%20parliament.pdf>

South African Venture Capital Association - <https://savca.co.za/wp-content/uploads/2020/03/SAVCA-2020-Private-Equity-and-Venture-Capital-Impact-Survey.pdf>

Staff Writer, 2021, “South Africa’s ‘silicon valley’ has over 450 tech firms and employs more than 40,000 people”, BusinessTech, 10 May, available at URL: <https://businesstech.co.za/news/technology/489253/south-africas-silicon-valley-has-over-450-tech-firms-and-employs-more-than-40000-people/>

South African Institute of Professional Accountants, 2019, “Part 1 – Taking money out of RSA – Reserve Bank Processes”, Bringing Accounting to life, available at

URL: https://www.saipa.co.za/wp-content/uploads/2019/10/SAIPA_Taking_money_out_of_the_country.pdf

South African Revenue Service, “Tax and Non-Residents”, available at URL: <https://www.sars.gov.za/individuals/tax-during-all-life-stages-and-events/tax-and-non-residents/>

OECD, “South Africa and the OECD”, Global Relations, available at URL: <https://www.oecd.org/global-relations/keypartners/south-africa-and-oecd.htm#:~:text=Key%20partners%20contribute%20to%20the,substantive%20bodies%20of%20the%20Organisation.>

Shobit, Seth, 2022, “Transfer Pricing”, Investopedia, updated 17 March 2022, available at URL: <https://www.investopedia.com/terms/t/transfer-pricing.asp>

Special thanks to:

My parents, Martin and Val Kelly who have supported me and my education from day one; I am incredibly privileged – thank you!

My wife, Sarah Kelly who has been by my side through-out the journey and supported me in so many ways – thank you!

Adrian Dommissie, who introduced me to the world of startups and has shared and continues to share his wealth of knowledge of law and business with me – thank you!