

**University of Cape Town
Faculty of Law**



**South Africa's Headquarter
Company Regime:
A Gateway Barred from Within**

Tsangadzaome A. Mukumba

Supervisor: Tracy Gutuza

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DECLARATION

I declare that the thesis for the degree of Master of Laws at the University of Cape Town, hereby submitted, has not been previously submitted for a degree at this or any other university, that it is my own work in design and execution, and that all the materials contained herein have been duly acknowledged.

Tsangadzaome Mukumba

13 March 2017

Abstract:

This paper aims to determine whether South Africa's section 9I headquarter company regime is fit for the purpose of incentivising multi-national enterprises to locate strategically beneficial activities in South Africa.

Part I investigates the tax policy appropriateness of s9I in the context of a developing, but regionally dominant South Africa. It finds that the passive intermediary holding company activities in fact incentivised by s9I are not directly beneficial to South Africa. While the active functions associated with true headquarter companies would produce the positive externalities needed by South Africa. Given the regional competition in this arena and strategic advantages in South Africa Part I advocates the incentivisation of regional headquarter companies, specifically regional treasury companies, as the most appropriate policy choice.

Part II interprets the provisions of s9I regime to determine their effect on its commercial attractiveness. The analysis covers both the interpretation of the relevant provisions under South African tax law and the place of s9I in the broader legal atmosphere. It is determined that due to an overemphasis on restricting the activities of prospective s9I companies and preventing the erosion of the tax base, the provisions of the regime themselves undermine its commercial attractiveness.

The ultimate conclusion reached here is that although South Africa is indeed poised to be the natural gateway into Africa, the s9I regime is both inappropriately designed and unattractive to prospective multi-nationals looking to enter the region. Therefore, if the regime adopts the 'effective, reliable tax relief for strategic local substance' model of incentivisation South Africa can still reap the benefits of direct investment by MNEs.

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Abbreviations Used:

| | |
|-----------------------|--|
| <i>ANC</i> | The African National Congress |
| <i>AHCA</i> | <i>Approved Headquarter Company Award</i> |
| <i>ASEAN</i> | Association of South East Asian Nations |
| <i>CFC</i> | Controlled Foreign Company |
| <i>DTA or treaty</i> | Double Taxation Agreement |
| <i>EDB</i> | <i>Economic Development Board</i> |
| <i>The Act or ITA</i> | Income Tax Act 52 of 1958 |
| <i>IFSC</i> | International Financial Services Centre |
| <i>GBC 1</i> | Global Business Corporation 1 |
| <i>IHC</i> | Intermediary Holding Company |
| <i>IN87</i> | Interpretation Note No. 87 |
| <i>LIS</i> | Location Incentive Scheme |
| <i>MNE</i> | Multinational Enterprises |
| <i>OECD</i> | <i>Organisation for Economic Cooperation and Development</i> |
| <i>OHC</i> | <i>Operational Headquarter Company</i> |
| <i>TLAA 2010</i> | Taxation Laws Amendment Act 7 of 2010 |
| <i>TLAA 2011</i> | Taxation Laws Amendment Act 24 of 2011 |
| <i>TLAA 2012</i> | Taxation Laws Amendment Act 22 of 2012 |
| <i>RHQ</i> | Regional Headquarter Company |
| <i>RTC</i> | Regional Treasury Company |
| <i>SAB</i> | South African Breweries Pty |
| <i>SABMiller</i> | SABMiller International BV |
| <i>SARS</i> | South African Revenue Service |
| <i>s9I co</i> | Section 9I Company |
| <i>YOA</i> | Year of Assessment |

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INTRODUCTION

- 1.1. The fall of apartheid brought a fervour to South Africa; the hearts of its people running over with the triumph of democracy and newfound hope of reconciliation. The passing of more than twenty years without sufficient, tangible progress for much of South Africa has seen these passions dampened. It is becoming increasingly evident that without socio-economic emancipation for the black majority the true victories of human dignity and equality will remain elusive. It is therefore imperative for the democratically elected government to push a developmental agenda which will bring about real change for the poor and disenfranchised caught in the wake of apartheid.¹
- 1.2. The African National Congress ('ANC') led government in recent years has chosen the developmental state as the means to take South Africa forward. It is generally accepted within this paradigm that inclusive economic growth facilitated by the state is essential to achieve much needed social progress.² However, the path to this end for South Africa and the best choice of policy vehicle to traverse it remain far from clear. Taxation and broader economic regulation have often been favoured as tools with which governments can engineer change in economic circumstance and behaviour towards given policy goals. The ANC led government has been no different and boldly states that it intends to 'build a developmental state which will intervene in the economy in favour of labour and the poor'.³
- 1.3. National Treasury in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 declared that South Africa's location, sizable economy, political stability, overall strength in financial services and network of tax treaties make it the natural holding company gateway into the region.⁴ It therefore set out to encourage Parliament to enact a regime which

¹ ss 7 (2), 9 & 10 of the Constitution of the Republic of South Africa, 1996.

² Omano Edigheji 'Constructing a democratic developmental state in South Africa: Potentials and Challenges' in Omano Edigheji (ed) *Constructing a democratic developmental state in South Africa: Potentials and Challenges* (2010) 1– 2.

³ African National Congress 'Election Manifesto: Together We Move South Africa Forward' (2014) 7.

⁴ National Treasury of the Republic of South Africa 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010' (2010) 77; The World Economic Forum rates South Africa's financial sector's competitiveness at 5.2 out of 7 and 11th out of 140 countries, see further Klaus Schwab (ed) *World Economic Forum Global Competitiveness Report 2016- 2017* (2016) 325.

would remove tax as a barrier to such company structures. The intention was to ensure obstacles, in the Income Tax Act 58 of 1962 ('the Act' or 'ITA'), to South Africa taking its place as the gateway into Africa were removed. The barriers initially identified were: the controlled foreign company ('CFC') regime, thin capitalisation rules and the taxation of cross border dividend and interest payments.⁵ The proposed relief would allow subsidiaries of qualifying headquarter companies to avoid being subject to CFC rules merely due to a majority shareholding, avoid dividends tax in the form of Secondary Tax on Companies and benefit from relaxed application of the arm's length principle for conduit, cross border loans.⁶

- 1.4. The current manifestation of South Africa's headquarter company regime was first enacted through the Taxation Laws Amendment Act 7 of 2010 ('TLAA 2010'). The nature of the regional holding/headquarter company intervention evolved over the following years. The regime began life centred around the definition of 'Headquarter company' in s1, which provided the criteria for qualifying companies.⁷ The relief mentioned above, as well as provisions on exchange gains, operated through exclusions in the relevant sections of the Act.⁸ The Taxation Laws Amendment Act 24 of 2011 ('TLAA 2011') saw the enactment of s9I as the functional core of the regime, with less stringent requirements for qualification.⁹ Further, Parliament dealt with the anomaly of unsolicited headquarter company status by introducing an annual election and an exit/entrance tax into the regime to prevent erosion of the pre-existing tax base.¹⁰ The Tax Laws Amendment Act 22 of 2012 ('TLAA 2012') saw further

⁵ National Treasury (note 3) 77-8.

⁶ *Ibid* 77-80.

⁷ s6(1)(o) Taxation Laws Amendment Act 7 of 2010.

⁸ For example, s16 of the TLAA 2010 enacted the headquarter company exceptions s9D of the ITA, the foreign currency relief found in s24I(1) and s25D(4) of the ITA was enacted through s47(1) and s50 (1) of the TLAA 2010 and exemption from the forthcoming dividends tax found in s64E(1) of the ITA was enacted through s71(1) of the TLAA 2010.

⁹ s21(1) Taxation Laws Amendment Act 24 of 2011; For example, the minimum equity share and voting right requirement found in s9(2)(a) was reduced from 20per cent to 10per cent and s9I(2)(b) was relaxed by excluding cash holdings from total assets.

¹⁰ National Treasury of the Republic of South Africa 'Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011' (2011) 92-3; s26 & s 27 TLAA 2011, which enacted s9I (3) and s9H ITA respectively.

relaxation of the requirements and brought in relief for intellectual property/royalty flow through – similar to the treatment of flow through debt finance.¹¹

- 1.5. The aim of this paper is to determine whether the headquarter company regime amendments, enacted at the impetus of National Treasury, live up to their stated intention of providing a viable gateway into the region. They must simultaneously satisfy the developmental imperative, which is necessarily a consideration in the post-apartheid economic policy. The route chosen for this enquiry is two-fold and can be summarised as: 1) whether the s9I regime is appropriate for South Africa's present context from a tax policy perspective; and 2) whether the provisions of s9I regime provide a commercially viable structure, which would likely be attractive to Multinational Enterprises (MNE).
- 1.6. In pursuit of an answer to the above, Part I investigates the nature of the various tax based incentivisation schemes aimed at influencing MNEs' choice to use a form of holding company structure or establish a headquarter company in a particular jurisdiction. This will provide the means to determine if the s9I regime conforms with contemporary best practice and is competitive with existing regimes. More importantly, it will provide an answer on whether the s9I regime is in sync with broader government policy.¹² This would be so if it targets the kind of MNE activity which is most beneficial to grass roots economic development of the people of South Africa.
- 1.7. Part II looks at the actual workings of the legislative provisions, because the likelihood that MNEs will opt into the s9I regime in the first instance depends on the reliability of accessing its benefits. While cognisant that tax is only one factor in the structuring decisions of MNEs, companies are unlikely to attempt to make use of the s9I regime if they cannot reliably predict whether they will comply with its requirements and therefore are unsure if they will benefit from its protection. An interpretative examination of s9I will elucidate the precarious nature of compliance with its requirements. Furthermore, the s9I regime's success is dependent on legal factors outside the ITA including the value of South Africa's network of double taxation

¹¹ s64(1)(d) Taxation Laws Amendment Act 22 of 2012.

¹² The key policy documents of the government at the time include the National Planning Committee 'National Development Plan 2030: Our Future – Make it Work' (2012) and Ministry for Economic Development 'Framework on the New Economic Growth Path' (2010).

agreements to the holding chains it encourages and the role played by exchange control. The above factors will be analysed to determine if the regime, in its broader legal context, presents a useful tool to optimise MNEs' regional activities.

- 1.8. The essence of the question posed by this work can be reduced to: whether the s9I regime is fit for purpose. The answer will be positive if it in fact, positions South Africa as an appropriately designed and commercially attractive gateway into and, perhaps unfortunately, out of Southern Africa and Africa more broadly.

PART I: LOCATION INCENTIVE SCHEME COMPARATIVE STUDY & S9I'S TAX POLICY APPROPRIATENESS

2.1. Introduction

- 2.1.1 The predominance and new-found mobility of the multinational enterprise in the most recent period of globalisation have created an atmosphere of competition among nation states. States compete for MNEs to locate various aspects of their activities, including investment holdings, manufacturing and management, within their borders. The positive externalities or indirect benefits of hosting MNE activities, such as increased employment and revenue, are major influences on states' economic regulation.¹³ Many states have attempted to encourage MNEs to locate certain activities within their borders through legislative and other rules aimed at making their jurisdiction the most favourable for those activities. The broad range of state interventions aimed at attracting MNEs are what I will refer to as location incentive schemes ('LIS'). The critical criterion in assessing the success of a LIS is its ability to attract MNE activities which produce the externalities targeted by the particular state. This is determined by appropriateness of the design of the LIS and its ability to compete on the global stage.
- 2.1.2 The s9I headquarter company regime is an example of a LIS aimed at attracting MNE activities into South Africa's jurisdiction by providing a tax efficient means to finance foreign subsidiaries and repatriate of proceeds to foreign parent companies. While the Explanatory Memoranda to the various Taxation Laws Amendment Bills dealing with the s9I regime clearly state that it is intended to facilitate holding companies, s9I is titled 'Headquarter

¹³ Richard N. Watanabe 'Developing Taiwan into a Regional Finance and Operations Centre: A Taxation Perspective' (1998) 8 *Revenue Law Journal* 88 at 89; Simon Avenell 'Competition for Corporate Regional Headquarters' (1996) 67 *Asia Research Centre Working Paper* 8.

Companies'. Headquarter company is a defined term in the ITA and references throughout the Act are to headquarter companies.¹⁴ This is consistent with the assertion by several authors that the naming of the regime was misplaced and that it is in fact an intermediary holding company regime.¹⁵ We can only speculate as to whether this misnomer was a result of the evolution of the regime from its intended beginnings as a regional holding company regime.¹⁶

2.1.3 The insertion of s31(5) as amended provides for the flow-through and repatriation of intellectual property/royalties, allowing the claim that s9I is also an intellectual property holding LIS.¹⁷ Furthermore, the absence of thin capitalisation rules, freedom to select functional currency and favourable provisions regarding exchange gains or losses, allow for holding activities which lean towards group treasury companies.¹⁸ Through this encouragement of these specialised holding activities, National Treasury has demonstrated a push towards allowing a more all-encompassing regime. Perhaps driven by the belief that a wide gateway, broad enough to accommodate any special purpose vehicle, would be the most attractive to MNEs.

2.1.4 Regardless of the correct title for the regime, what type of MNE activities the s9I regime is in fact designed to facilitate is important for determining what the likely externalities will be and whether it is competitively positioned to attract them. While intermediary holding and headquarter companies may incorporate elements of one another, the distinction between their respective core functions remains valid.¹⁹ Given that different holding functions have specific

¹⁴ National Treasury (note 3) 77-8; National Treasury (note 9) 92; s1 'Headquarter Company', s9I, s9H, s31(5), para 64B (1) of Eight Schedule of Income Tax Act 58 of 1962.

¹⁵ Annet Wanyana Oguttu 'Developing South Africa as a Gateway for Foreign Investment in Africa: A critique of South Africa's Headquarter Company Regime' (2011) 36 *South African Yearbook of International Law* 61 at 90; Tracy Gutuza 'The Headquarter Company Structure in the Southern African Context: A South African Tax Law Perspective' (2014) XLVII *Comparative and International Law Journal of Southern Africa* 187 at 191.

¹⁶ National Treasury 'Media Statement: Taxation Laws Amendment Bills 2010' at 3, available at http://www.treasury.gov.za/comm_media/press/2010/2010051001.pdf, accessed on 2 February 2017.

¹⁷ s 57 Taxation Laws Amendment Act 24 of 2011 and s 64 (1) (d) of Taxation Laws Amendment Act 22 of 2012.

¹⁸ See sections 31(5), 25D and 24I Income Tax Act

¹⁹ Oguttu (note 14) at 90

related activities, requiring different manifestations in a host jurisdictions; a functional distinction allows for a deductive analysis of the likely benefits for South Africa. A comparative analysis between the s9I regime and LISs aimed at the corresponding company types will be used to investigate which of the abovementioned holding company functions s9I is the most amenable to incentivising. Its exhibition of the virtues of an intermediary holding or headquarter company LIS, cognisant of the web of non-tax factors at play, will be indicative how s9I will be able to compete with contemporary LISs in African countries.

2.2 The Netherlands as an Intermediary Holding Company Jurisdiction

- 2.2.1 Honiball and Olivier define an intermediary holding company ('IHC') as one which has as its main function the holding and administration of investments in group companies.²⁰ The intermediary nature of the company lies in its interposition in an ownership chain between a parent company and the IHC's own subsidiaries, all of which are often in different jurisdictions. In these ownership chains the IHC acts as a conduit for the cross-border flow of finance or intellectual property to operating subsidiaries and the repatriation of profit to the parent company. IHCs here will be treated as including companies which have as a major function the conduit, flow-through or back-to-back, cross border licencing of intellectual property and debt financing. This treatment is due to the similarity in the treatment of equity/dividends, licencing/royalties and debt/interest under the s9I regime.²¹ Furthermore, these functions are often combined in a single holding entity in practice.²²
- 2.2.2 The very requirements for access to the s9I regime and its benefits lend themselves to IHCs acting as conduits for operational finance and profit repatriation. A company wishing to make use of s9I must, under s9I(2)(b), have 80per cent of the cost of its assets attributable to equity, debt or intellectual property licenced to a foreign company where the IHC holds more than 10per cent of the equity shares and voting rights. Under s9I(2)(c), a s9I beneficiary with an

²⁰ Michael Honiball & Lynette Olivier *International Tax: A South African Perspective* 5 ed (2011) 690.

²¹ For example, royalties, interest and dividends flowing through a s9I company are all excluded from withholding taxes under s49D, s50D(1)(a)(i)(cc), s64E(1) of the Income Tax Act.

²² Honiball & Olivier (note 19) 692; Francis Weyzig *International Finance and Tax Avoidance via Dutch Special Purpose Entities* (Paper for presentation at research seminar, Radboud University Nijmegen, 21 October 2013) 10.

annual turnover of more than R5 million must have at least 50 per cent of its gross income attributable to proceeds from or on the disposal of the above investments in similarly qualifying foreign companies. The benefits available under the regime are designed for use by an intermediary holding company acting as a conduit. This is because it allows for flow-through finance from parent companies to operational subsidiaries and exempts s9I companies ('s9I co') from withholding taxes on certain transfers to a parent company.²³ For example, s9I cos can access an exemption from the arm's length principle in s31 for financial assistance received from a non-resident and transferred to a qualifying foreign company; a typical example of conduit loan financing.²⁴ Therefore, a company seeking to benefit from s9I must be intermediary in nature and hold significant investments in qualifying foreign companies; falling squarely within the above definition.

2.2.3 The key determinants of a jurisdiction's suitability for hosting intermediary holding companies, from a tax perspective, centre on the ability for IHCs located there to finance foreign operating subsidiaries' activities and repatriate profits to its foreign parent company in a tax efficient manner. At the core of this is the ability to minimise or avoid withholding taxes in both the source countries and the IHC's residence country.²⁵ This can be achieved unilaterally through provisions in a LIS or it could be a result of the tax rates imposed under a Double Tax Agreement ('DTA' or 'treaty'). IHCs are an important element in the intentional exploitation of treaty benefits which has been dubbed 'treaty shopping'. Treaty shopping is found where IHCs are incorporated in third countries, mainly to take advantage of DTA based withholding tax rates that are preferable to those which apply between the parent company state and operational subsidiary state.²⁶ Further notable elements of tax systems that have proven suitable to IHCs include: not imposing controlled foreign company rules on foreign

²³ Gutuza (note 14) at 193 & 203.

²⁴ s31(5)(a) of the Income Tax Act.

²⁵ Weyzig (note 21) 13-4 & 28; Alfons J. Weichenrieder & Jack Mintz *What Determines the Use of Holding Companies and Ownership Chains* (Working Paper, 15 March 2006) 29 & 42.

²⁶ Weichenrieder & Mintz 2006 (note 24) 23; Francis Weyzig *Taxation & Development: Effects of Dutch Tax Policy on Taxation of Multinationals in Developing Countries* (Phd Thesis, Radboud University Nijmegen, 13 November 2013) 91-2.

subsidiaries; a low rate of tax on dividends received; the absence of exchange controls; and a tax credit system for unilateral relief from double taxation.²⁷

2.2.4 The Netherlands has proven itself to be a popular jurisdiction for the placement of intermediary holding companies and other special purpose entities of MNEs.²⁸ According to Desai et al, in 2003 it held the most US conduit companies at 652 or 21 per cent of the total ultimately owned by US corporations.²⁹ More recently, Weichenrieder recorded it hosting a significant amount of German conduit activity acting as a host in 660 instances.³⁰ The basis for this success is that the Dutch taxation system is designed to facilitate the competitiveness of local MNE, presenting an opportunity for non-Dutch MNEs to plant an IHC there to exploit the benefits.³¹ The Netherlands also benefits from the notable capital mobility advantages that come with European Union directives such as the Parent-Subsidiary Directive and the Interest and Royalty Directive.³² These directives have the effect of removing the tax cost of cross border intra-group dividends, interest, and royalty flows between EU member states by restricting the use of withholding taxes by source states.³³ Their present importance being that they remove the tax cost of inbound investments and licencing, into the Netherlands from EU countries.

²⁷ Honiball & Olivier (note 19) 697; Thabo Legwaila 'Characteristics of an Ideal Holding Company Location' (2012) 45 *De Jure* 22 at 34.

²⁸ Weyzig Taxation and Development (note 25) 97.

²⁹ Mihir A. Desai, C. Fritz Foley & James R. Hines Jr. 'Chains of Ownership, Regional Tax Competition, and Foreign Direct Investment' W9224 *NBER Working Paper* 1 at 22.

³⁰ Weichenrieder & Mintz 11.

³¹ Alex Berkhout & Marc Derks 'Dutch Holding-, Finance-, and Royalty Companies, 2016' at 4, accessed on 17 July 2016, available at https://www.horlingsnexia.nl/_WORDPRESS/wp-content/uploads/2016/12/Dutch-Holding-Finance-Royalty-companies.pdf.

³² European Commission Directive 2003/123/EC of 22 December 2003; European Commission Directive 2003/49/EC of 3 June 2003.

³³ Weyzig (note 21) 6-7; Thabo Legwaila 'Tax Impediments to Holding Company Structures in Belgium, Ireland and the United Kingdom: Caution for South Africa' (2011) 128 *SALJ* 533 at 534.

2.2.5 Despite having a relatively high rate of corporate tax, at 25per cent on profits beyond €200 000, the Netherlands has several domestic tax provisions which are favourable to IHCs.³⁴ The most notable is the Dutch participation exemption that allows for a 100per cent exemption from taxation on dividends, currency gains, and capital gains on shares. Provided the IHC holds at least 5per cent and certain substance requirements are met.³⁵ Dividends withholding tax is payable on outbound payments, but may be nullified by the participation exemption or the Netherlands' implementation of the EU Parent-Subsidiary Directive.³⁶ The Netherlands does not charge withholding taxes on outbound royalty and interest payments even to non-EU countries.³⁷ The now defunct Group Financing Activities regime previously provided for a 6-10per cent effective tax rate on the balance of interest received less interest paid on loans from foreign affiliates.³⁸ Lastly, the Netherlands both uses tax credits and allows deduction of foreign tax as a trade cost for unilateral relief of double taxation, which provides even further relief to MNEs subject taxation abroad.³⁹

2.2.6 Other relevant legal features outside of the main taxation legislation include: Dutch Co-operative Associations which are commercial legal entities that, when inserted into an ownership chain, can provide a means to distribute profit to foreign, non-EU parent companies without paying a dividend withholding tax. This is because distributions by these entities under Dutch law do not qualify as dividends, unless there is evidence of abuse.⁴⁰ The Dutch *Beslatingdiens* has a practice of providing advanced tax rulings and advanced pricing agreements.⁴¹ Both provide certainty for MNEs wishing to set up structures, on matters such as whether the participation exemption applies. Some of the advanced tax rulings and

³⁴ Marnix Schellekens 'Netherlands - Corporate Taxation' (January 2017) Country Surveys IBFD para 1.6.1, accessed on 24 February 2017, available at https://online-ibfd-org.ezproxy.uct.ac.za/document/gtha_nl_chaphead.

³⁵ Art 13 Dutch Corporate Income Tax Law of 1969; Schellekens (note 34) para 2.2.

³⁶ Schellekens (note 34) para 1.6.2; Art 4 of the Dutch Withholding Tax Law of 1965.

³⁷ Schellekens (note 34) para 1.6.2.

³⁸ Weyzig Taxation and Development (note 25) 75; although as Weyzig notes there has been a proposal to implement a similar system on the table since 2011.

³⁹ Schellekens (note 34) para 6.1.4

⁴⁰ Weyzig (note 21) 4; although this treatment may change given the proposals by the Dutch Ministry of Finance in 2016 to apply the same treatment for dividends issued by Co-operatives and companies, see further Letter to the Lower House by Deputy Minister of Finance dated 20 September 2016.

⁴¹ Dutch Secretary of Finance Decree DGB 2014/3099 of 12 July 2014.

advanced pricing agreements have been very favourable to MNEs, applying very low withholding tax rates or special treatment with tax advantages.⁴² A final, critical aspect is the wide net of tax treaties negotiated by the Dutch authorities, which provide low rates of withholding taxes for distributions from source states.⁴³ For example the Dutch–South Africa Protocol to the DTA provides for a minimum of 5per cent and maximum of 10per cent withholding tax on dividends for the source state.⁴⁴ All these factors combine to allow MNEs a secure framework where the flow of equity, debt finance, and intellectual property licences can be conducted with a minimal tax cost.

2.2.7 There are several similarities between the Dutch tax system and s9I regime, meaning they can both be categorised as LISs aimed at attracting IHC activity. Both regimes provide potential withholding tax savings for dividends, interest, and royalty payments to parent companies.⁴⁵ The ability to avoid withholding taxes is a critical element necessary for a good IHC LIS and s9I displays best practice by incorporating such measures.⁴⁶ As s9I cos are resident in South Africa they have access to its DTA network – an advantage which has been instrumental in the success of the Dutch system.⁴⁷ South African and Dutch resident companies both have access to tax credits and deductions for foreign taxes paid.⁴⁸ Both systems facilitate the loan financing of subsidiaries and licencing of intellectual property to them. S9I does so by not applying arm’s length requirements for licencing and debt finance to subsidiaries and exempting these payments from withholding taxes.⁴⁹ While the Dutch system, being embedded in the EU allows for the routing of these investments through jurisdictions with

⁴² Weyzig (note 21) 7 – 8; see also EU Commission Decision of 21 October 2015 On State Aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, where it was found that an advanced pricing agreement was tantamount to state aid because of the extent of beneficial treatment.

⁴³ Weyzig (note 21) 4; the validity of this proposition for South Africa is tested below in Part II para 3.5.

⁴⁴ GN 32 GG 31795 of 23 January 2009 at Art II; some of the Netherlands’ treaties reduce the withholding tax rate to 0per cent as is the case with Mongolia see further Weyzig (note 21) 4.

⁴⁵ In South Africa see s49D, s50D(1)(a)(i)(cc), s64E(1) of the Income Tax Act.

⁴⁶ Weyzig (note 21) 13-4 & 28, Weichenrieder & Mintz 2006 (note 24) 29 & 42 and Thabo Legwaila ‘The Tax Treatment of Holding Companies in Mauritius: Lessons for South Africa’ (2011) *SA Merc LJ* 1 at 14-5

⁴⁷ s9I (1)(a) of the Income Tax Act.

⁴⁸ ss6quin & 6quat of the Income Tax Act.

⁴⁹ s35(5), s49D, s50D(1)(a)(i)(cc), s64E(1) of the Income Tax Act.

favourable interpretations of the arm's length principle, tax efficiently by utilising EU directives.⁵⁰ Both systems also do not impose a capital gains tax on the proceeds from disposal of shares in qualifying subsidiaries.⁵¹ Accordingly, both systems are *ex facie* well suited to facilitating IHC activity that is conduit in nature and display tax policy design features that follow best practice.

2.2.8 The Netherlands has seen a vast amount of IHC activity and is probably the world's most active conduit jurisdiction, but what benefit has it reaped for its troubles?⁵² Intuitively, IHCs acting as conduits would not have a major physical footprint, as they do not require large numbers of staff to perform their functions or conduct complex business operations. In the Netherlands IHC's administrative functions, such as the incorporation and financing of subsidiaries, have generally been performed by either mailbox companies with minimal staff or have been outsourced to trust offices.⁵³ Weyzig notes that "trust services and related financial and legal services generate approximately 3000 jobs and nearly €500 million in revenue for the Netherlands."⁵⁴ However, this is small compared to other types of headquarter activities.⁵⁵

2.2.9 Weichenrieder and Mintz conducted a review of the nature of German outbound investment through conduit IHCs and found the Netherlands to have high balance sheet totals, €54.7 billion or 9per cent of the German total in 2001, but with little to no fixed investment or job creation accounting for approximately 3per cent of either for German enterprises abroad.⁵⁶ This trend has held true going forward, as in 2011 the Netherlands hosted 1319 (4.9per cent of global total) German subsidiaries, but only 97000 (1.9per cent) of German subsidiaries'

⁵⁰ For example, Irish transfer pricing rules do not apply to passive activities Irish Tax Consolidation Act 1997 Part 35A.

⁵¹ See para 64B of the Eighth Schedule of the Income Tax Act; Schellekens (note 34) para 2.2.

⁵² Weyzig Taxation and Development (note 25) 90, the Netherlands channelled about €1600 billion worth of foreign directed investment in 2009.

⁵³ Weyzig Taxation and Development (note 25) 73.

⁵⁴ *Ibid* at 83.

⁵⁵ *Ibid* at 83.

⁵⁶ Weichenrieder & Mintz 2006 (note 24) 14 & 4.

employees.⁵⁷ In 2014 the position had not changed with 1355 (4.9per cent) German Subsidiaries in the Netherlands, employing 105400 (1.9per cent) people.⁵⁸ Two countries which provide useful comparators are Switzerland and the Czech Republic as they are a tax haven and operational centre, respectively. In 2014 Switzerland held 1081 (3.9per cent) German subsidiaries, employing 104900 people (1.9per cent).⁵⁹ While the Czech Republic hosted 706 (2.6per cent) German subsidiaries, employing 238200 (4.5per cent) people.⁶⁰ This demonstrates that the Netherlands hosts a relatively high number of subsidiaries, which employ comparatively few employees. Therefore, as IHCs exhibit little propensity for fixed investment or employment in the Netherlands it becomes important to determine what is becoming of the capital they administer.

2.2.10 Weyzig using 2007 data from the De Nederlandsche Bank's statistics on IHCs, provided an asset holding and financial flow typology for Dutch IHCs.⁶¹ Weyzig also notes that Dutch IHCs conduct little real business activity within the Netherlands and that the balance sheet totals of the 468 IHCs with foreign subsidiaries were mainly dedicated to holding chain and group finance activities such as debt issuance and equity financing.⁶² Approximately 75per cent (€1050 billion) of the balance sheet totals of Dutch IHCs were dedicated to these activities, with holding chains making up the largest portion at €700 billion and intra-group lending coming in second at €250 billion.⁶³ This trend has also remained in place and in 2014 of a total asset base of €3 814 billion, €2 319 billion (60per cent) was dedicated to equity holdings abroad and €505 billion (13per cent) was loaned to affiliate companies abroad.⁶⁴ In comparison to: local investments in real estate at €10 billion; Dutch equity holdings at €24

⁵⁷ Deutsche Bundesbank 'Statistics on the Structure and Activity of Foreign Affiliates of German Investors 2014' (2014) At 4 & 7.

⁵⁸ Deutsche Bundesbank 'Statistics on the Structure and Activity of Foreign Affiliates of German Investors 2016' (2016) at 4 & 7.

⁵⁹ Ibid at 5& 8.

⁶⁰ Ibid at 4 & 7.

⁶¹ See generally Weyzig (note 21).

⁶² Weyzig (note 21) 19.

⁶³ Ibid at 16.

⁶⁴ De Nederlandshce Bank 'Table 15.1 Balance of Payments of Special Financial Institutions' (26 September 2016), accessed on 24 February 2017, available at https://www.dnb.nl/en/binaries/t15.1ey_tcm47-330620.xls?2017031122.

billion; and loans to Dutch affiliates at €4 billion.⁶⁵ This is a strong indication that Dutch IHCs are largely concerned with cross border activities related to the financing of operating subsidiaries, rather than directly investing into the Dutch economy.

- 2.2.11 Therefore, while there are large volumes of financial flows going through the Netherlands, there has been little direct investment by MNEs. Meaning the direct beneficiaries of this conduit investment would be the Dutch financial services industry that advises on and facilitates transactions or administers subsidiary investments.⁶⁶ However, it is important to remember that attracting FDI was not the main factor at play in the design of the Dutch tax system, rather it was facilitating a competitive advantage for Dutch MNEs. An important difference to note when assessing the success of the Dutch system, as opposed to the s9I regime. So, the impact of the above is not necessarily negative for the Netherlands, because the routing of foreign direct investment through it brings about an increase in balance of payments and gross national product, which can provide positive indications for future direct investment. In addition to providing the competitive advantage intended for Dutch MNEs.
- 2.2.12 Considering the nature of the functions of IHCs acting as conduits and the proven experience of the Netherlands, it is possible to infer the most likely externalities the s9I regime will produce. This is particularly so given the similarities between the two systems as discussed above. As the Dutch experience above shows, the IHC activity to be expected will likely be in the form of mailbox or small scale companies making use of financial/legal services. This would be beneficial to South Africa's world class and large financial services industry, but it will not go far towards creating large numbers of job opportunities or result in the diffusion of business know-how which may stimulate South African enterprises.⁶⁷
- 2.2.13 With the expanded rate of unemployment at 36.3per cent at the end of the third quarter of 2016 and a Gini coefficient for total household income at 0.66, a boost to an established financial services sector is not what South Africa needs the most to meet its developmental

⁶⁵ Ibid.

⁶⁶ Weyzig Taxation and Development (note 25) 83.

⁶⁷ Schwab (note 3) 326, the World Economic Forum rates South Africa's financial services meeting business needs at 6.2/7 and its financial market development at 11th out of 138 countries.

goals and constitutional, socio-economic obligations.⁶⁸ South Africa needs to incentivise FDI which produces concrete grass roots benefit; with actual businesses setting up active enterprises providing much needed fixed investment, labour absorption, and the diffusion of technological know-how or business skills.⁶⁹ Importantly, this does not necessarily translate into actual operating companies, because a regional headquarters or financial management centre could provide indirect stimulus in this direction.

2.2.14 Not only will conduit IHC activity not provide the positive externalities which South Africa needs the most, but it may have severely negative consequences for the South African state, local MNEs and the region at large. The South African state is *a priori* foregoing potential revenue from these international transactions, as this is the basis for the attractiveness of the regime. The lack of the necessary return for South Africa, as shown above, makes this loss of revenue difficult to justify. Moreover, research has repeatedly shown that the implementation of tax incentives in the absence of market fundamentals will encourage little new investment.⁷⁰ Therefore, there is a likelihood that s9I will be victim to a deadweight or a redundancy cost, where investments which would have been routed through South Africa in any case are done so without contributing to South Africa's tax base, through s9I.

2.2.15 The Dutch tax system was designed to facilitate a competitive advantage for Dutch MNEs, hence the beneficial rules applying to resident parent companies in the holding chains. However, South Africa has treated the s9I as a possible route for base erosion leading to legislative restrictions intended to curb this. These include limiting the benefits available to transactions with foreign affiliate companies and inserting s9H which requires the payment of an 'entrance tax' to qualify for the regime. Section 9I companies not being subject to the arm's length principle, CFC rules, tax on interest, or dividends received therefore distorts competition in favour of large MNEs capable of exploiting the cross-border based benefits

⁶⁸ Southern Africa Labour and Development Research Unit 'National Income Dynamics Study: Wave 4 Overview' (2016) at 15; Statistics South Africa 'Quarterly Labour Force Survey, Quarter 3: 2016' (2016) at 20.

⁶⁹ Oguttu (note 14) at 64; Katz Commission of Inquiry 'Fifth Interim Report of the Commission of Inquiry into certain aspects of the tax structure of South Africa' (1997) at para 3.1.2.7 (Katz Commission).

⁷⁰ Howell H. Zee, Janet G. Stotsky & Eduardo Ley 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries' (2002) 30 *World Development* 1497 at 1508-9; Weyzig *Taxation and Development* (note 25) (note 25) 82.

available under s9I.⁷¹ Leaving local MNEs to bear a tax and administrative burden where foreign owned MNEs would not.⁷² A further disadvantage to South Africans is that resident shareholders may have the income of a CFC controlled by a s9I co attributed to them, where they collectively own more than 50per cent of the s9I co.⁷³

2.2.16 The above is not consonant with the fundamental principles of equity and neutrality. Neutrality requires that taxation not impose a cost or saving which would distort the ordinary behaviour of tax payers, as this would distort an assumedly efficient market.⁷⁴ Equity's relevance for present purposes is requiring that tax payers in similar positions are taxed similarly.⁷⁵ These principles are cornerstones of good taxation policy and breaching them in this context manifests in direct negative consequences for South African MNEs.⁷⁶ This violation of principle is actually harmful to the developmental agenda of South Africa as it has the effect of depressing local enterprises which could be providing revenue and employment.

2.2.17 A further disadvantage for South Africa in hosting an IHC LIS is the regional damage to be wrought by providing an efficient location for treaty shopping.⁷⁷ A regime which encouraged or enabled treaty shopping would constitute a harmful preferential tax regime according to the Organisation for Economic Cooperation and Development ('OECD').⁷⁸ If so, this would be contrary to South Africa's regional obligation to refrain from harmful tax competition

⁷¹ Gutuza (note 14) at 193-7 & 201; Weyzig *Taxation & Development* 71.

⁷² Gutuza (note 14) at 197.

⁷³ s9D(2) ITA; Oguttu (note 14) 76; AP de Koker & RC Williams *Silke on South African Income Tax* ed 58 (2016) para 13.45.

⁷⁴ Tracy Gutuza *An analysis of the methods used in the South African domestic legislation and in double taxation treaties entered into by South Africa for the elimination of international double taxation* (Phd Thesis, University of Cape Town, 2013) 6.

⁷⁵ *Ibid* 4-5

⁷⁶ *Ibid* Phd 4

⁷⁷ Weichenrieder & Mintz 2006 (note 24) 23.

⁷⁸ Organisation for Economic Cooperation and Development *Harmful Tax Competition: An Emerging Global Issue* (1998) 32.

under the SADC Memorandum of Understanding on Taxation and Related Matters.⁷⁹ An example of treaty shopping in action is the allegedly successful avoidance of corporate tax by South African Breweries Pty ('SAB'). SABMiller International BV ('SABMiller'), the Dutch resident parent company of SAB, is reported to have bought the trademarks of various beers and registered them in the Netherlands.⁸⁰ SAB then exploited the low rates of royalty withholding tax applicable under the Dutch-South Africa DTA to make large royalty payments to SABMiller, reducing its gross income.⁸¹ This is estimated to have resulted in an estimated loss to the South African fiscus of approximately R77 million in 2012.⁸²

2.2.18 Similar results could be obtained if a s9I cowas used to exploit the benefits of a South African treaty which provides for beneficial withholding tax rates to the country of residence. S9I also has the added benefit that no withholding tax is charged when repatriating beyond South Africa. If MNEs can avoid significant taxes in an emerging economy such as South Africa by making use of treaty shopping, then the chances of less sophisticated countries in the region not falling victim to this is slim at best. The enactment of a LIS which constitutes a harmful preferential taxation regime presents an element of policy inconsistency, as it runs contrary to efforts at regional integration, such as the Common Monetary Area and Southern African Customs Union.

2.2.19 In sum, the s9I regime is a LIS that provides a means for MNEs to establish a conduit IHC in South Africa, offering similar benefits as the Dutch tax system. This similarity has been used to show that the results which have manifested in the Dutch context are likely to occur in South Africa, as the same business functions are incentivised. Unfortunately, these results are not what South Africa needs at this stage in its development. Importantly South Africa is willingly depriving itself of tax revenue, a sacrifice which has not been sufficiently justified through anticipated positive returns. Further, s9I is providing a competitive advantage to foreign owned MNEs that is likely to distort competition in favour of these firms and against

⁷⁹ Oguttu (note 14) at 67-8; Tracy Gutuza 'Economic development and the role of tax in Southern Africa: the South African headquarter company structure' in Yariv Brauner and Miranda Stewart (eds) *Tax, Law and Development* (2013) 77.

⁸⁰ Martin Hearson & Richard Brooks 'Calling Time: Why SABMiller should stop dodging taxes in Africa' (2010) 23.

⁸¹ *Ibid.*

⁸² *Ibid.*

South African MNEs attempting to penetrate the same market, under a greater tax burden. The negative outcomes which are to be produced by the s9I regime also include a regional aspect. The likelihood that South Africa would be used as a destination for treaty shopping is greatly increased by the nature of the s9I regime. Thus, encouraging a practice which is increasingly being shown to unjustifiably detract from developing countries' revenue generation.⁸³ This leaves the s9I in a position where, from a tax policy perspective, it is very difficult to justify its continued existence in the statute books.

2.3 Singapore's Regional Headquarter Company Incentive Schemes

2.3.1 With the numerous shortcomings of a pure IHC regime in South Africa it is useful to explore the form of holding company which is s9I's namesake: headquarter companies. This section seeks to determine whether headquarter companies are a more appropriate fit to South Africa's tax and overall government policy. This will be so if headquarter companies present a viable form of MNE activity to incentivise and produce the developmental results necessary for the country. Additionally, the comparative exercise with Singapore's efforts to incentivise regional headquarter companies will elucidate the virtues of a LIS geared towards attracting these MNE activities.

2.3.2 A headquarter company is defined by Honiball and Olivier as an intermediary company which in the main provides "any or all of the services which are auxiliary to the multinational group's main business or operational activities on a centralised basis."⁸⁴ Avenell adopts a definition which describes the regional variant as providing coordination, control and business planning functions for geographic locations distant from the parent company.⁸⁵ Typical headquarter activities would include strategic management, accounting, treasury, legal services, marketing, and innovation.⁸⁶ The precise mix of functions; depth of involvement in

⁸³ See generally Hearson & Brooks (note 79).

⁸⁴ Honiball & Olivier (note 19) 692.

⁸⁵ Avenell (note 12) 1.

⁸⁶ Honiball & Olivier (note 19) 692; Oguttu (note 14) at 66.

operational affiliates; and role in the group's structure embodied in a particular headquarter is usually tailored to the strategy of the specific enterprise.⁸⁷

2.3.3 Regardless of the variations in a particular headquarter company, they are by their nature active companies, often with substantial staff complements.⁸⁸ This is an important distinction for present purposes, to the holding and remittance functions of IHCs. Therefore, incentivising such companies is to target the positive externalities associated with active enterprises.⁸⁹ For example, throughout the early 1990s the Singapore's Economic Development Board estimated that annual investment commitments by regional headquarter companies ('RHQ') ranged between S\$250 million and S\$350 million.⁹⁰ This type of foreign direct investment would provide direct economic benefits to the people of South Africa and thereby contribute to its developmental ambitions. Meaning that incentivising regional headquarter activities would be more in tune with overall government policy, than pure holding activities.

2.3.4 The economic boom during the early to mid-1990s in South East Asia saw many countries vying to be the jurisdiction from which multinational companies penetrated the region. The success stories became known as the 'newly industrialised countries' or 'Asian Tigers' and have been used as case study comparators for developing countries since. The RHQ increasingly became viewed as the best means to enter the region, as it reduced geographical distance to markets and other disincentives to foreign direct investment in unfamiliar terrain.⁹¹ To exploit the trend towards RHQs several Asian jurisdictions put forward LISs intended to attract this form of investment. Many of these were taxation based, with states competing to ensure their jurisdiction was the most favourable. Avnell posits that this competition was

⁸⁷ Martin Perry, Henry Yeung & Jessie Poon *Regional Office Mobility: the Case of Corporate Control in Singapore and Hong Kong* 29 *Geoforum* 237 at 251.

⁸⁸ Perry, Yeung & Poon (note 86) at 239, citing the EDB stated that Sony's RHQ in 1996 employed 300 staff providing financial management, sales, marketing and logistical support to regional affiliates; see further Oguttu (note 14) at 67.

⁸⁹ Avenell (note 12) 8.

⁹⁰ Perry, Yeung & Poon (note 86) at 239.

⁹¹ Avnell at 2; Alben J. Gradeva *Inward FDI determinants: The Case of the Netherlands* (Msc Thesis, Erasmus School of Economics) 29.

based on the assumption that RHQs' service based functions were locationally flexible.⁹² Unlike operational functions which are tied to the factors of production such as labour or raw materials. Many East and South East Asian jurisdictions continue to rely on the policy of incentivising RHQs today, to attract MNE's 'top brass' and entice key, value adding MNE functions.⁹³ The RHQ incentivisation methodology adopted by the Asian Tigers could be replicated by South Africa as a more effective facet of its developmental agenda than the present s9I.

2.3.5 Authors on the theme of location choice for RHQs recognise that tax is but a factor in the matrix of influences upon the decision on where to locate a RHQ.⁹⁴ Perry, Yeung and Poon are among several authors who have placed little store in the efficacy of tax incentives in attracting RHQs.⁹⁵ However, even they find that the significant uptake of tax incentives points towards them being a factor in the decision.⁹⁶ Furthermore, Yin & Walsh note that authors on the location decisions of US corporations have identified both personal and commercial reasons for the location of RHQs.⁹⁷ The commercial factors or market conditions are important, because RHQs are active companies which need an inviting, stable and sound commercial climate. RHQs also require skilled staff, many of whom relocate to the RHQ jurisdiction leading to the importance of personal factors such as quality of life and cost of living.⁹⁸ The mix of factors available in a particular country would be considered by an enterprise seeking to enter a region in light of its commercial strategy and needs, towards making a decision on which jurisdiction is the most suitable.⁹⁹

⁹² Avenell at 2, Perry, Yeung & Poon (note 86) at 250-1 discusses the finding that RHQs are relatively immobile entities once established, with MNEs preferring to set up new RHQs than relocate existing offices.

⁹³ Grant Thornton 'Locating in South East Asia: Weighing up the headquarter options' (2015) at 1.

⁹⁴ Avenell (note 12) 11; Perry, Yeung & Poon (note 86) at 247 – 50.

⁹⁵ Perry, Yeung & Poon (note 86) 248; Avenell (note 12) 12; Zee, Stotsky & Ley (Note 69) at 1508-9.

⁹⁶ Perry, Yeung & Poon (note 86) 248 & 253; Avenell (note 12) 12.

⁹⁷ Myat Su Yin & John Walsh 'Analysing the Factors Contributing to the Establishment of Thailand as a Hub for Regional Operating Headquarters' 2 *Journal for Economics and Behavioural Studies* 275 at 279.

⁹⁸ Yin & Walsh (note 96) at 279.

⁹⁹ K.C. Ho 'Competing to be Regional Centres: A Multi-agency, Multi-locational Perspective' 37 *Urban Studies* 2337 at 2340.

2.3.6 South Africa displays characteristics which are desirable in a RHQ location such as good telecommunications infrastructure, entrenched rule of law, English proficiency, and overall dominance in the Southern African region.¹⁰⁰ However, certain market imperfections may be viewed as obstacles, including low labour productivity, policy uncertainty despite the dominance of the ANC over the political system, and a concentrated demand which comes with a highly unequal society. An efficient and favourable tax has acted as a swing factor in the location decisions of RHQs and the presence of an RHQ LIS could be determinative where country's rank similarly.¹⁰¹ Also, a fine-tuned approach to incentivisation could produce favourable results by compensating for unfavourable factors.¹⁰²

2.3.7 The average annual per capita GDP growth of above 6per cent experienced by South East Asia between 1965 and 1995 set the stage for the surge in RHQs looking to exploit this market during the 1990s.¹⁰³ Southern Africa is not in a comparable period of rapid growth, yet it remains a viable destination for foreign direct investment and therefore for the use of RHQs. Southern Africa's growth drivers have traditionally centred around the established extractive industries. This continues to be the case, as evidenced by the strong performances of the Mozambican and Angolan economies in the recent past, mainly on the back of resource industries.¹⁰⁴ However, the dominance of the service sector in South Africa's GDP has led to this being the leading contributor to regional GDP at 55per cent.¹⁰⁵ With different growth drivers in the various Southern African countries, there is a variety of opportunities for MNEs.¹⁰⁶ Overall for the region, there has been good recovery in foreign direct investment inflow levels in the wake of the 2008 financial crisis. Regional FDI inflows peaked at \$14

¹⁰⁰ Yin & Walsh (note 96) at 281 – 3; South Africa had a 55per cent share of the SADC GDP in 2014, see South African Institute of International Affairs 'Regional Business Barriers: Unlocking Economic Potential in Southern Africa' (2014) at 17 (Regional Business Barriers).

¹⁰¹ Yin & Walsh (note 96) at 279; Perry, Yeung & Poon (note 86) at 249; Avenell (note 12) 23.

¹⁰² Watanabe (note 12) at 88 & 116; Avenell (note 12) 15

¹⁰³ Monaheng Seleteng & Sephooko Motelle 'Sources of Economic Growth in the Southern African Development Community: Its Likely Impact on Poverty and Employment' (2015) at 2 (); Avenell (note 12) 2-3; Singapore's OHC regime interestingly was a response to the 1986 recession, see further Economic Committee 'The Singapore Economy: New Directions' (1986).

¹⁰⁴ Regional Barriers at 16; Seleteng & Motelle (note 102) at 4-5 & 9.

¹⁰⁵ Regional Barriers at 21.

¹⁰⁶ For a summary of the various growth drivers across the SADC region see Seleteng & Motelle (note 102) 4-16.

billion in 2008, dropped to a low of \$3.5 billion in 2010 and have climbed to previous levels with a figure of \$17.9 billion in 2015.¹⁰⁷ This demonstrates the resilience of the appetite for investment into the region. This viable economic atmosphere could be useful to an MNE seeking to expand into Africa, giving cause to establish an RHQ. Given Southern Africa's potential and continued foreign direct investment inflow, there are valuable lessons to be taken from the experiences of the Asian Tigers, which could provide the competitive edge in incentivising RHQs.

2.3.8 Applying the best practices of successful Asian RHQ LISs, past and present, will help South Africa encourage companies to establish RHQs by compensating for its less appealing characteristics. Yin and Walsh report that a survey conducted in the 1990s showed that 30per cent of MNEs selected Singapore as their preferred RHQ jurisdiction; this was second only to Hong Kong which was preferred by 35per cent of MNEs.¹⁰⁸ Between 1986 and 1996 approximately 100 RHQs were awarded preferential tax treatment under agreements with the Singaporean government.¹⁰⁹ The 1996/97 Far Eastern Economic Review survey of 6000 executives in 11 countries placed Singapore first for regional headquarters, ahead of Hong Kong.¹¹⁰ The above demonstrates Singapore's growing success in attracting RHQs to its shores during the 1990s; a clear indication of best practices. This success was despite having faced aspects which were not appealing to RHQs such as high office premises rents, and relatively scarce, expensive labour.¹¹¹ It therefore presents a valuable comparator to South Africa which shares many of Singapore's positive aspects, including a strong financial services sector and geographic positioning; while also embodying comparable challenges.

¹⁰⁷ United Nations Conference on Trade and Development 'World Investment Report 2016: Annex Table 1 FDI inflows' (2016).

¹⁰⁸ Hong Kong was less suitable for present purposes, because its success as a RHQ location is based on its application of source based taxation at the time, while Singapore implemented a tax based incentive programme akin to s9I; see further Katz Commission par 3.1.4.1 cited in Oguttu (note 14) 72.

¹⁰⁹ Perry, Yeung & Poon (note 86) 248

¹¹⁰ K.C. Ho 'Competing to be Regional Centres: a Multi-agency, Multi-locational Perspective' 2337 at 2343.

¹¹¹ Perry, Yeung & Poon (note 86) 248

2.3.9 Singapore in the 1990s, managed to present an attractive destination for RHQs. From a tax perspective, its corporate tax system already presented features which were favourable to holding activities. These included not imposing a withholding tax on dividends or a capital gains tax.¹¹² It had a good network of DTAs in place, providing favourable rates for withholding in source states.¹¹³ These factors, in combination with RHQ incentives, allowed for hybrids of RHQs and IHCs providing structural flexibility, valuable to prospective RHQs. More generally, Singapore's ruling People's Action Party had early on adopted the stance of a developmental state and was unwaveringly true to its role in Singapore's development.¹¹⁴ This led to a perception of political stability and openness to business which was appreciated by RHQs.¹¹⁵ Singapore is also well positioned in the region geographically, being at the centre of the Association of Southeast Asian Nations ('ASEAN') region.¹¹⁶ The developmental state policies of the People's Action Party helped produce a skilled labour force and good infrastructure, including telecommunications and port facilities.¹¹⁷ These factors provided the background for the success of Singapore's RHQ LIS efforts, which had the effect of incentivising RHQ activities and compensating for Singapore's negative aspects.¹¹⁸

2.3.10 Singapore implemented the first manifestation of its RHQ LIS in 1986 through the Operational Headquarter Company ('OHC') scheme.¹¹⁹ The OHC will be used to determine transferable RHQ incentivisation fundamentals, because at that time Singapore was more proximate to South Africa's present stage of development. The OHC was replaced by several variations, most recently the Approved Headquarter Company Award ('AHCA'), which was

¹¹² Dean A Yoost & John E Fisher 'Choosing Regional HQs in Asia' (1996) 7 *International Tax Review* 35 at 36 (Yoost & Fisher).

¹¹³ Mukul G. Asher 'Tax Reform in Singapore' (1999) 91 *Asia Research Centre Working Paper* 1 at 4.

¹¹⁴ Linda Low 'The Singapore Developmental State in the New Economy and Polity' (2001) 14 *The Pacific Review* 411 at 412.

¹¹⁵ Perry, Yeung & Poon (note 86) at 248.

¹¹⁶ *Ibid* at 244, 248-9.

¹¹⁷ *Ibid* at 248.

¹¹⁸ *Ibid*.

¹¹⁹ Avenell (note 12) 14; s43E of the Singapore Income Tax Act 39 of 1947 read with Income Tax (Concessionary Rate of Tax for Approved Headquarters Company) Regulations 1988, GN No. S 43/1988.

itself repealed in 2015.¹²⁰ This later LIS will be used to investigate what lessons were learnt by Singapore and what adaptations were required for RHQ incentivisation in the 21st century.

2.3.11 The Singapore Income Tax Act 39 of 1947 and relevant regulations empowered Singapore's Economic Development Board ('EDB') to negotiate and award OHC status to qualifying MNEs with a resident entity in Singapore.¹²¹ The EDB targeted enterprises which were front runners in their sector for OHC status and acted as a one-stop shop for RHQs, negotiating the prerequisites and facilitating their establishment.¹²² The requirements for OHC status enforced by EDB included commitments to have an agreed level of paid-up equity capital in the OHC, a local spend at a minimum level and a number of expatriate, skilled employees in Singapore.¹²³ The benefits available under the OHC included a concessionary tax rate of 10per cent, rather than 27per cent applicable at the time, on income from the provision of specified services to foreign group companies; as well as royalties and interest received from regional affiliates.¹²⁴ OHC companies also benefitted from an exemption on dividends paid out of income taxed at concessionary rates, allowing remittance to parent companies.¹²⁵ The core of the scheme can be described as: requiring a predetermined level of local fixed investment and MNE activity, in return for tax concessions on the proceeds of intra-group services.

2.3.12 There are a several clear distinctions between the OHC scheme and the s9I regime, which point to their divergent core purposes. First, s9I does not require any minimum level of investment in South Africa or any other country. Rather, it only stipulates the types of foreign investments to be held by the s9I co.¹²⁶ Secondly, the OHC provides for a measure of administrative discretion, as the EDB is given the authority to negotiate the awarding of OHC status. There is no role for the administrative organs of state under s9I, aside from receiving the requisite form, determining qualification and accepting the election into s9I's provisions. Thirdly, while the OHC scheme is mainly directed towards providing tax concessions for qualifying intra-group services, s9I allows these to be fully taxable in the hands of a qualifying

¹²⁰ Singapore 2015 Budget Annex A-6: Tax Changes.

¹²¹ s43E of the Singapore Income Tax Act; Yoost & Fisher at 37; Avenell (note 12) 14.

¹²² Avenell (note 12) 14

¹²³ Yoost & Fisher at 37.

¹²⁴ Yoost & Fisher at 37; Avenell (note 12) 14.

¹²⁵ Ibid.

¹²⁶ s9I2(b) of the Income Tax Act.

company. These differences are indicative of areas where s9I could be re-engineered to target RHQ activity, but also possible improvements to the regimes general efficacy and attractiveness.

2.3.13 For South Africa to begin heading down the path towards incentivising RHQs the proceeds from the main activities of these companies should be given tax relief. The OHC does this by applying the concessionary tax rate of 10per cent to income generated from listed intra-group services. This concession, aside from indicating a willingness to host RHQs, has utility for an MNE by reducing the overall tax burden it faces.¹²⁷ Replicating this aspect of the OHC is critical if s9I is to be geared towards attracting MNE's RHQ activities.¹²⁸ This sees to the incentivisation aspect, yet the local substance benefits would not be guaranteed. South Africa thus ought to consider mimicking local direct investment requirements such as those adopted in the OHC, to ensure direct returns for the country.

2.3.14 The AHCA regime followed a similar pattern to the OHC, requiring local direct investment in exchange for tax concessions. The EDB also administered this scheme and continued with its policy of targeting leading firms in the relevant sector.¹²⁹ The EDB offered a fast-tracked consideration of applications for the AHCA, allowing for a two week turn around.¹³⁰ Under the AHCA potential qualifiers were required to be the regional hub for senior management, perform a substantial level of headquarter functions, and for the staff performing these functions to be based in Singapore.¹³¹ This status would be conferred for a renewable five year periods.¹³² Throughout the time a 15per cent concessionary rate of income tax was applied to a wide range of income, including trading income and service fees.¹³³ AHCA

¹²⁷ Avenell (note 12) 14-5; Watanabe (note 12) at 117.

¹²⁸ The same point was made by Oguttu (note 14) at 85-7.

¹²⁹ Edmund Leow & Allen Tan 'Singapore: Regional Tax Minimisation' May/June 2007 *Asia-Pacific Tax Bulletin* 190 at 191(); Shanker Iyer (note 128) 'International Tax Planning Under Singapore Domestic Law and Treaties' January/February 2004 *Asia-Pacific Tax Bulletin* 92 at 97 (Iyer (note 128)).

¹³⁰ Leow & Tan (note 128) at 191.

¹³¹ Ibid at 191; Iyer (note 128) at 97.

¹³² Leow & Tan (note 128) at 191.

¹³³ Leow & Tan (note 128) at 191; reg 2, read with reg 4 Income Tax (Concessionary Rate of Tax for Approved Headquarters Company) (Amendment) Regulations 2013, 15. G. N. No. S 516/2013

companies would also benefit from the absence of a tax on dividends received and relief for withholding tax on dividends paid to parent companies.¹³⁴ Should the company fail to comply during the period, there was the possibility of a clawback of tax saved.¹³⁵ However, if the period of incentivisation ended, the RHQ was offered a tax free exit out of Singapore.¹³⁶ To be awarded AHCA status a company must commit to satisfying relatively stringent criteria for local investment and human capital absorption. Potential awardee companies must commit to: having a paid-up equity capital of S\$200 000 by the end of year one, and S\$500 000 by the end of year three; to incurring at least a S\$2 million spend in Singapore by the end of year three; to perform at least three qualifying intra group headquarter services; employ 75per cent skilled workers; and pay an average remuneration of S\$100 000 by the end of year three.¹³⁷ A variation aimed at international headquarter companies was also introduced, with more stringent local content requirements, but with the potential for a tax rate of 0per cent for 20 years.¹³⁸

2.3.15 The AHCA maintained the same core foundation as the OHC, but the incentive scheme was fine-tuned over the years to target the benefits Singapore required the most. The AHCA was even more stringent on the local investment requirements, incorporating both increased monetary and new labour absorption requirements. With a relatively skilled population Singapore could provide the skills required by RHQs locally. It therefore chose to require AHCA companies to absorb local labour, rather than incentivise the importation of expatriate labour, as has been the case in Thailand and other developing jurisdictions.¹³⁹ The requirements for AHCA companies to employ 75per cent skilled workers and pay an average of S\$100 000 are also indicative of the type of labour absorption aimed for by Singapore. The modification of the scheme to allow for concessionary rates on wider range of income provided more flexibility to potential RHQs. However, this was compensated for by bringing

¹³⁴ Yin & Walsh (note 96) at 227.

¹³⁵ Leow & Tan (note 128) at 190.

¹³⁶ *Ibid.*

¹³⁷ Leow & Tan (note 128) at 191; Iyer (note 128) at 97.

¹³⁸ Leow & Tan (note 128) at 191-2, Iyer (note 128) at 97

¹³⁹ Yin & Walsh (note 96) at 278.

the concessionary rate closer to the corporate tax rate.¹⁴⁰ AHCA status and the concomitant benefits were granted for renewable periods of five years which was important as it provided certainty of benefit for a set amount of time, even before entering negotiations with EDB.¹⁴¹ This certainty was reinforced by the possibility of a tax-free exit out of Singapore after the expiry of the period.

2.3.16 From the above, three major themes can be deduced which if implemented in s9I could be beneficial to South Africa's incentivisation efforts. The AHCA's fine-tuned targeting compared to the OHC is a lesson which could be adopted specifically to aid in South Africa's competitiveness in attracting RHQs, and maximising the utility of hosting RHQs. Secondly, guaranteed access to the benefits of the scheme for a generally applicable, certain time period is a facet of Singapore's RHQ LIS efforts which has evolved from the ad hoc agreement approach applicable under the OHC. Lastly, allowing administrative management and agility is a more general lesson on the competitiveness of LISs and is an element of the incentivisation scheme shared with the Netherlands. Overall, Singapore's experiences show that South Africa should offer targeted, dependable tax concessions, but require the type of local direct investment which would further its developmental agenda.

2.3.17 The utility of proper targeting of a LIS's requirements and benefits, to achieve what would provide the most utility to a given country, has been exemplified in the evolution of the OHC into the AHCA. The returns guaranteed for Singapore through its efforts in enforcing investment requirements, have moved beyond capital investment and assured expenditure, to including set standards for labour absorption by RHQs.¹⁴² This is evidence of fine-tuning for local circumstances, because Singapore's relatively plentiful supply of skilled labour needed absorbing, and RHQs were a potential means to achieve this policy goal. This could analogously be applied to the South African context where sluggish growth and high unemployment could be alleviated through required levels of direct investment into South Africa, attracted through commercially useful tax concessions. With a skilled labour supply

¹⁴⁰ The rate at the time was 17 per cent, see further Chris J. Finnerty et al 'Tax Strategies for Investing and Structuring into Asia-Pacific – Use of Hong Kong and Singapore as Regional Holding Companies' September/October 2011 *Asia-Pacific Tax Bulletin* 332 at 335.

¹⁴¹ cf s9I (3) of the Income Tax Act; initially 5 years, closer to repeal 3 years.

¹⁴² Leow & Tan (note 128) at 191; Iyer (note 128) at 97.

that is often exported in what has been termed a ‘brain drain’, applying similar labour absorption requirements to those in Singapore could assist in abating the outflow of skilled employees. This is particularly so, because RHQs generally require skilled staff to perform the intra-group services. S9I, if modified to attract RHQs, could produce guaranteed, concrete benefits for South Africa should similar local investment and labour absorption prerequisites be introduced.

- 2.3.18 Secondly, both the OHC and AHCA were driven by the organ of state implementing the schemes. Providing the EDB with authority over the scheme, provided two important benefits. It allowed the EDB to control the process, with the authority to decide which firms to proactively target for RHQ status and thereby the industries to stimulate.¹⁴³ Under the AHCA, this authority enabled the EDB to provide the fast-tracking system and the escalating benefits available under the Approved International Headquarter Company Award (‘AIHCA’).¹⁴⁴ Responsibility for the regime vesting in one institution also provides the opportunity for it to build a repository of specialised knowledge of the dynamics of incentivisation. Such as the types of companies applying and their levels of investment, which could be used to further refine the regime. Under s9I there is no role for either National Treasury or the South African Revenue Service (‘SARS’), aside from SARS’ normal returns processing and advanced tax ruling functions. Were the s9I regime to place full responsibility for its promotion, implementation and refinement in either entity it would provide a champion of the incentive which could engage in its promotion and build up information to aid in its fine-tuning.
- 2.3.19 Providing certainty for potential RHQs, that it will benefit under a LIS for a certain period is of critical importance. This certainty allows for effective medium term planning, as these benefits become a constant variable. The importance guaranteed benefit is amplified where there are local investment requirements built into the LIS, because an MNE would not be willing to make significant investments it would not otherwise make, if it was not guaranteed a resultant benefit. The AHCA provided a level of certainty, because it provided the tax concessions for a period of five years, subject to compliance with requirements.¹⁴⁵ Additionally, it provided the peace of mind that came with a tax-free exit upon expiry of the

¹⁴³ Ibid.

¹⁴⁴ Ibid.

¹⁴⁵ s9I (1); initially 5 years, closer to repeal 3 years.

period, enabling the efficient ending of a short-term investment.¹⁴⁶ The lack of certainty endemic in the s9I regime is a major theme of Part II, and is explored fully there, particularly sub-part 3.3. Regardless, the patent implication is that South Africa needs to implement a measure of certainty beyond the, at best, single year of assessment currently provided for in s9I (1) read with s9I (3).

2.3.20 In conclusion, regional headquarter company activities are highly suited to encouraging broad based benefit for the people of South Africa, as RHQs produce the externalities of operating enterprises such as direct and indirect employment, local direct investment in requirements such as office space and skills diffusion as local employees are exposed to RHQ practices. Therefore, incentivising such activities would be consistent with the broader government policy of encouraging enterprise development and labour absorption. South Africa provides a viable destination for RHQ MNE activity and it ought to capitalise on this potential. What led to Singapore's success is the combination of positive structural factors brought about by the People's Action Party's concerted efforts to get Singapore's market basics right and the compensatory effect of the RHQ LISs.¹⁴⁷ South Africa is in a comparable position and with a proper emphasis on market fundamentals it could achieve the same results in incentivising the locating of RHQs within its borders. In embarking down the road of incentivising RHQs, South Africa would do well to adopt the tax concessions in exchange for required investment model implemented by Singapore. This model's major benefit is that it guarantees a certain level of investment and activity within the borders of South Africa. This would be a positive step from the present position of s9I which provides tax concessions merely in the hope of attracting MNE investment into South Africa. To begin attracting RHQ activity s9I would have to be modified to incentivise the activities of RHQs, which are mainly the provision of services to regional affiliates. Options for optimising the efficacy of the s9I regime include placing responsibility for the running of the scheme squarely within a single institution and ensuring that MNEs are guaranteed returns under the regime for a predetermined period of time.

2.4 Contemporary Regional Competition

¹⁴⁶ Leow & Tan (note 128) at 190.

¹⁴⁷ Zee, Stotsky & Ley (Note 69) at 1508; Watanabe (note 12) at 88 & 116; Avenell (note 12) 15.

- 2.4.1 South Africa has chosen to pursue IHC activity through s9I. Despite the position taken in this work that IHC activity is in fact harmful and contradicts broader government policy, it remains to determine how competitive, the policy design as evidenced by the provisions of the s9I regime, is in comparison to other African tax incentive options. It will also be of use to investigate whether contemporaries are attempting to incentivise RHQs or IHQs, to determine the level of competition in this area.
- 2.4.2 The above exploration of both the Netherlands and Singapore has brought forward several general propositions on best practice design features for IHC and RHQ LISs respectively. The best practices regarding IHC LISs include: the ability to limit withholding taxes and provide access to treaty benefits, the extent and nature of tax concession provided on cross border passive investment and repatriation, the nature of unilateral double taxation relief and the certainty of accessing the benefits of the scheme. RHQ LIS best practices incorporate many of the same as for IHCs, in addition to: tax relief for intra-group services, a prerequisite level of local investment and targeted substance requirements.
- 2.4.3 There are several jurisdictions in Southern African which have shown themselves as amenable to incentivising MNE activity.¹⁴⁸ Mauritius' Global Business Licencing regime is an established IHC LIS in a comparable developing, come middle income country and indeed is the main competition faced by s9I.¹⁴⁹ Botswana in recent times has managed to position itself as an attractive destination for the setting up of regional headquarters, particularly in the mining sector.¹⁵⁰ It will therefore provide a comparator which has fairly recently begun incentivising MNE activity, that is not a low tax jurisdiction and which has encouraged both holding and headquarter activities.

Table 1: Comparison Between s9I, GBC 1 & IFSC

| | | | |
|--|--------------------------|--|--|
| | South Africa: s9I Regime | Mauritius: Global Business Company 1 (GBC 1) | Botswana: International Financial Service Centres (IFSC) |
|--|--------------------------|--|--|

¹⁴⁸ See for example Nigeria and Kenya in Gutuza (note 14) at 204 in note 77.

¹⁴⁹ Gutuza (note 14) at 188.

¹⁵⁰ Seleteng & Motelle (note 102) 5.

| | | | |
|--------------|---|---|---|
| Requirements | <ul style="list-style-type: none"> • At least 10 per cent of equity shares & voting rights held by each shareholder, or group; • 80per cent costs attributable to shares in, debt of, or intellectual property licenced to qualifying foreign company; • 50per cent gross income attributable to passive investment in foreign qualifying company.¹⁵¹ | <p>Resident GBC must be managed and controlled from Mauritius. Authorities consider factors including.¹⁵²</p> <ul style="list-style-type: none"> • Registered Office in Mauritius, where accounting records are kept; • 2 directors resident in Mauritius, who attend board meetings; • Mauritian principle bank account; • Financial statements audited in Mauritius; and • One of the following: <ul style="list-style-type: none"> ▪ Office premises in Mauritius, ▪ At least one full time administrative/technical employee; ▪ Constitution of the company requires disputes arising from constitution to be settled by arbitration in Mauritius; ▪ Holds assets of at least US\$100 000, aside from cash or shares in GBC company, in Mauritius; ▪ Listed on Mauritian stock exchange; ▪ Reasonable annual expenditure in Mauritius.¹⁵³ | <ul style="list-style-type: none"> • Certificated by Botswana Investment and Trade Centre;¹⁵⁴ • Performance of specified financial service to non-residents.¹⁵⁵ |
|--------------|---|---|---|

¹⁵¹ s9(2)(a)-(c) of the Income Tax Act.

¹⁵² s71 (1) & (4)(b) Mauritius Financial Services Act 14 of 2007.

¹⁵³ Financial Services Commission 'Guide to Global Business' (2012) para 3.3.

¹⁵⁴ s138(2) & (8) of the Botswana Income Tax Act.

¹⁵⁵ s138(7) of the Botswana Income Tax Act.

| Local Investment | Direct | • None | • Required considerations in award of GBC 1 licence ¹⁵⁶ | • Required considerations in award of IFSC certificate ¹⁵⁷ |
|--------------------|--------|---|--|--|
| Tax Concessions | | <ul style="list-style-type: none"> • Exempt from withholding taxes on royalties, interest and dividends;¹⁵⁸ • No cross border anti-avoidance rules: CFC, TP & Thin Cap;¹⁵⁹ • Freedom for operational currency & absence of tax on exchange gains;¹⁶⁰ • No capital gains on disposal of shares in a qualifying foreign company;¹⁶¹ | <ul style="list-style-type: none"> • Maximum effective tax rate of 3per cent, due to foreign tax credits; | <ul style="list-style-type: none"> • 15per cent on taxable income from approved services & 25per cent on any other income;¹⁶² • Exempt from withholding taxes on interest, royalties, dividends and management fees;¹⁶³ • Exempt from capital gains tax, except on disposal of Botswanan assets;¹⁶⁴ • Dividends received from 25per cent controlled non-residents exempt;¹⁶⁵ |
| Duration/Certainty | | 1 year of assessment ¹⁶⁶ | Indefinite | Until 31 December 2020 or revoked ¹⁶⁷ |
| Treaty access | | Yes ¹⁶⁸ | Yes, including tax sparing credit clauses ¹⁶⁹ | Yes, but limited number of DTAs ¹⁷⁰ |

¹⁵⁶ S71 (1) & (4)(b) Mauritius Financial Services Act; Financial Services Commission (note 152) para 3.3.

¹⁵⁷ s138(8) of the Botswana Income Tax Ac.

¹⁵⁸ s49D, s50D(1)(a)(i)(cc), s64E(1) of the Income Tax Act.

¹⁵⁹ s31(5); s9(2) of the Income Tax Act.

¹⁶⁰ s25D(4) & s24I (1) of the Income Tax Act.

¹⁶¹ para 64B of the Eighth Schedule of the Income Tax Act.

¹⁶² Eighth Schedule, Table III item 7 of the Botswana Income Tax Ac.

¹⁶³ s58(4) of the Botswana Income Tax Ac.

¹⁶⁴ s139 of the Botswana Income Tax Ac.

¹⁶⁵ s38, Second Schedule Part II para (xxxvii), s1 def 'qualifying foreign participation' of the Botswana Income Tax Ac.

¹⁶⁶ s9I(3) of the Income Tax Act.

¹⁶⁷ s138(2) of the Botswana Income Tax Ac

¹⁶⁸ s9(1)(a) of the Income Tax Act requires potential beneficiaries to be resident in South Africa.

¹⁶⁹ Oguttu (note 14) at 17.

¹⁷⁰ Ibid.

| | | | |
|-------------------------------|---|---|---|
| Unilateral Taxation Relief | Double Credit & deduction systems ¹⁷¹ | <ul style="list-style-type: none"> • Presumed Credit of 80per cent of tax payable on foreign sourced income;¹⁷² • Foreign Tax Credit on comparable Mauritian tax or proven tax paid;¹⁷³ | Credit of lesser of foreign tax paid or as per formula ¹⁷⁴ |
| Exchange control | Yes ¹⁷⁵ | No ¹⁷⁶ | No ¹⁷⁷ |

2.4.4 The above table shows that South Africa's LIS incorporates best practice features mainly geared towards IHCs. Including a broad network of DTAs, exemption from withholding taxes on outbound payments, unilateral double tax relief, and an absence of capital gains on disposal of shares in foreign subsidiaries. However, all three jurisdictions provide best practice tax relief along these lines. Specifically, all three provide relief on withholding taxes on outbound payments, access to treaty benefits, and unilateral double taxation relief in the form of tax credits. This increases the relative importance of the other determinant factors, both regarding the design of the LISs and broader market basics.

2.4.5 Mauritius' GBC 1 incentivisation programme is the most competitive in the region, as it provides the most tax efficient means to conduct both IHC and RHQ activities. This lies in the maximum 3per cent effective tax rate on foreign sourced income, resulting from the application of Mauritius' brand of unilateral double taxation relief. When this is combined with the potential origin country tax credit savings applicable under tax sparing clauses in Mauritian DTAs, the tax saving grows. The absence of exchange controls allows mobility for funds, which is useful to intermediary holding companies. Mauritius also incorporates optimisation features such as certainty of duration and involvement of the implementing authority. The only potential detraction is the local substance requirements which must be

¹⁷¹ s6 quin, s6 quat of the Income Tax Act

¹⁷² reg 8 (3) Mauritius Income Tax (Foreign Tax Credit) Regulations 1996: GN 80 of 1996.

¹⁷³ Ibid reg 6 (1).

¹⁷⁴ ss63-63 of the Botswana Income Tax Ac.

¹⁷⁵ Financial Surveillance Department *Exchange Control Manual* (2015) para 6.1.4.5.

¹⁷⁶ Oguttu (note 14) at 17-8; Doelie Lessing & Daleen Malan 'Private Equity Investments: SA headquarter company v Mauritius GBC1' November 2014 *Without Prejudice* 68 at 69.

¹⁷⁷ Oguttu (note 14) at 17.

satisfied for the GBC 1 company to be managed and controlled from Mauritius. However, as indicated above such measures are an acceptable trade-off to the offering of tax concessions and provide an important guarantee of investment for developing countries.

2.4.6 Botswana's IFSC LIS is uncompetitive from a tax perspective, because it applies a relatively high rate of tax on qualifying income at 15 per cent, the foreign tax credit provided may result in less than full recoupment and the network of tax treaties available is limited. It however is administered by an implementing authority, does not apply exchange controls and the expiry date for benefits was certain from the outset. It also has local direct investment requirements built into the incentivisation process, securing local returns. The success mentioned above must therefore be attributable to the combination of the IFSC with other incentives, such as a competitive taxation system for mining royalties.¹⁷⁸

2.4.7 South Africa's economic dominance in the region positions it as a likely host jurisdiction for RHQs, but s9I does not incentivise these activities. It's overall strength in financial services places it as a leading choice for IHC activity, but this is hampered by exchange control. To assume its place as a regional gateway into Africa, South Africa must focus on augmenting its inherent strengths by incentivising the activities it is best placed to host, namely RHQ activities. It must also lever the strategic advantage of a world class financial services sector to its benefit. This must however bring a return for the people of South Africa and aid in its developmental project, meaning returns must be guaranteed. South Africa therefore must consider targeting the s9I incentive towards RHQ activities with a heavy reliance on a strong financial sector.

2.5 Conclusion on the Tax Policy Appropriateness of s9I

2.5.1. South Africa's tax policy ought to conform with the principles laid out in the various government policy documents applicable for the present period.¹⁷⁹ More importantly, South Africa's tax policy and taxation authority must contribute towards the constitutional mission

¹⁷⁸ Jude Amos 'Botswana: Corporate Taxation' (2016) *IBFD Country Reviews* available at https://online-ibfd-org.ezproxy.uct.ac.za/document/gtha_bw_chaphead, accessed on 24 February 2016 para 1.7.2.

¹⁷⁹ See NDP 2030 (note 11) Chs 3 & 7.

of achieving equality and dignity for those trapped under the blight of poverty.¹⁸⁰ The role of a fiscal incentive in this context is therefore to encourage enterprises to perform activities which produce public goods, such as employment or state revenue. If a tax incentive does not do so, then it is an inefficient use of state resources. Where an incentive in fact produces negative consequences such as distortion of competition then it is completely contradictory to the goals of tax policy in South Africa and must be urgently remedied or repealed.

- 2.5.2. This part has explored the tax policy design of the s9I regime with the aim of determining what types of MNE activities it is best able to attract and whether these activities are likely to produce the externalities required by the country. Through a comparative analysis with one of the world's leading IHC jurisdictions, the Netherlands, it has been determined that s9I is geared towards attracting intermediary holding activities. However, this form of MNE activity has been shown to produce highly negative results for South Africa. First, the loss of revenue is not justified by a direct investment return for South Africa, because IHCs tend to be minimal companies carrying out little activity. Secondly, s9I violates the fundamental taxation principles of equality and neutrality, because it distorts competition against local MNEs which cannot access similar tax benefits, and therefore have to compete under a greater tax burden.
- 2.5.3. Having established that IHC activities as incentivised by s9I would not be suitable to the current context of South Africa, regional headquarter company activities were investigated as an alternative. The active nature of the functions carried out by RHQs was found to be beneficial to the developmental project underway in South Africa. Therefore, the position was taken that South Africa ought to pursue this form of MNE activity through s9I. Singapore was used as the comparator for RHQs, because of its overwhelming success in attracting these companies. The best practice recommendations arising from this comparative analysis were that s9I needs to provide tax relief for the intra-group services performed by RHQs and that requirements for qualification need to be crafted to ensure adequate levels of local direct investment. Further, lessons which could benefit s9I's policy design were also delineated from this comparative study including the importance of having an institution championing a LIS.
- 2.5.4. Using the factors identified as best practices in attracting both IHCs and RHQs, s9I was compared to Botswana and Mauritius' LISs. This comparison saw Mauritius coming out on

¹⁸⁰ ss 7 (2), 9 & 10 of the Constitution of the Republic of South Africa, 1996.

top, as it best embodies the best practice elements and reliably provides a very low effective rate of tax on foreign source income. Furthermore, it was established that for South Africa to assume its natural place as regional gateway, it would have to target its incentivisation efforts at RHQ activities which it is well positioned to host. However, it ought not to throw out the IHC baby with the bathwater, because these tax efficiencies, combined with its strength in financial services could provide the competitive edge necessary to surpass Mauritius.

2.5.5. Regional treasury companies ('RTC') are a sub-type of RHQs which require a strong financial sector, but which provide the active intra-group services endemic to RHQs. RTCs thus have the characteristics and functions necessary to resurrect South Africa's LIS efforts. RTCs have become increasingly popular with the capital mobility and currency volatility of open capital markets of recent times.¹⁸¹ These companies perform activities centring around the cash and financial risk management of an MNE's activities in a particular region.¹⁸² Examples of typical RTC functions include: foreign exchange risk management, market and credit risk management, cash management, and overseeing banking relationships.¹⁸³ Polak and Roslan conducted a literature review of work on the location criteria important for RTCs. They emphasise that favourable taxation is fundamental for RTCs and that this is the most important criterion in selecting a location.¹⁸⁴ They find that authors generally posit that the other important features of RTC locations include: minimal bank transaction fees, especially on cross border payments; minimal withholding and corporate taxes; minimal reporting requirements to monetary authorities on transfers of certain volumes; a good sovereign credit rating; a flexible functional currency environment; and existence of other treasury centres in the region.¹⁸⁵

2.5.6. South Africa meets many of these structural requirements: it has a world class financial services and banking sector and is near to Mauritius, another prominent treasury centre. When the present s9I is considered, the capital mobility advantages add to South Africa's suitability as a host for RTCs. The foreign currency provisions in s25D and para 45 (1A) provide the

¹⁸¹ Petr Polak & Rady Roswanddy Roslan 'Location Criteria for Establishing Treasury Centres in South East Asia' (2009) 2 *Journal of Corporate Treasury Management* 311 at 331 (Polak & Roslan).

¹⁸² *Ibid* at 331.

¹⁸³ *Ibid* at 332-3

¹⁸⁴ *Ibid* at 332, 334.

¹⁸⁵ *Ibid* 334-6.

means to convert receipts and expenditure in a foreign currency into the prospective s9I company or Rand. This allows for flexibility in the denomination of asset bases, which is part of the function of diversifying currency risk. When this is combined with the effective foreign exchange exemption found in s24I(1) definitions of ‘local currency’ para (d), and ‘exchange difference’, read with s24I (3), this provides relief on foreign exchange gains not attributable to a foreign permanent establishment, denominated in the s9I companies functional currency. Effectively insulating the s9I company’s taxable income from exchange gains and losses. Also, the exemption from withholding taxes, especially on interest payments is useful for RTCs making cash distributions across the group.¹⁸⁶ A further aspect of capital mobility is being exempt from exchange controls, which is based on similar requirements to qualification under s9I.¹⁸⁷ With these features, South Africa presents a potentially competitive jurisdiction to host RTC activity. Relief for intra-group financial services and tweaking the foreign exchange gain taxation to exempt foreign exchange gains on all currencies would concretise this. Targeted local substance requirements could then ensure RTCs are guaranteed contributors to South Africa’s economic development goals. RTCs present a form of intermediary MNE activity which South Africa is primed to accommodate and reap the benefits of hosting.

- 2.5.7. The ultimate position reached in this Part therefore is that s9I’s current policy design is detrimentally inappropriate for its context. Rather, it ought to be modified to properly target MNE activities that would provide greater local benefits. The first step towards achieving this would be to target RHQ activities, which can provide an economic boost to the developmental mission of present day South Africa through active provision of services to group companies. A consideration of the competition South Africa faces in the intermediary holding company arena, indicates that South Africa must exploit its competitive advantages effectively to gain ground on Mauritius. RTCs are the natural choice for South Africa, based on its world class financial and banking sector that provides a favourable context in which to conduct these activities. As subtypes of RHQs, RTCs are sound choices from a tax policy perspective. Section 9I’s currency fluidity, when combined with the capital mobility enabled by

¹⁸⁶ s50D ITA; Polak & Roslan (note 181) at 336.

¹⁸⁷ For a discussion of headquarter companies and exchange control see sub-part 3.5.

headquarter company exemptions to exchange control, provide a solid incentivisation basis to embark down this path.

PART II: THE INTERPRETATION OF SECTION 9I AND ITS COMMERCIAL ATTRACTIVENESS

3.1 Introduction

- 3.1.1. The commercial attractiveness of a fiscal incentive is intuitively based on the degree to which it effectively compensates for costs, which would otherwise act as a barrier to the targeted activities being located in a particular jurisdiction. Regardless of how well designed an incentive is from a policy perspective, if companies do not view it as commercially advantageous to participate in, there will be no positive externalities produced by their increased activity. Commercial attractiveness lies not only in the extent and nature of the tax relief provided, but also in companies' ability to readily determine what is required to access the benefits, and the burden required to comply. Therefore, it is imperative that fiscal incentives are put forward through simple predictable rules, that do not impose unwarranted barriers to access and which have been drafted cognisant of the broader legal atmosphere.¹⁸⁸
- 3.1.2. This part seeks to determine whether s9I has been drafted in a manner that ensures the incentive is commercially attractive. To do so the seminal overview of the correct approach to interpretation propounded by Wallis JA in *Natal Joint Municipal Pension fund v Endumeni Municipality (Natal Joint Pension Fund)* will be applied to the provisions.¹⁸⁹ This approach requires the interpreter to determine the meaning of the words used, based on an objective consideration of the context of the document as a whole and in light of all relevant circumstances.¹⁹⁰ Wallis JA also endorses considering certain objective, interpretational factors: ordinary rules of grammar and syntax; context in which the provision occurs; its apparent purpose; and the material known to be responsible for its production.¹⁹¹

¹⁸⁸ Alan Auerbach 'The Cost of Capital and Investment in Developing Countries' in Anwar Shah (ed) *Fiscal Incentives for Investment and Innovation* (1995) 153; Jack Mintz & Thomas Tsiopolous 'Corporate Income Taxation and Foreign Direct Investment in Central and Eastern Europe' in Anwar Shah (ed) *Fiscal Incentives for Investment and Innovation* (1995) 465.

¹⁸⁹ 2012 (4) SA 595 (SCA).

¹⁹⁰ *Natal Joint Pension Fund* (note 188) para 24.

¹⁹¹ *Ibid* para 18

- 3.1.3. Applying the above here will require a consideration of the text of s9I and any other relevant provisions. Considered, conscious of the purpose of the s9I regime, as established above at paras 2.2.2 and 1.3: the incentivisation of holding company activities. It will also require consideration of the context of s9I. Wallis JA did not explicitly state what can validly be considered as the context of a provision, but he implied that it included the document as a whole and all relevant circumstances.¹⁹² Consideration of a statute in its entirety here will be taken as an endorsement of the interpretative presumption that a word retains its meaning throughout a statute.¹⁹³ The broader body of tax case law, including persuasive foreign cases, must be taken as a relevant circumstance, informing the meaning to be ascribed to words used in the same sense in multiple sections of the Act. Therefore, the words used in the provisions will be interpreted using their ordinary meaning, as guided by precedent on the same or similar words. The ordinary meaning, if it leads to ‘glaring absurdities’ must be interpreted in a manner which aids the fulfilment of the purpose of the provision’s IHC incentivisation.¹⁹⁴
- 3.1.4. Companies seeking to make use of the s9I regime must be resident in South Africa, comply with the provisions of s9I(2) and make an annual election in the prescribed form.¹⁹⁵ Section 9I(2)’s requirements are the foundation of its commercial attractiveness, because they determine what is required of a company to access the scheme. Interpreting the specifics of these requirements will therefore expose the commercial attractiveness of the s9I regime. The seemingly benign requirement of an annual election interacts with the anti-avoidance provisions inserted through s9H. This interaction is laden with the potential to impose significant costs on companies seeking to elect to be treated as s9I companies and therefore has the potential to be a fatal deterrent. Lastly, the nature of South Africa’s DTAs and its exchange control rules are factors outside the ITA to be considered for their relevance to the efficacy, and therefore commercial attractiveness, of the scheme.

¹⁹² Ibid para 24

¹⁹³ See *Dlamini v S; Dladla and others v S; S v Joubert; S v Schietekat* 1999 (4) SA 623 (CC) para 47.

¹⁹⁴ *Natal Joint Pension Fund* (note 188) para 25.

¹⁹⁵ S1 ‘resident’ read with S9 (1) of the Income Tax Act; see further *Oceanic Trust Co Ltd NO v CSARS* 74 SATC 127; s9I (2) & (3) of the Income Tax Act.

3.1.5. As noted above the commercial attractiveness of a fiscal incentive is based upon how effectively it compensates for costs which would otherwise be barriers to investment. The interpretative analysis to be conducted of s9I and its context below raises certain recurrent themes. Namely, the ambiguity of the provisions; the reliability of compliance; and the restrictiveness or burdensomeness of the requirements – absent sufficient policy justification. That these concerns arise recurrently s9I (2) requirements, and are considerations in the broader context as well, does not bode well for the commercial attractiveness of the regime.¹⁹⁶ Where a fiscal incentive’s provisions itself act as a deterrent to partaking in the scheme it is as though the state has locked the door to the incentive from within. Therefore, rather than aiding in the establishment of South Africa as an entry point into Africa, the provisions of s9I have barred the gateway into the region from within.

3.2 Section 9I (2)(a): the 10per cent equity shares and voting rights requirement

3.2.1. This subsection reads:

“(a) **for the duration** of that year of assessment, each holder of shares in the company (whether **alone or together with** any other company forming part of **the same group** of companies as that holder) held **10 per cent or more of the equity shares and voting rights in that company**: Provided that in determining whether a company complies with the requirements prescribed by this paragraph in relation to any year of assessment of that company during which the company commenced the carrying on of trade, no regard must be had to any period during that year before which the company so **commenced the carrying on of trade**”, (emphasis added)

3.2.2. The first requirement of this section is that compliance must be “for the duration” of the year of assessment (‘YOA’) in question. According to SARS Interpretation Note No. 87 (IN87) this means that the company must comply every day of the YOA and that the shareholding can change, but the 10per cent threshold must always be maintained.¹⁹⁷ The stringency of this requirement proved to be a barrier to entry into the scheme for start-up companies and therefore the exception in the later part was introduced in 2012.¹⁹⁸ The exception allows for non-compliance in the period before the prospective company has commenced carrying on of trade.

¹⁹⁶ cf Mintz (note 188)

¹⁹⁷ National Treasury ‘Interpretation Note No. 87’ (2016) p6 para 3.2.3.

¹⁹⁸ National Treasury ‘Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012’ (2012) 124.

3.2.3. Intermediary holding companies, as noted above, are mainly concerned with passive holding activities and their administration.¹⁹⁹ The question therefore is whether IHCs carry on a trade when engaging in these activities in an intra-group context? Trade is defined as including ‘every profession, trade, business, employment, calling, occupation or venture’, including the letting of property and licencing of intellectual property.²⁰⁰ Thus where a s9I colicences the use of IP to foreign subsidiaries it is clearly trading. However, where it merely holds shares in subsidiaries or provides debt finance the position is less clear.

3.2.4. The cases interpreting what constitutes carrying on a trade are found in two main variants: those dealing with the distinction between capital and revenue receipts, and those dealing with the deductibility of expenditure.²⁰¹ The cases on the capital/revenue distinction are more apposite to answering the question here. These cases deal with the situation where taxpayers begin trading or cross the Rubicon into business, where they previously held capital investments.²⁰² The taxpayer’s intention morphing from passively holding or realising capital, into active revenue seeking is the hallmark of commencing to trade.²⁰³ The test to determine whether the gain is a trading gain is factual, with the activities undertaken in relation to asset being used to infer if the taxpayer was employing their capital in a scheme of profit making.²⁰⁴ Several factors have repeatedly been used by the courts as indications either way, including the taxpayer’s *ipse dixit*, the length of time the asset was held, and the behaviour of the taxpayer which caused the receipt.²⁰⁵ However, the core criterion remains whether the gain arose through business operations which form part of a scheme of profit making by the taxpayer.²⁰⁶

¹⁹⁹ See above para 2.2.2.

²⁰⁰ s1 ‘trade’ in the Income Tax Act.

²⁰¹ For capital/revenue see *CIR v Stott* 1928 AD 252 & *Natal estates v SIR* 1975 (4) SA 177 (A); for expenditure see *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A) & *CIR v Pick n Pay Wholesalers* 1987 (3) SA 453 (A)

²⁰² *Stott* (note 199) at 259, *Natal Estates* (note 199) at 203.

²⁰³ *Stott* (note 199) at 259 & 264; *Natal Estates* (note 199) at 199 & 202 -203

²⁰⁴ *Stott* (note 199) at 259; *Natal Estates* (note 199) at 199 & 202 -203; *CIR v Pick n Pay Share Purchase Trust* 1992 (4) SA 39 (A) at 56G.

²⁰⁵ *Natal Estates* (note 199) at 202; *CSARS v Capstone 556 (Pty) Ltd* 2016 (2) All SA 21 (SCA) para 31.

²⁰⁶ *CSARS v Capstone 556 (Pty) Ltd* 2016 (2) All SA 21 (SCA) para 26.

- 3.2.5. The recent case of *CSARS v Capstone 556 (Pty) Ltd (Capstone)* dealt with a situation where shares which were previously acquired and held as a capital investment were disposed of at a profit.²⁰⁷ Leading SARS to question whether the taxpayer had commenced trading. The court followed *CIR v Stott*, *Natal Estates v SIR* and *CIR v Pick n Pay Share Purchase Trust* in assessing the objective circumstances to determine if the taxpayer had the intention to embark on a scheme of profit making.²⁰⁸ Factors held relevant included the nature of the business activities engaged ordinarily engaged in by the taxpayer; the period for which the asset was held; and the intended duration at acquisition.²⁰⁹ This case is therefore analogous to the situation of IHCs seeking to access s9I and holding investments in foreign subsidiaries.
- 3.2.6. Prospective s9I companies are IHCs and as such their main functions are the holding of passive investments in subsidiaries. These investments are not speculative; rather, they are acquired with the intention to efficiently resource regional activities. They will not therefore be readily disposed of and are more likely to be held for substantial periods of time. These factors, following *Capstone*, are indicative of fixed capital investments which the company is not trading in. Furthermore, the s9I regime does not lend itself to prospective companies treating the investments they hold as floating capital. This is reinforced by the foreign dividend exemption in s10H and the capital gains exemption on the disposal of shares in qualifying companies in 64B of the Eighth Schedule of the ITA. With the passive nature of the holding activities of IHCs and thus prospective s9I companies, there is little chance that the behaviour of the IHCs being such that the objective inference is that they intended to engage in a scheme of profit making.
- 3.2.7. It is thus possible that a prospective s9I company never have to comply with the s9 (2) (a) requirement, where it does not enter the arena of trading and merely engages in passive holdings in subsidiaries. While not a damning flaw, this lacuna betrays poor drafting and an absence of appreciation for the subject matter being incentivised. It places prospective s9I companies in the unenviable position of having to comply, even where in law they ought to

²⁰⁷ 2016 (2) All SA 21 (SCA).

²⁰⁸ *Capstone* (note 205) paras 24-8

²⁰⁹ *Capstone* (note 205) paras 31-2

be able to operate free from the requirement. This ambiguity is a negative factor for MNEs seeking to invest, as it detracts from the clarity of the provisions of the scheme.

- 3.2.8. In the ordinary course, s9I companies must comply with s9I (2)(a) for the duration of the YOA in question. However, requiring constant compliance invites the possibility that a prospective company may fail to comply through no fault of its own, or even without its knowledge. Events which could disrupt compliance in this way include: liquidation of an insolvent shareholder's assets, cession *in securitatem debiti* of shares, and the diluting of a shareholding where a natural person bequeaths ownership to multiple people. Considering the international nature of s9I companies, the company not having full information on its foreign shareholdings throughout the entire YOA is possible. Added to this quandary is the absence of direct control by a company over its shares. The possibility that a company may make investments, anticipating the benefits of s9I, only to be undone by events which it had no prior knowledge of or control over is a major disincentive to attempting to access the regime.
- 3.2.9. S9I(2)(a)'s second requirement dictates the broad shareholding structure of prospective s9I companies. Each shareholder, alone or as a group of companies, is required to hold 10 per cent of both the equity shares and voting rights in the company. Equity shares are a defined term in the ITA.²¹⁰ Essentially, equity shares exclude shares which have limited or no rights to participate in a company's distributions after a certain point.²¹¹ Ordinary shares will qualify as equity shares, because they give the right to participate in both dividends and capital upon winding up, without a restriction.²¹² Voting rights are undefined in the ITA, but are a defined term in the Companies Act 71 of 2008. There voting rights connote the right of a holder of a company's securities to vote on a matter to be decided by the company.²¹³ Given the parallels in context, this definition provides a proximate meaning for the term under the ITA.
- 3.2.10. Requiring a concentration of both equity shares and voting rights is a restriction on the flexibility inherent in the bundle of rights which form a share or security.²¹⁴ Prospective s9I

²¹⁰ s1 'equity shares' in the Income Tax Act.

²¹¹ Silke (note 75) para 13.23.

²¹² Ibid.

²¹³ s1 'voting rights' in the Companies Act of 71 2008.

²¹⁴ Farouk HI Cassim (ed) *Contemporary Company Law* 2 ed (2012) 214.

companies should be wary of implementing financing structures which make use of preference shares or hybrid instruments with voting rights, as the separation of voting rights from equity shares could lead to a breach of the 10per cent minimum requirements. This rigidity is another factor which detracts from the commercial attractiveness of s9I, because it restricts the company from structuring its capital in a way which is strategically useful to the business. For example, a prospective s9I co would have to tread carefully, ensuring the group companies definition is satisfied, in seeking to conclude hybrid debt instruments with voting rights attached.²¹⁵ Considering the cross-border context of this form of financing is useful to a group where interest payments can provide a reduction in taxable income.²¹⁶ This would be the case where a s9I co engages in unincentivized management activities, earning fully taxable income and efficiently reduces this through interest payments to a related company in a jurisdiction with a lower tax rate. This would be a risky dilution of voting rights if the viability of the MNE's investment relied on access to s9I.

- 3.2.11. It is difficult to determine the policy utility of S9I (2)(a) in an IHC LIS. It may be a reasonable requirement from the perspective of a tax authority wanting to ensure that s9I companies have a concentrated shareholding and homogenous financing structure to aid with auditing and other anti-avoidance measures. However, this practical gain is insufficient to justify the uncertainty and structural rigidity which prospective s9I companies are saddled with, and the resultant disincentive imposed on participation in the regime. The case for the subsection is not aided by containing an exception that runs contrary to the anticipated IHC activities of prospective s9I companies, which creates a lacuna. Ambiguity and precarious compliance are not attractive aspects for commercial enterprises which value flexibility and certainty when investment is prompted by a fiscal incentive.

3.3 Section 9I (2)(b): the '80per cent of cost of total assets attributable to' requirement

- 3.3.1. This subsection reads:

“(b) at the end of that year of assessment and of all previous years of assessment of that company, 80 per cent or more of the cost of the total assets of the company was attributable to one or more of the following:

²¹⁵ s1 'group of companies' in the Income Tax Act, requires the controlling company to directly hold at least 70per cent of the equity shares in the controlled companies.

²¹⁶ See generally on the efficiency of intra group debt finance: Jack Mintz & Alfons J. Weichenrieder 'Taxation and the Financial Structure of German Outbound FDI' (2005) 1612 *CESifo Working Paper* 1.

- (i) any interest in equity shares in;
- (ii) any debt owed by; or
- (iii) any intellectual property as defined in section 23I (1) that is licensed by that company to,

any **foreign company in which that company** (whether alone or together with any other company forming part of the same group of companies as that company) **held at least 10 per cent of the equity shares and voting rights**: Provided that in determining-

(aa) the total assets of the company, there must not be taken into account any amount in cash or in the form of a bank deposit payable on demand; and

(bb) whether a company complies with the requirements prescribed by this paragraph in relation to any year of assessment of that company, no regard must be had to any such year of assessment if the company did not at any time during such year of assessment own assets with a total market value exceeding R50 000;" (emphasis added)

3.3.2. The core of this subsection requires at least 80per cent of the cost of the total assets of the prospective s9I co to be attributable to the assets enumerated in paragraphs (i) to (iii) in a qualifying foreign company. This requires a prospective company to determine both the cost of its total assets and the fraction attributable to qualifying assets. Cost is a seemingly simple and ordinary word, defined in the Oxford English Dictionary as having two main noun senses: "an amount... paid or spent to buy or obtain something" and "the effort, loss or sacrifice necessary to achieve or obtain something."²¹⁷ The word 'cost' in relation to assets has been authoritatively interpreted in an Appellate Division case and many persuasive foreign cases in apex courts. The essence of the interpretation is that cost ought to be given the meaning most appropriate to the context. The context has been identified as the legislative setting in which cost is used and relevant facts, often relating to the specifics of the business or transaction in question.²¹⁸

3.3.3. The two senses of cost noted above correspond to two separate manners of obtaining assets relevant to s9I(2)(a): purchase and creation. The scope of the cost underlying these two manners of obtaining assets have clear parallels to the principles from cases dealing with wear and tear allowances on purchased asset, and stock in trade valuations in manufacturing businesses respectively. Where the cost is equivalent to a price the determination is simple, but where there are other inputs to be considered there is a justifiable place for prevailing

²¹⁷ Angus Stevenson (ed) *Oxford Dictionary of English* 3 ed (2010) 394.

²¹⁸ *Eaton Hall v Secretary for Inland Revenue* 1975 (4) SA 953 (A) at 956.

accounting practice to aid in determining the cost drivers or elements are *de facto* relevant to the creation of an asset.²¹⁹

- 3.3.4. IN87 has put forward SARS' view as the cost requirement here being equivalent to 'expenditure incurred' and as a result sections which deem expenditure affect s9I (2)(b). The authoritative interpretations of the two, while similar, are not interchangeable. Expenditure does not provide as appropriate guidance on the scope of costs to be considered, particularly with asset creation. Lastly, the position on recoups of cost or reduction of overall outlay for an asset is incorrect. Thus, the position taken by SARS unnecessarily muddies the waters.
- 3.3.5. Having determined what cost ought to be interpreted as meaning, this subpart turns a consideration of the attractiveness of what is required. Valuing cost can be a very burdensome exercise, particularly as the requirement must be satisfied for every past YOA, on all assets. The requirement is also susceptible to being inadvertently not complied with due to unexpected asset acquisitions or increased outlay costs. Thirdly, while the imposition of the cost requirement is intended to limit the activities of prospective s9I companies, however it also disincentives direct investment into South Africa. Lastly, while compliance may be burdensome, the group context presents the opportunity to avoid the requirements through donations or manufactured costs between related parties. Therefore, the lack commercial appeal in this burdensome and ineffective requirement is clear. Its continued existence in a fiscal incentive given the local detriment it engenders must be questioned.
- 3.3.6. The most authoritative case on the meaning of cost in the context of the ITA is *Eaton Hall v Secretary for Inland Revenue (Eaton Hall)*.²²⁰ In *Eaton Hall*, the Appellate Division was called to decide whether several allowances granted "in respect of the cost to the taxpayer... of the portion of any building" included the interest paid on a loan used to finance construction. Trolip JA held that in absence of a definition, 'cost' was to be given its ordinary meaning.²²¹ Judicial notice was taken of the meaning per the Oxford English Dictionary

²¹⁹ Cost drivers or elements here will be used to indicate the instances of expenditure which go to make up the cost of a particular asset.

²²⁰ 1975 (4) SA 953 (A).

²²¹ *Eaton Hall* (note 219) 956F-G

which defined cost as: "That which must be given or surrendered in order to acquire, produce, accomplish, or maintain something; the price paid for a thing."²²²

3.3.7. Trollop JA also made use of both the broader background and specific provisions of the ITA, to determine the purpose of the provisions as encouraging the building and improvement of hotels.²²³ Enabling the interpretation of cost of any portion of any building as referring to the erection cost of hotel buildings.²²⁴ Two textual interpretive points were decided informing the scope of cost. The use of the phrase 'cost of', as opposed to 'cost in respect of' denotes a close, direct connection between the cost and item in question.²²⁵ Secondly, "any building" and "any improvements" was held to indicate a more direct relationship between the asset and the cost, than simply the cost of building.²²⁶ Overall, the court held that the ordinary, grammatical meaning of the words used in the provision indicated that the relevant cost was limited to the consideration given or price paid for the erection of hotel buildings.²²⁷ As this was required to be a direct and close connection, the indirect interest expense could not be said to be part of the cost of erecting the buildings.²²⁸

3.3.8. Following *Eaton Hall*, the immediate textual context is fundamental to determining the parameters of the meaning of cost in the provision.²²⁹ The core requirement of s9I (2)(b) is that the costs attributable to qualifying assets make up a certain fraction of the cost of the company's 'total assets'. This phrase uses cost as referring to both the cost of qualifying assets and the cost of total assets. Therefore, the cost of all the assets, including foreign assets, held by a prospective s9I co must be determined annually.²³⁰ The words 'attributable to', indicate that there must be a causal link between the cost drivers and the specific assets going to make

²²² Ibid 956F-G

²²³ Ibid 956F

²²⁴ Ibid 956F

²²⁵ Ibid 956H

²²⁶ Ibid 956H

²²⁷ Ibid 957A

²²⁸ Ibid 957D

²²⁹ Ibid 956H

²³⁰ Asset is not defined in s1, but is defined para 1 of the Eighth Schedule as including both property, corporeal and incorporeal, and rights or interests in such property and this will be the meaning adopted here.

up the 80per cent minimum. Meaning a prospective s9I co must then determine what proportion of its total costs are attributable to qualifying assets. The choice to use the phrase ‘cost of total assets’, rather than ‘total cost of assets’ is notable. The former phrase emphasises the totality of the assets rather than of the cost. Implying that the cost refers to the sum of each instance of asset acquisition, calculated at a certain point. Total cost would imply the inclusion continuous or maintenance costs up to the point of calculation. Further, it is submitted that ‘total’ here ought to be read as indicating only the currently held assets of the prospective company, because although the criterion must be satisfied for every past YOA, the calculation is being done at the end of ‘that YOA’. Therefore, to comply the company must determine it’s the cost of its total asset base at a point in time, using historical acquisition costs and determine whether 80per cent of these costs were incurred in relation to qualifying assets.

3.3.9. Trollip JA relied on no direct authority for his interpretation of the scope of cost in *Eaton Hall*. However, several foreign cases cited by counsel in *Eaton Hall* are instructive on what cost elements one ought include within the cost of an asset. *C v Commissioner of Taxes (C v COT)* dealt with the deductibility of expenses related to export market development.²³¹ It was held that where cost is undefined it may be used in various senses and therefore the context in which it is used is determinative of the sense intended.²³² The context is also determinative of the extent of items to be included in an instance of cost. That is whether only the direct costs necessary to bring the *res* into a vendible state are to be included or whether a proportion of the business’ ancillary costs ought to be factored in.²³³ Goldin J noted that an amendment had been effected to the relevant provisions reversing the effect of a case which had interpreted them as including indirect costs, such as railage and insurance.²³⁴ Also, the provision contained an exhaustive list of specific inclusions of indirect cost drivers.²³⁵ It was therefore held that the direct costs were all that could be deducted.²³⁶

²³¹ 1973 (4) SA 449 (R) at 449H.

²³² *Ibid* at 453F & 454B.

²³³ *Ibid* at 453E.

²³⁴ *Ibid* at 453H & 454D.

²³⁵ *Ibid* at 454C.

²³⁶ *Ibid* at 454B.

- 3.3.10. The principles informing how to determine the makeup of the cost of a particular asset can be traced to these three cases: *Ex Parte Brierley*, *Re Elvidge (Ex Parte Brierley)*,²³⁷ *The Lord Mayor, Alderman and Citizens of the see The Lord Mayor, Alderman and Citizens of the City of Birmingham v Barnes (HM Inspector of Taxes) (Birmingham v Barnes)*,²³⁸ and *Ostime (HM Inspector of Taxes) v Duple Motor Bodies Ltd (Ostime v Duple)*.²³⁹
- 3.3.11. *Ex Parte Brierley* per Jordan CJ was cited in *C v COT* as authority for drawing the distinction between applying the direct cost and on-cost methods, in varying contexts. It was held that the ordinary meaning of cost can connote a different scope depending on context.²⁴⁰ When a manufacturing business is determining its cost, this would be the price paid for inputs such as raw materials and wages paid.²⁴¹ This would be determined using the on-cost method which would allocate a proportion of the indirect or overhead costs of manufacturing to a particular asset.²⁴² While with retailers the cost would be the price paid for acquiring the *merx*.²⁴³ However, in both cases the cost may include ‘all other expenses related to bringing into existence or obtaining’ and then turning a *res* to profit.²⁴⁴
- 3.3.12. *Birmingham v Barnes* was cited by counsel for the Secretary in *Eaton Hall* as informing what ‘actual cost of plant and machinery meant’ in the context of a taxing statute. It interpreted cost where used as a basis for a depreciation allowance on a train line constructed by the taxpayer. Lord Atkin held that ‘actual cost’ “meant nothing more than the cost accurately ascertained.”²⁴⁵ Further, that the cost to a taxpayer was what they paid or expended for the erection of the capital asset, regardless of whether a third party had contracted to pay the taxpayer an equivalent sum.²⁴⁶ This establishes that the sense of cost applicable to acquisition of assets is the price paid for the *merx*. In the context of s9I this would be applicable where

²³⁷ (1947) 47 N.S.W.S.R. 423.

²³⁸ 1935 (1) A.C. 292.

²³⁹ (1961) 1 W.L.R 739.

²⁴⁰ *Ex Parte Brierley* (note 236) at 427.

²⁴¹ *Ibid*.

²⁴² *Ibid* at 426.

²⁴³ *Ibid* at 427

²⁴⁴ *Ibid*.

²⁴⁵ *Birmingham v Barnes* (note 237) 298.

²⁴⁶ *Ibid*.

the company buys shares, purchases a right to intellectual property or borrows funds to on lend to a qualifying foreign company. Ergo, acquisition of qualifying assets by a prospective s9I is analogous to the situation of a retail business described in *Ex Parte Brierley*.

- 3.3.13. There is a parallel between cost being equated with price in the acquisition of assets and the use of acquisition cost as a base value for wear and tear deductions provided for in the ITA, where the proviso in s11(e)(vii) does not apply.²⁴⁷ This parallel ratifies the claim that the scope of cost relevant to purchased assets is the cost price, with little room for other direct costs. It also allows insight into the likely practical interpretation by SARS. Under the abovementioned provisions of the ITA, cost has been interpreted as the cost to the taxpayer, viz the purchase price.²⁴⁸ SARS has issued Binding General Ruling 7, under s89 of the Tax Administration Act 28 of 2011, setting practice regarding s11 (e) to treating value as denoting the taxpayer's cost of acquisition in a cash transaction, without finance charges.²⁴⁹
- 3.3.14. Applying the above to the analogous circumstances of s9I(2)(b) cost, where qualifying assets are acquired through purchase the price paid alone would constitute the cost of the asset. For example, with the purchase of qualifying shares the labour and office related costs of setting up the transaction are indirect and would not be considered part of the cost, unless specifically included in the contract price. While with the borrowing of funds to on lend as qualifying debt, interest would be a direct cost as it is consideration for the loan. This would conform with the strict version of the direct cost method applied in *C v COT* and the classification as per *Ex Parte Brierley*.
- 3.3.15. *Ostime v Duple* was cited in *C v COT* in support of the distinction between manufacturing and retail costs drawn in *Ex Parte Brierley*.²⁵⁰ The case's relevance is that it dealt with the valuation of stock on hand of a manufacturing business, as being the cost to the taxpayer.²⁵¹ The court was asked to decide if the direct cost or on-cost method should in principle apply

²⁴⁷ Silke (note 75) para 8.117; these amendments deem the specific parameters of cost including that it is to be at an arm's length price, in cash and are inapplicable to s9I see s11(e)(vii).

²⁴⁸ *ITC 1546* (1992) 54 SATC 477 at 481.

²⁴⁹ Binding General Ruling 7 at 3.

²⁵⁰ *C v COT* (note 230) 453G.

²⁵¹ *Ostime v Duple* (note 238) at 750-1.

to determine the cost to a taxpayer engaged in manufacture.²⁵² It was decided that the direct cost method ought to continue to apply *in casu* as this was established practice.²⁵³ Notable *obiter dicta* for present purposes include that the costing method which gives the most accurate reflection of the value of stock for the particular business is the correct method to be applied.²⁵⁴ Further, while manufactured assets have a more complex cost base than purchased assets, potentially including what the court termed factory and office costs, the precise content is difficult to prescribe in principle.²⁵⁵

3.3.16. Where assets are created by the taxpayer the second sense of cost denoting the effort expended can be relevant, because the manufacture of an asset has a broader set of inputs. Some of these may not be readily reduceable to a specific sum of money. For example, the cost of producing qualifying intellectual property may include the use of scientific equipment and the mental exertion of employees. Both of these cost elements could be engaged in multiple aspects of the business making the allocation of a portion of the cost to the intellectual property difficult, if at all possible. Useful guidance can be found in the cases dealing with the valuation of trading stock in the ITA.

3.3.17. The scope of a mining company's production or acquisition cost of trading stock, in the context of s23F(3), has recently been considered in *ITC 1847*.²⁵⁶ There the court was called to decide whether mining and certain related costs were part of the acquisition costs of fluorspar stock in trade.²⁵⁷ The related costs included processing costs, extraction and separation, and delivery costs, such as railage and insurance.²⁵⁸ Although it was conceded that delivery costs were not acquisition costs, it was held that only the processing costs constituted part of the acquisition cost of the fluorspar. Willis J cited *George Forest Timbers* and *Foskor* as authority for the proposition that they constituted acquisition costs, because they were part of getting the article into a saleable state.²⁵⁹

²⁵² *Ibid* at 746 & 750.

²⁵³ *Ibid* at 749 & 754-755.

²⁵⁴ *Ibid* at 755.

²⁵⁵ *Ibid* at 751 & 754.

²⁵⁶ 73 SATC 126; at the time of the case this provision was s23F (2) of the Income Tax Act.

²⁵⁷ *ITC 1847* para 10.

²⁵⁸ *Ibid* para 12.

²⁵⁹ *Ibid 1847* para 12

- 3.3.18. Where a prospective s9I co engages in research and development towards intellectual property to be licenced, lends funds out of its capital or cash surplus, or incorporates a qualifying foreign company, it creates the asset and acts analogously to the manufacturing business described in *Ex Parte Brierley*. The cases dealing with the valuation of stock in trade, as well as *Ex Parte Brierley*, are clear endorsements of the on-cost method in the case of asset creation. However, which inputs will be taken as relevant to a particular asset still remains a challenging determination.²⁶⁰ Section 22(3)(a) stipulates how the relevant inputs there are to be determined and this is through application of International Financial Reporting Standard practices. This could serve as a possible means to assist in ascertaining which input costs are relevant in the context of s9I.
- 3.3.19. Several cases warn of the subordinate role of accounting standards in determining the scope of cost in a taxing statute. For example, in *Sub-Nigel Ltd. v Commissioner for Inland Revenue (Sub-Nigel)*,²⁶¹ it was held that “the Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act.”²⁶² However, applying generally accepted accounting standards can have utility within the bounds set by the law.²⁶³ This has been recognised and s22 (3)(a)(i) requires the application of International Financial Reporting Standards in the determination of the indirect costs applicable to trading stock.
- 3.3.20. International Accounting Standard 2 (IAS 2) is the International Financial Reporting Standard (IFRS) presently applicable under s22(3)(a)(i).²⁶⁴ It allows the inclusion of indirect costs which are necessary for bringing an asset to its present condition and location, both where it

²⁶⁰ *Richards Bay v CIR* 1996 (1) SA 311 (SCA) at 328.

²⁶¹ 1948 (4) SA 580 (AD).

²⁶² *Ibid* 588.

²⁶³ Noting the profit basis of taxation prevailing in the United Kingdom at the time see further *Whimster & Co. v Inland Revenue Commissioners* 1926 S.C. 20, where it was held that accounting practice ought to be observed in so far as it does not violate the provisions of the statute.

²⁶⁴ IFRS Foundation ‘International Accounting Standard 2: Inventories’ Available at <http://www.frascanada.ca/international-financial-reporting-standards/resources/unaccompanied-ifrss/item45598.pdf>., accessed on 20 September 2016.

is purchased and acquired, but not with financial instruments.²⁶⁵ The precedent of *Eaton Hall* is likely to bar the application to purchased qualifying assets, but given the complex nature of determining the input costs it ought to be of assistance with the cost of asset creation. As the cost of asset creation is embedded within the broader cost structure of a given company, the relevant input costs and their significance may differ in each business. Following the guidance of precedent and IAS 2 it is likely that costs necessary to bring the asset to its present location and state will be accepted as part of the cost of the creation of these assets. In *Richards Bay* this was obiter stated to include labour and materials.²⁶⁶ However, as demonstrated below, this is not definitive in all circumstances.²⁶⁷ Therefore, even with the assistance of accounting standards the cost arrived at can be challenged as inaccurate or inappropriately composed.

- 3.3.21. On the approach detailed above the cost of qualifying assets under s9I may carry either sense of its ordinary meaning, as guided by the factual context. It will always mean what was given by the prospective s9I co for the asset, but the scope of what has been given for the asset is dependent on whether it has been purchased or created. This difference has been judicially and administratively interpreted as allowing only the purchase price for acquired assets, but a broader set of costs to be included in the computation where assets are created. Therefore, the categorisation in *Ex Parte Brierley* is sound in the context of s9I: the direct cost method is applicable to purchasing qualifying assets, while a version of the on-cost method is applicable to assets produced by the prospective s9I co.
- 3.3.22. Interpretation Note 87 puts forwards SARS' position on the interpretation of the s9I regime. The position taken on s9I(2)(b) leaves much to be desired. The claim is made that 'cost' here is equivalent to 'expenditure incurred'.²⁶⁸ Further, that sections which deem expenditure actually incurred should be taken as altering the cost relevant for s9I(2)(b).²⁶⁹ However, on a consideration of the meaning of cost as established above propositions are unsound.

²⁶⁵ Ibid para 6 & para 2.

²⁶⁶ *Richards Bay* (note 259) 328.

²⁶⁷ See para 3.3.28.

²⁶⁸ IN87 (note 195) at 11.

²⁶⁹ Ibid at 12

3.3.23. Despite the wealth of precedent available on the meaning of cost SARS has chosen to interpret cost in s9I(2)(b) as equivalent to expenditure incurred, relying on *Labat v CSARS (Labat)*.²⁷⁰ Expenditure is defined in the Oxford English Dictionary as “the action of spending funds” and “the use of energy, time or other resources”.²⁷¹ Expenditure has received a significant amount of judicial attention in cases dealing with the general deductions formula, but Harms AP in *Labat* held that it is used in its ordinary sense.²⁷² Expenditure and cost differ in their semantic emphasis, with the crux of cost being the obtaining of something for a price or effort. While expenditure’s focus is on the action of spending. Expenditure, as a tax law concept, has limited application when considering the cost of a particular item. It gives no principled indication as to how to associate an instance of expenditure with a particular asset. Furthermore, cost has a broader scope than expenditure and may be reduced by receipts in relation to an asset; *Knights Deep v Colonial Treasurer (Knights Deep)* is a case in point.²⁷³ There the *Colonial Treasurer* had argued that the ‘cost of production’ for a gold mining company would be reduced by the proceeds from the sale of water pumped out of shafts in order to make them accessible.²⁷⁴ However, the court disagreed, because ‘cost of production’ was a defined term which limited the cost to amounts ‘actually expended’.²⁷⁵ Mason J stated that the definition of production cost was a deviation from its ordinary commercial meaning in the context.²⁷⁶

3.3.24. Based on the view that cost and expenditure are interchangeable under s9I(2)(b) IN87 posits that there is an interaction between this section and deeming provisions such as s40C, s31(2), section 80B and paragraph 38(1)(b). These sections form part of the broader legislative context and therefore must be considered. However, as IN87 correctly states each relevant section must be interpreted to determine whether it applies to s9I.²⁷⁷ For example, s12C(2) begins with “for the purpose of this section” and therefore, the deemed arm’s length price for these assets does not extend beyond this section. However, contrary to SARS’ view, where a

²⁷⁰ 2013 (2) SA 33 (SCA); IN87 at 11.

²⁷¹ Oxford English Dictionary (note 216) 615.

²⁷² *Labat* (note 269) para 12.

²⁷³ 1905 TS 689.

²⁷⁴ *Ibid* 693.

²⁷⁵ *Ibid*.

²⁷⁶ *Ibid*.

²⁷⁷ IN87 (note 195) 12

section deems an adjustment to taxable income or expenditure actually incurred, s9I should not be affected. For example, where a notional adjustment is made to a taxpayer's taxable income under 31(2), contrary to the position of IN87, this would not affect the cost to be calculated under s9I. However, should a provision of the Act generally apply a deemed adjustment to cost, then this would be a valid adjustment under s9I (2)(b).

3.3.25. IN87 states that cost under s9I will not be affected by amounts given under provisions of the ITA, such as capital allowances.²⁷⁸ Capital allowances are remote from the price paid or production costs to the taxpayer, so it is likely that this position is sound. However, IN87 goes on to state that recoupments from the "other party to the potential" s9I co will reduce the original cost of an asset.²⁷⁹ No authority is cited for this curious proposition and it runs contrary to persuasive precedent in the context of asset purchase. In *Birmingham v Barnes*, it was held that the cost to the taxpayer was what had been expended in satisfaction of the price and contractual payments by interested third parties, although affecting the overall outlay by the taxpayer, did not go to reduce the purchase cost.²⁸⁰ Indeed, considering *Ryan v Asia Mill* even where the taxpayer makes a payment increasing the overall outlay regarding an asset the cost price remains the cost.²⁸¹ The position may be different in the context of asset creation, because following *Knights Deep* the recoupments of input costs in the production of gold, through the sale of by-product water would have gone to validly reduce production costs in their ordinary, commercial sense.²⁸²

3.3.26. Although interpretation notes are not binding, SARS' poor guidance on s9I (2)(b) is still detrimental to the commercial attractiveness of the regime. It goes to the ease of understanding what is required by a prospective company to access the regime. If the guidance provided by the administrative entity responsible for the scheme is out of sync with the applicable law, then a prospective s9I co would be torn between complying with the standards set by SARS and what is required by the law.

²⁷⁸ Ibid 12.

²⁷⁹ Ibid 12.

²⁸⁰ *Birmingham v Barnes* (note 237) 296.

²⁸¹ *Ryan (HM Inspector of Taxes) v Asia Mill Ltd* 32 T.C. 275 298.

²⁸² *Knights Deep* (note 272) 693.

- 3.3.27. Having established the meaning of cost as used in s9I (2)(b), it falls to investigate whether this requirement is a deterrent to making use of the scheme and whether it adds value from the perspective of achieving the IHC incentivisation objective of s9I. Whether requiring the determination of the fraction of total asset costs made up by qualifying assets is attractive will turn on what a company must do to ascertain this. It is submitted that a prospective s9I co would have to determine the cost of its total assets, corporeal and incorporeal worldwide, using the judicially endorsed cost model relevant to how the assets were acquired. It would then determine whether the proportion of cost drivers attributable to the acquisition cost of qualifying assets meets the 80per cent minimum. Although accounting standards may be of assistance, it would have to be ensured that the prescriptions are in line with the meaning of cost in law under s9I.²⁸³
- 3.3.28. Where assets are purchased the determination of cost may be relatively simple, as the case law indicates the price should be used.²⁸⁴ It becomes a complex task where assets are created by the taxpayer, because the correctness or proportion of the cost drivers that go into that determination cannot be selected with absolute certainty.²⁸⁵ Drury states the costing systems implemented by companies' accuracy is relative to their cost.²⁸⁶ He argues that traditional costing systems, which the majority of organisations adopt, are designed to fulfil financial accounting requirements and 'rely extensively on arbitrary cost allocations'.²⁸⁷ More sophisticated systems, termed activity based costing systems, however still rely on a measure of arbitrariness to determine the scope of indirect costs relevant to a particular product.²⁸⁸ However, an measure of arbitrariness is necessarily present under either system, because it is impossible to accurately determine the proportion of overheads that are more remote to the asset. For example, where a senior executive's effort and decision are the *causa causans* of a company producing specific intellectual property, it is prohibitively difficult to calculate what proportion of their salary ought to be considered an indirect expense in production.

²⁸³ It must be noted that unlike s22, s9I does not explicitly endorse the use of accounting standards

²⁸⁴ *Eaton Hall* (note 219); Where the price is variable or is determinable as prescribed in the contract this becomes more difficult.

²⁸⁵ Colin Drury *Management and Cost Accounting* 8 ed (2012) 45-6.

²⁸⁶ *Ibid* 47-8.

²⁸⁷ *Ibid* 44-7.

²⁸⁸ *Ibid* 49 -51.

3.3.29. This is aggravated by the fact that prospective s9I companies would not be creating goods that fit neatly fall into standard models of determining manufacturing cost which tend to disregard more remote indirect costs and focus on ‘factory expenses’.²⁸⁹ Determining the cost of intellectual property would be the most directly analogous to manufacturing businesses and perhaps International Accounting Standard 38: Intangible Assets could assist. However, for example, would the cost of creating an equity shareholding asset be restricted to the registration fee, pre-incorporation expenses and starting capital, or would it include the labour expense of the staff deciding on and carrying out the incorporation and the associated office overheads? It is impossible to say with certainty what would be accepted by SARS or a court. Therefore, significant effort and cost could be required to determine the cost of a creating a qualifying asset using the on-cost method and it would still not provide a certain result given the generality of the judicial decisions in this area.

3.3.30. Aside from the practical determination being difficult, there are some logical tensions inherent in the construction of the provision. S9I (2)(b) requires the calculation of the cost of total assets and the proportion which qualifies, at the end of each YOA of the company from incorporation. Although at first glance this seems simple: requiring the taxpayer to add up all the acquisition costs of its currently owned assets. This requires comparison of both purchased and produced asset, across various time periods. Ergo, the taxpayer must compare costs which are differently composed, at times when the value of money may not be the equivalent. This is a logical inconsistency, because it requires comparing costs which are differently composed in the case of differently acquired assets. Further, across different time periods the measurement unit has changed, because assets acquired in earlier periods would have lower nominal costs, despite being of the same value as assets acquired later, given the time value of money.²⁹⁰ Practically, this comparison means a prospective s9I co would have to be wary of acquiring new, non-qualifying assets. Furthermore, requiring compliance from the company’s inception invites the problems which could arise where unexpected cost relating to non-qualifying assets arise or a court decides that indirect costs in fact are attributable to non-qualifying assets. Given the comparison across different time periods, the effect of

²⁸⁹ Ibid 49-51.

²⁹⁰ Moshe Shekel *The Timing of Income Recognition in Tax Law and the Time Value of Money* (2009) 19, describes this theory as stipulating that ‘the sum of money represented in a certain nominal values at one point in time is not worth the same at another point in time’

unexpected increases in the cost of non-qualifying assets in a later period is disproportionately reckoned in relation to older qualifying assets. This consideration vying with commercial considerations is not likely to be attractive to companies, because it restricts the operational freedom.

- 3.3.31. The fact that s9I companies operate as intermediaries in holding chains is an important consideration. In this context, the acquisition of assets is unlikely to be at an arm's length consideration. Furthermore, none is applied where s9I companies are acting as conduits given s31(5). Therefore, the acquisition costs of purchased qualifying assets are fully open to manipulation with parent companies free to donate assets or even charge inflated prices. Thus, groups can manipulate compliance and artificially ensure that s9I companies have qualifying assets with high acquisition costs. This is particularly so, because s9I does not incorporate anti-avoidance stipulations on cost such as those found in s11(e)(vii). Simply, requiring the cost to be calculated as that of an arm's length transaction, in cash would prevent this manipulation by making use of a more objective cost, as is the case s11(e)(vii).
- 3.3.32. The ability for prospective companies to relatively easily avoid this requirement, as with s9I (2)(a) above, indicates a lack of appreciation for the subject matter being incentivised and clouds the compliance requirements. Furthermore, this requirement is part of the core provisions of the s9I regime which limit the prospective companies to engaging in IHC functions. From the perspective of the state, artificial compliance means that the intended policy goal of incentivising regional holding activities could be undermined. A s9I co could have non-qualifying assets which have a greater value than qualifying assets, but comply because the former were donated by its holding company. Therefore, using cost to limit the asset base of s9I companies is ineffective as a policy tool.
- 3.3.33. As indicated above the requirement does not effectively restrict the asset base of prospective s9I companies and therefore does not achieve the activity limiting purpose. However, as demonstrated above at sub-part 2.2 incentivising IHC activity would not be a beneficial thing for South Africa in any case. Restricting the asset base of s9I companies may be an active disincentive to investment into assets in South Africa. Only in limited circumstances would assets productively applied locally go towards satisfying the s9I(2)(b)

- 3.3.34. Overall, while s9I (2)(b) does include some good points such as the provisos relating to cash and the early stages of the company, cost remains difficult to determine and open to manipulation. Despite legal parameters being set through *Eaton Hall* and other relevant precedent, prospective s9I companies still cannot reliably predict compliance. Despite using the judicially endorsed indirect or on-cost method and applying accepted accounting practice, the cost figure arrived at may be susceptible to challenge by SARS. It would be open to SARS to argue that the cost arrived at by the taxpayer was not appropriately determined as a cost driver was inappropriately factored in or relevant cost drivers omitted. Conversely, SARS would not be able to challenge the price set between related parties, because judicial precedent has established that in the case of purchased assets the cost is the price paid.
- 3.3.35. The unpredictability of compliance under this section is intuitively a disincentive to prospective participants in the s9I regime, because it does not allow for reliable planning. Reliable access has been noted as a factor in the success of Singapore's incentivisation efforts and s9I ought to ensure certainty as far as possible. Furthermore, requiring constant, historical compliance is a stringent measure which is can be faulted in logic and practice. Therefore, given that this requirement is burdensome to the taxpayer, runs contrary to the stated policy goals of South Africa and is in any event ineffective in the context, its continued place in the s9I regime must be questioned.

3.4 The Annual Election & Section 9H of the Income Tax Act

- 3.4.1. Despite the difficulties involved in complying with the s9I(2) requirements, only gaining access to the regime for a YOA at a time, and potentially being deemed to have a significantly increased taxable income are the most detrimental factors impacting the commercial viability of s9I. It is clear from s9I(1) read with s9I (3) that a prospective s9I company must elect into headquarter company status and that this is only effective for a single YOA. Ergo, prospective companies must make the election annually. A single YOA is a very short period of time for a company to be assured of tax relief and this is a fundamental flaw of the regime. Added to this, under s9H of the ITA, entering the s9I regime entails a deemed disposal of all the prospective company's assets, in every YOA that a company elects to be a headquarter company. Moreover, it acts as a direct contradiction to the provisions core to the incentivisation of IHC activities. Given that fiscal incentives by definition provide tax relief, potentially swelling the taxpayer's taxable income is deeply counter-intuitive. Few companies would be willing to risk having to absorb such a tax cost annually, where there are readily

available alternatives within the region which provide greater tax relief, potentially for an indefinite period. Therefore, fearing that s9I would ravage South Africa's tax base Parliament, guided by National Treasury, has robbed s9I of the core of its commercial appeal: a decreased group tax burden.

- 3.4.2. On the surface, the annual election required by s9I(1), read with s9I(3), seems to be a benign administrative process. Indeed, the election in a taxpayer's ITR14 return and populating the required RCHO01 schedule, is administratively simple.²⁹¹ Under s9I (3) this election is valid from the beginning of the YOA it is made in. Therefore, considering s9I in isolation all that would be required is to submit the prospective s9I co's tax return as normal and include the required schedule. Although not a major administrative burden for the company, the concern remains that a company would not ever be assured of accessing the relief for the lifespan of its investment, or even a significant portion thereof.
- 3.4.3. Above at para 2.3.14, 2.4.5, and 2.4.6, it was indicated that other holding company LIS' provide guaranteed access for a certain period, even if compliance is a prerequisite for continued benefit. It is submitted that MNEs value this certainty, because it enables medium or even long term planning of their investments into a jurisdiction. Should the company fall outside s9I the regime after having arranged its affairs to take advantage of the tax relief, it would be saddled with a significant tax cost. For example, it may no longer benefit from exemption to the CFC rules leading to an attribution of the income of foreign subsidiaries.²⁹² Moreover, the tax cost would spread further up the holding chain, as repatriation payments would now be subject to withholding taxes.²⁹³ Thus, by not incorporating any reasonable levels of certainty detracts from the commercial attractiveness of s9I and makes the regime less competitive viz regional competition.
- 3.4.4. Section 9H (3)(a) provides for a deemed disposal to a resident, of all the assets of a resident company, on the date immediately before it becomes a headquarter company. Further, it is deemed to have reacquired those assets, at market value, on the day which it becomes a

²⁹¹ s9I(1) has empowered the Minister of Finance to prescribe this as the manner and form of election.

²⁹² s9D(1) 'controlled foreign company' of the Income Tax Act.

²⁹³ see s49D, s50D(1)(a)(i)(cc), s64E(1) of the Income Tax Act.

headquarter company.²⁹⁴ The tax effect of this deeming is likely to be nil with revenue assets. These would be disposed of retaining their nature leading to inclusions in gross income, but a corresponding deduction ought to be available upon the deemed re-acquisition.²⁹⁵ However, with capital assets there is a capital gain or loss following the disposal, depending on the difference between the base cost and market value, but no corresponding deduction upon reacquisition.²⁹⁶ Therefore, when capital assets are subject to s9H the taxpayer is faced with an effective tax cost equivalent to the 18.65 per cent of the gain.²⁹⁷ This can be a heavy burden for a prospective s9I co to bear, because due to s9I (2)(b) they are shepherded towards largely holding capital assets. Therefore, s9I companies may be susceptible to costly inclusions where the capital assets are not excluded from capital gains calculation and appreciate in value.

3.4.5. IN87 claims that where a capital gain or loss is realised on the deemed disposal of equity shares in foreign companies, where the taxpayer holds at least 10per cent of the equity shares and voting rights, paragraph 64B will operate to nullify the capital gain.²⁹⁸ While this is a correct statement of the law, it is a minor consolation when the full implications of s 9H (3)(e) are considered. Although, the section states that it applies when ‘a company ceases to be resident’, this done is with a reference to para (a). De Kocker and Williams posit that this does not operate to limit the section and that it applies where resident companies become headquarter companies.²⁹⁹ This section operates to deem an inclusion of all the capital gains excluded by para 64B in the preceding three years. Essentially, therefore the protection afforded to s9I companies on the disposal of share in qualifying companies is nullified where a company disposes of such shares and elects into headquarter company status within the following three years. This consequence is highly detrimental to the regime, as the para 64B exemption forms part of the core suite of tax relief incentivising the establishing of headquarter companies.

²⁹⁴ s9H(3)(a) of the Income Tax Act.

²⁹⁵ s1 ‘gross income’, s11(a) & s23(g).

²⁹⁶ Para 3, para 4 & Part V of the Eighth Schedule of the Income Tax Act.

²⁹⁷ paras 8 & 10 of the Eighth Schedule of the Income Tax Act, read with para 2 Schedule 1 of the Rates and Monetary Amounts Amendment of Revenue Laws Act 13 of 2016.

²⁹⁸ IN 87 (note 195) 57.

²⁹⁹ Silke (note 75) para 14.2.

- 3.4.6. A parallel argument applies to s9H(3)(f) which deems an inclusion of the foreign dividends not subject to inclusion in taxable income under s10B for three preceding years. This may be even more of a deterrent, because the likelihood of receiving dividends from subsidiaries is greater than that of disposing of a qualifying shareholding. Therefore, the risk of an increased tax burden and disincentive effect is greater with the application of s9H(3)(f).
- 3.4.7. Section 9H (3)(c)(iii) operates to deem a company becoming a headquarter company, to have declared and paid a dividend *in specie*, equal to the market value of all issued shares, less the amount of its contributed share capital. This implies a dividends tax cost for the s9I co, calculated 20 per cent of the difference between the contributed share capital and market value of its equity. IN87 states that the beneficial owner exemptions in s64F(1)(a) will operate to exempt this deemed payment, because it is deemed to be distributed to a resident.³⁰⁰ Although the effect of this may be valid in specific circumstances, this is not generally applicable. Section 64F(1)(a) is only applicable to a dividend distribution ‘to the extent that it does not consist of a dividend *in specie*’. Section 64FA then provides that where a company declares and pays a dividend it is possible for this to be exempt then to the extent that this constitutes a dividend *in specie*, and this would have been exempt under s64F but for it being a dividend *in specie*. However, this requires s64FA(1)(a) to be satisfied and the person to whom the payment is made has timeously submitted the requisite declaration from the beneficial owner. Alternatively, s64FA applies where the distribution is made to a beneficial owner that is part of the same group of companies as defined in the ITA.³⁰¹ Therefore, although it is possible for the s9I co to escape liability this is not a given and requires an administrative burden on the part of the beneficial owners of the dividends. Despite the s9H dividend in specie likely fulfilling the requirements of s64F(1)(a), as it deemed to be distributed to residents.
- 3.4.8. Given that the election is annual and attends such unfavourable tax consequences on headquarter companies the combined effect of the provisions is a fatal disincentive to the attractiveness of the scheme. Not only can it nullify the tax relief achieved through the operation of other sections, but given s9H (3) (e-f) the relief granted under the scheme is actively eroded. This state of affairs is clearly not attractive to prospective s9I companies which seek to enjoy the benefits of a fiscal incentive which provides a tax saving for the intra-

³⁰⁰ IN 87 (note 195) 58.

³⁰¹ s1 ‘group of companies’.

group activates inherent in intermediary companies. The Explanatory Memorandum to the Taxation Laws Amendment Bill, 2012 states that s9H was introduced an anti-avoidance measure to protect South Africa's tax base from former residents avoiding capital gains tax.³⁰² Without any specific justification it goes on to state that 'The above rules also apply when a company becomes a headquarter company.'³⁰³ Given the drastic effect this provision has on the viability of the s9I regime it is submitted that more is required than the tacking on of a provision onto another anti-avoidance provision. Further, that by revoking the proffered tax relief through s9H (3)(3-f) the provision goes beyond what is required to protect the tax base.

3.5 Section 9I's Interaction with Double Tax Agreements, Foreign Tax Systems & Exchange Control

- 3.5.1. The interaction of s9I with the greater legal atmosphere in force in South Africa is important to its likely success in achieving the tax relief which is the central drawcard of any fiscal incentive, s9I included. As shown above in the discussion on Dutch IHCs, the ability for a LIS to beneficially interact with double taxation agreements to reduce withholding taxes is a crucial aspect to its commercial appeal. It therefore remains to determine the range of benefits a prospective s9I co can expect to reap through South Africa's DTA network. Secondly, Watanabe argues that the effect of a LIS can be to reduce a company's tax liability or basis for taxation to such a point that it triggers anti-avoidance rules in the parent company's jurisdiction.³⁰⁴ The extent to which this hold true is important for the commercial attractiveness of the regime, but even negative consequences may be ameliorated if the relevant DTA contains a tax sparing clause. A last facet of the legal terrain which is likely to have a great effect on the efficacy of s9I is the exchange control regime administered by the South African reserve bank.
- 3.5.2. To access treaty benefits a taxpayer has to be engaged in cross border activity leading to the drawing of income from a source, which is not its resident jurisdiction. As s9I(1) requires that prospective headquarter companies are residents this aspect is satisfied. However, as the context is a fiscal incentive which seeks not to tax, the applicability of treaty provisions in the absence of double taxation arises. The Appellate Division did not disturb the findings of the

³⁰² National Treasury (note 196) 109-110.

³⁰³ Ibid.

³⁰⁴ Watanabe (note 12) at 100.

court *a quo* per Miller J that ‘such [double tax] agreement need not be confined to therapeutic measures, but may include prophylactic measures as well.’³⁰⁵

3.5.3. Having established that s9I companies can access treaty benefits, it remains to determine the nature of the benefits they stand to access. As noted above the key criterion sought by prospective s9I companies would be low applicable withholding tax rates, both for s9I cos making and receiving cross border payments. An exclusive right to tax the conduit activity in South Africa or a reduced rate under a DTA with a source country would be beneficial to s9I cos receiving payments. A reduced rate is also important in the context of outbound payments, however the exemptions to withholding taxes in South Africa provided for by s9I will be of little value if the resident country of the receiver could then impose a tax on the receipt.

Table 2: Withholding Rates for Major African Economies³⁰⁶

| Country | Dividends | Interest | Royalties | Exclusive Right |
|-----------|--|-------------|------------|-----------------|
| Algeria | 10per cent where 25per cent capital holding and 15per cent otherwise | 10per cent | 10per cent | None |
| Botswana | 10per cent where 25per cent capital holding and 15per cent otherwise | 10per cent | 10per cent | None |
| Egypt | 15per cent | 12per cent | 15per cent | None |
| Mauritius | 5per cent if 10per cent capital holding, 10per cent otherwise | 10per cent | 5per cent | None |
| Nigeria | | 7.5per cent | | |

³⁰⁵ Unreported decision of the Natal Income Tax Special Court of 27 October 1972, see further *SIR v Downing* 1975 (4) SA 518 (A).

³⁰⁶ GG 21303 of 21 June 2000 Arts 10-12; GN 39485 in GG 21303 of 11 December 2015 Arts 10-12; GN 471 in GG 38862 of 17 June 2015 Arts 10-12; GN in GG 19706 of 22 January 1999 Arts 10-12; GN31241 in GG 31241 Arts 10-12.

- 3.5.4. Table 2. shows that the applicable reduced rates are fair and generally represent a 5per cent reduction in the rate applicable in South Africa.³⁰⁷ The articles used in the above DTAs do not provide an exclusive right to South Africa, because they all make use of a phrase similar to ‘may also be taxed in the Contracting State of which the company paying the ... is a resident’.³⁰⁸ Therefore, the tax benefit while good is not optimal. Moreover, there are a number of key African states which South Africa is yet to sign treaties with, limiting the reach of the regional relief available to s9I cos. The states include: established economies like Angola and Libya, but also emergent resource rich economies such as Equatorial Guinea and Gabon. Therefore, inbound payments to s9I cos will be subject to some level of withholding tax in payable in the source state.
- 3.5.5. The suboptimal outcome of applying the DTAs increases the importance of unilateral double taxation relief, specifically *s6quat* of the ITA. Where a taxpayer has suffered a foreign tax on taxable income not sourced in South Africa, South Africa provides unilateral double taxation relief through *s6quat*.³⁰⁹ This relief is in the form of a rebate on tax payable, limited to the proportion that the foreign tax proven payable, bears in to the total taxable income; applying the relevant tax rate to the result.³¹⁰ The utility of this provision in the context of s9I is that even where DTAs do not go to reduce the full amounts of withholding tax on inbound payments, the s9I company can still gain relief for its tax cost. Therefore, effectively with inbound payments s9I produces the best possible result, eliminating the tax cost. Considering the emphasis placed on the importance of reducing withholding taxes by authors such as Weyzig and Weichenrieder the incorporation of this is likely to be seen as attractive to MNEs.

Table 3: Withholding Rates for Major Global Economies³¹¹

³⁰⁷ For example, dividends tax is levied at 15per cent s64E (1).

³⁰⁸ GG 21303 of 21 June 2000 Arts 10.1-10.2; see further OECD Committee on Fiscal Affairs *Model Tax Convention on Income and Capital: Full Version* (2015) para c(10) II 4. & c(10) II 9.; these commentaries were held to be authoritative in *Downing* (note 304).

³⁰⁹ *s6quat* (1)(a) of the Income Tax Act.

³¹⁰ *s6quat* (1A), *s6quat* (1B) of the Income Tax Act.

³¹¹ GN 31721 in GG 31721 of 23 December 2008 Arts 5-7; Proc R. 125, 1973 of 25 May 1973; GG 22041 of 2 February 2001; & GG 24335 of 31 January 2003, read with GN 52 in GG 34971 of 2 February 2012.

| Country | Dividends | Interest | Royalties | Tax Sparing/ Exclusive Right |
|----------------|---|-----------------------------|---|------------------------------------|
| Australia | 5per cent where beneficial owner holds 10per cent of voting power, 10per cent otherwise | 10per cent | 5per cent | None |
| Germany | 7.5per cent where 25per cent of voting shares, 15per cent otherwise | 10per cent | Full resident country rate | Royalties; |
| China | 5per cent | 10per cent | 10per cent of full amount or 10per cent on 70per cent of gross payment for use of equipment | |
| United Kingdom | 5per cent with 10per cent capital holding; 15per cent viz property Investment company; & 10per cent otherwise | Full residence country rate | Full residence country rate | Interest & royalties |

3.5.6. Section 9I cos do not fare as well regarding outbound payments, with a tendency for DTAs with more powerful states, such as Germany and the United Kingdom, to incorporate exclusive rights to tax in the state of residence. Therefore, the tax relief of not charging withholding taxes in outbound interest of royalty payments to the UK is irrelevant. However, for YOAs beginning after March 2016, *s6quat* again plays a supporting role. Under *s6quat(1C)*, where a resident carries on any trade within South Africa which results in their being subject to foreign tax, that taxpayer may elect to pursue a deduction of those tax costs.³¹² This deduction is limited to the total taxable income attributable to foreign sourced income and a proportion of the deductions under ss11(n), 18 and 18A must be included where applicable.³¹³

³¹² *s6quat(1C)(a)* of the Income Tax Act; see further Silke (note 75) para 17.22.

³¹³ *s6quat(1C)(b)*, read with *s6quat(1C)* of the Income Tax Act.

3.5.7. Although *s6quat* does go a-ways towards addressing the shortcomings of DTA relief for s9I cos, as noted above, Watanabe argues that the preferential treatment could bring on foreign anti-avoidance provisions such as CFC rules.³¹⁴ For example, considering the rules of the Dutch participation exemption mentioned above under para 2.2.7?? this may not apply in relation to s9I companies, as the restricted effective tax base may lead the Netherlands s9I cos as a ‘low-taxed, investment company’.³¹⁵ This brings forth the importance of preserving the benefits achieved by s9I through tax sparing clauses in DTAs with developed countries, likely to host parent companies. Tax sparing clauses are designed to preserve the benefits of fiscal incentives offered by preventing bars to foreign tax credits on incentivised income in the parent company’s jurisdiction. These are often applied by requiring the credits to be calculated on the notional amount of tax that would have been paid without the incentive.³¹⁶ Despite the potential benefits for the s9I regime, South Africa shown an inclination towards abandoning tax sparing clauses, due to their potential to allow for double non-taxation.³¹⁷ Mauritius conversely continues to make use of tax sparing clauses in several of its DTA to the benefit of its GBC 1 companies, which are assured that the Mauritian tax relief will not be nullified.³¹⁸ Tax sparing credits are a missed opportunity to bolster the appeal of s9I, by ensuring the group tax benefit is not nullified by an increased tax cost in the parent company’s jurisdiction.

3.5.8. Lastly, although the capital mobility critical to conduit functions of qualifying s9I cos is not restricted by exchange controls, having to fulfil a distinct set of requirements with a separate controlling body is not optimal. The intention at the inception of the s9I regime was that exchange control regulations would approximate its requirements. The two regimes have been coming closer together over time, but there is still not a perfect match. The requirements per para 6.1.4.5 of the Exchange Control Manual, adds the requirement that no more than 20per

³¹⁴ Watanabe (note 12) at 100.

³¹⁵ art 13 of the Dutch Income Tax Act; see further Schelkens (note 34) para 2.2.

³¹⁶ Legwaila (note 46) 10.

³¹⁷ National Treasury, Media Statement: New South Africa and Mauritius Tax Treaty Enters into Force’ (2015) 2; see on the negative effects of tax sparing Annet Wanyana Oguttu ‘The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa’ *Bulletin for International Taxation* (2011) 65 *Bulletin of International Taxation* 1.

³¹⁸ Legwaila (note 46) 10.

cent of the headquarter company's shares may be held directly or indirectly by residents.³¹⁹ Further, the requirement relating to headquarter company's foreign asset base is worded differently, focusing on the assets and having no regard to their cost.³²⁰ Prescribing different prerequisites adds to the already extensive compliance burden faced by the prospective s9I co both administratively and substantively. To qualify for the exchange controls which are critical to its holding functions, it will likely have to determine the market value of its assets to evidence compliance, while being restricted to a 20per cent local shareholding, which could have commercial value. Therefore, although the exchange control requirements are clearer and less taxing than those of s9I, they still go to compound the heavy compliance burden faced by prospective s9I companies.

3.6 Assessment of s9I's Commercial Attractiveness

- 3.6.1. The basis of commercial attractiveness for a fiscal incentive has been argued to consist of the ability for the incentive to reduce costs which would otherwise tip the scales away from investment in a jurisdiction.³²¹ Section 9I's purpose is the attraction of IHC MNE activity which would otherwise not view South Africa as a viable location for holding activates. To do so, s9I needs to be simple, to ensure companies are confident in their knowledge of the requirements. It must also provide reliable access to the benefits, because without assured access to tax relief South Africa can be assured that this will not arise. The last criterion to successful incentivisation is an absence of prohibitive costs for access to the tax relief proffered.
- 3.6.2. Section 9I (2)'s requirements all indicate a level of anti-avoidance, beyond what is validly required to limit the activities of s9I cos. With s9I (2)(a) the requirement to have a 10% equity share and voting right holding minimum for each shareholder is likely geared towards assisting SARS with the implementation of anti-avoidance measures. Requiring a consolidated holding structure serves little other purpose than to limit the scope of an audit. This is particularly so, because by their nature IHCs are embedded in holding chains, meaning the probability that there would be a vast array of shareholders is slim. Therefore,

³¹⁹ Financial Surveillance Department *Exchange Control Manual* (2015) para 6.1.4.5.

³²⁰ It is submitted that this is a more appropriate approach, which would have the effect of calculating the asset base using an arm's length price, as noted above at para 3.3.???

³²¹ Op cit (note 188)

concretising this requirement has led to it serving as a barrier to entry into the regime. In recognition of this, the Act was amended to provide a proviso to the requirement. This proviso has been shown to be open to manipulation, because IHCs are not active trading companies. Their activities consist largely of holding capital assets, rather than embarking on schemes of profit making. In sum, s9I (2)(a) does little to improve the policy design of the regime and is both ambiguous and precarious; leading to it detracting from s9I's commercial attractiveness.

- 3.6.3. Section 9I (2)(b) prima facie has some utility in the regime, by restricting the asset base of prospective s9I companies the provision seeks to limit their activities to holding. This is consonant with the underlying purpose chosen by National Treasury for the scheme. However, not only does requiring a specified level of asset cost not limit the activities of companies, but a deeper analysis of the core requirement of the section brings forth its true colours. It is an unwieldy provision which smacks of illogicality and the accurate determination of asset cost in relation to total asset cost can be prohibitively intricate, making compliance burdensome for the prospective companies. Furthermore, given the group context and absence of enforcement of arm's length principles it is susceptible to manipulated compliance through donations or inflated costs being constructed between related parties, which both have the same objective: a decreased tax burden. In sum, s9I (2)(b) also falls short of properly regulating the activities of s9I companies, while being ambiguous to a fault
- 3.6.4. A counterargument which could immediately be levelled against the above is that the interpretation leads to an ambiguity justifying a detraction from the ordinary meaning of the language. However, as Wallis JA *Natal Joint Municipal Pension Fund* a difficult result does not necessarily warrant a detraction from the ordinary meaning. In essence, the provisions while bordering on absurdity fall short and are merely burdensome to comply with. Given the burdensome nature of these provisions, it is possible to argue that the *contra fiscum* presumption of interpretation ought to operate to lighten the burden of compliance. Although an unlikely prospect give Milne J's finding that

“The mere existence of hardship or inequity resulting from the application of the plain provisions of fiscal legislation is beside the point. Hardship and inequity are not to be used for the purpose of reading into plain terms a meaning which they do not otherwise bear”³²²

A further consideration is whether companies have the litigative appetite to test if the requirements are absurd or ought to be interpreted *contra fiscum*.

- 3.6.5. Considering the broader legislative context s9I fares little better. Its interaction with DTAs while beneficial when considering countries in the region likely to operate as source countries, South Africa lacks the kind of DTAs which would truly bring a LIS scheme to life. When s9I companies repatriate to parent companies, the likelihood is that the articles present in the relevant DTA would either limit the reduced rate of withholding very low or bar South Africa from taxing altogether. In the ordinary course this would be beneficial, but seeing as s9I cos are exempt from withholding taxes this is not optimal for their tax burdens.
- 3.6.6. South Africa’s DTAs also do not provide any protection to the parent company’s foreign tax credits applicable to income derived from s9I companies. Given the proposed limited tax base s9I companies could be viewed as low tax entities by other jurisdictions leading to a decrease in the abovementioned tax credit, thereby nullifying much if not all of the benefit.
- 3.6.7. Therefore, while the benefits of the scheme are set up to be attractive to MNEs wishing to make use of a conduit for financing operations and repatriating profit, S9I loses its lustre because compliance is ambiguous and precarious; and the annual election makes the benefit far too temporary and costly. However, the gateway is remains open a crack. The provisions of s6quat effectively compensate for some of the shortcomings of South Africa’s DTAs, by providing credits. Further, the continued approximation of s9I and exchange control requirements is an indication that this critical aspect of the regime is being considered with due gravity.

OVERALL CONCLUSION

- 4.1. South Africa has decided that an element of the remedy to its merge developmental progress is to be found in fiscal incentivisation. However, as Part I demonstrated, it has adopted an

³²² *Badenhorst v CIR* 1955 (2) SA 207 (N) at 215A.

inappropriately designed incentive for its stage of development. Section 9I incentivises passive holding activities, requiring little to no local substance and in fact doing real harm to both the region and local MNEs struggling to compete on an uneven footing.

- 4.2. However, South Africa's core imperative, the Bill of Rights, requires that the state 'protect, promote and fulfil' the rights contained therein.³²³ Thus, allowing people to languish in squalor is not an option for any government presiding over this constitutional democracy. National Treasury therefore is under an injunction to pursue policies which enable South Africans to enjoy their constitutional rights.
- 4.3. Part I has argued that South Africa ought to adopt the model of incentivisation used by Singapore in the 1990s: offering reliable, effective tax relief in return for requiring strategically tailored local substance. This would ensure that the incentivised activities produce direct results towards economic upliftment.
- 4.4. S9I is also commercially unattractive, because its provisions are ambiguous, compliance is burdensome and uncertain, and there is a regular, high tax cost given the annual election. It would even be open to government to design requirements for transformation, the empowerment of women or rural development. The crux however is targeting the appropriate activity so that these requirements are not out of place. Furthermore, an increase in the number of active companies will produce externalities beyond the substance requirements.
- 4.5. Given South Africa's regional dominance and strategic advantages, such as a strong financial sector and world class regulation thereof, RHQs are the obvious choice. These companies provide intra-group services, requiring actual employees and ancillary services. Thus, South Africa is amenable to hosting RHQ activity, allowing scope for the imposition of substance requirements. To embark down this path s9I would have to include tax relief for intra-group services, such as marketing and strategic management, which are at the core of RHQ functions.
- 4.6. However, South Africa is not the only jurisdiction in the region seeking to reap the benefits of MNE activity and whatever LIS it puts forward will have to compete with able competition

³²³ Constitution of the Republic of South Africa s7 (2).

from jurisdictions like Mauritius. Therefore, if RHQs are selected as the type of MNE intermediaries to incentivise then retaining IHC elements of existing s9I would be an added incentive. Additionally, these elements are necessary to target the type of RHQ which South Africa is the best suited to hosting and benefitting from: RTCs.

- 4.7. RTCs conduct currency management related functions, which are heavily reliant on a sound finance and banking sector. This is an area where South Africa is overwhelmingly dominant in the Southern African region. To the point where it's financial institutions can compete with developed country's institutions. South Africa has also shown itself as willing to host these activities, because s9I cos already benefit from capital mobility and exchange gain relief. Therefore, in order to concretise this position South Africa ought to explicitly seek out these activities by having a clearly targeted incentive for RTCs.
- 4.8. Incentivisation is not an exact science however and the factors which make South Africa a prime location for both RHQ and RTC activity, could lead to a waste of state resources. Given the dominance of South Africa in the region, it is likely that many headquarter companies are already located in South Africa. Were the state to then offer tax relief as an incentive, existing companies would seek to benefit. The absence of new investment would mean the incentive is subject to a deadweight loss or redundancy cost.
- 4.9. However, the core tenant of the model of incentivisation adopted by Singapore guards against this by requiring a quid pro quo for incentivisation. The counterbalance to a deadweight loss is requiring substance, which will compensate for the unproductive outlay under the incentive with savings from RHQs providing public goods such as employment.
- 4.10. The position taken in this work regarding the tax policy appropriateness of s9I is that incentivising IHC activity is unsuitable to producing what South Africa seeks by providing fiscal incentives: economic development which penetrates the society. Therefore, it ought to reassess and pursue MNE activities it ought to allow through its gateway into Africa. These should provide tangible benefit, guaranteed through legislative substance requirements.
- 4.11. Substance requirements will not produce results sought after if the legislation is not soundly drafted. Part II has argued that for a fiscal incentive to be attractive to MNEs it must effectively compensate for costs which would otherwise be prohibitive to the investment. An

incentive which is based in provisions which are do not readily indicate what is required for compliance, which cannot be reliably be complied with through the intended actions of the MNE, and which impose a relatively high cost, administrative or monetary, on access to the tax relief, would not conform to the definition of an effective fiscal incentive.

- 4.12. The present provisions of s9I have been drafted without a careful consideration of their effect on the reasons MNEs seek to make use of fiscal incentives: to decrease their group wide tax burden and thereby increase profitability. Leaving the impression that protecting South Africa's existing tax base was the driving consideration behind the drafting, rather than expanding the tax base through the increased economic activity attendant to MNE activity.
- 4.13. The two provisions of s9I (2) interpreted above both demonstrate the negative elements enumerated above. Section 9I(2)(a) restricts the capital structure of prospective s9I companies, robbing them of the flexibility necessary to acquire finance from the most efficient quarter. While s9I (2)(b) attempts to restrict s9I cos activities by limiting their asset base. It however does so in an oblique manner by restricting the cost of the total assets of the company, which brings with it an extensive cost in determining the cost. Importantly, both provisions have wide lacunas which entail that despite the burdensome compliance s9I companies can avoid them without deviating from their intended activates or place in a holding chain.
- 4.14. A final nail in the coffin of s9I is the annual election, read with s9H's anti-avoidance provisions. Rather than providing a reliable benefit, these provisions provide a reliable burden for s9I companies. Not only will they not be secure in access to tax relief, but they will be deemed to not have received the relief even where they had run the labyrinth of compliance with s9I through the operation of s9H(3)(e-f).
- 4.15. In conclusion, in order to achieve its developmental goals and provide its people with the opportunity to live with equal measures of dignity the South African state must pursue every avenue to push for economic growth with a deep impact. This ought to be the motivation that underpins the drafting and if avoidance is the concern, then explicit provisions designed to deal with the mischief ought to be implemented. As South Africa cannot afford to lock out the opportunity that is presented by targeted MNE activity.

- 4.16. Overall, South Africa could truly benefit from MNE activity and is a prime location to successfully incentivise it. By pursuing the forms put forward here, without being fixated on the potential base erosion, there is the potential for incentivising activities which MNEs are interested in locating in South Africa and that would provide economic benefits. Throwing open gateway which has been sealed by the misdirected provisions of s9I is in the broader interest of the country and will aid in ensuring that the victory over apartheid does not ring hollow in the stomachs of South Africa's people.

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