

**A DISCUSSION OF THE CONCEPT, “PLACE OF EFFECTIVE
MANAGEMENT” AND THE PROPOSED CHANGES, IN THE CONTEXT OF
SOUTH AFRICAN TAX LAW**

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ABSTRACT

The concept, “place of effective management”, is used in South African tax legislation to determine the residency of companies and it is also used by the Organisation for Economic Co-operation and Development (OECD) and in many tax treaties as a tie-breaker clause to determine the residency of companies that may appear to be dual resident or to determine which country has the taxing rights to income that may be subject to double tax due to the income being from a source outside of the company’s country of residence. The concept is not defined in any tax legislation and there is no uniform interpretation of the concept globally. The former guidance provided by the South African Revenue Services (SARS) adopted a hierarchal approach and the focus was the implementation of the Board of Directors’ decisions. This interpretation was not aligned to the guidance of the OECD whose focus is the place where the key management and commercial decisions of the entity are made. The current SARS guidance has been aligned to the OECD guidance and, essentially, the core principle is to determine who makes the key commercial and management decisions of the company and the place where these individuals are making these decisions. The current SARS and OECD guidance have now been aligned. The current SARS and OECD interpretations have been found to be a more effective tie-breaker clause than the former interpretations.

Key words: Place of effective management, residency of companies, tie-breaker clause, dual resident companies, international tax, Organisation of Economic Co-operation and Development (OECD), SARS Interpretation Note 6, Article 4 of the Model Tax Convention on Income and on Capital

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CHAPTER 1: Introduction

1.1 Context

In South African tax legislation, the concept “place of effective management” plays a vital role in determining the residency of a person other than a natural person. The concept “place of effective management” is also widely used internationally as it is included in many double tax agreements as a tie-breaker rule to determine the residency of a person other than a natural person, to prevent a person being subject to double taxation.

1.2 South African tax legislation

The definition of a “resident” is contained in section 1 of the Income Tax Act, 58 of 1962 (referred to as “the Act”), and in relation to a person other than a natural person, it means: a “person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic” (own emphasis). A company is therefore either resident in a country in which it is incorporated, established or formed or in the country from which it is effectively managed.

There is no difficulty involved in determining the country in which a company is incorporated, established or formed as this is a matter of fact, however the concept “place of effective management” is not a defined term in the Act and very little guidance has been provided by the South African Revenue Service (referred to as “SARS”) in this regard. This results in the determination of the “place of effective management” of a company being subject to interpretation by the various parties involved.

SARS issued Interpretation Note 6 (SARS Legal and Policy Division: 2002a (referred to as “IN6”)) in which a general approach was adopted, involving a hierarchy of tests to be used to determine the place of effective management of a company. However, SARS has acknowledged that the relevant factors that should be considered in determining the place of effective management of a company need to be considered on a case-by-case basis. In a Discussion Paper, SARS (SARS Legal and Policy Division: 2011) acknowledges that

this Interpretation Note has been criticized by many tax experts, individuals and organizations as it fails to provide clear guidelines, contains contradictory guidance and is also in conflict with international precedence. International precedence focuses “on the place where a company’s board of directors or similar body meets” (SARS Legal and Policy Division, 2011:5) to make key commercial decisions, whilst in its Interpretation Note, In Interpretation Note 6 (SARS: 2015) SARS has focused on the executive directors or senior management and the location at which they execute and implement the decisions of the board of directors.

In the Discussion Paper (SARS Legal and Policy Division: 2011), SARS has also acknowledged other areas of concern that have been raised, which include inconsistent terminology used in Interpretation Note 6, as well as inconsistency in the general approach adopted by SARS and the factors that SARS suggests should be considered on a case-by-case basis to determine the place of effective management of a company. The general approach set out in the Interpretation Note also refers to the term, “strongest economic nexus” (SARS Legal and Policy Division, 2011:4), which is also not a defined term. In addition, the guidelines in the Interpretation Note (SARS: 2015) do not address the place of effective management of passive or intermediate holding companies. SARS has taken note of international precedence and in its Discussion Paper (SARS Legal and Policy Division: 2011) has proposed changes to its Interpretation Note to provide clarity on areas that were raised as problematic (as discussed above) and to ensure that the guidelines provided serve as a substantive test that is not open to manipulation.

In 2011, the first case law guidance was provided in South Africa on the concept, “place of effective management”. Although the court did not rule on the residency of the trust as the facts of the case were not clear, the key features highlighted in the judgment (*The Oceanic Trust Co. Ltd N.O. and the Commissioner for the South African Revenue Services*, [2012] 74 SATC 127, [2015] 132.1 SALJ 41) were in conflict with the general approach suggested by SARS (2015) in its Interpretation Note 6. The key features highlighted were however more closely aligned to international precedence as well as the changes to the Interpretation Note proposed by SARS in its Discussion Paper (SARS

Legal and Policy Division: 2011) and its version 2 of the Interpretation Note (SARS Legal and Policy Division: 2015 (referred to as “IN6 version 2”). A key feature highlighted in the judgement was the place where, in substance, the key management and commercial decisions that are necessary for the conduct of the entity’s business are made, which is the same guidance provided by the Organisation for Economic Co-operation and Development (referred to as the “OECD”) in its Model Tax Convention on Income and on Capital (referred to as the “Model Tax Convention”) (OECD: 2014). This judgment was also aligned with the judgments in cases in the United Kingdom that dealt with a similar concept “central management and control” (*De Beers Consolidated Mines, Ltd v Howe (1906) 5 TC 198* and *Cesena Sulphur Company Ltd v Nicholson (1876) 1 TC 88*). SARS had issued a revised draft interpretation note in early 2015 for public comment (SARS Legal and Policy Division: 2015 (referred to as “draft IN6 version 2”) and the revised version 2 of the Interpretation Note (IN6 version 2) was issued in the latter part of 2015. Both these documents will be discussed in Chapter 4.

1.3 Double tax treaties

The OECD’s Model Tax Convention (OECD: 2014) uses the concept, “place of effective management” in its tie-breaker rule to determine the residency of a person other than a natural person. The OECD’s tie-breaker rule is incorporated in many double tax treaties and although South Africa is not a member of the OECD, the tie-breaker rule is adopted in the double tax treaties entered into by South Africa with various countries (SARS Legal and Policy Division: 1973 and SARS Legal and Policy Division: 2002b).

Paragraph 3 of Article 4 of the Model Tax Convention (OECD: 2014) addresses the situation of dual residency of a company or double taxation faced by a company. Dual residency may arise in situations when a company is legally formed and registered as a company in Country A but is being managed from Country B, and double taxation arises in instances when a company is a resident in Country A and therefore liable to tax on its world wide income in Country A, but the source of the income is in Country B and therefore it will be subject to tax based on source in Country B as well.

Paragraph 24 of the Commentary on Article 4 (OECD: 2014) was amended in 2008 to clarify the guidance provided on the OECD's interpretation of the concept "place of effective management", which was re-phrased as "the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made" (OECD, 2014: 90 and 91). Prior to July 2008, the OECD held the view (OECD: 2012) that the place of effective management was ordinarily the place where the most senior group of persons (for example, the board of directors) makes its decisions. The decisions of the board of directors are ordinarily taken at board meetings, but this factor can be easily manipulated and with the advancement in technology the relevance of this factor to determine the residency of a company has become questionable.

The OECD (2014) also acknowledges that certain countries do not perceive dual residency to be a common issue and therefore this issue would be assessed on a case-by-case basis in these countries and the relevant authorities would decide the residency of the company concerned. Therefore the OECD (2014) has shifted its emphasis from relying on the place where board meetings are held to recommending that the relevant authorities assess each case of dual residency individually by taking into account various other factors, such as the place where activities of the chief executive officer, other senior executives and the senior day-to-day managers are carried on, the location of the company's headquarters, where the accounting records are kept, which country's laws govern the company's legal status, etc.

The OECD's "Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits" (referred to as the "Technical Advisory Group") (OECD, 2003: 1) issued two documents, the first (OECD: 2001) in February 2001, which addresses the advancements in communication technologies and the impact on the way a company operates, and the second document (OECD: 2003) was issued in May 2003, which suggests alternatives to the "place of effective management" concept to address the distance communication issues that were previously highlighted. The OECD (2001) had noted that the place of effective management of a company may

be difficult to pinpoint to a single location. Firstly, with the advancements in technology, a director or senior manager need not travel to conduct meetings but may use video conferencing, for example, to hold meetings to make key decisions. The result of this approach is that the decision makers may sit in various countries and therefore the place of effective management cannot be said to exist at a single location. Another consideration is that foreign travel for a director has become more common, as the cost of travel has reduced and therefore a director may be making decisions from various locations and meeting other decision-makers at different locations each time a decision needs to be made. The OECD (2001) therefore considered refining or replacing the concept, “place of effective management” that is used as a tie-breaker rule to determine the residency of a company.

There have, however, been no significant amendments or new proposals from the OECD Council. However, in the 2008 amendments to the Commentary on Article 4 of the Model Tax Convention (OECD: 2012), the sentence that suggests that the place of effective management will be the place where the most senior group of persons, such as the board of directors, meets has been deleted.

The concept “place of effective management” is not defined in South African legislation or by the OECD and the former guidelines available domestically are not aligned with international precedence. The case law guidance available in South Africa is furthermore more closely aligned to international precedence rather than the domestic guidance. This research discusses the problems currently experienced in establishing the place of effective management of an entity and the solutions that have been suggested and implemented in South Africa and internationally to clarify the meaning of this concept.

1.4 Research problem

The research problem addressed relates to determining the place of effective management of an entity and solutions that have been suggested in South Africa and abroad to address the concerns that have been raised by tax experts, individuals and organizations regarding

the practical difficulties experienced in applying the “place of effective management” concept.

1.5 Goals of the research

The goal of this research is to analyse the various South African guidelines and court decisions, as well as international guidance by the OECD Council and United Kingdom case law in relation to the interpretation of the concept “place of effective management”.

The purpose is to consider whether the changes proposed by SARS and the OECD clarify the concept “place of effective management” and align domestic and international guidance more closely.

This has been achieved by:

- reviewing the former domestic guidance issued by SARS and comparing it with the current OECD guidance available (in Chapters 2 and 3);
- reviewing South African and United Kingdom case law in determining whether these judgements are closely aligned with each other, as well as with the guidance provided by SARS and the OECD (in Chapters 3 and 4); and
- considering the changes proposed and implemented by SARS as well as the proposed changes by the OECD in determining whether these changes clarify the concept “place of effective management” and whether these changes result in the domestic and international guidance being more closely aligned (in Chapters 2 and 3). This includes a consideration of SARS’ revised Interpretation Note (IN6 version 2) issued in 2015 (in Chapter 4).

1.6 Limitations of the scope of the research

The research does not consider the problems that may be encountered when determining the place of effective management of companies in instances where a virtual permanent establishment is created.

1.7 Research methodology

A non-empirical approach is adopted in this research. An interpretative research approach is adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to the determination of the place of effective management of a company), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2014).

The data used for the research comprises of documentary data, including South African tax legislation and guidelines from SARS, guidelines issued by the OECD Council, case law in South Africa and the United Kingdom, as well as articles in journals incorporating the views of tax experts.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions is ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

As all of the data are in the public domain, no ethical considerations arise in relation to their use.

1.8 Organisation of the research report

Chapter 1 of the research report discusses the background to the problem, the research problem, goals of the research and the research methodology used. The criteria used to determine the place of effective management both in South Africa and internationally are briefly referred to and the problems arising from these criteria are discussed.

The second chapter discusses the South African guidance that was previously available to assist in the interpretation of the concept, “place of effective management”. The former guidance contained in SARS Interpretation Note 6 (IN6) and the South African tax case, the *Oceanic Trust* case, will be discussed. Problems with the guidance provided in the previous Interpretation Note are also identified and discussed.

Chapter 3 discusses the guidance available in the OECD’s Model Tax Convention (OECD: 2014) which is used by its member countries in interpreting double tax treaties. The practical difficulties of implementing this guidance are identified as well as the proposed amendments to address these difficulties experienced are considered and discussed. The “central management and control” concept which is used internationally is similar to the “place of effective management” concept. Relevant international case law regarding the “central management and control” concept is discussed to identify the relevant factors to consider in determining the location of central management and control as these factors may also be relevant in interpreting the place of effective management of companies in South Africa.

Chapter 4 presents a discussion of the SARS revised draft Interpretation Note (draft IN6 version 2) as well as the revised version 2 of the Interpretation Note (IN6 version 2) that was issued in 2015. The proposed amendments in the Draft Interpretation Note and the implemented amendments in version 2 of the Interpretation Note regarding the interpretation of the place of effective management of companies are considered to determine whether the shortfalls identified in the first version of the Interpretation Note (IN6) as well as the practical difficulties in implementing the OECD guidelines (OECD: 2014) have been adequately addressed.

In Chapter 5, the findings of the thesis are discussed.

1.9 Conclusion

The interpretation of the place of effective management of companies has been an area that creates uncertainty for taxpayers. There is neither a definition provided in the South African tax legislation nor is it a universally defined term. The former guidance provided by the South African tax authorities (IN6) differs from the OECD guidance (OECD: 2014) available as well as international precedence and the decision in the *Oceanic Trust* case recently heard in the South African tax courts. There was therefore a need to consider amendments to the South African guidance to ensure it is more closely aligned to international precedence, eliminates the uncertainties that the former guidance may have created, to address the practical difficulties experienced in implementation and to ensure that the place of effective management test is not easily open to manipulation. The next chapter is a discussion of the former guidance available in South Africa.

CHAPTER 2: Place of effective management in the context of South African tax legislation

2.1 Introduction

Subsequent to 2001 when the South African tax basis was changed from the source basis of taxation to the residence basis of taxation, a definition of the term, “resident” was introduced into the Act. The introduction of this definition into the tax legislation created a need for SARS to clarify the resident definition, in particular, the definition for persons other than individuals, which referred to the concept, “place of effective management”.

The Katz Commission of Inquiry had recommended that the definition of a resident include the international terminology of “effective management” as opposed to the varying terminology that was being used at the time. The reason for the inclusion of “effective management” in the resident definition was to align the terminology with international norms as well as to remove the uncertainty that taxpayers faced with the various different terms being used and therefore opening this area to manipulation by taxpayers (Katz Commission: 1997). With the introduction of the definition of a “resident”, references to the concepts “managed and controlled”, “managed or controlled” and “effectively managed”, were simultaneously replaced by the concept “place of effective management” (IN6: 1). The Act, however, did not define the concept “place of effective management” and it is therefore open to interpretation.

Guidance can be sought from various sources, both locally and internationally. Firstly, the dictionary meaning of the words can be considered, as well as SARS’ guidelines (IN6) regarding the interpretation of the concept, “place of effective management”. This chapter discusses the former SARS guidance which was issued in 2002 and the shortfalls and difficulties created by this guidance. It is important to note that SARS Interpretation Notes are merely guidelines to be used to interpret the tax legislation and therefore the courts do not merely accept SARS’ guidelines but rather rely on international precedence in reaching their decisions (Constitution of the Republic of South Africa, Act 108 of 1996). The former SARS Interpretation Note (IN6) has been criticized by many tax

experts, individuals and organisations (SARS Legal and Policy Division: 2011) as it is not aligned to international precedence.

SARS has previously interpreted the place of effective management to be at the location of the senior management of the company who are responsible for implementing strategic and commercial decisions taken by the board of directors (IN6), whilst international precedence focuses on the board of directors who are responsible for the strategic and commercial decision making activities of the company (SARS Legal and Policy Division: 2011). In 2011, the South African tax courts heard the first and only case (the *Oceanic Trust* case) to date that addresses the interpretation of the “place of effective management” concept. The factors considered to determine the place of effective management in the *Oceanic Trust* case were aligned to international precedence dealing with a similar concept, “central management and control”. The court’s considerations regarding the place of effective management in this case further added to the need for SARS to reconsider their interpretation of the place of effective management and revise their former Interpretation Note.

This chapter considers the various sources that may be used to assist in the interpretation of the concept, “place of effective management”. The discussion also includes a consideration of the criticisms and shortfalls of SARS former Interpretation Note (IN6) and discusses the findings of the *Oceanic Trust* case in South Africa. The research in this chapter addresses the goal of understanding the South African court decisions and former guidelines issued by SARS to determine the place of effective management of companies. The former SARS’ guidance is discussed as this is the guidance that has been used by taxpayers in determining the place of effective management of companies until the guidance was revised and replaced in 2015.

2.2 Dictionary meaning of “effective” and “management”

Van der Merwe has stated (van der Merwe: 2002) that the “place of effective management” concept may be ambiguous as it can refer to the level of management and their decisions or the manner in which a company is managed. However from

international precedence, it appears that effective management has always been interpreted as referring to the level of management and their actions (*Commissioners for Her Majesty's Revenue and Customs v Smallwood and Anor*, (2010) EWCA Civ 778 and *Wood and another v Holden (HMIT)*, (2006) EWCA Civ 26) as the factors considered are the individuals who are responsible for making the key commercial decisions of the company.

Regarding the interpretation of statutes, du Plessis (2002: 103) states that “the golden rule requires adherence to the ‘plain words’ of a statute *unless* this would lead to an absurdity or to a result contrary to the intention of the legislature”. These “plain words” (du Plessis, 2002: 103) is what the “ordinary-meaning rule” (du Plessis, 2002: 198) is about. “The ordinary meaning of statutory language is, in other words, glibly identified with what is believed to be the plain or literal or grammatical meaning of language as such (du Plessis, 2002: 1999). The ordinary grammatical meaning of the words can therefore be better understood by considering the dictionary meaning of the words and this approach is often adopted by courts (du Plessis: 2002).

The Oxford Advanced Learners Dictionary (Oxford University Press, 2010: 469) defines the term “effective” as:

1. producing the result that is wanted or intended; producing a successful result
2. (only before noun) in reality, although not officially intended

The dictionary meaning of the term “effective management” can be interpreted as either managing a company to produce the intended and successful results that management would expect for the company, or the real or actual management of the company. The first dictionary meaning implies that the company is managed to achieve the desired results of the company, which can be interpreted as achieving the expected results of the board of directors. This interpretation appears to be the interpretation previously adopted by SARS as the location at which the results and business objectives set by the board of directors are being achieved by the company and may be the appropriate location to be

used to determine where the company is being effectively managed. On the other hand, the second interpretation implies the place from where the company is actually being managed. The location of where the actual management occurs would need to be identified by considering the appropriate relevant factors. This appears to be the interpretation adopted by the tax authorities in the United Kingdom and the OECD to identify the location at which the actual management of the company takes place and this would be the determining factor of where the place of effective management is. The actual management of the company is currently interpreted by the OECD as where the key commercial and strategic decisions of the company are taken (OECD: 2014).

The second interpretation of the dictionary meaning of the term “effective”, as being the real or actual management of the company, is supported by the interpretation in the case, *Her Majesty’s Revenue and Customs v Smallwood and another* (2010) EWCA Civ 778, where it was held (at par. 60) that “effective” should be understood in the sense of the French *effective (siegede direction effective)* which connotes real, French being the other official version of the Model, though not of the Treaty. Special Commissioner David Shirley stated (*Wensleydale’s Settlement Trustees v Inland Revenue Commissioners* [1996] STC (SCD) 241 at 252) in relation to effective that it “is not sufficient that some sort of management was carried on in the Republic of Ireland such as operating a bank account in the name of the trustees. ‘Effective’ implies *realistic, positive management*. The place of effective management is *where the shots are called*, to adopt a vivid transatlantic colloquialism”.

The term, “management”, is defined in the Oxford Advanced Learners Dictionary (Oxford University Press, 2010: 902) as:

1. the act of running and controlling a business or similar organization
2. the people who run and control a business or similar organization
3. the act or skill of dealing with people or situations in a successful way

The term, “management”, thus refers to the people who are responsible for controlling the company as well as the actions of these individuals who implement the strategic and

commercial decisions taken by the board of directors. SARS considers the executive directors and senior management of the company and their activities of implementing the key commercial decisions of the company to be relevant in determining the location of the place of effective management of the company (IN 6), whilst the OECD considers the board of directors and their decision making activities to be relevant (OECD: 2014).

It is submitted that the concept, “effective management”, interpreted from the dictionary meanings is the actual management of the company by the individuals who have been designated the responsibility of managing the company. SARS has provided guidance on these terms and this is discussed below.

2.3 SARS Interpretation Note 6

2.3.1 General approach

SARS’ former Interpretation Note 6 (IN6) sets out guidelines to be used to determine the effective management of a person other than a natural person. The former Interpretation Note distinguishes between the different tiers of management and their respective activities:

1. the board of directors who are responsible for central management and control,
2. the executive directors or senior management who execute and implement the board of directors’ policies and strategic decisions and make and implement the day-to-day and operational management and business activities,
3. the place where the day-to-day business activities are conducted.

SARS has also noted that there is a distinct difference between shareholders and management, as management is involved in the “company’s purpose and business” (IN6: 2).

SARS’ former guidelines involve a hierarchal approach to determining the place of effective management of a company. This hierarchal approach (IN6) to determine the place of effective management is based on a consideration of the location of the executive directors or senior management. If their activities are conducted at a single location, this

location is the place of effective management. However if their activities are conducted from different locations due to the use of distance communication, it is suggested that the place of effective management is where the daily activities are conducted. Lastly, if the daily activities are conducted from various locations then the place of effective management is the place with the strongest economic nexus. The concept “strongest economic nexus” (IN6: 4) is also not a defined term in the Act and SARS has also not provided any guidelines. Therefore this is also an area that is subject to interpretation and would probably be based on the facts of each case.

2.3.2 Relevant facts and circumstances

SARS has acknowledged that the relevant factors that should be considered in determining the place of effective management of a company need to be considered on a case-by-case basis. This includes a consideration of the following factors (IN6: 4 and 5):

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

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

2.4 SARS Discussion Paper on Interpretation Note 6

SARS has acknowledged the increasing use of distance communication and in the instance where management functions are not located at a single place, then the place of effective management is deemed to be where the day-to-day operations are conducted (IN6). This approach may be effective for companies involved in the manufacture or sale of tangible goods, but it poses a problem for companies involved in the provision of services as these services can be provided from multiple locations and therefore it creates uncertainty and is open to manipulation (Oguttu & van der Merwe: 2005).

2.4.1 Criticisms of Interpretation Note 6

The former Interpretation Note has been criticized on four key areas by many tax experts, individuals and organisations (SARS Legal and Policy Division: 2011). The former Interpretation Note suggests that the place of effective management of a company is where the executive directors or senior management, who execute and implement the board of directors' strategic decisions, are located (IN6) (own emphasis). This general approach adopted by SARS was in conflict with the former international precedence and guidelines (as discussed in Chapter 3) which focuses "on the place where a company's board of directors or similar body meets" (SARS Legal and Policy Division, 2011: 5). It is observed that the former international precedence has focused on the board of directors and their activities, which include the decision making process, whilst SARS has focused on the executive directors or senior management and their activities of executing and implementing the decisions taken by the board of directors. However, since 2008, the OECD guidelines have shifted the focus away from board meetings and suggest that each case be assessed individually taking into account various factors (as discussed in Chapter 3). The focus has however remained on the key commercial and strategic decision making activities of the entity.

The terminology used in the sections of the former Interpretation Note (IN6) that discusses the general approach and practical application is not consistent (SARS Legal and Policy Division: 2011) as the distinction between the executive directors and senior management and the managers responsible for the daily operations of the business has been blurred. Concerns have also been expressed regarding the final step in the hierarchal approach of using the place of the “strongest economic nexus” (IN6: 4) as a determination of the place of effective management of a company if the daily activities are not located at a single place. The concerns have arisen as there is no defined term or guidelines for interpreting the place of the strongest economic nexus.

There are also inconsistencies in the general approach adopted and the factors to be considered (SARS Legal and Policy Division: 2011). Two of the factors to be considered include “where the controlling shareholders make key management and commercial decisions in relation to the company” (SARS Legal and Policy Division, 2011: 4) and “legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer” (SARS Legal and Policy Division, 2011: 5). However it is submitted that the relevance in considering these two factors to determine the place of effective management of a company is questionable as the legal factors mentioned are open to manipulation.

With regard to the consideration of the controlling shareholders, there is also uncertainty regarding the relevance of this factor as SARS’ focus in the general approach was not on the decisions made by the controlling shareholders but where the executive directors or senior management, who execute and implement the board of directors’ strategic decisions, are located. SARS’ view was that the management of a company (as opposed to the shareholders) is usually involved in the company’s purpose and business (IN6).

Finally, the former Interpretation Note (IN6) does not address the place of effective management of passive or intermediate holding companies.

2.4.2 Criticisms by tax commentators

There is currently no consistent interpretation of the concept, “place of effective management”, by tax commentators in South Africa. Meyerowitz (2002/2003) states that the place of effective management is where the board of directors meets to make key decisions and not where the company business is carried on by its staff (unless the board’s managerial functions have been delegated). This view is also held by the editors of *The Taxpayer* who have stated that (Meyerowitz *et al*: 1995) the place of effective management was interpreted as where the day-to-day running of the business takes place, which means that the business is controlled where its board of directors normally meets to transact its business operations.

Olivier in direct contrast to this has stated that the place of effective management is “where the higher level of day-to-day running of the business takes place” (Olivier & Honiball, 2005: 25). This does not need to be where the strategic and policy decisions are made and ultimately controlled. This interpretation is more aligned to the SARS guidelines contained in the former Interpretation Note 6 (IN6). The interpretation that is more closely aligned to the OECD (OECD: 2014) is held by Davis and his co-authors who stated (Davis, Olivier & Urquhart: 1999/2000) that effective management takes place where the “most vital” management actions or decision-making and implementation occur.

SARS’ former Interpretation Note (IN6), which aims to provide guidance in interpreting and determining the place of effective management of companies, has also been criticized by many of these tax experts as it fails to provide clear guidelines, contains contradicting guidance and also conflicts with international precedence (SARS Legal and Policy Division: 2011).

SARS’ former interpretation of the concept, “place of effective management”, is largely focused on the actual implementation of the day-to-day operational management and commercial decisions taken by the senior managers (IN6). Annet Wanyana Oguttu (2008) believes that this activity is likely to occur at a single location thereby reducing the risk of

companies facing a situation of multiple residency. However the interpretation of “implemented” is open to manipulation as the former Interpretation Note (IN6) does not provide any guidance as to its meaning. The interpretation of “implemented” is therefore in itself subjective and is open to interpretation. Olivier and Honiball (2005) give an example of a South African director who makes a telephone call overseas to arrange for bank finance. The director formally signs the agreement in the other country offshore. The question arises as to whether the transaction was “implemented” in South Africa when the telephone call was made or offshore when the agreement was signed.

The Oxford Advanced Learner’s Dictionary (Oxford University Press, 2010: 753) defines “implement” as “to make something that has been officially decided start to happen or be used”. This definition confirms the interpretation adopted by SARS that implement is the carrying out of the executive directors and senior managers’ decisions. However there are still difficulties in applying this interpretation as it is noted by van der Merwe (2006: 125) that the ordinary meaning of ‘implement’ is not very helpful in “identifying or locating the act of implementing where this ‘act’ consists of several separate actions undertaken in various jurisdictions through virtual or mobile offices”.

The various factors previously suggested by SARS to be considered in determining the place of effective management do not provide guidance as to how these factors should be weighted and whether they should be viewed quantitatively or qualitatively (van der Merwe: 2006). The relevance of some of these factors is questionable as the “list includes factors seemingly more connected to the Anglo-American version of the management test (overriding central control) than its South African interpretation (day-to-day management)” (van der Merwe, 2006: 130). An example is that one of the factors refers to “where the centre of top level management is located” (IN6: 4), which would generally be the board of directors responsible for the strategic decision-making and policies of the company and not the executive directors and senior management who are responsible for the implementation of the strategic policy and commercial decisions taken by the board of directors.

The list also refers to “where controlling shareholders make key management and commercial decisions in relation to the company” (IN6: 4) but this factor makes little sense (van der Merwe: 2006). The former Interpretation Note specifically states that “effective management is not the same as shareholder control” (IN6: 2). In addition, shareholders are generally not involved in the decision making of a company, but in the case of controlling shareholders there may be some decisions of the company that are taken by the controlling shareholder. This could be the reason why SARS had suggested that this factor would need to be considered. Klaus Vogel (1997: 263) believes that this factor is relevant “if he (the shareholder) can and does interfere with the usual conduct of the business, if he has arranged to be constantly informed of the various transactions, and if by his decision, he has a decisive influence on how current transactions are dealt with”.

The factors previously suggested by SARS (IN6) for consideration to determine the location from which the company is effectively managed, includes “legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer” (IN6: 4). These factors, in a South African context, would already result in a taxpayer being resident in South Africa, in terms of the Act, if it was incorporated, formed or established in South Africa; however the reason for the inclusion of this factor may well be for the taxpayer to take this into account in instances where the company is established, formed or incorporated outside South Africa, as the company may still be effectively managed in South Africa and therefore resident in South Africa.

The relevance of other factors is assessed by van der Merwe (2006). The factor “where the directors or senior managers of the designated manager, who are responsible for the day-to-day management, reside” (IN6: 5) is probably relevant because these individuals would have to reside at or near the place where the business activities are taking place. However there are instances where a company may not have a physical presence and the managers can run the company from remote locations. This would result in this factor having no relevance to this case. Another factor that possibly attempts to curtail manipulation of the effective management test by taxpayers is considering the

“experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity” (IN6: 5).

Van der Merwe (2006) has noted that the introduction to the former Interpretation Note (IN6) is not consistent with the general approach adopted by SARS. The introduction refers to the place where the executive directors or senior management “make and implement day-to-day/regular/operational management and business activities” (IN6: 3) (emphasis added) but the wording used in the general approach differs slightly. The words “make and implement” and “operational management and business activities” have been excluded from the general approach. The guidance contained in the general approach is “the place where the company is managed on a regular or day-to-day basis by the directors or senior managers” and “management by these directors or senior managers refer to the execution and implementation of policy and strategy decisions made by the board of directors” (IN6: 3).

Van der Merwe (2006) has speculated that the inclusion of these words in the introduction only may have not been purposeful as the words, “make and implement” generally refer to decisions and not activities and SARS’ previous focus was not on the decision making process. SARS’ former approach focuses on the implementation of decisions and therefore the words “make and implement” which are associated with the decision making process would not have been suitable to be included in the former Interpretation Note (IN6), which focuses only on the implementation of the decisions.

Further if the word “activities” that was included in the introduction were also to be included in the general approach, this would blur the distinction between the first and second rule of the hierarchy. The first rule refers to the implementation of day-to-day operational and commercial decisions taken by the board of directors, whilst the second rule refers to conducting the day-to-day business activities. The use of the word “activities” in the general approach would therefore make it difficult to distinguish between the first and second rule as they both would refer to day-to-day activities, but the first approach would refer specifically to the day-to-day operational and commercial

decisions that are required to be implemented whilst the second rule refers to the day-to-day business activities taking place. “If the intention was to convey that effective management of a business is not limited to the acts of executing and implementing strategic board decisions, but includes the implementation of all the regular operational management decisions necessary for the effective functioning of the business, it would perhaps have been better served by replacing the word ‘activities’ by ‘decisions’” (van der Merwe, 2006: 126) as this would clarify that the first rule is referring to the implementation of the strategic and commercial decisions of the company as well as the day-to-day operational decisions being made and implemented by the senior management, and the second rule relates to the day-to-day business activities being carried out .

Van der Merwe (2006) has also noted that the introduction refers to “executive directors and senior management” (IN6: 3) but the word, executive is omitted from the general approach. The omission of executive directors widens the scope of management that is to be considered in determining the place of effective management of a company, as executive directors specifically refer to the directors holding management positions in a company that is “usually not expected to do more than attend a reasonable number of board and committee meetings” (van der Merwe, 2006: 127), whilst a non-executive director would also be involved in the daily management of the company. SARS’ former interpretation (IN6) of the place of effective management is the location at which these strategic policies and commercial decisions are implemented and therefore the management level under consideration should not be limited to the executive directors as it is the non-executive directors who are responsible for the implementation of decisions.

Another example of the inconsistencies in terminology which van der Merwe (2006) noted, is the use of the terms “business operations” (IN6: 4) and “business activities” (IN6: 3). It appears that these terms have been used loosely (van der Merwe: 2006). The term “business operations” (IN6: 4) has been referred to as a relevant factor for consideration to determine the place of effective management of a company and the term “business activities” (IN6: 3) has been used in the introduction. Further the practical

application refers to both terms as an alternative to each other. It appears that SARS has not attempted to draw a distinction between these terms as they are being used interchangeably. However this does result in ambiguity and confusion in the interpretation of SARS' former guidance.

Van der Merwe (2002) believes that SARS' approach of adopting the concept, "place of effective management", as opposed to "management and control" is indicative of the fact that SARS intended the term "place of effective management" to be interpreted differently from management and control. However, it is the "central management and control" concept that is aligned to the United Kingdom precedence. Effective management can include the place where "day-to-day management and administration are performed, unlike the "central management and control" concept, which refers to the place where the superior policy and strategic decisions are made" (van der Merwe, 2002: 92). Based on the former guidance issued by SARS and discussed above, it appears that SARS has intended to distinguish the term "place of effective management" from the term "central management and control" that was previously referred to, as SARS has suggested in its first level of the hierarchy that the place of effective management is the place where the directors and senior managers implement the policy and strategic decisions taken by the board of directors. This is clearly different from the term, "central management and control" which refers to the place where these policies and strategic decisions are being made.

Olivier and Honiball have noted that (Olivier & Honiball, 2005: 55)

in a UK Manual it is stated that the second level of management is 'the place where you would expect to find the executives and senior staff who actually make the business tick', and 'the place where one would expect to find for example, the finance director, the sales director, and, if there is one, the managing director. As these executives would be on the board of directors, the location of the place of effective management will only differ from the place where central management and control is exercised, if the

term ‘effective management’ refers to where the directors normally reside and not where they may go to specifically for board meetings.

The second level in the hierarchy which looks at the location of where the daily activities are conducted is generally not problematic if the entity’s operations involve tangible goods. It can become problematic however if these business activities are conducted across the globe. In the case where the entity is involved in intangible goods, this opens the interpretation of place of effective management to manipulation. Van der Merwe (2006, at 128) has stated that this approach will not “necessarily result in a single place of residence as a taxpayer may have several places across the world where operational and commercial decisions are implemented, and where the business activities, or parts or phases of such business activities, are carried out or conducted”.

The last approach in the hierarchy used by SARS relies on the “place with the strongest economic nexus” (IN6: 4). Van der Merwe (2006) argues that this test is not useful in determining the place of effective management as it is not linked to effective management, but it can be used as an alternative tool. The term “economic nexus” is also not defined in the Act. However the OECD has referred to the concept, either as a replacement to using the place of effective management as a tie-breaker rule, or as a rule in a hierarchal approach to determine the place of effective management (OECD: 2003) (as discussed in Chapter 3). The OECD suggested that a consideration of the place of strongest economic nexus would involve a consideration of various factors including, amongst others, where the entity has most employees and assets, where it carries on most activities and derives most of its revenue or where it has its headquarters (OECD: 2003).

In the SARS Discussion Paper (SARS Legal and Policy Division: 2011), it has also been acknowledged that international precedence differs from the former interpretation of the place of effective management in South Africa. The OECD’s Technical Advisory Group issued two documents, the first in February 2001 (OECD: 2001) which addresses the advancements in distance communication technologies and their impact on the way a company operates and the second document was issued in May 2003 (OECD: 2003),

which suggests two alternatives to addressing the distance communication issues that were previously highlighted. These documents are discussed in further detail in Chapter 3.

The recent *Oceanic Trust* case heard in the South African tax courts (discussed below) did not take SARS' former guidance (IN6) into account in considering the place of effective management of a taxpayer, but relied on international precedence. Therefore it is submitted that this guidance (IN6) needs to be reconsidered and aligned with international precedence and the recent *Oceanic Trust* case in South Africa.

2.4.3 Proposed changes to Interpretation Note 6

SARS has proposed changes to its former Interpretation Note 6 (IN6) to provide clarity on areas that were raised as problematic, as well as to ensure that the guidelines provided serve as a substantive test that is not open to manipulation.

2.4.3.1 General approach

SARS (SARS Legal and Policy Division: 2011) has proposed changes to its general approach section to align it with international precedence. Although it will continue to focus on the executive directors and senior management, the focus has shifted from executing and implementing decisions to “actually developing or formulating key operational or commercial strategies and policies for, or taking decisions on key operational or commercial actions by the company (regardless of whether those strategies, policies and decisions are subject to formal approval by a board or similar body) and to ensure that those strategies and policies are carried out” (SARS Legal and Policy Division, 2011: 12).

To provide more clarity, SARS also intends to define various terms used in the former Interpretation Note (IN6), including the terms “senior management, operational management, executive/inside directors, non-executive/outside directors, head office, base of operations and passive holding company” (SARS Legal and Policy Division, 2011: 12 and 13). These proposed changes will hopefully address the distinction that

SARS seeks to make between the different levels of management and their responsibilities, which is either the making of decisions or the implementing of decisions, as well as the nature of decisions i.e. “policy and strategic decisions” (IN6: 3) or the “commercial decisions” (IN6: 4). This would make it easier to interpret which level of management and the type of decisions that should be considered to determine the effective management of a taxpayer.

2.4.3.2 Relevant facts and circumstances

The facts and circumstances section in the Discussion Paper (SARS Legal and Policy Division: 2011) also proposes amendments to address the criticism previously raised. The amendments include deleting the reference to legal factors (i.e. place of incorporation, formation or establishment, the location of registered office and public officer) and providing clarity that the reference to the controlling shareholders is only applicable in certain circumstances where the shareholders are in fact the ones that make the key operational and commercial decisions, for example, with passive holding companies.

These amendments address the two inconsistencies between the general approach adopted and the factors to be considered as discussed in SARS Discussion Paper (as discussed above) (SARS Legal and Policy Division: 2011). These amendments will assist to address the confusion that is currently experienced by taxpayers in determining the place of effective management of a company. The deletion of the legal factors will remove the opportunity for taxpayers to easily manipulate the determination of the place of effective management of a company, as the place of incorporation, formation or establishment of the company as well as the location of the registered office and public officer will no longer be relevant in determining the place of effective management of the company. The place of effective management test will therefore serve its purpose as a test of substance over form (SARS Legal and Policy Division: 2011).

With regard to passive holding companies, there are instances in which the controlling shareholders play an influential role in the decision making activities of the operating

subsidiary company. The proposed amendments clarify that it is only in these circumstances that the consideration of the controlling shareholders is relevant.

The proposed amendments include the addition of more relevant factors to consider (SARS Legal and Policy Division, 2011: 13):

- Delegations of authority by the board of directors or similar body, for example, to an executive committee;
- Consideration of differing board structures, for example, distinctions between commercial and non-commercial or supervisory boards;
- The identification of various factors that will generally be given little weight, for example, the place where administrative activities, such as the opening of bank accounts, take place;
- Refinement of the distinctions between various levels of management. For example, in companies operating on a divisional basis, individual divisions are often run by an executive vice-president or operational manager who reports to a higher level of management that is responsible for the company as a whole. In such a situation, the place of effective management would be the place where that top level of management is primarily or predominantly based and
- Criteria for determining the base of operations for senior management in situations where senior management travels frequently or operates from multiple locations (with meetings held, for example, *via* video conferencing).

The guideline would also be expanded to include examples illustrating the application of the factors.

It is submitted that the inclusion of these factors attempts to address various scenarios, such as circumstances where the board of directors responsible for the decision-making activities of the company delegate their responsibilities to an executive committee as well as the various board structures present in a company. An additional factor to consider is the distinctions between the various levels of management. This inclusion will assist to clarify the distinction between the various levels of management that SARS seeks to make. The other additional factors, such as the criteria for determining the base of

operations for senior management and the place where administrative activities, such as the opening of bank accounts, take place is relevant for the second level of the hierarchy adopted by SARS in determining the place of effective management of a company. The second level is relevant in instances when the senior management is based at various locations and performs their duties via distance communication, thereby making it difficult to pinpoint a single location as the place from where the senior management conducts their duties. It is in this instance that SARS suggests that the place of effective management is the place where the business activities are being conducted (IN6).

2.4.3.3 Further addition to Interpretation Note 6

SARS acknowledges that even with these proposed changes, there would still be instances where there is a disagreement between SARS and a treaty partner and therefore to resolve these disputes, the Interpretation Note (IN6) will be revised to “explicitly provide for the dispute to be resolved by the competent authorities of the two states through the applicable mutual agreement procedures” (SARS Legal and Policy Division, 2011: 14).

This approach makes provision for any unresolved disputes to be resolved by the authorities of the two contracting states and is aligned to the international proposed amendments of the OECD (discussed in Chapter 3). This approach ensures that should there be instances when the suggested guidelines do not assist to determine the place of effective management of a company, the determination will be left to the competent authorities of the contracting states involved.

2.5 The *Oceanic Trust* Case

In 2011, the first case, the *Oceanic Trust* Case, regarding the interpretation of the “place of effective management” concept was heard in South Africa. The consideration of various factors to determine the place of effective management of the Trust in this case conflicted with the general approach suggested by SARS in its former Interpretation Note 6 (IN6) and was more aligned to international precedence (as discussed in Chapter 3) as well as the proposed changes (as discussed above).

2.5.1 The Facts of the case

The Oceanic Trust Company Ltd NO (“Oceanic Trust Company”) was the sole trustee of the Specialised Insurance Solutions (Mauritius) Trust (“SISM”), carrying on the business of captive re-insurance. Both the Oceanic Trust Company and SISM were registered in Mauritius. SISM provided re-insurance to MCubed Life Limited, a company registered in South Africa and SISM appointed MCubed Life Limited’s fellow subsidiary, Corporate Money Managers, as the asset manager and investment advisor. SISM was registered for tax in Mauritius.

In March 2008, SARS issued a notice of audit to SISM and this led to SARS making a tax claim against the company. After correspondence between SARS and the Oceanic Trust Company, acting on SISM’s behalf, SARS issued a letter of assessment in July 2009 for income tax, additional tax and interest for the tax periods 2000 to 2007, amounting to R1.5 billion. The reasons for the assessment were that SISM was liable for income tax in South Africa, either because its place of effective management was in South Africa or it had a permanent establishment in South Africa and derived South African sourced income.

SISM objected to the assessment. SARS, however, appointed SISM’s bankers, the Standard Bank of South Africa Limited as agent, and recovered R20 million of the R1.5 billion. SARS issued a notice of legal proceedings against SISM which included the liquidation of SISM to recover the tax debt.

The matter was heard in the Western Cape High Court of South Africa and the applicant brought forward the matter in two parts. Part A dealt with an interim urgent order sought by SISM, pending the determination of relief in Part B, restraining SARS from taking any steps mentioned in SARS’ notice to enforce payment. Part B was a declaratory order which sought to declare that SISM was not a resident of South Africa, SISM did not carry on business through a permanent establishment and SARS is liable to repay the amount of R20 million to SISM. The discussion below relates to determining whether SISM was

a resident of South Africa (other areas considered in the judgement are not within the scope of this thesis).

2.5.2 Reasons for judgment

Due to a lack of facts, the court did not rule on this matter, but the key features to be considered to determine the residency of the Trust were discussed. Judge Louw (at par. 22 and 23) agreed with the Commissioner for SARS reasons for assessment that SISM was liable for tax in South Africa. Although SISM was registered in Mauritius and its sole trustee, Oceanic Trust Company, was based in Mauritius, the following key factors were considered by the Commissioner of SARS in determining that the place of effective management was in South Africa:

- SISM's entire income was derived from its captive re-insurance business with MCubed Life Limited, a South African company.
- SISM held a South African bank account and no funds were transferred back to Mauritius.
- MCubed Life Limited and its holding company, MCubed Holdings Limited, a company registered in South Africa, were responsible for instructing SISM regarding the reinsurance premiums, policies and maturities.
- MCubed Life Limited made all decisions regarding the premiums (i.e. investments and disinvestments). This was in accordance with the re-insurance agreement.
- All SISM's investments were made in South Africa.
- Corporate Money Managers, a fellow South African subsidiary of MCubed Life Limited, was appointed as SISM's asset manager and investment advisor. Corporate Money Managers regularly received instructions from MCubed Holdings Limited and its operating division, Asset Management Outsourcing.
- There were no minutes of meetings available to substantiate that the trustee, Oceanic Trust Company, took management decisions in Mauritius.
- MCubed Life Limited formed SISM and entered into the re-insurance agreement to escape the provisions of section 34 of the Long Term Insurance Act (which prohibited MCubed Life Limited from encumbering any of their assets) by using a

re-insurance business outside South Africa which was not subject to similar provisions that prohibited them from encumbering their assets.

The judgment was based on the England and Wales Court of Appeal in *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor* [2010] EWCA Civ 778. This case involved a scheme that was devised to avoid capital gains tax on the sale of shares in the United Kingdom by temporarily moving a trust registered in the United Kingdom to Mauritius for the period during which the shares were to be sold as there was no capital gains tax in Mauritius. Thereafter the trust was deregistered in Mauritius and re-registered in the United Kingdom with two new trustees from the United Kingdom being appointed.

The United Kingdom Revenue Authorities assessed the trust for capital gains tax on the sale of shares. The trust's appeal to the Special Commissioner was unsuccessful; however, their further appeal to the High Court was successful. The United Kingdom Revenue Authorities appealed to the Court of Appeal where it was held that the trust was liable for capital gains tax as it was throughout this period effectively managed in the United Kingdom and this was only a temporary scheme devised to avoid the tax in the United Kingdom.

It was held that the management of the trust and the key commercial decisions are usually taken by the trustees. In the Smallwood case, the two newly appointed trustees were in the United Kingdom and although the trust was temporarily moved to Mauritius and a Mauritius trustee appointed, the overriding control remained in the United Kingdom with the two newly appointed trustees who were involved in devising the scheme to avoid the capital gains tax.

If the same reasoning were to be applied to the *Oceanic Trust* case, the trustee was based in Mauritius and it would therefore appear that the effective management of SISM is in Mauritius. However similar to the Smallwood case, the overriding control and the place where the key management and commercial decisions were made needed to be

considered. Based on the facts stated above, which included that MCubed Life Limited played a key role in making the commercial decisions regarding the reinsurance premiums, investments and disinvestments, policies and maturities, it is evident that the Commissioner was correct that commercial decision-making was taken in South Africa. However due to a lack of all the facts, the court did not rule on the matter.

This case clearly shows that the relevant facts and circumstances need to be carefully considered and the test that will more than likely be applied by the South African tax courts in determining the effective management of a company is where the key commercial decisions are taken. This interpretation of the “place of effective management” concept differs from the SARS former guidance (IN6) which focuses on the location at which the key commercial decisions and strategic policies are implemented.

2.6 Conclusion

The “place of effective management” concept included in the definition of a resident other than a natural person has not been defined in the Act. The interpretation of this concept can be easily manipulated to achieve a tax benefit of being resident in a low tax jurisdiction. SARS had issued an Interpretation Note in 2002 (IN6) which provided guidelines to assist in the interpretation of the “place of effective management” concept. However these guidelines did not provide the certainty and clarity that would have been expected.

This former Interpretation Note (IN6) sets out a hierarchal approach to determine the place of effective management of a company which is also an approach proposed by the OECD (as discussed in Chapter 3). Van der Merwe (2006) is of the opinion that the hierarchal approach adopted by SARS is a more practical approach but the detail still requires clarification. The previous SARS hierarchy to determine the place of effective management of the company focuses on the executive directors and senior management of a company. The location of the place of effective management is where the executive directors and senior management carry out their activities. However if these activities are

not limited to a single location, such as instances where distance communication may be used more often in managing the company, then the location of the place of effective management is where the daily activities are conducted. If these activities do not occur at a single location then the place of effective management is at the location where the company has its strongest economic nexus. SARS also included a list of factors that should be considered for each case to determine the place of effective management of the company.

The former Interpretation Note (IN6) has been criticized as it fails to provide the certainty required in applying the “place of effective management” concept (SARS Legal and Policy Division: 2011). There is inconsistent use of terminology, inconsistencies between the guidance suggested in the hierarchy and the factors considered, lack of guidance for passive or intermediate holding companies and an interpretation adopted by SARS that differs significantly from the OECD guidance and international precedence.

Further, in 2011 the South African courts heard the first case, the *Oceanic Trust* case, regarding the “place of effective management” concept. The court considered the guidance from the judgement in the England and Wales Court of Appeal in *Commissioners for Her Majesty’s Revenue and Customs v Smallwood and Anor* [2010] EWCA Civ 778. It was held that the trustees of the trust are usually responsible for the key commercial and strategic policies of the trust, however the circumstances and facts of each case would need to be considered. In the *Oceanic Trust* case, it was held that although the trustees are based in Mauritius, the overriding control and the place where the key commercial and strategic decisions of the company were taken was in South Africa, by the company to which they provided re-insurance services. This was on the basis that the company to which the re-insurance was provided, was responsible for the key commercial decisions of the Trust, such as decisions regarding the re-insurance premiums, investments and disinvestments as well as the policies and maturities of the investments.

Subsequent to the *Oceanic Trust* case, “it seems safe to say, as matters stand, that the balance in South Africa has swung away from the criteria for locating the place of effective management of a juristic person, as laid down in Interpretation Note 6 toward the *Smallwood* criteria which are in turn consistent with those laid down in the OECD commentaries” (de Koker, AP & Willians, RC, 2013: par. 14.42). SARS acknowledged this and issued a Discussion Paper (SARS Legal and Policy Division: 2011) proposing amendments to address the concerns raised as well as responding to the interpretation adopted by the South African tax courts in the *Oceanic Trust* case, which was aligned to the OECD guidance as opposed to the previous SARS guidance provided. The proposed amendments include shifting the focus from the implementation of the key commercial decisions and strategic policies of the company to the decision making activities regarding these key commercial decisions and strategic policies (SARS Legal and Policy Division: 2011). The factors to consider were also proposed to be amended accordingly to ensure that the factors are relevant to the new interpretation to be adopted by SARS. An addition to the Interpretation Note was that the competent tax authorities would be responsible to determine the place of effective management should there be a disagreement between SARS and a treaty partner regarding the location of the place of effective management of the company.

Subsequent to the Discussion Paper (SARS Legal and Policy Division: 2011), SARS has revised the former Interpretation Note (IN6) and issued a draft second version of the Interpretation Note 6 in early 2015 (draft IN6 version 2) as well as the final version 2 of the Interpretation Note in the latter of 2015 (IN6 version 2). The revised Interpretation Note has taken into account the OECD guidelines, criticisms of the former Interpretation Note, international precedence and the considerations discussed in the *Oceanic Trust* Case. The revised draft and final version 2 of the Interpretation Note is discussed in detail in Chapter 4.

The *Oceanic Trust* case has confirmed that the South African courts will firstly consider international precedence as they are not bound by SARS’ guidelines. Therefore international precedence will need to be considered as it is useful as a guideline to

understanding the interpretation of the concept, “place of effective management” that would most likely be adopted by tax courts in South Africa. International precedence regarding the “central management and control” concept such as court decisions in the United Kingdom will be relevant in understanding the appropriate factors to consider in determining the place of effective management of companies in South Africa.

The OECD Model Tax Convention’s tie-breaker clause to determine the residency of companies is to determine the place of effective management of that company (OECD: 2014). The United Kingdom court decisions regarding the “central management and control” concept is aligned to the guidelines provided by the OECD regarding their tie-breaker clause, incorporating the “place of effective management” concept. Therefore the OECD guidelines and the United Kingdom court decisions regarding the “central management and control” concept are analysed in the next chapter to understand the appropriate factors that should be incorporated in SARS’ guidance to interpret the “place of effective management” concept in South Africa.

CHAPTER 3: International precedence on the place of effective management

3.1 Introduction

The OECD Model Tax Convention provides a means to settle on a uniform basis the most common problems that arise in the field of international juridical double taxation (OECD: 2015). The OECD guidelines form the basis for double tax treaties and although South Africa is not a member of the OECD, the guidelines are adopted in its double tax treaties with various countries (SARS Legal and Policy Division: 1973 and SARS Legal and Policy Division: 2002b). The OECD guidelines include a tie-breaker clause for residents other than natural persons and this clause includes the concept, “place of effective management”. The interpretation of the concept is not universally uniform and although countries like the United Kingdom have a similar interpretation to the OECD guidelines, South Africa’s former interpretation differed greatly.

In South Africa, the “place of effective management” is a concept incorporated in the definition of “resident” in the Act, as well as in its double tax agreements (SARS Legal and Policy Division: 1973 and SARS Legal and Policy Division: 2002b). It is therefore important that the interpretation in South Africa does not differ significantly from the OECD guidelines as the concept is not only used in domestic tax legislation but is also used as a tie-breaker test in the double tax agreements for companies that appear to be dual resident or subject to double taxation on their income that is from a source outside of the country that they are resident in. It is noted that double tax agreements will however take precedence over domestic legislation.

The former SARS guidelines (IN6) differ from the outcome of the *Oceanic Trust* case heard in the South African courts in 2011 and therefore this created a need for SARS to re-look at their former guidance. The former guidance included a hierarchal approach and suggested that the place of effective management of a company is located where the executive directors and senior management implement the strategic policies and commercial decisions of the company. However if this activity cannot be identified at a single location then the place of effective management is where the activities of the

company are conducted. If these activities do not occur at a single location then the place of effective management is where the company has its strongest economic nexus.

This hierarchal approach differs from the OECD's approach (OECD: 2014), where the determining factor of the place of effective management of the company is where the key commercial and strategic decisions of the company are made rather than where they are implemented as the SARS former guidance had suggested. The outcome of the *Oceanic Trust* case was determined based on the approach and factors to determine the place of effective management of a company as suggested by the OECD. Therefore in considering amendments to be made to the SARS guidance to be provided, the OECD interpretation, international precedence and the *Oceanic Trust* case were considered (IN 6 version 2).

The OECD has also acknowledged that there is no uniform interpretation and that the concept is not easily understood and applied in practice by various OECD countries and other countries (such as South Africa) and has therefore considered suggestions and comments from various OECD countries to either refine, replace or include a hierarchal approach to determine the place of effective management of a company. These approaches all align the interpretation of the concept to case law in the United Kingdom which addressed a similar concept, "central management and control".

This chapter addresses the goal of reviewing the OECD's Article 4 of the Model Tax Convention and its Commentary on the concept, "place of effective management", including the proposed amendments, which include either refining or replacing the "place of effective management" concept or adopting a hierarchal approach to determine the place of effective management of a company. International precedence, such as case law in the United Kingdom, which addresses the interpretation of central management and control, is also discussed. "Central management and control" is a concept with a meaning similar to the "place of effective management" concept and therefore serves as precedence for other courts such as the South African tax courts in addressing the interpretation of the place of effective management of companies.

3.2 Article 4 of the OECD Model Tax Convention

The definition of a resident in the case of a person other than a natural person in terms of Article 4 of the Model Tax Convention is “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature” (OECD, 2014: 26). There are instances in which a company may appear to be resident in two contracting states and therefore the OECD has included a tie-breaker rule to determine the residency of such a company. This tie-breaker rule is the same tie-breaker rule adopted in the double tax treaties to which South Africa is a party, for example, the Agreement between The Republic Of South Africa And The Federal Republic of Germany For The Avoidance Of Double Taxation With Respect To Taxes On Income (SARS Legal and Policy Division: 2002(b)) and New Convention between the Government of the Republic of South Africa and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains (SARS Legal and Policy Division: 2003). The tie-breaker rule to determine the residency of a person other than a natural person, according to the OECD, is that the person “shall be deemed to be a resident only of the State in which its place of effective management is situated” (OECD, 2014: 26).

3.3 OECD Commentary on Article 4 of the Model Tax Convention

Paragraph 24 of the Commentary on Article 4 of the Model Tax Convention was inserted in the OECD’s Model Tax Convention in the update in 2000. This paragraph seeks to provide clearer guidance on the OECD’s interpretation of the “place of effective management” concept. The current guidance provided is that the place of effective management is “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made” (OECD, 2014: 90 and 91).

The OECD has acknowledged (OECD: 2014) the comments received from certain countries that the dual residency of companies is less likely to be an issue for them and therefore the matter should be assessed on a case-by-case basis by the relevant

authorities. The OECD has given this consideration and stated that this can be achieved by replacing paragraph 3 of Article 4 of the Model Tax Convention with the following paragraph (OECD, 2014: 91):

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

The OECD (2014) has also stated that each country can supplement this paragraph with any other factors that they consider relevant.

Despite the comments from some countries that dual residency is less likely to be of concern, the OECD has acknowledged that with the availability of technology that enables distance communication, the problem of the place of effective management not being located at a single location is in fact common and therefore instances of dual residency are more likely to occur (OECD: 2001). The factors that the OECD refers to that should be considered by the contracting states involved in a dual residence case, include both the legal factor of the place of incorporation as well as the tie-breaker rule used to determine the place of effective management. It appears that the inclusion of the legal factor is an indication that not all OECD member countries have adopted the place of effective management as a tie-breaker rule to determine the residency of a person other than a natural person.

Prior to July 2008, the OECD had accorded significant importance to the place at which board meetings were held as it was viewed that it is at such meetings that the most senior people of a company are responsible for making key commercial decisions (OECD, 2012: C(4)-20)). As discussed in Chapter 2, this factor can be easily manipulated and with the advancement in technology that enables distance communication, the relevance and reliability of this factor has therefore become questionable. The OECD has therefore shifted its emphasis away from relying on the place where board meetings are held to recommending that the relevant authorities assess each case of dual residency individually by taking into account various other factors, such as the place where activities of the chief executive officer, other senior executives and the senior day-to-day managers are carried on, the location of the company's headquarters, the place where accounting records are kept, which country's laws govern the company's legal status, the location of board meetings, etc. (OECD: 2014).

Some of these factors suggested by the OECD for consideration to determine the place of effective management of a company appear to contradict the guidance provided by the OECD in Article 4 of the Model Tax Convention. Firstly, the consideration of the location of board meetings appears to contradict the OECD's intention, in their 2008 update to the Model Tax Convention, of shifting the focus away from the location of board meetings to giving consideration to where the actual key commercial decisions are being taken (OECD: 2014). The OECD has also proposed the consideration of legal factors such as the location of the company's headquarters, where the accounting records are kept and which country's laws govern the company's legal status. The relevance of these factors is also questionable (as discussed in Chapter 2) as they are also open to manipulation.

However countries such as Japan, Korea and Turkey rely on the place where the company's head office is located to determine the residency of a company, whilst the United States uses the place of the company's incorporation as the factor to determine the residency of a company (OECD: 2014). France and Hungary seem not to have changed their approach in line with the OECD's change in focus as they are still of the view that

the place of effective management will usually coincide with the place where the most senior persons of the company, such as the board of directors or managers, make their decisions and where the activities of the chief executive officer, other senior executives and the senior day-to-day managers are carried on (OECD: 2014). Italy, on the other hand, views the place where the main and substantial activities of the company are carried on as also being relevant (OECD: 2014). This factor will not necessarily assist in determining the location at which the key commercial decisions are being taken as the senior management responsible for taking the key commercial decisions need not be located at the location of the actual business operations. This factor is also largely impacted by the use of distance communication such as instances where directors and senior management of the company are located across various countries although the actual business activities are only conducted from a single location.

These OECD guidelines (OECD: 2014) focus on “the place where the ‘real’ board of directors (as opposed to appointed ‘straw men’) actually make decisions on important business affairs of the company, the place where important decisions are actually taken as opposed to the place where they are formally resolved (i.e. rubber stamped) and the place where important management decisions are taken and/or exercised as opposed to day-to-day administrative management” (The Taxpayer, 2014: 85).

3.4 OECD Discussion Paper: The impact of the communications revolution on the application of “place of effective management” as a tie-breaker rule

The OECD Council (OECD: 2001) had acknowledged a very important factor that affects the determination of the place of effective management of a person, other than a natural person, which is the way a company uses distance communication in operating its business. This is a real issue as key individuals within an organization may be located across the globe but with the use of modern technology available currently, they are able to effectively communicate with each other on a daily basis and manage an organization from their various locations. The OECD Council welcomed suggestions and comments from individuals and organizations to determine alternative options in clarifying the term “place of effective management”.

The OECD has noted (OECD: 2014) that the place of effective management of a company may be difficult to pinpoint to a single location. Firstly, with the advancements in technology, a director or senior manager need not travel to conduct meetings but may use video conferencing, *inter alia* to hold meetings to make key decisions. The result is that the decision makers may sit in various countries and therefore the place of effective management cannot be said to exist at a single location. Another consideration is that foreign travel for a director is more common these days and therefore a director may be making decisions from various locations as well as meeting other decision-makers at different locations each time a decision needs to be made. The OECD has therefore considered amendments to the “place of effective management” concept included in the tie-breaker rule to determine the residency of a company.

3.4.1 Replacing the “place of effective management” concept

Consideration has been given to whether the place of effective management test serves its purpose as an adequate tie-breaker rule, specifically in light of the increased use of distance communication in managing a business. The OECD has acknowledged that if this tie-breaker rule does not assist to identify a single country of residence for a person other than a natural person, then this tie-breaker rule is in fact ineffective (OECD: 2001) and therefore other options need to be considered as a replacement to the current tie-breaker rule. These options include the place of incorporation or place where the directors or shareholders reside or the place where the economic nexus is the strongest (OECD: 2001).

It is submitted that the options of replacing the current tie-breaker rule for determining the place of effective management with either the place of incorporation or the place where directors or shareholders reside would not be a sound option as both these factors are legal factors that are easily open to manipulation (as discussed in Chapter 2). The third suggested option is the place where the economic nexus is the strongest. This test requires further clarification as the concept, “economic nexus”, is not a defined term and therefore open to interpretation. Further it may be “difficult to apply as it could involve subjective comparisons” (OECD, 2001: 12).

Luca Cerioni (2012) has considered an alternative tie-breaker rule to be used in the European Union's Double Tax Conventions. He believes that (Cerioni, 2012: 1125) "the place of the closest economic ties" can be used as a tie-breaker rule, however "a second and residual criteria, to be used only in the case of those companies, such as holding companies, whose activity could not lead to genuine economic integration in the host country", could use the place of effective management as a tie-breaker rule. Cerioni (2012: 1128) is in favour of this alternate tie-breaker rule as it is "based on objectively verifiable elements, would be easier to ascertain by third parties (and by tax authorities) than the place of effective management, the latter of which appears destined to become obsolete in the modern computerized economy and distance communication environments". The criteria to be used to verify the place with the closest economic ties include "objective criteria such as the physical presence in terms of premises, staff, equipment, and production activity" (Cerioni, 2012: 1124). Ceroni (2012: 1124) also holds that this tie-breaker rule will be "well grounded from the viewpoint of the very rationale of a tax system".

3.4.2 Refining the place of effective management test

Consideration has also been given to refining the place of effective management test by stating a predominant factor that determines the place of effective management or giving weightings to various factors. Paragraph 24 of the Commentary on Article 4 of the Model Tax Convention (OECD: 2014) already includes a predominant factor that is looked at i.e. "the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made" (OECD, 2014: 90 and 91). The Commentary also sets out further factors that should be considered, such as the place where activities of the chief executive officer, other senior executives and the senior day-to-day managers are carried on, the location of the company's headquarters, the place where accounting records are kept, which country's laws govern the company's legal status, location of board meetings, etc. (OECD: 2014). The Discussion Paper (OECD: 2001) set out additional factors such as the place of incorporation, location at which majority of the directors reside, consideration of the importance of the various functions performed in the two contracting states as well as the place of central

management and control, as stated in the company's incorporation documents (OECD: 2001).

It is submitted that the legal factors referred to in this Discussion Paper, the place of incorporation and the place of central management and control as stated in the company's incorporation documents, are open to manipulation and therefore will not serve as adequate factors in determining the place of effective management of a company (as discussed in Chapter 2). It is also submitted that the other two factors, location at which majority of the directors reside and consideration of the importance of the functions performed in the two contracting states, are factors that are worthy of consideration.

The refinement would seek to include assigning a weighting to each of these factors and including other relevant factors with their weightings. A provision can be included to overcome the difficulty experienced when directors are mobile, however this will still not address the problem encountered in instances where directors are residing in various countries and therefore resulting in the place of effective management appearing to be in more than one location (OECD: 2001).

3.4.3 Establishing a hierarchy of tests, as in the case of an individual

To determine the residence of individuals, a hierarchal approach is adopted as a tie-breaker rule. A similar approach for determining the residence of companies has been suggested by the OECD Council. The possible hierarchal structure to be considered is:

- a. place of effective management;
- b. place of incorporation;
- c. economic nexus; and
- d. mutual agreement.

The suggested structure includes the place of incorporation test in the second level of the hierarchy. However it is submitted that the inclusion of this factor in the tie-breaker clause will defeat the purpose of ensuring that the tie-breaker test is not open to manipulation and the tie-breaker clause will also fail to serve its purpose as a test of

substance over form. It is further submitted that the first and third levels in the hierarchy require further clarification in order to ensure that this hierarchal approach is useful and effective in determining the residency of a company.

3.4.4 A combination of refining the concept, “place of effective management”, and a hierarchal approach

It was also suggested by the OECD Council that consideration should be given to whether combining the two options, of using a hierarchy as well as refining the concept “place of effective management”, will produce a more effective tie-breaker rule. This option will require further consideration and clarification. It appears to be the more feasible of the options as it will address the concerns and shortfalls of the current OECD guidelines (OECD: 2014).

3.5 OECD Discussion Draft: “Place of effective management” concept: Suggestions for changes to the OECD Model Tax Convention

The “Technical Advisory Group” (OECD, 2003: 1) received comments in response to its Discussion Paper (OECD: 2001). The Technical Advisory Group considered the comments and in May 2003 issued a Discussion Draft (OECD: 2003) that proposes two alternatives, either a refinement to the concept “place of effective management” or amending Article 4 of the Model Tax Convention to a hierarchal approach to determine the place of effective management.

3.5.1 Refine the concept “place of effective management”

The first proposal is to amend paragraph 24 of the Commentary on Article 4 of the Model Tax Convention. The paragraph that discusses the place where key management and commercial decisions are being made will be deleted. The amendment proposed is also to move the sentence that suggests that the place of effective management will be the place where the most senior group of persons, such as the board of directors, meets to a new sub-paragraph and include a list of other factors to consider. These other factors include (OECD, 2003: 2 and 3):

- where a board of directors formally finalises key management and commercial decisions necessary for the conduct of the entity’s business at meetings held in one State but these decisions are in substance made in another State, the place of effective management will be in the latter State;
- if there is a person, such as a controlling interest holder (e.g. a parent company or associated enterprise), that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity’s business, the place of effective management will be where that person makes these key decisions; for that to be the case, however, the key decisions made by that person must go beyond decisions related to the normal management and policy formulation of a group’s activities (e.g. the type of decisions that a parent company of a multinational group would be expected to take as regards the direction, co-ordination and supervision of the activities of each part of the group); and
- where a board of directors routinely approves the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the place of effective management of the entity; in distinguishing between a place where a decision is made as opposed to where it is merely approved, one should consider the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed.

It is interesting to note that subsequent to this Discussion Draft in 2003 (OECD: 2003), paragraph 24 of Article 4 of the Model Tax Convention was amended (OECD: 2014). The amendment did not delete the entire paragraph that discusses the place where key management and commercial decisions are being made but the statement that “the place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined” (OECD, 2012: C(4)-20) was deleted. Although this amendment does not completely clarify the concept “place of effective management”, it does eliminate the confusion created by the rule that the place

of effective management is determined solely where the board of directors' meetings is taking place. However it is submitted by Majachani (2010: 53) that "the Commentary does not provide for a testable criterion". Further consideration needs to be given to the proposals stated above to refine the "place of effective management" concept before further amendments become effective.

It is noted that the consideration of the proposed factors clarifies that if a decision is made at one location but is formally finalized or rubber-stamped at another location, the place of effective management will be the place where the decision was actually made (van der Merwe: 2006) as well as considering that if it is the shareholder who in fact is responsible for making these key commercial decisions of the company, then the location of the shareholder will determine the place of effective management of the company. These proposed amendments regarding the shareholders are similar to the proposed amendments by SARS (SARS Legal and Policy Division: 2011) to its factors to consider in determining the place of effective management of companies included in its former Interpretation Note (IN6). SARS suggests a consideration of the controlling shareholders in instances where the controlling shareholders are the individuals making the key operational and commercial decisions of the company, for example, with passive holding companies. This factor appears to be a real problem in practice as both SARS and the OECD have acknowledged that this area needs clarification and therefore have proposed amendments to their prospective guidance.

3.5.2 Establish a hierarchy of tests

The second proposal looks at a hierarchal approach to determine the place of effective management of a company and the proposals for the hierarchy are as follows (OECD, 2003: 3):

- a) It shall be deemed to be a resident only of the State in which its place of effective management is situated.
- b) If the State in which its place of effective management is situated cannot be determined or if its place of effective management is in neither State, it shall be deemed to be a resident only of the State [Option A: with which its economic

relations are closer] [Option B: in which its business activities are primarily carried on] [Option C: in which its senior executive decisions are primarily taken].

- c) If the State [with which its economic relations are closer] [in which its business activities are primarily carried on] [in which its senior executive decisions are primarily taken] cannot be determined, it shall be deemed to be a resident of the State from the laws of which it derives its legal status.
- d) If it derives its legal status from neither State or from both States, or if the State from the laws of which it derives its legal status cannot be determined, the competent authorities of the Contracting States shall settle the question by mutual agreement.

The Commentary to Article 4 will also be updated accordingly. The suggested amendment relating to the first level in the hierarchy, the place of effective management, is the same as those changes suggested in the option to refine the concept “place of effective management”. In instances where the place of effective management cannot be determined because the use of distance communication makes it difficult to determine a single location as the place of effective management of a company, there are three options suggested in the second level of the hierarchy. Specific amendments providing guidance as to the interpretation of the three options in the second level of the hierarchy have also been suggested.

In the second test in the hierarchy, Option A relates to the place with “which its economic relations are closer” (OECD, 2003: 3). The guidelines provided in this regard suggest that in determining the place with the strongest economic relations, the taxpayer will have to consider in which country the taxpayer “makes greater use of economic resources as well as the legal, financial, physical and social infrastructures” (OECD, 2003: 5). The factors that should be considered include in which country “most of the employees and assets (are situated), where it carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from which state the entity has derived its legal status” (OECD, 2003: 5).

The location where the entity carries on its business activities is suggested as Option B in the second level of the hierarchy. A taxpayer will have to conduct a functional analysis of the activities it performs in each country and determine which of the functions are the most important. No further guidance is provided as to how to conduct the functional analysis, the weighting to be given to the factors, which specific functions are to be considered and whether there are any predominant functions that should be considered.

The last option suggested is that the place where the senior executive decisions are taken should be used as the option in the second level of the hierarchy. The guidance provided in this regard is the country in which the “clear majority of senior executive decisions (e.g. the decisions of executive officers such the president, vice-presidents, treasurer, etc.) are taken” (OECD, 2003:6). It is also stated that this location is where the headquarters of the company are located, to the extent that they are located in one country. This approach requires an identification of where the senior executives responsible for running the business are located.

Oguttu (2008) believes that a hierarchal approach is a better approach to be adopted and that Option C, the place where the “senior executive decisions are taken” (OECD, 2003: 3), in the hierarchy discussed above is the best option, both from a practical perspective and as a matter of principle. This refinement will require changes to Article 4 of the Model Tax Convention and there is a concern about how quickly such changes could be introduced by countries in their treaties.

The suggestion to adopt a hierarchal approach is the approach formerly adopted by SARS (IN6) and the determining factors in each level of the hierarchy suggested by the OECD is also similar to the factors in the previous hierarchy adopted by SARS. The first level in the hierarchy is the location of the place of effective management and this will be where the board of directors meets. However, subsequent to these proposed amendments, in 2008 the OECD deleted the sentence in the guidance that suggested that the “place of effective management will ordinarily be the place where the most senior person or group

of persons (for example, a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined” (OECD, 2012: C(4) – 20). This deletion confirmed that relying on the location of board meetings to determine the place of effective management of a company is not the most ideal test to determine the residency of companies as it is open to manipulation. Therefore the OECD will need to re-consider whether the place of effective management is suggested to be where the key commercial and business decisions are taken, which is what Option C in the second level of the hierarchy suggests.

Option A, which is where the company has its strongest economic nexus, is the same factor as SARS’ third level in the former hierarchy (IN6), however the OECD has provided some guidance as to the interpretation of this term whereas SARS’ former guidance failed to do so.

Option B in the second level of the hierarchy is where the company’s business activities are primarily carried on. This is the same factor as the second level in the former SARS hierarchy (IN6).

The third level in the proposed OECD hierarchy is the location where the company derives its legal status. This was a factor suggested for consideration in the former SARS guidance (IN6), however it was noted as a concern that this factor can be easily manipulated.

The OECD and SARS proposed amendments appear to be closely aligned. However in 2015, SARS issued their final version 2 of the Interpretation Note (IN6 version 2) which adopted a core principal approach and abandoned the previous hierarchal approach. Therefore the proposed amendments of the OECD are in fact no longer congruent with the revised guidance of SARS.

3.6 International precedence

3.6.1 Central management and control

The “central management and control” concept is used in countries such as the United Kingdom, Ireland and Australia to determine the residency of persons other than natural persons (Maharaj: 2002). “The concept, central management and control, refers to the place where the superior policy and strategic decisions are made” (van der Merwe, 2002: 92) and this will generally coincide with where the directors meet and exercise their power and control. This factor, however, could be easily manipulated as a company could arrange to hold board meetings in a low tax jurisdiction as it would be seen to be resident in the country in which board meetings were held (South African Institute of Chartered Accountants: 2009).

The prevailing opinion is that the concept, “central management and control”, is not an equivalent concept to the “place of effective management”, however both terms are similar in meaning, therefore the international precedence on central management and control can be helpful to determine the meaning of the place of effective management (de Koker, AP & Willians, RC, 2013: par. 14.42).

Vogel (1997: 268) is of the opinion that place of effective management is not the same as “controlled and managed” but that the term is similar to the German terminology, “place of management”. “The German law interpretation of place of management is the ‘business’ centre of top level management” (Vogel, 1997: 231). Vogel states (at 262) that “what is decisive is **not** the place where the management’s important directives **take effect**, but rather the place where they are **given**” and “the centre of management activities of a company generally is the place at which the person authorized to represent the company carries on its business-managing activities” (emphasis in the original).

From the discussion above, it appears that the terms “central management and control” and “place of management” are very similar in meaning. The court cases discussed below deal with the concept, “central management and control”, and these cases will be

analysed to understand the factors that were considered to determine the residency of these companies and trusts as these factors will be equally relevant in applying the place of effective management in South Africa.

3.6.2 *Commissioners for Her Majesty's Revenue and Customs v Smallwood and Anor*, [2010] EWCA Civ 778

3.6.2.1 The facts of the case

The respondents, Smallwood and Anor, were tax residents of the United Kingdom and were the beneficiaries of the Smallwood Trust. The trustees of the Smallwood Trust were Lutea, which was also tax resident in the United Kingdom. The Smallwood Trust held shares in the FirstGroup plc and Billiton plc. The Smallwood Trust took a decision to sell their shares in both companies and consulted with KPMG Bristol as to how this can be achieved in the most tax efficient manner. Under the United Kingdom tax legislation, the beneficiaries, Smallwood and Anor, would be liable for the capital gains tax arising from the sale of the shares. KPMG Bristol therefore advised the Smallwood Trust of a scheme to be entered into whereby no capital gains tax would arise. The scheme involved the resignation of Lutea as trustee and the appointment of PMIL as the new trustees of the Smallwood Trust. The Trust would also be deregistered in the United Kingdom and registered as an offshore trust in Mauritius. The shares were transferred to Quilter to be held in their nominee account until such time it was decided to dispose of the shares. During the same tax year, PMIL were to resign as trustees of the trust and Mr and Mrs Smallwood were to be appointed as the new trustees. The Trust would also be deregistered in Mauritius and re-registered as a trust in the United Kingdom.

The Special Commissioner had assessed the trustees on the capital gain arising from the sale of the shares, against which Smallwood and Anor appealed to the High Court. The High Court's judgement was in favour of the trustees as it held that the trust was resident in Mauritius and not the United Kingdom. The Special Commissioner appealed to the Court of Appeal which held that the place of effective management of the trust was always in the United Kingdom and therefore the Trust was a tax resident of the United

Kingdom and accordingly the trustees would be liable for the capital gains tax arising on the sale of the shares.

3.6.2.2 Reasons for judgement

The Special Commissioners had interpreted (at par. 48 and 49) the meaning of the place of effective management as “the place which is the centre of top-level management: i.e. where the key management and commercial decisions are made” and what needed “to be identified is the place where the real top-level management of the trustee qua trustee occurred rather than the day-to-day administration of the trust”. The court relied on the following factors in determining the place of effective management to be in the United Kingdom:

- The power to appoint new trustees was held by Mr Smallwood.
- Based on a consideration of the detailed facts regarding the appointment of PMIL, “the real top level management, or the realistic, positive management of the Trust, remained in the United Kingdom” (at par. 53), whilst it was only the day-to-day administration of the Trust that moved to Mauritius.
- PMIL was not responsible for making the decision to sell the shares. This decision was made prior to the appointment of PMIL as trustees. PMIL was only responsible to exercise their power as trustee and give the final approval when the time was right to sell the shares. The “realistic, positive management” (par. 53) involved the decision to dispose of the shares in a tax efficient manner, which was a decision taken by Mr Smallwood in the United Kingdom.
- Mr Smallwood had already decided to transfer the shares to Quilter’s nominee account and it was Mr. Bazzone of Quilter that reminded PMIL of the quantity of FirstGroup plc shares that should be sold. This is an indication that PMIL was not the person actually responsible and accountable for the sale of the shares.

Lord Justice Hughes concluded quite precisely (at par. 70) that “the scheme was devised in the United Kingdom by Mr Smallwood on the advice of KPMG Bristol. The steps taken in the scheme were carefully orchestrated throughout from the United Kingdom, both by KPMG and by Quilter. And it was integral to the scheme that the trust should be

exported to Mauritius for a brief temporary period only and then be returned, within the fiscal year, to the United Kingdom, which occurred. Mr Smallwood remained throughout in the United Kingdom. There was a scheme of management of this trust which went above and beyond the day to day management exercised by the trustees for the time being, and the control of it was located in the United Kingdom”. “It was reaffirmed that effective management implies realistic, positive management on a material level” (Padia & Maroun, 2011: 129).

3.6.3. *Laerstate BV v the Commissioners for Her Majesty’s Revenue and Customs (Corporation Tax)*, [2009] UKFIT 209 (TC)

3.6.3.1 The facts of the case

The appellant, Laerstate was wholly owned by a United Kingdom resident, Mr. Bock, who was also one of the two directors. Subsequently, Mr. Bock ceased to be a director and Mr. Trapman continued as the sole director of Laerstate. The appellant was incorporated and had its place of registered office in the Netherlands. During 1992, the appellant acquired shares in a company called Lonhro through two share transactions. The first share transaction was a purchase of 100 million newly issued Lonhro shares and the second transaction involved the purchase of 43 million shares in Lohnro from Yeoman, a company owned by Mr. Rowland. A further transaction entered into between the appellant and Yeoman was a put and call option for a further 45 million Lonhro shares owned by Yeoman. The purchase of the shares was funded by Frankfurt Bank, through negotiations with Mr. Bock acting on behalf of the appellant.

In 1996, the appellant entered in an agreement with Anglo to sell their existing shareholding in Lonhro to Anglo. The final option agreement signed was a put and call option between Anglo and the appellant for the appellant’s existing 143 million shares held in Lonhro. In November 1996, the appellant exercised its put option thereby resulting in the sale of their 143 million Lonhro shares to Anglo.

The United Kingdom tax authorities sought to tax the appellant, Laerstate, on the gain realized on the sale of the Lonhro shares to Anglo as Laerstate was seen to be tax resident in the United Kingdom. The appellant appealed against this assessment to the First Tier Tribunal Tax Court and also appealed in terms of the double tax agreement between the United Kingdom and the Netherlands for relief for the repayment of tax credits relating to the tax on the dividend income received from Lonhro during 1993 – 1996. The appeal relating to the residency of the appellant will be discussed in further detail (as the discussion regarding the appeal relating to the foreign tax credits is not within the scope of this thesis).

3.6.3.2 Reasons for judgement

The judgement sought was whether the appellant was tax resident in the United Kingdom or the Netherlands, and the judges considered the central management and control of the company in considering the residency of the appellant. The judgement relied (at page 33) on the *De Beers Consolidated Mines, Ltd v Howe*, (1906) 5 TC 198 case where the application of the central management and control test “does not confine itself to a consideration of particular actions of the company, such as the signing of documents or the making of certain board resolutions outside the United Kingdom if, in a given case, a more general overview of the course of business and trading demonstrates that as a matter of fact central management and control abides in the United Kingdom”.

The judgment focused on two distinct phases of the company i.e. the period till August 1996 during which Mr. Bock was a director of the appellant and thereafter the period during which Mr. Bock ceased to be a director of the appellant. The court held that the appellant was tax resident in the United Kingdom during the period that Mr. Bock was a director of the appellant as he exercised the central management and control of the company whilst in the United Kingdom. The court did not agree with the appellant’s arguments that Mr. Bock’s actions, whilst in the United Kingdom, involved meetings with lawyers and other advisors, which were acts that did not constitute central management and control. It was found that Mr. Bock was involved in the decision

making activities of the company and therefore the appellant was tax resident in the United Kingdom during the period that Mr. Bock was a director of the company.

The second phase under consideration was the period during which Mr. Bock ceased to be a director of the company and Mr. Trapman, the sole director, was responsible for signing the binding agreements on behalf of the company. The judgment relied on the four scenario test to be used when the Board signs documents (Gutuza, 2012: 432):

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

Scenario 1 and 2 is indicative of shareholder control and the place of effective management is the place where the shareholder resides. The court considered the four scenario test and three particular actions of the appellant. The first action was the notice of intention that was given to Anglo that the appellant would exercise its put option and sell the 143 million shares to Anglo. The court found (at page 38) that based on the consideration of the facts and timings, it appears that “Mr. Bock made the decision that the notice would be given and told Mr. Trapman to sign it, which Mr. Trapman did without considering whether or not to do so and not having the necessary information to make such a decision anyway”. This conclusion was further supported by Mr. Trapman’s inability to give the exercise notice at the earliest possible time in terms of the appellant’s put option which resulted in a loss of £258 million. The court believed (at page 39) that “if it was Mr. Trapman’s independent decision to give the notice of intention then a businessman of Mr. Trapman’s experience would have followed it up with an exercise

notice at the earliest possible time”. The third action was the exercise of the put option and it was found (at page 39) that “Mr. Bock told Mr. Trapman to sign the exercise notice on 29 October 1996, which he did without considering it because that was what Mr. Bock wanted”. It was therefore found that the appellant was tax resident in the United Kingdom even during the period that Mr. Bock ceased to be a director as Mr. Bock had made the relevant decisions and Mr. Trapman had thereafter merely signed the agreements on behalf of the appellant.

The central management and control of the company was found to be in the United Kingdom where Mr. Bock was a resident, irrespective of whether he was a director, as he was the person responsible for “real top level management” (*Laerstate*: par. 41).

3.6.4. *Wood and another v Holden (HMIT)*, [2006] EWCA Civ 26

3.6.4.1 The facts of the case

The taxpayers, a husband and wife resident in the United Kingdom, owned shares in a company, G. Ltd and wished to dispose of these shares. However the taxpayers would be liable for significant capital gains tax on the disposal of their shares in G. Ltd. They therefore consulted their tax advisors on the most tax efficient method of disposing of their shares and entered into a sophisticated scheme to avoid the capital gains tax that would be attributed to the taxpayers as settlors in terms of the tax legislation. The scheme involved the sale of shares to take place between two members of a non-resident group of companies so that the capital gains tax would not be attributed to the taxpayers. This was achieved by the taxpayers firstly setting up family trusts with non-resident trustees. The non-resident trustees incorporated a British Virgin Island company, CIL in which they held 100 per cent of the shares. Subsequently, the taxpayers formed a company, H. Ltd. They gifted 100 per cent of G. Ltd shares to H. Ltd and 49.9 per cent of H. Ltd shares to CIL. CIL acquired E. Ltd, a dormant Dutch company, which had a Dutch company as the managing director. CIL sold their H. Ltd shares to the dormant company, E. Ltd which thereafter sold the shares to the outside purchaser.

The Revenue Authorities assessed the taxpayers to capital gains tax on the disposal of G. Ltd shares as they found that the disposal of shares was not between two non-resident group companies i.e. CIL, a company incorporated in the British Virgin Islands and E. Ltd, a company incorporated in Netherlands. The Revenue Authorities were of the view that although E. Ltd was incorporated in Netherlands, it was resident for tax purposes in the United Kingdom as its place of central management and control was in the United Kingdom. The taxpayers appealed to the High Court and were successful.

Thereafter the Revenue Authorities appealed to the Court of Appeal but their appeal was unsuccessful as the judge held that the share transaction was between two non-resident companies. The judge relied on the facts of the previous court that found that E. Ltd was resident in the Netherlands where it was incorporated and the Court of Appeal therefore did not conclude on the central management and control of the company. Although this decision was in favour of the taxpayer and the High Court's decision was based on the incorporation of the entity as opposed to the central management and control of the entity, the factors identified by the Revenue Authorities in considering the central management and control of the company will be discussed.

3.6.4.2 Reasons for judgement

The facts that supported the views of the Revenue Authorities that the central management and control was in the United Kingdom were that the managing director of E. Ltd did not make the decision to dispose of the shares but merely acted upon the instructions of their tax advisors. Further E. Ltd was a dormant company and therefore the business of E. Ltd was limited to the acquisition and subsequent sale of H. Ltd shares, in relation to which the managing director did not take any decisions. Therefore the central management and control was found to lie outside of Netherlands, where it was incorporated. The Revenue Authorities looked for some evidence that would prove that the central management and control of the company occurred in the Netherlands and this included considering whether the managing directors of the company viewed the accounts of H. Ltd, the disclosure letter or the warranties relating to the share transaction as well as considering whether the purchase price was fair, but it appeared that they did

not view these documents or consider the price prior to making their decision to purchase H. Ltd shares. The Revenue Authorities held that the managing directors were responsible for (*Wood and another v Holden*: par. 18):

the making of board resolutions and the signing or execution of documents in accordance with those resolutions. We do not consider that the mere physical acts of signing resolutions or documents suffice for actual management. Nor does the mental process which precedes the physical act. What is needed is an effective decision as to whether or not the resolution should be passed and the documents signed or executed and such decisions require some minimum level of information. The decisions must at least be informed decisions. Merely going through the motions of passing or making resolutions and signing documents does not suffice.

This judgement considered the four scenario test (Gutuza: 2012) applied in *Laerstate* regarding how decisions are made i.e. is it an act of merely approving decisions taken by another individual or is there a thought process involved prior to making decisions and signing the respective legal documents. Padia (2011: 128) noted that “where management decisions are superficial or purely administrative, this is not an indicator. It is where the true ‘head’ of decision making is situated that determines where ‘central management and control’ is vested. Again, it appears that the substance of decision making is relevant. Accordingly, it is where the primary act of decision making takes place, and not just where a procedural process is executed, that is relevant”.

3.6.5. *Wenleydale’s Settlement Trustees v Inland Revenue Commissioners*, [1996] STC (SCD) 241

3.6.5.1 The facts of the case

This case involves a scheme undertaken by the taxpayer, a resident of the United Kingdom, who wished to dispose of his shares in a company, SL Ltd, in a tax efficient manner. The scheme involved the taxpayer setting up a Trust in Ireland of which the

trustees were his solicitor, Mrs. S and a partner of a firm of solicitors in Ireland. SL Ltd was a manufacturing company which owned various properties in England; namely, land, a dwelling house and a riding centre. The taxpayer gifted his 76 per cent shareholding in SL Ltd to the Trust but wished to retain these properties. Therefore the Trust disposed of the shares in SL Ltd and subsequently re-purchased the properties from SL Ltd. The Commissioner assessed the Trust to capital gains tax in the United Kingdom as the Trust was held to be resident in the United Kingdom and not in Ireland, where it was incorporated. The Trustees appealed the Commissioner's decision as they were of the opinion that the place of effective management of the Trust was also in Ireland, the place of its incorporation. The Court held that the place of effective management was in the United Kingdom and therefore the Trust was liable for the capital gains tax.

3.6.5.2 Reasons for judgement

The facts that the Court relied on in determining the place of effective management of the Trust were the actions and decisions of the Trustees relating to this scheme that was undertaken. The taxpayer and his solicitor were responsible for planning the scheme and transactions in the United Kingdom, whilst Mrs. S, a trustee resident in Ireland, was merely responsible for signing the agreements. The Trustees were not involved in making any decisions and considering any information regarding the sale of the shares as the settlor was actively involved in ensuring that the scheme was implemented. The Court held that (at par. 250):

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

The meetings held between the trustees and the settlor were considered and it was found that, based on the evidence provided, the trustees were not “calling the shots” (*Wensleysdale's Settlement Trustees*: par. 251).

3.6.6. *Mark Higgins Rallying (a firm) v Revenue and Customs*, [2011] UKFTT 340 (TC)

3.6.6.1 The facts of the case

Roy Dixon, a resident in the Isle of Man, approached Mark Higgins, also a resident in the Isle of Man at the time, and offered to mentor and provide financial sponsorship for him as a professional rally driver. Mark Higgins excelled as a professional rally driver and started to compete internationally. Mark Higgins and Roy Dixon decided to pursue this as a business venture and entered into a partnership, with Roy Dixon being assigned the responsibility for all the legal and commercial matters of the partnership, whilst Mark Higgins would pursue his passion as a professional rally driver. Mark Higgins and his family thereafter moved to the United Kingdom where his father took over a rally school and from where he would continue to pursue his profession as a rally driver.

The partnership earned income from a source in the United Kingdom and from abroad. The profits of the partnership were split in accordance with the partnership agreement and these profits were taxed in the hands of the partners. The tax authorities in the United Kingdom sought to tax Mark Higgins on all his income, including the income from a source outside of the United Kingdom, on the basis that the partnership was tax resident in the United Kingdom and therefore Mark Higgins would be liable for tax in the United Kingdom on his share of the partnerships worldwide income. The tax authorities were of the view that the partnership was tax resident in the United Kingdom as the partnership was being managed and controlled by Mark Higgins from the United Kingdom. Mark Higgins appealed against the income tax closure notices and the Court of Appeal found in favour of Mark Higgins that the partnership was not managed and controlled in the United Kingdom and thus Mark Higgins would not be liable for tax in the United Kingdom on income that had a source outside the United Kingdom. Although this decision was in favour of the taxpayer, the factors identified by the Revenue Authorities in considering the central management and control of the company will be discussed.

3.6.6.2 Reasons for judgement

The court considered the various decisions and actions of each of the partners and the location from which these decisions were made and actions performed, in order to determine the location from which the partnership was managed and controlled. The court, however, noted that there were some decisions and actions that were less relevant as these were “not determinative of control and management” (at par. 43). These decisions and actions included amongst others, signing of contracts at partnership meetings held outside of the United Kingdom which included the partnership agreement, the partnership accounts and the various contracts entered into with third parties relating to Mark Higgin’s profession as a rally driver. The location at which the actual signing of contracts occurred was not a factor that indicated where the partnership was being managed and controlled, rather the location at which these decisions to enter into such contracts were taken were relevant.

The location of Roy Dixon was therefore relevant as Mark Higgins “would not enter into any significant commercial commitments without referring them to Mr Dixon for a decision” (at par. 63). It was concluded that Mark Higgins who was resident in the United Kingdom, was responsible for the operational activities of the partnership such as interacting with key contacts, expanding the business and training. It was Roy Dixon who from the Isle of Man was responsible for the key commercial and strategic decisions of the partnership as he would review contracts and provide his approval to Mark Higgins to enter into these contracts.

3.6.7. Summary of other relevant case law in the United Kingdom

There is other relevant case law in the United Kingdom that considers the concept, “central management and control”. A summary of the factors relied on to determine the place of central management and control in each of these cases is included in the table below.

Case	Place of registration/ incorporation	Place of day-to-day activities	Place where decisions were made	Place of Residence
<i>De Beers</i>	South Africa	South Africa	UK	UK
<i>Cesena</i>	UK	Italy	UK	UK
<i>Unit Construction</i>	East Africa	East Africa	UK	UK
<i>American Thread</i>	USA	USA	UK	UK
<i>Kootcher</i>	UK	South Africa	UK	UK
<i>NZ Shipping</i>	NZ	NZ	UK	UK
<i>Koitaki</i>	Australia	Papua	Australia	Australia
<i>Egyptian Delta</i>	UK	Egypt	Egypt	Egypt
<i>Calcutta Jute</i>	UK	India	India	India
<i>Swedish Central</i>	UK	Sweden	Sweden	UK
<i>North Australian Pastoral</i>	Northern Territory	Northern Territory	Brisbane	Northern Territory

Table 1 – Summary of cases reviewed and criteria used.

(Padia, 2005: 67)

In majority of these cases, the factor that determined the place of central management and control of the entity was the location at which the entity’s decisions were taken. However the place of central management and control was determined where the company was incorporated in the *Swedish Central* case and the location of the place of incorporation, which also coincided with the day-to-day business activities of the entity, were the determining factors of the place of central management and control in the *North Australian Pastoral* case.

The key findings from some of these cases noted by Padia (2011) are as follows:

- ***Cesena***: British courts rely on the concept, “central management and control”. This refers to the highest level of management as opposed to the day-to-day management.

- **Calcutta:** The concept is interpreted as the place where the policies are decided on as well as decisions regarding the company's manufacturing and trading activities take place. The Companies Act usually assigns this decision making responsibility to the board of directors, however delegation is possible and therefore each case would need to be considered based on the relevant facts.
- **Calcutta & De Beers:** Where the decision making activities are assigned to the board of directors, the place where the directors meet to decide on policy, finance and related matters is the place of central management and control.
- **Egyptian Delta:** "Firstly, the process of deciding on the residence of a company was one of seeing where 'it keeps house', and not of considering only the place or form of its incorporation. Secondly, and related to the first point, the real business was carried on where the central management and control were situated" (Padia, 2011: 127).

It seems there is clearly no uniform interpretation of the concept, place of "central management and control", amongst the courts. However the majority are in favour of where the decision making activities of the entity occur. This interpretation is aligned to the OECD's interpretation of the place of effective management. However South Africa's former interpretation of the same concept differed significantly as the focus is not on the decision making activities by the board of directors but rather on the implementation of the board of director's decisions by the executive directors and senior management.

3.7 Conclusion

The OECD Model Tax Convention (OECD: 2014) includes a tie-breaker clause to determine the residency of companies. The tie-breaker clause allocates the residency of companies to the country in which it has its "place of effective management". The concept is neither defined by the OECD nor uniformly interpreted by different tax authorities. The OECD's Commentary on Article 4 of the Model Tax Convention (OECD: 2014) provides guidelines as to the interpretation of the concept, however taxpayers still experience difficulties when applying these guidelines in practice.

A significant difficulty experienced is the mobility of directors and the advancement in technologies which makes distance communication more common, therefore blurring the lines of where the effective management of a company is located. The OECD has considered these concerns raised and proposed amendments for consideration (OECD: 2001). These amendments include replacing the “place of effective management” concept as a tie-breaker test with either the place of incorporation of the company or where directors or shareholders reside or the place with the strongest economic nexus. The place where the directors or shareholders reside and the place of incorporation are legal factors that can be easily manipulated.

The strongest economic nexus test may be a suitable replacement, but this would need to be defined or clarified further.

Another option was to refine the “place of effective management” concept by including more factors together with the current predominant factor (i.e. where the key commercial decisions are taken) to be considered and assigning weightings to these factors. However it is submitted that these amendments will not specifically address the problem of distance communication which occurs when directors reside in various countries and therefore the place of effective management cannot be pinpointed to a single location.

The third option was to change the approach to a hierarchal approach, however the first level in the hierarchy would be the place of effective management of the company. The refinements proposed for the option of refining the concept will be applied to this level of the hierarchy. The second level of the hierarchy was to rely on the place of incorporation, however this is open to manipulation, and the third level was the location of the strongest economic nexus, which will require further clarification or should be defined.

As a last resort, the determination of the place of effective management rests with the competent tax authorities to come to a mutual agreement. The fourth option was to include a combination of a hierarchal approach and a refinement of the “place of effective management” concept.

After consideration, the OECD proposed either refining the “place of effective management” concept as a tie-breaker clause, or adopting a hierarchal approach to determine the place of effective management of companies (OECD: 2003). Currently the guidelines suggest that the place where the key commercial and management decision making occurs is the place where the effective management of a company is located (OECD: 2014). This does not necessarily coincide with the place where the board meetings are held and attended by directors.

The refinement to the concept includes deleting the current predominant factor that the location of the place of effective management is where the key commercial and business decisions are taken. Other factors would be included for consideration and include considering whether shareholders play any role in the key commercial and business decisions of the entity as the place of effective management may be at the shareholders’ location in this instance and also considering where the decisions are actually taken as decisions may have been taken prior to board meetings at a location other than where the board meeting is held and the decision is thereafter merely ratified and rubber-stamped by the board of directors at board meetings.

The other option was to adopt a hierarchal approach where the first level was the place of effective management of the company and the refinements suggested in the first option would equally apply to adopting the place of effective management as the first level in the hierarchal option. The second level in the hierarchy was either where the economic relations are closer or where the business activities are carried on or where senior executive decisions are taken. Guidance regarding the place where economic relations are closer has been included and to determine where the business activities are primarily carried on, a functional analysis is suggested, but no guidance is provided on conducting this functional analysis. The place where senior executive decisions are taken is actually the predominant factor in the current guidance which was removed and instead proposed to be included as an option for the second level in the hierarchy. The third level is where the company derives its legal status but this factor is open to manipulation and lastly, the

tax authorities are responsible to determine the place of effective management of a company by mutual agreement should the hierarchical approach not assist to resolve the matter. It appears that these amendments still raise the concern that the tie-breaker clause may not be effective as it is open to manipulation and also more guidance and clarification is required before any of these amendments can be effected.

International case law precedence is aligned with the OECD current guidelines (i.e. where the key commercial decisions are taken) (OECD: 2014) and serves as precedence for other tax courts, including the South African tax courts (section 233 of the Constitution of the Republic of South Africa, Act 108 of 1996). The majority of the cases in the United Kingdom determine the central management and control to be at the location where the business decisions are taken. The facts of each case were considered individually but the core principle that was applied was determining what the key commercial and business decisions of the entity were, who was responsible for these decisions and where these decisions were made by the respective individuals (IN 6 version 2). There was the odd case where the determining factor for the central management and control of the entity was the place of incorporation.

In 2011, the South African tax court heard its first court case (the *Oceanic Trust* case) that addressed the interpretation of the concept, “place of effective management”, and the decision in that case was aligned to international precedence, which was where the key commercial decisions were taken. This reinforced the need for SARS to reconsider and revise its former Interpretation Note (IN6) on the place of effective management. The draft version 2 of SARS Interpretation Note (draft IN6 version 2) as well as the final revised Interpretation Note (IN6 version 2) was issued in 2015 and these new guidelines have taken into account international precedence and the outcome of the *Oceanic Trust* case, as well as the concerns identified by taxpayers and tax commentators and the clarity they are seeking from guidance of this nature.

CHAPTER 4: Recent developments in South Africa regarding the interpretation of the place of effective management

4.1 Introduction

The Act defines a company as being resident in South Africa if it is incorporated, established or formed in South Africa or has its place of effective management in South Africa (section 1 of the Act). The concept, “place of effective management”, is not defined in the Act but SARS has issued guidance to assist in the interpretation of the concept. However the former Interpretation Note (IN6) was not as useful as taxpayers had hoped it would be and there have been criticisms and concerns that were raised as the guidance was not capable of being easily applied in practice. It is submitted that SARS acknowledged these concerns and issued a Discussion Paper (SARS Legal and Policy Division: 2011) incorporating their proposed amendments for consideration.

The Discussion Paper (SARS Legal and Policy Division: 2011) acknowledged these concerns, which had also been highlighted by the OECD (OECD: 2001) and which included the increased use of distance communication in business and the mobility of directors therefore making it difficult to pinpoint the place of effective management of a company to a single location.

The OECD also suggested various amendments for consideration (OECD: 2001) and this was narrowed down to two proposed amendments, either refining the “place of effective management” concept or a combination of refining the “place of effective management” concept and adopting a hierarchal approach (OECD: 2003). The refinement of the “place of effective management” concept proposed was to delete the predominant factor of relying on the location where the key commercial and business decisions of the entity were taken and rather including a wider variety of factors to consider in an attempt to address the various difficult and challenging situations that are experienced in practice, which has made it fairly difficult to apply the predominant factor approach. The hierarchal approach adopted the place of effective management test as the first level in the hierarchy. Further input is still required regarding the second level in the hierarchy as

it included three options, one being the current predominant factor of where the key commercial and business decisions are taken, the second option was the place where the economic relations are closer and the third was where the business activities are primarily carried on (OECD: 2003). However, further clarification is still required as very limited guidance was suggested for these factors. The third level in the hierarchy was where the entity derives its legal status, however that is open to manipulation and, as a last resort, the determination of the residency is left to the tax authorities through a mutual agreement procedure. Although there are changes proposed by the OECD, it still requires clarification and further guidance. However these amendments would be a starting point at least for SARS to consider possible amendments to their guidance to be provided.

Subsequent to the SARS Discussion Paper issued in 2011, which considered a refinement to the concept “place of effective management” to align the interpretation with international norms such as the OECD and international precedence, SARS issued a draft Interpretation Note 6 (draft IN6 version 2) early in 2015. The Note addresses the criticisms raised by various parties regarding the first issue of the Interpretation Note in 2001. SARS has subsequently finalised and issued version 2 of the Interpretation Note (IN 6 version 2) in the latter part of 2015 after comments and suggestions were received from taxpayers, tax experts and other stakeholders.

The goal of this chapter is to critically analyse SARS’ proposed and implemented changes in comparison to the considerations highlighted in their Discussion Paper in 2011 and the chapter will consider whether the revised current interpretation is now more closely aligned to the OECD guidelines and international precedence. Consideration will also be given to whether SARS’ revised guidelines serve as a more effective tie-breaker test that is less likely to be open to manipulation.

4.2 Proposed changes by SARS

The former Interpretation Note (IN6) has been significantly revised and the draft (draft IN6 version 2) now includes definitions of specific terms to assist in the interpretation of the concept, “place of effective management”. The definition of resident is also included

under a paragraph dealing with the law. The general approach and relevant facts and circumstances section contained in the first issue of the Interpretation Note (IN6) have been revised and the draft issue (draft IN6 version 2) includes a general principle section and a key facts and circumstances section.

4.2.1 Definitions

Various definitions have been included in the draft Interpretation Note (draft IN6 version 2) and include definitions of board, Companies Act, company, company law, director, head office, Memorandum, OECD, rules or by-laws, section, senior management, Shareholder Agreement, tax treaty and the Act.

“Head office” is defined as “the place where the company’s senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company’s head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets” (draft IN6 version 2: 2). The latter part of the definition provides clarification for the uncertainty that may exist when the location of a company’s head office is considered. SARS makes it clear that the location of the head offices does not necessarily coincide with the place where the majority of its employees work. This is possibly in an attempt to establish that the place where the senior management may be located is not necessarily the same as the place from where the daily operations may be taking place or where the board meetings are held. The board meetings were referred to in the OECD Commentary (OECD: 2014) prior to 2008 and the reference to the location of the daily operations was included in SARS second level of the hierarchy in their first version issued of the Interpretation Note (IN6). It appears that SARS has attempted to eliminate the uncertainty that may arise in understanding the change in the interpretation of the concept, “place of effective management”, from its previous approach.

The Draft Interpretation Note (draft IN6 version 2: 2) defines “senior management” as the

level of employees of a company who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring and overseeing the execution and implementation of those strategies on a regular and on-going basis. While terminology may vary, these employees include:

- Managing Director or Chief Executive Officer;
- Financial Director or Chief Financial Officer;
- Chief Operating Officer; and
- The heads of various divisions or departments (for example, Chief Information or technology Officer, Director for Sales or Marketing).

This definition of senior management confirms that SARS has changed the interpretation of the place of effective management, away from focusing on the implementation of decisions to being responsible for making these decisions and overseeing the execution of these decisions. The examples provided establish that senior management does not necessarily mean the board of directors but it does include directors involved in the daily operations of the business, as well as specific senior individuals that may be appointed in a specific area, for example, information technology or marketing.

The terms, “head office” and “senior management”, were amongst the terms that SARS Discussion Paper (SARS Legal and Policy Division: 2011) suggested needed to be defined. Definitions for the other suggested terms, such as operational management, executive directors, non-executive directors, base of operations and passive holding companies were not provided in this draft Interpretation Note (draft IN6 version 2). SARS, however, does make reference to these terms under their key facts and circumstances section and provides guidance as to what these terms mean, through the use of examples of specific scenarios.

The references made to operational management seem adequate to provide guidance as to SARS’ interpretation of the term, but terms such as executive directors, non-executive directors and passive holding companies should be defined as the references made to

these terms does not really clarify what these terms mean. Defining the term, “base of operations”, will add very little value as SARS has not suggested this as a factor for consideration in determining the place of effective management of a company.

4.2.2 General principle

The general principle proposed to be adopted by SARS is “a company’s place of effective management is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in *substance* made” (draft IN6 version 2: 4). SARS has stated (draft IN6 version 2) that this proposed interpretation is more aligned to the OECD’s guidance provided in their Commentary to Article 4 of the Model Tax Convention (OECD:2014) as the focus has shifted away from the implementation of decisions towards the location of the key management and commercial decision making activities of the entity. SARS has also considered recent South African and United Kingdom case law. References are made to the *Oceanic Trust* case (as discussed in Chapter 2) and the *Smallwood* case (as discussed in Chapter 3).

SARS’ previous hierarchal approach has been completely removed. SARS have noted that (draft IN6 version 2: 5) where the “key management and commercial decisions affecting” a business are not being made at a single location, then the “location where those decisions are primarily or predominantly made” (emphasis added) will be the place of effective management of the company. Further guidance or a definition of the term, primarily or predominantly is not included in the draft Interpretation Note (draft IN6 version 2) however SARS has noted that there generally would not be many instances when determining a single location for the place of effective management would become problematic.

They have noted two scenarios in which complexities arise, the first scenario being when a global group operates in various locations through divisions and therefore the senior management is not based at a single location and may travel frequently and the second scenario being the advancements in technology that enable senior management to perform their duties and responsibilities without being physically present at a single

location. Despite these complexities that may arise, SARS has noted that the core principles still need to be applied. The adoption of a core principle approach is aligned to the current OECD's approach (OECD: 2014). Note, however, that the OECD is considering the possibility of adopting a hierarchal approach (OECD: 2003).

4.2.3 Key facts and circumstances

The core principles that SARS refers to in order to determine the place of effective management of a company is “where the key management and commercial decisions are regularly and predominantly made. It is not a snapshot requiring an assessment at a particular moment in time” (draft IN6 version 2: 6). The core principles to be applied include consideration of two items. The first item is “the identification of those persons in a company who actually ‘call the shots’ and exercise ‘realistic positive management’”. Otherwise stated, a company's place of effective management must be determined by ascertaining who makes the key management and commercial decisions for the conduct of the company's business as a whole” (draft IN6 version 2: 7) and the second item is the determination of “where those decisions are in *substance* actually made” (draft IN6 version 2: 7).

To assist in applying the core principles to determine the place of effective management of a company, the lengthy bulleted list of factors to be considered has been removed and specific key factors (draft IN6 version 2: 6 - 13) have been included with an explanation or example given of circumstances that may have proven to be problematic or created uncertainty in the past. A major factor to consider is the location of the head office of the company as this is usually where the senior management is located and therefore where the key commercial decisions are being made. It has been noted that it is not always that key commercial decisions are taken at board meetings, especially in cases where board meetings are not held frequently (draft IN6 version 2).

Further guidance is provided to assist in determining the place where the senior managers “primarily or predominantly” (draft IN6 version 2: 5) make the key decisions. These terms are not defined in the draft Interpretation Note, but the Oxford Advanced Learner's

Dictionary defines primarily as “mainly” (Oxford University Press, 2010: 1163) and predominantly as “mostly; mainly” (Oxford University Press, 2010: 1152). To apply this in practice, the guidance makes reference to where the senior management “normally return to following travel to other locations or meet when formulating or deciding key strategies and policies for the company as a whole” (draft IN 6 version 2: 7).

It has been acknowledged that with the use of distance communication, “the head office would normally be the location, if any, where the highest level of management (for example, the Managing Director and Financial Director) and their direct support staff are located” (draft IN6 version 2: 7). If this guidance still cannot assist in determining the place of effective management of a company as the senior management is decentralized, then the relevance of considering the head office of the company to determine the place of effective management is of little value (draft IN6 version 2). The other factors would need to be considered in further detail to determine the place of effective management of the company.

A second and important factor to consider is the board of directors delegating its authority to executive committees. In these instances, the location of these executive committee members and the location at which they make the key commercial decisions of the company will determine the place of effective management of the company (draft IN6 version 2). SARS (draft IN6 version 2) has also clarified that the delegation of authority can be done formally through a board resolution or Shareholder Agreement or informally through the usual conduct between the board and the executive committee.

The term, “board”, has been defined in the draft Interpretation Note (draft IN6 version 2) as “the board of directors (or similar body, however designated), that has the legal authority to exercise the powers and perform the functions of a company, except to the extent that Company Law or the company’s Memorandum provide otherwise” (draft IN6 version 2: 1). The board is included as a factor for consideration in determining the place of effective management of the entity. SARS has noted (draft IN6 version 2) that the location of the board meetings may coincide with the place that the key commercial

decisions of the company are made, as the board may retain the authority to govern the company in this manner. In this instance, the board meetings coincide with the head office of the company and distance communication is not a problem as the directors are generally physically present to make these decisions. SARS has expressly noted that this will not always be the case as the board may have delegated its authority and they may merely ratify the decisions taken by the individuals to whom they have delegated their authority.

There are certain factors that should be considered when assessing if the board merely rubber-stamps decisions taken by someone else or whether they are making the decisions themselves. These factors include (draft IN6 version 2: 8) “whether the directors have sufficient knowledge and information at hand, whether the directors are suitably qualified and experienced generally and in relation to the particular company, and whether the directors had reasonable time to assess the information and make the decision”. This consideration is aligned to the four scenario test applied in *Laerstate* (as discussed in Chapter 3). Certain companies may hold pre-meetings and these meetings need to be considered to determine their purpose, who attends, the location of the meeting and if any decisions are being taken, as this will definitely also impact the place of effective management of the company.

The role of the directors should also be considered. Certain directors may be actively involved in the decision making of the company whilst there may be other directors who do not get involved to such an extent in governing the company and they merely ratify decisions taken by someone else. A distinction between executive and non-executive directors was proposed in the Discussion Paper (SARS Legal and Policy Division: 2011), but it appears that SARS did not consider it important to make this distinction, possibly because SARS is of the strong opinion that no hard and fast rules can be applied, but each case and the specific facts should be considered by applying the core principles and guidance provided in their draft Interpretation Note (draft IN6 version 2). These proposed amendments are aligned to the OECD’s proposed amendments to refine the “place of effective management” concept (OECD: 2003).

Once again, SARS has emphasized that the place where board meetings may be held does not necessarily result in the place of effective management of the company. “Modernisation and global travel” (draft IN6 version 2: 9) have impacted companies’ operations and therefore there may be increased use of distance communication as well as “round robin voting” (draft IN6 version 2: 9), which results in the place where board meetings are held being less relevant in these circumstances.

There may also be instances where the company’s shareholder is ultimately responsible for making the key commercial decisions of the company. This is more common “with passive holding companies located in low tax jurisdictions” (draft IN6 version 2: 10). The term, “passive holding company”, has not been defined in the draft Interpretation Note (draft IN6 version 2). SARS has drawn a distinction between the type of decisions that are generally made by shareholders and “typically affect the existence of the company itself or the rights of the shareholders *as* shareholders, rather than the conduct of the company’s business from a management or commercial perspective” (draft IN6 version 2: 9). Examples of the decisions generally made by shareholders include “the sale of all or substantially all of the company’s assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares” (draft IN6 version 2: 9).

Another distinction that has been made is the involvement of the shareholder with the company. The shareholder can guide or influence the senior management of the company, but if the shareholder usurps the decision-making authority of the company’s senior management, then the location of the shareholder and where his or her decisions are being made will be relevant in determining the place of effective management of the company. Shareholders may also set limits on the authority of the senior management of the company and the facts regarding these limits of authority need to be carefully considered to determine who is in fact making the key commercial decisions of the company. This guidance is aligned to the proposed guidance and amendments of the OECD to refine the “place of effective management” concept (OECD: 2003).

SARS has also provided an important distinction in the type of management decisions. “Operational management generally concerns the oversight of the day-to-day business operations and activities of a company” (draft IN6 version 2: 11) and these are generally not relevant to determine the place of effective management of a company whereas “key management and commercial decisions are concerned with broader strategic and policy decisions and tend to be made by members of the senior management team” (draft IN6 version 2: 11).

The 2011 SARS Discussion Paper (SARS Legal and Policy Division: 2011) proposed to delete the legal factors such as the “company’s place of incorporation, formation or establishment, the location of its registered office and the location of its public officer” (draft IN6 version 2: 12) as this factor has no relevance in determining the place of effective management of a company. The draft Interpretation Note (draft IN6 version 2) has removed the previous list of factors for consideration that was included in the previous Interpretation Note (IN6) and it expressly states that these legal factors have no relevance in determining the place of effective management of a company. This amendment should therefore eliminate any confusion or uncertainty that previously existed when deciding whether these legal factors play a role in determining the effective management of a company.

The term, “economic nexus” (draft IN6 version 2: 12) was included in SARS’ previous hierarchal approach to determine the place of effective management of a company. The place with the strongest economic nexus was the last approach to use if the previous two approaches did not assist to determine the place of effective management of the company. This draft Interpretation Note (draft IN6 version 2) states that this factor may be considered in certain circumstances where the consideration of other factors does not yield a result for the place of effective management of the company. SARS has however not provided any guidance in this regard.

Multinational companies may centralize their support services such as “data management, human resources, customer support or accounting” (draft IN6 version 2: 13) but SARS has clarified that these services generally have little relevance in determining the place of effective management of a company.

It is submitted that, based on the proposals for consideration suggested by SARS in their Discussion Paper (SARS Legal and Policy Division: 2011), the majority of these proposals have been included in the draft Interpretation Note (draft IN6 version 2) and as such this draft Interpretation Note appears to provide more guidance than its first issue and addresses the areas of concern that were raised previously. In comparison to the OECD proposals contained in the OECD’S 2003 Discussion Draft (OECD: 2003), SARS has opted not to adopt a hierarchal approach. It is submitted that SARS current approach of having a core principle and relevant facts and circumstances for consideration to determine the effective management of a company, as opposed to its previous hierarchal approach and the OECD’s proposed hierarchal approach, is a better approach to adopt. This approach ensures that the place of effective management test retains its purpose as a substance over form test and a test that is not easily open to manipulation and can be applied more objectively than its previous guidance.

4.3 SARS revised Interpretation Note 6 – version 2, 2015

In the latter part of 2015 SARS issued their final revised version 2 of the Interpretation Note dealing with the place of effective management (IN6 version 2). This guidance is effective for years of assessment commencing on or after 3 November 2015. SARS does not anticipate that the changes to these guidelines will impact companies that have used the previous guidance (IN6). However, it is submitted that this may not necessarily be true as the interpretation has changed significantly from determining the place of effective management as the location where the key commercial and strategic decisions are implemented to the location where these decisions are being made.

The final version 2 of the Interpretation Note (IN6 version 2) has no significant changes from the draft version (draft IN6 version 2) that was issued for public comments and

suggestions earlier in 2015. There are minor additions to the final Interpretation Note to provide clarity and further considerations on the key facts and circumstances section, namely, the board and support functions.

The considerations regarding the board have been expanded by including a statement for consideration that if the key management and commercial decisions are in fact taken at board meetings, this location might not be the location where these directors are usually tax resident (IN6 version 2). Further considerations are “to examine how a company’s board handled a crisis or various crises, expected or unexpected, that arose during the relevant period” (IN 6 version 2: 8), as well as quorums and casting votes, where applicable. The distinction is also made between executive directors who are normally involved in the decision making activities of the company and non-executive directors who are not. Although the title of the director may be a good indication of whether the director is involved in the decision making activities of the entity, the actual roles of the director should be identified to confirm that the director is involved in the decision making activities of the entity.

Clarification is provided that the location where a company’s accounting records are retained is generally not indicative of where the key management decisions are taken and is actually irrelevant in determining the place of effective management.

4.4 Conclusion

SARS former Interpretation Note 6 (IN6) on the “place of effective management” of companies has been criticized for not providing the certainty and clarity that is required in applying this interpretation of the concept in practice. The interpretation of the concept provided in SARS’ former guidelines had also deviated from the interpretation by the OECD (OECD: 2014) and international precedence, such as case law in the United Kingdom. This created a serious need for SARS to reconsider their interpretation of the concept and revise their Interpretation Note accordingly. The draft version 2 of the Interpretation Note (draft IN6 version 2) was issued in early 2015 for consideration and feedback with suggestions and comments to SARS were invited. Subsequently, the final

revised Interpretation Note (IN6 version 2) was issued in November 2015 with minor additions made to the final version.

The Interpretation Note (IN6 version 2) has been revised to align the interpretation of the “place of effective management” concept to the OECD (OECD: 2014) and international precedence, as well as the *Oceanic Trust* case in South Africa which interprets the place of effective management as being located where the key management and commercial decision making of the company occurs. SARS has removed its hierarchal approach and adopted a core principle approach which is the current approach of the OECD (OECD: 2014). However, the proposals of the OECD include a hierarchal approach for consideration which is no longer congruent with SARS revised approach.

If there are instances when the place of effective management cannot be pinpointed to a single location with certainty due to an increased use of distance communication and mobility of directors, etc, SARS has stated that the place of effective management is at the location where the key management and commercial decisions are “primarily and predominantly” (IN6 version 2: 6) located. This approach is evidence that SARS strongly believes that the place of effective management is located where the key commercial and decision making of a company occurs and there is no alternative interpretation of the concept that will assist in determining the place of effective management of companies if there is difficulty in identifying the location where the key commercial and decision making occurs.

The amendments also include definitions of key terms that will assist in the understanding and application of the concept in practice. Certain terms have not been defined but are included in a “key facts and circumstances” (IN 6 version 2: 6) section which specifically addresses the concerns and uncertainty raised by taxpayers previously. Specific terms such as “senior management” and “head office” (IN 6 version 2: 2) have been defined to provide clarity that the focus is not limited to the board of directors and the location of the board meetings but the facts to identify is the persons responsible for making the key commercial and business decisions of the entity and the location of this

activity (OECD: 2015). The persons responsible may be the board of directors, directors involved in the day-to-day management of the company, senior management, executive committees to whom the board has delegated their powers, or even the shareholders. The facts of each case would need to be assessed individually.

SARS has also clarified that the legal factors such as the place of incorporation or the location of the public officer included in the previous version of the Interpretation Note (IN6) is not relevant in determining the place of effective management of the company. The term “economic nexus” which was included in SARS previous hierarchal approach (IN6) has now been merely referred to as a factor to be considered (IN 6 version 2), however no guidance or clarification regarding the term has been provided.

It is submitted that the revised Interpretation Note (IN 6 version 2) serves its purpose as a substance over form test which is not easily open to manipulation. Further it provides adequate guidance and clarity, as it is now aligned to the OECD’s interpretation (OECD: 2014), international precedence and the *Oceanic Trust* case and it eliminates confusion arising when applying this guidance in practice.

CHAPTER 5: Conclusion

5.1 Context

The “place of effective management” concept is used as a tie-breaker clause in double tax treaties and although South Africa is not a member of the OECD, it has adopted this tie-breaker clause in all its double tax treaties. Therefore the concept needs to have a common interpretation across all tax authorities and be understood, to prevent confusion for taxpayers and result in tax authorities being able to reach a mutual agreement on the residency of an entity that may appear to be dual resident, or in relation to income subject to double taxation.

Many countries, including South Africa, have incorporated the “place of effective management” concept in their tax legislation. The South African tax legislation defines a person other than a natural person as a resident if the entity is established, incorporated or formed in South Africa or if its place of effective management is located in South Africa (section 1 of the Act). The definition incorporates both legal factors and a subjective test of effective management which is open to interpretation. There are guidelines that have previously been issued by SARS (IN6) to assist in the interpretation of the “place of effective management” concept, but it has been found that this guidance does not provide the clarity and certainty expected and that it is inconsistent with the interpretation and guidance of the OECD (OECD: 2014) and international precedence. Due to the increased use of distance communication and the mobility of directors, the difficulty in pinpointing the place of effective management of a company to a single location has increased. Therefore there was a need to clarify the “place of effective management” concept and ensure that it retains its purpose as a substance over form test that is not easily open to manipulation.

5.2 Goals of the research

The goal of this research was to analyse the various South African guidelines and court decisions, as well as international guidance by the OECD Council and United Kingdom case law in relation to the interpretation of the concept “place of effective management”,

which is used as a tie-breaker rule in double tax agreements to determine the residency of a person other than a natural person. The purpose was to consider whether the changes proposed by SARS and the OECD clarify the concept “place of effective management” and align domestic and international guidance more closely.

This was achieved by:

- Reviewing, in Chapters 2 and 3, the former domestic guidance issued by SARS and comparing it with the current OECD guidance available;
- Also in Chapters 2 and 3, reviewing South African and United Kingdom case law to determine whether these judgements are closely aligned with each other, as well as with the guidance provided by SARS and the OECD; and
- Considering, in Chapter 4, the changes proposed and implemented by SARS and the OECD to determine whether these changes clarify the concept “place of effective management” and whether these changes will result in the domestic and international guidance being more closely aligned. This includes a consideration of SARS’ revised Interpretation Note (IN6 version 2) issued in 2015.

5.3 Important findings from South African guidance

With the introduction of the definition of a resident in the South African tax legislation, SARS had previously issued an Interpretation Note 6 (IN6) to clarify the “place of effective management” concept. SARS’ focus in the former Interpretation Note (IN6) was on the executive directors and senior management of a company and the implementation of strategic and commercial decisions taken by the board of directors. SARS adopted a hierarchal approach to determine the place of effective management of a company and the first tier of the approach was to determine if the implementation of the strategic and commercial decisions are conducted at a single location. If a single location can be determined, this location is the place of effective management. However if the executive directors and senior management’s activities are conducted from different locations due to the use of distance communication or the mobility of directors, it was suggested that the place of effective management is where the daily activities are conducted. In the last level of the hierarchy, if the daily activities are conducted from

various locations then the place of effective management is the place with the “strongest economic nexus” (IN6: 4). To assist in the application of SARS’ hierarchal approach, factors were suggested for consideration, however, it was noted that each case should be considered individually on its specific facts and circumstances.

The shortcomings in the guidance provided by SARS in their former Interpretation Note (IN6) included the use of inconsistent terminology and factors suggested for consideration that were in conflict with the hierarchal approach. This resulted in confusion and uncertainty, which was exacerbated as the SARS guidance was also in conflict with the OECD guidelines (OECD: 2014) and international precedence. The international precedence and OECD guidelines interpret the place of effective management as the location at which the strategic and commercial decisions are taken by the senior management of the company, whereas SARS focused on the implementation of such decisions. Other problems included uncertainty regarding the interpretation of the strongest “economic nexus” concept or the meaning of the implementation of decisions, there was no guidance regarding passive or intermediate holding companies and no guidance as to the relevance of some of the factors suggested that appear to be irrelevant, or clarity on how the consideration of these factors should be weighted or whether the consideration should be quantitative or qualitative.

In light of these problems, SARS considered revising their Interpretation Note (IN6) and suggested that the interpretation which focuses on the implementation of decisions would be revised to focus on the strategic and commercial decision making activities of the company. A draft Interpretation Note (draft IN 6 version 2) was issued in early 2015 for public comment and suggestions and this was finalised and issued as version 2 of the Interpretation Note in November 2015 (IN 6 version 2).

In 2011, the South African tax courts heard the first case, the *Oceanic Trust* case, regarding the interpretation of the “place of effective management” concept. Due to a lack of facts, the court did not rule on this matter, but the key features to be considered to determine the residency of the Trust involved in the case were discussed. It was noted in

the analysis of this case that the South African court's interpretation contradicted the former SARS Interpretation Note (IN 6) and was aligned to the OECD's interpretation (OECD: 2014) and international precedence, such as case law in the United Kingdom, as well as the now revised Interpretation Note of SARS (IN 6 version 2).

5.4 Important findings from international precedence

The concept, "place of effective management", is incorporated in the OECD Model Tax Convention (OECD: 2014) as a tie-breaker clause to determine the residency of dual resident companies or companies that may be subject to double taxation on their income due to the source of income arising in a country other than its country of residency. The Commentary to Article 4 of the Model Tax Convention (OECD: 2014) provides specific guidance that the place of effective management of a company is based at the location at which the key commercial and strategic decisions of the company are taken. The previous reference made prior to 2008 to the location of board meetings has been deleted as this is not a determining factor to be considered in locating the place of effective management of companies (OECD: 2014).

Difficulty has been experienced in locating the place of effective management of companies due to the more frequent use of distance communication and the mobility of directors (OECD: 2001). The OECD had considered (OECD: 2001) the adequacy of the place of effective management as a tie-breaker clause and contemplated either replacing the tie-breaker clause, refining the "place of effective management" concept, including a hierarchal approach to determining the place of effective management or combining a hierarchal approach with a refinement of the "place of effective management" concept.

After various considerations from stakeholders and taxpayers, the OECD (OECD: 2003) suggested a refinement of the "place of effective management" concept and consideration of a hierarchal approach. The refinement proposes amendments to the commentary that clarifies the "place of effective management" concept as being at the location where the key commercial and strategic decisions of the company are being taken. These decisions may be taken by any level of management and in some cases, by shareholders of the

company, depending on the facts and circumstances of each case. The first level of the hierarchy proposed as a tie-breaker clause was the location of the place of effective management of a company. If this location was not certain, then there were three options under consideration, either the location to which the company's economic relations were closer, the location of the primary business activities or the location at which the senior executive decisions were taken. If this location could not be ascertained, then the location from which the company derived its legal status would be relevant and, as a last resort, the tax authorities of the countries involved would be responsible to determine the residency of the company.

It is submitted that the hierarchal approach suggested is a less favourable option as it does not provide the necessary clarity and it leads to further uncertainty with the introduction of other subjective tests in the hierarchy. It also defeats the purpose of a substance over form test. The hierarchal approach has been abandoned by South Africa in their current guidance (IN 6 version 2) for these same reasons. The proposed refinement in the OECD Discussion Draft (OECD: 2003) to the "place of effective management" concept was more aligned to international precedence such as the case law in the United Kingdom.

There is case law on the "central management and control" concept, which is similar to the "place of effective management" concept, and is interpreted as "the place where the superior policy and strategic decisions are made" (van der Merwe, 2002: 92). The proposed refinements in the OECD Discussion Draft (OECD: 2003) to the "place of effective management" concept are aligned to this case law. The activities that should be considered are not confined to any specific activities at a particular level of management, but rather each case should be considered individually as no particular test can be easily applied to each and every case.

The important considerations are to determine what constitutes the key commercial decisions of the company, who is responsible for these decisions and finally to determine the location at which these individuals take these decisions. The various cases (*HRMC v Smallwood and Anor*; *Laerstate*; *Wood and Holden v another*; *Wensleysdales*) do not,

however, provide the certainty required when the location cannot be determined with certainty due to the use of distance communication and the mobility of directors. Therefore there is still a need for the OECD to confirm the amendments to their Commentary on Article 4 of the Model Tax Convention (OECD: 2014) to provide clarity on the interpretation of the “place of effective management” concept.

5.5 Amendments to the South African guidance and conclusion

SARS had issued a revised draft of its Interpretation Note (draft IN 6 version 2) on the place of effective management which has been subsequently issued as version 2 of the Interpretation Note 6 (IN 6 version 2) and replaces the previous guidance (IN 6). This revised Interpretation Note aims to clarify the interpretation of the “place of effective management” concept and eliminate the uncertainty and difficulty experienced in applying the concept to companies.

The amendments include the introduction of key definitions to assist in an understanding of key concepts in the interpretation of the “place of effective management” concept. SARS has removed the hierarchal approach contained in the previous Interpretation Note (IN 6) and has now included a core principle to determine the place of effective management of companies. This core principle is that the place of effective management is located at the place where the key management and commercial decisions of the company are taken. SARS has noted that there would be a few instances in which the location may not easily be pinpointed to a single location and these would include circumstances in which distance communication is used frequently by the management of the company as well as the mobility of directors. However SARS maintains that the core principle should still be applied and the location at which the key management and commercial decisions are primarily and predominantly taken is the location of the place of effective management of the company.

The list of factors to be considered in each case has also been removed and replaced with an explanation of various scenarios which have been areas that have been identified

previously as problems creating uncertainty and difficulty in applying the “place of effective management” concept.

It is submitted that these amendments provide the clarity and certainty expected from guidance issued by SARS. These amendments are also aligned to the current OECD guidance and international precedence as well as the recent *Oceanic Trust* case that was heard in the South African tax courts. The amended guidance will therefore serve as a more effective tie-breaker rule and a test of substance over form.

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