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Legal & Policy Division
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BY E-MAIL: policycomments@sars.gov.za

Dear Sir / Madam

CALL FOR COMMENT: DRAFT INTERPRETATION NOTE NO. 6 (PLACE OF EFFECTIVE MANAGEMENT)

We refer to the call for comment on the above-mentioned document. Set out below please find the SAICA National Tax Committee’s submission comments regarding the Draft Interpretation Note No. 6 (Place of Effective Management) ("IN6").

We heartily welcome and endorse the revised approach, which brings the South African interpretation closer to the international norm. South Africa is too small an economy in the world to be out of step with the general consensus view, including the views of our main treaty partners (who are mainly OECD members). It also reduces the prospect of having to resort to a mutual agreement procedure; not to mention reducing the likelihood of litigation in the South African courts.

We would like to recommend that IN6 also provides guidance on the interpretation of the term “effective management” when dealing with a treaty partner. It is trite that when domestic legislation is in contradiction to a provision in a Double Taxation Agreement (“DTA”), the DTA overrides domestic legislation. The argument can therefore be made that when interpreting the term “effective management” in the context of a DTA, the definition proposed by the OECD Commentary on the Model Tax Treaty should prevail. However the application of the tiebreaker rule in the Model Tax Treaty can be problematic for South African companies operating in other African countries for the reasons outlined below.

We support the statement made on page 11 that “to the extent possible, the revisions should seek to relieve needless anxiety over situation involving foreign operating subsidiaries with bona fide foreign operations and “on the ground” top level managers responsible for the high level day-to-day running of those operations.” However, it is submitted that the proposal to shift the focus from the place where strategic decisions are executed and implemented to the place where decision making in substance takes place to determine effective management will
in fact increase the anxiety in the context of Southern Africa. In relation to foreign subsidiaries in Africa, it is often very difficult and costly to appoint or relocate the appropriate level of management. The problem may best be illustrated by way of an example:

a) Say a division of a South African holding company incorporates companies in Swaziland, Lesotho, Mozambique and Malawi to sell its products to customers in these countries and to provide vital after sales support and parts to the customers located in these countries. These companies are established as subsidiaries of the South African holding company. The establishment of these companies is driven exclusively by commercial considerations and there is no tax avoidance motive. Each company rents or buys premises from which it conducts its operations, staffed by sales personnel, finance and administrative personnel, a parts manager and workshop staff. In addition, two managers at senior level (namely a general manager and a project manager) are appointed in each company to oversee its business operations and reside in each of these territories. These companies are therefore “foreign operating subsidiaries with bona fide foreign operations”.

b) To establish the most efficient management structure and overcome the problem caused by a shortage of suitably trained and experienced senior management, the holding company establishes a regional management team that is dedicated to managing the operations of the division in these three countries. The team consists of a chief operating officer, a chief finance executive, chief operations executive, a human resources executive, a marketing executive and a risk executive. While the members of this team visit the territories on a regular basis, they are based mainly in South Africa. The holding company charges the three subsidiaries an arm’s length fee for the services rendered by the South African regional management team.

c) Each of the operations in Africa is therefore arguably managed jointly by senior managers of the local subsidiary in the country of incorporation and by the regional management team in South Africa.

d) It is submitted that the determination of the place of effective management in cases such as these is going to give rise to practical difficulties if the policy and strategic decision making role of the regional management team employed by the South African holding company must be taken into account in determining the place of effective management of the foreign subsidiary. It will arguably entail a determination of which managers comprise “senior management”, an analysis of the functions performed by each senior manager involved, taking into account the relevant time spent by the regional management team in relation to each of the four foreign subsidiaries, a classification of these activities between top and operational levels of management and then a judgment call as to where the “top level of management is primarily or predominantly based”.
Despite the fact that the foreign subsidiaries have well established foreign operations and have been incorporated in each respective country for commercial reasons, it could turn out that these companies are effectively managed in South Africa and therefore South African residents.

Even if this is the case, it is submitted that this will have no impact on the tax collected in South Africa provided the regional management team is compensated for their efforts on an arm’s length basis. The operations in these countries will clearly constitute a permanent establishment as defined and the income from sales and after sale support and services will be arguably be attributable to the permanent establishment and the resultant profits will be taxed in the African country, i.e. outside South Africa. The management fees for the regional management team will be taxable in South Africa.

However, each foreign subsidiary will have to register for tax both in South Africa and its company of incorporation. It will have to complete two tax returns (ignoring provisional tax returns STC and dividend withholding tax issues) and track its foreign tax credits.

The net effect is thus significantly increased administrative burden with no additional taxes coming into the South Africa tax net.

In a Divisional group structure, the local management in a foreign subsidiary may not be sufficiently senior to be regarded as part of the top management of the division. However, they may be sufficiently senior to make the day to day management decisions of the local subsidiary taking into account the nature and extent of the business activities carried on in the foreign country. In this case, one option would be to ignore the strategic management services performed by the South African holding company and only take into account the functions performed by local management in determining the place of effective management of the company. It could also be argued that since the African subsidiary is paying an arm’s length fee for management services provided from South Africa, it has effectively outsourced its senior management function and that factor alone should not be given so much weight as to make the African subsidiary a resident of South Africa.

It is recommended that the revised IN6 considers the unique circumstances associated with trading in Africa. In the context of Africa, it may very well be that the test for residence should take into account where the economic nexus is strongest. It is also submitted that in the context of Africa, the economic nexus test should be the primary consideration in the tie-breaker clause in double taxation agreements.

This option is mentioned as an alternative to determining residence in the OECD’s Technical Advisory Group (TAG) issued a draft discussion paper, entitled *The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie Breaker Rule*: 
"The economic connection to a State may be characterised by the extent that land, labour, capital and enterprise (the factors of production) are used by the company in deriving its profits. Using those characteristics the tie-breaker would serve to determine to which State, the company has its strongest ties and to deem the company to be a resident solely of that State. While on the surface it may appear that such an option is more aligned to source taxation rationale, it also may have some links to the underlying rationale for residence taxation. It could be argued that if the State provides certain facilities and infrastructure for its residents, those who benefit most from such facilities and infrastructure ought to contribute to the State via residence-based taxes. So if a company uses the legal infrastructure, consumes or uses the facilities etc. in that State, there is a case that it ought to be treated as a resident. If it does so in more than one State, then a tie-breaker rule based on economic nexus would require a determination (as with individuals) of where its ties/consumption are stronger. However, it could also be argued that the use by a company of the facilities and infrastructure of a State is a rationale that supports source, rather than residence, taxation. Nevertheless, the concept of economic nexus could still be used as a tie-breaker even if it is not used as a basis for residence taxation. It should be noted that such a concept being used in a residence tie-breaker is not unprecedented. For example, the individual tie-breaker uses "centre of vital interests" as a determining factor in deeming residence. It may be that this option warrants further consideration on the appropriateness of such a test to confer residence. If so, the consideration should be given as to what characterises economic connection to a State. Consideration should also be given to whether such a test may be overly difficult to apply as it could involve subjective comparisons. It also may discriminate against multinational enterprises resident in small countries."

It seems from the discussion document that the focus in the revised IN6 will move from the place where strategic decisions are executed and implemented to the place where decision making in substance takes place. This could arguably have the effect that companies that were previously not considered to be residents of South Africa based on the current IN6, become residents in terms of the revised IN6 and vice versa. The revised IN6 should address the tax consequences of a company becoming a resident or ceasing to be a resident purely as a result of an interpretation change by SARS.

On page 12 the example of a manufacturing company with a head office in Johannesburg and a main manufacturing plant in Botswana is discussed. It is requested that this example be expanded to also include a group situation and guidance be provided in circumstances where the senior management of the group is employed by a holding company, whilst the operational functions/manufacturing is performed by subsidiary companies located in various jurisdictions. Guidance should be provided in respect of the place of effective management of the operating/manufacturing subsidiaries, where the management of the subsidiaries is required to report to the higher level of management of the holding company or where the management of the subsidiaries is required to adhere to the group strategy as formulated by the holding company.

On page 13 the discussion document advises that a “refinement of the distinctions between various levels of management” is to be included in the factors that are to be added to the relevant facts and circumstances in the current guideline. In this regard, we request that guidance be provided, not only in respect of companies operating on a divisional basis, but also in respect of group companies where the management of the operational companies report to the higher level of management of the holding company.
We applaud the intention to attempt to define the basic terms used throughout IN6. It is however submitted that the meaning of these terms may differ from company to company.

Additional terms that should be defined include:

a) Day-to-day operational decisions
b) Junior management
c) Middle management
d) Top management
e) Administrative functions
f) Support functions
g) First, second and third levels of management
h) Key management and commercial decisions
i) High level decisions
j) Policy and strategic decisions

The discussion document states that “…it would be clarified that the primary emphasis is upon those “top” personnel who “call the shots” and exercise “realistic positive management.” In general, these individuals would be the senior officers or executives who are responsible for:

a) 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
b) ensuring that those strategies and policies are carried out.

Please find attached as Annexure A, a summary of the first four results of a Google search on levels of management. All four searches agree that “top level” management are responsible for inter alia the functions mentioned above, i.e. develop goals, strategic plans, and policies for the company, as well as make many decisions on the direction of the business. All four searches indicate that these functions are undertaken by the Board of directors. It would therefore seem that there is a contradiction in the discussion document: the board-centric approach is rejected, but the place of effective management will be determined by the actions of the Board.

In terms of the King III Report on Governance 2009, the role of the Board is separate from Management in that the Board is responsible for the strategic direction and control of the company and requires Management to execute its strategic decisions. For the avoidance of confusion, we therefore suggest that references to the Board as the “first level of management” should not be included in the revised IN6.
We further noted that it is not clear from the IN6 whether the definition of ‘resident’ in section 1 of the Act is to remain as is. Will the first part- “incorporated, established or formed in the Republic” remain in the Act?

We also noted that the list of relevant facts and circumstances in 3.4 of the existing Interpretation Note should not be reproduced in this form. It is a confusing list. It should be redesigned similar to the format for the ‘tie-breaker’ tests in the OECD Model. For example there must be a starting point- e.g. where top level management carry out effective management, if they do not effectively manage where the next level manage etc. This then leads to the following two initial inquiries:

a) Who are top management and  
b) Do they effectively manage

If the answer is negative then

a) Who is the next level (or maybe a level above e.g. shareholders)  
b) Do they effectively manage

It is submitted then that the list supports factors indicative of where that takes place.

Furthermore, we noted that unfortunately, despite putting in significant effort in introducing and leading up to the conclusions of what has to be and will be done, the discussion paper is somewhat short on detail in some of the key areas contained in 8.2. Draft definitions would have been helpful. In fact the draft re-write of IN6 would have been helpful as an annexure.

We do note that in 8.3 of the IN6 on the 3rd bullet of additional factors

“The identification of various factors that will generally be given little weight, for example, the place where administrative activities, such as the opening of a bank account, take place.”

This bullet point should be deleted. It is only one of many factors not to be given any weight and it would be confusing to mention just one. It is far better to only give the positive test.

We do note the emphasis on the mobility of management given modern technology and travel capabilities. And we also do observe, however, that the extent of the mobility and ability to manage at distance is likely to be more evident and pressing in, say, a European context where distances between major economic hubs and financial centres are quite short, as opposed to the South African situation where our geographic distance still makes highly mobile management less convenient. We still believe that, in the vast majority of cases, it is not difficult to identify where the senior management makes its decisions; and they are likely to do so consistently at the same place. It is really only at the margins that one finds effective management being somewhere other than where one expects it to be.
Moreover, it may well be that in a large corporation the board of directors is not responsible for effective management. But in mid-size companies (which predominate in number, and in South Africa are the norm rather than the exception, even when listed), and even in private operating subsidiaries of listed holding companies, the whole or the majority of the board of directors will usually be heavily involved in executive management anyway. Thus the role of the board should not lightly be ignored.

It is interesting to note the shift in the UK tax decisions, such as Laerstate where there appears to have been a shift away from equating central management and control with formal board meetings, but rather they looked at where central management and control actually abides - in this case where Mr Bock made his decisions. This case also follows on another series of tax cases in the UK, which was not mentioned in the discussion paper, being the cases of Wood and Holden, where the various courts did emphasise the word "actually" in the expression "central management and control actually abides", and, in each of the hearings as the appeals were heard by the different courts, those courts tended to say that there was no real difference between the concepts of central management and control and effective management. (We note the distinction set out in footnote 29, but that distinction cannot apply in South Africa where the expression "effective management" is used in our domestic law as well as in our treaties.)

It is all very well criticising the so-called board-centric approach in Anglo-American countries, but sight should be lost of the fact that South Africa is a former British Colony and is a member of the Commonwealth and we do operate under, what is essentially, an English court system, and our courts routinely look at UK and Commonwealth precedent, as opposed to Continental precedent. It would not avail of the SARS to put out an interpretation note, as it did with IN6, which encourages litigation and the opportunity for our courts to look at UK authority and adopt a board-centric approach.

Consequently we do think that the revised IN6 should not underestimate or under-emphasise the role of the board of directors in a South African context.

Nevertheless, we do accept that effective management means where the senior executives make their decisions. What we are saying is that it should be recognised that, even in operating companies (at least in the South African context) in many cases this is also likely to be where the board meets.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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The South African Institute of Chartered Accountants