Dear Sir/Madam,

SUBMISSION: DRAFT INTERPRETATION NOTE 6 - PLACE OF EFFECTIVE MANAGEMENT (COMPANIES)

1. Please find the SAICA National Tax Committee’s response to the request for comments on issue 6 of the draft interpretation note on the place of effective management (PoEM) as contained in the definition of "resident" in section 1(1) of the Income Tax Act 58 of 1962.

2. We welcome this Draft IN and consider it a considerable improvement over the existing IN which SARS should be commended on.

3. However there remain a few matters which we require clarity on or further guidance as set out below in our comments.

COMMENTS

OECD & International law alignment

4. SARS’ interpretation of the phrase PoEM, was generally different to international guidelines (including the Organisation for Economic Co-operation and Development (OECD) Model Commentary), this resulted in uncertainty as to which of the tests for POEM the SA courts will ultimately adopt when deciding on a matter brought before it.

5. The shift in SARS’ interpretation on PoEM, where the interpretation is now consistent with the OECD Model Commentary, is welcomed by taxpayers and tax practitioners alike, as it will remove some of the uncertainty that currently exists.
6. Despite the fact that there is not a uniform and concise definition in use internationally, we agree that the OECD Model Commentary (which explains the terms of the OECD Model Tax Convention), which have been formulated through extensive and broad consultation, does carry some weight within a South African context, given that South Africa’s double tax agreements (DTA) are primarily based on the OECD Model Tax Convention.

7. In terms of draft IN6, substance over form will prevail and will require the identification of those persons in a company who actually “call the shots” and who exercise “realistic positive management”. In other words, a company’s PoEM must be determined by ascertaining who makes the key management and commercial decisions in respect of the company’s business as a whole. It then needs to be determined where these decisions are substantively made.

8. This is consistent with the OECD’s commentary on PoEM.

9. It is clear from the wording of the draft IN6 that there is greater emphasis placed on the need for a company to demonstrate that it has substance to its presence in any jurisdiction. Without such substance, the test for residency will not be satisfied and SARS extends an invitation in draft IN6 to companies to discuss the facts of each case.

10. There is however a concern that whilst there seems to be an attempt to align the SARS interpretation with the international interpretation, SARS’s views, internally, has not shifted and the original interpretation remains.

**Holding companies**

11. Additional guidance is sought insofar as the PoEM of holding companies is concerned. As these companies do not operate they do not require regular and ongoing management.

12. The key decisions that need to be made by management are infrequent and the period between such decisions may actually span several years, considering that the key decisions would likely be limited to the initial acquisition and disposal of the investments.

13. This creates particular difficulties, particularly insofar as the timing of a change in the PoEM is concerned (see comments on effective date below).

14. We would therefore request SARS to provide specific guidance as to how it will interpret the PoEM in such circumstances. Some guidance may be sought from foreign cases in this regard. In particular, the case of *Wood v Holden* [2006] EWCA Civ 26 provides useful guidance.
Challenges with subsidiaries into Africa

15. While we welcome the decision to align the interpretation of PoEM to that of the OECD, we submit that this interpretation does not recognise the unique challenges of investing in Africa.

16. Following the discussion paper and our comments raised thereto, the section 1 definition of “resident” in relation to persons other than natural persons was amended for years of assessment commencing on/after 1 January 2013 to exclude the PoEM trigger in relation to controlled foreign companies in high tax jurisdictions with foreign business establishments.

17. This amendment resolved many of the practical problems set out below. Unfortunately the amended was deleted before it could take effect.

18. The current draft IN states that SARS does not anticipate that the application of this Note, will result in many, if any, companies previously held to have their PoEM outside South Africa now being held to have it in South Africa, and vice versa.

19. We respectfully disagree.

20. 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 result in many companies in Africa held via South Africa becoming resident in South Africa.

21. In relation to foreign subsidiaries in Africa, it is often very difficult and costly to appoint or relocate the appropriate level of management. While senior managers may be employed in territory to execute and implement key decision, these decisions may be made by a management team consisting of in-territory senior managers as well as SA based senior managers and directors.

22. The problem may best be illustrated by way of an example:

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.

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, a 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.

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.

23. 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.

24. It is submitted that in this instance 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.

25. 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 and dividend tax returns) and track its foreign tax credits.

26. The net effect is thus significantly increased administrative burden with no additional taxes coming into the South Africa tax net. In addition, SARS already has access to all relevant information as these companies are more often than not, controlled foreign companies of which the IT10B’s and annual financial statements are submitted to SARS on an annual basis.

27. The draft IN acknowledges the difficulties that can arise in determining the PoEM of entities that are part of a multi-national group managed according to divisions. 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 “calling the shots” but are nonetheless senior managers executing and implementing key decisions.

28. Multinational companies in many instances implement policies that will require a foreign head office to approve or decide on certain key decisions such as:
   - Incurring CAPEX in excess of a specified threshold or
   - Acquiring a new business venture.

29. These types of governance policies should not be sufficient to move the PoEM from a one jurisdiction to another.

30. It is submitted that the focus should be on the purpose for which certain processes are put in place. If the purpose is to manage an entity from a foreign jurisdiction, then the PoEM should be where these types of transactions are approved. However, if the reason for not duplicating a specific function in multiple countries is because it is commercially not sustainable then, by adding the administrative burden in respect of compliance (especially in high tax jurisdictions) does not add value to any party involved.

31. It is recommended that the revised Draft 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.

32. Though a legislative matter, if the revised interpretation is adopted, consideration should be given to reintroducing the amendment to the definition of resident discussed in paragraph 2 above. It is South Africa’s policy to be the gateway into Africa but adopting principles and practices that were designed for developed nations without modification may hinder the achievement of this goal.

Effective date

33. As noted above the change in the approach by SARS in determining PoEM by adopting the OECD view is welcomed. However, with any change, it is imperative that the change is done from a given point in time, especially if it is a retrospective change that may affect historical matters.

34. However given the historical SARS interpretation, where an effective date is not set this may again lead to uncertainty as to which PoEM test SA courts will ultimately adopt when deciding on a matter brought before it for a particular year of assessment.
35. Further, where the foreign company is incorporated in a country which has not concluded a DTA with South Africa, and the courts may be compelled to use SARS’ interpretation of PoEM, the lack of an effective date may again lead to uncertainty as to which PoEM test SA courts will ultimately adopt.

36. We recommend that an effective date is specifically set, to ensure that there is no uncertainty as to which PoEM test should apply and that this date at least be when the discussion paper is finalised.

**Definition of “company”**

37. The definition of “company” contained in the draft Interpretation Note includes both local and foreign incorporated, formed or established companies.

38. However the companies referred to in the draft Interpretation Note should only be foreign incorporated, formed or established companies, as the PoEM principle will not apply to local incorporated, formed or established companies.

39. We propose that the definition of “company” should be limited to foreign incorporated, formed or established companies only.

**Foreign investment entity**

40. Paragraph 2 refers to a “foreign investment holding company” as defined in the Act.

41. This reference is incorrect as the proviso to the “resident” definition contained in section 1(1) of the Act, refers to a “foreign investment entity” which is also defined in section 1 and not to a “foreign investment holding company” which is not defined.

**Key management and commercial decisions**

42. The draft IN states in paragraph 4.2 that “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”.

43. Once this determination has been made, it is necessary to determine where those decisions are in substance actually made.” It is submitted that these two steps must be preceded by a determination of what the key management and commercial decisions in relation to the company is.

44. The guidance provided in the draft IN to distinguish between what “key operational management decisions” are versus what the “key management and commercial decisions” are is not sufficiently taking into account the central importance of the concept of “key management and commercial decisions” has in the determination of PoEM.
45. It is requested that SARS provides more clarity in this regard.

**Composition of the board**

46. Although we note that the draft Interpretation Note highlights that definite rules cannot be laid down in determining the PoEM and all the relevant facts and circumstances must be considered. Paragraph 4.2.3. deals with the board, where it meets and delegation of authority and clause 4.2.6. notes the considerations between operational and top level management.

47. However the composition of the board (i.e. executive versus non-executive directors) and how this affects these questions have not been addressed in the draft IN.

48. In addition, the residency of the relevant directors has not been dealt with in the draft Interpretation Note; there are only references to where directors operate and where they are based (which may be indicative of their residency but the location where they are based may be very different to where they are resident).

49. We request that these matters be dealt with as well in relation to their relevance as factors to consider in determining the PoEM as we are of the view that both remain relevant.

**Location of accounting records**

50. The draft IN highlights that the location of support services generally has a limited influence on the company’s PoEM. However it is silent on whether the location of where the accounting records of the foreign company are kept, will impact the PoEM analysis.

51. We acknowledge that the storage of accounting records in a jurisdiction other than the country of incorporation should not impact the PoEM analysis, we believe for completeness sake that this should be included.

**Conclusion**

Should you require further clarification of this submission or which further engagement is required, please do not hesitate to contact us.

Yours faithfully

**Pieter Faber**  
**PROJECT DIRECTOR: TAX**  
*The South African Institute of Chartered Accountants*