The headquarter company structure in the Southern African context: a South African tax law perspective

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Abstract

The introduction of the headquarter company structure in the South African Income Tax Act as a means to allow South Africa to be used as a regional gateway, requires a comparison with other resident South African companies involved in intra-African trade and investment. It also requires a comparison with non-resident companies using South Africa purely as a management base for their intra-African trade and investment. The comparison must take into account the effect of the structure on the income flows, the transfer of funds, the administrative burden, and collectively, the effect on the tax liabilities of the various company structures. In addition the tax policy concepts of neutrality and the South African constitutional requirement of 'equality' should be considered. Taken collectively, the analysis illustrates that the headquarter company structure as provided for in the tax legislation, does not meet the objective of the use of South Africa as the gateway into Africa. Neither is the differential treatment satisfactorily justified.

INTRODUCTION

How does South Africa, coined by some as the economic power house of Africa,[1] expand the use of its infrastructure and financial services to companies intending to or currently investing in various African initiatives?

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1 National Treasury of the Republic of South Africa Media statement: Taxation Laws Amendment Bills 2010, dated 10 May 2010 at 3; Maluwa 'The African Union, the Southern African Development Community, and the New Partnership for Africa's Development: some observations on South Africa's contribution to international law-making and institution building in Africa, 1994–2004' (2004) 29 *SAYIL* 12; National Treasury of the Republic of South Africa 'Explanatory memorandum on the Taxation Laws Amendment Bill, 2010' 77; Soko, Balchin, Cupido & Hess 'SADC and the global economic crisis: origins, impacts and state policy responses' 2010 (40) *Africa Insight* 168 at 176 where it was stated that 'South Africa is an economic powerhouse within the SADC region and has been a powerful driver of regional growth over the past decade'.

One possible solution is to align tax and economic policies by introducing specific company structures and allowances in the tax legislation.

The South African National Treasury did this alignment by introducing a specific company structure in the form of a '"headquarter company" with the objective of eliminating tax hurdles',[2] which impede the use of South Africa as a 'gateway' into Africa.[3] A multinational company wishing to trade or invest often locates its headquarters in a specific country. Such a headquarter company will co-ordinate the activities and operations of the company's various branches or subsidiaries in other countries. One of the factors influencing the establishment of a headquarter company in a specific country is the tax allowances and incentives granted by such a country for head office activities.

The specific headquarter company structure (HCS) was introduced into the South African Income Tax Act[4] in 2010 with the objective of supporting or enhancing the use of South Africa as a 'gateway' into Africa.[5] According to the South African National Treasury, this introduction would allow South Africa to be used as a 'launching point into the region'[6] and as a 'central point for various regional equity fund investors'.[7]

There are different views on the feasibility and implementation of an HCS. The main concern for practitioners, it is submitted, is the comparison to other similar regional structures, particularly the Mauritian structure. For practitioners, the concern is whether the South African HCS and its allowances would better serve their clients' needs in comparison with the company structures and allowances available in other countries in the region. There are also those who may consider a comparative analysis unnecessary in that such structures and allowances are found in other countries. In terms of this view, the structure has – excluding the OECD harmful tax practice

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2 See National Treasury Media Statement 2010 n1above at 3.

3 See Explanatory Memorandum on the Taxation Laws Amendment Bill n1 above at 77. The provisions introducing the headquarter company structure were inserted into the South African Income Tax Act 58 of 1962 by the Taxation Laws Amendment Act 7 of 2010.

4 South African Income Tax Act 58 of 1962 as amended from time to time.

5 See Explanatory Memorandum on the Taxation Laws Amendment Bill n1 above at 77.

6 See National Treasury Media Statement n1 above at 3.

7 *Ibid*.

concept[8] – an element of international acceptance. Another perspective, it is submitted, is concerned with the relationship and income flows between developed and developing countries. In terms of the latter view, such structures are considered harmful to the tax revenues of developing countries on the premise that they merely facilitate the outflow of income from developing countries – countries which least can afford such outflows.

Whether or not this structure is useful for tax practitioners, or whether it has an element of acceptance or non-acceptance, an introduction of this type of structure requires, it is submitted, an holistic view of the effect it has on the income streams into and out of Southern Africa. This holistic view is imperative given the need for growth and development in the region. The implementation of an HCS and other similar types of structure, may appear to be appropriate policy tools for South Africa's development and for African regional development in general. This article does not purport to provide such an holistic analysis.[9] Instead, it is concerned with the comparison of such company structures with other companies in South Africa in relation to the provisions of the South African Income Tax Act, and whether the differentiated company structure achieves its stated goal. This article is only concerned with the domestic law provisions as found in the South African Income Tax Act. Thus, a discussion of the effect of the HCS on the application of the double taxation agreements entered into between South Africa and other African countries, is beyond the scope of this article.

An analysis of the HCS must take into account, and be compared to, the tax treatment of companies which do not fulfil the requirements for classification as a 'headquarter company'.[10] It is submitted that the reasons for and the practical result of any differential treatment of companies must

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[8] See the following OECD Reports: *Harmful tax competition: an emerging global issue* (1998); *Towards global tax co-operation, report to the 2000 Minister Council Meeting and recommendations by the Committee on Fiscal Affairs: progress in identifying and eliminating harmful tax practices* (2000); *The OECD's project on harmful tax practices: the 2001 progress report* (2001); *The OECD's project on harmful tax practices: the 2004 progress report* (2004); *The OECD's project on harmful tax practices: the 2006 progress report* (2006).

[9] For a discussion on the headquarter company structure in Southern Africa, see Gutuza, 'Economic development and the role of tax in Southern Africa: the South African headquarter company structure' in Brauner & Stewart (eds) *Tax, law and development* (2013).

[10] As set out in s 9I of the South African Income Tax Act.

be clearly identified and articulated. In particular, the income flows of such headquarter companies must be compared with the income flows of other resident and non-resident companies. The reason for this comparison is the effect that such specific company structures and allowances have on the equity and neutrality principles of a tax system. It is assumed that these principles of equity and neutrality underlie any tax system. It is submitted that the introduction of such structures and allowances should be made on the premise that these two principles should be disturbed in the least possible manner. It is further submitted that the impact of these structures and allowances should be clearly focused on achieving the goal of using South Africa as a gateway into Africa. Any externalities resulting from these structures and allowances should be limited.

BACKGROUND

In explaining the background and objective of the HCS, the South African National Treasury stated that 'South Africa is the economic powerhouse of Africa';[11] and has a developed infrastructure and an advanced financial services industry.[12] Other qualities which 'make South Africa an ideal location for foreign investors to base the management of their regional operations'[13] are its 'location, sizable economy, political stability,'[14] and treaty network. The tax structure of the headquarter company implies that such a company would use South Africa as the regional base for a multinational enterprise, and use the South African infrastructure or potentially use South Africa, as a 'sourcing hub'.[15]

The use of the headquarter company perhaps indicates the dual context of South African economic policy, namely the need attract investment and trade into both South Africa and Africa, and in particular Southern Africa. This dual role can also be seen in the efforts of the South Africa National

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[11] See Explanatory Memorandum on the Taxation Laws Amendment Bill n 1 above at 77. See also the 2011 presentation made to the Parliamentary Standing Committee on Finance by the South African National Treasury and South African Revenue Services on the 2011 Draft Taxation Law Amendment Bill, dated 15 June 2011. Available at http://www.pmg.co.za.

[12] See National Treasury Media Statement n 1 above at 3. See also Explanatory Memorandum on the Taxation Laws Amendment Bill n1 above at 77.

[13] See National Treasury Media Statement n1 above at 3. See Explanatory Memorandum on the Taxation Laws Amendment Bill n1 above at 77.

[14] See Explanatory Memorandum on the Taxation Laws Amendment Bill n1 above at 77.

[15] See Development Dialogue Seminar 'South Africa as a gateway into Africa'. Available at http://www.tips.org.za/event/development-dialogue-seminar-south-africa-gateway-africa (last accessed 22 September 2012).

Treasury to protect its tax base while at the same time playing a role in supporting regional investment.[16]

The concept of a headquarter type structure and the use of South Africa as a type of African regional gateway is not new. Before 1998, as a result of the mainly source-basis of taxation, South Africa could be used as a headquarter company location. The status of this source-based HCS changed between 1998 and 2001, a transitional period where the basis of taxation changed. The basis changed from a largely source-based to a residence-based form of taxation. Foreign sourced interest and royalty income were deemed to have a South African source and only active business income was exempt from tax in South Africa.[17] In 2001, the introduction of the residence or worldwide basis of taxation,[18] was accompanied by an HCS.[19] This structure lasted for three years and was repealed in 2004.[20]

THE STRUCTURE OF THE HEADQUARTER COMPANY

Conduit or headquarter?

It is interesting that the phrase 'headquarter company' is used in the South African Income Tax Act. The use of the phrase 'headquarter' is something of a misnomer. The structure as set out in the South African Income Tax Act is more akin to a regional or intermediary holding company as more than eighty per cent of the cost of the assets of the headquarter company must be attributed to shares in a foreign subsidiary company, loans made to the foreign subsidiary operating company, and intellectual property licensed to the foreign operating subsidiary company.[21] It is a headquarter company only insofar as it is a holding company or managing company for the operations of its subsidiary operating company to which it provides finance in the form of equity and loans, and the use of intellectual property.

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[16] See Philander 'Africa and foreign direct investment' NEPAD Planning and co-ordinating agency, 25 January 2011. Available at: http://www.nepad.org/nepad/blog/2011/01/25/1968/africa-and -foreign -direct-investment (last accessed 28 August 2012).

[17] By the introduction of s 9C into the South African Income Tax, in terms of which certain passive income received by South African residents were deemed to be from a South African source.

[18] The residence basis of taxation was introduced by the Revenue Laws Amendment Act 59 of 2000, effective from 1 January 2001.

[19] Inserted by the Revenue Laws Amendment Act 59 of 2000.

[20] Repealed by the Revenue Laws Amendment Act 45 of 2003.

[21] Section 9I(2)(b) of the South African Income Tax Act.

Structure

The structure of the 2010 headquarter company as provided for in the South African Income Tax Act[22] allows a holding (or multinational) company to locate a regional headquarter company in South Africa with such company tax resident in South Africa.[23] The structures further envisages the establishment of a foreign operating subsidiary company of this regional headquarter company in another country,[24] with the latter company being a conduit company for the income generated by the former company and passed on to the holding company.[25] The conduit company status results largely because of the limited taxation on the income received by the headquarter company and transferred to the holding multinational company where the latter company is not resident in South Africa. In particular, the dividend, interest, and royalty income received by or accrued to the headquarter company and then transferred to its non-resident holding company, is generally not taxed in South Africa.[26] Tax is also not imposed on the disposal of shares owned by the headquarter company.[27] Furthermore, South Africa's controlled foreign company provisions and transfer pricing rules do not apply under certain circumstances where transactions are entered into between the headquarter company and its non-resident holding company.[28] South Africa's exchange control restrictions which would apply where capital is transferred from the headquarter company to its non-resident holding company, have also largely been removed.[29]

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[22] The headquarter company was introduced by the Taxation Laws Amendment Act 7 of 2010 and has since undergone a number of amendments.

[23] Section 9I(1)(a) of the South African Income Tax Act.

[24] Section 9I(2) of the South African Income Tax

[25] *Ibid* read with *inter alia*, s 10B, s 31 and s 35 of the South African Income Tax Act. A conduit company is a company entitled to income arising in another country with the economic benefits of that income accruing to a person in a third country. The conduit company is therefore a conduit or a flow-through for income arising in a foreign company and being transferred to a person in another foreign country. See the explanation in the Glossary of the IBFD Tax Research Platform. Available at: http://www.ibfd.org (last accessed 14 March 2014).

[26] The non-taxation results from the interaction of the Headquarter company structure and the various allowances provided in the South African Income Tax Act such as s 10B, s 31 and s 35.

[27] In terms of paragraphs 43 and 64B of the Eighth Schedule of the South African Income Tax Act.

[28] In terms of ss 9D(1) and 31(5) of the South African Income Tax Act.

[29] See South African Reserve Bank Exchange Control Circular 37/2010 issued on 27 October 2010; South African Reserve Bank Exchange Control Circular 2/2011 issued on 25 January 2011.

Income streams: Comparison of 'normal' resident company and headquarter company

Interest income

The interest income received by the headquarter company from its non-resident operating company and paid to the non-resident holding company, will not be taxed in South Africa.[30] Although received by the headquarter company, the payment of the interest income will qualify for an exemption when paid to the non-resident holding company.[31] In addition, the withholding tax on interest income paid to a non-resident[32] holding company will not apply because the interest payment by a headquarter company to its non-resident holding company is exempt from this tax.[33]

The result differs if the holding company is a South African resident because the exemption does not apply. If the holding company is a non-resident, and the South African resident company paying the interest income does not qualify as a headquarter company, the exemption provided for the payment of interest from a resident to a non-resident may still apply.[34]

One of the main differences between the payment of interest to a non-resident company from a headquarter company, on the one hand, and from a 'normal' resident company on the other, is the non, or rather limited, application of the transfer pricing rules in section 31.[35] As a result of the limited application of the transfer pricing rules applicable to the interest paid from a headquarter company to a non-resident holding company, the interest which such a headquarter company is able to transfer to its non-resident holding company, can exceed the amount that would be payable by a 'normal' resident company. In addition to this difference, a headquarter company, in comparison to a normal resident company, is relieved of the administrative burden of complying with the transfer pricing and thin capitalisation provisions.[36]

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30 Section 10B of the South African Income Tax Act.
31 In terms of the s10B of the South African Income Tax Act.
32 Sections 37I to 37M of the South African Income Tax Act with effect from 1 January 2013.
33 Section 37K(1)(vi) of the South African Income Tax Act.
34 Provided that the provisions of s 7K of the South African Income Tax Act are met.
35 Section 31(5) of the South African Income Tax Act.
36 *Ibid.*

Another difference between the tax treatment of a headquarter company and a normal resident company, results from the foreign operating subsidiary not being classified as a 'controlled foreign company'.[37] This has the effect of a foreign operating subsidiary being able to defer interest and other payments to a headquarter company. The income of a foreign operating subsidiary will not be attributed to a headquarter company in terms of the controlled foreign company provisions.[38] By comparison, the income of a foreign subsidiary company of a 'normal' resident company is attributed to the 'normal' resident company. Such a resident company will have to consider the various provisions of section 9D to determine whether such income is either exempt[39] or taxed in its hands.[40] It, therefore, appears as if a headquarter company is, at the very least, relieved of the administrative burden of complying with section 9D. Furthermore, in the event that the income attributed to a normal resident company does not qualify for an exemption under section 9D,[41] a limited tax credit is provided to relieve double taxation.[42]

As a result of the combination of the above provisions, a headquarter company is a true conduit company for interest payments when applying the domestic tax rules found in the South African Income Tax Act.

Dividend income

Dividend income received by a headquarter company from its foreign operating subsidiary company is a foreign dividend, and when paid to its non-resident holding company, would qualify as a South African dividend. Section 10B of the South African Income Tax Act provides that dividends received and paid by the headquarter company are exempt from tax in South Africa.[43] This means that, as in the case of interest income, a headquarter company is a conduit for the dividend income between a foreign operating subsidiary and a non-resident holding company.

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[37] The definition of 'controlled foreign company' in s 9D(1) of the South African Income Tax Act.

[38] The attribution of income to the shareholder or participant of a controlled foreign company is found in s 9D(2) of the South African Income Tax Act.

[39] Section 9D(9) of the South African Income Tax Act.

[40] Section 9D(2) read with the s 9D(9) of the South African Income Tax Act.

[41] In terms of s 9D(9) of the South African Income Tax Act.

[42] In terms of s 6*quat*(1)(b) of the South African Income Tax Act.

[43] Section 10B(1) read with s10B(2) of the South African Income Tax Act.

If the requirements of a headquarter company are not met, then the foreign dividend will be included in the 'gross income' of the normal resident company but may qualify for an exemption in terms of section 10B.[44] The payment of a dividend from the normal resident company is also exempt if the holding company is a South African resident company,[45] and may be exempt if the provisions of section 10B have been met. The treatment of dividend income, therefore, depends on whether the foreign dividend received by the headquarter company or the resident company is exempt from tax in South Africa. It would appear that irrespective of the company structure, such an exemption is possible.

Royalty income

The royalty income paid by a foreign operating company to headquarter company will fall into the 'gross income' of the headquarter company. It is likely that such royalty will be deducted when paid over to the holding company. The requirement for the royalty income in section 9I is that the headquarter company must license the intellectual property to the foreign operating subsidiary company. It therefore appears that a holding company owns, or has a licence to use, the intellectual property. It, in turn, would either license or sub-license the intellectual property to the headquarter company. It also appears that the structure envisages that the intellectual property is not to be used in South Africa[46] and further that the 'source' of the income relating to the intellectual property is not to be located in South Africa.[47]

On payment of the royalty income from a headquarter company to a non-resident holding company, the royalty income will be taxed either on the basis of normal tax,[48] or on the basis of the withholding tax on royalties.[49] However, given that royalty income does not arise from the use of the intellectual property in South Africa, it is unlikely that the withholding tax on royalties will apply.[50] Here, too, therefore, the headquarter company acts

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[44] Section 10B has largely replaced s 10(1)(k)(ii) and provides for the exemption of foreign dividends for certain shareholders.

[45] Section 10B of the South African Income Tax Act.

[46] Section 9I(2)(b)(iii) of the South African Income Tax Act uses the wording 'any intellectual property … that is licensed by that company to, …'.

[47] 'Source' as determined by s 9 and the case law interpretation of 'source'.

[48] In terms of the calculation of 'taxable income' as defined in s1 of the South African Income Tax.

[49] Section 35 of the South African Income Tax Act.

[50] Section 35(1) read with s 9(2) of the South African Income Tax Act.

as a conduit company. The treatment of the royalty income in the hands of a headquarter company does not differ from that of a normal resident company. No special provision has been made for the treatment of royalty income to deal with the headquarter company structure, probably due to the emphasis being placed on the use of the intellectual property in South Africa.

The one major difference between royalty income paid by a headquarter company and a normal resident company, is the effect of the limited application of the transfers pricing rules.[51] As in the case of interest income, the amount transferred to the non-resident holding by the headquarter company being able to exceed the amount that can be transferred by a normal resident company.

Rental income

Rental income received by a headquarter company from a foreign operating company would be included in the 'gross income' of the headquarter company. It is likely that this income will be paid to the non-resident holding company in the form of interest or dividends, as it is unlikely that rental income will retain its character when passing through the headquarter company. It may, however, retain its character depending on the contracts entered into between the holding company and the foreign operating company. As rental income receives no specific preferential treatment in the South African Income Tax Act – in contrast to interest and dividend income – it would seem that an arrangement in terms of which the rental income retains its character, would not assist in the conduit status of the HCS.

Management fees

As in the case of rental income, the receipt of management fees by the headquarter company falls outside the scope of the conduit status of the headquarter company. The HCS, with its aim that South Africa be the 'gateway' into Africa, envisages the use of South Africa's 'infrastructure and financial services.'[52] It also envisages the use of South Africa as a 'launching point in the region'[53] and as a 'central point for various regional

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51 Section 31(5) of the South African Income Tax Act.

52 National Treasury Media Statement n1 above at 3; Explanatory Memorandum on the Taxation Laws Amendment Bill n1 above at 77.

53 *Ibid*.

equity fund investments'.[54] This means that, at the very least, some level of management or coordination must take place in South Africa. This management or coordination must devolve from the holding company to the headquarter company. The headquarter company must offer this management service to the foreign operating subsidiary company. The income of this headquarter conduit company, taxed in South Africa, will therefore largely be management fees, supervisory fees, or coordination fees for services rendered by the headquarter company to the foreign operating subsidiary company. In the event that tax is imposed on management fees in the country of the foreign operating subsidiary company, and depending on whether the source of the income is located in South Africa, limited relief from double taxation is provided in the South African Income Tax Act.[55] In addition, South African resident employees and services rendered to and by the headquarter company, will result in income on which tax will be imposed in South Africa. Although not receiving all the tax revenue, the South African fiscus will obtain some taxes.

COMPARISON WITH OTHER COMPANIES DOING BUSINESS IN SOUTH AFRICA

The tax treatment of headquarter companies differs from the tax treatment of other companies resident in South Africa specifically in relation to its exemption from the transfer pricing, thin capitalisation, controlled foreign company provisions, and the specific income exemptions for interest and dividend payments to non-residents. These provisions enable a headquarter company to take income transferred to South Africa out of the country without tax consequences. By comparison, a company which does not meet the requirements of the HCS, will be constrained by these provisions when it wishes to transfer money from South Africa. In addition, such a company would have a tax liability from the income of its foreign operating subsidiary based on the application of the controlled foreign company legislation. A normal resident company would have the additional tax administrative burden of complying with the transfer pricing rules and the controlled foreign company provisions.

Two issues arise as a result of this differential treatment. The first relates to whether this differential treatment complies with the South African

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54 *Ibid.*

55 In terms of s *6quat* and s *6quin* of the South African Income Tax Act.

constitutional requirement of 'equality'.[56] The second is linked to the first, and questions why South Africa is giving up its taxing rights, and whether the 'return to the country' is greater than the taxes it is giving up.

DIFFERENTIAL TREATMENT

A company classified and registered as a headquarter company clearly enjoys different tax treatment in South Africa when compared to other South African resident companies. The first issue to consider is the provision of 'equality' in the South African Constitution – on the assumption that such legislation is rational. The equality provision in the Bill of Rights of the South African Constitution provides that the 'everyone is equal before the law and has the right to equal protection and benefit of the law.' The Constitution specifically provides for its application to 'juristic persons'.[57] An argument can possibly be made that the equality provision does not apply to provisions dealing with economic policy, but for the purposes of this analysis it is assumed that it does apply.[58] Even if it assumed that the equality provisions do apply, clarity is required as to who or what is being compared.

Is the headquarter company being compared to

- South African resident companies in general?
- South African resident companies which have outward investments?
- South African resident companies which have outward investments in neighbouring African countries? or
- non-resident companies who are investing or trading in the region and who need some base within the region? Such companies would only be taxed in South Africa if the source of their income is located in South Africa,

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[56] Section 9(1) of the Constitution of the Republic of South Africa Act of 1996 provides that 'Everyone is equal before the law and has the right to equal protection and benefit of the law'. Section 36 of the South African Constitution provides for the limitation of rights contained in the Bill of Rights 'to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom'.

[57] Section 8(4) provides that a 'A juristic person is entitled to the rights in the Bill of Rights to the extent required by the nature of the rights and the nature of that juristic person.'

[58] See the discussion in Cheadle, Davis & Haysom *South African constitutional law: the Bill of Rights* Lexis Nexis Butterworths electronic version last updated September 2011 at par 4.6.

either in terms of the source rules as applied by in case law,[59] or in terms of section 9.[60]

What about the different forms of doing business? Is there, and should there be a difference between a non-resident investor using a company and merely having a place of business or office in South Africa? The reference here, of course, is to the possibility of having a 'source' located in South Africa in the form of a place of management or an office, instead of incorporating a separate legal entity in South Africa.[61]

Given the stringency of the requirements for qualification as a headquarter company,[62] there is differentiation between headquarter companies and other companies, irrespective of the comparator chosen. This raises the question of whether this differentiation is justified for the comparators (b) and (c), but in particular, (c). Applying the equality provision of the South African Constitution, the differentiation must be 'reasonable and justifiable'.[63] This requires an analysis of the reasoning underlying this differentiation.

As indicated above, the difference between the HCS and other normal resident companies, apart from the rules relating to the structure of the company, is that the international anti-tax avoidance provisions, such as controlled foreign company provisions and the transfer pricing rules, do not apply to such headquarter companies. Furthermore, as illustrated, the HCS largely allows such a company to be a conduit company for interest and dividend income paid to its non-resident holding company. Income which is not granted this 'preferential' exemption treatment, includes the

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59 For example, see *CIR v Lever Bros and Unilever Ltd* 1946 AD 441, 14 SATC 1.

60 The current version of s 9 was inserted into the South African Income Tax Act in 2012 by the Taxation Laws Amendment Act 24 of 2011. Prior to the amendment of this provision, s 9 provided for various deeming source provisions.

61 In terms of the definition of 'permanent establishment' as found in the Organisation of Economic Co-operation and Development Model Tax Convention on Income and Capital (2010).

62 Section 9I of the South African Income Tax Act provides for a minimum percentage of shareholding (ten per cent) of a shareholder of the headquarter company, a minimum (eighty per cent) of the costs of the assets of the company to be attributed to interest in equity shares, loans and intellectual property in the subsidiary operating company and a limitation on the types of income of such a company.

63 Section 36(1) of the Constitution of the Republic of South Africa Act of 1996 provides that '[t]he rights in the Bill of Rights may be limited only in terms of law of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom, taking into account all relevant factors, including …'.

management fees or service fees earned from managing the foreign operating subsidiary where the management, as envisaged by the South African National Treasury, is either undertaken by South African residents, or is in South Africa. Relief in the form of a foreign tax credit[64] or a deduction[65] is available in the event of the international double taxation of such management or service fees. By comparison, other normal resident companies which do not qualify as headquarter companies, are taxed on their worldwide income; the international anti-tax avoidance provisions apply to their transactions; and in the event of international double taxation, they qualify for tax relief in the form of either a foreign tax credit[66] or a deduction.[67] It is not clear on which grounds this differential treatment between normal resident companies involved in outward investment from South Africa is 'reasonable and justifiable', except perhaps for the purpose of control and for ensuring that the South African tax base is not eroded or adversely affected by these companies. This latter statement is based on the assumption that such a possibility of tax erosion does exist.

A further differentiation between headquarter companies and other normal resident companies is that the headquarter company is largely a passive holding company. This passive holding company status is indicated by its income and asset base – where the gross income is greater than R5 million; fifty per cent of its income is from the provision of finance in the form of both debt and equity; and the licensing of intellectual property, and the rental of property,[68] while at least eighty per cent of its assets are comprised of shares, loans, and intellectual property.[69] The active business aspect of the headquarter company is, therefore, largely limited. An appropriate comparator for the headquarter company, therefore, has to be a passive holding company which is used for trade and investment outside South Africa. This passive holding company must then be compared with other passive holding companies investing and doing business in South Africa through the use of foreign subsidiary holding companies.

Apart from the specific provisions which allow a headquarter company to be treated as a conduit company, the limited application of the anti-tax

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64 Section 6*quat* of the South African Income Tax Act.
65 Section 6*quin* of the South African Income Tax Act.
66 Section 6*quat* of the South African Income Tax Act.
67 Section 6*quin* of the South African Income Tax Act.
68 Section 9I(2)(c) of the South African Income Tax Act.
69 Section 9I(2)(b) of the South African Income Tax Act.

avoidance provisions – such as the controlled company provisions, the transfer pricing, and thin capitalisation provisions place the headquarter company, insofar as a non-resident holding company is concerned, in a more favourable position when compared to a normal passive resident company.

The favourable position exists irrespective of the location of the foreign operating subsidiary of the headquarter company. It is therefore possible for such a structure to have the foreign operating subsidiary company located in any country outside of Africa. This is despite the Explanatory Memorandum and the various media reports from the South African national government, stating that the objective of the headquarter company is to the benefit the Southern African region.[70] The legislation does not indicate this limited nature at all, and it is therefore possible that none of the expected benefits will accrue to the region. This, in itself, is an indication that the objective of the headquarter company as a 'gateway' into Africa is not supported by the legislation. The non-limitation of the legislation may be due to political and non-discriminatory factors. The reasons for the non-limitation may be valid and legitimate, but it does have the result that the stated objective is not met. Based on the legislation, a comparison of headquarter companies with normal resident companies which have outward investment in neighbouring or other African countries, is subsumed by the comparison with normal resident companies which generally have outward investment in the form of a foreign operating subsidiary.

The other comparison to consider is between a headquarter company and the use by a non-resident holding company of an office or branch in South Africa. The latter situation, namely a non-resident holding company having only a branch or an office in South Africa, may also arise where the headquarter company ceases to be a South African resident company. This possibility arises, in particular, from the proviso to the definition of a 'resident' in the South African Income Tax Act. In terms of the proviso, a taxpayer would cease to be a resident if 'on the application of a double taxation agreement', such a taxpayer is deemed to be a resident of the other contracting state.[71] To limit the application of this proviso, and to prevent a company's loss of its South African residence, it would seem prudent for both the incorporation and the 'place of effective management' of the

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[70] Explanatory Memorandum to the Taxation Laws Amendment Bill n1 above at 77; National Treasury Media Statement n1 above at 3.

[71] See the proviso to the definition of 'resident' in s 1 of the South African Income Tax Act.

company to be located in South Africa. If the 'place of effective management' of the company changes, and is located outside South Africa, such a company would cease to be a resident for the purposes of the South African Income Tax Act.[72] The office or place of management of such a non-resident company would then possibly qualify as a 'source' of income for the non-resident holding company and as a 'permanent establishment',[73] and the tax treatment would then differ from that of a headquarter company. The South African source rules, in particular, would apply to non-resident companies,[74] and the thin capitalisation and transfer pricing rules would apply on the transfer of income from the 'permanent establishment' in South Africa to the foreign, now defunct, holding company. The application of these rules and provisions may not hinder the investment in the region if the source of the interest, dividend, and royalty income is not located in South Africa simply because the non-resident holding company will be liable for tax on such income in South Africa. Potentially, only the source of the management services income will be located in South Africa. On the application of the domestic laws only, there does not appear to be a significant difference between the use of a headquarter company and a branch or office. It is, however, the use of double taxation agreements where the issue of the 'residency' of the entity in South Africa plays a significant role. As indicated above, this discussion falls beyond the scope of this article.

The differential treatment of a headquarter company results largely from the limited taxation of this entity in South Africa. Its treatment is similar to a non-resident company whose tax liability is dependent on the source of its income being located in South Africa. It could be said that South Africa does in fact not have a nexus or link to the dividend, interest, or royalty income because:

- the capital and infrastructure of these income streams are derived from the country of residence of the non-resident holding company; and
- the income stream originates from the infrastructure and support of the foreign operating subsidiary's country of residence.

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[72] See *Commissioner for the South African Revenue Service v Tradehold Ltd* 74 SATC 263.

[73] 'Permanent establishment' as defined in s 1 of the South African Income Tax Act and also as defined in Article 5 of the Organisation of Economic Co-operation and Development Model Tax Convention on Income and Capital (2010).

[74] Section 9 source rules in the South African Income Tax Act.

In this sense, the equity, loan, and intellectual property comes from the holding company, and the income streams merely flow through South Africa because that income is actually used in the country of residence of the foreign operating subsidiary. The use of the headquarter company can, therefore, be seen as a true conduit company since neither the 'source', nor the 'beneficial' owner,[75] is located in South Africa. The headquarter company is, therefore, comparable to a non-resident company with limited source located in South Africa.

Given that there is this clear differential treatment between normal resident companies and headquarter companies, and a similarity between a non-resident companies with limited links to South Africa, the reasons for this differential treatment must be considered, and in particular, the reasons for South Africa giving up its right to impose tax on a resident company must be considered.

WHY IS SOUTH AFRICA GIVING UP ITS RIGHTS TO TAXES?

The reasons or justification for the headquarter company in general, include the headquarter company assisting in the development of additional and related intellectual infrastructure in Southern Africa.[76] As shown above, the structure of the headquarter company is not limited to its use in Africa or Southern Africa and thus this justification is not supported by the structure.

Another justification is that South Africa may be losing the battle against Mauritius and other African countries being used as gateways into Africa. This concern relates, in particular, to the management of the African subsidiaries of multinational enterprises taking place in Mauritius and other African countries.[77] It is not clear how the current structure with its non-preferential treatment of management fees will assist in achieving this objective.[78]

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75 A beneficial owner refers to the economic ownership as opposed to the legal ownership.

76 Explanatory Memorandum to the Taxation Laws Amendment Bill n1 above at 77–83.

77 With respect to regional investment, the growth of Intra-Africa trade and the need for Africa to create an investor friendly environment exists. With respect to the protection of South Africa's tax base, the use of Mauritius, Nigeria and Kenya as 'gateways' into Africa might be a factor.

78 Management fees of headquarter companies have the same provisions for relief as non headquarter companies in the form of s 6*quat* or s 6*quin.*

A further justification could be South Africa's strategic role in the development of Southern Africa, especially given the desire to form an African trade block.[79] It could also be argued that at least skills remain in South Africa, and some of the taxes from the management fees flow into the coffers of the South African fiscus. While these are valid reasons or justifications for setting up a headquarter company, one has to question whether the way it has been set up expresses this intention. The restrictions on the shareholding in, the assets, and income of, the headquarter company, taken together with the lack of restriction on where the operating subsidiary company must be located, potentially undermines these justifications.

A further argument may be made with reference to the source of the interest, dividends, and royalty income not being located in South Africa. This argument, it is submitted, cannot be used to distinguish between the taxation of headquarter companies and other normal resident companies. The taxation of the income of the latter companies does not depend on whether the source of their income is located in South Africa; nor does it matter that the income originated from a non-South Africa source. This argument is further weakened by the strict requirements placed on recognition as a headquarter company. These rules only apply if the company qualifies as a headquarter company. Given that the definition or requirements for a company have changed since its introduction, the reason or justification seems to diminish and it appears as if the structure is merely allowing certain types of income to flow out of the region.

CONCLUSION

At first glance, the use of headquarter companies to attract investment or assist investment into the Southern African region, and to expand the use of South Africa's skills and infrastructure has merit, especially seen in the light of tax competition from Mauritius.

However, a more detailed analysis indicates that the reasons for the differential treatment in comparison to other South African resident companies, need to be clearly identified and articulated by South Africa's National Treasury. A comparison with normal resident companies clearly

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79 See, for example, SADC Protocol signed in 1996. Available at www.sadc.int. See also The New Partnership for Africa's Development adopted in 2001 as a programme of the African Union. For more information on NEPAD, see www.nepad.org (last accessed 18 June 2014).

indicates differences for which real justification is lacking, especially where the headquarter company is compared, firstly with other resident passive holding companies which have intra-Africa trade and investments, and secondly, with non-resident companies using South Africa as a base for their intra-Africa trade and investments. The differential treatment and non-neutrality which results from the way in which the HCS has been enacted leads to unjustifiable externalities both for South Africa and the region. Given that this analysis has not considered the effect of double taxation agreements on such headquarter companies, it may be that such effect has a more equitable and neutral result. If this is the intention, then this must be analysed and clearly articulated. These domestic tax provisions as enacted, it is submitted, clearly do not achieve their stated objectives.