Synopsis

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A monthly journal published by PwC South Africa providing informed commentary on current developments in the tax arena, both locally and internationally. Through analysis and comment on new law and judicial decisions of interest, it assists business executives to identify developments and trends in tax law and revenue practice that might impact their business.

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Fiscal residence – new Mauritius DTA provision modifies the test for companies

Recent news articles on international tax have focused heavily on the use by multinational companies of tax-friendly regimes through which to hold investments and to transact business. Heads of industry have been summoned to appear before legislators to explain their companies' tax structures and transactions. Much has been made in the course of these discussions of the use of benefits afforded under tax treaties to mitigate exposure to tax. It is perhaps significant that these issues did not raise their head when economies were booming, and one may be forgiven for observing that there is an air of desperation in economies whose tax revenues have suffered from the economic downturn of the past few years and which now cast about for scapegoats.

News that South Africa has just concluded a new agreement for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income with Mauritius bears examination in the present tax environment.

It is no secret that the fiscus views the tax treaty with Mauritius as a potential source of tax leakage. This view is well summarised in a Parliamentary report summarising a briefing by SARS to the Parliamentary Committee on Finance on 9 February 2011 on the tax treaty programme, of which the renegotiation of the Mauritian treaty formed part.

After alluding to "abuse and erosion of the South African tax base" the briefing explained the "problem of dual residence". Applying the domestic rules of tax residence in South Africa and Mauritius it was possible that a company could be a resident of both countries, the Committee was informed. In order to make the treaty work, one had to assign residence to one of the two only. This had to be done by mutual agreement between the two countries concerned. If mutual agreement could not be reached then such companies would be excluded from benefit of the treaty. The report on the briefing states:

"The message to companies was that if they caused confusion as to their place of residence, then they could not expect to benefit from these treaties."

If one examines the current treaty, it is evident that dual residence is not an issue. The treaty provision that deals with fiscal residence contains a provision that is designed to ensure that a company can never be regarded as a resident of both countries. It states that:

"Where … a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated."

In other words, a person will always be resident under the tax treaty in the country in which its place of effective management is located. So, for example, if a company is incorporated in Mauritius, but regarded as tax resident in South Africa on the basis that its place of effective management is located in South Africa, the existing treaty is clear that it will be regarded as resident in South Africa for purposes of the treaty and not in Mauritius.

Place of effective management

International jurisprudence on the meaning of place of effective management and the OECD interpretation thereof for treaty purposes is now relatively well established as the place where the key decisions affecting the company as a whole are in substance made and

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that there can only be one place of effective management at any point in time. There should therefore be little confusion except in marginal cases.

The new treaty with Mauritius provides that, where there is a conflict relating to the residence of a person other than an individual, the competent authorities of the two states shall endeavour to settle the issue by mutual agreement; in the event that agreement cannot be reached, the person shall be considered outside the scope of the agreement except for purposes of Article 25 (relating to the exchange of information).

This gives rise to the interesting potential outcome that a company may be regarded by the respective tax administrations as having its place of effective management in both jurisdictions, and, if the jurisdictions cannot agree on the appropriate criteria for determining its place of residence or on the application of the facts and circumstances to those criteria, the treaty will simply not apply to that company and it will face the risk of double tax.

Under the Income Tax Act, a company is a resident of the Republic if it is incorporated or has its place of effective management in the Republic. Thus, if a company is incorporated in Mauritius, it can only be regarded as a resident of the Republic if it has its place of effective management in the Republic. In the event that South Africa should seek to tax a Mauritian incorporated company on the basis that it is regarded as having its place of effective management in the Republic, the company would be in a position under the current dispensation to exercise its rights to object and appeal against the assessment. The courts would be compelled to determine the dispute by establishing the jurisdiction in which the company has its place of effective management. There is therefore synergy between South Africa's domestic legislation and the tie-breaker clause of the current treaty.

Under the new treaty, a Mauritian incorporated company will still have the right to contest a decision of SARS to impose tax on the basis that it is considered a resident of the Republic by way of objection to an assessment and subsequent appeal. In the event that it should be found

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that the company does not have its place of effective management in the Republic, it will not be a resident and will not subject to tax in South Africa in respect of its worldwide income. If that place of effective management is found to be in Mauritius (or in any other country), it will be entitled to invoke treaty relief in relation to any of its income that is derived from a source within the Republic. There will be no necessity to invoke the mutual agreement process as the domestic judicial determination will preclude SARS from persisting with its interpretation.

On the other hand, South African incorporated companies that claim to have their place of effective management in Mauritius will have no ground for contesting an assessment to tax in the Republic on the basis of fiscal residence if they are assessed to tax in South Africa. By reason of their incorporation, they are, by default, resident in the Republic unless they are found to be exclusively a resident of Mauritius under the treaty. Their sole avenue for relief will be to invoke the mutual agreement procedure and seek a mutual declaration that they are exclusively resident in Mauritius.

Unless there is a single agreed hierarchy of criteria to be applied by the competent authorities to identify the county of residence for treaty purposes, there is potential for disagreement. Although the commentary on the OECD Model Tax Convention lists the factors that should be taken into account in such a tie-breaker clause and invites contracting states to include these in the clause, this has not been done in the new treaty. The result is significant uncertainty of the factors and the weightings thereof to be considered by the competent authorities, which leaves taxpayers in an invidious position given that the factors listed by the OECD range from where meetings of directors are held to where accounting records are kept and even to whether determining that the company is a resident of one of the contracting states but not of the other for the purpose of the treaty would carry the risk of an improper use of the provisions of the treaty (whatever that may mean).

The anomalous position can therefore arise that a Mauritian incorporated company may effectively invoke the assistance of the South African courts to resolve a dual residence dispute with SARS, whereas a South African incorporated company will be unable to do so.

South African companies with Mauritian incorporated subsidiaries may find that the residence status of their subsidiaries will be more closely examined by SARS once the new treaty comes into existence. However, they should not be pressed into a hasty decision on the future of the subsidiaries. Instead they should examine the management of their Mauritian incorporated subsidiaries and establish where the key decisions affecting these subsidiaries are in substance taken. If they are able to conclude with confidence that the subsidiaries have their place of effective management in Mauritius, they should not be adversely affected by the proposed new treaty provision.

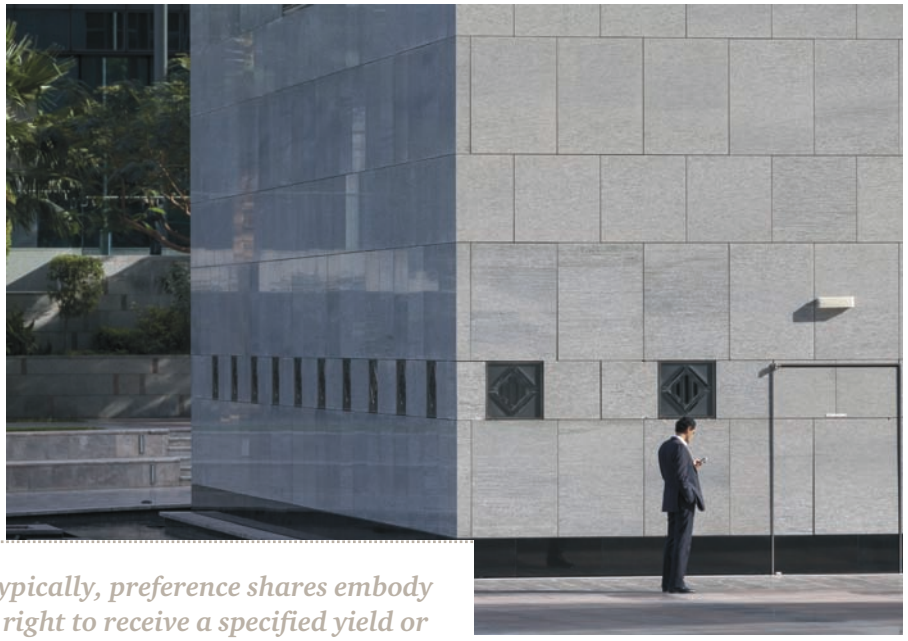
South African incorporated companies that presently enjoy exclusive Mauritian residence status based on effective management being in Mauritius under the existing treaty should carefully examine their status taking into consideration the factors listed by the OECD. In marginal cases, they may consider a change to the company's management structures and procedures to weigh these more in favour of Mauritius as the country of residence, changing residence to another treaty jurisdiction or otherwise restructuring to avoid any risk that they may be denied treaty protection when the new treaty comes into operation.

Binding Private Ruling 143 adopts a generous interpretation of the definition of "equity share" in relation to a headquarter company

Binding Private Ruling 143, dated 2 May 2013, issued in terms of section 76Q of the Income Tax Act 58 of 1962, deals with whether certain preference shares held by the applicant (a public company incorporated and resident in South Africa) qualify as equity shares in the context of the definition of headquarter company in section 1 of the Act.

The applicant holds *preference shares* in a foreign company and those shares confer on the holder the right to participate in a return of capital only to the extent of the subscription price of the shares plus any arrear dividends.

The right to participate in dividends, although expressed in the company's articles of association as a rate on the subscription price, is effectively unlimited and unrestricted, since the rate is within the discretion of the directors and is thus not restricted to a predetermined amount or coupon. The directors are thus free, if they so wish, to declare the same dividend on preference shares as on ordinary shares.



Typically, preference shares embody a right to receive a specified yield or return which is expressed as a percentage of the nominal value or issue price (this yield is often referred to as the "coupon").

The applicant intends to list a certain percentage of its shares on an international stock exchange, should it qualify as a *headquarter company* as defined in section 1 read with section 9I(1) – (2).

The Binding Private Ruling is that the preference shares in question, held by the applicant in the foreign company, will be regarded as *equity shares* for the purpose of applying the definition of *headquarter company*. The ruling is valid for five years from 25 November 2011.

The significance of the ruling

The term *headquarter company* is defined in section 1 of the Income Tax Act as a company envisaged in section 9I(1) (in other words, a resident company that fulfils the requirements set out in section 9I(2)) that has made an election, in terms of that section and in the form and manner prescribed by SARS, to be a headquarter company for a particular year of assessment of that company.

An *equity share* is defined in section 1 as –

"*any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution*"

(Emphasis added.)

This definition thus disqualifies a share from being categorised as an equity share if the right of the holder, *both as regards dividends and as regards a return on capital*, is limited to a *specified amount*.

The preference shares held by the applicant in the foreign company in question were limited in respect of the right to participate in a return of capital to a specified amount, namely, the subscription price plus arrear dividends. The second of the disqualifying criteria in the definition of equity share, quoted above, was thus present.

The first disqualifying factor, namely, the restriction of dividends to a specified amount seemed, at

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first blush, also to be present in that the right of the shares in question to participate in dividends was, in terms of the company's articles, limited to a rate (specified in the articles) on the subscription price.

Typically, preference shares embody a right to receive a specified yield or return which is expressed as a percentage of the nominal value or issue price (this yield is often referred to as the "coupon").

It would appear that a straightforward limitation as to *coupon* would have caused the share to fall foul of the second disqualifying criterion, given that the *amount* can be readily determined by reference to either the par value or the issue value of the preference share and would not vary over the term of the preference share.

In the case of this applicant, however, the coupon in respect of the preference shares in question was not fixed, but was in the discretion of the directors. Once this factor was taken into account, the right to participate in a dividend distribution was not subject to a limitation either as to *coupon* or as to *amount*.

The way in which the foreign company's articles of association expressed the rights of the holders of the preference shares in question was thus ingenious, in that the specified rights, attaching to the shares in question, were held not to fall foul of the exclusionary criteria set out in the definition of *equity share,* even though the directors could, in practice, limit the right to participate in dividends by way of a discretionary determination, year by year, of the coupon.

The broader perspective

SARS did not take the view, as it could have done, that in substance, if not in form, the preference shares in question fell foul of the exclusionary criteria in the definition of *equity share* in that the right to participate in dividends was indeed limited, or at least, was not unlimited.

However, SARS's expansive attitude in this regard is not surprising, given that National Treasury had announced in the 2010 Budget Review that South Africa is to be promoted as a gateway to investment in Africa, and given that legislative amendments have already been made and exchange control regulations eased to encourage the establishment of headquarter companies in South Africa.

South Africa's tax treaty with the DRC provides a new avenue for international investment

The tax treaty entered into between the Democratic Republic of Congo (DRC) and South Africa provides opportunity to promote South Africa as a hub for inward investment into the DRC. The tax treaty provides multinational companies with alternative investment opportunities in the DRC.

Until recently, the DRC had entered into only one Double Taxation Agreement (DTA) tax treaty (with Belgium). On 18 July 2012, the DRC doubled this number when its DTA with South Africa came into effect. When a foreign company holds its DRC investment through South Africa, the treaty and South Africa's headquarter company regime may reduce the tax cost of doing business in the DRC.

The South African Government regards the DRC as a strategic partner in the African continent. According to recent statistics issued by the Department of Trade and Industry, two-way trade between South Africa and the DRC stood at R7.8 billion in 2011 compared to R6.2 billion in 2010 and R4.8 billion in 2009.

The treaty applies to amounts paid on or after 1 January 2013 and with respect to tax years beginning on or after 1 January 2013.

The DRC's domestic laws provide that dividends paid by resident companies to non-resident companies are subject to a 20% withholding tax (10% for mining companies). However, the treaty with South Africa will reduce the rate to 5% if the South African resident company holds at least 25% of the DRC company. In all other cases, the rate is reduced to 15%.

Dividends include income from shares, mining shares, founders' shares or other rights, as well as income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

Interest arising in the DRC is subject to a 20% withholding tax rate (0% in the mining industry under certain conditions). If the beneficial owner of the interest is a South African resident, the treaty reduces this rate to 10%. Interest includes income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits.

Royalties arising in the DRC are subject to a withholding tax at an effective rate of 14%. However, if the beneficial owner of the royalties is a South African resident, the treaty reduces this rate to 10%. Royalties include payments received for the use of any copyright of literary, artistic or scientific work including films, tapes or discs used for radio or television broadcasting, any patent, trademark, design or model, plan, or for the use of industrial, commercial, or scientific equipment.

As is common in most agreements of this nature, the DRC/South Africa Double Tax Treaty ensures that the business profits of a South African enterprise will be subject to tax in the DRC only if the South African enterprise carries on business in the DRG through a permanent establishment. In the case of professional services rendered by an individual, the individual will be deemed to have a permanent establishment in the DRC only if he is present in the DRC for a period or periods in aggregate of more than 183 days in any 12 month period commencing or ending in a year of assessment.

Directors' fees derived by a South African resident are an exception to this provision as the tax treaty grants taxing rights to the DRC for income earned in one's capacity as a member of the board of directors of a company resident in DRC.

On 24 September 2012, the DRC amended its tax legislation. The corporate income tax rate applied to a DRC company, subsidiary or branch or a foreign company has been reduced to 35%. This is applicable to the 2013 fiscal year in the DRC. Furthermore, a new withholding tax has been introduced on service fees. The DTA is based on the Organisation for Economic Co-operation and Development (OECD) Model Convention. On this basis one should consider that South African residents should be taxable on such fees only if they fall within the ambit of business profits and are attributable to a permanent establishment in the DRC. However the application of Article 20.3 of the DTA leaves room for doubt. If the service fees are treated by the DRC as income subject to Article 20, the service fees will be subject to the DRC withholding tax.

South African companies that qualify as a headquarter company enjoy treaty benefits, but the dividends, interest and (in future) royalties paid by such a company will enjoy relief from the withholding regime that will be fully operational from 1 March 2014. For this reason, multinational companies with existing and planned investments in the DRC may wish to consider the potential benefits of holding their investments through South Africa.

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SARS Watch - April 2013 to May 2013

Interpretation		
25 April	IN 73 - Tax implications of rental income from tank containers	This Note provides guidance on the income tax implications of the letting of tank containers.
30 April	IN 52 (issue 2) - VAT periods	This Note serves to – • set out those instances when tax periods may end on a day other than the last day of a month (hereinafter referred to as cut-off dates); and • withdraw and replace Interpretation Note No. 52 dated 14 December 2009, with effect from the date of issue of this Note.
Binding rules		
24 April	BCR 039: Reduction of an STC credit and sections 64G(2)(a) and 64H(2)(a) declarations	This ruling deals with the obligation of a company or a regulated intermediary to notify a beneficial owner of a dividend to be paid in cash or distributed in specie of the amount by which the dividend will reduce the STC credit of the company paying the dividend and the publication of that notice.
30 Apr	BGR 019 - Approval to end a tax period on a day other than the last day of a month	
2 May	BPR 143: Preference shares constituting equity shares in relation to a headquarter company	This ruling deals with the question as to whether preference shares held will qualify as equity shares for purposes of applying the definition of "headquarter company" in section 1 of the Act.
7 May	BPR 144: Write-off period in respect of the increase in either the cost or the value of assets pursuant to a section 45(4) de-grouping	This ruling deals with the write-off period to be allowed in respect of the increase in either the cost or the value of assets initially acquired under section 45, as a result of a de-grouping of companies as contemplated in section 45(4).
8 May	BPR 145: Allowances - Assets forming part of a sale and leaseback arrangement	This ruling deals with the write-off period under section 11(e) of assets forming part of a sale and leaseback arrangement and the deductibility thereof.
10 May	BPR 146: Mining tax – Contract mining agreement	This ruling deals with – • whether a company appointed as a contractor in terms of a contract mining agreement is conducting mining operations and entitled to deductions under section 11(a), 15 and 36 of the Act during a transition period when the company is awaiting the transfer of mining rights to it; and • the deductibility of contributions made by such company under section 37A(1)(d)(ii) in respect of environmental obligations.
14 May	PR 147: Consideration received for the surrender of a right to acquire shares	This ruling deals with the income tax consequences for a taxpayer in respect of consideration to be received for the surrender of a right to acquire shares.
14 May	BCR 040: Investors acquiring rights in a completed film	This ruling deals with the tax consequences for an investor who will acquire rights in a completed film.
PwC publications		
30 April	Tax Alert - Third party returns	This Tax Alert was to notify taxpayers that SARS issued a notice in terms of s26 of the Tax Administration Act 2011 (TAA), requiring specified persons (reporting institutions) to submit bi-annual returns in respect of information as required in terms of the notice.
6 May	Tax Alert - Interest limitation proposals	National Treasury and SARS have issued a media statement and a request for comment on proposals to limit excessive interest deductions. The proposals target four areas of concern: Hybrid Debt Instruments, connected person debt, transfer pricing, and acquisition debt.