

The new South African headquarter regime doesn't quite cut it


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Internationally there are many jurisdictions, such as Austria, Luxembourg, The Netherlands, Switzerland and Singapore which are popular for purposes of establishing holding and headquarter companies for multinational groups. Closer to home Mauritius has established itself as a favourable jurisdiction for these purposes, especially for investments into African countries. Up to now, the South African tax and exchange control system has prevented South Africa from being suitable for this purpose.

South Africa has always had certain commercial advantages for use as an African headquarters location, including:

- geographic location;
- a relatively sizeable economy;
- relative political stability;
- strength in financial services;
- a wide network of tax treaties; and
- a wide network of investment protection agreements;

Despite these commercial advantages, historically South Africa lacked the favourable tax treatment that some other jurisdictions offered to inbound investors. While the tax treatment in a particular jurisdiction is never the sole reason for using it, it remains an important determinant.



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The new South African headquarter company regime is an attempt to remedy this. The government plans to make South Africa a gateway for both foreign and local investments into Africa. The tax issues which have acted as a bar were identified as being the controlled foreign company (CFC) rules, the secondary tax on companies (STC) as well as transfer pricing rules. The new headquarter regime is generally exempt from all these rules.

The new South African headquarter company regime has been introduced by means of a new defini-

tion of "headquarter company" into s1 of the Income Tax Act with effect from January 1 2011.

In terms of this definition, in order to use the headquarter regime, the following requirements must be met:

- A headquarter company must be a tax resident company in which each shareholder (alone or together with other companies within the same group of companies) holds 20% or more of the equity shares and voting rights. This requirement is a continuous requirement which applies throughout the tax year, that is, year after year;
- At the end of each year of assessment, 80% or more of the cost of the total assets of the company must be attributable to:
 - any interest in equity shares in,
 - any amount loaned or advanced to, or
 - any intellectual property that is licensed by that company to;
 - any foreign company in which that company (alone or together with the same group of companies) held at least 20% of the equity shares and voting rights.
- In addition to these requirements, in each year of assessment, 80% or more of the total receipts and accruals of that company must consist of:
 - dividends, interest, royalties or fees paid or payable by any foreign company (contemplated above); or
 - proceeds from the disposal of any interest in equity shares or of any intellectual property (contemplated above).

This latter requirement can only be determined at the end of the relevant tax year.

If these requirements are met, the following tax concessions will apply:

- The foreign subsidiaries of a headquarter company will not be CFCs in relation to the headquarter company, and consequently their net income will not be attributed to the headquarter company. The foreign subsidiaries of the headquarter company will, however, be CFCs in relation to any South African resident shareholders of the headquarter company, if such shareholders indirectly hold more than 50% of the participation rights or voting rights in the subsidiaries;
- Dividends declared by a headquarter company will be exempt from income tax in the hands of the shareholders and will not be subject to STC (nor the future dividends tax);

purposes of the CGT participation exemption, which exempts from CGT the gain from the sale of a 20% or more equity stake in a foreign company from CGT;

- Special favourable rules apply in regard to the calculation of foreign exchange differences and to the ring fencing of the deduction of interest incurred by a headquarter company on financial assistance granted by a non-resident. Such financial assistance will not be subject to the transfer pricing rules to the extent such assistance is applied by the headquarter company to financing foreign subsidiaries or foreign companies in which it directly or indirectly holds at least 20% of the equity shares and voting rights; and
- Certain exchange control restrictions have been relaxed. In terms of Exchange Control Circular No. 37/2010 (October 27 2010), headquarter companies will be allowed to raise and deploy capital offshore without exchange control approval. However, headquarter companies remains exchange control residents for all other purposes.

Despite recent relaxations, exchange control restrictions remain in force in South Africa. In determining whether the proposed headquarter regime will be a success, cognisance needs to be given, therefore, to the various South African exchange control rules which could still apply irrespective of the recent general relaxation. Specifically, a South African incorporated headquarter company will still be regarded as a "resident" for exchange control purposes. On this basis, other restrictive rules will continue to apply such as the so-called "loop" rule, which prohibits South African residents from "exporting capital" by investing in non-CMA based jurisdictions which reinvest back into the CMA in whatever form possible (including the advancement of loan funding).

One way of getting around the remaining exchange control restrictions is to use a foreign company. A foreign incorporated company could qualify as a headquarter company because the definition refers to any company long as it is a resident.

The definition does not require the headquarter company to be incorporated in South Africa. A Mauritian company incorporated in Mauritius but which is effectively managed in South Africa may, therefore, qualify as a headquarter company. A foreign incorporated company will not be South African exchange control resident even if it is a tax resident. Consequently, the relatively onerous remaining South African exchange control restrictions can be avoided by simply incorporating a Mauritian company and using it as a headquarter company.

While the new headquarter regime remains a positive development, the following disadvantages remain:

- The new headquarter company remains fully taxable on trading income, management fees, interest and royalties. Headquarter companies will also be subject to donations tax and to capital gains tax (other than in respect of the disposal of subsidiaries held on capital account to non-residents



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held on revenue account will be fully taxable. In this regard, it is important to note that the s9C 3-year deemed capital gain rule does not apply to a foreign shareholding. The reason for this tax treatment is presumably in order for such a company not to constitute a harmful tax regime which is not allowed under the OECD anti-tax haven initiatives.

- A headquarter company will be deemed not to be a resident for the purposes of the corporate rules which are contained s42 to s47 of the Act, which means that roll-over relief in those sections will generally not be applicable to a headquarter company.
- The new headquarter company regime is available to South African shareholders, irrespective of whether resident companies, individuals, trusts, etc, are the shareholders, but as soon as South African residents collectively hold more than 50% of the headquarter company, then its subsidiaries will be CFCs, not in relation to the headquarter company, but in relation to the shareholders of the headquarter company.
- Certain transfer pricing provisions will apply to non-funding transactions with foreign subsidiaries, like management services and intellectual property utilisation.

Internationally, there is a difference between headquarter regimes and intermediary holding company regimes. An intermediary holding company (IHC) is generally interposed between the ultimate holding company and the operating subsidiaries of a multinational group of companies. The purpose of an IHC is simply to hold shares and manage dividend flows. An IHC does not engage

in its own commercial or trading activities.

The most beneficial location for an IHC depends on the specific facts and circumstances of each multinational group of companies. There are, however, certain important characteristics which must substantially be met for a multinational group of companies to benefit from utilising an IHC. The most important characteristics of an ideal holding company location can be summarised as:

- the absence of tax or low tax on dividend income and preferably also on other income received from the intermediary holding company;
- no or low withholding tax on dividends declared to the shareholders;
- the absence of capital gains tax on any profit arising on the disposal or deemed disposal of an investment;
- the absence of tax or reduced tax on capital introduced to a company or on increases in a company's share capital;
- the absence of a controlled foreign company regime; and
- the absence of exchange controls.

Should all or most of these principal features be present, the jurisdiction can be described as an 'ideal' IHC jurisdiction. Generally, countries like Mauritius, Luxembourg and The Netherlands meet all of these requirements. In adjudicating whether the new South African headquarter regime can be regarded as an ideal IHC regime, the following observations are apposite:

- ▶ Dividends declared by a headquarter company will be exempt from income tax in the hands of the shareholders and will not be subject to

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