Tax characteristics of an ideal holding company location*

Thabo Legwaila
BIuris (Venda) LLB LLM (Wits) PGDip Tax Law LLM (UCT) LLD (Pret)
Extraordinary Lecturer, University of Pretoria

OPSOMMING

Belastingeienskappe van 'n ideale ligging vir 'n houermaatskappy

Die Suid-Afrikaanse regering het in 2008 aangekondig dat hulle van voorneme is om Suid-Afrika te bevorder as 'n gepaste maatskappyjurisdiksie vir beleggings in Afrika in die algemeen en sub-Sahara Afrika in die besonder. Ten einde hierdie doel te bereik behoort die regulatoriese-, ekonomiese- en juridiese-raamwerke geskik te wees vir internasionale belegging. Een van die ekonomiese en juridiese aspekte wat tans hersien word, is die belastingstelsel. Die belastingstelsel mag sommige eienskappe bevat wat nadelig is vir internasionale houermaatskappye en ander wat bevorderlik is vir sulke maatskappye. Hierdie artikel ontleed die belastingeienskappe van 'n ideale houermaatskappybedeling en beklemtoon die spesifieke elemente tot die mate wat dit houermaatskappye beïnvloed en wat sal verseker dat Suid Afrika 'n ideale ligging vir houermaatskappye word. Hierdie is hoofsaaklik 'n gunstige kapitaalwinsbelastingbedeling, lae inkomstebelasting, geen of lae belasting op dividende, eensydige vermyding van dubbelbelasting, 'n gunstige belastingverdrag netwerk, die afwesigheid van beheerde buitelandse maatskappy wetgewing en 'n liberale dun kapitalisasie- en oordragprys bedeling. Sekere belasting eienskappe soos 'n eensydige vermyding van dubbelbelasting in die vorm van 'n korting vir buitelandse belasting betaal, deelnemende vrystelling en 'n oorvloed van dubbelbelasting verdrae trek beleggings suksesvol aan in die vorm van houermaatskappye na 'n land met sulke eienskappe. In teenstelling hiermee het eienskappe soos buitelandse beheerde maatskappy wetgewing en streng oordragprys bepalings en streng dun kapitalisasie bepalings die teenoorgestelde uitwerking. Selfs in gevalle waar die bepalings nie op houermaatskappye van toepassing is nie mag die blote teenwoordigheid van bogenoemde bepalings steeds buitelandse beleggers afskrik.

1 Introduction

Recent years have witnessed a heightened appetite by numerous countries to attract investment to, and through, their shores in the form of holding companies. At the forefront of this development are countries such as Belgium, Denmark, Luxembourg, Mauritius, the Netherlands, Singapore and the United Kingdom. With the announcement in the 2010 Budget review, South Africa has recently joined this fray.[1]

* This article is an adapted version of part of the research done and submitted by the author in part fulfillment of the requirements for the degree LLD at the University of Pretoria.

1 National Treasury *Budget Review* (2010) 78–79.

The South African National Treasury announced that it intends to create a business orientated environment that will promote South Africa as a gateway to investment into Africa.[2] In pursuance of this goal, the National Treasury is reviewing the South African corporate and business framework as well as exchange control and corporate tax laws, to determine if the corporate, business, legal and tax environment could stifle the ability of South Africa to serve as a base through which investors could access investment opportunities in Africa.[3]

2 Background

Holding company investment takes various forms depending on the particular needs of the investor.[4] For example, a holding company can be created in a group as an international holding company to control the companies in the group; as an intellectual property holding company to hold and manage intellectual property rights; as a international headquarter company where multinational groups of companies have significant economic interests in a region which is distant from its head office to oversee and co-ordinate the group's business interests in a particular region; or as an intermediary holding company to acquire, manage and sell investments in group companies, mainly its subsidiaries and in general to provide transactional and organisational flexibility in a group of companies.[5]

As a general matter these holding companies are interposed between the ultimate shareholder company and operating companies. They are thus holding companies and subsidiaries at the same time. They are also set up in the jurisdiction other than that of the ultimate investor.

Once an investor has determined that the business structure of his or her investments require the establishment of a holding company of any form, the investor engages in identifying a jurisdiction with the infrastructure that would optimally enable the attainment of such objectives. Infrastructure presents itself in these characteristics, both tax and non-tax, of the particular jurisdiction.[6]

The tax regime that applies in a specific location is generally an important factor for determining the efficiency of a holding company and usually plays a role as far as a decision on the jurisdiction where the holding company should be established is concerned. However, non-tax

2 National Treasury *Budget Review* 78–79.
3 See National Treasury *Budget Review* 78–79. See also Lermer "2010 Budget Attracts SA Based Headquarter Companies" *Moneyweb* available at http://www.moneyweb.co.za/mw/view/mw/en/page302588?oid = 347864&sn = 2009 % 20Detail (accessed 2010-04-01).
4 Legwaila "Intermediary Holding Companies and Group Taxation" 2010 *De Jure* 308 313–314.
5 See Legwaila 2010 *De Jure* 308 313–315.
6 See Easson *Tax Incentives for Foreign Direct Investment* (2004) 17.

factors cannot be undermined as they are key to the success of the investment that is undertaken.

This article outlines the characteristics of an ideal location for the conducting of holding company functions. The article does not deal specifically with any of the variations of the holding companies, but rather it analyses the common characteristics that need to be demonstrated by the potential holding company jurisdiction. This article mainly focuses on the tax characteristics. However, at the outset it briefly canvasses non-tax characteristics that are required of an aspiring potential jurisdiction.

This article analyses the tax characteristics of an ideal holding company regime and the analysis is not limited to the characteristics that would suit any specific form of a holding company. Most forms of holding companies would require and benefit from the same tax attributes as those in an ideal tax jurisdiction. While this article is occasioned by the introduction by the South African government of the headquarter company regime, focusing on characteristics suitable for holding companies in general, makes this article of great use to a wide range of circumstances where specific holding companies are set up. This article also observes the specific aspects of South African tax laws that would ensure that South Africa becomes an ideal holding company location.

3 Non-Tax Characteristics of a Holding Company Jurisdiction

A holding company requires infrastructure that is conducive to the performance of its operations and the achievement of its goals. Factors that affect the choice of location, in other words locational determinants, will differ from one holding company to another, depending on the objectives of the investment. The more important non-tax factors include: economic and political stability; adequate physical, business, accounting and legal infrastructure; the absence (or limited presence) of bureaucratic obstacles; adequate communication channels; the ability to repatriate profits freely; an effective banking system; and the availability of an adequate dispute resolution mechanism.[7]

The social, economic and political stability and risk within different countries are major considerations in the decision-making especially where the need for the raising of finance is important.[8] A factor that supplements the social, economic and political stability is the

7 See Udal & Cinnamon "How to select a Jurisdiction for Your Holding Company" 2004 *International Tax Review* 18 available at http://proquest.umi.com/pqdweb?did=789908371&Fmt=3&clientId=27625&RQT=309&VName=PQD (accessed 2010-05-19).

8 Olivier & Honiball *International Tax – A South African Perspective* (2008) 304.

functionality of the country's legal system and rule of law. Thus, not only should the legal system be suitable for transacting but it should also be possible for legal subjects to enforce their legal rights. Alternative dispute resolution as a legal process is normally an expedient and cheap alternative to the often lengthy legal processes. Where available, it too should be reliable.[9]

The country's government should also respect the rule of law and ideally have an enshrined constitution that protects the rights of the country's subjects. As Olivier and Honiball[10] observe:

> … a combination of operational business activities with an intermediary holding company in a single legal structure could expose an operational company's assets and investments to commercial risks. Stable laws and ease of compliance could assist in offsetting such risks.

The commercial language of the host country is also important. It is important that the language used is the same as the language of the investor (or at least a common language such as English or French). The importance of this factor is illustrated by the loss of popularity of the Danish holding company structure due to the requirement that compliance and reporting documentation had to be in Danish.[11] Linked to the prevailing commercial language, are reliable communication channels such as telecommunication, fax and email, without which the performance of various roles would be impaired.[12]

As holding companies mainly deal with control and management (including investment management) and the discharging of such services requires a few highly skilled people in the areas of law, financing and financing structures, economics, accounting and auditing, most holding companies do not necessarily require large numbers of employees to be stationed in the host country.

4 Tax Characteristics of a Holding Company Jurisdiction

An ideal or beneficial holding company jurisdiction depends on the specific characteristics of that jurisdiction. The degree of flexibility required by a multinational group of companies is also paramount when

9 See further on the factors that make a jurisdiction suitable for investment Cinnamon "Tasty Regimes Tempt Holding Companies" 1999 *International Tax Review* 9 9–11.
10 Olivier & Honiball 305. See also Rohatgi *Basic International Taxation* (2002) 239; Udal & Cinnamon 18.
11 Olivier & Honiball 305.
12 See Cussons & Bojkovic "Where do I hold my company?" 1998 *Accountancy* 123 124–125.

juxtaposed with such a jurisdiction. The critical characteristics that must be met by a potential jurisdiction are discussed below.[13]

4 1 A Favourable Capital Gains Tax Regime

Capital gains tax subjects gains realised on the disposal of capital assets to tax. Given that holding companies hold the shares of the companies within the group, it is very important for the potential holding company jurisdiction to have a tax system that is lenient in respect of the taxation of capital gains. The burdensomeness or otherwise of a tax system on capital depends not only on the rate of tax charged on capital. To a very large extent it depends on the rules for determining the acquisition price of assets, realisation and recognition rules and rules for determining gain or loss on disposal.[14]

The contours of the concept of capital gains and losses vary considerably from country to country. This concept also plays a different role in different systems. Generally it refers to a non-recurring gain which is not part of the normal stream of income involved in a business or investment.[15]

4 1 1 Determining the Acquisition Price

Acquisition price[16] is generally the consideration given for, and ancillary to, the creation or acquisition of an asset.[17] Most jurisdictions follow this pattern, thus resulting in the definitions or classifications of base cost being manifold. Acquisition costs could extend to the costs of insuring the asset, cost of remuneration of advisors or consultants involved in the acquisition of the asset, costs of moving the asset, cost of any improvement or enhancement of the asset during the acquisition, etcetera. The broader the coverage of expenditure included in the definition of base cost, the more favourable the taxation of capital.

4 1 2 Timing and Event for Realisation of Gain or Loss

The second important aspect is the event giving rise to the realisation of gain or loss. Capital gains, unlike revenue gains, are generally not realised on accrual or receipt but on the disposal of the asset or the cessation of ownership of the asset.[18] "In its ordinary meaning, disposal

---

13 See further on a summary of the essential characteristics, *Netherlands: Dutch Holding Companies*, on http://www.lowtax.net/lowtax/html/offon/netherlands/nethold.html (accessed 2010-05-21).

14 See Burns and Krever "Taxation of Income from Business and Investment" in *Tax Law Design and Drafting* (ed Thuronyi) (1998) 646.

15 Ault & Arnold *Comparative Income Taxation: A Structural Analysis* (1997) 194.

16 Acquisition price is also referred to as "base cost", "basis", "cost price", "book value" or "cost base".

17 See par 20 Sch 8 Income Tax Act 58 of 1962. See also Burns & Krever *Tax Law Design and Drafting* 648.

18 Whiteman *et al Whiteman on Capital Gains Tax* (1980) 23.

covers all situations in which the ownership of the asset changes."[19] Not only does it cover voluntary alienation of assets. It also covers, ordinarily or per deeming provisions, redemption, forfeiture, expiry, cancellation, renunciation, surrender, loss, destruction and abandonment.[20]

Some systems provide for the disposal rules when the assets or shareholders of a company exit the tax system. Others provide also for a disposal when the residence of a company is changed.[21] These are major considerations for a holding company, as some or all of its assets may be itinerant. If the disposal events are vast, numerous and broad, the chances of business actions being taxable increase and this presents a disadvantage to the jurisdiction being considered for the location of a holding company regime.

4 1 3 Amount Included in Calculation of Taxable Capital Gains

The amount that is included in the calculation of taxable capital gains is the proceeds of the disposal less the base cost. This includes the market value of any asset given (or given in part) in return for the asset. Where the asset is disposed of for no consideration or a consideration that is less than the base cost, the seller would be in a capital loss situation.[22]

These losses can beset off against all income or only against capital gains. It benefits the investors more where the losses are not ring-fenced as they can be set off immediately against the income as opposed to being deferred until the next capital gains event in which a gain is realised. The problem is exacerbated by the fact that most countries do not adjust tax losses for inflation, therefore eroding their value through the passing of time.

4 1 4 Disposals Between Connected Persons

Connected persons[23] may choose to transfer assets *inter partes* to achieve various objectives, including minimising the recognition of gain to defer taxes, inflating gains to absorb losses that were carried forward, value shifting to transfer gains to a lower bracket or exempt taxpayer,

19 Burns & Krever 647; see also Boidman & Ducharme *Taxation in Canada, Implications for Foreign Investment* (1985).
20 See Burns & Krever 647.
21 Burns & Krever 647.
22 Whiteman *Whiteman on Capital Gains Tax* (1988) 27.
23 Connected person is a defined term in the South African tax legislation (see the definition of "connected person" in s 1 Income Tax Act 58 of 1962). In other jurisdictions, reference is made to "related party" and "associated person". The definition differs from country to country and from situation to situation, mainly depending on the purpose of the definition and the context in which it is used. Generally, such definitions include blood relatives, lineal descendants and ancestors, members of the same partnership, and a company, its controlling shareholders and other companies in the same group of companies. See International Bureau of Fiscal Documentation (IBFD) *International Tax Glossary* (2005) definition of "connected person".

etc.[24] Non-arms-length transactions are mostly subject to deeming provisions. The person disposing of the asset is deemed to have received a consideration equal to the market value of the asset at the time of the disposal. At the same time, the amount is treated as the base cost of the asset for the person acquiring the asset.[25] As holding companies are generally members of a group of companies, tax-free intra-group transfers are essential for the carrying out of the functions of the holding company.

4 1 5 Roll-Over Provisions

Roll-over provisions are rules that regulate the non-recognition of the disposal of an asset in the year that the asset was disposed of.[26] This applies both to actual and deemed disposals. The tax system treats the disposal of the asset as if it was disposed of at cost or base cost and the acquirer to have acquired it for a consideration equal to the original cost.[27]

Three main situations where roll-over provisions are relevant for holding companies are where–

(1) the tax status of an asset changes, for example where an asset acquired as a business asset or an item of inventory is subsequently held as an investment asset or *vice versa*.[28]

(2) an asset is disposed of with an intention to trigger a loss to countenance the gain made in respect of other assets that are disposed of, the tax systems often deny the loss recognition and impose a roll-over treatment.[29]

(3) an asset is disposed of involuntarily and a replacement asset is acquired, non-recognition rules apply.[30]

As the saying goes, "tax deferred is tax saved", so investors are likely to be attracted to countries where there is an abundance of roll-over provisions.

4 1 6 Capital Gains Tax Rate

Generally, capital gains are given preferential treatment in tax.[31] The rates are normally lower than the rates of income tax. Capital tax rates are usually the first issue addressed when the suitability of a jurisdiction to host a holding company is being considered. In effect the rate should not be that important because the effective rate is decisively affected by

24 Burns & Krever 651.
25 *Idem.*
26 See *IBFD International Tax Glossary* definition of "roll-over relief". See also http://www.ftomasek.com/RickKreverDraft.html (accessed 2010-04-28).
27 Burns & Krever 652.
28 *Idem.*
29 *Ibid* 653–654.
30 *Ibid* 654.
31 See Whiteman 27.

the rules outlined above. In addition to the aforesaid, they can, as is the case in South Africa, be further determined by usage of an inclusion rate.[32] This method includes a certain percentage of the gain in the normal taxable income of the taxpayer and the amount is taxed at the normal tax rate applicable to that taxpayer.[33]

4 1 7 South African Capital Gains Tax

For South African purposes capital gains tax is levied at the disposal of a capital asset.[34] Disposal is widely defined, and broadly covers transfers which result in change of ownership of an asset.[35] Certain events are deemed to be disposals where they would otherwise not be disposals due to the change of ownership not being readily determinable.[36] For companies capital gains are taxed at 50% of the corporate income tax rate, i.e. 14%.[37] This is a low rate as opposed to countries which tax capital gains at the same rate as normal income such as the Netherlands,[38] United Kingdom[39] and United States of America.[40] As a result the South African capital gains tax provisions do not adversely affect South Africa's suitability to host holding companies.

4 2 Low Income Taxes

Income tax is the most important source of direct taxation for almost all countries. It is also referred to as normal tax and generally caters for all income, other than that specifically provided for, like donations tax, estate duty and capital gains tax. As a result, a discussion on income tax in this context cannot be about the lack thereof, as that would be superficial. It is limited to the rate of tax and the chances of reducing the effective tax payable.

Some countries levy income tax on their residents and others on the income earned from a source within that country. Generally, the residence-based systems enjoy a broader tax base than the source-based ones.[41] Therefore, most countries change their systems in favour of the residence basis. This move is not very favourable for holding companies, as the holding company could be taxed on its capital gains made from countries other than its country of residence in which its subsidiaries are

32 In terms of par 10 Sch 8 Income Tax Act 58 of 1962.
33 *Idem*.
34 See s 26A read with par 3 Sch 8 Income Tax Act 58 of 1962.
35 See definition of "disposal" in par 1 Sch 8 read with par 11 Sch 8 Income Tax Act 58 of 1962.
36 See par 12 Sch 8 Income Tax Act 58 of 1962.
37 See par 10 Sch 8 Income Tax Act 58 of 1962.
38 Lambooij & Peelen "The Netherlands Holding Company – Past and Present" 2006 *Bulletin for International Taxation* 335 par 4.1; Ernst & Young *The 2011 Worldwide Corporate Tax Guide* (2011) 769.
39 Ernst & Young 1178–1179.
40 Ernst & Young 1227.
41 Organisation for Economic Co-operation and Development *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework* (2001) 144.

located. However, a double tax treaty between the host country and the country of the subsidiaries may significantly influence the countries' right to tax.[42]

The effective income tax rate can be reduced by exemptions, deductions and allowances. It can also be reduced by tax incentives that a country may use to attract investors. Such incentives can be general, such as tax holidays, investment allowances, tax credits, timing differences, tax rate reductions or incentives based on administrative discretion.[43]

4 2 1 South African Corporate Income Tax Rate

The South African corporate tax rate is 28%. This tax rate is low compared to the United States at 35%,[44] Australia at 30%,[45] equal to the United Kingdom[46] and higher than other countries such as China at 25%[47] and Brazil at 15%.[48] Based on the varying tax rates both on the high and low side of the South African corporate tax rate, it is submitted that the 28% corporate tax rate is a neutral item for purposes of attracting foreign investment in the form of holding companies.

4 3 No or Low Tax on Dividends

The measure of a company's success is the amount of dividends that that company distributes to its shareholders alongside the appreciation of the value of the company (in the form of retained earnings that translate into the increase in the value of the shares). Each company's ultimate objective is to make enough profit and to pass on that profit to its shareholders as a dividend, unless such amounts are reinvested in the company.[49] The company, at best, would like the value of its undistributed profits to translate into the amount of dividends received by its shareholders without, or with the least, liability for tax. A low tax on dividends is an overarching statement that encapsulates both a numerically low amount of tax payable thereon or it can refer to a thin dividend tax base.[50]

42 See the discussion in paragraph 4.5 below.
43 Incentives can also be special-purpose based such as those dedicated to famine relief, infrastructure development, employment creation, technology transfer and export promotion.
44 Ernst & Young 1225.
45 *Ibid* 50.
46 *Ibid* 1177.
47 *Ibid* 197.
48 *Ibid* 133.
49 Baker *Dividend and Dividend Policy* (2009) 3;
50 Schreiber & Stroik *All About Dividend Investing: The Easy Way To Get Started* (2005) 5-12.

4 3 1 Numerically Low Amount of Tax on Dividends

This favourable type of low tax on dividends, which again can be represented by either a low percentage[51] or a numerical division of a unit of currency,[52] is frequently used to apply to dividends generally or specific forms of dividends, e.g. where a participation preference is granted. It also gives the impression that tax jurisdictions have attractive tax regimes, as the low percentage is at the forefront of the information on taxation of dividends.[53]

4 3 2 Thin Dividend Tax Base

The effective dividend tax rate can be low, though not represented by the tax rate applicable thereto, but by the amounts that are included in the base of dividends. This may be by way of restrictive dividend definition, fewer or no inclusions in the definition of dividends, exceptions, exemptions etcetera. Some jurisdictions have broader dividend tax bases covering most distributions by companies while others have considerably limited bases. The South African secondary tax on companies system[54] on the one hand and the Canadian dividend tax system,[55] on the other, represent such extremes.

4 3 4 No or Low Withholding Tax on Dividends

As with the low tax on dividends, a determination of a withholding tax is mainly informed by the nature of amounts that constitute a dividend and the numerical rate attached to that withholding. A withholding tax is normally not an underlying tax. The terminology hinges on a two-step construction in terms of which the dividend tax is determined and a withholding obligation is imposed on the company declaring the dividend to a non-resident to withhold that amount of the tax.[56] Therefore, a withholding tax is an administrative intervention. It is common on dividends declared to non-residents, as the tax authorities would otherwise not have the legal power or jurisdiction to collect the tax payable on dividends.[57]

The amount withheld is determined by national legislation but often reduced by treaties.[58] As a result the investor would prefer a jurisdiction where there is either low or no withholding tax – or, where there is a high rate of withholding, it is in a country that has a good treaty network which includes treaty relief against the withholding. Alternatively, the

51 For example 2 %.
52 For example 2 cents in each Rand.
53 Further on the need for impression of the country's ability to host holding companies see Legwaila "Taxation of Holding Companies in South Africa" 2011 *SA Merc LJ* 1.
54 See ss 64B–64R Income Tax Act 58 of 1962.
55 *Canadian Master Tax Guide* (2008) par 6030; Ernst & Young 169.
56 See IBFD *International Tax Glossary* definition of "withholding tax".
57 *Idem*.
58 See Olivier & Honiball 359–361.

group's income distribution track could require only a treaty between the host country and the ultimate holding company's country that relieves the declaration of a dividend out of the holding company from taxation.[59]

4 3 5 South African Taxation of Dividends

Currently, South Africa taxes companies on declaration of dividends. The tax, referred to as secondary tax on companies ("STC"), is levied on the company declaring dividends and is calculated with reference to the amount of dividends declared.[60] The STC rate is 10%.[61] With effect from 2012, the STC will be replaced by a dividends tax system in terms of which the tax will be on the shareholder receiving the dividend. The rate will remain unchanged at 10%.[62] The dividends tax rate of 10% is good for holding companies as compared to higher rates of dividends tax in other countries such as the United States at 30%[63] and the Netherlands at 15%.[64] Furthermore qualifying dividends declared by South African headquarter companies are exempt from South African tax on dividends.[65] This implies that holding companies that qualify as headquarter companies will benefit from this exemption.

4 5 A Favourable Tax Treaty Network

A favourable network of tax treaties which limit withholding taxes in general levied on payments by and to other investment countries is one of the features that make a country suitable to host a holding company.[66]

Treaties have the advantage of promoting international trade and investment by preventing double taxation through assignment of taxing rights via tax exemption or credits and through agreements on maximum withholding tax and thus reducing the overall tax burden.[67] Loncarevic[68] states that:

> [o]n the other hand restrictions on tax avoidance and tax evasion, anti-treaty shopping rules, as well as exchange of information between tax administrators may have negative effects on international movement of

59 *Idem.*
60 The tax is levied in terms of s 64B Income Tax Act 58 of 1962.
61 S 64B(2) Income Tax Act 58 of 1962.
62 The tax is levied in terms of s 64B–64R Income Tax Act 58 of 1962.
63 See Ernst & Young 1225.
64 *Ibid* 767.
65 See s 10(10(k)(ii) Income Tax Act 58 of 1962.
66 See Udal & Cinnamon 21.
67 Loncarevic *Tax Treaty Policy and Development* (2005) 19. See Vogel *Klaus Vogel on Double Taxation Conventions* (1997) 1130. See also Ault & Arnold 385–403.
68 Loncarevic 20.

goods, services, persons and capital since these measures reduce possibilities of taxpayers to avoid taxes through transfer pricing,[69] treaty shopping,[70] etc.

It is not only the number of the treaties that is important. Perhaps even more important is the content of the treaty. As Vanhaute[71] states:

> In deciding on a suitable jurisdiction for the location of a holding company, the availability of a treaty network, and moreover the scope of such network and its specific features are, of course, as important as in any other international tax planning scheme. In this respect, the relevant factors to be considered are:
>
> - the scope of the tax treaty network (number of treaties, with which countries, etc.);
> - the attractiveness of these treaties in terms of accessibility, and the average level of withholding tax on interest, dividend and royalty income which may accrue to the holding; and
> - the impact of certain limitation of benefits (LOB) clauses.[72]

Investors looking to invest could limit their exposure to dividend withholding tax and capital gains tax by placing a holding company in a jurisdiction which has a double tax arrangement that limits dividend withholding tax and tax on capital gains.[73] While the prevention of double taxation is the main purpose of double tax agreements, they are also not intended to facilitate tax avoidance and evasion.[74]

Double tax agreements avoid double taxation by using the exemption or credits methods as well as by awarding some taxing rights exclusively to one country. The methods vary according to the negotiations between the countries. The Organisaton for Economic Co-operation and

69 Transfer pricing is an area of law and economics that is concerned with ensuring that prices charged between associated enterprises for the transfer of goods and services are not used to avoid tax by shifting profits to a low tax jurisdiction. See IBFD *International Tax Glossary* definition of “transfer pricing”. See further on transfer pricing the discussion of transfer pricing in paragraph 4 8 1 below.

70 Treaty shopping refers to a situation where a person who is not entitled to the benefits of a tax treaty makes use of another person in order to indirectly obtain treaty benefits that are not available directly. See IBFD *International Tax Glossary* definition of “treaty shopping”.

71 Vanhaute *Belgium in International Tax Planning* (2008) 157.

72 A “limitation of benefits clause” is a treaty provision that limits benefits to entities that have a certain minimum level of local ownership, deny benefits to entities which benefit from a privileged tax regime or which are not subject to tax in respect of the income in question, or which pay on more than a certain proportion of the income in tax deductible form (see IBFD *International Tax Glossary* definition of “Limitation on benefits provision”)

73 Nelson “China: How to Prepare for Implementing Rules” 2007 *International Tax Review* 1 http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=24353&SID=697470&SM=&SearchStr=%22intermediary%20holding%20company%22 (accessed 2010-06-13).

74 Such prevention of tax avoidance and evasion is achieved by the exchange of information provisions in the Double Tax Agreements. See Van Weeghel *The Improper Use of Tax Treaties* (1998).

Development Model Convention and the United Nations Model Convention, as guides, outline both methods.

4 5 1 South African Tax Treaty Network

South Africa has more than 70 tax treaties and is in the process of entering into treaties with more countries. Furthermore, some of the treaties currently in force are being renegotiated.[75] This is fairly considerable tax treaty network covering most developing countries from which investment in the form of holding companies can be expected.

4 6 Unilateral Avoidance of Double Taxation

Some countries have systems of unilateral avoidance of double taxation. In these systems the countries independently provide tax relief to income that was taxed in a source country or give credit for taxes incurred in those countries in respect of the same income.[76] This is a system that investors also look at in determining the suitability of a holding company host jurisdiction.[77] Where a country has adequate unilateral double tax avoidance provisions the purpose of the double tax agreement would be to supplement such provisions. As Loncarevic[78] states,

> [a] tax treaty supplements the unilateral double tax relief provisions in the respective treaty partner countries' domestic law and clarifies the taxation position of income flows between them.

Unilateral double tax avoidance measures fail to provide investors with the sense of certainty that taxpayers need for investment as countries can and do amend or cancel them unilaterally. The certainty provided by treaties is effective in attracting foreign investors, as treaties reassure investors in advance as to how they will be taxed on their offshore profits.[79] Countries generally hesitate to violate their treaty obligations and would not want to be seen to abandon their original treaty undertakings by suggesting amendments.[80] A source of guarantee and certainty to investors which is also a downside of treaties from a tax policy point of view is that treaties take long to amend as the amendment process requires bilateral negotiations between the treaty partners.

---

75 See http://www.sars.co.za/home.asp?pid = 3919 (accessed 2011-10-17).
76 Vogel 1174.
77 See Udal & Cinnamon 18.
78 Loncarevic 19.
79 Loncarevic 22.
80 Testimony of Barbara Angus, *US Department of Treasury before the Senate Committee on Foreign Relations on Pending Income Tax Agreements*, 24 September 2004, http://www.treas.gov/press/releases/js1952.htm (accessed 2011-10-25).

4 6 1 The South African Unilateral Avoidance of Double Taxation

South Africa provides unilateral double tax avoidance in the form of a tax credit for taxes payable to any sphere of government outside South Africa on income sourced outside South Africa.[81] A deduction is allowed for taxes paid to spheres of government of foreign countries where the income is sourced or deemed to be sourced in South Africa.[82] The tax credit provision has been extended to apply to management and other fees.[83] These provisions are a positive attribute in the South African tax system for holding companies.

4 7 The Absence of Controlled Foreign Company Legislation

Countries generally tax both residents and non-residents on the domestic-source income derived from their tax jurisdiction.[84] Some countries tax their residents on their worldwide income irrespective of the source. Other countries tax residents on their worldwide income and non-residents on income that is sourced domestically. Countries that tax on a residence basis supplement their taxing authorities by subjecting their residents to tax on income made by foreign corporations in which residents hold substantial shares. These systems tax the income of a controlled foreign company (CFC) as if it were earned by the CFC's resident shareholders.

Tax systems define CFCs for their domestic purposes. These definitions differ from country to country. The main difference relates to the shareholding by the resident and connected persons in the foreign company. However, a CFC can broadly be described as a foreign company over which its resident shareholders have sufficient influence to determine when to pay the dividends, and therefore can use such influence in the foreign company to defer the declaration of dividends, thereby deferring the tax thereon.[85]

The effect of the CFC rules on the shareholders is considerable. Under the normal tax rules a shareholder cannot be taxed on his or her underlying share of the profits of a company until it is distributed to him or her as dividends. Without remedial legislation domestic tax on foreign-

81 S 6*quat* Income Tax Act 58 of 1962.
82 S 6*quat*(1C) Income Tax Act 58 of 1962
83 S 6*quin* Income Tax Act 58 of 1962.
84 This could be varied by the provisions of a double taxation agreement. See Vogel "Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)" 1998 *Intertax* 219. See also Forst "The Continuing Vitality of Source-Based Taxation in the Electronic Age" 1997 *Tax Notes International* 1455; Udal & Cinnamon 20.
85 Rohatgi 305.

source income can easily be deferred or postponed by establishing a foreign corporation to receive the income.[86]

The absence of CFC legislation is therefore one of the characteristics that would render a jurisdiction an ideal one for hosting a holding company.[87] It is therefore important for prospective investors to examine the main features and application of CFC legislation in potential jurisdictions to determine the extent to which the CFC legislation is applicable. What follows is an outline of the main features to consider in CFC legislation.

4 7 1 Definition of Controlled Foreign Ccompany

In jurisdictions where CFC provisions are applicable, the provisions would be legislated to become part of law. The CFC provisions never apply as part of the common law of any country. In such tax law sources, the operation of CFC provisions begins with the definition of CFC. The defining characteristics of CFCs are their residence in the foreign country and the control of the CFC by resident shareholders.[88]

The determining holding requirement in the CFC definitions differs significantly. Some countries do not base it on the issue of control. In these countries the determination is based on the ownership interest.[89] Where a person's voting interest does not accurately reflect the shareholder's economic interest in the company, control may be determined based on "market value circumstance".[90] To avoid obvious tax avoidance schemes, control generally includes indirect control and/or ownership.

The important deciding factor is the amount of control or interest in the foreign company that makes it a CFC. Here too the range is broad. While in most countries a minimum of 50%[91] is required, some

86 Rohatgi 305 states: "The CFC rules counter the deferral of taxation in such companies. Under its rules, the income earned by a CFC is attributed on a current basis to the shareholders on a pro rata basis even when not distributed to them."
87 See Legwaila "Tax Reasons for Establishing a Headquarter Company" 2011 *Obiter* 129.
88 See Arnold & McIntyre 90.
89 France, Portugal and Denmark are examples of this. See Arnold & McIntyre 90.
90 In New Zealand, market value circumstance is heavily relied on where the shareholder interests are to be determined. Market value circumstance exists where a person's voting interest does not accurately reflect the shareholder's economic interest and the shareholder's percentage ownership is determined by reference to both voting interests and the market value interests held in the company. It takes into account the existence of debentures, shares, options and other arrangements which may affect the balance of interests within the company to such an extent that a simple examination of voting power may be misleading. Lindsay *New Zealand Master Tax Guide* (2008) par 16:170.
91 In France the percentage holding required is 50%.

countries go as low as 25%.[92] This holding can be through one resident or more, either connected or unconnected persons. These constructive ownership rules are designed to prevent taxpayers from avoiding the CFC rules by fragmenting the ownership of the shares among connected persons.[93] In some countries, the CFC control requirement is satisfied if control is concentrated in a small number of resident shareholders.[94]

It is submitted that investors would be more attracted to a jurisdiction where the holding in a foreign company needs to be high (for example 60%) for a company to be a CFC, where widely held foreign companies are treated differently from companies held by connected residents, where the minimum participation exemption for attribution is high and where the income is only attributable to persons holding a certain higher amount of shares. For holding company purposes the more limited the application of CFC legislation, the more the flexibility to structure the holding of the underlying investments with, for example, its ultimate holding company.

4 7 2 Computation of Attributable Income

It is also essential for the investors to know what constitutes attributable income in the potential jurisdiction as compared to other jurisdictions. The income is generally attributed to the resident shareholders and computed in accordance with domestic tax rules and in domestic currency.[95] In determining attributable income, two different approaches are adopted. Some countries adopt the entity approach while others adopt the transactional approach.

(a) The Entity Approach

The entity approach looks at the fact that a foreign company is a CFC. Once that is determined the income of that entity is attributable to the resident shareholders irrespective of the source of that income or the nature of the transaction that the company would have entered into to generate that income. This approach entails an all-or-nothing inclusion mechanism.[96] According to Arnold and McIntyre:[97]

> [i]f a CFC does not qualify for any of the exemptions, all its income is attributable to its domestic shareholders. If, however, the CFC is exempt, none of its income, even passive income, is attributable to its domestic shareholders.

---

92 The required percentage holding in Portugal is 21.5% and in Denmark is 25% (see Ernst & Young 276, 900).
93 Where the holding requirement refers to connected or related persons the required holding per person is generally low.
94 For example, Australia (s 340 Income Tax Assessment Act 1936), Canada (s 112 Income Tax Act) and New Zealand (s EX1(1) New Zealand Income Tax Act 2004) require that for a foreign corporation to be a controlled foreign corporation five or fewer residents should control such a corporation.
95 Arnold & McIntyre 96.
96 There are, however, exceptions to the general rule.
97 Arnold & McIntyre 94.

The entity approach attributes the net income of the CFC. This is so because attribution of the gross income would not take into account the cost of making business in the country where the CFC is resident. The residence country would then generally grant foreign tax relief.

(b) The Transactional Approach

The transactional approach, on the other hand, attributes only certain kinds of "tainted income" to the resident shareholders. "Under the transactional approach, each transaction entered into by a CFC must be analysed to determine if it produces tainted or other income."[98] Tainted income consists of passive investment income (dividends, rent, royalties, interest and capital gains) and base company income (income mainly derived from offshore transactions between the CFC and connected persons in relation to that CFC).[99] Only amounts that constitute tainted income would be attributable to the shareholders of the CFC and therefore be taxable.

4 7 3 Attributable Amount

The amount attributed to the shareholder is usually the proportion of the shareholder's shareholding in relation to the entire shareholding in the CFC. Thus, in this calculation, it is the shareholder's interest in the distribution that determines the proportion attributable to that shareholder. Any diversion from this general principle would be distorting the concept of attribution and its adverse implications would most definitely discourage investors from choosing such a jurisdiction as suitable for a holding company.

Countries may adopt a hybrid approach in which they would, for example, use the transactional approach but grant an exemption to a CFC whose tainted income is less than a specified percentage of its total income.[100]

It is submitted that whether the investor prefers a transactional or entity approach jurisdiction, depends largely on the nature of the underlying investments that the operating companies engage in. For a holding company whose operating subsidiaries' business is market-orientated, for example in the manufacturing sector, the undertaking would qualify for the genuine business activities exemption.

Where the jurisdiction ignores the underlying activities of the operating subsidiaries and only considers the activities of the holding company, it is submitted that the entity approach could be prejudicial. The transactional approach would also be prejudicial, as all the activities of the holding company would generally fall short of genuine business

98 *Idem.*
99 *Idem.* See also *IBFD International Tax Glossary* definition of "base company".
100 Arnold & McIntyre 94.

activities that give rise to active income.[101] The transactional approach would also be appropriate in certain of these activities, though in the previous example some income which could be ancillary to the business of the CFC may fall in the tainted income classification.

4 7 4 Exemptions

Exemptions play a significant relieving role in the taxation of CFCs. The most common exemptions are the *de minimis*, genuine business activities and distribution exemptions.

(a) *De Minimis* Exemption

The *de minimis* exemption applies to the proportion of the tainted income in relation to the total income of the CFC. It exempts tainted income of a certain percentage to the extent that it is deemed to be negligible. This applies both to transactional and hybrid approaches. However, often the tainted income is excluded from the exemption with the end result that the genuine business would be exempt but still attribute the tainted income.[102]

The amounts and values to which the *de minimis* rule applies differ. In some cases they are expressed in percentages and in others in amounts or both. For example, the Canadian *de minimis* exemption is available only if the tainted income of the CFC is CAN $5,000 or less. The Australian exemption, on the other hand, applies if the tainted income of the CFC does not exceed the lesser of AUS $50 000 and 5% of gross income.[103] The South African exemption applies to the extent that tainted income does not exceed 10% of the income and capital gains of the CFC.[104]

(b) Genuine Business Activities Exemption

This exemption basically recognises that, while CFC legislation is basically intended to curb tax avoidance by relocating the tax residence of an entity, there are certain circumstances under which genuine business activities are carried out in a different jurisdiction without an intention to avoid the tax. This exemption is granted under both the entity and transactional approaches. It is generally granted if the CFC is engaged in certain defined businesses, has a substantial presence in the foreign country and more than a certain percentage of its income is derived from sources in the foreign country or from transactions with unrelated parties.[105]

101 *Idem*.
102 For this provision in the South African system see proviso to s 9D(9)(b) Income Tax Act 58 of 1962.
103 Arnold & McIntyre 97.
104 See s 9D(9)(b)(iii) Income Tax Act 58 of 1962.
105 Arnold & McIntyre 96–97.

Income that normally does not qualify for this exemption is income that cannot be attributed to the genuine business (i.e. mobile business income) and income arising from transactions where the possibility of price manipulation exists.[106]

(c) Distribution Exemption

This is perhaps the least used exemption due to its vulnerability to abuse. In terms of this exemption CFCs that distribute their income to shareholders who are subject to domestic tax are exempt. This is normally coupled with a requirement that the distribution be made within a certain period from the end of the tax year. In the UK the exemption applies if 50 % or more of the available profits of the CFC are distributed within 18 months of the year end.[107]

4 7 5 South African CFC Legislation

The South African CFC legislation provides for the taxation of CFC income in the hands of the CFC's shareholders subject to exemptions, most notable of which is the genuine business activities exemption.[108] The system follows a transactional approach. Furthermore, the CFC legislation has been relaxed in line with the intention to increase South Africa's suitability to host headquarter companies. The CFC income is not attributable to South African residents that qualify as headquarter companies.[109] As a result, the CFC legislation would not apply to holding companies that qualify as headquarter companies. However, the mere presence of CFC legislation may deter investors from setting up holding companies in South Africa as CFC legislation is notoriously complex.

4 8 Thin Capitalisation and Transfer Pricing Rules

Very often, the purpose of a holding company includes acquiring, managing and/or selling investments in domestic and/or foreign companies.[110] These transactions happen between the holding company and its related parties or non-related parties. A holding company generally funds the formation or operations of its subsidiaries and is in turn also funded by its holding company.[111]

Thin capitalisation rules regulate the taxation of amounts arising out of or incurred as a result of the international funding of related companies. Transfer pricing rules determine the taxation of amounts

106 See Olivier & Honiball at 373–375. Also see Legwaila 'The Business Establishment Exemption' December 2004 *De Rebus* 42 42–43.
107 Arnold & McIntyre 97.
108 See s 9D Income Tax Act 58 of 1962.
109 S 9D(2) Income Tax Act 58 of 1962.
110 See Legwaila 2010 *De Jure* 308 314–315.
111 Legwaila 2010 *De Jure* 308 313–315.

arising out of transactions between related parties at an international level.[112]

4 8 1 Transfer Pricing

Transfer pricing is an area of economics and tax law that is concerned with ensuring that prices charged between related parties or associated enterprises for the transfer of property, goods and services are not manipulated.[113]

The purpose of a multinational group setting the price at a transfer rate as opposed to a market rate would normally be to shift the tax losses to a high taxing jurisdiction and the profits to a low-tax jurisdiction or a jurisdiction with special tax features like tax holidays, or other industry-specific incentives.[114] As Vann[115] states:

> [t]he prices charged within the group for goods or services provided and the financing methods used between the members of the group simply serve as a means of moving funds around the group and do not in a commercial sense create profits for the group.

Transfer pricing rules generally provide that where goods or services are supplied or rendered in terms of a cross-border transaction between connected persons at a price that does not represent an arm's length consideration, an adjustment would be made on the pricing to reflect such arm's length.[116] Normally penalties are levied on amounts so adjusted.

(a) Cross-Border Transactions

This is an agreement between a resident and a non-resident. It also covers agreements between two non-residents for the supply of goods or services in the country, and agreements between residents for the supply of goods or services outside the country.[117]

(b) Connected Persons

The concept of connected persons seeks to cover affiliated or related persons. These are persons who can transact with each other at any

---

112 Vann "International Aspects of Income Tax" in *Tax Law Design and Drafting* (ed Thuronyi) (1998) 781. In some countries, for example the United Kingdom, transfer pricing rules apply even to transactions entered into between related parties within the domestic sphere. This application is not adopted by many countries due to the fact that there would not be any depletion of the tax base, as the ultimate income would still be taxable in the particular country.

113 Vann 781.

114 See Olivier & Honiball 399.

115 Vann 781.

116 See OECD *Model Tax Convention on Income and on Capital* (2008) - Commentary on Art 9 Par 1.

117 Vann 781–784.

consideration without adversely affecting the interest of their ultimate shareholders. Vann[118] confirms that:

> [f]or the group as a whole, all that matters at the end of the day is the after-tax profit of the group rather than of its individual members.

Different jurisdictions use different yardsticks to determine to whom the transfer pricing rules apply. Certain countries apply it to company groups, which are also in turn differently defined. Others apply it to companies held at a certain percentage lower than what would generally qualify as a group. A higher amount of holding relaxes the rules and restricts application thereof.

(c) Arm's Length

Transfer pricing applies the so-called arm's length principle as a generally recognised method to attribute profits made by related enterprises to enterprises operating in different countries.[119] The arm's length standard is met if the company sets its transfer prices in its dealings with its related persons so that those prices are the same as prices used in comparable dealings with unrelated persons.[120]

Countries can either use the arm's length method or the formulary apportionment method.[121] However the arm's length method is accepted by almost all countries as it is theoretically correct because it most closely approximates the operation of the open market.[122]

Investors naturally prefer countries where the more flexible system of choice by taxpayers of the arm's length methods apply. A jurisdiction is even more attractive where it provides for advance pricing agreements in terms of which the taxpayer agrees with the revenue authorities regarding the transfer pricing method to be used by the taxpayer in the future.[123]

4 8 2 Thin Capitalisation

Thin capitalisation is the practice of excessively funding a related party, being a branch or subsidiary, with excessive interest-bearing loans (debt)

---

118 Vann 781.

119 The attribution applies both to enterprises and parts or divisions of those enterprises. See Hamaekers "Arm's Length – How Long?" in *International and Comparative Taxation, Essays in Honour of Klaus Vogel, Series on International Taxation* (ed Raad) (2002) 29.

120 Rolfe *International Transfer Pricing* (1998) 6–23; Arnold & McIntyre 60.

121 Olivier & Honiball 405.

122 Hamaekers 38. Arnold and McIntyre 61–65. The following methods are used to determine whether a price is at arm's length or not: (a) Comparable Uncontrolled Price ("CUP") Method; (b) the Resale Price Method; (c) the Cost Plus Method; (d) Profit-Split Method; and (e) Transactional Net Margin Method (TNMM).

123 See Sawyer "Advance Pricing Agreements: A Primer and Summary of Developments in Australia and New Zealand" (2004) *Bulletin for International Fiscal Documentation* 556 556–565.

from related parties rather than with share capital or equity.[124] Thin capitalisation rules are intended to combat tax avoidance by the relocation of interest from one jurisdiction to another. The relocation is normally made from a high to a low-tax jurisdiction, with a deduction being claimed as an allowance in the high jurisdiction country. Often the interest is subject to a reduced tax rate as a result of the application of tax treaties.[125]

The application of thin capitalisation rules denies the deduction of the excessive part of the interest in the hands of the debtor.[126] This makes the thin capitalisation rules an aspect of the tax jurisdiction that needs proper consideration with regard to planning the location of the holding company, as the holding company is often responsible for the formation of operating companies or specific operations in such companies.

Thin capitalisation rules apply to loans by non-residents who own a substantial share of the borrowing company. The level of share ownership varies from 15% to 100% in the resident company.[127] This interest can either be held directly or indirectly through another resident or non-resident company. Countries differ in the way the denial of interest deduction is structured. Some countries use the ratios of loan capital to share capital beyond which interest deductions are denied (debt-equity rules) and others limit interest deductions by reference to a proportion of the income of the taxpayer (earning-stripping rules). The former is more common.[128]

Where the excessive interest deduction is disallowed, the excessive interest can either be treated as a dividend or be carried forward and deducted in subsequent years.[129] The methods and ease with which one gets caught by these rules as well as the consequences attached to excessive interest contribute to the suitability of a country as a holding company jurisdiction.[130]

4 8 3 South African Transfer Pricing and Thin Capitalisation Provisions

The South African tax law contains transfer pricing and thin capitalisation provisions. These provisions apply largely in line with the rules provided

124 Vann 785.
125 See Arnold & McIntyre 83.
126 Vann 785–786.
127 Arnold & McIntyre 85.
128 Among the countries using the debt-equity rules the ratios differ. The common range is between 1.5:1 and 3:1. The rules also provide for an application to the revenue authorities to allow a higher ratio. With the earnings-stripping rules, the rules are more permissive for financial institutions whose businesses consist in borrowing and lending and that typically operate at much higher debt levels than other businesses. Vann 785.
129 Arnold & McIntyre 86.
130 See Udal & Cinnamon 21.

above.[131] In addition, the transfer pricing and thin capitalisation provisions do not apply to financial assistance granted by a headquarter company to any foreign company.[132] Furthermore the provisions do not apply to financial assistance provided to a headquarter company if the headquarter company in turn provides that financial assistance to a foreign company in which the headquarter company holds at least 20% of the equity.[133] Transfer pricing and thin capitalisation provisions are essential in a tax system to combat tax avoidance. The South African transfer pricing and thin capitalisation rules ensure that tax avoidance is curbed, but at the same time ensure that genuine transactions in general and specifically involving headquarter companies are not adversely affected by the provisions.

5 Conclusion

The non-tax characteristics of a country are key in determining whether the country is ideal for locating a holding company. However, tax characteristics also play a major role in this regard. Specifically, a tax on dividends is one of the major reasons why companies have huge accumulated profits on their books. A tax system with low or zero tax on dividends alleviates the concern of repatriating the income from the underlying investments of dividends. The double tax agreement network of the potential host country and the contents of double tax agreements are crucial to the suitability of the jurisdiction. This is so because double tax agreements play a major role in exempting the dividends from tax or at the very least reducing the dividend tax rate applicable.

The taxation of capital gains can deplete the growth of the company and the group in general. Where there is a tax, the rate at which the gains are taxed is an essential aspect whose effect needs to be adequately assessed. Equally essential, however, is the rules for calculating the acquisition cost, determining the tax event, providing deferral opportunities and governing transactions between related parties.

The design of the CFC regime as an anti-avoidance measure results in CFC legislation containing strict provisions as opposed to instances where CFC legislation is seen as merely a taxing provision. This affects the imputation of the underlying investments to the shareholders of such underlying investments. The extent of the application of these CFC provisions is also of great importance. For example, as a result of the stringent UK CFC rules, a number of companies have moved out of the UK."[134]

131 See s 31 Income Tax Act 58 of 1962.
132 See s 31(4)(b) Income Tax Act 58 of 1962.
133 See s 31(4)(a) Income Tax Act 58 of 1962.
134 See http://www.strategicrisk.co.uk/story.asp?storycode=380661 (accessed 2011-11-03); Oguttu *Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts* (LLD dissertation 2007 UNISA) 271–273.

CFC regimes that apply the transactional approach are more favourable than those applying the entity approach. However, tax authorities find the entity approach administratively less burdensome to apply and police while unscrupulous taxpayers would prefer the transactional approach, as it is easier to manipulate. Available exemptions from the CFC regime reduce its ambit. While taxpayers structure their activities to qualify for the genuine business activities exemption, passive income earners find it difficult to satisfy the stringent requirements.

A jurisdiction with the above features favourable to conducting the business activities of a holding company would attract various other forms of investment. Such a jurisdiction would have the ability to manipulate and redirect the investment strategies of many investors. Whether it is intended and designed to do so or not, such a jurisdiction would pose a serious threat to the tax bases of other countries not offering the same preferred tax and administrative treatment to investors.

With reference to the South African tax instruments that have a bearing on the conduct of the business of holding companies, it is clear that the corporate tax rate, dividends tax rules, capital gains tax regime and transfer pricing provisions are not adverse to the hosting of holding companies. The presence of CFC legislation, though not necessarily adverse and based on the favourable transactional approach, may have the effect of deterring possible investment due to the notorious complications of CFC provisions internationally. The South African tax laws are adjusted in line with the intention by government to create a suitable regulatory environment for headquarter companies. Such an environment will, to a large extent be suitable for holding companies in general.