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TAX ALERT

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REGISTRATION OF AN EXTERNAL COMPANY

Section 23 of the Companies Act, No 71 of 2008 (Act) that came into effect on 1 May 2011, deals with the issue where a foreign company is required to register as an external company in terms of the Act. The legislative framework in s23 of the Act sets out the level of activities that a company from a foreign jurisdiction is carrying on in South Africa, and in which case it must register as a branch. Note that the Act does not use the expression 'branch'.

As a corollary that follows from this, the question arises whether the registration of an external company will create a permanent establishment in South Africa in terms of the tax legislation. The effect of registration as an external company is that the foreign company is given legal recognition in the Republic. Section 23(1) provides that an external company must register within 20 days after it first begins to conduct business or non profit activities in South Africa. Section 23(2) goes on to tell you what conduct will make you cross the test in ss(1). It stipulates that if you have one or more employment contracts in the Republic or have engaged in a course or pattern of activities over a period of six months that one could reasonably conclude that you intended to continually engage in business then you need to register.

Section 23(2A) goes on to stipulate a number of activities where the foreign company would not be regarded as conducting business within the Republic. The categories included are establishing or maintaining any bank account, establishing any office or agency within the Republic for the transfer and exchange or registration of the foreign company's own securities. Similarly included, are creating or acquiring any debts within the Republic, any mortgages or security interests or acquiring property, which also are not regarded as conducting business within the Republic.

This legislative framework is well described by Heather Brownell writing in De Rebus magazine (April 2012 at page 39), "So if a foreign company is engaged in any one of the s23(2A) activities, that in itself will not necessarily conclusively evidence the intention to continually engage in business. The activities listed in s23(2A) could, however, be indicative factors that the company is 'conducting business'. Each of the activities listed in s23(2A) that the foreign company is engaged in or is conducting in South Africa would have to be considered in the light of its broader activities in South Africa to determine whether or not the foreign company is conducting business for the purposes of s23(1)."

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In Binding Private Ruling 102 (issued 4 May 2011) SARS considered the question in the context of registering as an external company in terms of s322 of the old Companies Act of 1973. The facts in this matter were that the external company would advance subordinated interest bearing loans to companies incorporated in the Republic and subscribe for preference shares in these companies. Participation in the external company was reserved for foreign investors only. The external company would be managed by a board of directors, which would conduct board meetings in a foreign country, and conduct the affairs of the external company in accordance with predefined investment objectives and strategies. Investment advice would be given by a third party investment adviser which also would not be situated in the Republic. The external company applied for the ruling on the basis that it would not be resident in South Africa, as its place of effective management would be located in a foreign jurisdiction and so it would not create a permanent establishment. But it did have to register as an external company and as a consequence was a resident of South Africa for exchange control purposes.

SARS's ruling was that the registration as an external company would not create a permanent establishment for this company. The ruling was based on the assumptions that:

- The place of effective management was located in the foreign jurisdiction.
- It did not have any employees or conduct any business activities in South Africa, other than the maintenance of its external company status for exchange control purposes.
- It did not have a dependent agent operating on its behalf in South Africa.

The issue is that the test for whether such a foreign presence or branch constitutes a permanent establishment is distinct from the external company test in s23 of the Act. In terms of international tax law, where an enterprise carries on business in two distinct jurisdictions, the profits of a Contracting State are taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated there. Only profits attributable to the permanent establishment may be taxed in the source state.

If we look at an indicative double tax treaty (such as United Kingdom), Article 5 stipulates that a 'permanent establishment' is a fixed place of business through which the business of an enterprise is wholly or partly carried on. It then continues in Article 5(2) to specifically include a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, and an installation or structure for the exploration for natural resources. But it is clear that the permanent establishment needs a place of business, which is fixed (that is a degree of permanence) and that the business of the enterprise is carried on at the fixed place of business. The definition of a permanent establishment for domestic law is contained in s1 of the Income Tax Act, No 58 of 1962, which refers one to the concept as it is defined from time to time in Article 5 of the OECD Model Tax Convention. However, one will have seen from what has been said above, that the test applied by the SARS in the context of the permanent establishment is quite different from the 'conducting business' that the Act looks for to require registration as an external company.

Alastair Morphet

NO MORE EXIT CHARGE?

Judgment in the case of *Commissioner for the South African Revenue Service v Tradehold Ltd (case no 132/2011)* was handed down in the Supreme Court of Appeal (SCA) by Boruchowitz AJA on 8 May 2012.

The facts were that Tradehold Ltd (Tradehold), an investment holding company incorporated in South Africa (SA) and listed on the Johannesburg Stock Exchange, resolved on 2 July 2002 that all further board meetings would be held in Luxembourg. The effect was that as from 2 July 2002, Tradehold became effectively managed in Luxembourg. Despite the change in effective management, Tradehold remained a resident of SA by virtue of the definition, at that time, of 'resident' in s1 of the Income Tax Act, No 58 of 1962 (Act). The definition provided that a person other than a natural person (for example a company or close corporation) will be a resident of SA if it was either incorporated, established or formed in SA, or if it had its place of effective management in SA. Having been incorporated in SA, Tradehold became and remained a resident of SA for the purposes of s1 of the Act, despite it relocating its place of effective management.

On the 26 February 2003, the definition of 'resident' in s1 of the Act was amended to exclude a person who is deemed to be exclusively the resident of another country for the purposes of any double taxation agreement. In other words, a company will not be a resident of SA despite being incorporated in SA or having its place of effective management in SA if the provisions of a double taxation agreement determine that the company is exclusively a resident of that another country. In this regard, Article 4(3) of the double taxation agreement (DTA) entered into between SA and Luxembourg on 6 December 2000 provides that where a company is a resident of both SA and Luxembourg, it will be deemed to be a resident of the state in which its place of effective management is situated. After relocating its place of effective management to Luxembourg, Tradehold was effectively a resident of both

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SA (place of incorporation) and Luxembourg (place of effective management). However, following the amendment to the definition of 'resident' in the Act on 26 February 2003, and applying Article 4(3) of the DTA, Tradehold became a resident exclusively of Luxembourg.

Relying on the provisions of paragraph 12 of the Eighth Schedule to the Act, SARS contended that when Tradehold relocated its seat of effective management to Luxembourg on 2 July 2002, or when it ceased to be a resident of SA on 26 February 2003 (the date the definition of 'resident' changed), it was deemed to have disposed of all its assets, including its 100% shareholding in Tradehold Holdings, resulting in a capital gain.

Paragraph 12(1) of the Eighth Schedule to the Act deems a person to have disposed of its assets at market value where an event described in paragraph 12(2) occurs. Subparagraph (2) as enacted at the relevant time read as follows:

(2) Subparagraph (1) applies, in the case of-

- (a) a person who ceases to be a resident, or a resident who is as a result of the application of any agreement entered into by the Republic for the avoidance of double taxation treated as not being a resident, in respect of all assets of that person other than assets in the Republic listed in paragraph 2(1)(b)(i) and (ii);
- (b) an asset of a person who is not a resident, which asset-
  - (i) becomes an asset of that person's permanent establishment in the Republic otherwise than by way of acquisition; or
  - (ii) ceases to be an asset of that person’s permanent establishment in the Republic otherwise than by way of disposal contemplated in paragraph 11…"

Tradehold contended that if there was a deemed disposal of its assets in terms of paragraph 12 of the Eighth Schedule to the Act, the capital gain that resulted from the disposal was not taxable in SA but in Luxembourg. The reason advanced by Tradehold was that at the time the capital gain arose it was deemed to be a resident of Luxembourg in terms of Article 4(3) of the DTA. In terms of Article 13(4) of the DTA, gains from the alienation of the assets shall only be taxed in the state of which the alienator (Tradehold) is a resident. On this basis, Tradehold submitted that the gains could only be taxable in Luxembourg.

SARS, in turn, contended, inter alia, that the term 'alienation' in Article 13(4) of the DTA does not include within its ambit deemed (as opposed to actual) disposals of assets and as a result Article 13(4) of the DTA does not apply to a deemed disposal in terms of paragraph 12 of the Eighth Schedule to the Act. This according to the court was the crisp question that fell to be determined.

Griesel, J, presiding in the Cape Town Tax Court *(case number 73 SATC 1848)*, decided the matter in favour of Tradehold, stating that he is unable to see any reason why a deemed disposal of property should not be treated as an alienation of property for purposes of Article 13(4) of the DTA. It is against this decision that SARS appealed to the SCA.

Boruchowitz AJA, deciding the matter in the SCA, stated that a DTA modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict. The judge, agreeing with Griesel J, concluded that he is of the view that the term 'alienation' as it is used in the DTA is not restricted to actual disposals or alienations but that it is a neutral term that has a broader meaning, comprehending both actual and deemed disposals of assets giving rise to taxable capital gains. Applied to the facts, Boruchowitz held that from 2 July 2002, when Tradehold relocated its seat of effective management to Luxembourg, the provisions of the DTA became applicable and that country had exclusive taxing rights in respect of all of Tradehold's capital gains.

The judgment seems straight forward and certainly favoured the taxpayer, Tradehold. However, a few issues require further comment.

Although it is understood that the issue of 'timing' of the disposal was raised and argued by SARS, it appears not to have been dealt with by the court. Paragraph 13(1)(g) of the Eighth Schedule to the Act provides that the time of disposal under paragraph 12(2) means the date immediately before the event giving rise to disposal occurs. Applied to the facts of the case, Tradehold was deemed to have disposed of its assets on the day before it was treated (in terms of Article 4(3) of the DTA) as not being a resident of SA pursuant to relocating its place of effective management to Luxembourg. On the day before Tradehold relocated the seat of its effective management to Luxembourg, it was a resident solely of SA arguably rendering the provisions of the DTA irrelevant and inapplicable. As mentioned above, Boruchowitz made a general statement that a DTA modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict. Perhaps he was indirectly referring to the timing provisions in paragraph 13.

We understand further, that the issue of the shares being attributable to a permanent establishment of Tradehold was also raised by SARS. Paragraph 12(2)(a) applies to all assets of the taxpayer other than assets referred to in paragraph 2(1)(b)(i) and (ii). In particular, paragraph 2(1)(b)(ii) refers to assets attributable to a permanent establishment of a person in SA. The effect is that to the extent that the shares held by Tradehold in Tradehold Holdings were attributable to a permanent establishment in SA, they are not deemed to be disposed of in terms of paragraph

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12(2)(a). However, it is then necessary to consider the provisions of paragraph 12(2)(b)(ii), which provide for a deemed disposal of an asset of a non-South African resident, which asset ceases to be an asset of that person's permanent establishment in SA. The difficulty with applying this provision to the particular facts in the case under discussion is that when Tradehold ceased to be a resident of South Africa on 26 February 2003 following the amendment to the definition of 'resident' in s1 of the Act, its permanent establishment in SA had already ceased to exist. It appears from the factual background set out by Griesel J in the court a quo that on 29 January 2003, when one of the executive directors of Tradehold relocated to Europe, any permanent establishment that Tradehold might have had in South Africa ceased to exist. In other words, Tradehold was still a resident of SA for the purposes of s1 of the Act when any permanent establishment it might have had in SA ceased to exist and therefore paragraph 12(2)(b)(ii) could not have applied. Nonetheless, it is interesting that the both the court a quo and the SCA regarded it unnecessary to express a view on the issue of permanent establishment.

A day after the judgment in the SCA was delivered, the National Treasury issued a statement to the effect that the SCA's judgment that a DTA applied to a deemed disposal and thus does not allow for an exit charge, disturbs the balance achieved by the country's fiscal system. It was mentioned that National Treasury and SARS are busy studying the judgment and, if necessary, will propose amendments to clarify that a double taxation agreement does not apply to deemed or actual disposals while a taxpayer is resident in SA. In particular, it was mentioned that measures such as the immediate termination of the taxpayer's year of assessment on the day before becoming non-resident are being explored and that it is likely that any amendment will apply retrospectively to 8 May 2012, the day the SCA delivered the judgment.

In closing, one should appreciate that s9H (as opposed to paragraph 12 of the Eighth Schedule) of the Act now caters for a deemed disposal where a person ceases to be a resident of SA. In principle, this event will trigger either a capital gain or ordinary revenue and will not result in a deemed dividend as was the case under the now repealed s64C(2)(f). However, until legislative amendments are introduced, it is anticipated that taxpayers will rely on the Tradehold case to escape fiscal liability pertaining to any deemed disposals arising out them ceasing to be resident in SA.

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