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In this edition

Many organisations are looking to expand their businesses into new markets and, in the international context, the 'global integration' of operations is a common theme. In this edition of Tax News, we cover a number of topics that have relevance in this area, with a particular focus on issues relating to international personnel secondments.

Properly managing the appointment of personnel and the placement of these people in a location is critical to the success of any venture, and our first article examines how companies can better align their global mobility programmes to create real value.

We explore the principles that govern the taxation of employment income in South Africa, including: what constitutes 'South African source income', the tax exemption applicable to foreign-service income and the confusing rules regarding the taxation of residential accommodation provided to expatriates.

There is a growing trend for organisations to use global talent pools and just-in-time staffing, and our article on short-term business travellers examines specific tax issues relating to this category of employee.

Africa continues to enjoy increased investor attention and our article on this topic identifies some key factors to consider when expanding one's business into Africa.

We consider some important corporate tax issues arising from the 'external company' regime in the new Companies Act, and we conclude this edition with an update on the regulations issued under section 12L of the Income Tax Act to promote energy savings.

In our personality slot, we profile Bernadette Abbott, who heads up the Global Employer Services division for Deloitte in South Africa.

We trust that you will enjoy and benefit from the content in this publication. Please feel free to provide us with your feedback.

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Professional profile: Bernadette Abbott

Bernadette Abbott

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Bernadette was appointed as head of Global Employer Services South Africa in May 2010. She has 15 years of experience within the field of personal taxation and global mobility.

She has assisted many corporates with their withholding obligations, advised main board directors of our largest clients on their complex personal income tax affairs, developed a software system to assist companies managing their non-permanent workforce and project managed payroll projects in Africa.

Global Employer Services in South Africa has a client base of 1600 individual clients and 240 corporate clients.

"The universe we inhabit as human beings is becoming a common home that shows growing disrespect for the rigidities imposed on humanity by national boundaries."

Quote from Nelson Mandela in an address to the House of Commons, London, England 5 May 1993

Harnessing the full power: the new building blocks of Global Mobility

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Companies have long used global mobility programmes to move employees around the world, but never to the extent that is required today. For many organisations, growth and even survival hinges on penetrating rapidly growing and emerging markets unlocked by globalisation, including Africa.

Many international investors are attracted to the continent because of its large population, rising middle class,rich natural resources and vast amounts of land, amongst other factors. South African companies have also expanded beyond the country’s national borders into the rest of the African continent.

Expanding into new markets is a tough challenge, especially when the critical opportunities and critical talent are often not in the same country. To a large extent, future success for many companies will depend on how well they can connect their talent with their most profitable and strategically important business opportunities, wherever they may be. To this end, the global mobility function is now being asked to do more than simply fill international positions. Companies are starting to view global mobility programmes as a way to pursue key talent development goals.

Moving global mobility to this next level will require careful planning, focused investments, and the development of new advanced capabilities. Even getting the basics right – such as keeping track of who is working where, what technology to build, buy or integrate, and whether the company is complying with national and local tax and regulatory regimes, such as work permits – can present real challenges and may require significant investment.

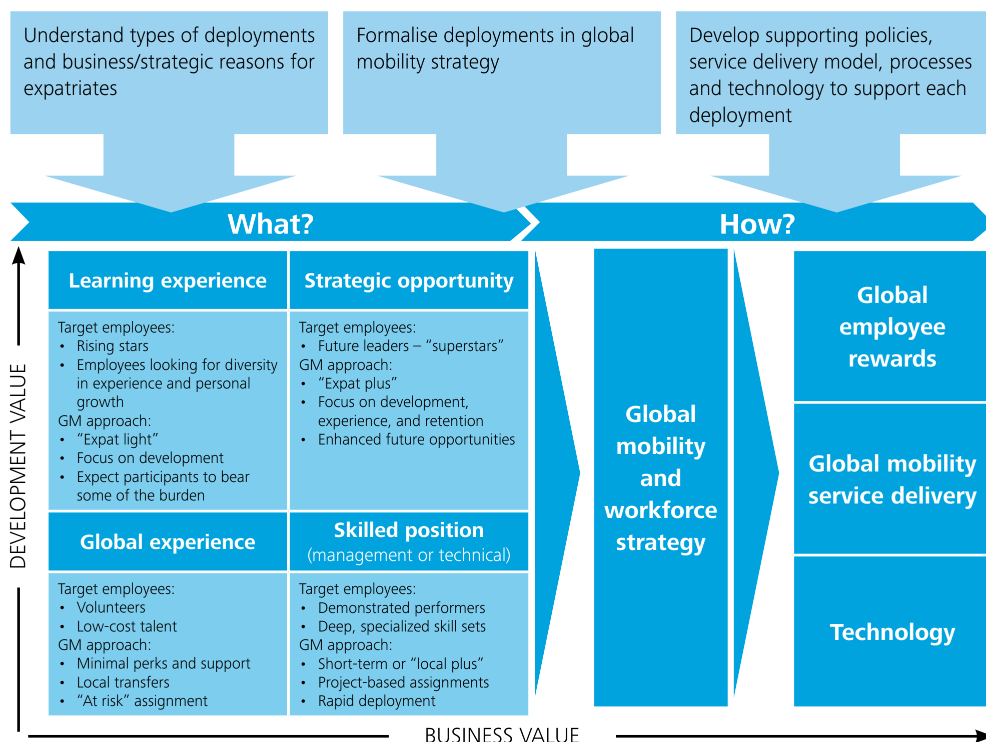
In this article, we share our perspective on how companies can manage their global mobility investments to harness their full value and create a sustainable competitive advantage.

In order to harness the full power of global mobility, we believe that companies must improve their global mobility capabilities in four key areas:

- strategy
- service delivery
- technology
- rewards

We briefly discuss the first three.

Our Approach to Global Mobility Transformation



Workforce Strategy

Effective global mobility requires a formal strategy that focuses on a company's long term business needs and global talent priorities rather than simply reacting to individual opportunities as they arise.

In our view, an effective global mobility and workforce strategy should:

- Identify which business and talent objectives should be supported by global mobility (for example, development of capabilities in strategic growth markets, or accelerated development of management bench strength).
- Define a multi-year plan and budget for mobility (at both the organisational and divisional levels).
- Stratify roles and career paths,and determine varying levels of support based on the anticipated value of the assignment to the business as well as the individual. International assignments that are important to the individual's development should offer only a modest level of support, while "strategic deployment" assignments that aim to develop superstars by deploying them to significant business opportunities should be provided with the greatest amount of support.

Service Delivery

We believe that an effective global mobility programme should be able to support the business and assignees with high-quality service that is cost-effective, consistent, and easy to use, manage and administer.

The purpose of global mobility service delivery is both to help business make smart assignment decisions, and to help assignees with their moves. In particular, we believe effective service delivery should:

- Provide guidance to business on mobility-related decisions
- Estimate the cost and develop the business case for particular assignments
- Select assignment goals and develop related metrics
- Help managers evaluate candidates for assignment opportunities
- Advise managers on policy selection

and assignment duration
- Deliver the entire spectrum of HR services to assignees:
- Coordinate physical moves
- Assist with tax and other compliance issues
- Assist assignees and their families with acculturation and integration
- Deliver basic HR services (e.g. reimbursement, payroll, benefits and administration) during an assignee's time abroad.
- Integrate global mobility and talent management practices so assignees are appropriately deployed to suitable positions when they return to their home country (or are reassigned to another country)
- Utilise both internal resources and external service providers as needed to deliver a cost effective, high-quality service.

In addition, we believe companies should strive to offer both mobile and non-mobile employees (and their managers) a service experience that is as consistent as possible. Organisations can take significant steps toward achieving this consistency by integrating certain aspects of global mobility service delivery into the company's HR operations and infrastructure.

Technology

Using technology effectively to support global moves can help reduce costs while improving service quality and compliance. It also enables business leaders to make better, more informed mobility decisions.

Technology plays a crucial role in helping companies smoothly execute global moves and realise the full value of global mobility. An effective global mobility programme requires a well-developed and integrated technology platform that can:

- **Enable employee and manager self-service.** Offering mobile employees and their managers the tools for HR self-service can reduce costs, improve efficiency, and streamline the service experience.
- **Support compliance.** Compliance hinges on the accuracy and timeliness of assignee data and it is important to have appropriate technology, as well as well-designed processes and controls, to collect, organise and report the required information, especially when there are multiple countries involved.
- **Provide dashboard reporting for programme performance.** Such reporting might include process and service metrics for leaders in the global mobility function (e.g. employee and manager satisfaction, time to deployment, pay statement accuracy and timeliness).
- **Enable in-depth analysis of expatriate data.** Workforce analytics uses advanced statistical techniques to cull valuable insights from the vast amount of demographic, performance and employee data typically stored in a company's Human Resource Information Systems. This sophisticated analysis is particularly beneficial when applied to global mobility data. Many international assignees are the company's rising stars and future leaders, and it is important to know if the company's mobility investments are being used wisely and achieving the desired outcomes.

Conclusion

As growth in developed markets starts to slow down, global companies have identified the African market as a source of future growth. Most South African companies that have been bold and courageous enough to establish a strong African footprint have reaped the benefits. They have explored this African market for many years and have obtained valuable knowledge about the continent. This knowledge differentiates them in Africa. By marrying this experience with certain of the mobility best practices mentioned above, we believe that South African companies will be able to dominate the African region.

Article adapted from one published in the International HR Advisor authored by Andy Robb and Rob Hodkinson from Deloitte.

Source of income: not as straightforward as you would think?

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The basic principle of our tax system is that South Africa taxes residents on their worldwide income, whilst non-residents are only liable for South African tax on income that is from (or deemed to be from) a South African source.

Where you have employees (resident or not) rendering services both in and outside South Africa, the taxation right of SARS on this income becomes an important and costly question.

The basic principle of our tax system is that South Africa taxes residents on their worldwide income, whilst non-residents are only liable for South African tax on income that is from (or deemed to be from) a South African source.

The term 'from a South African source' is not defined in our Income Tax Act but is determined with reference to common law. In terms of our case law, one must establish the 'originating cause' of the income and determine the location thereof in order to decide if the source is South Africa.

The originating cause of income from services rendered is the services themselves and the location of the services rendered is generally accepted to be located where the services are physically performed. Accordingly, only that part of a non-resident's remuneration that relates to services actually rendered in South Africa will be regarded as from a South African source and thus taxable in South Africa.

This principle applies irrespective of where in the world an individual may be paid for these services or where the employment contract has been entered into.

The position is, however, slightly different for non-executive directors. Under South African law, the source of directors' fees is considered as being where the head office of the company is located. In other words, directors' fees earned by non-resident directors for services rendered as directors to a South African company will be considered to be from a South African source, even if some of the Board meetings take place outside South Africa and / or the actual payment of the directors' fees takes place outside South Africa or is effected by a person other than the South African resident company.

In addition to the common law principles above, section 9 of our Income Tax Act, 58 of 1962 ('the Act') deems certain income to be from a source within South Africa.

The Taxation Laws Amendment Bill, 2011, ('TLAB') introduces a new section 9 so as to unify and clarify previous anomalies in the system of source. The

new source rules (applicable to receipts and accruals in respect of years of assessment commencing on or after 1 January 2012) will largely integrate tax treaty principles in order to globally align the South African system, and common law principles will remain as a residual for any income type not specifically defined. Under these new rules, South African-sourced income will be defined and anything falling outside of this will be considered foreign-sourced income.

The source of private sector services will continue to be determined with reference to the common law principle of where the services were physically rendered. In addition to this, the Explanatory Memorandum to the TLAB states that newly legislated source provisions will create statutory allocation rules. If the services were partly rendered inside and partly outside of South Africa, the source will be apportioned based on time spent performing services within South Africa as opposed to the time spent abroad. Any pensions or annuities received as a result of these services will be apportioned on the same basis as the services.

Under the new source rules, South African tax residents will continue to be subject to tax on their worldwide income. The ever so important section 10(1)(o)(ii) continues to provide relief to South African resident employees (note, not independent contractors) who have rendered services partly within and partly outside of South Africa. A portion of their remuneration may be exempt in terms of section 10(1)(o)(ii) of the Act if:

- the remuneration is received in respect of services rendered outside the Republic by the employee for or on behalf of any employer outside the Republic; and
- the employee must be outside South Africa
  - for a period exceeding 183 full days in aggregate during any period of 12 months; and
  - for a continuous period exceeding 60 full days during that period of 12 months, and those services were rendered during that period

Where the above criteria are met, the source of the remuneration received can be apportioned between South Africa and abroad by calculating the days spent inside and outside of South Africa. Common law indicates flexibility regarding the method to use when apportioning the source of remuneration between jurisdictions and it is possible to argue an alternate method (for example, hours spent working inside and outside South Africa) should this give a more accurate apportionment.

It may be beneficial for the employee to use hours (rather than days) spent working outside South Africa, as we often find that much longer hours are worked when travelling than had the employee worked in South Africa, e.g. ten 12-hour days abroad versus ten 8-hour days in South Africa, should give a non-SA source ratio of 120/200 or 60% rather than 10/20 or 50%.

It is also import to remember that where bonuses or equity incentive arrangements are received in a specific tax year but the services to which they relate were rendered in different tax jurisdictions over a period of time, it does not necessarily mean that 100% of the bonus or equity incentive gain should be taxed in South Africa if the employee was only working in South Africa in that particular tax year. In this case, the period over which the services were rendered should be determined; the remuneration (bonus/equity incentive gain) should then be evenly apportioned over this period and allocated to the various tax years. The portion of the bonus or equity incentive gain that relates to a specific tax year should then be attributed between local and offshore services on the same basis as the employee's other remuneration was allocated during the tax year concerned.

As mentioned earlier, source is not a simple matter and care should be taken to ensure that employees working across international borders are taxed correctly, most importantly so as the employer remains SARS's first point of call in the event of any under-deduction of employees' tax.

Short-term business travellers – another tax headache

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It seems that many people believe that non-residents will not be taxable if the non-resident does not spend more than 183 days in a year in South Africa. Unfortunately, this is only part of the truth.

The term 'globalisation' has become a near cliché in today's integrated world. But it seems that the current financial crisis and recessionary pressures may, on the back of more intelligent software solutions, be accelerating the global integration of transnational organisations as these organisations seek to lower costs and increase their ability to penetrate emerging markets. We are therefore also seeing increased interest in related phenomena, such as regional or global shared service centres, and integrated tax and financial reporting.

Traditional long-term assignments have proven to be costly, especially so where organisations do not have proper systems to predict or track the associated costs, or to match the benefits provided with the specific nature of various assignments and with better resourcing models, such as global talent pools and just-in-time staffing. Organisations are therefore growing their use of short-term assignments to achieve business and project objectives.

South African organisations are part of this trend, but without necessarily incorporating it into their tax risk and compliance processes.

So what is the issue?

Although most countries use tax residency as the basis of their tax systems, they also seek to tax income that is sourced within their territory.

In the case of South Africa, for example, we include in 'gross income' any receipt or accrual of a non-resident that is from a South African source. Since the source of employment income, or income earned for services rendered in South Africa, is accepted to be located where the services are physically performed (irrespective of where in the world or by whom an individual may be paid for these services) and since South Africa does not have a de minimis rule, a short-term assignee would, in principle, be taxable on any remuneration earned for services rendered whilst in South Africa.

It seems, however, that many people believe that non-residents will not be taxable if the non-resident does not spend more than 183 days in a year in South Africa. Unfortunately, this is only part of the truth.

In order to use the so-called 183-day rule, the person relying on it needs to be a tax resident of another country, a Double Tax Agreement ('DTA') needs

to be in force between South Africa and the person's country of residence, and, finally, the person needs to comply with the other requirements of the DTA relating to the 183-day rule.

Generally speaking, DTAs entered into by South Africa accept the source principle, but provide that tax residents of the other country will be taxable in that country only on South African-sourced remuneration (i.e. South Africa will not have taxing rights) if:

- the foreign tax resident recipient of the remuneration is present in South Africa for a period or periods not exceeding in aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
- the remuneration is paid by, or on behalf of, an employer who is not a resident of South Africa (in other words the remuneration should not be paid by or on behalf of a South African resident entity), and
- the remuneration is not borne by a permanent establishment which the employer has in South Africa.

When looking at the second requirement, it is important to note that SARS has, in a Binding Private Ruling (BPR085 – issued in June 2010), effectively followed a substance over form approach (i.e. the so-called 'economic employer' approach).

South Africa's position follows the current trend in international interpretation as expressed in the Commentary to the OECD Model Tax Convention. Although South Africa is not a member of the OECD, it generally subscribes to the rules set out in the Commentary.

This means that where a person is on business in South Africa and, whilst in South Africa, should in substance be considered to be an employee of a South African resident entity, the person will not qualify for DTA relief even though the person is formally employed outside South Africa and paid by a non-resident entity.

Factors that will be taken into account in this regard will be, inter alia, who supervises and controls the person, and whether the salary costs are recharged to the local operations.

Another, sometimes overlooked but important consequence of short-term business travel is that a person's frequent and consistent presence in a country over a period of time, could create a 'permanent establishment' for their employer in the country where they perform such services.

DTAs increasingly include so-called services permanent establishment rules. These rules provide, generally speaking, that if an enterprise of a country provides services to or in another country and those services entail a presence in that country by the enterprise for more than the period specified in the DTA concerned, the enterprise will be considered to have created a permanent establishment in the country where it provided the services under consideration, unless any of the normal exclusions, for example relating to preparatory or auxiliary activities, apply.

Finally, these corporate tax concerns need to be reviewed also together with transfer pricing principles applicable to the cross-border provision of services.

What is the impact of this on South African organisations?

In light of the tax considerations highlighted above, South African organisations will have to redesign their processes to include consideration of the following:

- Tax compensation – Non-resident short-term assignees who become taxable in South Africa may insist that they be compensated for any increased tax costs.

- A specific short-term assignment policy may be required to deal with, inter alia:
  - Will the assignees be tax equalised or tax protected?
  - Will the organisation assist with the assignees' tax compliance and the associated costs?
  - Will normal practices in respect of expatriate employees apply?

- Policies, processes and procedures will also have to be introduced to:
  - Track the movement of short-term assignees
  - Incorporate short-term assignments into accounting functions, and tax and transfer pricing policies.
  - Define roles, responsibilities, and reporting lines.

We believe that with the pressure to increase revenue, SARS will increase its focus on this area over the medium term.

Residential accommodation – Is your company exposed to PAYE risks?

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If your company provides residential accommodation to expatriate employees who are on secondment in South Africa, you are most likely not calculating the taxable fringe benefit correctly. This will be particularly so if it is the expatriate's first two years on assignment in South Africa and you are applying the residential accommodation tax exemption that is afforded to expatriates during this period.

A fringe benefit arises where a South African company provides the use of residential accommodation to employees, including expatriate employees in South Africa.

This fringe benefit is equal to the so-called 'rental value', reduced by any rental consideration paid by the employee.

As a general rule, unless SARS directs otherwise, the 'rental value' is, inter alia, equal to the higher of:

- an amount determined in accordance with a prescribed formula; or
- the actual rentals payable by the company for the accommodation and any other expenditure defrayed by the company (or any associated institution).

One of the elements taken into account in the prescribed formula is the remuneration earned by the expatriate during the prior tax year or, where no remuneration was earned during that year, his remuneration earned during the current tax year, extrapolated for the full year.

Given that the remuneration packages of expatriates are often significant in value, the application of the prescribed formula will often yield an amount that is higher than the actual rental paid by the company for the residential accommodation. This means that the rental value (i.e. the taxable fringe benefit) will exceed the actual market-related rental of the residential accommodation. The expatriate is therefore placed in the unfortunate tax position of being subject to tax on a fringe benefit that is much higher than the actual rental cost paid by the company and hence the value of the benefit to him.

An important point (which most employers are not aware of) is

that this rule also applies where an expatriate qualifies for the so-called 'tax exemption' that applies to residential accommodation provided to an expatriate during his or her first two years in South Africa. This tax exemption only applies to the extent that the 'rental value' of the fringe benefit does not exceed R25 000 (multiplied by the number of months during which the exemption applies).

Thus, when applying this tax exemption, an employer must first determine what the 'rental value' is and only if that rental value is less than the R25 000 threshold, no fringe benefit arises. However, in determining the 'rental value', the rule noted above is applied – namely, the rental value is equal to the higher of the amount yielded by the prescribed formula or the actual rentals paid.

An anomaly may therefore arise where the amount yielded by the formula could be higher than the actual rentals paid by the company and/or could also be higher than the R25 000 threshold. In this case, a taxable fringe benefit will therefore arise even though the expatriate may be in his or her first two years of secondment in South Africa and even though the actual rentals paid by the company are lower than the R25 000 limit. Where this anomaly arises, the employer may only use the actual rentals paid as the value of the fringe benefit with SARS's written permission.

What this means for your company and its expatriate employees is that you will need to assess on an annual basis, and in respect of each expatriate, whether the prescribed formula yields a higher result than the actual rentals paid. If it does, the fringe benefit is equal to the amount yielded by the formula, reduced by the R25 000 exemption where applicable. This assessment will also need to be done each time the actual rentals change.

This creates a significant administrative burden for the company. That said, there is also an opportunity to reduce the tax burden of the expatriates in these circumstances, as employers may apply to SARS for a ruling requesting that it permit the company to calculate the fringe benefit as being equal to the actual rentals paid by the company (instead of the amount yielded by the prescribed formula). A single ruling application may be submitted in respect of all expatriate employees, but this ruling application would need to be supported by details (including the remuneration and rental) for each expatriate employee.

In practice, SARS generally only grants these rulings for the period of the rental agreement. As a result, when an agreement is renewed, a fresh application will need to be made in respect of the rentals under that renewed agreement.

Alternatively, taxpayers may also apply to SARS for a tax directive in respect of the 'rental value' (application to be made on the prescribed form EMPRB). If SARS is satisfied that the rental value, as determined in terms of the tax rules, does not represent a fair and

reasonable value, it may re-determine a rental value at a lower amount which it considers to be fair and reasonable. The determination may only be made if certain prescribed reasons exist, one of which is that the employee is a highly-remunerated individual and the average value of the accommodation in the area is much less than the rental value determined in accordance with the prescribed formula. Certain information needs to be included with the directive application form, for example, remuneration details and two valuation lists.

Note that a fringe benefit arises even if the expatriate is present in South Africa for less than 183 days since the tax relief afforded by any double taxation agreement generally does not apply in respect of residential accommodation provided by a South African company.

Note too, that if the South African company settles the tax arising on the fringe benefit on behalf of the expatriate, certain complex tax consequences will follow which the company must adhere to in order to avoid penalties and interest being levied by SARS.

In conclusion – If you provide high-earning expatriates with the use of residential accommodation, you need to consider the impact of the prescribed formula in the calculation of the taxable fringe benefit, particularly where these expatriates are in their first two years of rendering services in South Africa.

Where the prescribed formula yields a result which is higher than the actual rentals, tax relief may be available and, whilst obtaining a SARS ruling or a directive may seem like a burdensome task, the administrative burden from which the company will be relieved and the tax savings that the expatriates will enjoy as result, will make the effort worthwhile.

Conducting Business in Africa – Unveiled

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The fundamental question is how to successfully conduct business in Africa and what factors must remain top of mind for potential investors.

The interest to expand into Africa has rapidly increased over the years and Africa is capturing the attention of organisations all over the world. Although not necessarily true for Asian investors, many organisations are interested in expanding into Africa to embed their organisations in future growth markets since home markets are stagnating, or shrinking in many instances.

The fundamental question is how to successfully conduct business in Africa and what factors must remain top of mind for potential investors. It is important to provide guidelines and a considered solution to this question.

Key factors to consider when conducting business in Africa – Key factors to consider include work- and traditional cultures, languages, laws and regulations and understanding the market. This article explores the more prominent factors in brief but their importance in determining the success or failure of a business cannot be underestimated.

Work- and Traditional Cultures

A common error when considering a business investment into Africa is that comparisons are made with a country like Brazil, China or India that may have a shared ancestry and culture. Africa, on the other hand, is not homogenous and is made up of a diverse mixture of traditions and cultures. Often organisations do not understand the work- and traditional cultures of the people in the country in which they wish to operate.

In order for organisations to succeed in Africa, it is important to embrace cross-cultural traditions, management and communication styles. This involves understanding the role African culture plays in social interactions, management styles, organisational behaviour and business practices, and applying this to each specific country.

Language

There are over a thousand indigenous languages spoken in Africa. Many executives assume that since an African country was a Portuguese or English colony, that the population in that country speak the relevant European language as a first language. This misconception makes conducting business in Africa extremely difficult. As

it is impossible to be able to speak and understand all the different languages across Africa, it is crucial to have a person or people on your team that speak and understand the language/s in the country. Many countries have ten or more local African languages that are spoken. Business communication can falter if the question of language is not factored into one's business strategy.

Laws and Regulations

Africa, like every other continent, has laws and regulations that vary from country to country and therefore special consideration should be given to understanding these parameters before considering expanding into a country. This involves in-depth research and consultation with local experts on the different laws and regulations that govern conducting business in the specific country.

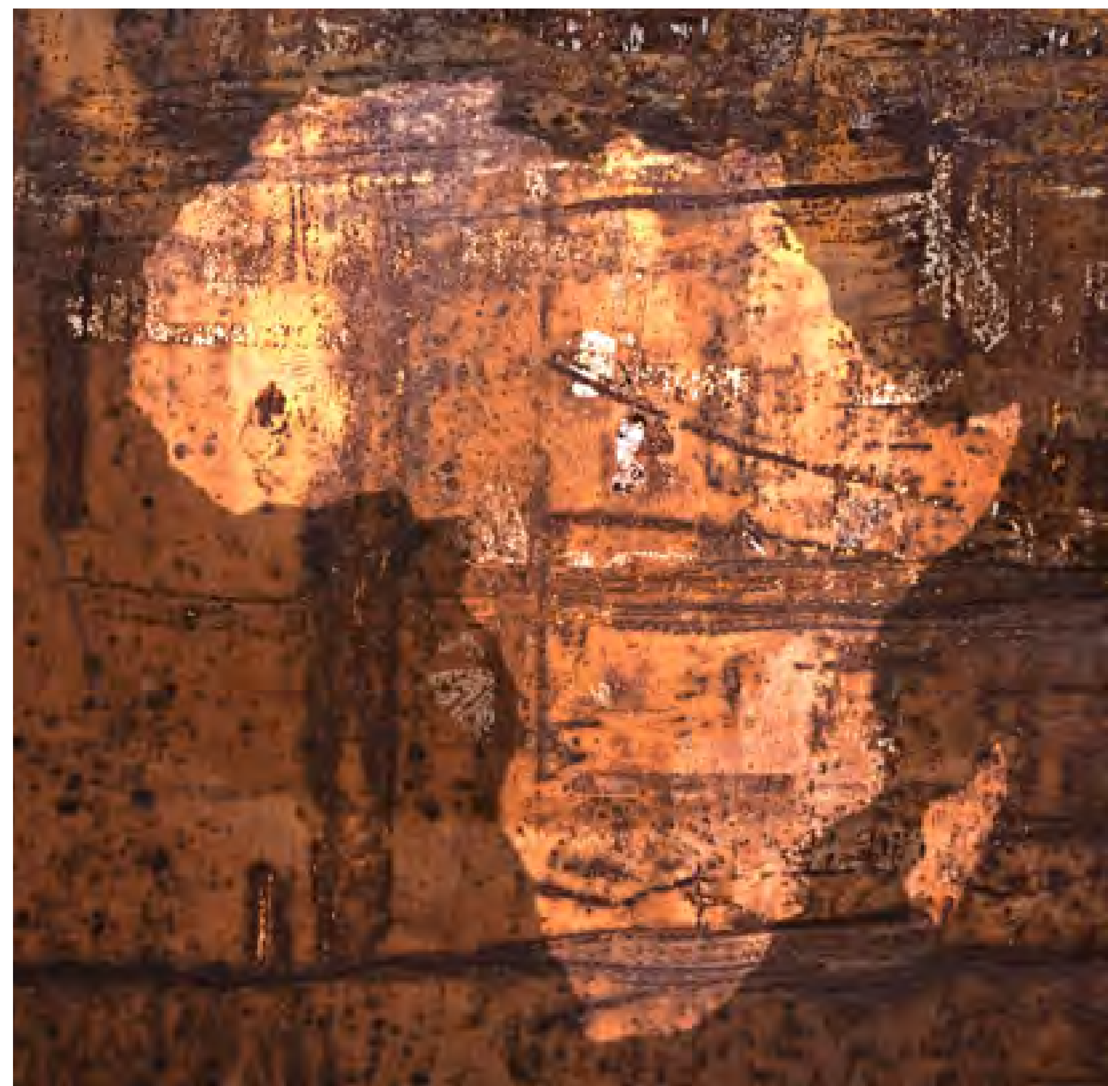
Considerations include the type of legal entity that is required to conduct business, as well as any regulatory approvals that are required. In some countries there may be industry-specific business licences that organisations need to apply for prior to being able to operate in the country.

The corporate establishment of an entity, and any relevant legal registrations and business licences, can take anything from one to six months to be completed. This is an important factor as it impacts directly on when an organisation can start operating in the country and may restrict the type of business that the investor is legally allowed to conduct.

Terminology may also have a different meaning and functionality in different countries across Africa. This makes consultation with local experts crucial.

Understanding the Market

Understanding the market is vital to success. Organisations should research and have an in-depth knowledge of the market. Sourcing the right customers in an African market, and marketing one's products and services, can take a long time and is a challenging task. In this respect, organisations can consult with



Chambers of Commerce, the respective Embassy or traders in the country of interest.

Organisations should also visit the location in question if they intend establishing a company or representative office – desktop research simply does not work on its own.

Guidelines for conducting business in Africa:

- **Research** the relevant country prior to conducting business in Africa and always take time to understand the culture, language, laws and regulations and market of the country. Before starting up a business base, send a staff member to the country to build a network of advisors and **learn from the operational difficulties** of others.
- **Planning** is important to the success of conducting business in Africa and an organisation can never plan enough. Planning involves **understanding the requirements, costs and timelines** required to implement and sustain the business.
- Organisations should **partner with seasoned experienced advisors**, such as Deloitte, to help with planning and the development and implementation of **a sound business strategy**. It is important to partner with an advisor who has experience and an established footprint in Africa.
- A good approach is to **apply local knowledge with a tested global methodology**. In this way, you leverage off local experience whilst using innovative global methodologies to enhance your business dealings.
- **Build a network of resources** in the country and maintain a relationship with them. Building relationships is important to the success of conducting business in Africa.
- **Ongoing evaluation** is important and organisations must equip themselves to be flexible and respond swiftly to change.

Deloitte takes a strategic approach to conducting business in Africa, using a combination of consultation with seasoned local and global experts, a sound strategy, and applying project management methodologies in planning and implementation. Our approach involves partnering with our clients to provide them with an innovative, customised solution designed to enable them to successfully penetrate the African market.

External company registration: a permanent establishment trap?

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Company law legislation in South Africa has recently undergone significant changes that will impact the way foreign investors conduct business in this country.

Previously, in terms of the Companies Act No. 61 of 1973 ('the old Companies Act'), a foreign company looking to conduct business in South Africa was required to register as an 'external company' within 21 days after it had established a 'place of business' within South Africa. The term 'place of business' was further defined as: *"any place where the company transacts or holds itself out as transacting business and includes a share transfer or share registration office"*. Under this definition, it was possible for foreign companies to operate in South Africa without registering as an external company.

The old Companies Act has, with effect from May 1, 2011, been superseded by Companies Act No. 71 of 2008 ('the New Companies Act'). In terms of the provisions of the latter, a foreign company is required to register as an 'external company' within 20 business days after it first begins to conduct business or non-profit activities within South Africa.

A foreign company will be regarded as 'conducting business' if:

- it is a party to one or more employment contracts in South Africa; or
- it is engaging in a course of conduct, or it has engaged in a course or a pattern of activities in South Africa over a period of at least six months, such as would lead a person to reasonably conclude that the foreign company intended to continually engage in business within South Africa.

It is clear from the above that the requirement to register as an external company in terms of the new Companies Act has the result of ensuring that virtually every foreign company employing individuals in South Africa has to register as an external company.

This has raised the question of whether registration as an 'external company' for company law purposes would automatically result in the creation

of a fixed place of business for the foreign company in South Africa (i.e. a 'permanent establishment') for corporate income tax purposes. We understand that the intention of the legislation was to simplify the matter, but it would seem that it has cast the net wider than the old requirements.

In South Africa, residents are taxed on their worldwide income and a company will be treated as a South African tax resident if it is incorporated, established or formed in South Africa or if it is effectively managed in South Africa. Non-residents, on the other hand, are taxed on a source basis. Where South Africa has concluded a treaty for the avoidance of double taxation with the country of residence of the foreign investor, the foreign investor would only be subject to tax in South Africa if it has a 'permanent establishment' in South Africa.

The issue of whether registration as an 'external company' for company law purposes results in the creation of a permanent establishment in South Africa was addressed in Binding Private Ruling 102 issued by SARS on May 4, 2011.

The Applicant for the ruling was a private company which was incorporated and resident in a foreign country. The Applicant intended to register, under the provisions of the old Companies Act, an external company in South Africa which would be involved in advancing subordinated interest-bearing loans to companies based in South Africa and in subscribing for preference shares in these companies.

SARS ruled that the registration of the branch as an external company would not create a permanent establishment for the Applicant. This ruling was, however, issued subject to the conditions and assumptions that:

1. the Applicant's place of effective management would be located in the specified foreign country in which the Applicant was a resident;

2. the Applicant would 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; and

3. the Applicant would not have a dependant agent operating on its behalf in South Africa.

It would appear from the above ruling, therefore, that the mere registration of an external company will not automatically result in the creation of a permanent establishment for South African corporate income tax purposes. Furthermore, the circumstances surrounding a foreign company's activities in South Africa should be taken into account on a case-by-case basis for the purposes of reaching a decision on this issue.

However, it needs to be noted that the ruling is a private one and it is not of general application. It can therefore not be assumed that SARS will always adopt this approach. Moreover, registration as an external company under the facts outlined above was in accordance with the provisions of the old Companies Act, as opposed to those of the new Act. Finally, SARS' view was predominantly influenced by the fact that the Applicant did not have employees or agents in South Africa.

Since, going forward, a foreign company will be deemed to be conducting business in South Africa when it engages employees locally, it remains to be seen to what extent this will cause SARS to reach a different conclusion on the issue.

Practically, a foreign investor is now placed in a position that it will be required to prove that it does not have a 'permanent establishment' if it is registered as an external company.

Foreign investors would therefore do well to carefully consider the potential corporate income tax implications of the new South African external company rules and to obtain tax planning advice in this regard.

Update on section 12L energy efficiency regulations

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The regulations to section 12L of the Income Tax Act (the Act) were published on 16 September 2011.

The Department of Energy, which is responsible for the Regulations, initially stated that the Regulations were 'draft' and asked for comments from the public within 60 days. Upon review, however, it transpired that the Regulations were in fact final. This has caused some confusion.

Nevertheless, unlike legislation, regulations can be changed relatively easily and the Department of Energy has undertaken to consider all comments made on the Regulations. Consequently, the Regulations may change in future once public comments are taken into account.

The Regulations are long outstanding and took nearly three years to complete. Section 12L was inserted into the Act in 2009 but the section did not become operational immediately (the date when the section will become operational is yet to be determined by the Minister of Finance).

We do not envisage that the section will become operational in the near future as the current wording of section 12L still refers to the REFIT tariffs and the section is therefore likely to change (another mechanism will need to be found to monetise section 12L's energy savings). In other words, we anticipate that section 12L will be amended first before it becomes operational.

This delay is not necessarily bad news. The regulations to section 12L, which set out how energy savings must be measured, require a baseline on which to measure future energy savings. In terms of the Regulations, the baseline must be determined on energy consumption over a one year period, which is the preceding tax year, in respect of which energy efficiencies in terms of section 12L will then be claimed. The baseline and energy efficiencies must be determined by a Certified Measurement and Verification Professional (CMVP), and must be calculated in terms of SABS Standard, SANS 50010.

Determining the baseline and subsequent energy efficiencies will require careful planning. It is important to determine what must be measured

and how this must be measured. Depending on the circumstances, measurement equipment may need to be installed as accurate measurements will be required. It must be noted that all forms of energy must be measured and not just electricity.

Once the baseline is established and energy efficiencies are verified by a CMVP, it must be registered with the South African National Energy Development Institute (SANEDI). SANEDI will issue an energy efficiency certificate which will allow a taxpayer to claim a section 12L allowance.

The delay in allowing section 12L to become operational will provide time to plan for the deduction and the required measurements.

Companies that are planning energy efficient initiatives should also consider Eskom's Demand Side Management Incentives (DSM) for electricity savings. Eskom's DSM incentives are currently in operation and much the same process is followed to determine electricity saving under this programme as is envisaged for section 12L.

It is noted that benefits under section 12L, based on the 2011 REFIT tariffs, are much lower than Eskom's DSM incentives: section 12L provides a tax deduction of 26 c/kWh whereas Eskom's DSM program will provide a cash injection of approximately 42c/kWh. In the circumstances, projects with energy savings relating mainly to electricity should rather consider Eskom's DSM program.

Our team of experts at Deloitte will gladly assist you should you require more information on how energy efficiency interventions can help your business.

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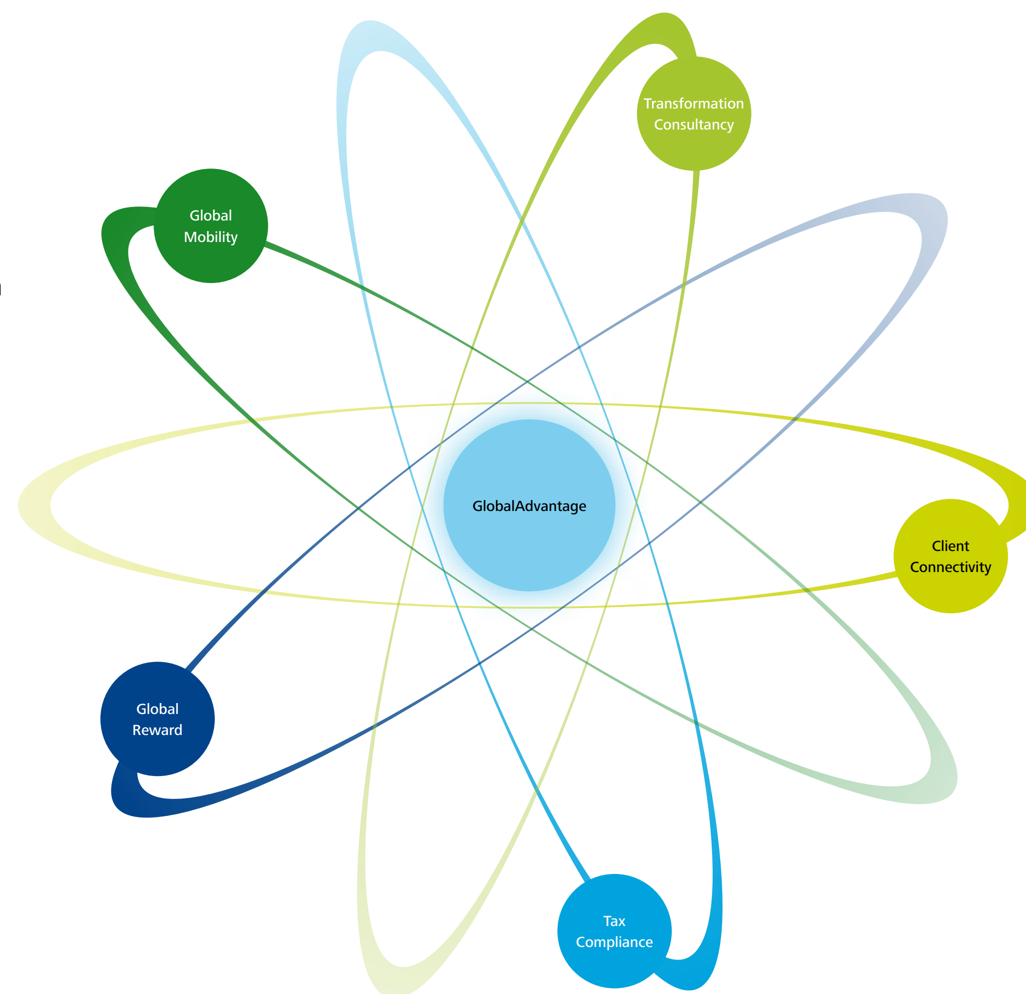

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