South Africa as a base for expansion into Africa?

Africa is the cradle of humanity yet it is only now, in the early years of the twenty-first century, that it is truly taking its place amongst the economic community of nations. With 60% of the world's uncultivated arable land, 1 billion people and abundant natural resources, Africa is rich in opportunities and potential.

Currently home to seven out of ten of the world's fastest growing economies, this exciting continent's outlook is promising. The International Monetary Fund (IMF) predicts that no other continent will compete in growth in the near future and, with 70% of its population under the age of 35, Africa will enjoy extraordinary demographic dividend as their energy and talents drive economic growth and development. In addition, governments across the continent are committed to improving the business climate, creating employment and endless business opportunities. Whilst natural resources and infrastructure remain key drivers of Africa's economic growth, the development of market economies is driving demand for goods and services including fast moving consumer goods, financial services, and telecommunications.

The growth of intra-African trade and investment, led by South Africa, Kenya and Nigeria is also a developing phenomenon which is starting to reduce the continent's traditional dependence on external trade and investment. However, foreign direct investment (FDI) is expected to remain strong with an increase of 5.5 percent last year, reaching $38 billion, even as the total to developing countries fell by nearly 7 percent. FDI forecast is to reach $56 billion by 2015 with remittances rebounding as well, posting a high of $23 billion in 2011.

Entry into, and expansion within, the African continent is regarded by many multinational corporations as essential to their continued existence, justifying the considerable business risk with the lure of high rewards. South Africa has long been considered the 'gateway' to doing business in the rest of Africa with South African firms pushing the message that it is a wiser choice to enter the rest of the continent via them, given their local knowledge and know-how. Many South African firms have taken this a step further by establishing a presence, whether through affiliations or established offices, in select African countries thereby enjoying on-the-ground assistance which clearly has immense benefit. African countries run on a timeframe and language of their own, quite unlike most other countries, and it is almost impossible to enter as an outsider and immediately know where to go, what to do and even more importantly, how it is done. The experience of doing business in Africa and the business connections of South African firms can make a significant difference to the success of operations and investments in other African countries.

However, foreign investors are often discouraged from establishing their base for Africa in South Africa by virtue of complex exchange control, tax and other regulations. Many of the potential competing base countries in Africa, such as Mauritius, Kenya or Botswana offer more generous and less complex regimes. Therefore, notwithstanding several concessions made by the South African Treasury in respect of a South African regional holding company (see below), non-residents remain reluctant to establish their base company for Africa in South Africa, which means missed opportunities for South Africa as it is often then bypassed altogether.

When it comes to holding company regimes, South Africa needs to consider that the main reason for the success of holding regimes in, for example, the Netherlands and Luxembourg for investments in the EU, Hong Kong and Singapore for investments in Asia, and Spain and Portugal for investments in South America, is that they allow the extraction of profits from the target regions via the intermediate holding region to the ultimate investor without incurring additional layers of withholding tax. Furthermore, the intermediate jurisdictions do not have exchange controls or other burdensome regulations.

South Africa has long since (2001) been trying to introduce a holding company regime which could provide similar benefits to those offered by the jurisdictions mentioned above. The current Headquarter Company ("HQ Company") regime introduced under section 9I of the Income Tax Act ("ITA") and corresponding exchange control rulings aim to allow a non-resident investor to make investments in other African countries without incurring an additional layer of South African withholding taxes and to effectively exempt the HQ Company from exchange control restrictions. Unfortunately, it does not allow that HQ Company to make substantial investments in South Africa (only 20%); furthermore, exchange control restrictions do not allow South African investors to acquire an equity interest in the HQ Company of more than 20% in aggregate.

For example, in the case of US giant Wal-Mart which purchased South African retailer Massmart, should Wal-Mart wish to use its South African-based company to invest into the rest of Africa, it would simply increase its tax burden on dividends, interest and royalties extracted from those investments with South African withholding taxes at a rate of 15%, subject to potential relief under an applicable double taxation agreement ("DTA"), for example, 5% for dividends under the USA/RSA DTA. The South African company cannot qualify under the HQ co regime since 80% of its assets do not consist of foreign investments as required under section 9I of the ITA. Since it would not be able to benefit from the exchange control concessions made under the HQ company regime, the flow of funds would also be subject to currency risks and conversion costs since the funds would first need to be converted to ZAR then to US $ to repatriate the funds. Furthermore, Wal-Mart could not establish a HQ Company in South Africa to hold all its African investments as the HQ Company must hold 80% of its assets outside South Africa.

In addition, successful holding company regimes, such as the examples mentioned, also provide further concessions for other activities, such as services rendered to their foreign subsidiaries. These concessions apply to incentivise the investor to base a services office in the holding regime which subsequently creates opportunities for specialists in the intermediate region. However, in South Africa, such services fees will be faxed at the full corporate rates plus dividends tax on the remittance of profits.

Clearly, therefore, while introducing an attractive HQ Company regime is a wise idea, it falls short of the examples set by competing regimes. Furthermore, the regime cannot be used to invest in South Africa which is an obstacle for any non-resident wanting to invest in Africa as South Africa would often be one of the important target jurisdictions.

These impediments make it understandable why foreigners are tempted to avoid using South Africa as their potential gateway and yet, it is important to consider that for all its promise and opportunities, Africa still presents challenges to investors (whether African or not). To mitigate some of these risks, it is essential to have an understanding of the law and regulation in a country in which a business is considering doing business or investing. Legal due diligence initially is usually far more effective than remedial legal advice after the event. Furthermore, whilst at the extreme a contract may "not be worth the paper it is written on", a well drafted one, based on clear, consistent and reliable advice on local law and regulation with legal risk mitigation provisions contained in it, will greatly assist. Whilst foreign investors could approach law firms or other advisors in the target African country directly, they frequently experience frustration to obtain the appropriate advice and are often charged exorbitant fees since the advisor has no loyalty or relationship with the foreigner. Therefore, it is very important to choose an advisor who has experience and relationship with a wide network of people who can be relied upon to provide professional advice at a reasonable cost.

Despite the negative aspects of the HQ Company regime, there are numerous other good reasons for a non-resident to establish a base office in South Africa which can be used to tap into the existing networks and relationships enjoyed by South African firms and to monitor any investment in South Africa itself. The well established infra-structure and the high standards of living make it easier for foreigners to feel at home in South Africa. The South African authorities are well aware of the need to improve the HQ Company regime to make that aspect of a base in South Africa more attractive. Therefore, it is very likely that the few remaining shortcomings of that regime will be removed in the near future which would really make South Africa the ideal base country for expansion into Africa.

South Africa therefore retains its appropriate place as the gateway to doing business in Africa offering substantial expertise and local know-how. Its hand-holding offers peace of mind and with its immense experience and established networks it makes absolute sense as a partner for any business looking to explore opportunities in the rest of Africa.

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