ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA
DAVIS TAX COMMITTEE INTERIM REPORT

ACTION PLAN 6: PREVENT TREATY ABUSE

1 INTRODUCTION

In terms of Article 1 of the OECD Model Tax Convention (OECD MTC), the first requirement that must be met by a person who seeks to obtain benefits under a double tax treaty is that the person must be "a resident of a Contracting State", as defined in Article 4 of the OECD MTC. There are a number of treaty abuse arrangements through which a person who is not a resident of a Contracting State may attempt to obtain benefits that a tax treaty grants to residents of the contracting States. These arrangements are generally referred to as "treaty shopping"; a term describes the use of double tax treaties by the residents of a non-treaty country in order to obtain treaty benefits that are not supposed to be available to them.[1] This is mainly done by interposing or organising a "conduit company"[2] in one of the contracting states so as to shift profits out of those states.[3] When a conduit company is set up in a tax-haven jurisdiction, this can result in tremendous loss of revenue for the signatories to the treaty .[4]

Treaty shopping is undesirable because it frustrates the spirit of the treaty. When treaties are concluded, the assumption is that a certain amount of income will accrue to both countries involved in the treaty. The anticipated capital flows are distorted if the treaty is used by third country residents. When unintended beneficiaries are free to choose the location of their businesses, then treaties designed to eliminate double taxation end up being used to eliminate taxation altogether.[5] Treaty shopping makes a bilateral treaty function

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1 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) at 1; S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) at 119.

2 Defined below.

3 After setting up the conduit company structure, other "stepping stone" strategies can also be applied to shift income from the contracting countries. This could be done by changing the nature of the income to appear as tax deductible expenses such as commission of service fees. See FJ Wurm *Treaty Shopping in the 1992 OECD Model Convention Intertax* (1992) at 658; S M Haug "The United States Policy of Stringent Anti-treaty shopping Provisions: A Comparative Analysis" (1996) 29 *Vanderbilt Journal of Trans-national law* at 196; E Tomsett *Tax planning for Multinational companies* (1989) at 149.

4 OECD Issues in International Taxation No. 1 *International Tax Avoidance and Evasion* (1987) at 20; A Ginsberg *International Tax Havens* 2nd ed (1997) at 5-6; P Roper & J Ware *Offshore Pitfalls* (2000)at 5.

5 Weeghel at 121 notes that treaty shopping results in international income being exempt from taxation altogether or being subject to inadequate taxation in a way unintended by the contracting states.

largely as a "treaty with the world" and this often results in tremendous loss of revenue for the contracting states. [6]

2 PREVIOUS MEASURES RECOMMENDED IN THE OECD MODEL TAX COVENTION TO CURB TREATY SHOPPING

The 2014 version OECD MTC (yet to be revised in line with the OECD BEPS recommendations) provides for two main measures to prevent treaty abuse. These are: the use of domestic anti-avoidance provisions and the use of specific treaty provisions.

2.1 Domestic anti-avoidance provisions

Paragraph 7.1 of the OECD Commentary on Article 1 of the OECD MTC Convention provides that where taxpayers are tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws, such attempts may be countered by jurisprudential rules that are part of the domestic law of the state concerned. In other words, the onus is placed on countries to adopt domestic anti-avoidance legislation to prevent the exploitation of their tax base and then to preserve the application of these rules in their treaties. The current Commentary on Article 1 states in paragraph 22 that, when base companies are used to abuse tax treaties, domestic anti-avoidance rules such as "substance over form", [7] "economic substance" and other general anti-avoidance rules can be used to prevent the abuse of tax treaties.[8]

2.2 Specific treaty provisions

The Commentary on Article 1 of the OECD MTC also suggests the following examples of specific clauses that can be inserted in tax treaties to curb the different forms and cases of conduit company treaty shopping.

- The "look through" approach: In terms of this approach treaty benefits should be disallowed for a company not owned, directly or indirectly, by residents of the State of which the company is a resident.[9]

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6 R Rohatgi *Basic International Taxation* (2002) at 363; Haug at 218; Weeghel at 121.

7 Ware and Roper at 77 where the 'substance over form' doctrine is described as a doctrine which permits the tax authorities to ignore the legal form of a tax arrangement and look at the actual substance of the relevant transaction.

8 This position seems to be based on the 1987 OECD Report entitled 'Double Taxation Conventions and the Use of Base Companies' which states in par 38 that anti-abuse rules or rules on 'substance over form' can be used to conclude that a base company is not the beneficial owner of an item of income.

9 Para 13 of the commentary on Article 1 of the OECD Model Convention. See also AJM Jiménez 'Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective – Part 1' (Nov. 2002) *Bulletin for International Fiscal Documentation* at 21.

o The subject-to-tax provision: In terms of this approach, treaty benefits in the state of source can be granted only if the income in question is subject to tax in the state of residence.[10]

o Exclusion provisions: This approach denies treaty benefits where specific types of companies enjoy tax privileges in their state of residence that facilitate conduit arrangements and harmful tax practices.[11]

o Provision that apply to subsequently enacted regimes: Paragraph 21.5 of the Commentary suggests a provision that can be inserted in treaties to protect a country against preferential regimes adopted by its treaty partner after the treaty has been signed. Such a provision would apply to both existing and subsequently enacted regimes.[12]

o The "limitation of benefits" provision: This provision is aimed at preventing persons who are not residents of the contracting states from accessing the benefits of a treaty through the use of an entity that would qualify as a resident of one of the States.[13] The gist of such a provision is to the effect that residents of a contracting state who derive income from the other contracting state shall be entitled to all benefits of the treaty with respect to an item of income derived from the other state only if the resident is actively carrying on business in the first mentioned state, and the income derived from the other contracting state is derived in connection with, or is incidental to, that business and that resident satisfies the other conditions of the treaty for access to such benefits.[14]

o The "beneficial ownership" clause: Paragraph 10 of the Commentary suggests the use of a "beneficial ownership" clause as one of the anti-abuse provisions that can be used to deal with source taxation of specific types of income set out in articles 10, 11 and 12 of the OECD MTC. The concept of "beneficial owner" was introduced in the OECD MTC in 1977 in order to deal with simple treaty shopping situations where income is paid to an intermediary resident of a treaty country who is not treated as the owner of that income for tax purposes (such as an agent or nominee). This resulted into the addition of a section on "Improper Use of the Convention" to the Commentary on Article 1. This section was subsequently expanded in succeeding years after the OECD released reports such as:

- The 1986 report on *Double Taxation and the Use of Base companies,* and
- The 1992 Report on *Double Taxation and the Use of Conduit Companies.*

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10 Para 15 of the commentary on article 1 of the OECD Model.'

11 BJ Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986) at 256.

12 Jiménez 'at 22.

13 Para 20 of the commentary on article 1 of the OECD Model Convention.

14 Ibid.

The term “beneficial ownership” is, however, not defined in the OECD MTC or its Commentary.[15] Although article 3(2) of the OECD MTC permits countries to apply the domestic meaning of a term that is not fully defined in the OECD MTC, with regard to the beneficial ownership concept, the OECD recommends that the definition should carry an international meaning that would be understood and used by all countries that adopt the OECD MTC.[16] There is however no clear international meaning of the term. The OECD MTC does, however, provide some clues to the meaning of the term. In terms of the OECD MTC, a nominee or agent who is a treaty country resident may not claim benefits if the person who has all the economic interest in, and all the control over, property (the beneficial owner) is not also a resident. To further clarity the meaning of the term, in 2003 the OECD released a Report on *Restricting the Entitlement to Treaty Benefits* which lead to amendments in the OECD MTC to further clarify that clarified that a conduit company cannot be regarded as a beneficial owner if, through the formal owner, it has as a practical matter, very narrow powers which render it in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties (such as the shareholders of the conduit company).[17]

In October 2012,[18] the OECD issued revised proposals to amend the Commentaries on articles 10, 11 and 12 to provide that beneficial ownership has a treaty meaning independent of domestic law[19] and that it means “the right to use and enjoy” the amount “unconstrained by a contractual or legal obligation to pass on the payment received to another person.” However the effectiveness of the beneficial ownership provision in curbing treaty shopping is now questionable in light of certain international cases such as the decisions in Canadian cases of of *Velcro Canada Inc. v The Queen*[20] *and Prevost Car Inc. v Her Majesty the Queen*[21] (discussed under the international approached below). As a result of cases such as the above, additional work by the OECD on the clarification of the “beneficial ownership” concept, resulted in changes to the Commentary on articles 10, 11 and 12 of the 2014 version of the OECD MTC which acknowledged the limits of using that concept as a tool to address

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15 International Fiscal Association *The OECD Model Convention – 1998 and Beyond; The Concept of Beneficial Ownership in Tax Treaties* (2000) at 15.

16 L Oliver & M Honiball *International Tax: A South African Perspective* (2011) at 46; The International Fiscal Association’s 2000 Report on the OECD Concept of Beneficial Ownership in Tax Treaties at 20.

17 OECD “Report on the Use of Base Companies” (1987) in par 14(b).

18 OECD “Revised Proposals concerning the Meaning of “Beneficial Owner” in Articles 10, 11, and 12” (19 October (2012).

19 Proposed paragraph 12.1 of the Commentary on Article 10, paragraph 9.1 of the Commentary on Article 11, and paragraph 4 of the Commentary on Article 12.

20 2012 TCC 57.

21 2008 TCC 231.

various treaty-shopping situations. [22] Paragraph 12.5 of the Commentary on Article 10 provides that: “whilst the concept of “beneficial ownership” deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.”

3 THE 2013 OECD BEPS REPORT: ACTION PLAN 6

The OECD BEPS report on Action Plan 6[23] notes that although current rules to prevent treaty abuse work well in many cases, they need to be adapted to prevent BEPS that results from the interactions among more than two countries and to fully account for global value chains. The OECD recommends that:

- Existing domestic and international tax rules should be modified in order to more closely align the allocation of income with the economic activity that generates that income.

To address treaty abuse, the OECD planned to carry on work to:

- Develop changes to model treaty provisions and provide recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.
- Clarify that tax treaties are not intended to be used to generate double non-taxation.
- Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

The deadline for the work on Action 6 was September 2014.

4 THE OECD SEPTEMBER 2014 REPORT ON ACTION PLAN 6

The September 2014 OECD Report[24] addressed work on Action 6 as follows:

4.1 DEVELOP MODEL TREATY PROVISIONS AND RECOMMENDATIONS REGARDING THE DESIGN OF DOMESTIC RULES TO PREVENT THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

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22 OECD “Tax Conventions and Related Questions: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” (17-18 September 2013) para 8.

23 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 19.

24 OECD/G20 Base Erosion and Profit Shifting Project Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6: 2014 Deliverable (2014). (OECD/G20 September 2014 Report on Action Plan 6).

The September 2014 OECD Report on Action Plan 6, sets out recommendations intended to prevent the granting of treaty benefits in inappropriate circumstances. For that purpose, a distinction is made between two types of cases:

A) Cases where a person tries to circumvent limitations provided by the treaty itself.

B) Cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits. [25]

Since the first category of cases involves situations where a person seeks to circumvent rules that are specific to tax treaties, the OECD recommends that these cases should be addressed through anti-abuse rules to be included in treaties. The situation is different with respect to the second category of cases that involve the avoidance of domestic law. These cases cannot be addressed exclusively through treaty provisions and require domestic anti-abuse rules, which raises the issue of possible conflicts between these domestic rules and the provisions of tax treaties. [26]

A) <u>Cases where a person tries to circumvent limitations provided by the treaty itself</u>

(i) As noted above, since cases involving situations where a person seeks to circumvent rules that are specific to tax treaties, the OECD recommends addressing these cases through anti-abuse rules to be included in treaties.

(ii) The OECD also recommends the use of new treaty anti-abuse rules to address treaty shopping strategies where a person who is not a resident of a Contracting State attempts to obtain benefits that a tax treaty grants to a resident of that State.

(iii) There are also additional recommendations to address other strategies aimed at satisfying different treaty requirements with a view to obtain inappropriately the benefit of certain provisions of tax treaties. [27]

These recommendations are addressed below.

A)(i) *Recommendations related to treaty shopping: include anti-abuse rules in treaties*

A review of the treaty practices of OECD and non-OECD countries shows that countries use different approaches to try to address treaty shopping cases not already dealt with by the provisions of the Model Tax Convention. [28] Based on the advantages and limitations of these approaches, the OECD 2014 report on

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[25] OECD/G20 September 2014 Report on Action Plan 6 at 10.
[26] OECD/G20 September 2014 Report on Action Plan 6 at 10.
[27] OECD/G20 September 2014 Report on Action Plan 6 at 11.
[28] OECD/G20 September 2014 Report on Action Plan 6 at 22.

Action 6 recommends the use of the following three-pronged approach to address treaty shopping situations.[29]

(a) Treaties should include, in their title and preamble, a clear statement that the Contracting States, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements:[30]

The OECD recommends that clarification is to be provided through a reformulation of the title and preamble of the Model Tax Convention that will clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance.

- Given the particular concerns arising from treaty shopping arrangements, such arrangements are expressly mentioned as one example of tax avoidance that should not result from tax treaties.
- Under applicable rules of international public law, this clear statement of the intention of the signatories to a tax treaty will be relevant for the interpretation and application of the provisions of that treaty.

(b) Tax treaties should include a specific anti-abuse rule based on the limitation-on-benefits provisions (LOB rule) included in treaties concluded by the United States and a few other countries:[31]

The OECD is of the view that such a specific rule will address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State. The LOB rule restricts the general scope of the treaty rule according to which a treaty applies to persons who are residents of a Contracting State.

- Paragraph 1 of the LOB rule provides that a resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a “qualified person” as defined under paragraph 2 or unless benefits are granted under the provisions of paragraphs 3, 4 or 5.
- Paragraph 2 determines who constitutes a “qualified person” by reference to the nature or attributes of various categories of persons; any person to which that paragraph applies is entitled to all the benefits of the Convention.
- Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a “qualified person” under paragraph 2 as long as that item of income is derived in connection with the active conduct of a trade or business in that person’s State of residence (subject to certain exceptions).
- Paragraph 4 is a “derivative benefits” provision that allows certain entities owned by residents of other States to obtain treaty benefits that these residents would have obtained if they had invested directly.

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[29] OECD/G20 September 2014 Report on Action Plan 6 at 22.
[30] OECD/G20 September 2014 Report on Action Plan 6 at 11.
[31] OECD/G20 September 2014 Report on Action Plan 6 at 11.

- Paragraph 5 allows the competent authority of a Contracting State to grant treaty benefits where the other provisions of the LOB rule would otherwise deny these benefits.
- Paragraph 6 includes a number of definitions that apply for the purposes of the Article. A detailed Commentary explains the various provisions of the LOB rule. [32]

(c) In order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule (such as certain conduit financing arrangements), the OECD recommends adding to tax treaties a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule). The PPT rule reads as follows:

> *Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.* [33]

- The recommendation to include a PPT rule in treaties is intended to provide a clear statement that the Contracting States intend to deny the application of the provisions of their treaties when transactions or arrangements are entered into in order to obtain the benefits of these provisions in inappropriate circumstances.[34]

The OECD notes that the following about the combination of the LOB and the PPT rules: [35]

- Each rule has strengths and weaknesses and may not be appropriate for all countries;
- These rules may require adaptations to the specificities of individual States and the circumstances of the negotiation of bilateral conventions. For example, some countries may have constitutional or certain legal restrictions that prevent them from adopting the exact wording of the model provisions that are recommended. Some countries may have domestic anti-abuse rules or their courts may have developed various interpretative tools that effectively prevent some of the treaty abuses and the administrative capacity of some countries may prevent them from applying certain detailed anti-abuse rules and require them to adopt more

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[32] OECD/G20 September 2014 Report on Action Plan 6 at 12.
[33] OECD/G20 September 2014 Report on Action Plan 6 at 12.
[34] OECD/G20 September 2014 Report on Action Plan 6 at 13.
[35] OECD/G20 September 2014 Report on Action Plan 6 at 22 -23.

general anti-abuse provisions.[36] Nevertheless, the report recommends that a minimum level of protection against treaty abuse, including treaty shopping should be included in the OECD Model and should be implemented by countries.[37]

- As long as the approach that countries adopt effectively addresses treaty abuses along the lines of the report, some flexibility is allowed in implementing the report's recommendations.
- At a minimum, however, countries should agree to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements;
- Countries should implement that common intention through either the combined approach described above, the inclusion of the PPT rule or the LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.[38]

A)(ii) *Recommendations dealing with other treaty limitations*

The 2014 OECD report on Action 6 also covers new specific treaty anti-abuse rules that seek to address strategies, other than treaty shopping, aimed at satisfying treaty requirements with a view to obtain inappropriately the benefit of certain provisions of tax treaties. These targeted rules, which are supplemented by the PPT rule described above, address:

- certain dividend transfer transactions;
- transactions that circumvent the application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property;
- situations where an entity is resident of two Contracting States, and
- situations where the State of residence exempts the income of permanent establishments situated in third States and where shares, debt-claims, rights or property are transferred to permanent establishments set up in countries that do not tax such income or offer preferential treatment to that income.[39]

B) <u>Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits</u>

36 OECD/G20 September 2014 Report on Action Plan 6 at 9.
37 OECD/G20 September 2014 Report on Action Plan 6 at 10.
38 OECD/G20 September 2014 Report on Action Plan 6 at 22 -23.
39 OECD/G20 September 2014 Report on Action Plan 6 at 13.

- The 2014 OECD report on Action 6 recognises that the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that may result from the work on other aspects of the Action Plan. [40]
- The OECD's work aimed at preventing the granting of treaty benefits with respect to these strategies seeks to ensure that treaties do not inadvertently prevent the application of such domestic anti-abuse rules: granting the benefits of treaty provisions in such cases would be inappropriate to the extent that the result would be the avoidance of domestic tax. [41]

With regards to the interaction between treaties and specific domestic anti-abuse rules:

- The report recommends that the principle that treaties do not restrict a State's right to tax its own residents (subject to certain exceptions) should be expressly recognized through the addition of a new treaty provision based on the so-called "saving clause" already found in United States tax treaties.
- The report recommends changes to the Commentary included in the Model Tax Convention in order to clarify that treaties do not prevent the application of so-called "departure" or "exit" taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State. [42]

4.2 CLARIFICATION THAT TAX TREATIES ARE NOT INTENDED TO BE USED TO GENERATE DOUBLE NON-TAXATION

With regard to the second part of the work on Action Plan 6 the OECD notes that it should be clarified that tax treaties are not intended to be used to generate double non-taxation". [43]

- In this regard, the OECD recommends that the title and preamble of the Model Tax Convention should clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance.
    - The OECD notes that existing provisions of tax treaties were developed with the prime objective of preventing double-taxation. The preamble for most treaties refers to the use of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital. They do

[40] OECD/G20 September 2014 Report on Action Plan 6 at 13.
[41] OECD/G20 September 2014 Report on Action Plan 6 at 13.
[42] OECD/G20 September 2014 Report on Action Plan 6 at 14.
[43] OECD/G20 September 2014 Report on Action Plan 6 at 14.

not refer to non-taxation or to the prevention of tax avoidance or abuse.

- Given the particular concerns arising from treaty shopping arrangements, such arrangements are expressly mentioned as one example of tax avoidance that should not result from tax treaties.
- Under applicable rules of international public law, the OECD is of the view that this clear statement of the intention of the signatories to a tax treaty will be relevant for the interpretation and application of the provisions of that treaty. [44]

4.3 TAX POLICY CONSIDERATIONS THAT, IN GENERAL, COUNTRIES SHOULD CONSIDER BEFORE DECIDING TO ENTER INTO A TAX TREATY WITH ANOTHER COUNTRY

The third part of the OECD work mandated by Action 6 requires countries "to identify the tax policy considerations that, in general, they should consider before deciding to enter into a tax treaty with another country". [45]

- The OECD intends to come up with policy considerations to help countries explain their decisions not to enter into tax treaties with certain low or no-tax jurisdictions;
- These policy considerations will also be relevant for countries that need to consider whether they should modify (or, ultimately, terminate) a treaty previously concluded in the event that a change of circumstances (such as changes to the domestic law of a treaty partner) raises BEPS concerns related to that treaty;
- It is recognised, however, that there are many non-tax factors that can lead to the conclusion, amendment or termination of a tax treaty and that each country has a sovereign right to decide whether it should do so. [46]

4.4 Further work

The OECD recognises that further work will be needed with respect to the:

- precise contents of the model provisions, in particular the recommend "limitation of benefits rules" (as discussed below).
- implementation of the minimum standard; and
- policy considerations relevant to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.

The OECD also notes that the model provisions and related Commentary that the it proposes in the 2014 Report on Action 6, should be considered as drafts

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44 OECD/G20 September 2014 Report on Action Plan 6 at 14.
45 OECD/G20 September 2014 Report on Action Plan 6 at 15.
46 OECD/G20 September 2014 Report on Action Plan 6 at 15.

that are subject to improvement before their final versions are released in September 2015.

5 INTERNATIONAL APPRACHES

5.1 The Canadian Approach

The Canadian tax authorities have three distinct measures available to combat tax avoidance, which include specific legislative anti-avoidance provisions, a general legislative anti-avoidance rule (the GAAR) and judicial anti-avoidance doctrines, i.e. the sham doctrine, the doctrine of legally ineffective transactions and the substance versus form doctrine.[47] In the Canadian Federal Court of Appeal *case of Paul Antle and Renee Marquis-Antle Spousal Trust v The Queen*,[48] the Minister of National Revenue relied on specific legislative anti-avoidance provisions, the judicial doctrines of sham and legally ineffective transactions, as well as on the GAAR to challenge the tax treatment claimed by a taxpayer with respect to certain international transactions.

Before the amendment of the Canadian GAAR in 2005 (retroactively to the date of inception in 1988), there was uncertainty whether the GAAR could apply to transactions that resulted in a misuse or abuse of a DTA. The Canadian government ended any uncertainty by amending the GAAR to include in the definition of "tax benefit" those benefits derived from a DTA and by providing that the GAAR applied to transactions that misuse or abuse a DTA.[49] The Supreme Court of Canada established the methodology to be followed to determine whether the GAAR can be applied to deny a tax benefit.[50] The following three requirements must be established: (a) a tax benefit; (b) an avoidance transaction; and (c) abusive tax avoidance. The burden is on the taxpayer to prove that there was no tax benefit or no avoidance transaction whilst the Canadian tax authorities must show that there was abusive tax avoidance. The abuse analysis is conducted in two stages. Under the first stage, the court must conduct a unified textual, contextual and purposive (TCP) analysis of the provisions conferring the benefit in order to determine why these provisions were put in place and why the benefit was conferred. With respect to DTAs, this means that the Court should look at (a) the text of the provisions; (b) their context, which is likely to include other DTA provisions, the preamble, the annexes, other treaties and the OECD Commentary on the OECD Model DTA; and (c) the purpose of the provisions as well as the purpose of the treaty. Under the second stage of the abuse analysis, the court should determine whether the

[47] Canadian Country Report in the 2010 IFA Report, Volume 1 at 172.

[48] 2009 TCC 465 (TCC), appeal filed to the Federal Court of Appeal (FCA), A-428-09.

[49] IFA Report at 175.

[50] *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, 2005 SCC 54, in paras 17 and 66; *Mathew v Canada* [2005] 2 SCR 643 in para 31.

avoidance transactions respect or defeat the object, spirit or purpose of the provisions in issue.

The approach by the courts in Canada was analysed by Nathalie Goyette in her thesis[51] and also in her subsequent paper in the Canadian Jaw Journal.[52] She considers whether the Canadian general anti-abuse rules could be applied to counter DTA abuse. Her 1999 thesis concluded that the preamble to Canadian treaties, which stipulates that the purpose of the DTA is to prevent tax evasion, does not constitute a general anti-abuse rule applicable to DTAs for three reasons. First, tax evasion is not synonymous with tax avoidance, and in cases of abuse, the issue is avoidance. Second, although the preamble refers to the prevention of tax evasion, DTAs generally do not include provisions to deal with evasion. Finally, the "domestic tax benefit provision" contained in most Canadian DTAs (according to which the provisions of the DTA do not restrict in any way the deductions, credits, exemptions, exclusions, or other allowances available under domestic tax law), coupled with the principle that DTAs do not levy taxes, supports the argument that the preamble to DTAs does not include a general anti-abuse rule.[53] However, she points out that in some French-speaking countries, the word "évasion" extends to avoidance transactions, i.e. the word "évasion" found in paragraph 7 of the OECD Commentary on article 1 of the OECD Model DTA probably extends to "évitement" ("avoidance"), as is confirmed by the English version. Therefore, she concludes that there are now grounds to argue that one of the purposes of DTAs is the prevention of avoidance.[54]

She refers to the decision of the Supreme Court of Canada in *Crown Forest Industries v Canada,*[55] where the Court was asked to determine whether a corporation incorporated in the Bahamas, Norsk, was resident in the United States for the purposes of the application of the Canada-US treaty. If such were the case, Norsk could benefit from a reduced rate of withholding tax in respect of rental income that it earned in Canada. Iacobucci J made the following comments in the course of his analysis:[56]

> "It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements. Jacobucci J went on to state that adopting the interpretation of the word "resident" proposed by Norsk would mean that a corporation that was not subject to any US tax

51 Nathalie Goyette "Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue: The Tax Professional Series" (Toronto: Canadian Tax Foundation, 1999).
52 Goyette at 766.
53 Ibid.
54 Ibid at 793.
55 [1995] 2 SCR 802.
56 Goyette at 773.

> could nonetheless benefit from the reduction in Canadian withholding tax provided for in the Canada-US treaty."

This observation led him to comment:[57]

> "Treaty shopping" might be encouraged in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded its jurisdiction to tax as the source country, namely that the US as the resident country would tax the income".

Goyette points out that the numerous other decisions that have referred to the modern and broad interpretive rule for DTAs proposed by the Supreme Court in *Crown Forest* seem to confirm that the latter judgment has had a distinct impact on the manner in which the courts approach Canadian DTA.[58] Furthermore, she notes that recent literature indicates that the presumption against treaty shopping articulated in *Crown Forest* may be a more useful weapon for Canadian tax authorities than GAAR. She observes that the question that remains is the appropriate scope of the anti-treaty-shopping presumption set out in *Crown Forest*. She points out that the Supreme Court stated that to allow treaty shopping would be contrary to the basis on which Canada ceded its jurisdiction to tax as the source country—namely, that the United States, as the country of residence, would tax the income. However, even if a state is allocated a right to tax under a DTA, nothing requires it to exercise that right. Consequently, one might question the soundness of the Supreme Court's reasoning. She expressed the view that it seems preferable to interpret the Court's pronouncement as simply stating that treaty shopping is contrary to the basis on which Canada agreed to restrict its jurisdiction to tax, namely, that the taxpayer who receives the income in question is a resident of the United States. Since Norsk was not a US resident, there was no reason for Canada to limit its taxing power.[59]

Goyette observes[60] that since 1999, the Federal Court Trial Division has rendered a decision in *Chua v. Minister of National Revenue*.[61] In that decision, the court stated that DTAs have two primary objectives: to avoid double taxation and to permit governments to collect amounts due to them by dividing these amounts between them and by combating tax *avoidance* and evasion.[62] She points out that this is the second time that the Federal Court has declared that one of the purposes of DTAs is to combat tax avoidance which may be the beginning of a trend toward clear interpretation in this regard. She concludes that if the courts were to uphold this trend, they could find it easier to rule that

57 Ibid.
58 Ibid at 774.
59 Ibid at 774.
60 Ibid at 793.
61 [2000] 4 CTC 159 (FCTD).
62 Ibid at 179.

the interpretation of DTAs on the basis of their object or purpose authorizes the application of a domestic anti-abuse rule such as GAAR in cases of DTA abuse; moreover, it is possible that the recent revisions to the OECD Commentary may persuade the courts to consider that one purpose of DTAs is to prevent tax avoidance.[63]

Goyette considers a "borderline" case is in fact a variation of the classic situation of "treaty shopping" through which a Dutch company is interposed in order to benefit from the DTA between Canada and the Netherlands[64]. In this example, a Bahamian company wanted to loan money to a Canadian company, but a direct loan would have given rise to part XIII tax of 25 percent on the interest. Consequently, the Bahamian company incorporated a company in the Netherlands (Dutchco), which loaned money to the Canadian company. The transaction was structured so that very little tax would be paid in the Netherlands and withholding tax would be avoided when the money was returned to the Bahamas.

In her 1999 thesis, Goyette concluded that the search for concordance meant that GAAR could not be invoked in this situation.[65] Her conclusion was based primarily on the following factors:

- the Netherlands considers that Dutchco is resident in that country and is entitled to the benefits of the treaty with Canada;
- the Netherlands treats the amounts received by Dutchco as taxable interest, and thus Canada also must consider that the Canadian company paid interest to Dutchco; and
- the objective intention of the contracting states is that domestic anti-abuse rules are not applicable to abuses of the Canada-Netherlands treaty.

Goyette points out[66] that a re-examination of this scenario, or a more flexible and objective application of the search for symmetry of treatment, calls for a different conclusion. First, it should be noted that in a number of situations similar to that of Dutchco, an argument can be made that a company like Dutchco is not the beneficial owner of the interest; and, on the basis of the facts, this argument could satisfy a court that there is no ground for granting the reduction in withholding tax provided for by the DTA. Article 11(2) of the Canada-Netherlands DTA provides for a reduction in the rate of withholding tax imposed by the source state (in this case Canada), but only to the extent that the person who claims this reduced rate is the "beneficial owner" of the interest.

63 Goyette at 793.
64 Ibid at 802.
65 Ibid.
66 Goyette at 793.

Goyette observes[67] that the revised OECD Commentary on articles 10, 11, and 12 of the OECD Model DTA points out that the term “beneficial owner” is not to be used in a narrow technical sense rather, it should be understood in its context and in light of the object and purposes of the Model DTA, including avoiding double taxation and the prevention of fiscal evasion and avoidance. She points out[68] that the revised OECD Commentary adds that it would be contrary to the purpose and the object of the DTA for the source state (such as Canada in the Dutchco example) to grant a reduction of tax to a resident of a contracting state who acts as an agent, a nominee, or a simple intermediary for another person who in fact receives the benefit of the income in question. It follows that if the facts demonstrate that Dutchco is merely an agent or conduit, or that it cannot profit freely from the interest paid by the Canadian company, a court will likely conclude that Dutchco is not the beneficial owner of the interest and is therefore not entitled to the reduced rate of withholding tax provided for by the Canada-Netherlands DTA.

The Canadian Federal Court of Appeal considered the “beneficial ownership” requirement in the 2006 case reported as *Prévost Car Inc v Her Majesty the Queen.*[69] In this case, a Swedish resident and a UK resident held their shares in Prévost Car Inc, a Canadian company, via a Dutch holding company (HoldCo). Under the applicable DTAs, a 10% withholding tax is imposed on dividends paid to a Swedish shareholder and 15% on dividends paid to a shareholder in the UK, whilst the Netherlands-Canada DTA reduces the dividend withholding tax to 5%. The Court had to decide whether, for purposes of claiming treaty relief, the Dutch holding company (as opposed to its shareholders) was the beneficial owner of dividends received from its wholly owned subsidiary. The court, in finding that the Dutch holding company (DutchCo) was the beneficial owner of the dividends, held that:

> “The beneficial owner of the dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received.”
>
> “When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit or has agreed to act on someone else’s behalf pursuant to that person’s instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients.”

In *Velcro Canada Inc v Her Majesty The Queen* (judgment delivered on 24 February 2012)[70] the Court again considered the beneficial ownership requirement for DTA relief. In this case, Velcro Industries BV (VIBV), a Dutch company which migrated to the Netherlands Antilles during 1995, owned

[67] Goyette at 803.
[68] Ibid.
[69] 2006 DTL 330.
[70] 2012 TCC 57.

certain intellectual property. At the time, VIBV made the intellectual property available to Velcro Canada Inc ("VCI") in terms of a licence agreement. Two days after its migration to the Netherlands Antilles, VIBV assigned the licence agreement to Velcro Holdings BV ("VHBV"), a company resident in the Netherlands. In terms of the assignment agreement, the ownership of the intellectual property remained with VIBV and VHBV:

- was assigned the right to grant licences for VIBV's intellectual property to VCI and to collect royalty payments from VCI as payment for the licences;
- was obliged to enforce the terms of the licence agreement and to take any steps necessary should VCI breach the terms of the contract; and
- was obliged to pay 90%[71] of the royalties so received to VIBV within 30 days of receiving royalty payments from VCI.

In terms of Canadian law, a withholding tax of 25% applies to royalties paid to non-residents. However, until 1999, the rate was reduced to 10% in terms of the Netherlands-Canada DTA, whereafter it was reduced even further to 0%.

The Court followed the approach of the Court in the Prévost-case by holding that, when considering the beneficial owner of income, "one must determine who has received the payments for his/her own use and enjoyment and assumed the risk and control of the payment he/she received." The Court held that the attributes of beneficial ownership are "possession", "use", "risk" and "control". The Court considered the dictionary meaning of each of these concepts (as defined in Black's Law Dictionary) and applied it to the facts. It held that:

- VHBV had possession of the royalties as it had exclusive possession of the funds upon receipt, the funds were comingled with VHBV's "general funds" and there was no automatic flow-through of royalties to VIBV;
- VHBV used the funds for its own benefit as there were no restrictions on the use of the funds. The fact that it was contractually obliged to pay an amount equal to 90% of the royalties to VIBV, did not impact on the fact that it had the use of the funds received from VCI;
- The royalties received were the assets of VHBV and available to creditors of VHBV, with no priority given to VIBV. The risk thus remained with VHBV;
- VHBV did have control over the funds as it received it for its own account, comingled the funds with its other funds, etc.

[71] This secured the arm's length margin required by the Dutch tax authorities.

On behalf of the Canadian tax authority, it was argued that VHBV was a mere agent for VIBV, or acted as nominee or conduit. However, the Court held that it would only "take the draconian step of piercing the corporate veil" should the recipient of the funds have "absolutely no discretion" regarding the use and application of the funds. The Court found that even though VHBV's discretion may be limited, it still had a discretion. The Court thus concluded that VHBV was the beneficial owner of the royalties and accordingly entitled to the benefit of the Netherlands-Canada DTA.

5.2 The UK Approach

The UK country report (UK IFA Report) in the IFA Report 2010[72] surmises that DTAs may well stand in conflict with UK domestic anti-avoidance provisions, including in ways which have not yet been fully tested before the courts. The UK IFA Report expresses the view that the conflict may be countered through further domestic provisions intended to re-establish the domestic law position, some involving a more overt DTA override than others. (Very occasionally, however, the DTA will itself contain an anti-avoidance provision which would not otherwise be reflected in UK domestic law and the domestic law provides that no better result may be obtained.) Judicial approaches to tax avoidance have been more restrained in construing DTAs than in construing domestic legislation, given in part the need for uniform construction of DTAs. This has further fuelled the difficult relationship between domestic anti-avoidance provisions and DTAs. The UK IFA Report concludes that the statement at paragraph 22(1) of the OECD Commentary on article 1, to the effect that there will be no conflict between anti-avoidance provisions and DTAs, is therefore too bald a statement as far as UK law and practice is concerned[73].

The UK IFA Report observes[74] that the title of most of the UK DTAs refers to the avoidance of double taxation and the prevention of fiscal evasion but not to the prevention of avoidance. Although the French version of the OECD Model carries equal weight, in the UK domestic context evasion means taking unlawful steps to escape a tax liability whereas avoidance means taking lawful but sometimes ineffective steps to escape a liability, where the effectiveness will depend on the application and interpretation of the relevant taxing provisions. Originally the emphasis was clearly on addressing juridical double taxation as well as the prevention of evasion by providing for the exchange of information. However, as avoidance became more of a concern specific provisions have been introduced incrementally in line with international practice.

[72] IFA Report at 805.
[73] Ibid.
[74] Ibid at 818.

In the absence of a GAAR in the UK Tax Act, the UK IFA Report outlines the application of specific anti-tax avoidance provisions of the UK Tax Act to counter DTA abuse.[75] Of particular interest is the application of the UK CFC rules in cases where a UK resident sets up a foreign intermediary company in a country which has a DTA with the UK, which protects the income of such intermediary from UK tax. This scenario was considered by the UK Court of Appeal in *Bricom Holdings Ltd v. CIR.*[76] The case dealt with the application of the UK CFC rules in respect of UK source interest received by a Netherlands subsidiary of a UK parent. The interest received by its Netherlands subsidiary was apportioned under the UK's CFC rules to the UK parent. The Court had to consider whether the CFC rules could apply in the context of article 7 of the UK/Netherlands DTA, which prohibited the UK from taxing income derived by a Netherlands company unless the company operated in the UK through a permanent establishment and such interest was attributable to such a base. The Court held that the CFC rules did not function to tax the interest income of the Netherlands subsidiary, but an amount equal to the net income of the CFC which is allocated to the resident of the UK, i.e. the Court found that there is no conflict between the CFC rules and the DTA provisions. The amount calculated under the CFC rules is merely a notional profit amount and is no longer interest income as contemplated in the DTA.[77] However, the Court appeared to acknowledge that the UK would have otherwise contravened its DTA obligations.

In *Indofood International Finance Ltd v J P Morgan Chase Bank*[78], a case heard by the Court of Appeal in the UK during 2006, the Court considered the situation where an Indonesian company wished to raise funding by issuing loan notes on the international market. However, should the Indonesian company have raised the funding directly, interest payable to note holders would have been subject to a 20% Indonesian withholding tax on interest. The Indonesian company thus incorporated a Mauritian company ("the Issuer") which issued loan notes to note holders. The Issuer and the Indonesian company ("the Parent Guarantor") then entered into a loan agreement which complied with the relevant terms of the DTA between Mauritius and Indonesia, which reduced the Indonesian withholding tax on the interest from 20% to 10%.

When it became known that such DTA would be renegotiated and that the interest withholding rate would not be reduced in terms of the renegotiated DTA, it was suggested that a Dutch company ("Newco") should be interposed

[75] Ibid at 807.
[76] [1997] EWCA Civ 2193.
[77] It is interesting to note that section 9D of the ITA was amended shortly after the decision in the Bricom case to add the words "amounts equal to the net income" of the CFC, which could imply that the legislator was concerned that the direct attribution of the income may contravene DTA obligations.
[78] [2006] STC 1195.

between the Issuer and the Parent Guarantor. Newco would have no role other than to receive the interest from the Parent Guarantor and to pay it to a paying agent ("the Principal Paying Agent") for the benefit of the note holders. In fact, Newco would be obliged in terms of the respective loan agreements to on-pay funds received from the Parent Guarantor to the Principal Paying Agent, and would be precluded from *"finding the money from any other source".*

In terms of the Netherlands-Indonesia DTA, should Newco be the beneficial owner of the interest, the interest withholding rate would be reduced to 10% or less. The Court of Appeal applied a substance over form approach and decided that Newco would not be the beneficial owner of the interest:

> "But the meaning to be given to the phrase "beneficial owner" is plainly not to be limited by so technical and legal an approach. Regard is to be had to the substance of the matter. In both commercial and practical terms the Issuer is, and Newco would be, bound to pay on to the Principal Paying Agent that which it receives from the Parent Guarantor.
> …
> [the role of Newco in the structure] can hardly be described as the "full privilege" needed to qualify as the beneficial owner, rather the position of the Issuer and Newco equates to that of an "administrator of income"].

The Court concluded:

> "that the term 'beneficial owner' is to be given an international fiscal meaning not derived from the domestic law of contracting states. As shown by those commentaries and observations, the concept of beneficial ownership is incompatible with that of the formal owner who does not have 'the full privilege to directly benefit from the income'."

The UK IFA Report points out that the Court relied on both the 1986 OECD Conduit Company Report and the 2003 OECD Commentary on the OECD Model DTA to arrive at the "international fiscal meaning" which is distinguished from the narrower "UK technical meaning of the Beneficial ownership" concept which applies under English law.[79]

5.3 The German Approach

The general anti-avoidance provision under German tax law applies to domestic as well as international transactions and allows taxes to be levied on the "adequate" substance of a transaction rather than on the "inadequate" legal form in order to prevent tax avoidance through abusive transactions; the application of this provision in a DTA context is seen as the determination of the "right" rather than the "alleged" facts and, thus, as not being in conflict with the DTA.[80] This general substance-over-form rule is backed up by a wide range of special anti-avoidance provisions in German international tax law. Where these

[79] UK IFA Report at823.
[80] German IFA Report in the IFA 2010 Report at 333.

rules are in conflict with DTAs, they are applied nonetheless as DTA overrides have been accepted by the tax courts in Germany.[81]

To prevent the abuse of a DTA through conduit company structures, essentially to reduce German withholding taxes, Germany introduced a special anti-treaty abuse provision into its domestic law[82]. Under the provision, a foreign entity is not entitled to DTA benefits if its shareholders would not be entitled to these benefits had they received the payments directly, and

- there are no commercial or other relevant non-tax reasons for the interposition of the foreign entity; or
- the foreign company earns no more than 10% of its gross earnings from a business activity of its own; or
- the foreign company is not adequately equipped to take part in business operations given its purpose.

The German courts have upheld the application of these specific anti-abuse provisions in the context of a DTA[83], but the German Constitutional Court (Bundesverfassungsgericht (BVerfG)) gave two judgments in 2004 which may have the impact to limit the scope for treaty override.[84]

Whilst the scope of the specific anti-avoidance rules are reasonably clear, there is an intense debate about the scope of the general anti-avoidance provisions, in particular to what extent “aggressive tax planning” may exceed the realms of legitimate planning and should be treated as “abuse”.[85] This uncertainty is a serious problem in Germany in view of the decisions by the German tax courts that a director of a company or a tax advisor has the obligation to utilize or advise of the most efficient tax structures otherwise they could become liable to damages.[86]

The German tax courts have confirmed that the specific anti-treaty abuse provisions override the general anti-tax avoidance provisions of AO 42.[87]

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81 Ibid at 341; see also A Linn Generalthemal *Steuerumgehung und Abkommensrecht IStR* (2010) 542 at 543.

82 § 50d Abs. 3 Satz 1 EStG; see the German IFA Report at 336 – 337.

83 German IFA Report at 341, which refers to the decision in BFH, I R 120/93, BStBl. II 1995, 129 as support.

84 German IFA Report at 341.

85 Wolfgang Blumers, Aggressive Steuerplanung, – Vielleicht legal, aber jedenfalls verwerflich, Beriebs Berater, 2013, Beck-online at 2785.

86 Blumers at 2785; also Pinkernell at 9.

87 R Klein, AO § 42 Missbrauch von rechtlichen Gestaltungsmöglichkeiten, Becks online, at 143.

5.4 The US Approach

The US does not currently have a general statutory anti-avoidance rule, but the tax courts have developed anti-abuse doctrines that may be used by the Internal Revenue Service (IRS) to challenge a transaction[88]. These doctrines include the business purpose, economic substance, step transaction, substance over form and sham transaction doctrines.[89] These anti-abuse doctrines may be applied in the international context, including when DTAs are involved.[90] In addition to these anti-abuse doctrines, the US tax rules (the Internal Revenue Code) contain several specific international anti-avoidance rules[91].

A transaction may be disregarded if the court finds it to be a "sham", devoid of genuine substance.[92] Thus, if the form employed for the transaction is unreal it can be ignored and effect can be given to the actual transaction performed.[93] More often however, the "substance over form" test is applied.[94] In such cases the taxpayer intends that effect should be given to the actual transaction performed. Since the form used is not covered by the literal provision of the statute, the taxpayer manages to escape taxation. In substance, however, he has achieved the economic result which the statute aims to cover. A court may, under certain circumstances, ignore the form of the transaction and consider its substance, e.g. a loan to an associated company may be treated as, in substance, a contribution to equity capital.[95]

The US IFA Report confirms that the substance over form principle has been used to disregard intermediate entities as mere “conduits” or “shams” where they are used to obtain DTA benefits.[96]

Tax avoidance schemes often rely upon the separate fiscal identity of a corporation. Although the IRS has often argued that the corporate identity of an

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88 USA IFA Report, in the 2010 IFA Report in para 1.1 at 827.

89 Ibid.

90 Ibid.

91 Ibid.

92 *Higgins v Smith* 40-1 USTC 9160; *Moline Properties Inc v CIR*, 43-1 USTC 9464 esp at 391; also the comments in the US Report on “Tax Avoidance/Tax Evasion” in Cahiers De Droit Fiscal International, Vol XXXVII, 1983, page 333 esp at 335.

93 US IFA Report in para 1.2.2 at 829, where it concludes that the Gregory case is viewed as a precedent for the disregard of the transfer of an asset without a business purpose but solely to reduce a tax liability.

94 *Gregory v Helvering* 35-1 USTC, 9043, esp at 420; also the comments in the US IFA Report in para 1.2.1 at 829.

95 US Report, Cahiers De Droit Fiscal International, Vol La, 1970 at 301; also *Knetch v United States* 60-2 USTC 9785.

96 US IFA Report in para 1.2.1 at 829 which refers to the decision in *Teong-Chan Gaw v Commissioner, T.C. Memo*, 1995-531, 70 T.C.M. 1196.

interposed corporation in a treaty shopping scheme should be ignored since it is a mere sham, the courts have not readily accepted this argument. The test to determine whether a corporation should be recognised as an independent fiscal entity was established in the *Moline Properties Inc v CIR*.[97] As long as there was a valid business purpose for the existence of the corporation or it carried out substantive business activities, its separate fiscal entity should be respected.[98] If a tax avoidance scheme consists of several separate steps, the various stages may be amalgamated and treated as one transaction if the steps are interdependent and are directed at a particular end result (the so-called "step-transaction" doctrine).[99]

A test which has been applied frequently to counter treaty shopping schemes is the "conduit test". The classical case in which the test was so applied is *Aiken Industries Inc v CIR*[100]. In accordance with this test the entity is regarded as a conduit since it is not in substance the beneficial owner of the income received from the source State. It merely passes the income on to the ultimate beneficiary. Therefore, it is not entitled to treaty benefits. The most significant cases on treaty "abuse" are analysed below to illustrate the attitude of the US courts.

In the case of *Maximov v US*[101], the petitioner was a private trust (represented by Maximov) which had been created in the US by a resident and citizen of the U.K. The grantor, his wife and their children were the beneficiaries (all residents of the U.K.). The trust which was administered in the US, realized capital gains income upon the sale of certain of its assets during 1954 and 1955. The petitioner claimed exemption from a liability for US income tax on its realized and retained capital gains. As support for this claim he relied on article XIV of the DTA between the U.S and the U.K. which provides:

> "A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale, or exchange of capital assets."

The petitioner argued that, since the real burden of the tax fell upon the beneficiaries of the trust all of whom were residents of the UK, the DTA should have been read as exempting the trust from the tax asserted by the US, i.e. the trust should not have been regarded as a taxable entity. The court could find no support in the plain language of the DTA for petitioner's argument in favour of disregarding the trust entity. It pointed out that the exemption provided for by article XIV applies only to a resident of the UK Article 11(i)(g) defines a UK resident as "any person (other than a citizen of the United States or a United

97 43-1 USTC 9464 esp at 391.
98 US IFA Report at 829.
99 US IFA Report in para 1.2.3 at 832.
100 56 T. C. 925 (1971) – see analysis of the case below.
101 63-1 USTC 9438.

States corporation) who is a resident in the UK for the purposes of UK tax and not resident in the United States for purposes of United States tax. The word "person" is not defined in the DTA and therefore recourse must be had to the domestic tax law of the State applying the DTA, i.e. the US, to determine its meaning (in accordance with article 11(3) of the DTA). Under US law "person" includes a "trust". Therefore the trust was regarded as a taxable entity, distinct from its beneficiaries and was held to be a resident of the US for purposes of US tax.

Petitioner's claim was, however, supported by a second argument. He argued that equality of tax treatment was an objective for the conclusion of the DTA and that a court had to further this objective. In the petitioner's view the court was compelled to adopt the theory that exemption had to be granted whenever the burden of the tax diminished such equality. The UK imposed no tax on capital gains and therefore, the petitioner claimed, no similar tax could be imposed by the US The court considered the purpose of the DTA and concluded that the general purpose is not to ensure complete and strict equality of tax treatment but rather to facilitate commercial exchange through the elimination of double taxation; an additional purpose is the prevention of fiscal evasion. Neither of these purposes required relief in the situation presented as the beneficiaries did not pay tax on the US income of the trust in the UK and fiscal evasion was not involved. The court thus refused to read the DTA in such a way as to accord unintended benefits, inconsistent with its words and not compellingly indicated by its purpose.

A fine example of "treaty shopping" is the case of *Ingemar Johannson v US.*[102] Johannson, a citizen of Sweden, fought Patterson for the heavyweight boxing championship of the world in three consecutive fights during 1960 and 1961. Johannson formed a service (base) corporation in Switzerland to obtain certain treaty benefits of the US - Switzerland double taxation agreement, i.e. the exemption from US source tax provided for by article X(1) of the treaty. To obtain this benefit Johannson had to prove that he was a resident of Switzerland and that he received the income as an employee of, or under contract with a Swiss corporation.

The court first examined whether US tax law provides for the taxation of Johannson's income. Section 871(C) of the Internal Revenue Code, 1954, provided at the time that a nonresident alien individual engaged in trade or business within the US shall be taxable there. The term "engaged in trade or business within the US" includes the performance of personal services within the US at any time within the taxable year. The court then enquired whether a DTA required a contrary result. It found no contrary provision in the US DTA

[102] 64-2 USTC 9743.

with Sweden. As Johannson, however, relied on the US - Switzerland DTA the court proceeded to examine its provisions. The term resident" is nowhere defined in the DTA. In accordance with article II(2) the contracting State applying the DTA should revert to its own national law definition if the DTA does not define a term.(291) As the criteria applied to determine the meaning are the same in both States the court regarded article II(2) as unimportant.

On the evidence before it, the court concluded that Johannson was not a resident of Switzerland as his social and economic ties during the relevant time remained predominantly with Sweden. The court also considered the second condition which had to be fulfilled before DTA benefits could be claimed, i.e. that the recipient must have received the income as an employee of, or under contract with a Swiss corporation.

The court established that the corporation had no legitimate business purpose and therefore held it to be a device used by Johannson to divert his US income so as to escape US taxes. The fact that Johannson was motivated in his actions by the desire to minimize his tax burden was, however, not the reason why the exemption, to which he was entitled in accordance with the DTA provision, was refused. The court stressed that the specific words of a DTA should be given a meaning consistent with the genuine shared expectations of the contracting parties and to do this is was necessary to examine not only the language (i.e. the literal text), but the entire context of the DTA. In the court's opinion the main objective of the DTA with Switzerland was the elimination of the impediments to international commerce resulting from double taxation. As a general rule, applied in DTAs, the income from services is taxable where the services are rendered. Exceptions to this rule are made to avoid taxation of an enterprise in every country where it is active or of agents and employees of such firms. Where the circumstances do not warrant an exception, so the court, the general rule must be applied. Thus the court held that Johannson had failed to establish any substantial reasons for deviating from the DTA's basic rule (income from services is taxable where the services are rendered) in spite of the fact that he had brought himself within the words of the DTA. The court concluded that international trade would not be seriously encumbered by its refusal to give special tax treatment to one only marginally, if at all, Swiss resident who was only technically, if at all, employed by a paper Swiss corporation.

In *Perry Bass v. Commissioner of Internal Revenue*[103] the taxpayer successfully used the US - Switzerland DTA to avoid US taxes. The petitioners (Perry and Nancy Lee Bass) were citizens and residents of the US Perry Bass organised a Swiss corporation, Stantus AG, and acquired for cash all the stock except three

[103] 50 T.C. 595 (1968).

shares which were held by the directors for the benefit of the petitioner. He then transferred to the corporation a substantial share of his interest in certain oil producing properties in the US The corporation thereafter signed working agreements, collected royalties, made investments and carried out other business activities. Stantus AG did report the income from these interests on its US and Swiss tax returns, but claimed exemption from U. S. taxes under the DTA between the US and Switzerland.

The sole issue, in the court's view, was whether Stantus AC could be disregarded for tax purposes so that the income and losses of the corporation would constitute the income and losses of the petitioner. The court stressed that a taxpayer may adopt any form he desires for the conduct of his business and that the chosen form cannot be ignored merely because it results in tax saving. To be afforded recognition, however, the form the taxpayer chooses must be a viable business entity, i.e. it must have been formed for a substantial business purpose or actually engage in substantive business activity.

After considering the facts, the court concluded that Stantus AG was a viable business corporation. It was duly organised in accordance with Swiss law and also carried out activities which a viable corporation normally carries out. The fact that an owner of a corporation (the petitioner in this case) retains direction of its affairs down to the minutest details affords no ground for disregarding it as a separate corporate entity. The court acknowledged that the corporation was formed with the aim to reduce US taxes but, in its opinion, the test is not the personal purpose of the taxpayer in creating a corporation, but rather whether he intends to reduce US taxes by using a corporation which carries out substantive business functions. The corporation was thus regarded as a separate tax entity which implied that it was taxable in Switzerland in accordance with the US - Switzerland DTA.

It should be noted that Bass had requested a tax ruling from the US IRS as to the validity of the proposed scheme. The ruling confirmed that Stantus AG would be exempt from US tax under the US- Switzerland tax DTA.

Another example of unsuccessful "treaty shopping" is the *Aiken Industries (see reference above)*. Aiken Industries Inc., a US corporation, borrowed money from its parent corporation situated in the Bahamas. To avoid US withholding (source) taxes on interest payments by Aiken Industries to its parent corporation, the parent corporation created a corporation in Honduras and assigned its rights and interest in the promissory note (issued by Aiken Industries) to this corporation. The US - Honduras DTA provided that interest received by a resident or corporation of a contracting State from sources within the other State would be exempt from source taxation in the other State if the receiver of the interest had no permanent establishment there. In support of its claim for exemption under the DTA, the petitioner argued that the Honduran corporation conformed to the definition of a corporation provided for in article II(1)(g) of the DTA. The court pointed out that DTAs are the supreme law of the land and superior to domestic tax laws. Consequently the courts and tax authorities must apply the definitions expressly set forth in the DTA. Therefore, when the formal requirements of a definition in a DTA are met the benefits flowing from the DTA as a result of conforming to such formal requirements cannot be denied by an enquiry behind those formal requirements. The Honduran corporation did fulfill the definitional requirements of the DTA and therefore, the court had to recognize it as a taxable entity for purposes of the DTA. This fact alone was, according to the court, not sufficient to qualify the interest in question for the exemption from tax granted by article IX of the DTA. A further condition required by article IX was that the interest payments had to be "received by" the corporation in the other contracting State. The meaning of "received by" had to be established by the court. Under article II(2) of the DTA, terms not otherwise defined had to carry the meaning which they normally had under the laws of the State which applied the DTA unless the context required otherwise. In order to give the specific words of a DTA a meaning consistent with the genuine shared expectations of the contracting States, it is necessary to examine not only the language but the entire context of the DTA.

The court applied these principles and found that the interest payments were not "received by" a corporation of a contracting State within the meaning of article IX. "Received by" was interpreted to mean not merely the obtaining of physical possession on a temporary basis of such interest, but to contemplate dominium and control over the funds. The petitioner could not prove that a substantive indebtedness existed between the US corporation and the Honduran corporation. The assignment of the debt between the Bahamian corporation and the Honduran corporation had no valid business purpose. A tax avoidance motive is generally not regarded as fatal to a transaction, but such a motive, standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes. The Honduran corporation was thus held to be a mere conduit which had no actual beneficial interest in the interest payments it "received" and thus, in substance, the US corporation was paying the interest to the Bahamian corporation which received it within the meaning of article IX of the US — Honduran DTA.

In *Compagnie Financiere De Suez Et de L'Union Parisienne v US*[104] the taxpayer attempted to use a double taxation agreement to avoid U.S, source tax. The "Compagnie Financiere de Suez et de L'Union Parisienne" was the

[104] 74-1 USTC 9254.

corporation that built and operated the Suez Canal until it was nationalized on July 26, 1956. The corporation entered into a trust agreement with J.P. Morgan and Co. Inc. of New York on January 17, 1949. A revocable trust was created. The corporation designated JP Morgan and Co. Inc. as trustee of a trust fund for the purpose of enabling the corporation to fund, or otherwise secure, its pension obligations. Current trust income, exclusive of capital gains was to be paid over to the corporation as of 1 December each year. The trustee had to withhold the US source tax on interest and dividend payments which the trust made to foreigners, in accordance with the US Internal Revenue Code. The corporation identified itself on all the tax returns it filed as an Egyptian corporation. It received the dividends and interest paid by the trust. At no time during the years from 1952 — 1956 did the corporation have a permanent establishment in the US On January 14, 1959 it filed refund claims for the withholding tax levied in the US.

The basis for the plaintiff's claim was that it was a French corporation for the purposes of article 6(A) of the DTA between France and the US as its administrative domicile was in Paris (according to article 3, of the articles of incorporation). Furthermore all the corporation's major administrative functions performed during its operating history were done through its general administrative office in Paris. All the officers and all the agents of the corporation, resident in Egypt, with one exception, were French citizens. The corporation was subject to French jurisdiction for purposes of handling its securities (but the securities were treated as foreign for tax purposes).

Countervailing factors were that the corporation had its designated head office, its primary place of business and its basic source of income in Egypt. After considering the history of the corporation the court concluded that it was an Egyptian corporation from 1952 to 1956. It was, therefore, not entitled to the reduced tax rate on US interest and dividend payments as provided in the DTA between the US and France and it was thus not entitled to refunds. The corporation was created under Egyptian law and Egypt exercised sovereign power over it. Its head office was in Egypt and all its profit-making business was carried on outside of France. Moreover, it was not subject to French tax. As support for this finding, based on facts, the court relied on a US Treasury Regulation (1961) which was an attempt to define the concept "French enterprise" or "French corporation or other entity" for purposes of the tax DTA with France. According to the Regulation an enterprise carried on wholly outside France by a French corporation is not a French enterprise within the meaning of the DTA. The court expressed the opinion that the Regulation was an attempt to prevent corporations that were incorporated in France, but which conducted all their profit-making business outside France in order to avoid French tax, to claim tax benefits of DTAs to which France was a signatory.

Therefore, even if the corporation had been created in France under French law, it would not have qualified for DTA benefits.

To further justify the decision, the court considered the purpose of the tax DTA. It concluded that the main purpose was to avoid double taxation and as the corporation paid no taxes in France there was no such burden. Thus there was no need for the DTA to be applied.

The US tax courts have also applied the "step transaction doctrine" to counter DTA abuse.[105] The USA IFA Report points out that step transaction doctrine may be viewed as another variation of the "substance over form" principle: In determining whether steps should be integrated under the step transaction doctrine, courts and the IRS typically have applied three alternative tests. In the strictest test, the "binding commitment" test, a series of transactions will be "stepped together" only if, at the time the first step occurs, there is a binding commitment to undertake the subsequent steps. In the "mutual interdependence" test, a series of transactions will be stepped together if the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series". Under the "end result" test, a series of transactions will be stepped together if the parties' intent at the commencement of the transactions was to achieve the particular result and the steps were all entered into to achieve that result."[106]

In *Del Commercial Properties Inc v Commissioner*,[107] Delcom Financial Ltd (Financial), a Canadian corporation obtained a $18 million loan from a third-party bank. Delcom Financial then loaned $14 million of the loan to its wholly owned Canadian subsidiary, which then contributed $14 million to its wholly owned Cayman subsidiary, which contributed the $14 million to its wholly owned Netherlands-Antilles subsidiary, which contributed the $14 million to its wholly owned Netherlands subsidiary. The Netherlands subsidiary then loaned the $14 million to Delcom Commercial in the US Initially, the taxpayer made its payments under the loan to the Netherlands subsidiary but later it made payments directly to Delcom Financial, ignoring the intermediate parties. The IRS argued that the real loan was made by Delcom Financial to Delcom Commercial and that interest payments were subject to 15 per cent withholding under the 1985 USA–Canada DTA. The taxpayer argued that the loan from the Netherlands subsidiary to Delcom Commercial should be respected and that the interest payments were not subject to withholding under the USA–Netherlands DTA.

105 USA IFA Report in para 1.2.3 at 832.
106 Ibid.
107 251 F.3rd 505, 512 (DC Cir. 2000).

The court denied the DTA relief on the basis of the step transaction doctrine, stating that a step in a series of transactions would be ignored if the step does "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax".[108] The court referred to two Revenue Rulings from the IRS, which provide that "if the sole purpose of the transaction with a foreign country is to dodge US taxes, the treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine. For the taxpayer to enjoy the treaty's tax benefits, the transaction must have a sufficient business or economic purpose."[109]

The USA IFA Report concludes that the court's decision appears to be grounded more in the substance over form and conduit principles since Delcom Commercial could not show that BV had "any business or economic purpose sufficient to overcome the conduit nature of the transaction". [110]

In general, the US courts have applied the domestic anti-abuse rules to counter DTA abuse, i.e. they have not viewed the application of such rules as inconsistent with the DTAs.[111] In terms of the US Constitution, federal domestic law and DTAs are on an equal footing; whilst a court will attempt to give effect to both, if there is a clear conflict, the later in time will prevail.[112] Several specific anti-avoidance rules directly limit the application of DTA provisions and may possibly be regarded as in conflict with US DTA obligations.[113]

The US has introduced many specific and general anti-avoidance provisions in its DTAs.[114] The most prominent is the US Limitation of Benefits (LOB) provision in Article 21 of the US Model DTA.[115] The LOB provision in US DTAs has been criticized for its inflexibility. For example, if a South African Group should hold its international investments via a Netherlands holding company (Holdco), which is typically established for many other reasons apart from tax benefits, that Holdco will not be entitled to the benefits of the Netherlands/US DTA, even though the South African parent company is entitled to virtually the same benefits under the US/South Africa DTA. The test is applied very rigidly, without consideration of the wider circumstances.

108 USA IFA Report at.833.
109 Ibid.
110 Ibid.
111 Ibid, par 1.4 at.837.
112 Ibid, par 1.4.2 at.838.
113 Ibid, par 1.4.3 at. 839.
114 Ibid, par 2 at 840.
115 Article 22 of the US/South Africa DTA.

6 PREVENTING TREATY SHOPPING IN SOUTH AFRICA

The list of double tax treaties on the SARS' website as at 28 November 2014 shows that South Africa has entered into 75 double tax treaties, which have been published in the Government Gazette, 21 of these DTAs are with African countries. Another 36 treaties are in the process of negotiation or have been finalised but not yet signed. The preamble to most of the double tax treaties provides that the purpose of the treaties is "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital". Some of the DTAs merely have the object to avoid double taxation.[116]

6.1 The Status of Double Tax Treaties in South Africa

DTAs are international treaties and thus subject to international (public) law rules regarding such treaties. Most of the customary rules of international law concerning treaties are contained in the Vienna Convention on the Law of Treaties.[117] The Convention also contains new elements which aim to promote the progressive development of international law.[118] Whilst South Africa has not signed the Vienna Convention, most of the rules contained in the Convention will apply under South African law since they constitute customary rules of international law,[119] which must be applied by South African Courts in accordance with section 232 of the Constitution, unless the rule is inconsistent with the Constitution or an act of Parliament. Furthermore, in terms of section 231 of the Constitution, South Africa is bound by international agreements.[120] If a court is faced with the task to interpret any provisions of a DTA, section 233 of the Constitution needs to be taken into account, which requires that when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

International agreements do not form part of South African law unless a legislative enactment gives the relevant provisions the force of law. This was

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116 See for example the DTAs with Germany, Austria and Denmark.

117 Vienna Convention on the Law of Treaties https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf.

118 R Lenz "The Interpretation of Double Taxation Conventions, General Report" *Cahiers de Droit Fiscal International* Vo. XLII, 1960 at 294; Van Houtte "Auslengungsgrundsaetze im internen und im internationalen Steuerrecht in der Entwicklung des Steuerwesens seit dem ersten Weltkrieg" IBFD, Amsterdam, 1968 at I1-41; DA Ward Principles to be applied in interpreting Tax Treaties" *IBFD Bulletin* 1980 at 546-7.

119 Ibid.

120 Several of the South African DTAs have incorporated provisions contained in the United Nations Model DTA into the DTAs which means they may be somewhat different to the OECD Model DTA definition.

clearly stated by Chief Justice Steyn in *Pan American Airways v SA Insurance Co Ltd*. He made the following remarks:[121]

> "It is common cause, and trite law I think, that in this country the conclusion of a treaty, convention or agreement by the South African government with any other government is an executive and not a legislative act. As a general rule, the provisions of an international instrument so concluded are not embodied in our municipal law except by legislative process."

This is confirmed under section 231 of the Constitution. In terms of section 108(1) of the Income Tax Act, the National Executive may enter into DTAs with the governments of other countries, whereby arrangements are made with a view to the prevention, mitigation or discontinuance of the levying of tax in respect of the same income, profits or gains or tax imposed in respect of the same donation, or to the rendering or reciprocal assistance in the administration of and the collection of taxes. Section 231 of the Constitution provides that a treaty becomes part of South African law when it is approved by the National Assembly and by the National Council of Provinces. As soon as the DTA is approved by Parliament, it is required that notice of the arrangements made in such an agreement be given by proclamation in the Government Gazette.[122] The proclamation has the effect that the arrangements made by the DTA apply as if they were enacted in the Income Tax Act.[123]

The question arises whether the provisions of a DTA can be overridden by subsequent domestic legislation. Since DTAs form part of national law, the normal rules of interpretation of statutes provide that subsequent legislation which is contrary to a provision of the DTA may override the DTA provision.[124] However, South African courts take judicial notice of international law.[125] This implies that the courts will ascertain and administer the appropriate rule of international law as if it were part of South African law.[126] This does not mean, however, that the courts are bound to apply all rules of international law. In accordance with the provisions of the Constitution and case law, international law enjoys no privileged position in South Africa's legal system.[127] Nevertheless, a court must take notice of the requirement under section 231 of the Constitution, i.e. that South Africa is bound by international agreements and section 233 of the Constitution which requires that when interpreting any legislation, every court must prefer any reasonable interpretation of the

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121 See also South Atlantic Inlands Development Corporation Ltd v. Buchan 1971 (1) SA 234 (C).

122 Sec 108(2) of the ITA.

123 Ibid.

124 The lex posterior derogat priori rule – see L du Plessis *Re-Interpretation of Statutes* (2002) at73; also L Olivier Tax "Treaties and Tax Avoidance: application of anti-avoidance provisions; South Africa branch report" Cahiers IFA 2010 Congress in Rome at 724.

125 The Buchan case at 238.

126 Ibid.

127 The SA IFA Report at 723.

legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

Article 27 of the Vienna Convention on the Law of Treaties reads as follows:

> "A party may not invoke the provisions of its national law as justification for its failure to perform a treaty."

This rule is a well established rule of international law.[128] The principle expressed in this article is codified in article 26 of the Vienna Convention which reads as follows:

> "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

A State should thus abstain from acts calculated to defeat the object and purpose of a treaty. Therefore, when a contracting State applies its domestic anti-tax avoidance measures to deny DTA benefits to a resident of the other contracting State, it may possibly contravene the basic prohibition under Article 27 of the Vienna Convention, particularly when it causes double taxation which thus contravenes the main objective of a DTA.

However, Article 31(1) of the Vienna Convention determines that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose[129]. Paragraph 2 defines the "context" for the purpose of interpretation.[130] Paragraph 3(a) and (b) specify that any subsequent agreement between the parties regarding the interpretation of the treaty or any subsequent practice in the application of the treaty which establishes the understanding of the parties regarding its interpretation should be taken into account when the treaty is interpreted. A third element which has to be considered within the context is any relevant rules of international law applicable in the relations between the parties (paragraph 3(c)). Paragraph 4 provides for the case where it is clear that the parties intended a term to have a special meaning and not its ordinary (literal) meaning.

When the interpretation in terms of Article 31 leaves the meaning obscure or ambiguous, or leads to a result which is manifestly absurd or unreasonable,

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128 TO Elias "The Modern Law of Treaties" *Leiden: Oceana Public* (1974) at 45.

129 RG Wetze *The Vienna Convention on the Law of Treaties* edited by D Rausching, Frankfurt: Alfred Metzner (1978) at 49; also the OECD Commentary on Article 1 of the OECD Model DTA, para 9.3 page 60; and the comments of Nathalie Goyette "Tax Treaty Abuse: A Second Look" *Canadian Tax Journal* Vol 51, no 2 (2003) at 768 where she remarks that "in light of the principle that states must execute a treaty in good faith, it is legitimate to doubt that the residents of those states are entitled to abuse the treaty in question."

130 Vienna Convention on the Law of Treaties https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf.

recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion[131] (article 32).

Most of the rules of treaty interpretation contained in the Vienna Convention on the Law of Treaties are, as pointed out, customary rules of international law.[132] It is sometimes claimed that the "new" rules of interpretation included in the Vienna Convention have also since acquired the status of customary rules of international law.[133] To the extent that this can be confirmed, that the South African courts would be required to apply these rules, but only to the extent that the rule is not inconsistent with an act of Parliament.[134]

The application of these rules by a South African court can also be justified on other grounds. A basic rule of interpretation under South African law is that effect must be given to the intention of the legislature if this intention is clear.[135] To establish the intention of the legislature, the surrounding circumstances must be taken into account.[136] The fact that a DTA is an international treaty implies that its international nature should be taken into account by a South African court when it has to establish the intention of the contracting governments.[137] This implies that the agreement should have the same meaning in South African law as it has in international law.[138]

The rules of interpretation contained in the Vienna Convention place emphasis on the textual or formalistic approach but considerable scope is left for the application of the teleological approach.[139] This implies that the ordinary meaning of a treaty term is not to be determined in the abstract, but in the light of the object and purpose of the treaty as a whole.[140] Furthermore, subsequent practice of the contracting States can modify provisions of the treaty.[141] It also sanctions the ambulatory approach, i.e. the interpreter may take the evolution of the laws of the contracting States into account, provided the change in the

131 Wetzel *The Vienna Convention on the Law of Treaties*t.
132 Lenz at 294; Van Houtte at II-40-41; Ward at 546-7; Klaus Vogel *Vogel on Double Taxation Conventions* 3rd Edition (1999) in para 28 at 21.
133 Vogel at 22.
134 As per section 232 of the Constitution.
135 Du Plessis at 102; See also T van Wyk *Probleme by die uitleg van belastingwetgewing*, LLM, Universiteit van Suid-Afrika, 31 Januarie 1975 at 83-84; T Van Wyk "Tax law: The interpretation of double taxation agreements" *De Rebus Procuratoriis*, (Jan. 1977) at 51.
136 Du Plessis,at 111; *Bhana v Dönges* 1950 4 SA 653 (A) at page 662D – 667H; Van Wyk, Probleme, at 84 -85.
137 Van Wyk, Probleme at 84.
138 Ibid.
139 Schwarzenberger *International Law* vol. I, 3rd Edition (1957) at 492-493.
140 Ibid; also see Wetzel at 49.
141 Ibid.

national law of a respective State does not defeat the object and purpose of the treaty. [142]

The Appellate Division of the Supreme Court considered the interpretation of a tax treaty in the case of *Secretary for Inland Revenue v Downing.* [143] The respondent left South Africa in 1960 to live in Switzerland. Apart from an allowance of R20 000, he was not permitted to take his assets with him. The balance of his assets consisted of a large share portfolio which he entrusted to a broking member of the Johannesburg Stock Exchange to manage. The basic issue before the Court was whether or not the respondent had carried on business in South Africa "through a permanent establishment situated therein", within the meaning of Article 7(1) of the DTA between South Africa and Switzerland. Article 7(1) of the treaty reads as follows:

> "The profits of an enterprise of a Contracting State shall be taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

The Court acknowledged that the terms of the DTA are based upon the OECD Model DTA of 1963. It was further recognised that this model served as the basis for the network of DTAs existing between this country and other countries. It did not indicate, however, to what extent it regarded the OECD Commentary as binding on South African courts. The lower Court did, however, base its argument on a passage from the OECD Commentary.[144] To interpret the relevant DTA terms, the court first considered the definitions of the relevant terms in the DTA. The appellant's counsel argued that the terms of the definition of "permanent establishment" (Article 5 of the DTA) should be narrowly construed, i.e. since the first two requirements (Article 5(1), read with Article 5(2)(c)) of the definition had been fulfilled, the respondent fell within the ambit of the permanent establishment concept. The Court rejected this approach and pointed out that Article 5 must be read as a whole. It expressed the opinion that such an interpretation would make Article 5(5) redundant which could not have been the intention of the contracting parties. In determining the meaning of the words "acting in the ordinary course of their business" (see Article 5(5)), the Court stressed that the words should be ascribed their natural meaning. It came to the conclusion that the respondent did not fall within the ambit of the permanent establishment concept.

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142 Ibid; also see the criticism of Vogel in para 125b at 66, that a contracting state should not introduce domestic rules to circumvent its DTA obligations, for example, the introduction of the Secondary Tax on Companies by South Africa which replaced the non-resident shareholders tax could be regarded as such an instance since the new tax was no longer covered by older South African DTAs as confirmed in Volkswagen case.

143 1975 (4) SA 518 (A).

144 See page 526 of the case report.

The approach adopted by the Court corresponds with the guidelines for interpretation contained in the Vienna Convention, although no reference was made in the decision to those guidelines. This approach was subsequently applied in *ITC 1503*[145] where the Court considered the OECD Commentary and then concluded that the income in question should be treated as ancillary to the main stream of income, as suggested by the OECD Commentary.

The courts have since often applied the OECD Commentary and other international guidelines in considering cases involving DTAs.[146] In *CSARS v Tradehold Ltd*,[147] the Court made the statement that a DTA overrides domestic law:

> "Double tax agreements effectively allocate taxing rights between the contracting states where broadly similar taxes are involved in both countries. They achieve the objective of s 108, generally, by stating in which contracting state taxes of a particular kind may be levied or that such taxes shall be taxable only in a particular contracting state or, in some cases, by stating that a particular contracting state may not impose the tax in specified circumstances. A double tax agreement thus modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict."[148]

6.2 Treaty Shopping in South Africa

There is no case law in South Africa on issues pertaining to treaty shopping that can be used to give an indication as to whether treaty shopping is a major BEPS concern for South Africa. An indication of the scale of treaty shopping could be determined by considering aggregate statistics on foreign direct investment (FDI). However, even with statistics on FDI, it is difficult to distinguish indirect investment through intermediaries from direct investment, and even more difficult to separately identify cases involving indirect investment for tax planning purposes. Moreover, the use of intermediaries may involve tax planning other than treaty shopping. Nevertheless, a comparison of FDI and trade data, and an understanding of the domestic tax and treaty policies of those countries that rank among the largest in terms of FDI in South Africa, can provide circumstantial evidence about the scale of treaty shopping.[149] In general, high levels of inbound and outbound FDI can be an indicator that a country commonly serves as a conduit investment country.[150] However, indirect

145 (53) SATC 342, at 349.
146 See the decisions in *CSARS v Tradehold Ltd* (132/11) [2012] ZASCA 61; *Oceanic Trust* 2012 74 SATC 127; also the UK High Court decision *Ben Nevis (Holdings) Limited and Another v CHMRC* [2013] EWCA Civ 578 which considered a request by SARS for the assistance by the HMRC under the UK/South Africa DTA to collect taxes due by a resident of South Africa.
147 (132/11) [2012] ZASCA 61
148 *CSARS v Tradehold Ltd*; Ibid in para 17.
149 OECD "Tax Conventions and Related Questions: Written Contributions from Members of the Focus Group on Treaty shopping"(2013) in para 2.
150 Ibid.

investment is not always driven by treaty shopping; it may reflect other objectives of a multinational enterprise.

6.2.1 Treaty shopping: Reducing Source tax on Dividends, Royalties and Interest Withholding Taxes

A number of withholding taxes have been introduced in South Africa.[151] It is hoped that this will be instrumental in eliminating base erosion. However, these withholding taxes (generally at a uniform rate of 15%) are more effective when the non-resident's country of residence does not have a double tax treaty with South Africa. Where a double tax treaty exists, the rate at which withholding taxes may be levied by South Africa as source countries is usually limited. Most of South Africa's DTAs based on the OECD MTC do not contain favourable withholding tax rates for South Africa. This puts South Africa in a vulnerable position as in some cases the withholding tax is zero. With the predominantly uniform domestic rate of 15% now in place, the DTAs to which South Africa is party, require renegotiation. The potential for treaty shopping has now become more significant in South Africa especially with the introduction of the new withholding taxes on dividends and interest. In particular, the risk of conduit companies being used as a means of reducing South African withholding taxes can be significant.

A foreign company carrying on business operations through a South African subsidiary can reduce the Dividends Withholding Tax (DWT),[(61)] imposed (at a statutory rate of 15%) in South Africa on dividend distributions by the subsidiary to its parent company, by using a treaty shopping scheme. For example, if the investment is channeled through an intermediate holding company (Dutch

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151 The following withholding taxes apply in South Africa.

- The interest withholding tax;
- The dividend withholding tax levied in terms of section 64D – N of the Act, introduced from years of assessment commencing 1 April 2012 at a rate of 15%.
- The withholding tax on royalties (which was historically levied under repealed section 35(1) of the Act at a final rate of 12%), now levied at a rate of 15% in terms of section 49A – G of the Act with effect from 1 January 2015 in respect of royalties that are paid or become due and payable on or after such date;
- The withholding tax on foreign entertainers and sportspersons which is levied at a rate of 15% in terms of section 47A – K of the Act, with effect from 1 August 2006;
- The withholding tax on the disposal of immovable property by non-resident sellers levied in terms of section 35A of the Act, at a rate of 5% if the non-resident is an individual, 7.5% if the non-resident is a company and 10% if the non-resident is a trust with effect from 1 September 2007;
- The withholding tax on service fees levied in terms of section 51A – H of the Act at a rate of 15% with effect from 1 January 2016 in respect of service fees that are paid or become due and payable on or after such date.

For a detailed discussion of South Africa's withholding tax regime please refer to: AW Oguttu "*An Overview of South Africa's Withholding Tax Regime*" TaxTalk (March/April 2014).

Holdco) established in the Netherlands, the Dutch/South African DTA will function to limit the DWT tax to 5%.[152]

With proper construction, the dividends should qualify for the Dutch participation exemption for foreign dividends and the net dividend income (a small margin is required in the Netherlands) could also be extracted from the Netherlands without any Dutch withholding tax. The Dutch/South African DTA will also function to reduce the proposed new withholding tax on interest (IWT) from 15% to 0%. Therefore, the ultimate investor could loan funds to the Dutch Holdco, which would on-lend the funds to the South African subsidiary, thus avoiding the IWT. The Netherlands does not impose any withholding tax on interest paid to a non-resident, subject to rather generous thin capitalization restrictions, i.e. again requiring a small margin for Dutch Holdco.

The Dutch/South African DTA will also function to reduce the withholding tax on royalties (RWT) from 15% to 0%. Therefore, the ultimate investor could license the supply of intellectual property (IP) to the Dutch Holdco, which would sub-license the use of the IP to the South African subsidiary, thus avoiding the RWT. The Netherlands does not impose any withholding tax on royalties paid to a non-resident and merely require a small margin for Dutch Holdco.

The benefits of a DTA could also be accessed by a non-resident on a temporary basis by ceding the right to the income to a company in a country which has a beneficial DTA with South Africa before such income accrues to the non-resident cedent, for example, a right to royalties, dividends or interest could be ceded to such a resident of the other contracting state, thus potentially qualifying for the benefits of that DTA at the time when such income accrues.[153] In the case of dividends, t may be difficult to ensure qualification for the particular requirements under the typical DTA, for example, the requirement that the intermediary holding company needs to hold at least 10% of the shares in the South African company. However, even this could be temporarily manipulated to ensure the required shareholding at the point in time when the dividend is declared with the subsequent redemption of the additional shares acquired merely for this purpose.

The total tax burden on such dividends, interest and royalties could thus be reduced significantly through the treaty shopping scheme.

It is however worth noting that South Africa is taking measures to adopt its tax treaty negotiation policy to cater for the new policy on withholding taxes.

[152] Article 10(2) of the DTA – provided the Dutch Holdco held at least directly or indirectly 25% of the voting power in the company paying the dividends.

[153] See the example of such arrangements in the OECD Report on Abuse, para 42 at 15.

Currently, all DTAs with zero rates are under renegotiation so that they are not used for treaty shopping purposes.

- It should however be noted that in practice, the process of negotiating or renegotiating DTAs is long. It is however important to ensure when re-negotiating the new limits for treaty withholding tax rates, that caution is exercised since high withholding taxes can be a disincentive to foreign investment. Equilibrium must be achieved between encouraging foreign investment and protecting South Africa's tax base from erosion.

6.2.2 Treaty Shopping: Accessing Other DTA Benefits

A resident of a country which has no DTA or a less beneficial DTA with South Africa could make an investment in a property holding company in South Africa via a country such as the Netherlands to protect the eventual capital gains realized on the sale of the shares from South African capital gains tax. In terms of Article 13(4) of the Dutch/South African DTA, only the Netherlands may impose tax on the gains realized from the sale of shares in a South African company. The Dutch/South African DTA does not contain the provision in the USA/South African DTA, which allows South Africa to impose tax on such gains if the South African property company derives 50% or more of its value from immovable property. In the Netherlands, the gain on the sale of the shares should enjoy the protection under Dutch participation exemption and it is possible to extract the gain from the Dutch intermediate company without incurring withholding tax.

A resident of a country that has no DTA with South Africa could use a treaty shopping scheme to obtain the benefit of the limitation of South African tax by the "permanent establishment" concept (see further discussion below). He could, for example, create a conduit company in Switzerland and channel his South African activities through this company to enjoy the protection from South African tax offered by the permanent establishment provisions under the Swiss/South African DTA.

6.2.3 Schemes to circumvent DTA limitations

(a) Using the "dual residence" concept

The concept of "dual residence" can be used to avoid the DWT. Many countries regard a company as resident in their territory if it is managed and controlled there, whereas other countries consider the place of incorporation of a company as a factor determining its residence. It is thus possible that a company can be regarded as a "resident" of both contracting States in terms of the general definition of a "resident" under the domestic laws of the respective contracting states which definition is usually confirmed in the DTA. DTAs generally solve such cases of "dual residence" by providing that such a company shall be deemed to be resident in the contracting State in which its place of effective management is situated.[154]

If a company incorporated in South Africa is effectively managed in the United Kingdom (UK), it will be deemed to be a resident of the UK for purposes of the DTA between South Africa and the UK. A UK resident parent company can thus avoid South African DWT on dividends derived from its South African subsidiary by transferring the effective management of the subsidiary to the UK. The subsidiary will then be treated as a UK tax resident which is not subject to DWT in terms of section 64C of the ITA.

(b) Using the Permanent Establishment Concept

The "permanent establishment" concept in DTAs functions to limit the source tax liability of a resident of one contracting State who carries on business in the other contracting State. South African DTAs generally provide that an enterprise of one contracting State will not be taxed on business profits derived from the other contracting State, unless that enterprise carries on business in the other State through a permanent establishment situated therein. Therefore, if a resident of a State that has concluded such a DTA with South Africa carries on trading activities in South Africa without establishing a fixed place of business in South Africa, the income derived will not be subject to South African tax by virtue of the DTA.

The permanent establishment concept in most South African DTAs does not include a building site or construction or assembly project if the project does not exist for more than twelve months (in some DTAs, e.g. the DTA with Israel, the period is limited to six months). A resident of those contracting States will, therefore, not be subject to South African tax on building or construction activities if the specific project does not last longer than twelve months (six months for residents of Israel).

A resident of the other contracting state could split up the project into different parts, which are performed by different legal entities, thus allowing the fuller project to be performed in South Africa without incurring a tax liability in South Africa.

In the context of e-commerce, a resident of the other contracting state could conduct fully fledged sales activities in South Africa via a website without creating a permanent establishment in South Africa, provided the enterprise

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154 See Article 4(3) of the UK/South Africa DTA.

operates via a server based outside South Africa or an independent server based in South Africa.

(c) Artificial Arrangements Qualifying for Reduced Rates

The DTAs generally contain provisions which function to reduce an exposure to withholding taxes in the source country if the resident of the other contracting state qualifies under certain criteria, e.g. that the latter should hold at least 10% of the capital of the company in the source state to qualify for the reduced DTA rate of 5% (from 15% in other cases). The resident of the other contracting state could arrange for a temporary increase in its shareholding, e.g. by taking up preference shares in the company in the source state, shortly before a dividend declaration (in respect of the ordinary shares) which shares are then redeemed shortly after the dividend declaration. This could thus secure a 10% saving.

6.2.4 Treaty Shopping Involving South Africa's Treaty with Mauritius

South African investors have used Mauritius as a vehicle for investing in other countries with which Mauritius has treaties. Likewise, international investors from other countries that have tax treaties with Mauritius have used Mauritius as an intermediary to invest in South Africa.

The first tax treaty between South Africa and Mauritius came into force in 1960, through the South Africa/United Kingdom tax treaty, which was extended to Mauritius. During that time, Mauritius was still a colony of the United Kingdom. It is important to note that even though Mauritius gained its independence from the UK in 1968, the above-mentioned tax treaty was still applicable to Mauritius until termination in 1997 with the coming into force of a new tax treaty in 1997 directly between South Africa and Mauritius. However South Africa signed a new treaty with Mauritius on 17 May 2013. The South African Parliament ratified the treaty on 10 October 2013. The treaty must similarly be ratified by Mauritian Authorities. Thereafter it has to be published in the Government Gazette in terms of section 108 of the Income Tax Act No 58 of 1962 (Act).

The main reason for the signing a new the treaty (hence forth "draft treaty") was due to perceived "abuse" of the 1997 tax treaty and resultant erosion of the South African tax base. The World Bank and the International Finance Corporation have consistently ranked Mauritius as one of the best Sub-Saharan African countries in which to do business. The main drivers are that Mauritius:

- Is a member of SADC, WTO and COMESA.
- Has a vast network of treaties with countries. It is party to 35 double taxation agreements.
- has no capital gains tax.

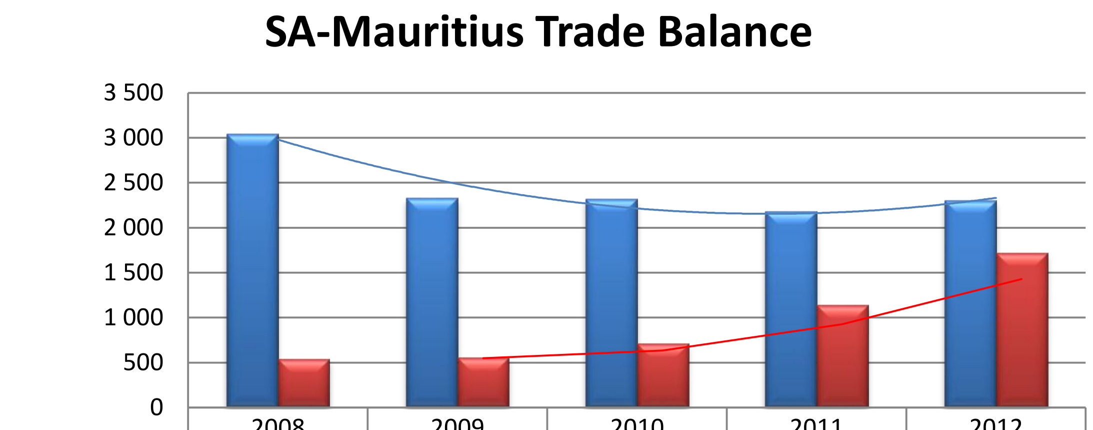
- has a low corporate income tax rate at 15%, which translates into an effective tax rate of 3% after taking into account available credits. (GBL1 gets up 80% credit while GBL2 qualifies for exemption).

The Economic Perspective

From an economic perspective, South Africa is, today, a major trade and economic partner of Mauritius. South Africa invests heavily in various sectors of the Mauritian economy such as banking and finance, retail, ICT, real estate, manufacturing, agribusiness as well as logistics. South Africa's foreign direct investment (FDI) into Mauritius over the past six years has grown significantly, making South Africa the largest single foreign investor after the United Kingdom.

Graph 1 below regarding current trade and values between South Africa and Mauritius shows that import values from Mauritius have ranged from R538m in 2008 to R1,719m in 2012 (CAGR of 36%), while export values have ranged from R3,041m in 2008 to R2,305m in 2012 (CAGR of -6%). While exports have shown negative growth in the years 2008 to 2012, they are still well above our imports from the region (R2,305m exports in 2012 vs. R1,719m imports in 2012). Below is SA-Mauritius Trade Balance.

Graph 1

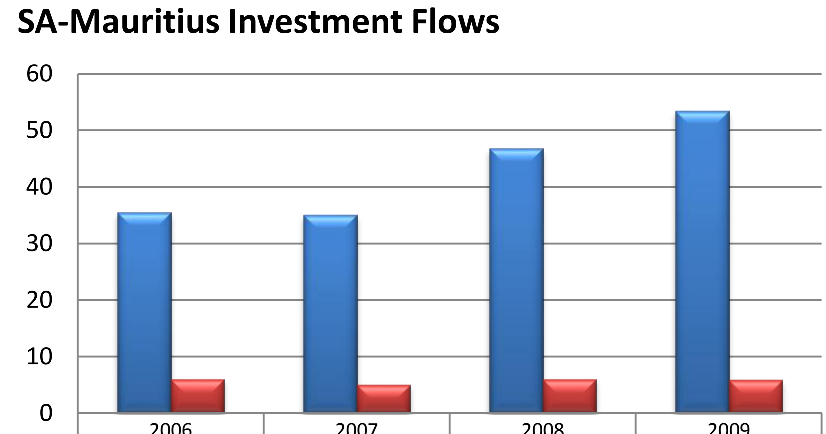


	2008	2009	2010	2011	2012
Exports (Rm)	3 041	2 329	2 318	2 182	2 305
Imports (Rm)	538	557	708	1 142	1 719

(Source: Finweek 27 May, 2013)

Graph 2 below shows the investment flows between South Africa and Mauritius.

Graph 2



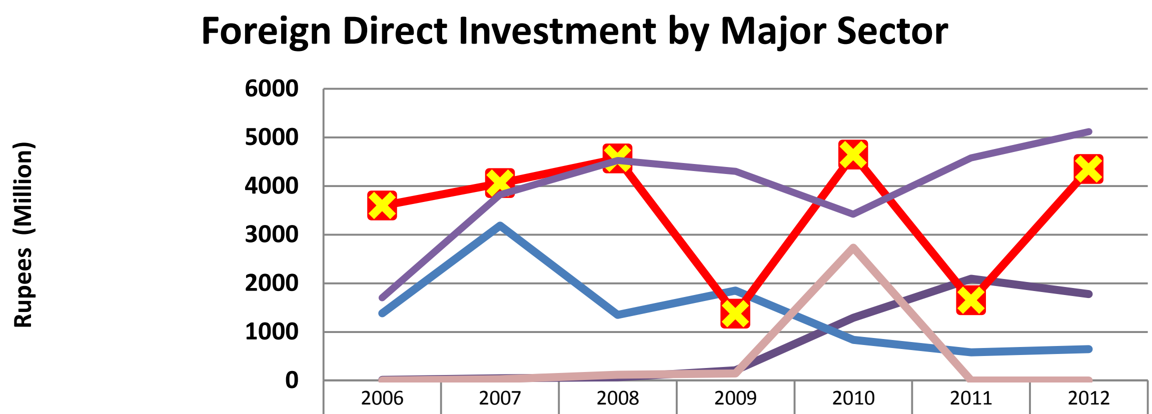
	2006	2007	2008	2009
Flows to Mauritius (Rbn)	35.5	35.1	46.8	53.5
Flows from Mauritius (Rbn)	6	5.1	6	5.9

(Source: Finweek 27 May, 2013)

South Africa’s FDI flows into Mauritius have been steadily increasing while Mauritius’ flows into South Africa have been flat in the period 2006 to 2009. This is indicative of the ease of doing business as well as the attractiveness of the Mauritius tax regime. However, with the proposed draft treaty, these flows could reverse as it will not be beneficial for South African companies to use Mauritius as a gateway for Sub-Saharan African expansion.

Graph 3 below shows that although foreign direct investment into Mauritius has been volatile over the last few years, finance and insurance has seen significant growth in investment. Accommodation and Food has been declining while Construction has seen tremendous growth off a low base. Real Estate investment growth is testimony to Mauritius being a tourist destination. This mirrors South African company investments in Mauritius as indicated in Appendix A to this document. The fallout of the euro zone's financial troubles had a negative impact on flows to the Indian Ocean Island, resulting in an inbound flow of 9.46 billion in 2011 from 13.9 billion rupees a year earlier. Conditions improved during 2012 with direct investments totalling 12.7 billion Rupees. Mauritius is shifting from an economy traditionally focused on sugar, textiles and tourism towards offshore banking, business outsourcing, luxury real estate and medical tourism. From the graph below, it can be observed that the largest investments are made in Real Estate (est.40%) and Finance and Insurance (est.34%) activities.

Graph 3

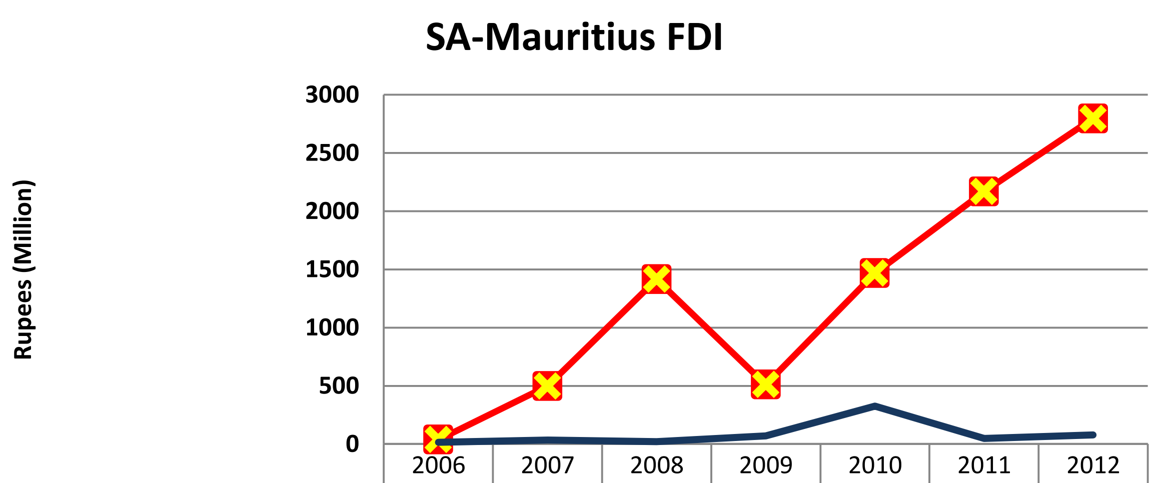


	2006	2007	2008	2009	2010	2011	2012
Construction	12	45	68	211	1292	2094	1775
Accommodation and Food	1382	3189	1348	1850	836	579	645
Finance and Insurance	3593	4056	4564	1371	4645	1646	4348
Real Estate	1701	3820	4525	4305	3422	4580	5122
Health and Social Work	2	29	120	145	2732	0	0

Source: Bank of Mauritius (Provisional)

Statistics from the Bank of Mauritius as indicated in graph 4 below show that South Africa is the 2nd largest investor in Mauritius (2,797 million rupees = 22%) behind the UK. From the analysis of investments by South Africa in Mauritius, a robust growth trend can be observed. The magnitude of foreign investment growth into Mauritius by South Africa is well pronounced post the 2008/2009 financial crisis.

Graph 4



	2006	2007	2008	2009	2010	2011	2012
Flows from SA to Mauritius	38	498	1415	510	1468	2169	2797
Flows from Mauritius to SA	14	35	20	70	325	49	77

Source: Bank of Mauritius (Provisional)

The tax perspective

Putting the above statistics into a tax context, the high FDI flows into Mauritius point to Mauritius being an enabler for arbitrage opportunities. This is encouraged by both its business-friendly environment as well as lower tax rates for offshore companies. Tax credits of up 80% for GBL1 (Global Business Licence) companies are available. Aslo GBL2 companies can invoke tax exemptions. Putting the above FDI flows into context, below is a discussion as to how South African residents make use of treaties Mauritius has signed for treaty shopping purposes.

The Mauritius/India Tax Treaty – Sale of Shares Taxable only in Shareholder Country

South African residents wishing to invest in India often take advantage of the Mauritius/India treaty by routing investments via Mauritius in order to gain tax advantages. In terms of the South Africa/India treaty (and most other treaties with India) capital gains derived from the sale of shares in a company may be taxed in the country in which the company whose shares are being sold is a resident (i.e. in India), and since India has a tax on capital gains the gain does not escape taxation. In short, where a South African company invests directly into India it will be subject to CGT on the sale of the shares in the Indian company. To avoid such taxation, South African investors route investments via Mauritius by setting up a GB1 company in Mauritius which takes advantage of the provisions in the Mauritius/India treaty, which provides that capital gains arising from the sale of shares are taxable only in the country of residence of the shareholder and not in the country of residence of the company whose shares are being sold. As a result, a company resident in Mauritius selling shares of an Indian company will not pay tax in India on the disposal of the Indian company's shares. Since there is no capital gains tax in Mauritius, the gain will escape tax altogether. The capital gain can then be repatriated back to the South African shareholder free of withholding taxes as Mauritius does not levy tax on dividends, interest or royalties for GBL1 companies.

Mauritius/African Tax Treaty Network – Lower Withholding Tax Rates

South African companies often route investments into other Africa countries via Mauritius since Mauritius has negotiated better benefits in its tax treaties with some African countries than South Africa has. This is especially so with regard to withholding tax rates (on dividends, interest, royalties and management/technical fees) in treaties between Mauritius and other African countries, which are generally lower than the withholding tax rates in tax treaties between South Africa and other African countries. To take advantage of the treaties that Mauritius has signed with some African countries, investors will route their investments in Africa via Mauritius.

Avoiding South African Dividends Tax

Hypothetical example: South Africa imposes a dividends tax at a rate of 15% on dividends paid by a company which is tax resident in South Africa (SACo) to its holding company (HoldCo) that is tax resident in a "tax favourable" non-treaty country (Country A). Country A however has a treaty with Mauritius, which in turn has a treaty with South Africa. In terms of the Mauritius/SA treaty, South Africa is prohibited from imposing dividends tax in excess of 5% where the beneficial owner of the shares in SACo is a company which is tax resident in Mauritius and the beneficial owner owns more than 10% of the shares in the SACo.

HoldCo establishes a company in Mauritius (SubCo) that in terms of the domestic law in both Country A and Mauritius is tax resident in Mauritius. HoldCo is able to demonstrate that the place of effective management of SubCo is not South Africa. HoldCo disposes of the shares in SACo to SubCo. By virtue of having moved the ownership of SACo to Mauritius, HoldCo is able to reduce the SA dividends tax burden by two thirds. This is because Mauritius imposes local corporate tax in respect of the dividends received from SACo, so no or little Mauritian tax would be payable because of its foreign tax credit regime.

No dividends tax withholding regime applies in Mauritius. It is open for South Africa to challenge whether SubCo is truly the "beneficial owner" of the shares. While Mauritius is used in this example, any other jurisdiction providing for a similar reduction in dividends tax rate could have been chosen (keeping in mind that many of those jurisdictions would themselves have a dividends tax withholding regime which would negate the benefit of any treaty shopping). However, it may be that a country has a dividends tax withholding regime but, because of specific provisions in its domestic tax law or its general corporate law, the dividends tax withholding regime does not apply. For example, notwithstanding that the Netherlands has a dividends tax withholding regime and foreign dividends constitute taxable income, the domestic law regards distributions from certain legal entities, such as the Dutch Co-Operative entity, as not being subject to the dividends tax regime. Thus the dividends derived from SACo would be exempt from tax in the Netherlands in terms of its participation exemption. The Netherlands could work just as well as Mauritius, but for a different reason.

Avoiding Other Withholding Taxes

A similar approach could be adopted in relation to royalties (and interest and services once the proposed draft withholding taxes become effective in South Africa). For example, Cyprus would be a good jurisdiction to divert royalties to as the withholding tax rate is reduced to 0% where the beneficial owner is resident in Cyprus. Once again South Africa would need to challenge the nature of the ownership of the Cyprus intermediate holding company that is in receipt of the relevant royalties.

Capital Gains Tax (CGT) Carve-Out for Property Rich Companies

Mauritius and the Netherlands are jurisdictions through which many inbound investments flow into South Africa. This is especially so in circumstances where investment funds are routed towards acquiring ownership of South African immovable property. The reason for this is that the current treaties[155] that South Africa has signed with Mauritius and the Netherlands provide protection against a South African CGT charge on companies based in these jurisdictions who own shares in a South African company holding immovable property.

In terms of the Eighth Schedule to the Income Tax Act,[156] non-residents are subject to CGT when they dispose of immovable property, an interest in immovable property, or assets of a permanent establishment[157] located in South Africa. An interest in immovable property includes shares or trust interests where more than 80% the market value of such share or trust interest is attributable to the immovable property (so-called "property rich companies"). It should be noted that immovable property includes not only land and buildings, but also mineral rights and improvements which accede to the land (such as happens with redraftable energy projects).

Many inbound foreign direct investments are planned in advance for an exit with the time horizon being as short as five years. Investments are therefore structured to ensure a CGT free exit, particularly where a good portion of the management fees charged by the foreign investor to the local company are embedded within the eventual selling price ("the free carry"). As a result, many companies, particularly mining companies and lately also those investing in re-draftable energy projects, route their investments into South Africa via Mauritius or the Netherlands[158] to avoid the CGT cost.

155 These treaties are not based on the more robust/fair OECD Model Tax Conventions.

156 To the Income Tax Act, 1962.

157 Par 2(1) of the Eighth Schedule.

158 The relevant clause (article 13(4)) of the Netherlands treaty reads as follows: "Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident." There is a school of thought to suggest "immovable property" as envisaged by article 6(2) of the Netherlands treaty (see below) would include the expanded definition of immovable property as envisaged by par 2(2) of the 8th Schedule. It is however generally accepted

It should, however, be noted that the CGT carve-out was removed from the renegotiated treaty between South Africa and Mauritius.[159] The capital gains Article of the draft treaty now specifically provides that a country may tax gains derived from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in such country. The treaty between South Africa and the Netherlands still contains a CGT carve-out clause, and therefore continues to pose a source of possible leakage to the fiscus.

<u>Aspects of the draft Mauritius/South Africa treaty designed to prevent treaty abuse</u>

The draft treaty between Mauritius and South Africa applies to normal tax, to withholding taxes on royalties and on foreign entertainers and sportsmen and the secondary tax on companies (which has been abolished). Although dividends tax has not been expressly included in Article 2 of the draft treaty, Mauritius has been advised by SARS that it will form part of the treaty, which Mauritius has implicitly accepted.

(a) Mutual agreement on residence

The most significant change brought about by the draft treaty concerns companies that are tax resident in both Mauritius and South Africa. In terms of the OECD Model Tax Convention tie breaker rules, double taxation of dual residents companies is resolved by ensuring that the company is tax resident in the State in which its “place of effective management” is situated. A South African incorporated company which is effectively managed in Mauritius would thus, in terms of the OECD tie breaker rules, be deemed to be tax resident in Mauritius and South Africa would lose its "taxing rights”. One of the perceived “abuses” of the 1997 Mauritius/South Africa treaty is by companies incorporated in Mauritius that purport to be effectively managed there, but are in fact run from South Africa. That is the case where significant functions that benefit the Mauritian company’s operations take place in South Africa.

Under the draft treaty the draft dual-residence tiebreaker rules provide that the competent authorities of the two states shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be resident for the purposes of the treaty. This “mutual agreement procedure” as a manner for determining the tax residence status of a taxpayer is contemplated by the commentary on Article 4 of the OECD Model Tax Convention. The alternative provision provides that, in endeavouring to come to agreement on where the taxpayer shall be deemed to be resident, regard must be had to its

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the meaning refers to the general meaning of immovable property under our law and not the par 2(2) meaning.

159 The renegotiated treaty has been signed, and has been ratified in South Africa but not yet in Mauritius.

place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. Where it is clear as to where the company is in fact effectively managed, such a provision would bring about no change. Accordingly, companies that are currently incorporated in Mauritius and are clearly managed there will not be affected by this provision. In a case where both South Africa and Mauritius believe that a company is incorporated in and purportedly effectively managed in Mauritius, and is also managed in South Africa, South Africa may wish to assert that the company is resident in South Africa. Unless South Africa and Mauritius can agree on where the company is resident, it will be a resident, for treaty purposes, of both countries and taxable in both countries. The contracting states are not required to grant the dual resident entity treaty benefits.

There is no obligation on the competent authorities to reach an agreement on the residency of an entity and it is probably practical to assume that the chances are remote of reaching agreement swiftly or even at all. The competent authority of Mauritius, for example, would, in principle, not have an active interest in coming to a mutual agreement where this would involve losing its taxing rights to South Africa. The fate of a dual resident company is that there is the potential for it to suffer tax in both countries but the effect of this could be ameliorated by any applicable domestic exemptions or credits (such as section 6*quat*). However, because Mauritius is a low tax jurisdiction, domestic relief for foreign tax paid is unlikely to offset the disadvantage of being subject to tax in both states (especially in light of the repeal of the tax sparing clause).

The practical effect of the above is that the dual resident company will be denied the benefits of the treaty and be subject to double taxation in South Africa and Mauritius if no agreement is reached between the two contracting states regarding the residence of the company. A binding arbitration process as per the current provisions of the OECD is not applicable under the proposed treaty.

Some consequences of the draft treaty are:

- It may force companies to stop creating dual residence situations. The draft treaty will necessitate taxpayers to relook their position as it places the onus on them to ensure that they structure effective management and substance of their entities so as to avoid double taxation. Since the Mauritian tax rates are lower than those in South Africa, it could imply that South African companies will also be unable to benefit from the section *6quat* rebate if effective management is deemed to be in South Africa. The double taxation impact could result in decreased South African FDI into Mauritius – albeit minimal.

- The draft treaty widens South Africa’s tax net as it increases South Africa’s ability to identify Mauritian companies that should be regarded as resident here, given the way in which they in fact operate.
- The draft treaty may also help to bring into the tax net certain Mauritian branches of South African companies, in that, if the branch houses the company’s only activity, it may be possible to claim that the company is dual resident by virtue of incorporation in South Africa and effective management in Mauritius.
- The draft treaty does not affect Mauritian companies that clearly have their effective management in Mauritius.

(b) Withholding rates

<u>Interest:</u> Under the current treaty, interest paid out of South Africa to a Mauritian beneficial owner would not be taxable in South Africa. Under the draft treaty, the amount that South Africa is able to withhold on interest paid to a Mauritian beneficial owner has increased from nil to 10% of the gross amount of the interest. Mauritius does not currently impose a withholding tax on interest paid. South African lenders to Mauritian borrowers would thus not be negatively affected by the amendment of the interest article, while on the other hand Mauritian lenders to South African borrowers would be affected.

<u>Dividends</u>: In terms of the draft treaty, dividends tax will be withheld at a 10% rate unless the beneficial holder of the dividend holds at least 10% of the capital of the company paying the dividends, in which case the tax will be 5%.

<u>Royalties:</u> In terms of the draft treaty, the amount that South Africa is able to withhold on royalties paid to Mauritius has increased from nil to 5%. The above withholding tax rates will have an impact on Mauritian financing or IP licensing entities that derive Interest or royalty income from South Africa.

(c) Capital Gains Tax (CGT) Carve-Out for Property Rich Companies

As noted above, apart from being a low tax jurisdiction in which to operate, Mauritius has also been a favourable base for investing into South African land rich companies. The draft treaty provides that capital gains earned by Mauritian tax residents could be subject to South African CGT if the gain is from the disposal of shares in a South African company holding immovable property - a “land rich” company. This will have an impact on Mauritian companies that currently hold South African based investments in the mining or property sector. Thus the capital gains article of the draft treaty repeals the so called “CGT cut out” clause as it specifically provides that a country may tax gains derived from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in that country.

However, this gives rise to the potential for investors to channel this type of investment through companies in other countries that still have a treaty with South Africa that still have CGT cut out clause. This was the case for example with the previously South Africa/Netherlands treaty. However, the South Africa/Netherlands DTA has been renegotiated and is awaiting signature and so is South Africa/Luxembourg DTA. It is also worth noting that the South Africa/Austria DTA and 18 other DTAs that have a zero rate on interest and/or royalties and those that do not have 13(4) of OECD are under renegotiation. These renegotiations will ensure Changes in ownership of shares in Mauritian land rich companies prevent the incentive to change the ownership to residents in other treaty countries now that there is South African CGT on disposal.

(d) Tax Sparing

The draft treaty no longer includes a tax sparing clause. Rather, it allows for relief in the form of a foreign tax credit.

(e) Exchange of information on tax matters and assistance in the collection of taxes

The 1996 tax treaty has a limited version of exchange of information provision that does not extend to bank secrecy. The draft tax treaty contains the latest OECD standard for the exchange of taxpayer information on tax matter as set out in article 26 of the OECD MTC. This will assist in the auditing of South African residents domiciled in Mauritius. The treaty also contains provision relating to assistance in tax collection of taxes.

(f) Remarks and Recommendations

There is no doubt that the draft treaty (if ratified) will put Mauritian companies in a less beneficial position vis-à-vis South Africa than is currently the case. This is so, specifically in the context of dual-resident companies, loans to South African borrowers and investments in companies owning immovable property in South Africa. However, this does not necessarily mean that the use of Mauritian companies is no longer beneficial in international structures.

It should be noted that treaty shopping can never be entirely stamped out and the chances are that some multinationals may look to other tax treaties to avoid having to pay CGT. One must bear in mind that the withholding taxes in the draft treaty are still lower than the normal South African holding tax rate. Where there is an entity in a third county either from which the Mauritian incorporated dual resident entity is receiving payments or to which it is making payments, being a dual resident could offer the advantage of the ability to cherry pick treaty rates. The dual resident company may thus be able to avail itself of either the tax treaty that South Africa has with a third country or of the tax treaty that Mauritius has with the third country. In these circumstances, since the "mutual agreement procedure" has to be initiated by the taxpayer, where the taxpayer takes advantage of other treaties, it would be difficult for such a taxpayer to initiate the mutual agreement procedure. In the absence of a specific fact scenario it is difficult to predict the extent to which the ability of a dual resident to "cherry pick" could lead to revenue leakage for South Africa, but it is a matter to be borne in mind during future risk profiling of Mauritian structures.

The withholding tax rates provided for in the draft treaty are still lower than the normal South African withholding tax rates. Although headquarter companies enjoy exemptions from these withholding taxes, headquarter companies cannot be used for investment into South Africa. Foreign investors would thus still prefer investing into South Africa via Mauritius, or they could look for another suitable jurisdiction to act as holding company jurisdiction for investment into Africa, including South Africa.

6.2.5 Treaty Shopping: South Africa's Treaties Encouraging Double Non-Taxation

(a) The Treaty with Switzerland

An example of double non-taxation arose in the context of the previous treaty between Switzerland and South Africa. In particular, that treaty provided for relief in respect of double taxation by way of exemption. It stated as follows:

> "Where a resident of a Contracting State derives income…which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall exempt such income from tax…"

In terms of this arrangement if Switzerland had and exercised its right to tax certain income, South Africa was obliged to exempt that income from tax. Switzerland offered various beneficial effective tax rates in respect of, *inter alia*, financing transactions. Transactions existed where South African companies operated through permanent establishments in Switzerland. Substantially all the income of the entity was attributable to the permanent establishment and Switzerland exercised its taxing rights in respect of the income. However, the effective rate in Switzerland was often as low as approximately 1.5%. In terms of the previous treaty between South Africa and Switzerland; South Africa was then required to exempt these amounts from tax. This resulted in economic double taxation due to the low effective rate applied in Switzerland. The previous treaty was re-negotiated and now provides a tax credit for foreign tax suffered by South African residents in Switzerland.

(b) The Treaty with Zambia

The treaty between South Africa and Zambia provides taxing rights to Zambia in respect of interest paid on certain debt instruments advanced by South African residents. South Africa may not tax such interest.

- In circumstances where interest is tax deductible in terms of South African domestic law. There is no requirement that such amounts be taxed in the other jurisdiction in terms of the OECD Model Tax Convention.
- There is also no "subject-to-tax" clause in respect of such amounts in terms of South African domestic tax law.
- This is one of the oldest DTAs in South Africa's network (it came into operation in 1956) was renegotiated was first renegotiated in 2002 and was finalised in December 2010. The treaty is now awaiting signature.

The above matter should be considered by the South African tax authorities at the time of entering into treaties with other jurisdictions.

- South Africa entered into treaties with, *inter alia*, Ireland, Belgium and Luxembourg, which jurisdictions have provisions effectively mitigating the quantum of tax paid in those jurisdictions. For example, an investor may set up a Luxembourg company and invest in equity in that company in the form of redeemable preference shares. The Luxembourg entity may then advance a loan to the South African entity. As a matter of Luxembourg tax law a deduction will be granted for the dividends payable in respect of the redeemable preference shares, leaving the Luxembourg entity taxable only on its spread/margin. Belgium has a similar provision. Ireland merely taxes at a low rate.
- In this regard there is significant competition for tax revenues on a world-wide basis. Jurisdictions are incentivised to enter into as many treaties as possible and then also to offer tax incentives, *inter alia*, to attract multi-nationals into their jurisdictions.
- South Africa is one such jurisdiction. For example, South Africa introduced the headquarter company regime in terms of which foreign investors may invest through South Africa into, *inter alia*, Africa. As part of marketing this initiative South Africa has made mention of its many treaties with African jurisdictions. In particular South Africa competes directly with Mauritius in respect of attracting foreign investment into Africa.
- It is therefore not in South Africa's interest, and would also provoke criticism, if South Africa, for example, did not allow tax deductions or refused to reduce withholding tax rates unless the jurisdiction receiving payments imposed tax at an appropriate rate.

6.2.6 Treaties with Tax Sparing Provisions

To encourage foreign investment, developing countries often grant fiscal incentives to foreign investors.[160] When countries sign a double tax treaty, and an investor from the developed country is offered a tax incentive by the developing country, the tax incentive may be eliminated or reduced by the tax regime of the investor's country.[161] This often occurs where the investor's country applies the credit method to prevent the double taxation of income. In reaction to this possibility, some double tax treaties preserve the benefit of source country tax incentives through "tax sparing" provisions in terms of which developed countries amend their taxation of foreign source income to allow their residents who invest in developing countries to retain the tax incentives provided by those countries.[162] In effect, tax sparing provisions preserve the tax incentive granted by the developing country by requiring the developed country to give a tax credit for the taxes that would have been paid to the developing country if the incentive had not been granted.[163] Tax sparing has, however, become rather unpopular and several developed countries have become restrictive in including tax sparing provisions in their tax treaties.[164] It is reasoned that tax sparing may not be that instrumental in promoting foreign investment and that it encourages abusive tax practices.[165]

Tax sparing also encourages "treaty shopping".[166] This is mainly done by interposing a "conduit company"[167] in one of the contracting states so as to shift profits out of those states.[168] Generous tax sparing credits in a particular treaty can encourage residents of third countries to establish conduit entities in the country granting the tax incentive.[169]

The OECD set out the following best practice guidelines for countries for drafting tax sparing provisions:

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160 A Easson *Tax Incentives For Foreign Direct Investment* (2004) 1-2; JR Hines "Tax Sparing and Direct Investment in Developing Countries" in Hines JR *International Taxation and Multinational Activity* (2001) 40; D Holland & R Vann "Income Tax Incentives for Investment" in V Thuronyi *Tax Law Design and Drafting* (1989) 986.

161 Hines at 40.

162 Hines at 40; R Rohatgi *Basic International Taxation* (2002) 213.

163 AW Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" *Bulletin for International Taxation* (2011) (Vol 65) No 1 in para 2; K Brooks "Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?" (2008-2009) 34 *Queen's Law Journal* 508.

164 V Thuronyi "Recent Treaty Practice on Tax Sparing" (2003) 29 *Tax Notes International* 301.

165 BJ Arnold & MJ McIntyre MJ *International Tax Premier* 2ed (2002) at 52-53.

166 H Becker & FJ Wurm *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988) 1; S Van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) 119.

167 A Rappako *Base Company Taxation* (1989) 16.

168 Ibid.

169 Arnold & McIntyre at 53.

(a) Tax incentives should be precisely defined to refer to specific incentives so as to prevent open-ended tax sparing that encourages abusive practices.[170]

(b) Tax sparing should ideally be restricted to local as opposed to export activities.[171]

(c) A maximum tax rate should be set for tax sparing credits to prevent the artificial increase of the rates.[172]

(d) Anti-abuse clauses should be included to prevent abusive practices.[173]

(e) Time limitations or sunset clauses should be included, so that the provision is not indefinitely used for abusive practices. [174]

(f) Tax sparing should ideally be restricted to business income rather than passive income. This would discourage harmful tax practices involving geographically mobile activities. [175]

Since tax sparing provisions are difficult to design and they often create undesirable and unintended economic and fiscal effects, [176] the OECD recommends that countries follow the form in Annex VI of the OECD Report on Tax Sparing when designing their tax sparing provisions.

As a member of the South African Development Community (SADC), South Africa espouses the recommendations of the Memorandum of Understanding (MOU) on Co-operation in Taxation and Related Matters among SADC countries,[177] which encourages member states to include tax sparing provisions in their tax treaties so as to promote foreign investment. However, in paragraph 2 and 3 of article 23 of the SADC Model, South Africa has reserved its right not to provide tax sparing. Although, South Africa previously stated its OECD non-member country position that it reserves the right to add tax sparing provisions in its treaties with regard to the tax incentives provided for under its laws, since the 2008 version of the OECD MTC, South Africa removed its reservation on tax sparing and it no longer includes tax sparing in its treaties. South Africa's Model Treaty does not cover tax sparing provisions.[178] Before, this new position on tax sparing was taken, South Africa had concluded 16 tax treaties with tax sparing provisions. The first one was with Israel in 1979, then Romania, Thailand, Mauritius, Ireland, Egypt, Pakistan, Tunisia, Algeria, Uganda, Greece, Seychelles, Botswana, Ethiopia, Brazil and the last one with Mozambique, came into force in 2009, but negotiations of the same were completed in 2002.[179] Since then South Africa no longer includes tax sparing in its DTAs.

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170 OECD Tax Sparing: A Reconsideration (1998) at 35-36.

171 OECD Tax Sparing Report at 36-37.

172 Ibid.

173 Ibid.

174 OECD Tax Sparing Report at 37-38.

175 OECD Tax Sparing Report at 36 and 43.

176 International Chamber of Commerce.

177 SADC "Memorandum of Understanding on Cooperation in Taxation and Related Matters" (art 4). Retrieved June 25 2009 from http://www.sadc.int/index/browse/page/167

178 Olivier & Honiball at 334; Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2.

179 SARS "Comprehensive Treaties in Force". Retrieved June 7 2010 from http://www.sars.gov.za/home.asp?pid=391931983 dd 13/03/2009

The tax sparing provisions in the treaties with Thailand (1996), Egypt (1999), Tunisia (1999), Pakistan (1999), Uganda, Algeria (2000), (2001) and Greece (2003) have reciprocal tax sparing provisions. The terms are that; an investor's state of residence allows an exemption against tax due on the tax which the state of source could have imposed, even if the source state source has waived all or part of that tax under its tax incentive laws that promote economic development.[180] Notably, these provisions are too widely drafted as they do not refer to any specific tax incentive but to all "laws designed to promote economic development in that Contracting State".[181] Furthermore, these provisions have no time limits and neither do they contain anti-abuse clauses that can be applied to prevent tax abuse.

The tax sparing provisions in the 1995 treaty with Romania and the (now re-negotiated) 1997 treaty with Mauritius have a much wider scope than the ones mentioned above. These two provisions, worded in almost a similar manner, extend the tax sparing provision not only to "laws designed to promote economic development … effective on the date of entry into force" of the treaty but also to "provisions which may be introduced in future in modification of, or in addition to, the existing laws".[182] The tax sparing provision in the treaty with Romania further extends this wide scope in that it refers not only to "laws designed to promote economic development" but also to laws designed to promote "decentralization".[183]

The tax sparing provisions in the relatively newer treaties with Seychelles (late 2003), Botswana (2004), Ethiopia (2006) and Mozambique (2009), are limited to schemes for the promotion of economic development that have been mutually agreed upon by the competent authorities of the Contracting States. It is important to note that when agreeing to tax sparing South Africa retained the right to reach mutual agreement in respect of the economic development schemes before allowing tax sparing to operate. Indeed, no schemes have ever been agreed with any of these countries with which mutual agreement is required.[184] Although the competent authorities have the power to settle the mode of application of the tax sparing provisions and thus limit their scope, these provisions still fall short of the OECD recommendations in that they lack sunset and anti-abuse clauses.

There are also some obsolete tax sparing provisions, such as the one in the 1979 treaty with Israel (which refers to tax holiday scheme for new investments

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180 Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2; Olivier & Honiball at 334.

181 E.g art 23(2) of the South African/Algeria treaty. Government Gazette 21303 dd 21/06/2000.

182 Art 23 (2) of the South Africa/Mauritius treaty. Government Gazette 18111 dd 02/07/1997.

183 Art 23(3) of the South Africa/Romania treaty. Government Gazette 16680 dd 27/09/1995.

184 Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2; Olivier & Honiball at 335.

in terms of 37H of the Income Tax Act,[185] which was abolished on 30 September 1999). The other obsolete tax sparing provision is in the 1997 treaty with Ireland which referred to the now defunct Undistributed Profits Tax.[186]

The treaty with Brazil: This treaty has a tax sparing provision in respect of government bonds. Article 11(1) of the treaty between South Africa and Brazil provides that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. However, Articles 11(4)(a) and (b) provide that notwithstanding the provisions of paragraphs 1 and 2:

> "(a) interest arising in a Contracting State and derived and beneficially owned by the Government of the other Contracting State, a political subdivision thereof, the Central Bank or any agency (including a financial institution) wholly owned by that Government or a political subdivision thereof shall be exempt from tax in the first-mentioned State;
>
> (b) subject to the provisions of subparagraph (a), interest from securities, bonds or debentures issued by the government of a Contracting State, a political subdivision thereof or any agency (including a financial institution) wholly owned by that government or a political subdivision thereof, shall be taxable only in that State".

Article 11(4)(b) read with Article 11(4)(a) of the treaty therefore applies, *inter alia*, to provide exclusive taxing rights to Brazil in respect of interest derived from bonds issued by the Brazilian government and derived and beneficially owned by South African residents other than the South African government, South African Reserve Bank or other governmental agencies set out in Article 11(4)(a) of the treaty.

Recommendations on Tax Sparing

- It is acknowledged that tax treaties are not generally negotiated on tax considerations alone and often countries' treaty policies take into account their political, social and other economic needs.[187] Nevertheless, care should be taken to adhere to international recommendations when designing tax sparing provisions, so as to prevent tax abuse. The OECD recommends that such designs should follow the form set out in its 1998 Report on Tax Sparing.
- The problem in the older treaties may be resolved by renegotiation of the treaty or through a protocol. The protocol should, for instance, ensure that the relevant tax sparing provision refers to a particular tax incentive

185 Introduced s 12(1) of Revenue Laws Second Amendment Act 46 of 1996.

186 Oguttu "The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa" in para 7.2; Deneys Reitz "Editorial comment: Tax-sparing Clauses" *Integritax* (Dec 1998) 1.

187 Weeghel at 257-260.

and should contain a sunset clause or expiry date to ensure that it is not open to abuse.[188]

- As the process of removing or modifying existing tax sparing provisions to prevent such abuses is often slow and cumbersome,[189] South Africa's legislators should ensure that future tax sparing provisions are drafted circumspectly.
- It is thus desirable for South Africa to adhere to the OECD's recommendations and best practices in drafting tax sparing provisions.
- All the obsolete tax sparing provisions should be brought up to date with the current laws if they are still considered necessary.

6.2.7 Issues Pertaining to the Migration of Companies

In the case of *CSARS v Tradehold Ltd,*[190] *a* South African company was "migrated" to Luxembourg from a tax perspective. This had the effect of capital gains which had accumulated in the company during the period that it was a resident of South Africa being taxable only in Luxembourg. Luxembourg then did not exercise its domestic tax law to tax any such gain. As a result of the decision in this case, South Africa's domestic law was amended in order to prevent such arrangements. Specifically, section 9H of the Income Tax Act states that, *inter alia*, where a company that is a resident ceases to be a resident, or a controlled foreign company ceases to be a controlled foreign company, the company or controlled foreign company must be treated as having disposed of its assets on the date immediately before the day on which that company so ceased to be a resident or a controlled foreign company, for an amount equal to the market value of its assets.

- It is recommended that a similar provision should apply for purposes of the Eighth Schedule to the Income Tax Act. In particular, there is a risk that such deemed disposals do not fall within the ambit of disposals as contemplated in paragraphs 11 and 12 of the Eighth Schedule. There should be a cross-reference between paragraph 12 of the Eighth Schedule dealing with "events treated as disposals and acquisitions" and the provisions of section 9H of the Act.

It is worth noting that the OECD September 2014 report on Action 6 provides that the OECD intends to make changes to the OECD MTC to the effect that treaties do not prevent the application of domestic "exist taxes".

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188 RJ Vann & RW Parsons "The Foreign Tax Credit and Reform of International Taxation" (1986) 3(2) *Australian Tax Forum* 217.

189 Para 76 of the OECD commentary on art 23A & 23B.

190 (132/11) [2012] ZASCA 61

6.2.8 Issues Pertaining to Dividend Cessions

Shortly after the introduction of dividends tax in section 64D of the Income Tax Act, various transactions were entered into by non-resident shareholders of South African shares in order to mitigate the tax. In particular, non-resident shareholders of listed South African shares in respect of which dividends were to be declared transferred their shares to South African resident corporate entities. The dividends were therefore declared and paid to the South African resident corporate entities which claimed exemption from dividends tax on the basis that, as set out in section 64F(1) of the Income Tax Act, the entities constituted companies which were residents of South Africa.

- The South African resident corporate entities then paid “manufactured dividend” or other derivative payments to the non-resident. These payments did not constitute dividends and were therefore not subject to the dividends tax.
- The South African resident corporate entities therefore received dividends which were not exempt from normal tax, but in respect of which they obtained a tax deduction for the “manufactured dividend” payments made to the non-resident shareholder.
- The non-resident shareholder received amounts that did not constitute dividends and therefore did not attract any dividends tax.
- The provisions of section 64EB of the Act were therefore introduced in August 2012. These provisions have subsequently been updated. The provisions adequately deal with such transactions since, *inter alia*; they deem the “manufactured dividend” payments to constitute dividends which are liable for dividends tax.
- A variation on this transaction is the transfer of the shares to an entity situated in a jurisdiction which has a treaty with South Africa that reduces dividends tax from the domestic rate of 15% to 5%. It is also envisaged that similar transactions will be entered into in respect of debt instruments once the interest withholding tax is imposed from 1 January 2015. The recommendation in respect of applying the GAAR and including anti-tax-avoidance language in the relevant treaties should be considered in respect of these transactions.

6.2.9 Base Erosion Resulting from South Africa Giving Away its Tax Base

Some foreign jurisdictions, especially in Africa, are incorrectly claiming source jurisdiction on services (especially management services) rendered abroad and yet those services should be considered to be from a South African source. These foreign jurisdictions are withholding taxes from amounts received by South African residents in respect of services rendered in South Africa. The withholding taxes are sometimes imposed even if a treaty between South Africa and the foreign country specifies otherwise, which could result in double taxation.

Section 6*quin* provides a rebate for management fees and technical service fees. National Treasury notes that section 6*quin* was intended to be a temporal measure aimed at addressing interpretation issues arising out of three DTAs where the treaty partners did not apply the provisions of the DTAs in respect of services rendered by SA residents in those countries. Although these countries in terms of the DTAs do not have the right to tax management fees they still imposed withholding taxes on services on services rendered within these countries despite the fact that the DTAs with these countries do not have an article dealing with management fees or South African residents have no permanent establishments in these countries. Nevertheless this temporary measure can be interpreted that SA has departed from the tax treaty principles in the OECD MTC in its treaties with African countries, in that it has given them taxing rights over income not sourced in those countries

As a result, South Africa has effectively eroded its own tax base as it is obliged to give credit for taxes levied in the paying country.

- South Africa's needs to develop a coherent policy in respect of treaty negotiation and interpretation, especially with respect to its response to Africa's needs. It appears that African countries tend to impose their will on South Africa.
- It is recommended that s 6*quin* be reconsidered.

6.2.10 Treaty shopping that Could be Encouraged by South Africa's Head Quarter Regime

South Africa has a Head Quarter Company (HQC) regime under section 9I and several other relevant provisions[191] of the ITA. The objective of the HQC regime is to allow non-residents to establish a holding company in South Africa which would be used to make acquisitions in other countries, i.e. to promote the use of South Africa as the base for holding international investments.

The South African tax impact of the regime is that a HQC will be able to earn dividends, interest, royalties and realisation gains from its foreign investments without incurring any South Africa tax on the flow of such items of income into and out of South Africa to the ultimate third party beneficiaries. This could be achieved as follows:

- Dividends derived by a HQC from its equity investments in foreign companies should qualify for the exemption under section 10B(2) of

[191] Sec 9(2)(d) read with sec 35, sec 9D, sec10B, sec 31, section 37K and par 64B(2) of the ITA.

the ITA, since it needs to hold at least 10% of the equity shares and voting rights in the foreign company to qualify.

- Dividends declared by a HQC will be exempt from dividends withholding tax ("DT") in terms of section 64E(1) of the ITA.
- Interest derived by a HQC from loans advanced to the foreign companies will be subject to normal tax. However, the HQC should be entitled to deduct the interest expense incurred in respect of loans raised to advance such loans to the foreign companies since the HQC is not subject to the transfer pricing (including thin capitalisation) restrictions under section 31 of the ITA. Therefore, any such loans could be arranged on a back-to-back basis to avoid any tax liability for the HQCs[192] In terms of section 20C of the ITA, the interest deduction will be ring-fenced to the interest earned on foreign loans. Therefore, to the extent that there is a margin between the incoming interest and the payment of interest, the difference will be taxed in South Africa. However, no margin is required.
- The HQCs will be exempt from the interest withholding tax (IWT) (to be introduced from 1 January 2015).
- The royalties derived by the HQCs from the foreign companies would be subject to South African tax but the corresponding royalties paid to the non-resident owner of the IP would be tax deductible. In terms of section 49D(b), royalties paid by a HQC are not subject to the withholding tax on royalties. Therefore, the non-resident owner of the IP could licence the right to use the IP to the HQC which would sub-licence the use to the foreign companies without incurring any South African tax. Since the transfer pricing rules would not apply, no margin would be required.
- In terms of paragraph 64B(2) of the Eighth Schedule to the ITA, a HQC must disregard any capital gain or capital loss in respect of the disposal of any equity share in any foreign company, provided the HQC held at least 10% of the equity shares and voting rights in that foreign company. The shares to be acquired by the HQCs should be regarded as capital investments (as opposed to trading stock), which means that the realisation gains would be of a capital nature, subject to the provisions of the Eighth Schedule to the ITA. Therefore, the realisation gains would not be subject to tax and no DT would be imposed on the distribution of such gains.
- The HQC will thus be subject to tax by virtue of its incorporation in South Africa, but the various exemptions from withholding taxes and

[192] In terms of the current version of section 23M, which is to be introduced with effect from 1 January 2015, a HQC is not excluded from its scope, which may then apply to restrict the interest deduction. It is, however, expected that this will be amended as it was not the intention to subject the HQC to tax on such interest earned from its foreign acquisitions.

the transfer pricing rules should have the impact that the HQC would not effectively be subject to any tax. Nevertheless, since the HQC will be "liable to tax by virtue of its incorporation", it will generally be entitled to the benefits of the South African DTA network[193].

The HQC regime could thus encourage treaty shopping by non-residents. The question arises whether a court could conceivably condemn a treaty shopping scheme by a non-resident to access a DTA with South Africa if the South African Legislator has effectively sanctioned treaty shopping by non-residents to access South African DTAs with other countries.

7 CURRENT MEASURES TO CURB TREATY SHOPPING IN SOUTH AFRICA

7.1 Use of Domestic Provisions

The use of domestic law provisions to prevent tax treaty abuse are endorsed by both the OECD and the UN.[194] Both organizations consider that tax treaties may be subject to domestic anti-avoidance rules in cases involving treaty shopping.[195] The OECD September 2014 report on Action 6 also recommends that in order to prevent treaty shopping where a person tries to circumvent the domestic tax law provisions using treaty benefits, domestic anti-avoidance have to be applied. The OECD DTA Abuse Report outlines the avoidance strategies that fall into this category, namely:[196]

- Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs;
- Dual residence strategies (*e.g.* a company is resident for domestic tax purposes but non-resident for DTA purposes);
- Transfer mispricing;
- Arbitrage transactions that take advantage of mismatches found in the domestic law of one state and that are

193 Article 1 of the UK/South Africa DTA, which is the typical requirement to qualify as a resident of South Africa for DTA purposes.

194 See sections 1 and 2 of the Annex. For example, paragraph 9.4 of the Commentary to Article 1 of the OECD Model Convention states that countries do not have to grant the benefit of a double taxation convention where arrangements that constitute an abuse of the convention have been entered into and any such denial of treaty benefits may be achieved under either a domestic law or treaty-based approach.

195 Subject to the caveat in paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention that "...it is not to be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above." In addition, paragraph 9.5 sets out the guiding principle that "…the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."

196 Ibid.

- related to the characterization of income (*e.g.* by transforming business profits into capital gain) or payments (*e.g.* by transforming dividends into interest);
- related to the treatment of taxpayers (*e.g.* by transferring income to tax-exempt entities or entities that have accumulated tax losses; by transferring income from non-residents to residents);
- related to timing differences (*e.g.* by delaying taxation or advancing deductions);

- Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the state of source but must be exempted by the state of residence or by abusing foreign tax credit mechanisms).

Some of these avoidance strategies could also be utilized in the context of South African DTAs, subject to the potential application of the General Anti Avoidance Rules (GAAR) or other specific anti-tax avoidance legislation.

The GAAR contained in sections 80A-L of the Income Tax Act[197] provides a significant weapon to SARS in attacking any transactions which seek to abuse a DTA. Although South Africa's GAAR provisions can be applied on any impermissible tax avoidance arrangements which would result in a tax benefit in a domestic context, they can also apply to international tax avoidance schemes in a treaty context. In many situations this will not result in ignoring South Africa's obligations under the particular DTA, but using domestic tax law to re-characterise the transaction. In this regard section 80B provides wide powers to the Commissioner to determine the tax consequences of any "impermissible avoidance arrangement" for any party by, *inter alia*, disregarding, combining or re-characterising any steps in or parts of the impermissible avoidance arrangement. South Africa can also apply the common law doctrine of "substance over form" to prevent tax avoidance in a treaty context where the parties are involved in sham or simulated transactions.

However, it could be argued that the application of such domestic provisions in a treaty context amounts to treaty override.[198] In terms of section 108(2) of the Income Tax Act[199], read with section 231 of the Constitution of the Republic of South Africa,[200] when the National Executive of South Africa enters into a double tax agreement with the government of any other country, and the

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197 Act 58 of 1962

198 Domestic law provisions to prevent tax treaty abuse are endorsed by both the OECD and the United Nations, both organizations consider that tax treaties may be subject to domestic anti-avoidance rules in cases involving treaty shopping.

199 Ibid

200 108 of 1996.

agreement is ratified and published in the Government Gazette, its provisions are as effective as if they had been incorporated into the Income Tax Act[201]. Since both the GAAR and double tax treaties can be used to prevent tax avoidance, there would be no conflict in purpose.

- However to prevent treaty override disputes the OECD recommends that onus is on countries to preserve the application of these rules in their treaties.[202]
- South Africa should ensure it preserves the use of the application of domestic ant- avoidance provisions in its tax treaties.

Regarding the issue of possible conflicts in the interactions between domestic and treaty rules, the OECD September 2014 Report on Action 6 clearly states that treaties do not prevent the application of such domestic anti-avoidance rules.

The other concern is that although the OECD recommends that treaty abuse can be countered by domestic provisions, currently the preamble of the OECD Model Tax Treaty does not include a reference to the objective to prevent tax avoidance. It merely refers to the “prevention of fiscal evasion”. Likewise, currently, the preamble to most of South Africa’s DTAs provides that the purpose of the treaties is “for the avoidance of double taxation and the prevention of fiscal evasion”. This does not include a reference to the object to prevent tax avoidance. It merely refers to the “prevention of fiscal evasion”. There is a significant difference between the concept of “avoidance” and “evasion” of tax.[203] Therefore, whilst a DTA should be interpreted in the light of its object and purpose stated in its preamble,[204] it is not certain that the object could be expanded to also include the avoidance of tax if such object is not specifically stated.[205] It may be arguable that the “prevention of fiscal evasion” as stated in the preamble of many DTAs was intended to cover a wider concept including tax avoidance. However, this may stretch even the teleological approach to treaty interpretation.

The South African country International Fiscal Association Report (the SA IFA Report) on 2010 concludes that since the relationship between DTAs and domestic anti-abuse provisions has not been considered by the South African courts, this relationship has to be determined according to South Africa’s

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201 Ibid

202 Arnold at 245.

203 SARS Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962, (2005) in para 221, where it refers to the definition of “tax evasion” by the OECD as encompassing “illegal arrangements through or by means of which liability to tax is hidden or ignored; also see Goyette at 766.

204 Article 33 of the VC.

205 Goyette at 766 – 768.

specific legal framework,[206] i.e. the status of DTAs under South African law and in relation to the provisions of the ITA.

The analysis above on the status of DTAs under South African law indicates that our courts have expressed the view on several occasions that the OECD Commentary on the OECD Model DTA should be taken into consideration when a DTA provision is to be interpreted. In accordance with the OECD Commentary, the domestic anti-tax avoidance rules of a contracting state may be applied to counter the improper use of a DTA, provided it can be shown that obtaining the tax benefit under the DTA was one of the main purposes for entering into the transactions or arrangements and obtaining such a benefit would be contrary to the object and purpose of the relevant provisions of the DTA.[207]

Since the essential test under the general anti-tax avoidance rules (GAAR) (contained in Part IIA of Chapter III of the ITA) is whether the sole or main purpose of the transaction, scheme or arrangement is to obtain a tax benefit, our courts would be able to apply the GAAR to counter DTA abuse, unless such application could be regarded, under the circumstances, as contrary to the object and purpose of the relevant provisions of the DTA. On the same basis, the common law doctrines of substance versus form or the sham transactions could be applied to counter artificial arrangements which are merely aimed at achieving a tax benefit.

However, the object and purpose requirement may not be so easy to apply, especially since the South African DTAs do not provide clearly in the preamble of the DTAs that tax avoidance is one of the objects and purpose of the DTA. Furthermore, there is uncertainty about the scope of the substance versus form and sham doctrines to counter tax avoidance schemes, particularly if there is some commercial rational for the arrangements.[208]

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206 SA IFA Report at 723.

207 OECD Commentary, op cit, para 9.5 on page 61.

208 Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR, 1996(3) SA 942 (A), 58 SATC 229; Commissioner for SARS v NWK Ltd 2011 (2) SA 67 (SCA) where the court said: If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.“; also see the subsequent decision in Bosch and Another v CSARS [2013] 2 All SA 41 (WCC) where the court remarked: “If there is no commercial rational, in circumstances where the form of the agreement seeks to present a commercial rational, then the avoidance of tax as the sole purpose of the transaction, would represent a powerful justification for approaching the set of transactions in the manner undertaken by the Court in NWK.”; see also the recent decision in Roshcon (Pty) Limited v Anchor Auto Body Builders CC 2014 JDR 0644 (SCA) where the Supreme Court of Appeal commented as follows:” If it meant that whole categories of transactions were to be condemned without more, merely because they were motivated by a desire to avoid tax or the operation of some law, that would be contrary to what Innes J said in Zandberg v Van Zyl in the concluding sentence of the

It is submitted that the wider scope of the DTA, apart from the mere general statement in the preamble, should be considered in determining the object and purpose of particular provisions of the DTA, as the US courts have done in applying the US anti-tax avoidance doctrines to counter abuse of DTAs.

The advantage of applying domestic law to treaty shopping is that amendments can be implemented in a timely manner. Such a domestic approach would have immediate effect across South Africa's entire tax treaty network, which would facilitate a greater consistency in practice than would unfold if South Africa were to rely exclusively on treaty-based solutions. [209] The effectiveness of the GAAR has however not been tested in any court. Since GAAR was introduced, there have been no reported cases applying GAAR. In this regard one may wonder to what extent SARS could use it to prevent treaty-abusive transactions. It is however notable that the proposed "principle purpose provision" in the OECD September 2014 report on Action 6, is akin to the "main purpose test" in the GAAR, which is applied to determine whether the main/primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined. In effect, the application of the GAAR to prevent treaty shopping, would be in line with the OECD recommendations.

7.2 Specific Treaty Provisions

7.2.1 The Beneficial Ownership Provision

Currently, the main specific treaty provision that is applied in South Africa's treaties to curb conduit company treaty shopping is the "beneficial ownership" provision as set out in article 10, which deals with dividends, article 11 which deals with interest and article 12 which deals with royalties. As explained above, the term "beneficial ownership" is not clearly defined in the OECD Model Tax Convention. Article 3(2) of many of South Africa's treaties provides that, should a term not be defined in the treaty, it shall have the meaning ascribed to it in terms of the domestic law of the contracting states. The erstwhile definition of a "shareholder" in section 1 of the ITA, although it did not specifically refer to "beneficial ownership", defined a shareholder as the registered shareholder, except where some other person is entitled "to all or part of the benefit of the rights of participation in the profits, income or capital attaching to the share so registered." In such instance, the "other person" was also deemed to be the

passage quoted above, namely that: 'The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.'"

209 OECD "Tax Conventions and Related Questions: Written Contributions from Members of the Focus Group on Treaty shopping" para 6.2.

shareholder. This definition was deleted with effect from 1 April 2012, when the new Dividends Tax legislation came into effect (section 64D – 64N of the ITA). The term “beneficial ownership” is now defined in section 64D of South Africa’s Income tax Act to mean “a person entitled to the benefit of the dividend attaching to a share”. This is a very vague definition and no guidance regarding its interpretation has been provided in the accompanying Explanatory Memorandum. The definition applies only for purpose of the Dividends Tax provisions of the ITA. It therefore does not apply to the rest of the ITA and/or to other tax legislation. The concept of “beneficial ownership” is used in the Securities Transfer Tax Act (STT Act).[210] Although the concept is not defined in the STT Act, the Explanatory Memorandum to the STT said the following in this regard:

> “The concept of transfer relates to economic ownership, as opposed to the mere registration of a security as in the case of a share registered in the name of a nominee. For that reason transfer excludes any event that does not result in a change in beneficial ownership.”

South African company law points out that the registration of shares in one person’s name does not imply that such a person is the beneficial owner of the shares since the registered holder may merely be a nominee. This was confirmed in *Dadabhay v Dadabhay*[211] and in *Standard bank of South Africa Ltd v Ocean Commodities Inc.*[212] However the real question which remains is under what circumstances a conduit company could be regarded as a mere nominee as opposed to the real owner of the shares. In this regard, South African courts could apply the criteria for the substance versus form and sham doctrines developed by our courts to determine who a “beneficial owner” is for purposes of the DTA provision in question. However, every case would have to be considered on its own facts to determine whether the actual transactions may be ignored on the basis that they represent a sham and to give effect to the real transaction between the parties.

To date, only a handful of South African cases have touched on the meaning of the concept of beneficial ownership. In *Holley v Commissioner for Inland Revenue* 1947 (3) SA 119 (A), the main question for consideration was whether the taxpayer received certain amounts (derived from assets he inherited from his uncle) as a conduit for the benefit of his aunt, or whether he was the beneficial owner of the funds in question but with an obligation to make payment to her of certain amounts. The Court held that his uncle’s will created a *fideicommissum* in favour of his aunt and that the taxpayer did not receive the amounts in his personal capacity, but in a representative capacity on behalf of his aunt.

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[210] Act No 25 of 2007

[211] 3 SA 1039 (AD).

[212] 1983 1 SA 276 (A).

In *Standard Bank of SA Ltd and Another v Ocean Commodities Inc and Others* 1980 (2) SA 175 (T), the Court considered the scenario where shares (in compliance with Rhodesian exchange control rules) were registered in the name of Standard Bank Nominees on behalf of two of the respondents. The Court said the following regarding the ownership of the shares:

> "In respect of registered shares, a court can go behind the register to ascertain the identity of the true owner. The fact, therefore, that the shares are registered in the name of Standard Bank Nominees does not mean that it is the actual owner or that one cannot look behind the register to ascertain the identity of the true owner."

The Court then dealt with the position of the purchaser where shares are sold, but not yet transferred:

> "Until registration of the transfer, however, the transferor or his nominee is a trustee of the shares for the transferee. The trustee must act according to the instructions of the transferee who becomes the beneficial owner of the proprietary rights in respect of the shares by means of the conclusion of the contract of cession."

In *Commissioner, South African Revenue Service v Dyefin Textiles (Pty) Ltd* 2002 (4) SA 606 (N), the Court considered the concept of beneficial ownership in the context of a discretionary trust to determine whether the trust or the sole beneficiary of the trust should be regarded as the shareholder of the shares in a company. The Court made the following remarks in this regard:

> "The trustees admittedly did not have the beneficial ownership of these shares, but nevertheless they were under an obligation to hold same and transfer them to a third party if directed to do so by the taxpayer's directors. This aspect of the matter points away from the notion that at all material times the taxpayer was in reality the beneficial owner of the shares."

The Court rejected the view expressed in the lower Court, which held that the trustees did not hold the assets of the trust on behalf of the trust as a separate legal entity (which it is not) but on behalf of the sole beneficiary. It appears that the High Court acknowledged that the trustees could not be regarded as the beneficial owners of the shares, but it came to the conclusion above because the trustees were under the obligation to hold the shares and potentially transfer them to a third party if so directed to do so by the directors. Therefore, the Court held that the trust was the shareholder and not the beneficiary. The reasoning by the Court could imply that a beneficiary with vested rights under the trust deed in respect of all the benefits of the shares, e.g. the right to share in a portion of the dividends and any proportionate proceeds from the disposal of the shares, would indeed be regarded as the beneficial owner of the shares in the proportion to his entitlement. However, it should be noted that the trust deed in question specifically provided that the "shares shall be held by the trust as nominees and subject to any terms and conditions as laid down by the board of directors of Dyefin Textiles (Pty) Ltd."

Although all the remarks regarding beneficial ownership in the cases considered above were *obiter*, it appears that the courts commonly accept the beneficial ownership concept in those instances where a party holds assets as nominee, agent or trustee for the beneficial owner. It is submitted that the scope to interpret the meaning to be wider than such nominee or agency relationships is thus very limited.

Despite the above domestic definitions, for treaty purposes the meaning of beneficial ownership should not be limited to a narrow South African interpretation. Care should be taken to ensure that it carries a wide international meaning that is in line with the guidelines offered by the OECD.

Nevertheless as explained above, internationally it is not precisely clear what the concept of "beneficial ownership" means. We have pointed out that section 233 of the Constitution of the Republic of South Africa requires that a court, when interpreting legislation, must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law. Therefore, our courts will consider the interpretation by foreign courts of new concepts used in the international arena. However, foreign judgments must be considered taking into account the relevant legislation and specific context. In the context of a DTA, our domestic courts and foreign courts often refer to the OECD Commentary on the OECD Model DTA for support of an interpretation. Therefore, the comments of the OECD Commentary noted above should also be considered by a court in considering the application of the beneficial ownership criterion used in a DTA.

As illustrated in the discussion of the international approaches to treaty shopping, the analysis of the foreign case law shows that there is no universally accepted interpretation of the "beneficial ownership" concept and courts in different countries have adopted different views in this regard. The UK *Indofood* case[213] is often referred to as support for the "expansion" of the concept of beneficial ownership to give effect to the "substance of the matter". However, the decisions of the Canadian courts in the *Velcro Canada Inc. v The Queen*[214] *and Prevost Car Inc. v Her Majesty the Queen,*[215] cases indicate a more formalistic approach,[216] in line with the South African courts cases analysed above. It is therefore most likely that the South African courts would apply the tests for beneficial ownership as confirmed in the Velcro case, i.e. the attributes of beneficial ownership are "possession", "use", "risk" and "control". If these attributes are considered in the context of a treaty shopping arrangement, they could lead to a conclusion that the intermediary company in the country which has a beneficial DTA with South Africa did not qualify for DTA relief, since it

213 See the analysis of the case under the analysis of the UK approach.
214 2012 TCC 57.
215 2008 TCC 231.
216 See the analysis of the Canadian approach above.

may not have sufficient control or use of the funds if it was clearly required to immediately on-distribute the dividends, interest or royalties to a third party. However, the factual circumstances would have to be taken into account to determine whether the intermediary company may fulfil the requirements of a beneficial owner.

Nevertheless the decisions in the *Prévost* and *Velcro* cases show that there are challenges in effectively applying the beneficial ownership provision to prevent treaty shopping. It is therefore submitted that the "beneficial ownership" provision cannot be fully relied on in South Africa to prevent treaty shopping.
It should be noted that although the "beneficial ownership" has proved ineffective in curbing conduit company treaty shopping, the OECD does not recommend that this provision should be completely dealt away with. The OECD explains that this provision can still be applied with respect to certain matters, but it cannot be relied on as the main provision to curb treaty shopping. In this regard, the concept of "beneficial ownership" can still be applied with respect to the relevant income in articles 10, 11 and 12.

- Where that is the case, in the South African context, it is important that SARS should address the practical application or implementation of the tax treaty by coming up with measures of how a beneficial owner is to be determined. This could be achieved by introducing measures such as:
    - Beneficial Ownership Certificate;
    - Tax Registration Form;
    - Permanent Establishment Confirmation Form.

7.2.2 The Limitation of Benefits Provision

Apart from the "beneficial ownership" provision, South Africa has a "limitation of benefits" (LOB) provision in its treaty with the United States, as the United States chooses to use this provision in its double taxation treaties. The basic premise of the LOB provision is that every person in a chain of ownership must be entitled to the benefits of the treaty (i.e. must be a resident of either of the two contracting states). Only persons satisfying specific and objective tests are eligible for treaty benefits. The premise underlying this provision is that if any of the objective tests for eligibility are satisfied, the requisite treaty shopping motive is not present then treaty benefits should be granted.[217] Although more targeted and certain in application, this LOB approach can also be over-

217 These specific and objective tests are similar in principle to certain of the exceptions discussed above in the context of some general anti-treaty shopping approaches which are likely to be over-inclusive. However, countries using objective rules in LOB articles to determine eligibility for treaty benefits would also tend to provide more specific guidance on the interpretation of those rules in other authoritative sources. This is the case in the US where in practice taxpayers and practitioners refer to the US Model Convention and other treaties for specific and technical guidance in addition to the technical explanation for any particular treaty.

inclusive and generally contains a provision enabling contracting states to grant treaty benefits on a discretionary basis in appropriate circumstances.

8 RECOMMENDATIONS TO ADDRESS TREATY SHOPPING IN SOUTH AFRICA IN LIGHT OF 2014 REPORT ON ACTION 6

The 2014 OECD report on Action 6 recommends the use of a three pronged approach to address treaty shopping in tax treaties.

(a) The OECD recommends that treaties should include, in their title and preamble, a clear statement that the Contracting States, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements:
   - ➢ It is recommend that in line with this recommended, South Africa should take steps to renegotiate its older treaties or sign proposals amending the preambles of its treaties to that effect. All new treaties should have the above recommended preamble.

(b) The OECD also recommends that tax treaties should include a specific anti-abuse rule based on the limitation-on-benefits provisions (LOB rule) included in treaties concluded by the United States and a few other countries.
   - ➢ In line with the OECD recommendations, South Africa should endeavour to apply this provision in its new treaties and older treaties can be renegotiated to include the LOB provision.

(c) In order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule (such as certain conduit financing arrangements), the OECD recommends adding to tax treaties a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or “PPT” rule).

The PPT rule requires tax authorities to make a factual determination as to whether the principle purpose (main purpose) of certain creations or assignments of income or property, or of the establishment of the person who is the beneficial owner of the income, was to access the benefits of a particular tax treaty.

- ➢ As alluded to above, the factual determination required under the “principle purpose test” is similar to that required to make an “avoidance transaction” determination under the GAAR in section 80A-80L of the Income Tax Act – in particular, whether the primary purpose of a transaction (or series of transactions of which the transaction was a part) was to achieve a tax benefit, broadly defined.
- ➢ It is therefore recommended that a provision in line with the PPT test as recommended by the OECD should be included in South Africa’s

treaties. Older treaties could be renegotiated. The adoption of this provision from South Africa's perspective would not be difficult since a PPT is relatively familiar to both South Africa's treaty partners and taxpayers.

It is worth noting that the main purpose test is actually applied in South Africa's treaty with Brazil. Article 11(9) thereof reads as follows:

> "The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment".

This article requires the tax authorities to determine whether the main or one of the main purposes of such "person" was "to take advantage" of Article 11 of the treaty "by means of that creation or assignment". The intention of Article 11(9) is to deny the benefits of, *inter alia*, Article 11 where transactions have been entered into for the main purpose of restricting the <u>source state's</u> (Brazil's) ability to tax the interest income. This is confirmed by the OECD Commentary on Article 11(9), which states that:

> The provision has the effect of denying the benefits of specific articles of the Convention <u>that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits</u>. The Articles concerned are 10, 11, 12 and 21…" (Emphasis added).

- Article 11(9) of the treaty is therefore aimed at preventing "treaty shopping" in circumstances which circumvent the source state's (Brazil) ability to impose withholding tax on income flows from the source state to the resident state (South Africa).
- In particular, in the context of Article 11, it is aimed at preventing a situation where a source state such as Brazil imposes withholding tax on interest paid to low tax jurisdictions at the rate of 25%. If the holder in a low tax jurisdiction of a debt instrument issued by a Brazilian resident transfers the debt instrument to, say, a South African resident in order to ensure that Brazil may only impose withholding tax at the rate stipulated in Article 11(2) of the treaty, namely, 15%, then the provisions of Article 11(9) of the treaty should apply.
- This may be distinguished from the provisions of Article 11(4)(b) of the treaty, which specifically incentivises a resident of South Africa or Brazil to invest in government bonds issued by the other Contracting State.
- It is recommended that South Africa should introduce provisions such as Article 11(9) of the Brazilian treaty in more of its treaties in order to protect its right as source state to impose dividends tax, interest withholding tax and other withholding taxes.

It is also worth noting that the Canadian approach, which is of persuasive value to South Africa, has been to implement a main purpose test in many of its recent treaties.[218]

218 For example, paragraph 7 of Article 10 (and paragraph 9 of Article 11 and paragraph 7 of Article 12) of the Canada-Hong Kong tax treaty reads as follows:
"A resident of a Party shall not be entitled to any benefits provided under this Article in respect of a dividend if one of the main purposes of any person concerned with an assignment or transfer of the dividend, or with the creation, assignment, acquisition or transfer of the shares or other rights in respect of which the dividend is paid, or with the establishment, acquisition or maintenance of the person that is the beneficial owner of the dividend, is for that resident to obtain the benefits of this Article."